

scale ranging from 2.5 to 2 percent; and those with a wholesale asked price at \$135 and higher are increased by approximately 2 percent. In summary, the published retail bid price of a security is the inside bid price supplied by one designated dealer, and the published retail "asked" price is the inside asked price supplied by that dealer, increased by an amount related to the NASD markup policy.<sup>261</sup>

In some newspapers, the quotations appear under this masthead suggested by the NASD:

The following bid and asked quotations,<sup>262</sup> from the National Association of Securities Dealers, Inc., do not represent actual transactions. They are a guide to the range within which these securities could have been sold (indicated by the "bid") or bought (indicated by the "asked") at the time of compilation.

The NASD states that, to the public, NASD quotations mean "objective, accurate retail price ranges within which members of the public could have expected to do business at the time the prices were recorded."<sup>263</sup> To insure accuracy, clerical employees check insertions in the national and eastern lists to see whether the quotations vary substantially from the preceding day's quotations, and a member of the National Committee's staff spends part of his time checking on the dealers submitting the quotations by comparing the newspaper bid against the best "pink sheet" bid, at the rate of about 50 issues every day. Thus, every issue is checked about once a month. If the newspaper bid is lower than the best "pink sheet" bid, subsequent days' insertions are watched and the dealer is warned; if the low newspaper bids continue, the source of that quotation is changed.<sup>264</sup> A change of source may occur as a result either of the periodic check or of complaints which prove valid. In 1962, there were about four changes of source, three of which were attributed by the NASD to the uncertainty caused by the May "market break."

The NASD, besides taking a position on the meaning of retail quotations "to the public," states this as their meaning "to the business":

*Retail* quotations designed (1) to give recognition to the fundamental fact that the over-the-counter market is a negotiation market, and (2) to assist retail dealers in *selling* securities as principal. [Emphasis in original.]<sup>265</sup>

Since the meaning for the public is stated to be not only accuracy but also objectivity, the question arises whether retail quotations "designed \* \* \* to assist retail dealers in selling \* \* \* as principal" can be "objective." As described earlier, the published retail asked prices include a spread over the wholesale asked price, consisting in whole or in part of an unrevealed markup.

In order to determine whether retail quotations provide an accurate guide for retail price ranges, the study analyzed and compared the information in the published retail quotations, the sheets, and the actual trading for randomly selected stocks on a single day. This examina-

<sup>261</sup> The markup policy itself is discussed in sec. b, below.

<sup>262</sup> The Wall Street Journal's masthead over the new combined national list speaks of "prices" rather than "quotations."

<sup>263</sup> NASD Manual, G-53.

<sup>264</sup> The same procedure applies to newspaper quotations that are higher than bids in the sheets.

In a recently undertaken operation to check on quotations in NASD District No. 10, the NASD staff found that in approximately 5 months, in every case in which a quotation in the sheets differed from that supplied to the NASD for publication, the lower bid quotation was that given to the NASD.

Similar checking procedures have been followed by some local committees.

<sup>265</sup> NASD Manual, G-53.

tion also provided data for determining the accuracy with which retail quotations represent underlying wholesale market prices, and revealed the range within which public transactions in fact take place.

Table VII-31 summarizes information comparing wholesale and retail quotations for 73 securities appearing on the NASD national list in the Wall Street Journal on January 19, 1962. These 73 securities are all that appear in the national list, of the 200 randomly selected securities (excluding the exchange-listed ones) for Questionnaire OTC-3. The retail quotations were prepared on January 18, 1962, and represented quotations for that day.

As the table's columns 1 and 4 indicate, the inside bid submitted by the designated dealers to the NASD was reported without adjustment in the newspapers as the retail bid for all 73 securities. The inside asked price, or, offer, generally was then increased pursuant to the NASD's Rule of Thumb. Thus, securities with the same inside offer were marked up identical amounts; the amount of the markup may be seen by comparing columns 2 and 5.

To determine the accuracy with which the retail quotations represent the underlying wholesale markets, the retail quotations published on January 19 are measured against the wholesale quotations which were collected at roughly the same times and which appeared in the sheets received by dealers on the morning of January 19. For this purpose, the NASD Rule of Thumb markup is added to the inside offer of each dealer appearing in the sheets. The results appear in the last four columns of the table. These results show that in many cases the published quotation was not as good—from the public customer's point of view—as one or more quotations appearing in the sheets so adjusted. It must be recognized, however, that the different quotations may have been submitted at different times by the different dealers involved.

On the bid side, for 46, or over 60 percent of the securities, the wholesale bid of at least 1 dealer appearing in the sheets was higher than the retail bid appearing in the newspaper. In 20 of the securities, 5 or more dealers were appearing in the sheets with higher bids.

On the offer side, in 38, or about one-half of the securities, at least 1 dealer appearing in the sheets had a lower adjusted offer than the published retail offer. In a few securities, including Bank of America and Boston Capital Corp., virtually all of the dealers appearing in the sheets had a lower adjusted offer than the retail offer.

In 26 of the securities, the *median* bid of all dealers who quoted a particular stock in the sheets was higher than the bid which was given to the NASD for inclusion in the newspapers; and in 20 of the securities the *median* adjusted offer was lower than that which appeared in the newspapers.

Moreover, for 20 securities, or 27 percent of the sample, the dealers who supplied quotations to the NASD did not even appear as market makers on January 18 in the sheets.

This analysis tends to indicate that the foundation of the retail system—the wholesale quotations supplied by designated dealers—is often something less than the best and in a significant number of instances is not as good as the median adjusted market quoted by other wholesale dealers in the sheets.

As shown by column 3, the retail quotations themselves generally contained a spread of from 7 to 10 percent, with some considerably

higher. To determine the extent to which public transactions actually occurred within the range of retail quotations, the actual prices paid by the public on January 18 (as determined through Questionnaire OTC-3) are compared, in table VII-32, with the retail quotations applicable to that day. Dealers, as principals, made 390 sales to the public on that day, in 54 of the 78 securities from the Questionnaire OTC-3 sample which were quoted on a retail basis. Of these sales, 73.8 percent occurred within the spread between the retail bid and asked, 10.3 percent occurred at the retail asked, and 15.9 percent occurred at prices higher than the retail asked. On the same day, customers sold to dealers, as principals, in 177 transactions in 45 such securities. In 52.5 percent of these transactions, customers sold for less than the retail bid, in 22.6 percent of the transactions they received the retail bid, and in 24.9 percent of the transactions they received something between the bid and asked.

