A. That is correct.
Q. Even though the stock was the same company, Grosset & Dunlap, the price was still $29 a share?
A. That is right.

After Blyth covered its short position, the stock slowly declined in price, falling to 24 per share on June 30, 1961.[125] When asked why the firm did not reinstitute the extra commission or sales credit after the short position was covered, a representative of the firm stated:

At the original issue price, there might have been some hope that it would be sustained there by a redistribution. Once that point is passed, you might well change your mind that it is not as attractive a value at 24. Comparable securities may have sold down even more sharply until this one might have looked overvalued at that point, so that I don't believe you can draw the conclusion that because it was attractive at 29, it is much more attractive at 24.

Blyth's after-market activities present some of the problems that may arise when an integrated firm, having managed an underwriting, decides to "make the market more orderly" by taking positions greater than normal trading practices might dictate. The price decline brought about by public selling in the after-market was apparently retarded by the firm's willingness to accumulate a sizable position and its desire not to let the price "drop off as quickly as we ordinarily would." When the accumulated securities were resold from inventory they were not resold in the open market but to the firm's own retail customers, at a price level which existed to an important extent because of its own activity in the market and with the help of extra compensation to salesmen. Immediately following the voluntary assumption of a short position as a result of negotiated sales to institutional investors, the firm ceased active solicitation of its customers by withdrawing extra compensation to salesmen and covered its short position as the market declined. Thus its role as market maker and the nature of its marketmaking activities were primarily conditioned by its role as underwriter and the availability of its retail outlet rather than by any established standards applicable to the role of market maker as such. Nor was there any disclosure, in connection with the firm's retail activities, of its dominant position in the market or of the fact that the sales were being made from the firm's inventory or that extra compensation was being paid to salesmen.[126]

(b) *Sponsorship.*—After completion of a distribution, an integrated firm may "sponsor" the trading market for an underwritten issue. The term "sponsor" suggests the continuing responsibility that an integrated firm may feel to maintain a continuous market in securities in which it has placed its customers. Many of the aspects of trading described above with respect to an integrated firm and a managing underwriter are equally applicable to the sponsored security; the discussion in the present section does not purport to be a comprehensive treatment of sponsorship but merely an analysis of limited statistical data regarding marketmaking activities of sponsors as compared with other market makers.[127]

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[125] See app. IV–A for a price chart of Grosset & Dunlap stock.
[126] See the recommendation in ch. III.B and ch. IV.C with respect to requiring disclosure of extra compensation in respect of particular types of transactions.
[127] In ch. IX.B there appears an analysis of the price performance of sponsored stocks and nonsponsored stocks over a 5-month period, which included the market break of May 1962, and it is there concluded that, using the one criterion of price change between the beginning and end of this period, sponsored stocks followed the same price pattern as nonsponsored ones.

In questionnaire OTC–3, all broker-dealers were asked to identify those stocks which they sponsored; the term was not defined in the questionnaire.[128] The trading of each broker-dealer which identified itself as a sponsor in any of the 200 stocks was studied to determine the distinguishing characteristics, if any, in terms of volumes and prices, of their activity in the market on the study day of January 18, 1962.

On the basis of this separate analysis of volume and price data of those broker-dealers designating themselves as sponsors, as well as interviews of broker-dealers conducted by the Special Study, it would appear that there is, on the one hand, a very considerable disparity in the marketmaking activities of the various firms designating themselves as sponsors and, on the other, a broad similarity in marketmaking activities of the entire group of sponsors as compared with market makers generally. Both the disparity within the group and the similarity with other groups may be partially attributable to different definitions of the term "sponsor" by respondents, differing characteristics of the securities involved, or simply the limitations of the one-day "snapshot" of the market. But, from the available data, the differences of performance within the sponsor group are more obvious than the differences between the sponsor group and market makers generally.

In all, 62 of the 200 stocks in the questionnaire OTC–3 sample were identified as being sponsored. In nine of these neither the sponsor nor any other market maker had any purchases for their own accounts on January 18, 1962. In 15 other stocks the sponsor made no purchases although other market makers did while, at the other extreme, in 9 securities the sponsor was the only dealer who bought stock in the market on January 18, 1962. In general, as would be expected and as would also be true of other market makers, sponsors' relative participation tended to increase inversely to the number of other dealers quoting markets (table VII–8).

Sponsors were not a particularly significant factor in direct transactions with the public for most securities. Indeed, the majority of sponsors executed no transactions with public customers on January 18, 1962, and in over three-quarters of the 62 stocks sponsors did less than 20 percent of the public business (table VII–9).

A further analysis was made of price spreads on January 18, 1962, in interdealer transactions and public transactions for sponsored stocks as a group as compared with nonsponsored stocks as a group. The analysis, based on the spreads between the average purchase price and the average sale price for each stock in each group where relevant transactions occurred, again shows a considerable disparity of spreads within each group and a general similarity in patterns between the two groups, in respect of both interdealer transactions and transactions with public customers (table VII–10). Thus, with respect to the price spreads of these transactions on January 18, 1962, the available data do not show any discernible basis of distinction between sponsored stocks and other stocks.[129]

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[128] See pt. A.2, above, and app. VII–B. As indicated previously, these firms were requested to supply detailed schedules of their transactions in 200 randomly selected stocks for 1 day, Jan. 18, 1962, (or in the case of less active stocks, a longer period).

[129] For a detailed summary of the prices charged and received by sponsors in transactions with the public and with other dealers, see app. VII–G.

The study also examined the performance of a random group of sponsors during the market break in May 1962. It has previously been noted that 40 securities of the original 200 were chosen for further study in relation to the market break.[130] Sponsorship was not a criterion for selection of the 40 securities; 18 of the 40 were sponsored, according to the responses of 22 different broker-dealers made to questionnaire OTC-3.[131] Among the more salient findings are the following:

1. Of the 22 sponsors, 6 did not trade on May 28; 8 were sellers on balance; and 8 were purchasers on balance, 5 of them purchasing 200 shares or less on balance.
2. The group of 22 sponsors were sellers on balance on May 28 (2,312 shares) and on May 31 (6,774 shares) and purchasers on balance on May 29 (2,707 shares). The study did not determine the extent to which the sales by sponsors on May 31 might have been the result of outside demand or might have reflected the sponsors' own decisions to liquidate inventory by sales into the market or to customers.
3. With respect to transactions with public customers, as distinguished from total transactions, sponsors were sellers on balance on May 28, 29, and 31. In the 3 days combined, they sold almost four times as many shares to the public from firm account as they purchased from the public for their firm account.

(3) *The integrated firm in a noncompetitive market*

For many securities in the over-the-counter markets, there may be a limited number of dealers—if any—actively making a market. As described in a previous section, in a random selection of 300 stocks appearing in the wholesale quotation sheets during a typical 2-week period, 273 of the stocks appeared in the sheets on a single day at the midpoint of the period. Of the 273 stocks, 64 had only 1 dealer entering any kind of quotation and 48 others had only 2 dealers entering any kind of quotation. Thus, for 91 securities out of the 300 in the sample (30 percent) at most only 1 dealer indicated an interest on the particular day; and for 139 securities (46 percent) at most only 2 dealers indicated such an interest.

These figures serve to illustrate one of the most important facts about over-the-counter markets as a broad category—that within the broad category are many securities of limited public interest where marketmaking may be confined to one or two dealers at most.[132] Apart from the fact that the depth, liquidity, and continuity of the market for such a security is dependent on the resources of one or two firms and their willingness to take positions, both business and regulatory considerations applicable to such a market differ from those applying to a market having more numerous market makers in several important respects.

The ultimate safeguard of competition among market makers is obviously lacking in such a situation as compared with one involving

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[130] See pt. A.2, above.

[131] The trading activities of these firms in the market on May 28, 29, and 31 is summarized in app. VII-H.

[132] Also see table 25 of app. VII-A which shows the number of dealers entering quotations in the National Monthly Stock Summary of the National Quotation Bureau for a sample of 1,618 over-the-counter stocks covered in questionnaire OTC-4.

numerous market makers. The possibility of checking competing markets and obtaining "best" executions is correspondingly limited if it exists at all, so that obligations of nonmarket makers in executing retail orders may not be definable in the same terms as where there are numerous market makers. Also, since the sole or dominant market maker frequently is an integrated firm, problems of interaction between its wholesale and retail activities may become particularly complex in the absence of any independent market maker.

For reasons such as these, many of the questions examined in this chapter must be looked at not in terms of over-the-counter securities as a single broad category but in terms of the depth of public and professional activity for various securities within the broad category. In particular, securities having a sole or dominant market maker must often receive separate attention in examining problems and devising business or regulatory solutions and the study attempts to give due recognition to this distinction in several of its recommendations. In this section, attention is focused primarily on problems of pricing and disclosure and possibilities of abuse where an integrated firm is the sole or dominant market maker.

The one or more dealers making markets in a security with limited professional and public activity are frequently in a position where their own activities and quotations exert a substantial influence upon the level of the market. The retail prices of a sole or dominant market maker are not affected by competition but may be affected by the firm's own activity at the retail level.[133] The public customer who purchases such a security either through another broker-dealer or from the dominant market maker may not be advised of the lack of an independent market for the security, of the market maker's potential control over prices, or even that marketability of his security may depend on a single broker-dealer's willingness to continue making a market.[134]

Problems are magnified when the dominant market maker firm solicits customers who have no independent means for evaluating representations about the issuer or its prospects, since the issuer is usually not subject to the reporting requirements of the Exchange Act and may report little or nothing about its affairs on a voluntary basis.[135] Similarly, the protection which results from a multiplicity of evaluations by several market makers is lacking. The NASD markup policy, which is designed to protect customers against overreaching in retail prices, may be of little help in such a situation since it is applied in relation to quotations or costs of a single broker-dealer who

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[133] The Commission has noted:

"Every over-the-counter dealer who 'specializes' in a security, in the sense that he effects a high percentage of the transactions in the security, and in the sense that he is the principal buyer and seller and is most familiar with the affairs of the issuer and the state of the market, to some extent dominates the market in that security. His trading volume may be the backbone of the market in the security and his determination to pay more or less may be determinative of market movements. However, to the extent that he does business with dealers or with informed members of the public who have access to information about issuers and quotations and can weigh investment in the security as against investment in others, and to the extent that there exists the possibility of an independent market in the security, the over-the-counter specialist's decisions about pricing are subject to the check of free and competitive forces." *Norris & Hirshberg*, 21 S.E.C. 865, 874 (1946).

[134] The Commission described this situation in the following way:

"* * * Purchasers did not know that they were being subjected to the hazards inherent in a situation where the withdrawal of support by the persons dominating the market would mean the closing of the only available forum for trading in such security." *S. T. Jackson & Co.*, 36 S.E.C. 631, 656 (1950).

[135] See ch. IX.B.

is in a position to establish the price level through its own retail selling campaign.[136]

During the new issue phenomenon of 1959–61, trading markets were frequently dominated and controlled by managing underwriters of small speculative issues. A particular type of abuse is illustrated by situations in which the underwriter would withhold a substantial portion of the issue by placing shares in fictitious accounts and other accounts which it controlled and then generate public demand for the issue. Customers were told by salesmen that the issue was oversubscribed, fictitious quotations were placed in the sheets, often through other firms,[137] to create the appearance of an active and broad trading market and to provide a basis for retail premium prices, and optimistic publicity was disseminated concerning the issuer. The public was then induced to buy the issue in the market at premium prices, the "market" being one created by and under the control of persons actively engaged in a distribution.[138] When investors who purchased at premium prices later sought to dispose of their holdings, they found that the market had evaporated or that the bids appearing in the sheets were "nominal."[139]

The Commission has attempted to reach this kind of abuse under the fraud provisions of the statutes. In a series of cases, the Commission has held that, when a security is sold "at the market," it is fraudulent for a broker-dealer to fail to disclose to a purchaser that the market for the security is subject to the artifical restraints of the broker-dealer's domination and control.[140] This approach depends almost completely upon the policing of transactions by the Commission and the NASD and the discovery of fraud, at best, after the damage is done. If investors had access to reliable information as to the number and identity of the broker-dealers making independent markets, and the nature of their markets, such a policing instrument against overreaching and fraud would of course remain important but at least the wary investor would be alerted and in a position to protect himself at an earlier point.

d. Wholesale trading under special conditions

This subsection considers the conduct of wholesale trading markets under two special sets of circumstances: the first, during the acquisition or disposition of a block, and the second, during a period of extreme price stress; i.e., the market break of May 1962. Each of these particular situations points up certain aspects of the over-the-counter markets not evident in the conduct of routine trading activities.

(1) *Block transactions*

The nature of the over-the-counter markets, together with the relative freedom of these markets from some of the regulatory restraints applicable to exchanges, particularly in connection with dispositions,

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[136] See pt. D.4.a, below.

[137] The fact that several dealers appear in the sheets is not inconsistent with there being a single or dominant market maker. The appearance of others may be at the request of a single firm and at prices prescribed by it. See the discussion of this practice in sec. 3 and pt. D.4.b, below.

[138] See, e.g., *Lewis Wolf, Inc.*, Securities Exchange Act release No. 6949 (Nov. 21, 1962) and ch. IV.B.

[139] See sec. 2.b, above.

[140] See, e.g., *Barrett & Co.*, 9 S.E.C. 319 (1941); *Sterling Securities Co.*, Securities Exchange Act release No. 6100 (1959). See also Bloomenthal, "The Case of the Subtle Motive and the Delicate Art—Control and Domination in Over-the-Counter Securities Markets," 1960 Duke L.J. 196 and pt. D.5, below.

has tended to result in more flexible methods for the handling of blocks.[141]

Generally, but not universally, the handling of a block acquisition or disposition is done with or through a wholesale dealer making a primary market in the security.[142] The primary market maker usually receives a large number of incoming calls which facilitates its handling of a block. One such wholesale dealer explained the usefulness of its facilities in the following way:

> * * * [B]ecause of the fact that we have so many houses, exchange houses and retail houses and any kind that you want to name plus our correspondents in out-of-town cities who are constantly getting calls. One person might want to sell, and another person wants to buy. That is what we do. He [the seller] knows that we are going to get so many more calls than he can possibly make. He can only call the person in the sheets while we get calls from all over the country because we are in the sheets and we are known to have made a market in the security.
>
> * * * * * * *
>
> Say that we make a market at 4 to 4¼ on the stock. When it comes in he wants to sell 800 shares at 4. * * * [I]f he went on the street, [a] fellow takes 100. By coming to us, if we make a market there is a better chance for us to give him that execution for the full amount of the stock at the full bid price.
>
> Q. Why?
>
> A. Because we are getting more calls than the average small dealer. He can't find a buyer. In our case, the buyer finds us. * * * [143]

The wholesale dealer may adjust its quotations and attempt to buy or sell on balance to facilitate the acquisition or disposition. In the case of an acquisition, bids and offers are raised above its competitors' markets, and conversely, lowered in the case of a disposition. By raising both bids and offers in connection with an acquisition, the firm attracts sellers and discourages buyers from coming to it. Lowering bids and offers has the opposite effect of discouraging selling inquiries and stimulating buying interest.

The acquisition of a block, particularly in the case of a security with a small floating supply, may under certain circumstances have a dramatic effect upon its price. For example, when a wholesale dealer acquired about 13,000 shares and 11,000 warrants of Cove Vitamin & Pharmaceutical, Inc., a new issue with a total floating supply of 108,000 units, for the account of a retail firm the price for the shares went from 11¾ to 25 and for the warrants from 8¼ to 23 in 3 weeks (March 26–April 13, 1961).[144] The trader who accumulated the block indicated that he was required to raise his bid consistently in order to facilitate the acquisition. He had warned the partner of the retail firm that "everybody on Wall Street knows that you are going to be a buyer."

The flexibility of the over-the-counter markets in the handling of blocks is reflected in the varying techniques for effecting dispositions. A disposition may be syndicated and the syndicate may be governed

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[141] See ch. IV.C for a discussion of unregistered distributions of securities and ch. VIII.C for institutional participation in the securities markets.

[142] Institutions have indicated that they most often use the primary market maker to acquire or dispose of blocks. See ch. VIII.C. In some cases, however, a customer or retail firm may split the order among several over-the-counter traders. The traders have stated that splitting large orders among dealers may be quickly detected as described in C.2.b(2), above. Some traders regard splitting of an order as a somewhat deceptive practice and feel justified in moving their prices away from the order in such a situation.

[143] See sec. 2.a, above. On occasion wholesale dealers with a substantial number of institutional customers may be able to cross the order with another institution, thus avoiding the necessity of executing in the open market with other dealers.

[144] See the discussion of this acquisition in ch. IV.B.3.d.

by either an informal understanding to participate jointly in its disposition or by a formal underwriting agreement. On the other hand, some dispositions may be simply "worked out" over a considerable period of time in trading transactions by the primary market maker.

If a formal underwriting agreement is used, it will usually contain provisions on such matters as stabilizing purchases by the manager and open market transactions by other members of the underwriting group. Such a disposition is made in the same manner as a secondary distribution of a listed security and the participants treat the distribution as subject to the regulatory controls governing market activities during a distribution.[145] In the absence of a formal underwriting agreement, however, many firms appear to regard the disposition of a block, no matter how large, as subject to no greater controls than normal trading transactions despite the fact that the disposition may have all the characteristics of a "distribution." For example, the study examined the disposition of 20,000 shares of Continental Casualty Co. stock on December 27–28, 1962, by Wellington Fund. These shares were purchased by a large wholesale dealer at 75¾ net—15,000 shares on December 27 and 5,000 shares on December 28. The wholesale dealer then sold 19,311 shares of the block to a syndicate of 60 broker-dealers at 76½ and retailed 689 shares to its own customers at 78½ net. While the disposition was in progress the wholesale dealer continued to bid for and purchase the security being sold in the open market. It would appear from an examination of the sheets that the wholesale dealer maintained a bid of 76½ during the disposition—a bid that was substantially higher than other bids in the sheets.[146] After completion of the disposition, the wholesale dealer dropped its supporting bid.

An example of a nonsyndicated disposition of a sizable block of stock on a "workout" basis is the sale of 75,000 shares of American Cement Co., Inc., stock by Affiliated Fund to the same wholesale dealer over a period of several weeks in early 1961.[147] The wholesale dealer was making a market in American Cement at that time; the market was competitive with a large number of interested dealers. The dealer while "working out" American Cement stock did not lower its quoted bid or offer because the market was active with heavy public demand. However, the dealer's offer was subject to negotiation and the spread which normally was around three-eighths of a point could be negotiated to a quarter of a point by purchasing broker-dealers. In this way although the dealer both purchased and sold stock, it was a seller on balance.