A further analysis was made of public transactions consummated on an agency basis, and these were compared to the retail quotations. In this analysis, the commission for purchases was added and the commission for sales subtracted. Customers purchased stock on an agency basis in 382 transactions involving 55 securities. Of these purchase transactions, 2.9 percent were effected at more than the retail offer, 0.3 percent at the retail offer, and 96.8 percent within the retail spread; as noted above, the respective percentages for transactions on a principal basis were 15.9, 10.3, and 73.8. Customers sold stock on an agency basis in 464 transactions involving 65 securities. Of these transactions, 26.7 percent were effected within the retail spread, 9.7 percent at the retail bid, and 63.6 percent at less than the retail bid. For sales on a principal basis, as noted above, the respective percentages were 24.9, 22.6, and 52.5. In short, a significant proportion of the public's sales were not effected within the spread.

As a result of the way the retail system is constructed, a majority of the public's sales, whether on a principal or agency basis, were at net prices below the published retail bid. This is accounted for by the fact that the bid is not adjusted from the wholesale bid, and that many dealers charge a commission or markdown resulting in a price to a customer lower than the inside or wholesale bid. The majority of public purchase transactions—including markups and commissions—occurred within the published price range. This is accounted for by the fact that the wholesale offer is adjusted prior to publication. However, though a majority of the public's purchases did occur within the range, over 25 percent of the purchases on a principal basis were at the range's upper limit or even above it.<sup>266</sup>

The study's analysis, as reflected in the preceding pages, at least raises grave doubts about the NASD's retail quotations as a reliable reflection of the underlying wholesale markets and as an accurate indication of the range within which the securities could be bought or sold.

### (3) *Background of the system*

Several themes have run consistently through the evolution of the present system. These involve the question whether the published quotations should be any different from the inside quotations; if there should be separate retail quotations, how they should be computed and

<sup>266</sup> See sec. 3.d, above, for a discussion of relative prices of principal and agency transactions and app. VII-E, VII-F, and VII-G.

whether their computation should be uniform; and how the separate retail quotations should be described in the masthead under which they appear.

Prior to the organization of the NASD, retail quotations were supplied to local newspapers from many different sources—some from local dealer groups and others from individual dealers; in some cases, a single newspaper was getting quotations from six to eight different sources at the same time. Methods for computing retail quotations, the securities quoted and the sources of quotations varied from locality to locality depending upon local interest in the security, the relationships between firms and local newspapers, competition among dealers, and other factors.

The 1938 legislative history of the Maloney Act indicates the discontent with existing methods for assembling, computing, and disseminating retail quotations, and as a result of that as well as for other reasons, the Commission was given general power over all broker-dealers in connection with the prevention of fictitious quotations.<sup>267</sup>

After its registration with the Commission, the NASD, in response to a Commission suggestion that it take over the gathering and distributing of retail quotations, set up its National Quotations Committee and the quotations committees in each of the NASD districts.<sup>268</sup> The NASD made considerable progress in replacing individual dealer bylines with bylines noting the NASD as the source of the quotations. But great diversity continued in sources actually used, in methods of computation, and in securities quoted.

Until the establishment of the national and regional lists in 1956, retail quotations continued as quotations on securities of local interest, supplied wholly by NASD local committees. At the outset an attempt at uniformity was made, in the proposal to have the National Quotations Committee, operating from New York City, supply quotations for securities of national interest. Dealers elsewhere and especially those in less populous areas, who had asserted that they had higher costs of doing business, objected to the proposal apparently because the National Committee's quotations might be based upon the narrower spreads of the high volume, low-cost New York firms. On the other hand, the latter groups apparently would have been satisfied with, or desirous of, narrow retail spreads more nearly approximating the wholesale market. Since that date the proponents of eliminating separate retail quotations have made little progress.

In 1941 (it should be noted that the NASD's general "markup" policy was still some 2 years in the future) the National Quotations Committee, seeking greater uniformity in computation, wrote to the district quotations committees requesting that a standard method be used. Each security was to be assigned a spread by the committee quoting it, based upon local market conditions, activity, type, and size of issue, price, and other pertinent attributes. The request continued:

In computing the published bid price of a security two or more of the best actual bids shall be taken into consideration. The bid price to be published shall not be less than the actual bids by more than the equivalent of a nominal selling commission.

The published asked price shall be determined by adding to the price determined, pursuant to the above, the spread which has previously been assigned

<sup>267</sup> See note 101, p. 573 in pt. C.

<sup>268</sup> These committees are briefly described in subsec. (1), above.

to the security by the Quotations Committee. This published asked price shall indicate a reasonable margin above the published bid price so as to afford retail dealers, exercising reasonable intelligence and skill in the purchase of such security, a fair and justifiable profit on the sale thereof.

Although some variations continued, the retail bid price used thereafter was usually a bid supplied by a single designated dealer, or such a bid reduced by an amount ranging from one-eighth to one-half of a point. Almost without exception, however, the retail asked price was computed by adding a predetermined spread to the retail bid price. The spread was left to the discretion of each committee. Moreover, the lack of coordination among the local committees sometimes resulted in overlapping quotations in securities of national interest; i.e., the bid published in one district might exceed the offering price in another district.

From time to time the Commission received complaints about published over-the-counter quotations, and in 1943 the staff was directed to study and report on the propriety of quotations published by the NASD, and more particularly on the methods used to compile such quotations, to determine whether they were "fictitious" within the meaning of section 15(c)(2) of the Exchange Act.<sup>269</sup>

After the actual practices had been surveyed, a conference was held between members of the Commission staff and officials of the NASD. A staff suggestion that wholesale or inside quotations be published was rejected by the NASD representatives. The chairman of the National Quotations Committee argued that the practice of spreading quotations was necessary so that the retailer could make a profit. He stated that no retail business could survive if wholesale market prices were publicized and he saw no reason why the securities industry should be the only industry forced to make any such disclosure. The NASD offered four alternatives: (1) continue without any change, (2) continue the existing system, with the spreads watched for consistency with the NASD's newly adopted markup policy and interpretation, (3) quote bid prices only, or (4) abandon entirely all quotation activity.<sup>270</sup>

A few months after this conference, the Commission had an opportunity to speak on the existing NASD retail quotation system in an NASD member's appeal to the Commission from an NASD disciplinary proceeding involving, among other things, violations of the markup policy. The case concerned the Boston firm of Sherman Gleason & Co.<sup>271</sup>

Gleason, replying to the charge that he took excessive profits, stated that his prices to customers were at or below the retail asked prices appearing in the Boston newspapers and that he had "always proceeded on the assumption that the newspaper quotations represented a fair price to the public, especially since it was my understanding that such quotations were subject to the approval and/or disapproval of the NASD, SEC, and the Boston Securities Traders Association." Gleason had been charging markups of as much as 25.7 percent in "riskless" transactions.