The arrangement with the fund was that the dealer would first sell stock, thus acquiring a short position. At the end of each day the dealer would compute the average sale price on that day. It would then purchase, or "take down," from the fund sufficient stock to cover its short position at a price about one-fourth of a point less than the average sale price. When the market looked weak, the dealer would not take down stock from the fund, to cover its short position at the end of each day but would permit it to run 2 or 3 days and keep its

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[145] See ch. IV.B.3.c and C, and ch. VIII.C.

[146] The wholesale dealer apparently did not regard the disposition of the block as a distribution since no stabilizing reports were filed with the Commission.

[147] This disposition was reported by Affiliated Fund in response to questionnaire IN–4.

bid high in order to "help the market along." The supporting purchases made by the dealer reduced its short position and delayed further "take downs" from the fund.[148] The necessity for supporting the market while making such dispositions of blocks is regarded as important by many wholesale firms executing transactions of this type.[149]

In the handling of block transactions, the wholesale dealer is relatively free of the regulatory restraints applicable to his counterpart on the exchange—the specialist. Block transactions involving listed securities that cannot be handled in the regular auction market are supervised by exchange officials and reported to the exchange and the Commission; some are publicized on the tape. The specialist cannot participate in some block transactions except under restrictions imposed by exchange rules, and when he does participate, the merchandising activities of his firm in connection with selling a block are subject to restraints upon the payment of compensation to salesmen and the use of selling literature.

Some of these differences in the degree of regulation between markets may be inherent in the nature of each market, e.g., the manipulative potential in the concentration of trading activity on an exchange and the presence of a tape which publicizes transactions. Others, however, appear to be due to the greater attention that historically has been paid to the exchange markets and the relative ease of access to information about exchange transactions.

(2) *Market stress*

The market break of May 1962 provides a case study of the over-the-counter wholesale markets operating under conditions of price stress.[150] During the summer of 1962 members of the Special Study staff visited 25 broker-dealer firms in 10 different cities throughout the country to discuss various aspects of that phenomenon. Most of these firms made a substantial number of markets and had sizable retail businesses. The firms were sent a memorandum advising them of the matters to be discussed [151] and requesting that they supply data concerning their positions and transactions, both for the break and for prior periods. The break was also discussed at various times with other firms, including pure wholesale dealers. The following discussion is based on these interviews and data.

As a general rule, in active markets wholesale dealers will tend to maintain relatively large inventories in anticipation of public demand. When activity begins to slacken, wholesale dealers will tend to reduce

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[148] No stabilizing reports were filed with the Commission under rule 10b–7 covering these purchases.

[149] In 1959, the Commission proposed an amendment to rule 10b–7 (the basic stabilization rule) relating to stabilizing activities other than in connection with a distribution. One of the industry comments on the proposal stated:

"It is feared that the rule might preclude a dealer who buys a block of 'free' stock for distribution from maintaining a bid or raising his bid price while the block in question was being legitimately distributed at retail. Frequently, in the over-the-counter market, a dealer will acquire a block of stock and while distributing the block through his organization will continue to acquire stock in the open market. Such continuing acquisition is not done with the intent of raising the market price but is done with the intent of acquiring additional stock for distribution because the dealer believes in the future of the company concerned and is of the opinion that the block is underpriced.

"To require a dealer to withdraw from the market or to freeze his bid price until the block was distributed would in many cases result in a hardship on a legitimate dealer operation bearing no relationship to the evil the rule is designed to stop."

This comment indicates the need for clarification of the application of rule 10b–6 in connection with unregistered distribution as recommended in ch. IV.B and C.

[150] See ch. XIII for a more general study of the 1962 market break.

[151] A copy of the memorandum is set forth in app. VII–D.

their inventories. During the year 1961, the over-the-counter markets were extraordinarily active and wholesale inventories generally were maintained at fairly high levels until the end of the year.

Beginning in January 1962 and throughout the spring of that year, inventories of most of the firms studied were substantially reduced, due primarily to bearish expectations about the market situation and a weakening of public demand for over-the-counter securities.[152] One firm making markets in 50 to 60 securities ceased making markets by early spring 1962; many others reduced the number of markets made and substantially cut down long positions, sometimes by direct sales into the market at the bid price of other market makers. Some firms discontinued trading in the more speculative new issues which were the source of much of the frenetic trading activity in the wholesale markets in 1961. However, pessimistic views of the market were by no means universally held among wholesale market makers and some firms held their highest inventories in May 1962.

Most firms indicated that reductions in inventory were accomplished by adjusting inside prices and "working the shares out" in the wholesale market.[153] Others reduced their inventories by selling on balance to customers. For example, one firm, at the time it was making a drastic reduction in inventory, sent out a market letter stating that it was a good time to purchase securities.

Wholesale trading markets in the spring of 1962 immediately prior to the market break became less active, resulting in wider spreads and markets "good" for a smaller number of shares. One large wholesale firm stated that a market which would have been firm for 2,000 shares in May 1961 and 1,000 shares in January 1962 became firm for only 200 to 500 shares in May 1962, prior to the market break. Also there was a stronger tendency to adjust quotations downward after execution of a transaction. The percentage of "subject" markets began to increase.

One over-the-counter dealer stated that he immediately opened his markets lower on the morning of May 28 because the financial section of a leading newspaper for the preceding day contained the worst news he had seen in many years. Most of the firms interviewed stated that they adjusted their prices in sympathy with prices on the NYSE, and not on the basis of direct selling pressures.

During the break, over-the-counter dealers quoted their markets with substantially wider spreads. In many instances spreads were so wide that they represented up to 30 and 40 percent of the bid price of the security. Accompanying wider spreads were "subject" markets. When a firm quotation could be obtained, it was rarely good for more than 100 shares and a wholesale firm which purchased 100 shares might immediately lower its bid, sometimes substantially. In stocks where firms had short positions or institutional buying orders there was slightly more depth. Some firms refused to make any markets at all and others refused to bid. One wholesale dealer said

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[152] One large wholesale firm sent the following memorandum to its traders on May 16, 1962:

"We think yesterday's rally was a sufficient correction of the previous selloff. We wish all long situations to be disposed of on this current strength. Hereafter no longs will be permitted to go into the loan position, and will have to be sold on the day they are delivered unless an offsetting sale is available."

Specialists on the NYSE also substantially reduced their positions in the months preceding the break. See ch. VI.D.6.e(4).

[153] See the discussion of the technique of "working out" shares in subsec. (1), above.

it liquidated "across the board" and purchased only when it felt it could do so with "impunity." [154]

As a general rule during the market break, those firms without a direct wire or telephone line to a trading firm experienced significant delays in attempting to communicate, largely due to overcrowding of telephone switchboards.[155] Most communicating was confined to turret lines and private wires. In order to deal with the problem of communication, particularly by wire, and because of the uncertain character of the markets being made during the market break, some calls coming into wholesale houses were firm offers rather than inquiries for a quotation. For example, one St. Louis firm stated that they were making a market in a stock on May 29 at 23 bid and 24 asked. At that time a New York firm came over the wire of the St. Louis firm's New York correspondent offering stock to them at 22, a full dollar below the price they were bidding.

Very few firms left firm markets with correspondents in other cities. Many firms ceased posting quotations on their boards and required that all executions be made directly with traders specializing in the particular stock.

On the basis of available evidence, although the volume of actual trading in the over-the-counter market during the break was substantially above that of prior recent periods, the increase did not approach proportionately the increase in volume on the New York Stock Exchange. In fact, the volume in the over-the-counter markets appears to have been less than that of a typical day 1 year earlier.

Part of the temporary loss of orderliness and liquidity in the over-the-counter markets stemmed from the inability of market makers to keep aware of what their competitors were doing, of the state of the market, and of their own operations. The NYSE tape ran hours late and that tape serves as an important barometer for all securities markets. A substantial loss in liquidity resulted from the unwillingness of some over-the-counter market makers to make firm markets, and from a widening of their spreads that discouraged public buying as well as selling and thus tended to eliminate the normal intermediary function of a market maker.

The markets made by integrated firms were criticized by some wholesale firms, who stated that the activities of integrated firms were geared only to making markets with the assistance of active retail departments which were inoperative during the period of the market break. On the other hand, the performance of the pure wholesale firm was criticized by integrated firms; they concluded that the latter acted only as "middlemen" with capital too limited to provide depth. Some dealers expressed the opinion that investors in over-the-counter securities, unlike exchange investors, benefited from the lack of liquidity in the market because they were discouraged from selling.

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[154] That firm also commented as follows:

"* * * at times during these days our quotations, during periods of sharply dropping listed markets, were in many cases nominal and without firm bids. In other cases our bids were limited to 100 shares. In other instances we would qualify our quotations by stating that the market was 'small,' the implication being that the bid was less than 100 shares. * * *

"The markets quoted by other trading firms were generally characteristic of our own. Sizes were reduced and quotation spreads were widened and it was difficult to effect sales of any appreciable amounts of stock except at substantially reduced and/or declining prices."

[155] See sec. 1.b(2), above.

Several wholesale dealers indicated that, when the market turned upward in the afternoon of May 29 and rose consistently on May 31, they sold on balance to take advantage of buying power. Though they increased their bids somewhat (but not to the previous level), they lowered their offers and were sellers on balance. As a result, when the market returned to a higher level, many dealers could point to lower inventories. Overall, the recovery in prices in listed securities was not matched by a similar recovery in the over-the-counter markets in the period immediately following the break.

After the market break some over-the-counter firms instituted a policy of purchasing only sponsored or active securities or those in which they had done significant research. Months after the market break, important wholesale firms were still quoting subject markets. In part, the lag in recovery reflected a reluctance on the part of market makers to take positions unless assured of a fairly rapid disposition to retail customers or retail firms.

3. WHOLESALE QUOTATION SYSTEMS

The "sheets" published by the National Quotation Bureau, Inc. (the "Bureau"), are the primary medium for the dissemination of wholesale or "inside" quotations among professionals. They are of crucial importance to the over-the-counter markets. The then chairman of the NASD's board of governors described their role to the study in these terms:

> I think we all know about the great reliance placed upon the sheets by dealers everywhere. It is their little daily bible, so to speak. * * *
>
> * * * * * * *
>
> The quotation system in recent years has assumed much greater importance. It is part of the whole growth of the over-the-counter market. * * * And so, as the market grows, the importance of these quotations, the backbone of this market, increases. I think it behooves the [NASD] to have these quotations as accurate and honest as is possible.

Professionals use the "sheets" to find and communicate buying or selling interests in securities and to judge activity. The wholesale prices supplied by dealers for the sheets are used by the NASD for determining which securities to quote at the retail level and computing retail quotations which are published in the newspapers.[156] In addition to their role in the securities markets and thus in the economy, they provide the basis for computing certain taxes and for the valuing of collateral for loans. They also provide information important to such regulatory bodies as the NASD, State securities commissions, and the Commission.

As section 2 of the Exchange Act points out,[157] quotations are affected with a public interest. Many Commission decisions have noted the quotation system's importance and the harm that may result from its misuses.[158] The Congress has in section 15(c)(2) of the

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[156] The quotations in the sheets are also used by the NASD in applying its "markup" policy and by the Commission in determining the reasonableness of markups. See pt. D.4, below.

[157] "The prices established and offered in [securities] transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans."

[158] See, e.g., *Halsey Stuart & Co.*, 30 S.E.C. 106, 127 (1949); *Sherman Gleason & Co.*, 15 S.E.C. 639, 653 (1944). See also *M. S. Wien & Co.*, 23 S.E.C. 735, 744 (1946).

Exchange Act authorized the Commisison to deal with such misuse, directing it to implement that section's ban on "any fictitious quotations." An official of the NASD has described the National Quotation Bureau which publishes the sheets as a "private business that is connected with a public interest." No legal restraints prevent any person from undertaking the operation of a wholesale quotation system, but since the Bureau now enjoys a virtual monopoly in its field, any discussion of such systems must focus on it.

a. National Quotation Bureau, Inc.

(1) *Structure and mechanics*

The Bureau is a private, profitmaking corporation unaffiliated with the NASD or any other organization.[159] The Bureau is not subject to regulation by the Commission.[160] While the present management of the Bureau is considered responsible, there is no legal assurance that this type of management will continue in the future. The NASD is not unconcerned about the potential dangers here; its executive director made the following statement to the study:

> A. I have to say I think Mr. Walker [president of the Bureau] has done and is doing a very good job within the limits of his ability to do so in policing the sheets. Sometimes there is a slip. But I know that he is sincere in his endeavors to police them. I do think that the NASD would take a very dim view of any group getting control of the NQB unless it was just a topnotch group of people. We would be very much concerned if a trading group got control of the NQB. We would be terribly concerned if an inside group consisting of certain underwriting people would get control, certain kinds of underwriters. So, we do have considerable concern as to the future of that organization and what might come out of it.
>
> Q. Could you expand a little bit as to why you would be concerned if certain types of people got control? Why would it be a matter of concern?
>
> A. In the last 3 or 4 years we have had an entirely new type of person entering the underwriting business. I do not think that their ethical concepts are the highest. I think they would not hesitate to use the sheets for their own purposes in maintaining their own markets. I think that would be very dangerous and disastrous. I can also see certain dangers in certain types of trading houses getting control of the sheets. They could use the sheets for their own purposes in making markets in which they were particularly interested. All of these things may add up to considerable danger.

The sheets of the Bureau are ostensibly available only to broker-dealers to inform them of interests in buying or selling securities. The bids and offers that appear may not be a completely accurate indication of the actual market at the time of publication since there is inevitably a delay between a broker-dealer's submission of a quotation and its publication. However, quotations are supposed to be "firm" as of the time of submission: when a broker-dealer submits a quotation, he represents that he is, at that time, willing to trade at the prices quoted. If the quotation represents only a basis for negotiation, there is supposed to be an indication to that effect.[161]

The sheets do not report on any set "list" of securities. A broker-dealer may submit quotations for as many securities as its contract

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[159] The service was founded in 1911 by Arthur Elliot, and in 1913 merged with a monthly publication to form the Bureau. Louis Walker, now its president, began as an employee in 1911. In the early 1920's he purchased an interest in the Bureau, and upon the death of Elliot in the 1930's, Walker bought the controlling interest, which he retains and actively exercises.

[160] Quotations for securities traded on exchanges are disseminated and their use is regulated by the particular exchange involved. See ch. VI.B.1. The Commission under sec. 19(b) of the Exchange Act has the power to alter or supplement exchange rules dealing with, among other things, "the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange."

[161] See the discussion of firmness of quotations in sec. 2.b, above.

with the publisher permits. Both the securities quoted and the broker-dealers submitting quotes differ from day to day.[162] Widely known and actively traded issues are likely to appear regularly, with as many as 20 or 30 dealers quoting 2-way markets. For many other securities, entries may be quite sporadic, with only one or two dealers appearing, and not even one indicating an interest in both buying and selling.[163] Many securities may not be quoted at all, either because no active trading interest exists or because the sources of trading interest are so well known that the market makers consider publication of wholesale quotations unnecessary.

The sheets appear each day in three editions. The Eastern Section, or "pink sheets," is printed in New York and is by far the largest, with over 200 pages of quotations on stocks and about 30 pages on bonds. The Western Section, or "green sheets," is printed in Chicago, with about 32 pages. The Pacific Coast Section, or "white sheets," is printed in San Francisco, with about 42 pages. Many firms in the Pacific Coast area subscribe to, and enter quotations in, the pink and green as well as the white sheets. The Eastern and Western editions have a unified list of 2,000 subscribers. The Pacific Coast edition has 225 subscribers, of which 25 broker-dealers are in the East.

In January 1963 the three editions listed each day a total of about 39,000 quotations covering approximately 10,000 securities and submitted by between 1,000 and 1,300 broker-dealers throughout the country.

The trend of listings over recent years is evidenced by the following:

TABLE VII–b.—*Number of stock and bond issues quoted in the National Quotation Bureau "sheets," 1950–63*

Year [1]	Stock issues	Bond issues	Year [1]	Stock issues	Bond issues
1950	5,050	2,000	1957	6,300	1,600
1951	5,200	1,900	1958	6,000	1,750
1952	5,400	1,700	1959	6,100	1,800
1953	5,450	1,700	1960	6,550	1,850
1954	5,500	1,650	1961	6,900	1,900
1955	5,700	1,800	1962	8,100	2,000
1956	6,100	1,700	1963	8,200	2,050

[1] As of Jan. 15 of each year.

The Bureau charges $336 per year for a subscription to the sheets, which any broker-dealer registered with the Commission may obtain. The sheets are also available to the Commission, the NASD, the Internal Revenue Service, and State tax and securities commissions.

Although the Bureau and the NASD have traditionally considered it a matter of policy that wholesale quotations be available only to broker-dealers (and regulatory bodies), 35 banks and 33 investment advisers were subscribers as of October 1962. The banks' subscriptions were acquired at a time when the Bureau permitted banks to subscribe and gave them perpetual options to renew; subscriptions are no longer available to banks lacking such contract rights. The subscription list includes many of the leading investment advisory services. The Bureau says, "Our reason for furnishing the daily service

[162] For a discussion of the continuity and frequency of appearance of issues and of the nature of the markets indicated, see sec. 2.b, above.

[163] For example, of the approximately 14,000 domestic over-the-counter stocks for which broker-dealers advertised markets in 1961–62, only about 8,100 were quoted on Jan. 15, 1962. See sec. 2.b, above.

to investment advisers is that they are registered with the SEC and are supposed to be fully informed on the job they are doing."

Institutions and other knowledgeable investors also usually are able to get copies of the sheets, or price information in them, from broker-dealers. For example, a number of institutions replying to questionnaire IN–4 indicated that they were accorded access to the sheets by broker-dealers in return for commission business. Thus, despite the Bureau's and the NASD's stand against any public dissemination, it appears that some non-broker-dealers do have access to the wholesale price information in the sheets.[164]

To insert listings in the sheets, a broker-dealer must satisfy certain requirements of the Bureau, discussed below. Once these have been met, it can insert 10 listings in the daily sheets for $564 per year, including the cost of the subscription and, in effect,[165] any additional listings for which it is willing to pay, at the rate of $240 for each additional 5 listings. At the present time, about 1,300 firms have the right to insert listings. Of these, 97 firms have the right to insert more than 100 listings, and 2 firms have the right to more than 700 listings.[166]

On the following page a sample from the sheets has been reproduced. The sheets are set up in columnar form, the first column containing the name of the security (alphabetically arranged); the second column, the name of the broker-dealers quoting the security and their telephone numbers; the third, the "bid" price; and the fourth, the "asked."

For at least 5 of each 10 listings submitted by a subscriber, the Bureau requires that the bid or offer include a price. For the other five, a broker-dealer who does not wish to submit an actual bid or offer price may insert "OW" (offer wanted) in the bid column and/or "BW" (bid wanted) in the offer column. If he merely wishes to advertise an interest on either side of the market, he may leave the price columns blank. According to Bureau and trade custom, a quotation in the sheets indicates an interest to buy or sell 100 shares; an interest in fewer shares is supposed to be so indicated.[167] An interest in more than 100 shares may be specified in securities priced below $5 or if the order is on an all-or-nothing basis. Entries in the sheets do not indicate if an issuer is in bankruptcy or reorganization; nor, except occasionally, do they indicate whether a quotation is ex-dividend.

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[164] In a recent disciplinary action, an NASD District Business Conduct Committee said this about public distribution of the sheets:

"Finally, while not an area in which the Committee presumes to impose its jurisdiction, we are of the opinion that the distribution of National Daily Quotation sheets to the public is not good practice, and is, we understand, contrary to the established policies and wishes of the publisher."

When the NASD learned that a few of its members were publishing wholesale quotations in newspapers, its board of governors in a statement to the membership condemned the practice. See NASD News, April 1959.

[165] The Bureau has a policy of not accepting more than 3 percent of its listings from any one subscriber.

[166] The firms' rights to list break down as follows:

Number of listings:	*Number of firms*
700 or over	2
600 to 699	--
500 to 599	1
400 to 499	4
300 to 399	11
200 to 299	21
100 to 199	58
Less than 100	1, 203

[167] See sec. 2.b(1), above.

3 STOCK MAY 14 1963 NATIONAL DAILY QUOTATION BERVCIE FH

AERO GEO ASTRO	WACHTEL & CO WASH	202 347 5422	3 3/4	4 7/8
	/H L SMITH & CO COLLEGE PARK	301 WA7 4859	3 7/8	
	TROSTER SINGER & CO NY	212 HA2 2400	3 3/4	4 1/8
AERO INDUS	MORAN & CO NWRK	212 BO9 3897		2
	M S WIEN & CO INC J CY	212 BA7 4300	1	1 1/4
	WELLINGTON HUNTER ASSOC J CY	212 WO2 4578	1	1 3/8
	MYRON A LOMASNEY & CO NY	212 BO9 8165	7/8	1 1/4
	GREGORY & SONS NY	212 WH3 7600	7/8	1 1/4
	G C HAAS & CO NY	212 BO9 7060	1	1 3/8
	L D SHERMAN & CO NY	212 WH4 5540	7/8	1 1/4
AERO SVC STPD	CARTWRIGHT & PARMELEE NY	212 DI4 3383	OW	BW
AEROFLEX LAB	MARTIN J JOEL & CO NY	212 HA2 1666	2 7/8	3 3/8
	KALB VOORHIS & CO NY	212 HA5 6000	2 3/4	3 1/4
	KAUFMAN N ALSBERG & CO NY	212 DI4 2700	2 3/4	3 1/4
AEROLOGICAL RES	O M STUART & CO INC NY	212 HA5 6840	1 1/8	1 5/8
	A D GILHART & CO INC NY	212 WO2 1020	1 1/4	1 3/4
AERONAUTICAL ELECTRONICS	COBURN & MIDDLEBROOK HFD	212 DI4 6713	2 1/4	2 5/8
	BREEN CREAMER STANLEY CORP BOS	212 CA6 7000	2 1/8	2 1/2
AERONCA MFG PFD	J K RICEJR & CO NY	212 RE2 4500	OW	BW
55 PFD	WESTHEIMER & CO CINN	212 WO6 2115	3	3 3/4
1.10 PFD	GREENE & LADD NY	212 WH3 3166	6 3/4	
5 1/2 PFD	WESTHEIMER & CO CINN	212 WO6 2115	6 1/2	7 1/2
	CARTWRIGHT & PARMELEE NY	212 DI4 3383	OW	
AEROSONICS	J C BRADFORD &CO ATLA	404 JA2 6834	1 3/8	1 5/8
	COURTS & CO NY	212 HA5 7874	1 3/8	1 5/8
AEROTEST LABS	PASTENAEK & CO NY	212 DI4 9550		
	HAYDEN STONE & CO NY	212 DI4 6593	4 1/4	5
AEROVOX CORP	JANNEY BARTLES EWCLARK INC PH	212 WO6 5646	3 7/8	4 1/4
	J B MAGUIRE & CO INC BOS	212 CA6 1613	3 7/8	4 1/4
	BREEN CREAMER STANLEY CORP BOS	212 CA6 7000	3 3/4	4 1/8
	MAY &GANNON INC BOS	212 CA6 2610	3 7/8	4 1/8
	HARDY & CO NY	212 WH3 2900	3 7/8	4 1/4
	GREENE & CO NY	212 HA2 4050	3 7/8	4 1/8
	/LEASON & CO INC CHGO	312 ST2 5001	3 7/8	4 1/8
	J F REILLY & CO INC NY	212 DI4 4970	4	4 1/8
	CASPER ROGERS & CO INC NY	212 BO9 6244	3 7/8	4 1/4
	SINGER BEAN & MACKIE INC NY	212 HA2 9000	3 3/4	4 1/8
	EASTERN SECS INC NY	212 DI9 3550	3 3/4	4 1/8
	M S WIEN & CO INC J CY	212 BA7 4300	3 7/8	4 1/8
	TROSTER SINGER & CO NY	212 HA2 2400	3 7/8	4 1/8
	HAROLD C BROWN & CO INC BUFF	716 TL4 2500		4 3/8
	NEW YORK HANSEATIC CORP NY	212 363 4777	3 7/8	4 1/4
	HERZOG & CO INC NY	212 WO2 0300	3 7/8	4 1/4
AETNA CAS	JOHN C LEGG & CO NY	212 WH3 9630	99 1/2	101
	FRANCIS I DUPONT & CO NY	212 DI4 2000	98	101
	MIDDENDORF COLGATE&CO NY	212 HA5 4900	100 99	100 101
	A M KIDDER & CO INC NY	212 DI4 2525	98	101
	WOOD STRUTHERS & WINTHROP NY	212 WH3 1952	99 1/2	101
	NEW YORK HANSEATIC CORP NY	212 363 4777	99	101
AETNA FINANCE	SCHERCK RICHTERCO STL	314 GA1 0225	13 1/2	14
AERNA INS	JOHN C LEGG & CO NY	212 WH3 9630	100	110
	W C PITFIELD & CO INC NY	212 HA2 9250	100	
	LASSER BROS NY	212 WH3 5081	100	115
AETNA LIFE INS	PUTNAM & CO HFD	212 CA6 1255	155	156 1/2
	NEW YORK HANSEATIC CORP NY	212 363 4777	155 1/2	157
	ALLEN &CO NY	212 HA2 2600	155	156 1/2
	FIRST BOSTON CORP NY	212 DI4 1515	155 1/2	157
	MIDDENDORF GOLCATE&CO NY	212 HA5 4900	100 155	100 156 1/2
	BLYTH & CO INC NY	212 RE2 1900	156	157 1/2
	TROSTER SINGER & CO NY	212 HA2 2400	154 1/2	156
	LAIRD BISSELL & MEEDSNY	212 BA7 3500	155	156 1/2
	A M KIDDER & CO INC NY	212 DI4 2525	155	156 1/2
	EASTMAN DILLON UNSECS & CO NY	212 770 8611	155 1/2	157 1/2
	MERRILL LYNCH PF&S INC NY	212 WH4 1212	155 1/2	157
	SHELBY CULLOMDAVIS&CO NY	212 BE3 0626	155 1/2	157
	WOOD STRUTHERS & WINTHROP NY	212 WH3 1952	155	157
	LASSER BROS NY	212 WH3 5081		
AETNA MAINTENANCE	W C PITFIELD & CO INC NY	212 HA2 9250	500 2 5/8	500 3
	SCHWABACHER & CO SAN FRAN	212 CO7 4150	2 5/8	3
	GREENE & CO NY	212 HA2 4850	2 5/8	3
	J BARTH & CO LOS ANG	213 385 5251	2 1/2	2 7/8
AFFILIATED FUND	/SMITH BURRIS & CO CHGO	312 AN3 1200	8.18	8.28
	ASIEL & CO NY	212 HA2 5000	8.18	8.38
AGRICULTURAL INS	BURGESS & LEITH BOS	617 RI2 9885		41
	FRANCIS I DUPONT & CO NY	212 DI4 2000	40	41
	JOHN C LEGG & CO NY	212 WH3 9630	40	41
AINSBROOK CORP	ROBERT L FERMAN & CO INC NY	212 HA5 6750	5 1/4	5 3/4
	M L LEE & CO INC NY	212 CO7 3708	5 1/2	6
	EASTERN SECS INC NY	212 DI9 3590	5 3/8	5 7/8
	SINGER BEAN & MACKIE INC NY	212 HA2 9000	5 5/8	6
	BERNARD L MADOFF NY	212 HA2 7675	5 3/8	5 7/8
AINSLIE CORP	HOWARD D CLIPPER & CO NY	212 WH4 7330	300 1 1/16	400 1 1/4
	RUSSELL & SAXE NY	212 HA2 2084	1 1/8	1 1/4
	E L AARON & CO INC NY	212 DI4 2196	OW	BW
AIR EXRESS INTL	MORRIS COHON & CO NY	212 DI4 5460	13 1/2	14 1/4
	MULHOLLAND KAUFMAN & BRADY NY	212 HA2 3500	13 3/4	
	JOHN E SAMUEL & CO NY	212 BA7 9600	13 3/4	14 1/2
	TROSTER SINGER & CO NY	212 HA2 2400	13 1/2	14 1/4
	SINGER BEAN & MACKIE INC NY	212 HA2 9000	13 3/4	14 1/2
AIR METAL INDUS	J B COBURN ASSOC INC NY	212 WO4 8015	1/4	5/8
AIR SPRINGS	LAURENCE FRAZIER & CO INC NY	212 WH4 5151	3/8	5/8
	ROBERT EDELSTEIN COINC NY	212 DI4 2475	1/2	5/8
	WELLINGTON HUNTER ASSOCJ CY	212 WO2 4578	3/8	5/8
	BREEN CREAMER STANLEY CORP BOS	212 CA6 7000	5/8	1 1/8
AIR TECHNOLOGY	DONAN & CO INC SPLFD	212 CO7 8021	100 3/4	
AIR X INDUS	M S WIEN & CO INC J CY	212 BA7 4300	1 3/4	2
	RUSSELL& SAXE NY	212 HA2 2084	1 5/8	2
AIRBALANCE INC	GREGORY & SONS NY	212 WH3 7600	1 3/4	2 1/4
	BIOREN & CO PHILA	212 BA7 9300	1 3/4	2 1/4
	FRANCIS I DUPONT & CO PHILA	215 LO3 8120	1 5/8	2
AIRCAPITOL MFG PFD	/WHITMAN SEC CO MEMP	901 JA7 9441	2 3/4	
.10 COM	/WHITMAN SECS CO MEMP	901 JA7 9441	.15	
.15 COM	/WHITMAN SECS CORP MEMP	901 JA7 9441	3/4	
'A'	/WHITMAN SECS CO MEMP	901 JA7 9441	2 1/4	
	/GEORGE K BAUM & CO INC K C	816 HA1 6432	OW	
AIRCRAFT ARMAMENTS	HAY FALES & CO NY	212 BO9 9200	6 3/4	7 1/2
	HERZFELD & STERN NY	212 HA2 8645	OW	
	STEIN BROS & BOYCE BALT	212 DI4 1669	6 3/4	7 1/2
	BIRNBAUM &CO NY	212 BA7 8100	OW	
AIRCRAFT MECHANICS	ADAMS & PECK NY	212 RE2 4949	1 1/8	
	J K RICEJR & CO NY	212 RE2 4500	1 1/8	1 1/2
AIRKEM INC	GREENFIELD & CO INC NY	212 HA2 9290	4 3/4	5 1/2
	LEONE & POLLACK NY	212 BO9 5171	OW	BW
	SEYMOUR HAYMAN & CO NY	212 WH3 9857	100 OW	
AIRPAX ELEC	JOHNSON LANESPACE CORP ATLA	404 523 3693	2 3/8	2 5/8
	NEW YORK HANSEATIC CORP NY	212 363 4777	2 3/8	2 3/4
	SHASKAN & CO NY	212 DI4 4964	2 3/8	2 3/4
AIRTEK DYNAMICS	LAPHAM & CO NY	212 WH3 1975	1000 7/8	500 1 1/8
	EASTERN SECS INC NY	212 DI9 3550	3/4	1
	S D FULLER & CO NY	212 WH3 0066	3/4	1
	HAY FALES & CO NY	212 BO9 9200	7/8	1 1/8
AIRTRONICS INTL	ROMAN & JOHNSONFORT LAUDERDALE	305 JA3 6586	1 1/2	1 7/8
	GOLKIN DIVINE & FISHMAN INC NY	212 WH4 0884	1 3/8	1 3/4
	J C ROBERTS & CO INC MIAMI BCH	305 532 3353	1 1/4	1 5/8
	REUBEN ROSE & CO INC NY	212 WO4 7272	1 1/4	1 5/8

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The manner in which the Bureau collects, processes, and disseminates wholesale quotations to its subscribers has changed little in the last 40 years; however, the size of its staff—now about 300—has increased with the expansion of the over-the-counter markets. In New York, messengers collect quotations, between 11 a.m. and 1 p.m. each day, from about 900 firms. Quotations can also be telephoned, wired (some out-of-town houses use their wire connections with New York firms), or mailed in from out of town.[168] The collected quotations are alphabetized and typed by about 40 to 50 typists on stencils. About 3,500 copies of the "pink sheets" are mimeographed every day and distributed to the 2,000 subscribers. In order to meet delivery requirements, the first 500 sets of the sheets must be finished by 5:15 p.m., and the remainder by 6 p.m. Within New York City, the sheets are delivered by messenger on the morning of the business day following printing. In about 16 other cities, subscribers get the sheets by messenger service or railway express; the sheets are sent elsewhere by third-class mail, or, for an additional fee, by first-class or air mail. The Bureau estimates that 85 percent of the sheets are received the day after printing.

The Bureau also publishes monthly and semiannual printed summaries of listings which, unlike the daily service, are made generally available to the public; the circulation of the monthly summaries, however, is only about 60 percent of the daily circulation. These summaries contain a sample of quotations on each security listed in the preceding periods[169] except those for which no price was quoted, and also include some basic information on the security.[170] They also include quotations on stocks which did not appear in the daily sheets.[171] There is no charge for any insertion in the summaries, which the Bureau views as reference documents rather than a current advertising medium.

(2) *Controls over broker-dealers inserting quotations*

As noted above, subscriptions to the sheets are available to any broker-dealer registered with the Commission, but to insert listings in the sheets a broker-dealer must satisfy certain Bureau requirements.[172] An applicant must give the Bureau a 10-year history of its partners, officers, principal stockholders, and traders and, if any of the firm's principals has been adjudicated bankrupt or enjoined from dealing in securities, the details of such proceedings. The Bureau has not set forth the standards by which it evaluates the information submitted. The Bureau also imposes a minimum capital requirement; a balance sheet must be furnished, showing a net worth of $50,000 if the applicant is a corporation or $10,000 if an individual or partner-

[168] Quotations received by mail carry a symbol in the sheets to indicate that they are not as recent as other quotations.

[169] While each of the semiannuals covers the preceding 6 months, the monthly summaries cover whatever period has elapsed since the publication of the last semiannual.

[170] Information is usually provided about the following: dividends and interest, any exchange on which the security is listed, any reorganization, the company's location, number and par value of shares outstanding (and whether a significant number are in the hands of one group or person), the terms of any recent public offering, and sinking fund, conversion, or redemption provisions.

[171] Firms subscribing to the summaries may list up to 100 such securities; a nonsubscriber may list up to 25, once the Bureau is satisfied as to its reputation.

[172] All broker-dealers presently listing in the sheets and all but 25 of the subscribing broker-dealers are members of the NASD.

ship.[173] The amounts required are unrelated to the number of listings which the firm inserts—that number depends entirely on the fees that the firm wishes to pay. The balance sheet submitted need not be certified by a public accountant and is not subject to audit by the Bureau.

The Bureau also obtains a report from a credit-rating organization, unless the applicant is a member of the Investment Bankers Association or the New York, American, Midwest, or Pacific Coast Stock Exchanges. All applicants must furnish references from two members of the IBA or of an exchange. An applicant is not given the right to participate at any stage of the process of consideration of his application, although, at least in the larger cities, the applicant's office is visited.

In reviewing an applicant's business history, the Bureau checks not only credit standing but also prior violations of securities laws or rules, and reputation in the financial community. At least one of the Bureau's purposes in imposing listing requirements is to insure the integrity of the sheets by excluding firms likely to insert fictitious quotations or to be otherwise unreliable. However, as discussed below, significant problems of the sheets' integrity nevertheless exist. The Bureau has only the semblance of an investigative staff to determine the truth of statements in an application or of allegations against an applicant.[174] Moreover, once a firm has obtained the right to list, there is no requirement that periodic balance sheets be submitted to assure maintenance of the minimum capital; nor is there any other continuing surveillance.

An important gap in the Bureau's requirements is its failure to secure necessary disclosures when one broker-dealer firm inserts quotations for the benefit of another or to limit such insertions when the quotation is on behalf of a broker-dealer ineligible to insert on his own. When a quotation in the sheets is actually for a firm other than the named broker-dealer, there is no indication of that fact. There are legitimate reasons why a subscriber might insert a quotation for another firm; for example, as described above, a firm in one city might have its correspondent in a second city insert quotations under the correspondent's own name, in order to increase the likelihood that broker-dealers in the second city will respond to the quotation.[175] But there are also instances in which the gap may contribute to improprieties, such as when one firm has a number of firms appear in the sheets for a particular security in order to give the appearance of sufficient trading interest to qualify for the NASD's national or regional retail quota-

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[173] Prior to February 1962, the requirements were $25,000 for corporations and $5,000 otherwise; the new requirements do not apply to firms already entitled to enter quotations prior to February 1962.