<sup>269</sup> At approximately the same time, the Commission's proposed rule 15c1-10 was under consideration, leading to the NASD's adoption of its markup policy. These matters were, of course, closely related to that of quotations. See sec. b, below.

<sup>270</sup> The NASD representatives indicated that while there might be some merit in quoting bids only, the industry probably would be slow to accept it; and that abandoning the field would be unwise in view of the situation before the NASD had come on the scene.

<sup>271</sup> *Sherman Gleason & Co.*, 15 S.E.C. 639 (1944).

In the Boston district the newspaper quotations were computed under supervision of the NASD and in conformity with the National Committee's 1941 letter: Each day a bid was obtained from a designated dealer for each security, and then "dropped" by one-eighth or one-fourth to give the bid price for publication. A spread was added to the published bid price to obtain the published asked price. Some other variants were used but, as the Commission found, the drops and spreads were arbitrary and were changed infrequently. In its opinion, the Commission noted that a local NASD official had testified in the disciplinary proceeding that the purpose of the spreads was to permit dealers to make a "fair profit in the sale of a security to a customer." On the other hand, the chairman of the district quotations committee had testified that the retail quotations represented a "range within which one could expect to buy or sell securities" but denied that the spreads represented a fair and reasonable profit in a transaction.<sup>272</sup>

The Commission described the quotations as not reflecting either actual transactions or bona fide expressions of trading interest. The Commission also concluded that the masthead which appeared over the published quotations was inadequate, in that the public was not told that the quotations represented neither reports of transactions nor bona fide bids and offers.<sup>273</sup> The masthead also implied that inaccuracies in the quotations resulted from market movements, whereas in fact they resulted from the manner of compilation. The Commission added by way of dictum:

In fact, we have grave doubts if any statement in the masthead or elsewhere can cure the basically misleading character of these quotations. After careful consideration of the method of their compilation, we are at a loss to say what they represent affirmatively; \* \* \*.<sup>274</sup>

The Commission went on to hold that Gleason effected transactions at unreasonable markups, for in acquiring securities on the same day as his sales, he could hardly plead ignorance of the actual prevailing market and of the misleading nature of the newspaper quotations.<sup>275</sup>

One month after the *Gleason* decision,<sup>276</sup> the Director of the Division of Trading and Exchanges wrote the NASD:

The Commission has instructed me to inform you that, in its opinion, the [retail] quotations in question are "fictitious" within the meaning of that phrase as used in section 15(c) (2) of the act. This opinion is based on the finding that

<sup>272</sup> 15 S.E.C., at 653.

<sup>273</sup> The masthead read:

"Approximate prices compiled under the supervision of the Boston Securities Traders' Association and National Association of Securities Dealers and may have been higher or lower during the day."

The masthead had been changed to this wording in the summer of 1941 because its predecessor, which had stated that the quotations "should fairly reflect the actual market," was thought to be misleading. Earlier in 1941, the Commission staff had questioned the use of mastheads which indicated merely that the quotations were approximate prices, and the NASD proposed this text:

"Approximate quotations furnished by NASD indicating limits between which transactions can probably be effected."

It appears that while some newspapers did use this text, others refused to do so and the NASD had no power to compel them.

<sup>274</sup> 15 S.E.C., at 653.

<sup>275</sup> It should be noted that the *Gleason* decision related directly to unreasonable markups and only collaterally to the character of the quotation system. It was the wide spreads in the published retail quotations—some as wide as 60 percent of the bid price—which permitted Gleason to charge excessive markups. NASD supervision of retail quotations and enforcement of the markup policy have served to narrow retail spreads.

<sup>276</sup> Just before this, a new chairman of the National Quotations Committee took office and, as recorded in a contemporaneous Commission staff memorandum, advised the staff that the small dealer needed a spread and that the amount of that spread could not be disclosed to the customer because the customer could not be made to understand the necessity for the spread.

the published asked prices and in many instances, the published bid prices, appear to be established by an arbitrary system which does not permit, and it is not intended to permit, an accurate reflection of the true prices at which dealers stand ready and willing to buy or sell the securities quoted. In particular, it appears that the published bid is usually either a bid supplied by a dealer designated for that purpose \* \* \* and that the published offering price, instead of being a bona fide offer in the market, is arrived at by adding an arbitrary, predetermined spread to the published bid.

The letter noted, on the basis of the record in the *Gleason* case, that the system sometimes results in publication of an asked price so far out of line with the actual market that any sale by an NASD member at that price would result in a violation of the markup policy. The letter continued:

The Commission is unwilling to accept as final the position that the association will not sponsor the publication of quotations which the association collects from its members unless those quotations can be adjusted before publication. It appears to the Commission that, if the over-the-counter markets are to deserve the confidence of American investors, the quotation of over-the-counter securities appearing in our daily newspapers should be accurate and collected and reported under conditions which will justify confidence in them. In sponsoring the legislation under which the NASD has acquired its status, the Commission had in mind that such an association should endeavor to safeguard investors who deal in the over-the-counter market. The Commission would view with extreme disappointment any failure of the association to promote the objectives of the statute, particularly if such failure were due not to its inability, but to its unwillingness, to serve.

The NASD took the position that the Commission's objections would be satisfied if the NASD's fixing of the arbitrary spreads were eliminated and dealers, acting individually, were to set the prices at which they believed retail trades actually would occur.<sup>277</sup> In October 1944, the NASD board of governors approved the conclusions of the National Quotations Committee that retail quotations should be continued, but that they should represent prices at which dealers are willing to trade with the public.

The chairman of the National Quotations Committee wrote each district and local quotations committee, recommending that the change be effectuated under the following principles:

1. No quotations may be compiled on the basis of any formula for "spreading" quotations.
2. The objective would be "to inform the public of prevailing RETAIL prices—prices which the public itself, at the time of compilation, could have expected to receive or pay for the securities quoted."
3. At the same time the quotations must reflect "no more than a fair and reasonable profit for the retail distributor and must be reasonably related to the current 'wholesale' market."
4. The revised quotations system will "protect the fundamental principle upon which our business functions—the existence of a wholesale and a retail market for over-the-counter securities."

The alteration of the quotation under these circumstances would occur at the dealer level rather than at the collection point. Detailed instructions for gathering and processing quotations accompanied

<sup>277</sup> The NASD News of December 1944 described the Commission's position as follows: " \* \* \* spokesmen for the Commission contended for 'inside' quotations, or prices in 'actual transactions' in over-the-counter securities, or disclosure of current markets on confirmations. \* \* \*"

The NASD's position was stated in the same issue of the News: " \* \* \* NASD consistently said it would not go into the business of publishing 'inside' markets; it could not undertake the monumental task of creating machinery for recording actual transactions and it forcefully rejected demands for disclosure. \* \* \* It remained firm, as it always had, on fundamental differences as between what the SEC ultimately sought and what NASD would agree to \* \* \*."

the letter. District and local committees were also instructed to use the following masthead:

These bid and asked quotations represent prices at which one or more dealers, members of the National Association of Securities Dealers, Inc., would trade with the general public at the time the quotations were gathered, 12 noon (today) (yesterday).

The NASD's executive director wrote the Commission that progress on the new program "at least in the initial stages" might be slow. There is no evidence of any further Commission action at that time.

During the years from 1944 to 1956, the NASD continued to call for retail quotations based upon "actual" retail prices supplied by dealers rather than upon the application of a fixed formula to wholesale quotations. The National Quotations Committee in 1950 adopted the following resolution:

*Resolved*, That it is the unanimous opinion of its members that \* \* \* the practice of compiling quotations for publication by the fixed formula system [is] detrimental to the best interests of the over-the-counter markets.

Also, the principle of separation of retail from wholesale markets was reaffirmed on numerous occasions,<sup>278</sup> and local committees continued to dominate the administration of the retail quotation system and to insist upon local quotations reflecting local costs of doing business.<sup>279</sup>

In May 1955 the executive director of the NASD stated to the board of governors that the NASD was "more vulnerable to an attack" in respect of its retail quotation system than on any other point and, accordingly, he recommended that the National Quotations Committee, together with a special committee of the board, reexamine "this whole problem." He stated that "one criticism of the over-the-counter quotations was the lack of method for determining the volume and size of a market, another was that the over-the-counter quotations are not based on actual transactions" and that one improvement "would be a better understanding by the public and Government as to what the over-the-counter quotations represent."

In January 1956, the National Quotations Committee recommended to the board of governors that efforts be made to establish a uniform national list of securities, with minimum listing standards. This step was stimulated by the Wall Street Journal's decision to transmit from New York the quotations for its regional editions, basing them on quotations supplied by New York dealers rather than continuing to collect them at the regional offices.

<sup>278</sup> For example, the National Quotations Committee in its 1948 report to the board of governors stated that "constructive results" could be achieved "by continued effort to obtain conformance of local quotations committees with the principle that all published prices for unlisted securities should represent retail prices (rather than the 'wholesale' prices customarily made between dealers) \* \* \*."

<sup>279</sup> In July 1948, the NASD News reported: "At the Chicago meeting, the committee discussed thoroughly the advisability and possibility of integrating quotation activities within certain districts, for the primary purpose of publishing more uniform prices for the same securities in different localities. However, majority sentiment within the committee was plainly opposed to the publication of uniform quotations of the same security in different districts, the committee's report stated.

"Different philosophies as to pricing policies exist, not only between districts but between individual members of the association who furnished quotations within the same district, the committee reported. It was also pointed out that merely the difference in times at which quotations are filed in different districts would tend to result in different quoted prices for the same security.

"However, the committee was in agreement that effort should be made to eliminate flagrant variations in quotations of the same security at approximately the same time, but in different districts."



In May 1956, the NASD presented the proposal to the Commission. The NASD representatives stated that the national list would include initially, for some 300 to 400 over-the-counter securities, identical quotations throughout the country, with additional regional lists of about 1,000 securities to be prepared separately. In preparing quotations for the national list, the NASD proposed that the published bid would be approximately the highest available inside bid, and the published offer would be determined by adding a fixed amount to the inside offer. This spread would not be determined by a "mechanical formula" but would be based on a number of factors including activity of the security, its price, and its market characteristics. It was expected that with the establishments of a national list, local committees would compile local lists in the same manner.

A reason given by NASD representatives for the proposed methods of compilation was that over-the-counter dealers whose business was essentially retail could not compete with the narrow spread of the New York City dealers. The proposed method would meet the cost problems of these distributors.

Later in May 1956, the Commission approved the NASD proposal.<sup>280</sup> The proposal, under which computation of the spreads by the dealer furnishing the quotations was abandoned in favor of computation by an NASD committee, paralleled in important respects the pre-1944 system. The disclaimer by the NASD of the use of any "mechanical formula" apparently obscured the similarities of the two systems.

As described earlier, the NASD committees preparing the national, regional, and local lists began to use (although not uniformly) a fixed pricing formula, the Rule of Thumb, following the Commission's approval in 1956 of the national list. At the present time, fixed amounts are added to the inside asked price, rather than to the retail bid price which was the base before 1944. Other differences between the present system and the pre-1944 one are that now the Rule of Thumb takes into account only the security's price level whereas then a fixed spread was determined for each particular security, now the inside bid instead of a marked down one is published, and now only one dealer's bid for each security is used, whereas before 1944 NASD policy called for comparing two or more bids to obtain the best available, although one bid was used in some cases. It should be noted that, generally, spreads today are smaller than they were before 1944.

#### (4) *Evaluation of the system*

Although the NASD had hoped to attain uniformity in prices for securities carried on national and regional lists—a problem the National Quotations Committee has been working on since its quotations activity began—such uniformity has not been achieved, because most newspapers still receive their quotations from local committees. Thus, even for securities on the national list, it is still not possible to be sure of uniform quotations. For example, on January 19, 1962, the national list in the Wall Street Journal showed Aztec Oil & Gas at  $22\frac{7}{8}$  bid,  $24\frac{1}{2}$  asked; in the Chicago Daily Tribune, the asked was the same but the bid was  $22\frac{1}{2}$ . On the same day, the nationally listed bank stock

<sup>280</sup> There was no public reflection of this action of the Commission at the time. As a collateral point, it would seem that Commission action of this kind and importance ought to be publicly announced and/or annually reported, even though no formal proceeding is involved, so that the public and the Congress may have a full awareness of important incidents in the Commission's administration of the securities laws.

of Morgan Guaranty Trust Co. of New York appeared in the Wall Street Journal at 144 bid, 151 asked; in the San Francisco Chronicle, it was 1 point higher on the bid and 5 points higher on the asked, giving a significantly greater spread.