It is noteworthy that the Bureau imposes the only minimum capital requirement in the over-the-counter market. As noted in ch. II, an NASD proposal for a minimum requirement applicable to its members was rejected by the Commission in 1942. For the recommendations of the study in this respect, see ch. II, p. 161 (pt. 1).

[174] Although the Bureau has investigative staffs of two in New York and of one each in Boston, Philadelphia, Chicago, and San Francisco, it is unclear what proportion of their time is given to investigation. The Bureau's president has stated the staff's duties are to sell, to check on applicants, and to make periodic visits to offices of subscribers, both those inserting listings and those merely receiving the sheets.

[175] See sec. 1.b, above.

tion lists, discussed below. The gap also facilitates manipulative use of the sheets as discussed below.[176]

The Bureau's present requirements for broker-dealers entering quotations in the sheets have been developed over the years. Originally, extension of listing privileges was based on personal knowledge of the applicant. As the over-the-counter markets expanded, such familiarity with firms desiring to quote became impossible, and a voting system was adopted under which 10 adverse votes by firms already quoting could "blackball" a new applicant. That system gave way to the present one when the U.S. Supreme Court ruled that a similar "blackball" constituted a violation of the antitrust laws.[177]

A broker-dealer firm that satisfies the requirements gets the right to list in the sheets by signing a Bureau subscription blank, the operative provisions of which are as follows:

> It is understood and agreed that this subscription entitles us to list 10 securities in the daily service and to receive for use in the office to which delivered the Eastern and Western Sections except on stock exchange and legal holidays. It is further agreed that all listings sent in by us in this service shall be genuine, subject to previous sale or change of price and that our subscription may be canceled at any time by the National Quotation Bureau, Inc., or if in its judgment the subscribing individual or firm indulges in any unethical business practice.
>
> National Quotation Bureau, Inc., will not be responsible for errors or omissions and reserves the right to omit any listing in its discretion.
>
> The Bureau will endeavor to deliver the service promptly but will not be responsible for late or nondelivery caused by strikes, lockouts, acts of the elements, delays or failure of the mails or other means of transportation, or any other causes beyond its control. Delivery of the service will be made by messenger, railway express, parcel post, or third-class mail, whichever is most efficient in the opinion of the Bureau. Rates will be supplied to cover airmail and first-class mail at the request of the subscriber.

On its application form, the Bureau "reserves the right" to reject any applicant without giving any reason. In 1961, there were 60 to 75 rejections according to the Bureau. When an application for listing is denied, the Bureau does not inform the applicant of the basis for the denial. It simply tells the applicant to file a new application in 6 months or a shorter period, if there is any material change in his business.

(3) *Controls over issues quoted*

The Bureau requires a broker-dealer to furnish certain information concerning any company whose securities it wishes to quote in the sheets: the company's location, the identity of its transfer agent, its state of incorporation, and the security's par value. The Bureau states that approximately 200 quotations were refused in 1961 because broker-dealers did not furnish the required data. Once the basic information is received, the Bureau collects further data, for use in the monthly summaries, by clipping published items and occasionally by soliciting information from the companies.

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[176] The Commission has stated:

"* * * activity in the sheets affords a basis on which estimates are made by dealers and the public as to the state of the over-the-counter market and the degree of active trading in that market." *M. S. Wien & Co.*, 23 S.E.C. 735, 744 (1946).

See also *Halsey Stuart & Co.*, 30 S.E.C. 106, 127 (1949):

"[T]he listings [in the wholesale quotation system] are commonly understood to have a serious meaning and business purpose. * * * There is no doubt that the sheets are intended to be used as indications of trading interest and are generally so regarded. They are capable of use as part of a manipulative scheme. * * *"

And see *Bruns, Nordeman & Co.*, Securities Exchange Act release No. 6540 (Apr. 26, 1961).

[177] *Associated Press* v. *United States*, 326 U.S. 1 (1944).

The Bureau applies a special check with respect to new issues, contacting the managing underwriter, or occasionally the Commission, to determine whether a registration statement has become effective.[178] No checks is made to determine whether a bona fide market exists.

When the Bureau receives quotation slips for broker-dealers for insertion in the sheets, they are sorted alphabetically by the name of the security and distributed to the typists, who are usually assigned the same portion of the alphabet every day. When a typist notices an unfamiliar security, she is under instructions to bring it to the attention of the Bureau official who checks to see whether the security is a new issue. For this purpose, the Bureau compiles a list of anticipated new issues on the basis of information appearing in the Investment Dealers' Digest and the Commercial & Financial Chronicle. If the security is on the list, the managing underwriter or the Commission is telephoned to determine whether registration has become effective.

If registration has become effective or if the issue is not on the new-issue list, the name of the security is passed on to a Bureau official who checks the Bureau files to determine whether the required basic information has been provided. On occasion the typists are instructed to be alert for quotations covering certain issues or inserted by certain broker-dealers. In spite of this, during a period from June 29 to July 25, 1960, two broker-dealers were able to insert quotations for shares of National Photocopy, Inc.—a nonexistent company.[179] According to the Bureau, this occurred because instructions given to the typist were misplaced.

The constant change in issues appearing in the sheets, combined with the Bureau's limited requirements and methods of control over issues quoted, has resulted in other anomalous situations. Addresses for a large number of issuers having securities quoted in the sheets are unknown, and a large number are dissolved, merged, or dormant. The study distributed approximately 1,456 copies of Questionnaire OTC-4 to companies having one or more stock issues in which there was an apparent over-the-counter market interest on the basis of quotations in the sheets. These companies were selected at random from the Bureau's Monthly Quotation Summary of January 1962.[180] Of the 1,456 companies, 76, or about 5 percent, had no ascertainable address, even after the Bureau had contacted broker-dealers quoting these issues. Forty-two of these 76 companies had at least 1 broker-dealer quoting a 2-way market and 25 had 2 or more broker-dealers quoting a 2-way market.

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[178] The front page of each section of the service contains the following legend:

"None of the solicitations carried in this service, of offers to sell or to buy shall constitute solicitations either in any State within which, or to any person to whom the solicitation would be unlawful, or by any dealer in any State in which such dealer is not licensed."

This disclaimer apparently explains the quoting of unregistered securities where an intrastate exemption has been claimed. See ch. IV.D.

[179] The two firms inserted quotations ranging from 9¾ to 10⅝. The scheme in this case involved the sale of National Photocopy stock through firms which had been induced to appear in the sheets by one Stanley Younger. Simultaneously Younger arranged for the purchase of National Photocopy stock for fictitious accounts established by him at several member firms of the New York Stock Exchange. In order to pay for the purchase of National Photocopy stock, Younger entered sell orders through these member firms for shares of various securities listed on the New York and American Stock Exchanges without intending to deliver the securities involved in such sales. Younger was later indicted and pleaded guilty to violations of the registration and antifraud provisions of the Securities Act. Litigation releases Nos. 1774, 1801, 1873, and 1987.

[180] Questionnaire OTC-4 is described in ch. IX.B and is set forth in app. IX.A. While the total sample was 1,965 companies, the sample used here is limited to the 1,456 companies that appeared not only in the monthly summary but also in the daily sheets during the last 3 months of 1961, the period covered by the January 1962 Monthly Quotation Summary.

Of the companies receiving the questionnaire, 49, or 3 percent, reported the following concerning their status:

They were merged, sold, or consolidated prior to the last 3 months of 1961	19
They were dissolved, bankrupt, or in receivership during the last 3 months of 1961	14
They were inactive or out of business by the last 3 months of 1961	2
They were wholly owned subsidiaries	4
They were closely held, with all stock in the hands of less than 25 holders [181]	10

It is understandable that the securities of some of these companies should continue to be publicly traded, but it is difficult to explain the appearance of quotations for securities in some of the above categories. It would appear that even the elementary information obtained by the Bureau is out of date or otherwise unreliable in a significant number of instances. Equally as important, there is no indication of the status of these companies in the sheets.

(4) *Controls over the insertion of quotations*

Under its subscription contract, the Bureau requires and each broker-dealer agrees that every quotation inserted shall be "genuine, subject to previous sale or change of price," and the Bureau reserves the right to cancel a subscription for violation of this provision, or "if in its judgment the subscribing individual or firm indulges in any unethical business practice." The Bureau's effort to control the insertion of quotations is aimed primarily at minimizing the frequency of fictitious quotations, including "backing away" by broker-dealers.[182] The Bureau does not concern itself with the spread between a broker-dealer's quoted bid and asked price.

The Bureau attempts to insure that only genuine quotations appear. One method is the detection of quotations "out of line" with other quotations submitted on the same security. The Bureau's typists are supposed to catch out-of-line quotations when they prepare the stencils for the sheets, although they work under pressure of meeting the delivery deadlines. If a quotation away from the market is discovered and not satisfactorily explained, the Bureau will suspend the firm's right to insert quotations for 30 days, and if it occurs again, the Bureau will cancel the subscriptions.[183] Because of its limited manpower and authority, the Bureau is not well equipped to evaluate the firm's explanation.

The Bureau states that in the past 5 or 6 years it has discovered about 12 out-of-line quotations. A review by the Special Study of quotations for a random sample of 205 securities listed in the sheets on 1 day [184] revealed what might be characterized as deviant quotations for 20, or about 10 percent, of those securities: that is, 1 dealer's quotation would be notably far from those inserted by other dealers. In some of these stocks, the offers of some firms were under the

[181] The sheets do not purport to show an issuer's status in any of the above respects.

[182] One professional has said that quotations are frequently for less than 100 shares but are not so indicated, in spite of the Bureau's requirement that they should be. Art. III, sec. 5, of the NASD Rules of Fair Practice requires that if a "nominal" quotation is used, it must be so labeled. See the discussion of "backing away" in sec. 2.b, above.

[183] These sanctions were established in 1960.

[184] The day, Oct. 25, 1962, was selected at random. The 205 securities were those appearing at the bottom of each page of the Eastern Section; mailed-in quotations were excluded.

bids of others. One can only guess how many of the deviant quotations were fictitious. Deviation may also be due to error by the Bureau or the submitting broker-dealer, to a sharp market movement between the times that the different quotations were given, or to differing evaluations of the stock. Moreover, a firm may enter a high bid price to bring sellers into the market quickly because it has a customer who wants to buy a relatively large block of shares in a relatively short span of time. Some of the deviations, however, seem hardly explicable in terms of market considerations,[185] and their presence raises, doubts about the efficiency with which nongenuine quotations are policed.

The Bureau's second method of control over quotations depends upon the receipt of complaints that a firm has "backed away" from a quotation; the Bureau then asks the firm for an explanation and, unless satisfied, tells the firm to make good its market. If the firm refuses, its quotation of that security is thereafter omitted from the sheets; repetition of the offense may, according to the Bureau, lead to cancellation of the subscription. Here again the Bureau is ill equipped to determine whether the firm backed away, whether the market changed, or the firm had filled its order.

The Bureau maintains a list of "suspect" firms—whose questionable activities have come to its attention—and makes special checks on quotations received from such firms. Cancellations of subscriptions is usually for failure to pay subscription fees rather than for backing away, inserting nongenuine quotations, or other improper practices. According to the Bureau, misbehaving firms generally become delinquent in paying fees; in the absence of such delinquency, subscriptions are seldom canceled. During the past 3 years, 30 subscriptions of firms which had the right to insert quotations were canceled, "mostly for nonpayment, meaning of course, lack of financial responsibility."

(5) *Manipulation and the insertion of quotations*

In case after case coming before the Commission and the NASD, fictitious quotations have been inserted in the sheets by subscribers who used the sheets to facilitate illegal distributions of worthless stock or to manipulate the after-market price for a new issue.[186] It has been the usual pattern in these cases for a broker-dealer, often a "boiler room," to have a number of broker-dealers place fictitious quotations in the sheets in order to create the appearance of active trading and demand for shares being distributed or about to be distributed. Public customers were then told that an active market existed which customers might—and often did—verify through other broker-dealers. A cus-

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[185] For example, in Infra Red, several dealers quoted 4¾ bid, 5¼ asked, and one dealer quoted 7 asked. Several quoted Realist, Inc., at ¼ bid, ⅝ asked, and one dealer quoted 7½ asked. Multi Amp Electronics was quoted by one dealer at 4 bid, 4⅜ asked, though other dealers were bidding 2 and asking 2½. In Monmouth Capital, one dealer had two quotations, the first similar to other dealers at 4½ bid and 5 asked, the second at 6¼ bid and 6⅝ asked.

[186] The following is only a partial enumeration of Commission cases in the years 1959 through 1962: *Anaconda Lead & Silver Co.*, litigation release Nos. 1481 and 1542; *American Equities Corp.*, litigation release Nos. 1955 and 2040; *American Quicksilver Co.*, litigation release Nos. 2237, 2258, 2325, and 2383; *Imperial Petroleum Co.*, litigation release Nos. 2079 and 2273; *Monarch Asbestos Co., Ltd.*, litigation release Nos. 1711 and 1948; *Atlas Securities, Inc.*, Securities Exchange Act release No. 6150 (Dec. 29, 1959); *Lawrence Rappee & Co.*, Securities Exchange Act release No. 6504 (Mar. 22, 1961); *Read, Evans & Co.*, Securities Exchange Act release No. 6467 (Feb. 9, 1961).

For a discussion of the use of fictitious quotations in connection with new issues, see ch. IV.B.3.

tomer who later attempted to sell his shares would find that his broker-dealer could not sell at the bid price quoted in the sheets, or if the distribution were completed, his broker-dealer would probably find that the market for the customer's shares had disappeared.[187] A recent Commission proceeding illustrates the manner in which fictitious quotations were used to facilitate a large distribution of worthless stock.[188]

Scott Taylor & Co. ("Scott Taylor"), a broker-dealer, acquired large blocks of unregistered stock of Anaconda Lead & Silver Co. at less than a dollar per share. The shares were then sold, principally by means of high-pressure sales tactics and fraudulent misrepresentations on the long-distance telephone, to investors in at least 29 States, mostly at prices of $4.75, many at $4.60, and a few at $4.25.

While the distribution was in progress, Scott Taylor asked Landau Co., another broker-dealer, "to go into the sheets," generally at a price of $4.25; this was done for a continuous period of 4 months. The testimony of Theodore Landau, proprietor of the firm, illustrates the technique:

> Q. Now, Mr. Landau, we would like to have you tell us, to begin with as a starting point, how you first became interested in this security, Anaconda Lead & Silver Co.
>
> A. * * * Scott Taylor asked me to go into the sheets for him and then I went into the sheets with him. That was the way it started.
>
> Q. You mean, that you first went into the sheets at the request of Scott Taylor & Co.
>
> A. That's right.
>
> * * * * * * *
>
> Q. At the time that you were going to go into the sheets with Mr. Stevens of Scott Taylor, was any price mentioned at which you should go into the sheets?
>
> A. He said to go in at that particular place in there. There was somebody else in the sheets at around that price and we went into it.
>
> Q. He suggested that you go into the Daily Quotation Sheets?
>
> A. I think it was at $4 or $4¼. I don't remember exactly what it was. He also gave me an order that if any stock came in, to buy—I believe he gave me an order of about 100 shares.
>
> Q. Well, now when Mr. Stevens of Scott Taylor gave you this order to buy 100 shares, was that a standing order to buy these 100 shares?
>
> A. A day.
>
> * * * * * * *
>
> Q. At the bid price?
>
> A. Yes.

In its decision revoking Landau's broker-dealer registration, the Commission stated:

> * * * Landau's continuous bids in the daily sheets during a period extending from April to August 1959 * * * materially assisted Scott Taylor to distribute the stock to the public by providing the appearance of a "market" at artificially high prices in the stock on the basis of which the shares could be sold. Therefore, Landau's actions here were in clear violation of section 10(b) of the Exchange Act and rule 10b–6.[189]

In the case involving the distribution of Diversified Funding shares, referred to earlier,[190] the broker-dealer, F. S. Johns & Co. ("Johns"), also arranged for the placement of fictitious quotations in the sheets while the selling campaign was in progress.

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[187] See the discussion of firmness of markets in sec. 2.b, above.

[188] *In the Matter of Theodore Landau,* Securities Exchange Act release No. 6792 (Apr. 30, 1962).

[189] Landau had also inserted quotations in the sheets in connection with a number of other "boiler room" distributions under circumstances similar to those in the *Anaconda Lead & Silver Co.* case.

[190] See sec. 2.a, above.

A trader from one of the firms inserting quotations in the sheets upon instructions from Johns, testified as follows:

Q. I notice that in almost every situation the sale was to F. S. Johns. Is there any reason for that?
A. He was the only real market for the stock.
Q. Why did you engage in this first transaction, dated October 23, 1961?
A. I don't know the reason for it, but I was given the transactions to put through by Mr. [T.] [the controlling person of Johns and Diversified Funding].
Q. At a guaranteed profit or a commission of one-sixteenth?
A. That is correct, one-thirty-second. I believe that is it. He gave me both sides of the transaction.

* * * * * * *

Q. Is this the first transaction that you enaged in in this stock?
A. Yes, it is.
Q. Now, prior to this time, why did you appear in the pink sheets commencing October 12, 1961?
A. I was asked to go into the pink sheets by [T.].
Q. Approximately when to the best of your recollection, sir.?
A. It would undoubtedly have been just the day or so before the first day of our appearance in the pink sheets.
Q. Did he give you the price at which to go into the pink sheets?
A. Yes, he did.
Q. Were you to receive any compensation for appearing in the pink sheets?

* * * * * * *

A. Mr. [T.] was ready to purchase it at a price he previously agreed on with me.
Q. What was that price?
A. Either an eighth or a sixteenth of a point higher than the price at which we appeared in the sheet.

* * * * * * *

Q. Did [T.] indicate to you why he wanted you to drop out of the sheets when he so requested you to do so?
A. No.
Q. He just called you up and said no more sheets any more?
A. Yes.
Q. Did you ask him why?
A. No.
Q. Did [T.] or anybody else at F. S. Johns ever refuse to take back from you any of the shares you purchased as a result of being in the sheets?
A. No, they did not.
Q. Did they ever complain to you about the quantity of stock that you were turning in to them?
A. Yes, they did.
Q. About when was that?
A. Whenever we had more than a couple of hundred dollars worth of stock, they would complain.