The NASD's many local quotations committees have been under virtually no national supervision or review, but at the January 1962 meeting of the NASD board of governors the National Quotations Committee was authorized to supervise the local committees.<sup>281</sup>

As described above, the NASD retail quotations do not provide completely a reliable reflection of the underlying wholesale markets or an accurate indication of actual price range of consummated retail transactions. While it is true that the system does not purport to reflect actual transactions, the fact is that most public customers, denied access to wholesale quotations, cannot determine the prices available in the marketplace—where demand and supply meet. If a customer's purchase is executed on a principal basis within the retail range, he may get the impression or actually be told that his security was bought commission free, below the "high."<sup>282</sup> On a sale, however, he may and often does find that his security was sold outside the range and below the published retail bid, and may be given the explanation of "changing markets."

As noted earlier, the costs of execution of principal transactions, and particularly of those executed on a riskless basis, are substantially higher than those executed on an agency basis. The range of prices in principal transactions does not appear to be related to differences in the size of transactions, nor to be explained by time lags between the quotations' submission and publication. Tables VII-25 and VII-25a show the range of prices paid by public individuals in principal transactions. There is significant price variation in principal purchases by customers primarily among the most active securities. The wide price range there was chiefly the result of the varying markups charged.<sup>283</sup> The range is significantly smaller in agency transactions where the service fee charged is disclosed.

The breadth of the retail quotation range, the method of computing the retail quotations, and the failure to disclose markups in principal transactions (as contrasted with the open indication of commissions in agency transactions) encourage many dealers to execute principal rather than agency transactions. The present system makes it impossible for a customer to judge whether the price he pays is the result of a fluctuating market or whether the service charge for his execution is in line with what other broker-dealers would have imposed. Moreover, it has been argued by one wholesale dealer that the broad spreads which the public customer sees in the newspaper may lead him to believe there is comparatively little activity in over-the-counter securities causing an unduly large disparity between the price at which he may buy and the price at which he may be able to sell, and thus he may turn to the exchange markets. The same wholesale dealer further stated that "present policies for published quotations

<sup>281</sup> At the time of this report's writing, the only step taken toward such supervision is the checking of quotations in district No. 10, as mentioned above.

<sup>282</sup> The significance of telling the customer that he bought at a price below the newspaper quotation is illustrated by the fact that certain selling practices are built around it. See ch. III.B.

<sup>283</sup> See sec. 3.d, above.

are anachronistic” and concluded that “prices provided to the press should reflect the dealer’s market realistically.”<sup>284</sup>

Undoubtedly many investors are unaware of the relevance of the principal-agency distinction.<sup>285</sup> In a principal transaction, he is usually ignorant of the amount charged as the dealer’s profit and is not likely to question a principal transaction as long as his cost is not above the published “asked” price—indeed, many buyers undoubtedly are gratified to learn they have not been charged a commission. Moreover, many members of the public—even apart from those who may confuse “bid”-“asked” with the “high”-“low” presentation of stock exchange quotations with which they are more familiar—are doubtless unaware that the “bid” and “asked” are not what the words literally imply, the former being instead an unadjusted wholesale bid and the latter an arbitrarily adjusted wholesale asked, and both being submitted by one predesignated dealer. Sophisticated buyers know that securities can ordinarily be bought well below the published “asked” price, but the vast majority, who are less sophisticated, cannot but be misled by the representation of an “asked” price. It is unlikely that any such confusion is dispelled by the explanatory masthead which appears in some of the newspapers, for that fails to explain the use of the terms “bid” and “asked” and adds confusion by relating them to a “range.”<sup>286</sup>

*b. NASD markup policy*

The public customer ordinarily has no way of knowing in principal transactions the relation between the price he is charged for an over-the-counter security and prevailing prices in the interdealer market. To protect investors, who are unaware of inside prices, against overreaching in retail prices charged by its members, the NASD has devised its markup policy. Before examining that policy, it may be helpful to review briefly a 1942 proposal which preceded adoption of the markup policy and NASD policing of retail prices.

<sup>284</sup> Bank Stock Quarterly, “The Need for Better Quotations,” issue of December 1962, pp. 16-18; see report in the New York Times, Dec. 6, 1962. In a similar vein, an investment adviser managing large portfolios stated to the study that the retail quotations bear no reasonable relationship to actual retail transactions and that the system’s purpose is to mask the profit of dealers in the over-the-counter market. He recommended that the retail quotation system be revised to permit a member of the public to be aware of the approximate markup.

<sup>285</sup> See sec. 2.a. above.

<sup>286</sup> For example, one customer complained to the NASD, the New York Stock Exchange, and the Commission, that on May 17, 1961, he sold 25 shares of Control Data Corp. through a member firm at \$80 per share when the retail bid price appearing in the Wall Street Journal on that day was \$91. In its reply to the complainant, the NASD stated that the retail quotations were only a “guide to the range within which a security could have been sold or bought at the time this range is compiled” and that the NASD “did not keep track of the highest and lowest selling price of a stock during any specific day.” Such an explanation would seem untenable in light of the published retail quotations on days immediately preceding and following, which show no bid lower than 90.

The retail quotations appearing in the Wall Street Journal on Control Data during this period were as follows:

1961	Bid	Asked
May 12.....	100	107
15.....	95	103
16.....	92	99
17.....	91	99
18.....	90	97
19.....	95	102
22.....	93	100

(1) *Background*

In 1942 the Commission at the suggestion of its Division of Trading and Exchanges published for comment a rule requiring that broker-dealers disclose the inside market price in over-the-counter trading transactions.<sup>287</sup> The proposed rule provided that dealers would be in violation of the antifraud provisions of sections 15(c)(1) and 15(c)(2) of the Exchange Act for failure to disclose to a customer in writing, at or before the completion of each transaction (including unsolicited transactions), the best independent inside bid and asked prices obtainable in the exercise of reasonable diligence, or the fact that only one such price—bid and asked—could be ascertained. Where neither could be ascertained, the dealer would have been required to disclose this fact and the most recent price paid by it in a bona fide transaction within the previous 60 days, if such a transaction occurred. Furthermore, dealers would have been required to keep records of the date, time, and sources of such information.