* * * * * * *

Q. Was there a market independent of F. S. Johns in Diversified Funding?
A. Not that I know of.

If a broker-dealer interested in the distribution of a block of stock by "boiler room" techniques did not have, or could not obtain, a subscription to the sheets, it has not been difficult to get a subscriber "to go into the sheets" at a fictitious quotation prescribed by the broker-dealer interested in the distribution. The firm inserting the quotation was, as described in the *Diversified Funding* case above, usually guaranteed a profit on each trade in which it was to take or furnish stock.

One of the more audacious schemes involved the insertion of fictitious quotations in the sheets to give the impression of increased value of stock pledged or to be pledged with banks as collateral for a loan. A number of subscribers to the sheets entered fictitious quotations for unregistered and worthless stock of Imperial Petroleum Co. and then sought to borrow money from banks in Miami, Fla., by pledging Imperial Petroleum shares as collateral on the basis of their quotations. One bank which was victimized by the scheme actually lent $25,000. The participants in the scheme were later indicted for conspiring to violate the antifraud provisions of the Securities Act and the mail fraud statute. Of the six defendants, five were convicted and sentenced; the charges against one defendant were dismissed.[191]

The testimony of the proprietor of one of the firms appearing in the sheets for Imperial Petroleum is illuminating.

Q. Tell me how you happened to go into the pink sheets in Imperial Petroleum?

A. Well, while I was in the hospital, I got a letter from Alex [F.]. He was out in California. In this letter, he described this new deal that he had arranged with Tom [C.] and he praised this deal very heavily. He said that it was a wonderful stock and had a lot of properties and, in fact, some of these properties were adjacent to a well-known oil company and they were interested in it and he thought it was one excellent deal for us to go into if I got better.

* * * I was going to get out of this brokerage business, not only because of my illness, but because of the fact that we weren't doing very well. As a matter of fact, there hadn't been any income for the last 2 or 3 months and I had already dismissed my employees and I was contemplating liquidating my business, and so when I received this letter, I practically ignored it.

* * * [H]e asked me to do him a favor and go into the sheets and bid on the stock at five and a quarter, thereby helping him promote a block of his stock which he had a deal going down in Florida.

*   *   *   *   *   *   *

* * * Mr. [F.] told me that if this deal went through and he was able to sell the stock, he would give me $500. At that time, being that I was—not having any income, $500 sounded pretty good to me and I agreed to go into the sheets for him.

*   *   *   *   *   *   *

I still had several months to go on my subscription to the pink sheets and he knew that and he asked me to put these bids in for him. I agreed to do that and I did go into the pink sheets and I quoted a bid of five and a quarter.

Might I mention before this that Mr. [F.] told me that I didn't have to make any physical effort to do this for him, I could do it at home and use my home telephone number in the pink sheets, which I did, and he said that this would be the easiest $500 I ever made.

Well, I finally agreed and, as I say, I went into the pink sheets and I received calls from about a dozen people and these are the names of the brokers from whom I received calls.

*   *   *   *   *   *   *

There is one thing I want to bring out and that is that Mr. [F.] when I asked him, "What happens if I get a call and somebody wants to sell me some stock," he said, "This is very simple. All you have to say is that you filled your quota for the day and you don't have to buy any. * * *"

The insertion of fictitious quotations in the sheets has appeared in other situations. For example, in one situation a broker-dealer entered fictitious quotations in the sheets over a 2-month period for the debentures of a company in order to induce another company to accept a block of the debentures in payment for cash and shares of stock of the second company. The tactic worked. Broker-dealers could also insert fictitious quotations prior to a registered public offering to create the appearance of a rising and active market,[192] or to increase the price of a security prior to merger negotiations. The insertion of quotations may also be used to qualify a security for re-

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[191] See litigation releases Nos. 2079 (Aug. 2, 1961) and 2273 (May 24, 1962).

[192] See *Floyd A. Allen & Co., Inc.*, 35 S.E.C. 176 (1953); *Gob Shops of America, Inc.*, 39 S.E.C. 92 (1959).

tail quotation on one of the NASD lists and to provide a basis for a fictitious retail price to be used in a selling campaign.[193]

A recent case indicates the manner in which unreliable wholesale quotations may infect the retail quotations systems. On April 19, 1963, the following item appeared on the financial page of the New York Herald Tribune:

> General Economics Corp., a securities broker-dealer, announced yesterday it has withdrawn market support from two issues it brought to the public less than a year and a half ago.
>
> General Economics Corp., a cornerstone of a securities-mutual fund-insurance combine, itself plummeted to 75 cents a share from a $5 opening bid price yesterday. It had sold above $6 on Tuesday after hitting 6¾ Monday. GEC later recovered yesterday to $1.50 a share bid in the counter market.

On January 22, 1962, the common stock of the General Economics Corp. ("GEC") was approved by the New York Quotations Committee of the NASD for inclusion on its eastern list of retail quotations.[194] At the time of its application, seven dealers appeared in the sheets quoting the stock at about 6½ bid, 7⅜ asked, creating the appearance of a broad and active market for the stock.

GEC was a holding company for a complex of corporations engaged in the underwriting of over-the-counter securities, financing, real estate and insurance. Through one of its broker-dealer subsidiaries, GEC employed a sales force of at least 350 salesmen to sell, among other things, its own securities and those of several companies underwritten by the subsidiary. It would appear that an intense selling campaign was employed in the sale of its stock extending into 1963. During early 1963, some 16 dealers inserted 2-way quotations in the sheets while GEC appeared on the eastern list of the NASD with retail quotations in the range of 5 bid, 7 asked.

On April 17, 1963, the retail quotation for GEC stock on the NASD eastern list was 5 bid, 5¾ asked. On the following day the retail quotation declined to 1½ bid, 2⅜ asked, when GEC withdrew market support for its own stock. It appears that many of the wholesale dealers inserting 2-way quotations in the sheets for GEC stock during the first 3 months of 1963 (the quotations which formed the basis for retail quotations disseminated to the public), sold most of the shares purchased by them to a GEC subsidiary. Several firms indicated that they appeared in the sheets at the behest of the GEC subsidiary with the understanding that they would be guaranteed a commission or markup of one-eighth of a point on all GEC stock purchased by them. Others stated that they showed the GEC subsidiary their positions each day or that they based their quotations on the price at which the subsidiary had previously agreed to purchase stock acquired by them.

b. Other wholesale quotation systems

There are several small wholesale quotation systems serving broker-dealers in certain regions of the country. For example, "Wants and Offerings," is published in Los Angeles and contains quotations for securities for which there is an interest in southern California. It has been operating for approximately 25 years. "Wants and Offer-

[193] See pt. D.4. below.
[194] See the discussion of the retail quotations system in pt. D.4 and pt. F, below.

ings" was organized after the National Quotation Bureau refused the request of Los Angeles broker-dealers to move its Pacific Coast office from San Francisco to Los Angeles. For a period, "Wants and Offerings" operated as a free service. At the present the service is sold on a subscription basis to broker-dealers who are members of the NASD and to banks. According to its management, the service is not made available to the public.

With the expansion of the over-the-counter markets a few new systems have attempted to compete with the Bureau, but none has been successful. With the market decline of early 1962, at least one system apparently went out of business. Recently another group unsuccessfully attempted to establish a system to provide nationwide service, using more modern communication, data processing, and reproduction techniques.

There is an established service, "The Blue List," specializing in municipal bonds and also quoting some corporate bond issues. Its operations were not included within the scope of this study.

Several electronic systems are now being used to disseminate retail quotations.[195] As described below in the discussion of the possible impact of automation upon over-the-counter markets, these systems could be readily adapted to the circulation of wholesale quotations. These electronic developments suggest the possibility of other wholesale quotations systems under different management and control from the Bureau's.

D. Retail Markets

1. INTRODUCTION

There is a dichotomy in the over-the-counter markets between the wholesale or interdealer markets and the retail markets where public investors buy and sell securities. Information about the interdealer market in which over-the-counter trading is principally conducted is generally not available to the public as a result both of its trading mechanisms and of industry policy. The absence of a central marketplace where trading can be observed and supervised and of a tape which reports and publicizes consummated transactions, the use of a farflung wire and telephone network in which wholesale dealers communicate bilaterally and privately with one another and the emphasis on the merchandising of over-the-counter securities, are some of the factors which result in fewer disclosures to investors about the trading markets for over-the-counter securities than are normal for exchange securities.

There is, on the other hand, a close and continuous relationship between the wholesale and retail over-the-counter markets. Retail quotations and prices, the quality of retail executions and the marketability of securities are all related to the underlying trading market. At present, in the absence of uniform standards prescribed either by the Government or industry, there are wide differences in the manner and costs of execution of retail transactions and the amount of disclosures afforded investors in over-the-counter securities.

The first sections of this part discuss some of the factors affecting the manner in which a public customer's order is executed by his

[195] These systems are described in pt. E, below.

broker-dealer and relates these factors to those affecting what he pays for an execution. A succeeding section considers the NASD-sponsored retail quotations system, which is now the primary source of information for a public customer (other than direct inquiries to a broker-dealer) concerning the trading markets for over-the-counter securities, and the role of the NASD markup policy and of Commission regulation in protecting investors in over-the-counter markets.

2. MANNER OF EXECUTION

a. Capacity—Agent or principal

When a public customer purchases or sells securities over the counter, his broker-dealer may act either as agent as as principal. Where a firm acts as agent (or broker) for its customer, it does not take title to a particular security and it charges a commission for executing the transaction, the amount of which is revealed to the customer on his confirmation.[196] When a firm acts as principal (or dealer), it buys from and sells to the customer for its own account and the customer pays or receives a net price. The customer is not advised of the cost to the firm of securities sold to him or of the current inside market price for the security.

A firm will act as principal when it is selling securities to public customers from an inventory position. In this case, the customer will usually pay the dealer's inside offer plus an undisclosed "markup." [197] On the other hand, a customer may purchase the security in a principal transaction from a broker-dealer with no inventory position. If the broker-dealer does not go short, it will purchase the security from a wholesale dealer after it receives the customer's order and not confirm the transaction to the customer until the security is purchased. In such a situation the broker-dealer usually buys the security at the market maker's inside offer and then resells it to the customer on a principal basis at a "markup" over its cost. This kind of principal transaction has been called a "riskless" transaction since the risks of ownership are absent.

It is important to recognize the difference between a broker-dealer executing as principal in a riskless transaction and the market maker who also acts as a principal. While both may execute on a principal basis, the function of the former is limited to execution of the order, and in essence performing the function of a broker for which his undisclosed markup is a service charge. The market maker, on the other hand, in addition to executing the transaction, provides marketability by assuming the risk of taking positions.

The decision whether the firm will act as principal or as agent in any transaction with a customer is a matter for agreement between the firm and its customer. Since the profit in retailing securities depends upon retaining customers, the firm will usually respect a customer's desire as to one form of execution as opposed to the other, unless the firm has so strong a preference for a particular mode of execution that it will decline to accept an order on any other basis. In practice, however,

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[196] See rule 15c1–4 under the Exchange Act and art. III, sec. 12, of the NASD Rules of Fair Practice which require disclosure on the confirmation of the amount of commission or other remuneration in agency transactions.

[197] See the discussion of the pricing practices of the integregated firm in sec. 4, below.

a firm can decide unilaterally in what capacity it is going to act in dealing with an unsophisticated customer who is unaware of the difference between the two types of execution. Such a customer may not even understand the significance of the disclosure in the confirmation received by him that the firm is acting as "principal" or as "agent."

(1) *Frequency of agency and principal transactions*

The study sought to ascertain through questionnaire OTC-3 the frequency of agency and principal transactions on a typical trading day (January 18, 1962) in the over-the-counter markets for equity securities. The table below shows the manner in which broker-dealers classified the capacity in which they acted in all their transactions for that day:

TABLE VII-c.—*Proportion of over-the-counter trading by individuals and by other public customers with firms as agent and as principal, Jan. 18, 1962*

	All public customers	Individuals	Other public customers
	a. Percent of number of shares traded		
Purchases, total	100.0	100.0	100.0
Through broker as agent	61.3	64.2	37.5
From dealer as principal	38.7	35.8	62.5
Sales, total	100.0	100.0	100.0
Through broker as agent	75.4	77.6	57.5
To dealer as principal	24.6	22.4	42.5
	b. Percent of value of shares traded		
Purchases, total	100.0	100.0	100.0
Through broker as agent	46.4	51.7	33.4
From dealer as principal	53.6	48.3	66.6
Sales, total	100.0	100.0	100.0
Through broker as agent	62.3	69.2	41.3
To dealer as principal	37.7	30.8	58.7

NOTE.—Percentages are based on figures shown in app. VII-A, table 9.

In terms of number of shares, 61 percent of the purchases and 75 percent of the sales by the public on January 18, 1962, were made through broker-dealers as agent. By dollar volume, broker-dealers acted as agent in slightly less than one-half of the purchases and 62 percent of the sales by the public.

(2) *Factors affecting capacity*

Based on an analysis of table VII-c and other data from questionnaire OTC-3, the following discussion summarizes some of the significant factors affecting the capacity in which a broker-dealer executes a transaction.

(a) *Type of customer.*—The proportion of transactions by nonindividuals (principally institutions) made on an agency basis was considerably lower than for all public customers, amounting for nonindividuals to only 38 percent of their purchases and 58 percent of their sales. The high percentage of purchases on a principal basis by nonindividuals is partially due to the fact that institutional and other large investors tend to deal directly with the primary market maker who usually acts as principal in purchase transactions.[198]

(b) *Characteristic of the security.*—The percentages in table VII–c for agency transactions are lower for dollar volume than for share volume because transactions in higher priced stocks are more likely to be on a principal basis. This is also indicated by the trading in the January 18, 1962, sample of 200 stocks (tables VII–11 and 11a). For each stock in which individuals purchased or sold shares, the proportion of their shares traded through broker-dealers as agent tended to decline as the price of the security increased.

Activity of the stock also is related to the frequency of principal and agency transactions. There appears to be some tendency for broker-dealers to act as agent in both purchases and sales to a greater extent in inactive stocks than in active ones measured both by share value and dealer interest (tables VII–12 and 12a, 13, and 13a).

(c) *Type of firm.*—Some firms may as a matter of firm policy act as agent for retail customers in all over-the-counter transactions. Many firms act as agent in unsolicited transactions or in transactions involving securities not on a recommended list and as principal in all other transactions. Still other firms act as principal in all over-the-counter transactions whether or not they inventory the security involved in a transaction.

From the reports received of trading in the January 18, 1962, sample of 200 stocks, it was observed that certain firms consistently traded as principal in stocks in which they made markets but acted as agent in all others. In all stocks on January 18, 1962, 740 broker-dealers, or 40 percent of the 1,839 who had purchases or sales for public customers (individuals and institutions), effected all of their transactions with the public on an agency basis. On the other hand, 290 broker-dealers, or 16 percent, effected all of their transactions with the public on a principal basis.[199] About two-thirds of the broker-dealers in the former group were small firms which had less than $10,000 of transactions for the public during the day.

On January 18, 1962, individuals purchased over-the-counter stocks from or through a total of 1,398 broker-dealers. Of these firms, 517 always acted as agent for the customer and 407 dealt exclusively on a principal basis; these 924 firms that dealt exclusively on one basis or the other tended to be firms with small public business so that 1 or 2 transactions may have represented their total volume of individuals' purchases that day. Apart from this, however, there was no readily apparent distinction between firms with smaller or larger volume as to the handling of public business on a principal or agency basis. A distribution of broker-dealer firms by size of individual customers' purchases and by proportion of such purchases made on an agency basis indicates that there is no tendency for firms with small volume to act more frequently on a principal basis than firms with larger volumes (table VII–13b).

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[198] See pt. C.2.d, above; sec. 3.c, below; and ch. VIII.C. Both broker-dealers and institutions may prefer to deal on a principal basis in order to avoid negotiating a commission rate different from the NYSE rate which is used for the vast majority of over-the-counter transactions on an agency basis. See sec. 3, below. As indicated in ch. VI.D, many institutions are critical of the NYSE rate in its application to large block transactions.

[199] Some of the firms which had only agency trades stated that this was not the usual day's training in that respect, but this was offset by other respondents who had only principal trades but stated that this was unusual for them.

Members of the New York and American Stock Exchanges effected a larger proportion of their public transactions in over-the-counter stocks as agent than did other broker-dealers (table VII-14). NYSE members acted as agent in 58 percent of their purchases and 71 percent of the sales, in terms of dollar volume of public transactions.[200] In contrast, the corresponding percentages for broker-dealers who were not members of any exchange were 27 percent for purchases and 37 percent for sales.

Generally, firms with an inventory in a particular security deal on a principal basis with the public in that security; few transactions are on an agency basis. There is a higher incidence of agency executions for such firms when customers are sellers than when customers are purchasers (table VII-16). Stated another way, when a customer sells, there is a greater chance that the integrated firm making a market in the security will execute the order on an agency basis than if the customer is a buyer.

In many principal transactions, a firm may not have an inventory at the time of the order. Of the shares purchased on a principal basis by individuals for the sample day of January 18, 1962, 54 percent were purchases from firms with no inventory who executed the transactions on a riskless basis.[201] Riskless transactions constituted approximately 24 percent of all individuals' purchase transactions (both principal and agency) by share volume for the same sample day.

To summarize: Though there are exceptions in individual securities and among individual firms, data with respect to the frequency of agency and principal transactions indicate that (1) in a majority of transactions broker-dealers deal with individual customers on an agency basis and with institutions and other nonindividual investors on a principal basis; (2) the likelihood of a broker-dealer acting on a principal basis tends to be greater if the security is higher priced, if it is active, and if a large number of dealers are quoting markets; (3) some broker-dealers, particularly members of the New York Stock Exchange and American Stock Exchange, will as a matter of policy usually act as agent in all transactions, except those involving inventory securities; (4) broker-dealers which inventory securities usually execute transactions on a principal basis though there is a tendency to act as agent in securities held in inventory more frequently on customers' sales than purchases; and (5) in many principal purchase transactions (i.e., over one-half of such transactions on the sample day), the executing broker-dealer does not have an inventory in the security.