The NASD and the industry vigorously opposed the proposed rule. In a memorandum, the NASD summed up its position as follows:

(1) Association experience has demonstrated that only a small marginal element within the business has engaged in the practice which the proposed rule would seek to cure;

(2) The purposes of the Association and the Commission can best be served in the interest of all concerned by further cooperative effort;

(3) The Association will demonstrate that the problem can be met most effectively in the interests of the public and the business by continuing our cooperative work in an atmosphere of mutual confidence;

(4) To put such a rule into effect would undoubtedly harm a large portion of the business and not reach those at whom the proposed rule is directed, it being our considered opinion that the proposed rule, if promulgated, would be easy to evade;

(5) The number of registered brokers and dealers outside of the Association is not large enough nor is their volume of business important enough to justify such a rule on the ground that they are beyond NASD policing and therefore constitute a major problem for the Commission; and

(6) There would be no further need for the Association in the field of work in which it has been most active and successful.

The proposed rule was not adopted by the Commission and in 1947 it was withdrawn.<sup>288</sup> One reason for its withdrawal was the adoption in 1943 by the NASD of its markup policy, and another was the important court decision in the *Hughes* case holding that where the market price is not disclosed to a customer, a dealer impliedly represents that his retail price is reasonably related to the current market price.<sup>289</sup> Under the *Hughes* doctrine, the Commission can revoke the registration of a broker-dealer for charging unreasonable markups.

In 1943, the NASD announced its markup policy as an interpretation of its basic Rule of Fair Practice that members "shall observe high standards of commercial honor and just and equitable principles of trade."<sup>290</sup> The interpretation stated that:

<sup>287</sup> Two factors contributed to the proposal: The Commission's staff indicated there was evidence based on studies made by it that dealers were buying and selling securities at prices which bore no reasonable relationship to prevailing market prices. The other factor was the difficulties encountered in policing the over-the-counter markets due to attrition of the Commission's staff during World War II.

<sup>288</sup> Securities Exchange Act release No. 3940 (Apr. 2, 1947).

<sup>289</sup> *Charles Hughes & Co. v. S.E.C.*, 139 F. 2d 434 (2d Cir. 1943) cert. denied, 321 U.S. 786. See also *Duker & Duker*, 6 S.E.C. 386 (1939). See sec. c, below.

<sup>290</sup> Art. III, sec. 1, NASD "Rules of Fair Practice." The "Rules of Fair Practice" have always contained a provision (art. III, sec. 4) requiring members to charge fair prices on commissions in over-the-counter transactions.

[i]t shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer at a price not reasonably related to the current market price of the security.<sup>291</sup>

At the time of the announcement of the markup policy and subsequently, the NASD board of governors has set forth interpretations of the policy. As stated at the time of the most recent revision, the purpose of such interpretations is to—

aid members in complying with the Policy and the various committees in fulfilling their responsibility to exercise judgment in determining the fairness of markups.<sup>292</sup>

When the NASD announced its markup policy in 1943, it stated that markups should normally not exceed 5 percent (hence the name "5 percent policy"). It was noted that 5 percent or even a lower rate is not always justified; but that in the case of low-priced securities such as those selling below \$10 per share a "somewhat higher percentage may sometimes be justified."<sup>293</sup> The NASD states in its present version of the markup policy that determination of the fairness of markups must be "based on consideration of all the relevant factors of which the percentage of markup is only one." These factors include the type of security involved, the availability of the security in the market, the price of the security, amount of money involved, the degree of disclosure, the pattern of markups, and the nature of the member's business.<sup>294</sup> Among the general principles applicable to the markup policy is the following.

The markup over the prevailing market price is the significant spread from the point of view of fairness of dealings with customers in principal transactions. In the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security.<sup>295</sup>

The markup policy marked the beginning of a program of substantive regulation by the NASD. Whereas the Commission had originally proposed a disclosure approach for dealing with unreasonable markups—an approach normally considered less drastic than substantive regulation—the NASD opposed disclosure and turned instead to a regulatory solution.

## (2) *Evaluation of the NASD markup policy*

The purpose of the markup policy is to set forth guidelines concerning fair and reasonable retail prices. It does not define spreads in exact percentages and dollars.<sup>296</sup> The policy applies both to sales from inventory and to riskless transactions, and to agency as well as principal transactions.<sup>297</sup> It applies to securities with active competitive markets and to securities which have no independent market,

<sup>291</sup> NASD Manual, G-1. Shortly after its adoption by the NASD board of governors, a group of members and nonmembers filed a petition with the Commission alleging that the interpretation constituted a "rule" which had not been submitted to a vote of the membership or filed with the Commission. It was held that the action of the NASD board of governors was "well within the sphere of interpretation." *National Association of Securities Dealers, Inc.*, 17 S.E.C. 459, 471 (1944).

<sup>292</sup> NASD Manual, G-2.

<sup>293</sup> This statement has been frequently cited by firms selling low-priced securities as a justification for higher markups. When the contention has been made, the Commission has rejected it on the basis of the facts in the particular case. See, e.g., *Midland Securities, Inc.*, Securities Exchange Act release No. 6413 (Nov. 16, 1960).

<sup>294</sup> NASD Manual, G-3 et seq.

<sup>295</sup> NASD Manual, G-3.

<sup>296</sup> Such a rule or interpretation would be inconsistent with sec. 15A(b)(7) of the Exchange Act prohibiting the NASD from imposing any schedule of prices or charges. See sec. 3, above.

<sup>297</sup> In agency transactions, since commissions are required to be disclosed to customers, the markup policy has had little practical significance.

to integrated firms making markets as well as firms engaged only in retail activities. Because it applies to so many diverse situations, without having the same application to all and without a clear rationale for each, difficulties of interpretation have arisen over the years.

One of the more difficult areas of interpretation has arisen in connection with judging the fairness of markups where a firm has a position and where it does not.

Where the dealer has no position, the dealer's contemporaneous cost is normally used as the base for computing the markup. The "member's own contemporaneous cost" in the usual riskless transaction will be the inside offer of the wholesale dealer from whom the purchase is made. If the retail dealer purchases at a price which is lower than the high asked price quotation in the sheets on the same day, the Commission has said that:

\* \* \* the price paid for a security on the same day it is sold to his consumer is the best evidence of market price for purposes of determining the amount of the markup charged the customer.<sup>298</sup>

In determining the fairness of a markup in a riskless transaction, the NASD may take into account unusual expenses or special services performed by the member for the customer, e.g., expenses for checking markets, solicitation of the order and research or other advisory services. The NASD has stated that such costs must not be "excessive," and that excessive costs cannot justify unreasonable markups. However, the NASD has not set forth standards for determining reasonable costs nor has it made a cost study to determine what are reasonable costs for the multiplicity of firms doing an over-the-counter business.<sup>299</sup> Even with respect to the cost of interpositioning, there is no clear policy within the NASD as to the propriety of its inclusion in determining the cost base.<sup>300</sup> In its review of NASD disciplinary actions, the Commission has adopted the NASD view that excessive costs do not justify excessive markups<sup>301</sup> and in one case stated that—

\* \* \* the industry may properly protect itself against the so-called "high cost" or "submarginal" producer, whose excessive cost of doing business results from inefficiency or unduly high overhead and compels his charging unreasonably high prices to show a profit.<sup>302</sup>

However, like the NASD, the Commission has not attempted to spell out in detail the amounts and kinds of costs that might be considered excessive.