(3) *Standards with respect to capacity*

Neither the Commission nor the NASD has prescribed standards with respect to the capacity in which a retail firm executing an over-the-counter transaction must act. As described below, there may be circumstances under which the broker-dealer is required to disclose the nature and extent of his adverse interest in the transaction despite

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[200] Member firms of the New York Stock Exchange handle a substantial part of the public's business in the over-the-counter markets. On Jan. 18, 1962, New York Stock Exchange firms effected 54 percent of the public share volume and 62 percent of their dollar volume (table VII-15). If public trading in over-the-counter stocks only (as distinguished from over-the-counter trading in exchange-listed stocks) is considered, NYSE members participated to an even larger extent, effecting 69 percent of the total value of public transactions in such stocks. See app. VII-A.

[201] This computation was based on the sample of 200 stocks studied in questionnaire OTC-3 for Jan. 18, 1962.

the nominal capacity in which he acts.[202] However, in most situations the election of the broker-dealer to act as agent or principal controls the extent of disclosures to customers.

Some firms have rigorous standards concerning the capacity in which they will act in over-the-counter transactions. Many others may leave the choice of capacity to their salesmen, who are compensated in most firms by a percentage of the gross commission or profit involved in the transaction.[203] Since the salesman's gross is ordinarily greater in principal transactions, this factor may dominate his choice of capacity. The manner in which salesmen's compensation can affect the type of execution is illustrated by this testimony of a representative of a retail firm:

Q. Would you explain those circumstances in which a salesman would decide * * * to be principal and in which he would decide to be agent?
A. How he would make that decision?
Q. Yes. Is there a firm policy on this?
A. No; there is no firm policy on it.
Q. Well, is there a firm standard operating procedure?
A. It is dictated somewhat by the salesman. In other words, he acts as principal.
Q. Would he make more money out of it?
A. In most cases, as a principal; yes.

The firm may be influenced by the fact that, if it acts on a principal basis, it need not disclose either its cost in a riskless transaction or the inside market where it sells from inventory. No rule requires these disclosures in a principal transaction, although rules of the Commission and of the NASD do require disclosure of any commissions or other remuneration received in an agency transaction. Thus, in connection with a "riskless" transaction, the firm need not disclose the inside price though the transaction cannot, in function, be distinguished in any way from an agency execution. If the firm executes the transaction from an inventory position, it can only act as principal, but in most instances no facts are disclosed to the customer to enable him to determine whether the net price which he pays is reasonably related to the inside price quoted by the selling firm or by others or to the commissions of firms executing on an agency basis.

b. Diligence of execution

(1) *Firms executing retail transactions*

Of the large variety of firms handling over-the-counter transactions for retail customers, it is estimated that more than two-thirds do not make markets in over-the-counter securities.[204] It is estimated, based on transactions for a sample day in the over-the-counter markets, that 80 percent of individuals' purchase transactions and 89 percent of individuals' sale transactions by share volume were executed by firms having no inventory in the particular security at the time of the transaction.[205] Retail business with both individuals and institutions

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[202] See sec. 4.c, below.
[203] See ch. III.B (pt. 1).
[204] See pt. B.3, above.
[205] This is based on the 130 stocks in the sample of 200 stocks which individuals purchased or sold on Jan. 18, 1962. In these stocks, 56 percent of individuals' purchases were on an agency basis, 24 percent were dealers' riskless principal trades, and 20 percent were on a principal basis at dealers' risk. In individuals' sales, 78 percent were on an agency basis, 11 percent were riskless, and 11 percent were on a principal basis and taken into inventory.

in most of the inactive securities tended to be concentrated in firms without positions (table VII-17).

Since most of the public business over the counter is done with firms who are not market makers, these firms in executing public orders have the obligation of making a reasonable effort to check markets and to execute with the wholesale dealer quoting the best market. For a firm which executes customer orders from an inventory accumulated in the course of making a market, however, its obligation in checking markets involves reasonably assuring that the customer pays or receives a net price not disadvantageous in respect of the price available elsewhere. For still another category of integrated firms, the dominant or sole market maker, the problem is somewhat more complex since there is no competitive market against which to evaluate executions in either of the senses described above.[206] The following sections explore the various problems associated with the concept of "best execution," and suggest various kinds of approaches to afford protection to investors consonant with the varied character of over-the-counter securities and markets.

(2) *Comparison of executions*

A diligent execution of a retail order should involve a reasonable effort in obtaining the best wholesale dealer quotation and an execution as favorable as may reasonably be obtained in light of the kind and amount of securities involved and other pertinent circumstances. If the public customer is to obtain the benefits of competition and diversity in the wholesale markets, his broker-dealer must make a reasonable effort to check competing markets.[207]

One way to measure the extent to which checking markets and negotiation can result in better executions is by comparing executions for institutions and fellow professionals with those for individual customers. The comparison appears to be meaningful since institutions and fellow professionals as sophisticated investors may be assumed to expect diligent executions and to be in a better position than most individuals to judge their quality. Also, because institutional and professional customers tend to buy and sell larger amounts, it is to be expected that brokers will generally exercise greater care and diligence in checking markets and negotiating for these customers than for most individual customers.

A market maker, which acts as principal, generally does not know whether the retail firm is selling or purchasing for its own account or that of a customer.[208] Therefore, differences in prices received by

*   *   *   *   *   *   *

"Q. How often would you say that occurs?

*   *   *   *   *   *   *

"A. Well, I am sure it happens 5, 10 times a day, at least."

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[206] See pt. C.2.c, above.

[207] See pt. C.2.b, above.

[208] On occasion, however, the broker may advise the market maker that he is acting for another broker-dealer. The information may be used as a negotiating tool, as illustrated by the testimony of a trader in a large wholesale firm:

"Q. Suppose you had a call from a New York firm, would he ever tell you that the order is coming from an out-of-town firm, over his wire, and that he needs to shave the price as much as possible in order to make a profit for himself? Has that ever happened?

"A. Maybe not just that way. He might call up and say, 'I can get XYZ for this particular stock, can you show me any commission?'"

executing firms from market makers often reflect the former's exercise of diligence in checking markets or in negotiating.[209]

Using the 200 stock sample of January 18, 1962, the study made a comparison of executions for institutions on an agency basis with executions on the same basis for individuals by firms having no positions.[210] In 14 of the 19 securities studied in which an institution used a broker with no inventory to act as agent in purchase transactions, the prices of execution for institutions were lower than for individual customers; in 3 securities prices were higher; and in 2 securities there was no difference in price. There was little difference between prices of execution for institutions and individuals in sales on an agency basis.[211]

Similar comparisons of prices of execution based on the 200 stock sample were made for transactions on behalf of broker-dealers and individual customers. When purchases were made through firms with no positions on an agency basis, the prices of execution for fellow professionals were lower in 17 out of 21 securities in which comparisons could be made; in 3 securities individuals purchased at lower costs and in 1, costs were the same. Thus, professionals generally received better executions than individuals in purchase transactions where the broker-dealer acting as agent was other than a market maker. In sale transactions in 9 of 14 securities, when broker-dealers with no positions acted for fellow professionals on an agency basis, the proceeds of sales were higher for them than for individuals.

Thus, it would appear that in the majority of cases studied institutions and broker-dealers received better executions on the purchase side than did individual customers.

(3) *Factors affecting diligence of execution*

There are factors other than the sophistication and importance of the customer affecting the diligence of an execution by a broker-dealer in the over-the-counter markets. The wire connections of a retail firm with wholesale dealers may also affect the manner of execution and the cost to the public customer. Often the retail firm is part of the correspondent network of the wholesale dealer firm which expects that its correspondents will execute with it.[212] The after-market trading in the common stock of Custom Components, Inc., one of the 22 new issues studied in chapter IV, illustrates such a pattern of trading.[213]

Two of the firms making wholesale markets in Custom Components stock after the offering date were Gregory & Sons ("Gregory") and

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[209] A review of the agency executions by market makers (or any firm with a position) shows that they do not execute orders for public customers on an agency basis at prices significantly different from those obtained by nonposition firms. This would indicate that being a market maker does not provide that firm with any better "feel" of the market in terms of obtaining a better price for an individual customer compared with a firm unfamiliar with the market. For example, in 11 securities of 20 studied the average agency purchase through a position firm was superior; in 9 securities it was inferior to the executions through a nonposition firm; in sales to an individual through a position firm the price obtained was superior in 11 securities of 26, inferior to the nonposition firm in 12 securities and the same in 3 securities. These securities represent all of those in the sample in which comparison could be made. See app. VII–F.

For a detailed summary of the average prices of transactions among broker-dealers, individuals and nonindividuals on a principal and agency basis for the 200 stock sample studied in questionnaire OTC–3, see app. VII–E, F, and G.

[210] See app. VII–F.

[211] See also tables VII–18 and 32 for summaries of the prices of executions of particular securities in transactions involving institutions and individuals. For a discussion of table VII–32, see sec. 4.2(2), below.

[212] See pt. C.1.b, above.

[213] See ch. IV.B.3.b and app. IV–A for further details concerning this offering and the after-market trading of this issue.

Singer, Bean & Mackie, Inc. ("Singer, Bean"). Bioren & Co. ("Bioren"), one of the underwriters, is a correspondent of Gregory and has a direct wire from its Philadelphia office to Gregory. Sutro Bros. ("Sutro") has a direct line to Singer, Bean.

During the early stages of after-market trading, Bioren's customers were substantial sellers to Gregory while Sutro's customers were substantial buyers from Singer, Bean. Gregory therefore was buying on balance, while Singer, Bean was going short. Thus Gregory became a "better seller" and Singer, Bean a "better buyer"; in fact, Singer, Bean turned to Gregory to replenish its supply. However, although Singer, Bean kept Bioren advised of its current quotations, Bioren still executed with Gregory. Also, had Sutro checked to find out that Gregory was a seller, Sutro's customers would undoubtedly have bought at lower prices.

To illustrate, on April 27, 1961—1 week after the effective date of the registration statement—Singer, Bean purchased on balance 900 shares from Gregory at $9 per share. On the same day, Bioren executed sales for customers to Gregory of 1,350 shares at prices ranging from 8 to 8¾; 8¾ was the highest price which Gregory paid to any seller on that day. Since Singer, Bean was willing to pay 9 for the stock and continuously advised Bioren of its quotations, it can be assumed that Bioren would have done better for its selling customers by executing with Singer, Bean.

Meanwhile, Singer, Bean was selling substantial amounts to Sutro. Of the 2,550 shares sold to Sutro on April 27, 550 were sold at 9½, 900 at 9¼, 900 at 9, and 200 at 8. Had Sutro checked Gregory's market it would have received a better execution, since Gregory was willing to sell for $9. Indeed, many of the transactions were executed by Singer, Bean for Sutro on an agency basis. For example, the 900 shares bought by Singer, Bean from Gregory at 9 were resold to Sutro at 9¼ in a simultaneous agency transaction.

Order clerks in retail firms may direct orders for over-the-counter securities to certain wholesale dealers rather than to others out of habit, lack of training, or for other reasons.[214] A broker-dealer handling institutional orders advised the study that it was generally known in the financial community that some order clerks receive substantial gratuities from wholesale dealers as an inducement to place orders for over-the-counter securities with the latter firms.[215] To the extent that this is a practice among retail firms, this factor would have a substantial effect upon the diligence of execution and the prices paid or realized by customers.

Reciprocal obligations and understandings between firms may also affect the manner of executing customers' orders in the over-the-counter markets. A retail firm may direct its over-the-counter business to one wholesale dealer rather than another because the wholesale dealer has provided services to the retail firm. Various arrangements

[214] One wholesale trader commented on the lack of training among retail order clerks: "* * * [N]inety-eight percent of the time these people in the order rooms don't know how to go about looking up even a manual to find out who might be a seller or buyer, who had the stock, he has no time, or he has not got the brains enough, or he is not trained enough, * * * because these men have been in the same position for 30 years and they don't want to do anything else beyond what they are supposed to do. They are not interested whether the client pays $14 or $16."

[215] An NASD Rule of Fair Practice prohibits members from giving or offering to give anything of value to any employee of another person for the purpose of influencing or rewarding such employee in relation to the business of his employer, without the consent of such employer. Art. III, sec. 10, NASD Rules of Fair Practice.

which have been developed by the industry to reciprocate have been described elsewhere in this report.[216] There are, however, a number of reciprocal business practices having a direct bearing on the handling of over-the-counter transactions.

The retail firm may direct all of its over-the-counter business to one wholesale dealer because the latter provides quotation services. As one wholesale dealer explained it:

> * * * [T]hese houses have a limited amount of personnel, a maximum amount of orders, and for service, I [give] anywhere from a hundred to a hundred and fifty quotes a day for the various issues, [of] which 95 percent, you never see an order from. Some salesman in some office wants a quote. You have to get it for them. They don't have the manpower or facility or the know-how, whoever handles the order, where to go to get the quotation or the price.
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> * * * * * * *
>
> They can do that themselves if they had *x* amount of added employees just to do that. The volume of inquiries they get is so large for the normal run of business that they have got to feed these things out. They have to. It is a brokerage service. We are servicing these dealer houses by giving them the service on the quotations.

For providing these quotation services, the wholesale dealer expects that the retail firm will reciprocate by directing over-the-counter business to it.

A wholesale dealer may not be a member of the NYSE, and it may direct all of its retail business in listed securities to an Exchange member firm. Since the rules of the NYSE prohibit the member firm from relinquishing any portion of its commission to the nonmember firm, the Exchange member may send over-the-counter business to the nonmember to reciprocate for listed business.[217] The NYSE has indicated that this practice might be a violation of its policy prohibiting the rebate of commissions to nonmembers if the member firm has a "well organized and well staffed department" for handling over-the-counter business. An official of the Exchange recognized the seriousness of the problem and commented as follows on the practice:

> By agreeing to give all your business in over-the-counter securities to one broker, you may not be servicing your customers properly because he may not properly cover the waterfront. An unlisted market is not the same as a listed market where there is a central point and policies and records of the transaction. We think it is the duty of the broker to do the best for his customer and by promising to give all the business to one person willy-nilly might violate that.

Under some circumstances, retail firms may fail to check markets because of factors beyond their immediate control. For example, during periods of activity, because of overcrowded communication facilities or the press of incoming orders, retail order clerks may be forced to execute orders with the first wholesale dealer with whom communication can be established. A representative of one wholesale dealer described such a situation in this manner:

> * * * In the spring of 1961, I would say the market had gotten well out of hand, especially in the new issues, and it was impossible for a clerk executing an order for a stock exchange house or a retail order, we will put it that way, to give the order due diligence * * * the first call he would make, if he was lucky enough to get a broker, he would have to execute his trade. Therefore, there were very big variations in markets between one specialist and another, because every specialist had to trade from the calls that he received in his own office and

[216] See ch. VI.I and ch. XI.C.
[217] See ch. VI.I.

could not go out and check his markets to see if they were in line. Of course many trades have had to be out of line due to this.

(4) *Interpositioning*

Another practice related to diligence of execution which has a direct effect on the costs of execution for public customers is that of "interpositioning." Normally, where a firm receives an order from a public customer in a security in which it is not making a market and in which it has no position, it goes directly to a firm making a wholesale market in the security or to the correspondent of the market maker. As indicated earlier, if a correspondent is used, the name of the initiating retail firm is usually "given up" to the wholesale firm, and the cost to the retail firm is the same as if it had dealt with the market maker directly.[218]

In some cases, however, the retail firm executes the transactions through a correspondent of the market maker or some other third firm which receives a fee from the retail firm for the transaction. One of the reasons for using an intervening broker-dealer to execute a transaction is to compensate him for other business or services rendered to the retail firm. The intervening firm may act as agent for the retail firm; or the intervening firm may sell the security as principal to the firm. In both cases the charge by the intervening firm becomes a part of the price paid by the customer's firm and is passed on to the customer by computing the "markup" or commission on the basis of the retail firm's cost, not the cost of the interpositioned firm.

One dealer gave this example of interpositioning:

Q. Let's assume * * * there is a seller who wishes to sell, but he will not sell for less than seven and a half, and he puts in an order with his broker wire house to sell at seven and a half * * *. Now in the situation where this commission wire house gives the order to you, what do you do with it?

A. Well, we try whoever is trading the security to get ourselves a commission over that seven and a half. In other words, if I am offered 500 shares at seven and a half, and A, B, and C are making a market at seven and a half plus an eighth, I will call the first one and say, "I have 500 shares of stock I can buy at seven and a half." He will say, "All right, take an eighth commission * * *."

* * * * * * *

Q. Now, why couldn't the wire house have gone to the same broker that you did and get seven and five-eights and then give the customer seven and five-eights minus the commission * * *. In other words, why couldn't he do exactly what you did?

A. He can do it.

Q. And save his customer an eighth?

A. He can do it if he has the time, if he is diligent enough, plus one other thing: If you call me and I am pretty friendly with you, I will give you an eighth of a point commission. If he [the retail house] calls me [the market maker] and I am not friendly, I won't give it to him if I am trading the stock. So there is no guarantee that that [retail] house would get the same five-eighths that I got.

In this example, if the retail firm had gone directly to the wholesale dealer, it might (but would not necessarily) have been able to sell the shares at seven and five-eighths. A representative of another interpositioned firm testified that his firm supplied quotations to retail firms:

Q. What do they do in return for you?

A. They try to give me preference and sometimes they do give me an extra eighth or quarter of a point.

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[218] See the discussion in pt. C.1.b, above, of the operation of correspondent systems.

A fellow, yesterday, gave me a—I made a hundred dollars * * *. He needed 400 shares of stock. I said, "I bought 400 shares of stock at 13."

He said, "All right. Take a quarter of a point for yourself," which is fair to me.

Q. It cost him how much?

A. Thirteen and a quarter.

Q. What does he do with it?

A. If he gets it for a customer—that 13¼—he charges stock exchange commission above 13¼.

* * * * * * *

Q. In that kind of a situation, which you have just described, could the stock exchange house, itself, have gone into the market and bought the stock at 13, if it had the time and wires to do it?

A. Sure.

In some instances when the interposed firm is not able to negotiate a price better than the best quoted, it will advise the retail firm to execute directly with the market maker. In others, the interposed firm will execute the transaction and charge a commission so that the customer pays more than the best price quoted in the market.