<sup>298</sup> *Managed Investment Programs*, 37 S.E.C. 783,786 (1957). However, where the broker-dealer has a firm commitment to take down shares at a substantial concession, the prices paid by the firm pursuant to the commitment are not indicative of the current market price at the time of subsequent sales and the asked price quotations in the sheets may be taken as evidence of current market prices. See *Boren & Co.*, Securities Exchange release No. 6367 (Sept. 19, 1960).

<sup>299</sup> See NASD Manual, G-4. The NASD has stated that the markup policy does not carry with it an " \* \* \* implied guarantee of an overall net profit regardless of unreasonable expense items (such as excessive commissions to salesmen, excessive salaries to officers, excessive telephone expense) or loss on inventory positions which may be incurred by the firm." NASD News, December 1959.

<sup>300</sup> See sec. 2.b(4), above. One member of the NASD board of governors stated to the study that a firm could include the service charge or commission paid to an interpositioned firm as an expense in computing the markup.

<sup>301</sup> The Commission has stated:

"The fact that a member is entitled to a profit is merely one of the circumstances to be considered in determining whether a price is fair, and excessive expenses cannot justify an excessive markup." *Boren & Co.*, op. cit. supra, p. 79.

See also *Midland Securities, Inc.*, Securities Exchange Act release No. 6413, (Nov. 16, 1960).

<sup>302</sup> *Herrick Waddell & Co.*, 25 S.E.C. 437, 447 (1947).

Where the dealer is at risk, i.e., has a position in the security, the proper base for computing the markup is not as clear. Is the markup to be computed from the integrated firm's contemporaneous costs, i.e., its inside bid, or from a representative offer of another wholesale dealer appearing in the sheets? An integrated firm making a market in a security by placing two-way quotations in the sheets ordinarily will purchase stock at its inside bid.<sup>303</sup> If the fairness of the markup is based on the integrated firm's contemporaneous cost, the markup would be computed on the basis of its bid price. In the case of many low priced securities, where the spread between the inside bid and offer may be considerably more than 5 percent, the integrated firm might then have to sell to its customers at a price less than its inside offer, i.e., the price at which it stands ready to sell to other broker-dealers. On the other hand, if the markup is computed on the basis of a representative offer appearing in the sheets, sales will be made at a price considerably in excess of 5 percent of the integrated firm's contemporaneous cost.

Most integrated firms follow the practice of basing their markup on their own inside offer.<sup>304</sup> The reason for using the dealer's offer rather than its bid as the base for computing the markup was stated in this way to the study by the then chairman of the board of governors of the NASD:

As I look at a transaction involving both a retail sale and a position, I think of it, in effect, as reflecting two functions. One is the retail function. For this, I think the dealer is entitled to a profit equivalent to the profit he would derive if he were not in position \* \* \* [A]ny profit that he earns as a result of being in position, and at risk, is a separate profit, to which he is entitled by virtue of his willingness to assume the risk.

The two charges are added so that in a wholesale market of 9½ bid, 10 asked, the dealer's public customer may pay 10½, reflecting a 5-percent markup over the inside offer.

A few years ago the NASD would appear to have required the use of contemporaneous cost as a base for computing the markup in situations where an integrated firm was at risk. For example, one former chairman of the NASD board of governors testifying as an expert witness in a criminal case in 1959 was emphatic about the use of contemporaneous cost:

A. If you have a market, 5 bid, 7½ [asked], if he [the integrated firm] buys stock at \$5, he would have to sell that at a reasonable price, say, 5¼ or 5½ if he were retailing it. If he was selling it to another dealer, he can sell it, of course, at any price he wants to. It is open season between dealers, but it is not open season between a dealer and a customer.

\* \* \* \* \*

They take the price at which you bought the stock and they check it with what the market is that day, the actual bid side of the market against whatever these offering prices may be, and then you have to justify anything beyond a reasonable markup against that.

Q. Even when you are at risk?

A. Even when you are at risk.

This position has been reflected in Commission decisions which have consistently used contemporaneous cost in trading transactions as the

<sup>303</sup> See the discussion in pt. C.2.a, concerning the execution of trades by wholesale dealers at their quotations.

<sup>304</sup> See sec. 2.a, above. In the case of higher priced securities with independent markets, the choice of contemporaneous cost or an independent market may be less important because of the typically narrow dealer market. Because of this fact, the question of compliance with the markup policy arises less frequently in such situations.

best indication of the prevailing market price, including cases involving firms making markets. The Commission has stated in numerous markup cases that—

\* \* \* in the absence of countervailing evidence, the prices paid concurrently by a dealer are the best evidence of market price.<sup>305</sup>

This position has been in accord with the position taken by the NASD on appeals of its decisions before the Commission.<sup>306</sup> Of course, if there is no evidence of contemporaneous cost, i.e. no purchases at or about the time of the sales to customers, then under the Commission's decisions bona fide quotations in the sheets may be used as evidence of actual market prices.<sup>307</sup>

Despite the position taken by the NASD before the Commission on the use of contemporaneous cost, there now appears to be some doubts among NASD officials as to its use in situations where a firm is at risk. Some NASD officials apparently now take the position that contemporaneous cost is not the proper basis from which to compute the markup, if the dealer is at risk and there is an independent market. Counsel for the NASD, in referring to the use of contemporaneous cost, stated:

Now, I would be inclined to think that, with the emphasis on contemporaneous cost in the early days of 5 years ago, that, probably members have been censured where we did not review it or there was not an appeal to the board. \* \* \* My impression of what happened up to 1959, I gained from what I began to see in cases being decided in 1958, when I came with the association. I think that the stress was put, in cases there, on contemporaneous cost.

\* \* \* \* \*  
 What we saw at the board level was what appeared to be an overemphasis on contemporaneous cost as a basis for computing markups, and in cases that we began to review and hear on appeal, we found there was another whole argument to be considered before we made a determination.