Another firm which frequently performed the service of supplying quotations and of executing for other firms was asked why retail firms would ask it to execute for them. The principal of that firm replied that he might be able to check the wholesale market carefully and purchase stock at, for example, nine three-eighths where without such careful checking the purchase would have been made at nine one-half:

Q. Why couldn't they [the retail firms] get it at three-eighths?

A. Because it is a question of time. These wire houses are so flooded with quotes and orders * * *

Q. Would we be interpreting you correctly, then, if we understood that this happened only in busy markets when they did not have the time?

A. No; not primarily. As I said before, I might be given such good service to XYZ security firm down here that they might want to throw me an order. Maybe I can make a sixteenth or an eighth, which I would like.

Q. Service by way of giving quotations?

A. Sure. * * *

This particular firm executed only 2 transactions for its own account in the 200 stock sample of questionnaire OTC–3 on January 18, 1962. Those transactions occurred in Great American Life Underwriters stock. The firm, which was not making a market, purchased 10 shares from a market maker at 198 and sold these shares to a retail firm at 202 at a time when the prevailing wholesale asked price was 198. The principal of the firm stated that the transactions probably occurred as a result of a call on the TWX from the retail firm in which the retail firm said that it could pay 202. Aside from the purchase at 202 by that retail firm the highest price paid by any other broker-dealer firm, either as agent or dealing for its own account, on January 18, 1962, was 199. In this case the interpositioned firm apparently was used to execute the order simply as a result of a previously established course of doing business with the retail firm.

The $4 per share charge by the interposed firm which was probably passed on to the customer should be compared with the usual 3 to 5 cents per share charge that same firm makes when executing orders for its correspondents, which are not passed on to the customer.[219]

[219] See pt. C.1.b, above.

The effect of interpositioning on the net price to the customer can be illustrated by the samples on the following page derived from transactions in the 200 stock sample:

TABLE VII-d.—*Prices paid in purchases by public customers as a result of interpositioning, Jan. 18, 1962*

Stock	Number of shares [1]	Price paid to wholesale dealer by interposed firm [2]	Price paid by customer's firm to interposed firm	Cost to customer	Capacity of customer's firm
Aztec Oil & Gas Co	100	23¼	23⅜	24½	Principal.
Illinois Mid-Continent Life Insurance Co.	100	14⅞	15	15.22	Agency.
Pacific Power & Light Co	25	57	57¼	60	Principal.
Producing Properties, Inc	100	11	11⅛	11⅝	Do.
Security First National Bank of Los Angeles.	100	78½	78¾	79.22	Agency.
Sonar Radio Corp	100	7	7¼	7.39	Do.

[1] Number of shares purchased by public.
[2] A different firm is involved in each of the transactions set forth in the table.

In each of the transactions shown in the accompanying table, public customers paid the cost of interpositioning. In transactions in which the retail firm acted as agent, the retail firm charged the customer a commission equivalent to the New York Stock Exchange rate based upon the cost to the retail firm. Had no firm been interposed, the commission charged would have been added to a lower base. In those three transactions in which the retail firm acted as principal, the markup of the retail firm was apparently based upon its cost, not the price charged by the wholesale dealer. In all three examples the markup charged to the customer as related to the interposed firm's cost (i.e., the price charged by the wholesale dealer) was more than the NASD's 5 percent markup policy. If based upon the retail firm's cost, the markup was within 5 percent.[220]

Retail firms sometimes justify interpositioning on the ground that the wholesale dealer may give the interposed firm a better quotation. It is argued that if the retail firm dealt directly with the wholesale dealer, the latter would know which side of the market the retail firm was on, particularly if the retail firm has a pattern of doing business with the wholesale dealer, and adjust its quotations accordingly. In addition, interpositioning has been claimed to be necessary where a retail firm outside a financial center seeks to execute an order and finds it unduly expensive to contact more than one firm. Neither argument seems a satisfactory justification for the practice in many situations in which it appears.

The retail firm can minimize any adjustment of quotations by wholesale dealers by checking competing markets. When the retail firm uses an interpositioned firm, the latter is often no better qualified to obtain quotations than the retail firm. For example, the retail firm in many cases is an integrated firm with a fully staffed trading department capable of checking competing markets. With the expansion and refinement of communication facilities, it appears that most retail firms have access to wholesale dealers either directly or through

[220] See sec. 4, below, for a discussion of markups.

correspondents.[221] Even assuming that communication costs are a factor, many firms outside of financial centers have found it possible to execute on a give-up basis with a charge that is nominal compared to the cost of interpositioning. In fact, several large wholesale dealers indicate that they check markets and execute transactions for out-of-town firms without any charge in securities in which they do not make markets.[222]

(5) *Standards with respect to diligence of execution*

A broker-dealer acting as an agent for a customer in the execution of a transaction assumes the obligations of a fiduciary. As the Commission has stated the common law principle:

> A corollary of the fiduciary's duty of loyalty to his principal is his duty to obtain or dispose of property for his principal at the best price discoverable in the exercise of reasonable diligence.[223]

Actual operating standards to assure execution of transactions in accordance with this principle have been largely left to individual firms. While some firms apparently have established specific standards for their own personnel,[224] many others leave the execution of retail orders to the personal habits and work patterns of individual order clerks and traders or to the demands of reciprocal obligations and understandings.

The NASD has broadly recognized the principle of best execution but specific guidelines or standards have not been prescribed.[225] The most specific recognition of the principle has been made in several NASD disciplinary proceedings involving interpositioning but there appears to be no consistent policy with respect to the propriety of that practice.

In three cases in Boston, an NASD District Business Conduct Committee found that, for purposes of determining the current market from which to compute a retail markup to a customer, it was improper to include the service charge paid to an intermediate broker-dealer interposed between the initiating firm and the wholesale market. The cost of the initiating dealer was held not to be a fair gage of the market because of the interposing of the intermediate firm.[226]

In another proceeding in New York in 1952, an NASD District Business Conduct Committee found that the practice of interposing

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[221] See pt. C.1.b, above.

[222] It is recognized that these wholesale dealers may be indirectly compensated for such services by reciprocal business.

[223] *Arleen W. Hughes,* 27 S.E.C. 629, 636 (1948), aff'd. 174 F. 2d 969 (D.C. Cir. 1949). See also "Restatement of Agency, 2d," sec. 424.

[224] For example, a number of firms have a rule that a quotation be obtained from at least three competing wholesale dealers before any commission order is executed.

[225] The NASD has recently been considering an amendment to its Rules of Fair Practice not yet submitted to its members, which would require that a member selling or buying a security "as agent for a customer shall exercise due diligence to find the best available market for such security; and to execute the transaction in such market." With respect to the proposed rule, the NASD states that it is intended to cover the "problem of failure to seek the best market which is presently dealt with under the general terms of rule 1." The latter rule is a general rule requiring members to "observe high standards of commercial honor and just and equitable principles of trade."

In the hearings on the legislation authorizing this study, the then chairman of the NASD board of governors stated:

"One of your functions in executing [an] order for your customer is to seek out the best market, and then to execute to his best advantage."

Hearings on H.J. Res. 438 (1961) before a subcommittee of the House Committee on Interstate and Foreign Commerce, 87th Cong., 1st sess. (1961), p. 79.

[226] It should be noted that recently the Boston District Committee has dealt with the practice of interpositioning by a letter of caution rather than proceeding by formal complaint. See the discussion of interpositioning in relation to the markup policy in sec. 4, below.

other broker-dealers between the executing firm and the best market was a violation of the Rules of Fair Practice when done without justification, without regard to whether the resulting price to the customer violated the markup policy. The district committee held that the initiating firm has an obligation to obtain the best market for its customer and noted that the interposed dealers were in effect executing riskless transactions for the initiating firm.[227] In this case, the NASD stated:

> The integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed.

As previously indicated, while the common law principle of best execution has been recognized by the NASD, there has been little or no delineation of what it is supposed to mean in practice—for example, in respect of checking of markets or use of interpositioned firms in various circumstances—and little or no enforcement effort with respect to it. The absence of explicit standards and of enforcement effort is reflected in an uneven quality of executions for customers in the over-the-counter markets.

3. COSTS OF EXECUTION

The size of markups (or markdowns) in principal transactions and commissions in agency transactions is not governed by a fixed schedule in the over-the-counter markets.[228] The service charge that a customer pays for an execution of an over-the-counter transaction is related to a diversity of factors including the firm with which he deals, the capacity in which the firm executes the transaction, i.e., on a principal or agency basis, whether the transaction is a purchase or sale, the size of the transaction, and the general relationship of the customer to the firm. This section examines some of these factors affecting the costs of execution paid by the public.

There is a significant range in the size of markups in principal transactions.[229] On the other hand, in agency transactions there tends to be a uniformity in the level of commission rates. Approximately 95 percent of the agency transactions on January 18, 1962, in the stock sample were executed at the applicable NYSE commission rate. The importance of NYSE member firms in handling the public business in the over-the-counter markets and the tendency of such firms to handle over-the-counter transactions on an agency basis points up the fact that the NYSE minimum commission rate schedule has a substantial effect upon pricing in the over-the-counter markets.[230] Indeed its

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[227] In the New York case and in two of the three Boston cases the NASD committees found that the occurrence of the practice was attributable in part to a lack of proper supervision of the activities of the traders in the firm.

[228] Sec. 15A(b)(7) of the Exchange Act prohibits the NASD from imposing "any schedule of prices, or to impose any schedule or fix minimum rates of commission." In the exchange markets commisison rates are fixed by exchange rule. See ch. VI.I. Investment company shares are offered pursuant to selling agreements at fixed public offering prices less selling commissions or loads fixed in such agreements. See ch. XI.

[229] See table VII–25 which shows the ranges of retail and wholesale prices in certain stocks. The variations in prices charged to customers cannot be ascribed to changes in market price. This is more fully discussed in sec. 3.d, below, where it is pointed out that wholesale variations were negligible in the same securities in which retail variations were substantial. See also sec. 4.b, below, and the range of prices in transactions between dealers in chart VII–b.

[230] See ch. VI.I. For a discussion of the importance of NYSE member firms in the over-the-counter markets see pt. B.3, and app. VII–A.

effect also extends to the pricing practices of nonmember firms, since it was found that nonmember firms tended to use the NYSE schedule in agency transactions.

a. Purchases by retail customers

Purchases by customers executed on an agency basis were consistently effected at lower total costs (including commissions) than purchases on a principal basis. In 82 percent of the stocks in the sample traded on January 18, 1962, in which comparisons could be made, the average cost to individual customers of purchases from dealers acting as principal was higher than the cost of purchases on an agency basis.[231] Moreover, agency transactions usually result in a lower cost of execution to a customer than a principal purchase on a net basis, whether the firm sells to the customer out of its inventory or purchases the stock and then sells it to the customer in a riskless transaction. In 80 percent of the securities studied, when an individual public customer purchased shares from a dealer with an inventory which existed prior to the order, the customer paid more on the average than when he purchased through a broker on an agency basis (including commissions).[232] Similarly, the net price to individual customers in principal purchases from firms which had no positions were also more costly than purchases on an agency basis. Of the stocks in the samplei n which both of these types of executions occurred on January 18, 1962, the average price of purchases on a principal basis was higher in 87 percent of the stocks.

In the category of principal transactions, the cost of execution are related to whether the firm does or does not have an inventory in the particular security at the time of the transaction. Principal purchases from firms which had no positions were more costly than principal purchases from firms with inventories. In 69 percent of the securities in which both types of execution for individuals occurred on January 18, 1962, the average cost in principal riskless transactions was higher than in principal purchases from firms with inventories. Of the riskless transactions in the stocks in the 200 stock sample for which comparisons could be made, 10 percent of the markups over contemporaneous cost exceeded 5 percent and one-half were in excess of 4 percent of contemporaneous cost (table VII–20). Although the higher markups appear to have occurred in the smaller dollar transactions, there was a significant percentage of large transactions in which markups of over 4 percent were charged though the dealer was without risk. There appeared to be some tendency for markups to be proportionately higher in riskless transactions for lower priced stocks than for higher priced ones (table VII–21). Moreover, if the riskless transactions had been effected on an agency basis, they would most likely have resulted in net prices to the customer which would have been lower than the net prices actually paid, since it was found that, in almost all of the 325 riskless transactions for which data were available, the public customer paid more than the applicable NYSE commission, in many instances by 2 to 3 times (table VII–22). As

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[231] See app. VII–E. These findings are corroborated by tables VII–19 and 32, which illustrate the lower costs of agency over principal executions for public purchases. Also see table VII–25a.

[232] See app. VII–F. The material in the text comparing prices of execution for firms with and without positions is derived from this appendix.

previously indicated, most transactions on an agency basis were executed at the applicable NYSE commission rate.

b. Sales by retail customers

Unlike the situation as to purchase transactions, there was little, if any, difference in proceeds received by individuals depending upon whether executions by the broker-dealer were on a principal or an agency basis. When individual customers sold securities on a principal basis, they received, on the average, greater proceeds than in agency transactions in 53 percent of the stocks studied.[233] Firms with positions paid, on the average, the highest prices to individual customers. It was found that in 64 percent of the stocks where dealers with inventory purchased from individuals as principal, the individuals received higher average prices than when they sold through firms as agent.[234] However, in the stocks studied, individuals who sold on a principal basis to firms with no inventory received higher prices in 46 percent of the stocks compared to executions on an agency basis.

In sales on a principal basis the service charge or markdown is usually lower than in the case of markups on the purchase side. Where first had an inventory in the security, it was found in a study of the stock sample that frequently purchases were made from customers at the inside bid or wholesale price. In 68 percent of the stocks studied, a dealer with a position paid more to a selling customer than did a firm with no position when each acted as principal. Typically, the dealer without a position "marked down" the security below the bid price of the market maker who simultaneously purchase the security from the riskless dealer; the difference between the price paid by the market maker and the price received by the customer was the riskless dealer's profit. Thus, in sales as well as purchases, executions on a principal basis in riskless transactions were more costly to the customer than those on a principal basis when the broker-dealer had an inventory. However, for firms which did not have an inventory in the security, the level of markdowns was still less than the level of markups (table VII-23).

There are a number of factors which account for the lower costs of execution in connection with customer sales compared to purchases. As industry spokesmen have frequently stated, merchandising or selling is a primary aspect of the over-the-counter retail business.[235] The industry is basically geared to fostering customers' purchases rather than sales, and selling expenses, including salesmen's compensation and research, are the principal costs of doing a retail business. A sale of a security by a customer usually involves less expense than the solicitation of a purchase, and the lower expenses for sales are reflected in lower charges for execution.

A factor of seemingly less importance but which may nevertheless be significant in some transactions is the structure of the NASD retail quotations system. As described more fully below, that system publishes in the newspapers "inside" or wholesale bid prices and marked-up asked prices for quoted securities.[236] The publication of the inside

[233] See app. VII-E.
[234] See app. VII-F.
[235] See ch. III.B.2.
[236] See sec. 4.a, below.

bid price may limit the dealer's ability to markdown below that price for sales on a principal basis.[237]

c. Institutional transactions

The costs of execution for the institutional investor hinge on fewer variables than the costs for the individual customer. As sophisticated investors, institutions "shop around," negotiate and execute in the same manner as other professionals.[238] As described earlier, institutions generally deal on a principal basis with the wholesale dealer making a primary market in a security. Most institutions have their own trading departments or use the trading department of a bank or an investment adviser to execute portfolio transactions. The institution can deal on a net basis with the market maker and purchase or sell at inside prices without being subject to the minimum commission charge which would be the case if the transaction were executed on an exchange.[239]

The different bargaining position of institutional investors and their different methods of executing transactions are reflected in an analysis of institutional transactions on January 18, 1962, in the stock sample where price comparisons could be made.[240] In 80 percent of the stocks studied, the average prices of institutional purchases on a principal basis from dealers were less than the average prices of agency executions. For individual customers, as described above, it was found that precisely the reverse was true—agency executions were cheaper than principal executions. With respect to institutional sales transactions it was found that in 75 percent of the stocks studied, institutions received higher prices when the dealer acted as principal than as agent.

d. Effects of differences in costs of execution

The range in prices between public purchases and sales in the over-the-counter markets breaks down into two components: the wholesale dealer's spread and the service charge for executing the order.[241] In the over-the-counter markets a wholesale dealer participates in almost every transaction and is compensated for his services by the spread or "jobber's turn."[242] For many securities which are inactively traded, particularly those which are low priced, the spread in the interdealer wholesale market may be considerable.[243] Wholesale

[237] Possibly another factor accounting for lower costs of execution on sales is the NASD markup policy. If the customer reinvests the proceeds of a sale in another security purchased from the same broker-dealer, under the NASD markup policy the profit or commission of the broker-dealer on the sale will be included in determining the reasonableness of the markup on the purchase. See the discussion of the markup policy in sec. 4.b, below.

[238] See ch. VIII.C and sec. 2.a(2), above. In this connection, some wholesale dealers may accord better terms to institutions than to other dealers. One NASD district secretary testified on this point as follows:

"* * * [W]e have had, over the years, several complaints about [Dealer X], because they will sell * * * stock, they claim, to a bank cheaper than they will sell it to a dealer and the dealers think this is unfair, that someone who is not a dealer can buy less than the wholesale."

[239] As pointed out in chs. VI.I and VIII, because of the lack of a volume discount on the commission rate structure, the large transactions in which institutions tend to engage are particularly susceptible to betterment of terms in a principal transaction on a net basis.

[240] See apps. VII–E, VII–F, and VII–G; and tables VII–18 and VII–32. In sec. 2.b., above, there is a comparison of the executions of institutions with those for individuals.

[241] Tables VII–25 and VII–25a show the range of wholesale prices and retail prices on both a principal and agency basis for the 200-stock sample. Tables VII–26, VII–27, VII–28, and VII–29 show the percent spread between average prices of all purchases and sales by individuals in stocks in the sample on a principal basis according to dollar volume, share volume, the price of the security, and number of dealers quoting a two-way market.

[242] See the discussion of specialist participation in the exchange markets in ch. VI.D.6.d.

[243] See table VII–3.

dealer participation in almost every over-the-counter transaction results from the fact that there is no mechanism for the collection, matching and execution of public orders on a central trading floor.

The other factor contributing to the total difference in the prices at which public purchases and sales occur is the service charge for the execution, whether taking the form of a markup, markdown, or commission. For individual public customers, the differences in costs of execution in over-the-counter transactions are reflected in relatively wide ranges in net prices paid (including markups or commissions) and net proceeds realized (deducting markdowns or commissions) in the same security even in a stable market situation. Customers placing similar orders for the same security under similar interdealer market conditions but through different firms may have significantly different costs of execution. This is particularly true on the purchase side. These ranges are depicted in chart VII-b.

In order to show the effects of diversity of costs of execution upon price ranges, only stocks with narrow interdealer price ranges were selected for chart VII–b. Stocks with large interdealer ranges were not chosen because the large range would indicate either a comparatively wide wholesale spread or considerable price movement in the stock during the day, or both, and part of the variation in prices of individuals' transactions could be attributed to these factors rather than differences in costs of execution.[244]

For example, the middle column on the chart for Bank of America stock (which represents the range of prices of all purchases by broker-dealers from market makers and sales by broker-dealers to market makers) shows a narrow dealer market on January 18, 1962. No dealer purchased Bank of America stock for less than 60⅝ and no dealer sold that security to another dealer for a price higher than 61⅝ (excluding transactions of less than $500).[245] This price spread includes both the interdealer spread (the wholesale dealer's profit) and market fluctuations in the price of the security during the day. The quotations reported in the sheets of January 18 for Bank of America stock ranged from a low bid of 60½ to a high offer of 61¼, roughly approximating the maximum range of the interdealer market. Most transactions by dealers with other dealers are concentrated in the center of the middle column. The wholesale quotations and transactions for Bank of America stock reflect a competitive dealer market in an active over-the-counter security.

Despite the narrow dealer market, individual customers on the same day purchased Bank of America stock at prices (including commissions in agency transactions) from 61 to 64⅛ (see right-hand column of chart) with the highest prices being paid by customers in principal riskless transactions. The relatively wide range in prices paid by customers purchasing Bank of America stock indicates primarily varied commissions or markups charged by broker-dealers, not a changing inside market, in view of the narrow range of inside prices during the day.

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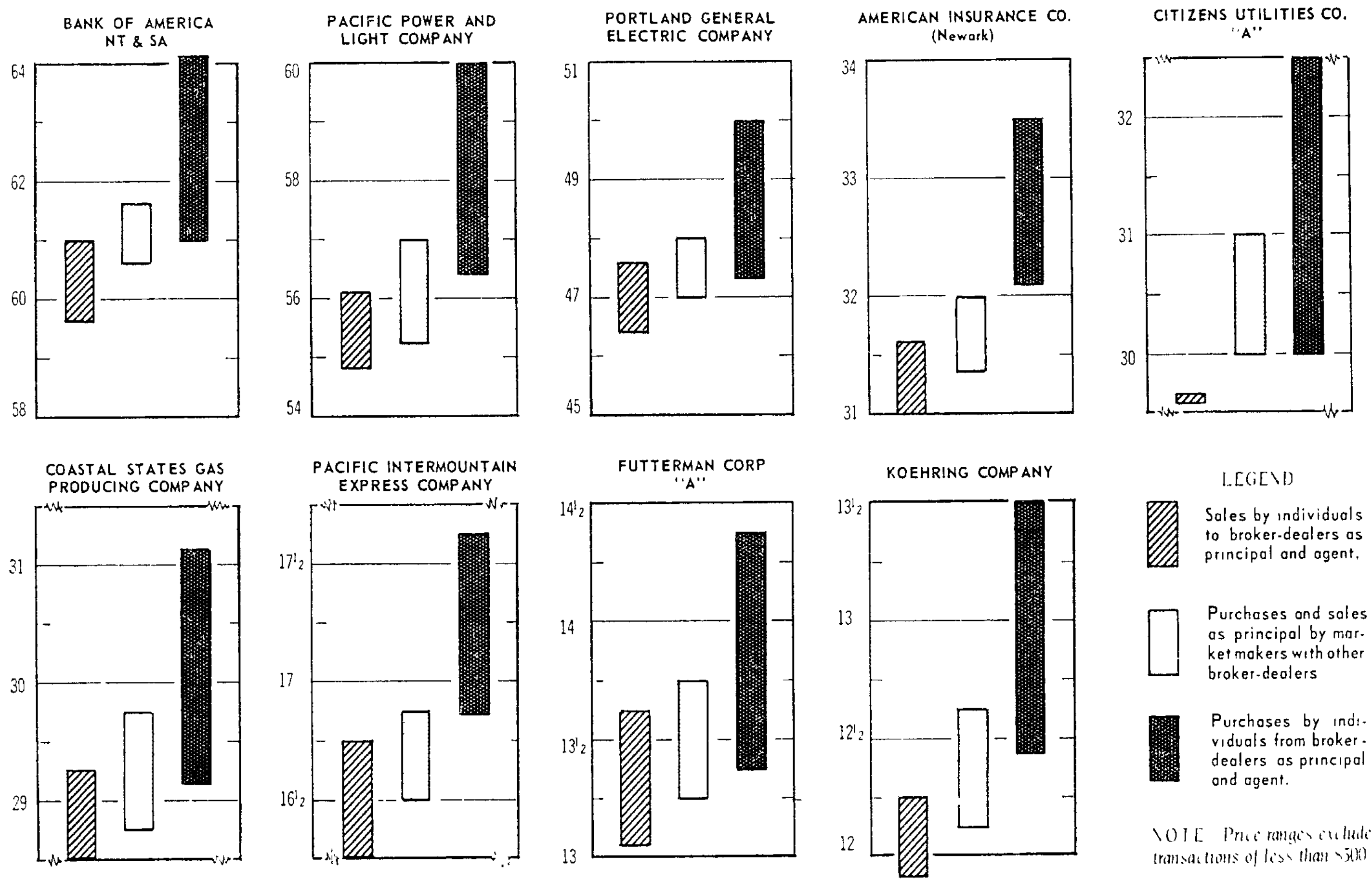
[244] Eight of the 9 securities on chart VII–b were among the most active in the 200 stock sample. There is a tendency for active stocks to have a wider range of costs of execution than those which are less active. See tables VII–25 and VII–25a.

[245] Small transactions were excluded to prevent distortion of the price ranges. If transactions of less than $500 were included, the range of prices would have been greater.

Chart VII-b

RANGE OF PRICES OF OVER-THE-COUNTER TRANSACTIONS BY INDIVIDUALS AND BY BROKER-DEALERS

Selected Stocks, January 18, 1962



The remaining eight examples on the chart demonstrate a similar pattern. In each case, the range of individuals' purchases is considerably greater than the interdealer range, indicating the diversity in the costs of execution for customers depending upon the broker-dealer handling the transaction, the capacity in which he acts and his manner of execution.

If a firm handles a transaction on a riskless basis, the costs of execution are usually substantially greater than if a firm executes on an agency basis.[246] For example, in each of the nine stocks shown on chart VII–b, the highest purchase price was paid by individual customers whose broker-dealers executed on a riskless basis. Agency executions were generally within narrow ranges and below the higher costs of principal transactions.[247]

The chart also shows for each stock the total range between purchases and sales. The range of prices in the left-hand column, representing the proceeds of sales received by customers (after deducting commissions in agency transactions), is not as great as the range of purchases.[248] The total range, however, is substantial.[249] For example, in Bank of America stock the range between the highest price at which individuals bought and the lowest price at which they sold was $4.50. Since the maximum wholesale market spread (for transactions over $500) was $1 (including dealer spread and price fluctuations), it is evident that most of the public individual range was due to diversities in costs of execution, particularly on the purchase side.

4. PRESENT DISCLOSURES AND OTHER PROTECTIONS FOR INVESTORS IN THE OVER-THE-COUNTER MARKETS

a. Retail quotation system

(1) *Operation of the system*

As noted earlier, wholesale quotations generally are not available to members of the public.[250] Retail quotations, on the other hand, are designed for public dissemination principally through newspapers.

Retail quotations do not represent specific dealer interests in doing business, as do wholesale quotations, nor a range within which business has been done, as do published stock exchange prices. They are described as representing only the approximate range within which a public customer could have bought or sold at the time the underlying wholesale quotations were submitted.

Apart from their different purposes, there are three key differences between retail and wholesale quotation systems: Whereas the wholesale system contains insertions on thousands of securities that may change from day to day and do change considerably over longer periods, the retail system covers smaller and more permanent lists of securities. Of the 8,200 stock issues quoted in the sheets, only about 3,000 are quoted at the retail level. (For securities not on a

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[246] An increase in volume does not decrease the incidence of riskless transactions (table VII–30).
[247] See apps. VII–E, VII–F, and VII–G, and table VII–25a.
[248] Markdowns and commissions on sales are usually less than markups on purchases in over-the-counter transactions. See sec. 3.b, above.
[249] See table VII–24.
[250] See pt. C.3, above.

list, or on a list but not published by a readily available newspaper, an interested public customer can obtain a retail quotation only from a broker-dealer.) Secondly, while for a single security there may be any number of dealer-identified wholesale quotations, in retail quotation systems each security has but a single entry which is not identified with any dealer.[251] Lastly, whereas wholesale quotations are disseminated by an unregulated private corporation, the principal retail quotation system is run directly by the NASD.

The NASD retail quotation system produces the various lists of securities which appear in the vast majority of the newspapers that publish over-the-counter quotations.[252] Daily lists include a national, four regional, and supplementary local lists. There are also certain weekly lists. The national list contains about 600 stocks and the eastern regional list contains about 500 stocks;[253] the other three regional lists together contain about 500 stocks. At the time of the writing of this report, the Wall Street Journal—one of the papers which prints a large number of over-the-counter quotations—had recently merged the daily lists into a single national list containing over 1,400 stocks. Some of the following discussion of retail quotation systems relates to the structure existing prior to this development and as it continues to exist with respect to other newspapers.

For inclusion on the national, regional, and weekly lists, the NASD has imposed minimum requirements of number and distribution of shareholders, number and value of shares outstanding, market price of the security, and "sufficient dealer interest to assure a realistic market" in the security;[254] the precise minimum requirements are shown in the table on the next page.[255] Furthermore, the national and regional lists require that dividend declarations be published at least 1 week prior to the record date and that certified financial statements be furnished at least once a year to stockholders and the NASD.[256] In September 1962, a requirement was added that companies on the national and regional lists disclose promptly to the public all corporate developments "which may affect the value of the company's securities or influence investors' decisions."

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[251] See the discussion of the activities and effect of the NASD's local committees below.

[252] The NASD does not furnish the dividend and similar information (except to indicate when a stock is ex-dividend), such as appears in exchange quotations in newspapers. Newspapers which do print certain information of this nature obtain it on their own.

[253] The national list also contains about 200 mutual funds, 80 public authority and corporate bonds, and 50 foreign securities.

[254] The appearance in the sheets of dealers without a bona fide trading interest may not form the basis for a "realistic market." In a number of situations dealers have inserted listings in the sheets upon the request of firms seeking to qualify a security for inclusion on an NASD list. In this connection, the chairman of the NASD National Quotations Committee stated:

"I would like to say as a footnote to what I said before that when we were operating as District 12 before we would qualify a security for listing one of the standards was that there was a legitimate dealer interest, four or five people making a market, and that there were enough of us sitting around a table to realize that, although five people appeared in the sheets, there was great interconnection and that only one had the primary market. In a number of cases we turned down applications of situations such as that." See pt. C.3, above, and sec. 5 below.

[255] By comparison, the NYSE (as of the end of 1962) requires a minimum of 500,000 shares broadly distributed among about 1,500 holders with 100 or more shares each, and the Amex (as of the same date) requires 200,000 shares broadly distributed among 750 holders, 500 of whom must have 100 or more shares each. Both exchanges also have requirements concerning market value of securities, earnings history, and assets. See ch. VIII.B.

[256] The eastern list also requires a minimum seasoning period of 3 months for all regulation A filings. For the midwest list, issuers must publish dividend declarations at least 10 days in advance.

TABLE VII-e.—*Minimum requirements for listing over-the-counter stocks in national and various regional quotation lists*

Minimum requirements	Quotation list						
	National	Eastern	Midwest	Southwest	Pacific coast	National weekly	Regional weeklies
Number of stockholders.	1,500 total, and 500 in each of 2 of the 4 regions.[1]	500 in region	300 in region	200 in region	300 in region	100 in each of 2 of the 4 regions.[1]	100 in region.
Number of shares	200,000 in general public's hands (or at least 2,000 holders nationally).		100,000, or 50 percent of stock outstanding, in public hands.				
Total market value of stock outstanding.		$500,000 in public hands.		$500,000 in public hands.	$500,000 in public hands.		
Share value in order to list.	$5	$5	$5	$5	$5	$2	$2
Bid price to maintain listing.	$3	$3	$3	$2	$3	$1	$1
Dealer interest	"Sufficient dealer interest to assure a realistic market."	Same standard as National.[2]	Same standard as National.	Same standard as National.	Same standard as National.[2]	Sufficient dealer interest, shown in eastern sheets.	Sufficient dealer interest, shown in regional sheets.

[1] At least for inclusion in the new combined national list as published in the Wall Street Journal, an issue must be in the hands of about 1,000 stockholders for inclusion in the daily list, and about 400 holders for the weekly list.

[2] To maintain listing there must be at least 2 regional dealers quoting bid and asked daily in the sheets.

Retail quotations are compiled and supplied to newspapers by or under the supervision of NASD quotations committees. The national list is the responsibility of the National Quotations Committee,[257] and the regional lists are under 4 of the 13 district quotations committees. There are also about 65 local quotations committees, in market centers in each of the NASD districts. In general, the committees use the following procedure: The first step is to obtain wholesale bid and asked quotations from one designated dealer for each security on the particular list; there is no practice of obtaining quotations from several dealers for purposes of comparison or selection. The dealer supplying the quotation always knows the purpose for which it is to be used. The dealers are selected with a view toward equalizing the burden of supplying quotations. Although some attempt is made to use as sources those dealers making a market in the particular security, quotations may be supplied by dealers who are not making a market at all. In these last cases, the supplying dealer obtains the quotation from another dealer.

The national and eastern lists are compiled in New York, the mechanics and computations being performed for the NASD by the National Quotation Bureau, which has a separate department for this purpose. The Bureau collects dealer quotations twice a day by messenger; in most other cities, quotations are collected by telephone. After the wholesale quotation is received, it is used as the basis for computing the retail quotation. This computation and attendant problems are discussed below.

The NASD then supplies the retail quotations to newspapers and wire services. The national and regional lists appear only in the New York Times and Wall Street Journal and their regional editions, and a few other New York newspapers. The NASD has considered replacing the one national and several regional lists with a single expanded national list as has already been done by the Wall Street Journal. In the few other cities that have an NASD committee compiling a regional list, the local newspapers carry most of the issues on such list and may also carry quotations on more local issues. For all the other newspapers throughout the country which carry over-the-counter quotations, the NASD local committees supply the quotations on all industrial securities. Quotations on banks, insurance companies, and mutual funds are usually obtained from the Associated Press; but the Associated Press carries no quotations on industrials, and the United Press International's over-the-counter coverage is even more restricted. The NASD has recently been conducting discussions with the Associated Press concerning possible expansion of its coverage.

The NASD's local committees do not confine themselves to quoting securities that appear on the NASD national or regional lists; ordinarily they furnish quotations on many securities actively traded in the area. Each local committee collects quotations from dealers in its area, even for those securities which it quotes that are carried on the national or regional lists. Members of the local committee may submit quotations for any securities in which they make markets, but the acceptance of such quotations usually is determined by the local committee. In some cases, the full local committee may consist of

[257] The National Committee has a paid staff of five whose function consists almost entirely of administering the national and eastern lists. See also the discussion of the National Committee in ch. XII.G.

only one or two members, usually those dealers most interested in the publication of quotations. Each local committee, though appointed by the district committee, itself decides which securities to quote and how to operate. Standards vary widely, and there is little supervision over the local committees.

Various committees of the NASD quote approximately 1,000 issues which do not appear on the national or any regional list. Although the NASD's policy is to quote both bid and asked prices in the national and regional lists, quotations provided by local committees are frequently on the bid side only.

One of the major concerns of the NASD has been that some newspapers carrying retail quotations of over-the-counter securities receive them directly from individual dealers rather than from an NASD committee.[258] As a result of the efforts of the NASD, this practice has diminished substantially. Local committees are often formed, at the suggestion of an NASD district committee chairman, by a dealer who has been submitting his own quotations to a newspaper. Probably fewer than 40 newspapers throughout the country now receive quotations independently of the NASD.

The NASD opposes and discourages the independent submission of quotations because it feels that the dealer furnishing the quotations and having a byline attributing them to him gets an unfair competitive advantage over other dealers. Moreover, it is argued that the practice may cause confusion among investors, for quotations furnished by different dealers may vary. In Hartford, Conn., for example, two different newspapers accept quotations from individual dealers and the prices for the same security sometimes vary between them as well as varying from quotations on NASD lists. It is also argued that there may be no standards of selection of securities quoted independently. Lastly, according to the NASD's executive director, in some of the cities where local committees were established there formerly had been publication of wholesale quotations.

The NASD has recently considered adopting a rule which would restrict the publishing or circulating of retail quotations by members without prior clearance by an NASD quotation committee.

(2) *Nature of retail quotations*

The retail bid price involves no computation: it is supposed to be simply the wholesale bid.[259] The retail asked price is found by adding to the submitted wholesale asked price an amount determined from a suggested but not uniformly applied NASD schedule called the Rule of Thumb.[260] In brief, stocks with wholesale asked prices up to $25 a share are converted to retail asked prices by adding about 5 percent to the wholesale asked price; those selling between $25 and $70 are increased by a markup ranging from 5 to 3.6 percent; those selling between $70 and $100 are increased by a scale ranging from 3.6 to 2.5 percent; those selling between $100 and $135 are increased by a

[258] The NASD's Statement of Policy on quotations is: "The Board of Governors believes that the interests of the investing public and the securities business can best be served when published quotations are supervised by NASD Quotation Committees. * * * The supervision of quotations representing the over-the-counter market is properly an industry obligation and responsibility. *The Board of Governors urges all members to assist in this important work by releasing quotations for publication only through an NASD Committee.*" [Emphasis in original.] NASD Manual, G–53.

[259] A few local committees reduce the wholesale bid to arrive at a retail price.

[260] The Rule of Thumb schedule was last revised in October 1962. For stocks priced above $25, the old schedule provided slightly higher markups.