\* \* \* \* \*  
 It appeared to me there was not a sufficient enough emphasis, in view of the thinking of the board that I became acquainted with, there was not sufficient emphasis put on the independent offer.<sup>308</sup>

A former chairman of the NASD board of governors indicated to the study that contemporaneous cost is applied only in riskless transactions. He testified as follows:

Q. Now, let us assume that, in making a market, that the firm buys 400 or 500 shares and sells 400 or 500 shares and never accumulates a significant amount of shares or dollars. Would your answer still be the same with respect to whether you used the contemporaneous cost or the independent offer?  
 A. Generally speaking, I would say yes.

<sup>305</sup> *Maryland Securities Co., Inc.*, Securities Exchange Act release No. 6442 (1960). See also *Mitchell Securities, Inc.*, 37 S.E.C. 178, 180.

<sup>306</sup> For example, in its brief in the *Boren & Co.* case, above, note 298, p. 648, the NASD stated in reply to the argument that the quoted market should be used:

"\* \* \* While in certain instances, where other better evidence is lacking, reference may be made to the quoted market, the best determination of a market is the price at which a dealer purchased a security from one or more professionals dealing in the security at a given time. Thus, where there is an actual transaction of purchase the contemporaneous cost to a broker/dealer is the best indication of a market. This general proposition has been repeatedly asserted by the association and accepted by the Securities and Exchange Commission."

<sup>307</sup> See, e.g., *Charles Hughes & Co.*, op. cit., p. 76; *Graham & Co.*, 38 S.E.C. 314 (1958); *Midland Securities, Inc.*, op. cit., p. 77.

<sup>308</sup> In the most recent version of the markup policy, the NASD states that in a "\* \* \* transaction in which a member sells a security to a customer from inventory—in such case the amount of the markup should be determined on the basis of the markup over the bona fide representative current market." NASD Manual, G-5.

It is not clear whether this statement was intended to reflect a change in view. In publishing the revision in 1960, the NASD stated that it "can find no justification for a change in the basic policy" and NASD officials have confirmed this point to this study.



Q. So the contemporaneous cost is only used, in effect, in riskless transactions. Is this what it comes down to?

A. That is what it boils down to; yes.

A past member of the NASD board of governors has indicated that the transaction would not be riskless even though the dealer's position was only transitory:

\* \* \* [I]f he [the dealer] had no order at the time he bought it from his retail accounts, whether he got an order 2 hours later or whether he waited for the rest of the day, into the next day, and accumulated 500 shares, as far as I am concerned, he is at risk.

This position has been confirmed by the recently deceased chairman of the board of governors.

However, the view of the chief examiner for the NASD, who is responsible for the supervision of its examiners, does not appear to reflect the shift in position described by counsel to the NASD and other NASD officials. The chief examiner stated to the study:

A. I believe, perhaps in recent years there has been a little more emphasis on the consideration of a contemporaneous cost as being the best indication of the market, in a blanket sense.

Q. In other words, where there is a contemporaneous cost that would govern?

A. That would prevail.

Q. Irrespective of whether there is an inventory or irrespective of whether the firm is a market maker?

A. Yes.

The important change in emphasis from contemporaneous cost to the independent offer has apparently not been recognized by all of those responsible for the administration and enforcement of the markup policy. Some NASD examiners in policing compliance with the markup policy continue to compute the markup from contemporaneous cost whether or not the firm is "at risk."<sup>309</sup> And some NASD district committees in disciplinary proceedings continue to use contemporaneous cost in situations where the independent offer, according to the statements of NASD officials set forth above, is the proper basis for computing the markup.

There is another difficult area of interpretation which emerges from NASD enforcement of the markup policy and which is not explicitly recognized or distinguished either in the policy itself or in the cases. As noted earlier, there are many securities of limited activity in the over-the-counter markets where market making may be confined to one or two dealers at most and for which there is no independent competitive market.<sup>310</sup> Often these securities are inactive and the consequent risks involved in taking positions may involve dealer spreads considerably in excess of 5 percent. If contemporaneous cost was used as a base for computing the markup, the dilemma described earlier would arise—the firm might have to sell to its customers at a price less than the price at which it stands ready to sell to dealers, thus making normal dealer activities impossible. On the other hand, since the market is a noncompetitive one, the use of the inside offer as the base for computing the markup may be unsatisfactory, particularly if the firm is engaged in a retail selling campaign where its own inside quoted prices provide the basis for retail prices.

<sup>309</sup> The NASD examiners police compliance with the markup policy by inspecting members on a 3-year cycle and on the occasion of each inspection sample a number of transactions for computation of the markup. See ch. XII.G.

<sup>310</sup> See pt. C.2.c(3), above.

In enforcing the markup policy, the NASD has taken the position that, if there is no independent market, contemporaneous cost should be used. This is apparently based on the premise that, if a dealer is in a position to establish the price level through its own retail selling its inside offer is not a valid basis for computing markups.<sup>311</sup> Carried to its logical conclusion, the application of the markup policy in this manner might, if applied uniformly, tend to reduce appreciably the availability of markets for low-priced securities having limited dealer interest. On the other hand, to ignore the fact there is no independent market may be to permit markups on an artificial base. One of the difficulties with the present approach of the NASD to the noncompetitive market situation is that it may result in using one base for the reputable firm and another for the marginal firm without any articulated basis for the distinction in the markup policy itself and without coming to grips with the question of what standards are to be applied in judging the fairness of retail prices where there is no independent market.

The result of these varying views and interpretations is that many dealers and local NASD district committees apparently do not understand the markup policy. For example, a recent chairman of the board of governors of the NASD expressed himself to his board in 1961 as follows with respect to the consistency of interpretations:

I think that problem [multiple jurisdiction of districts over activities of a broker-dealer] has always been with the association, and we probably would have to deal with it the same way we do now. Of course, sometimes it presents a little bit of an embarrassing situation, again mentioning the 5 percent policy, where we had a conflict of opinions involving the same firm in two different districts, and one wound up with finding them guilty in one district and not guilty in another.

And, in a similar vein:

\* \* \* the reason I am prompted to raise some of these questions is that, as you know, we spent quite a bit of time going back for 17 years on the 5 percent policy, and if more questions had been raised in the earlier years, it would have been easier at some later date to know a little bit more about what the intent of the board was.

The same member of the NASD board of governors summed up for his board the effects of confusions and misunderstandings as to the meaning of the markup policy:

The board found it impossible to define "what is a fair profit" in 1943 when it adopted the "5 percent policy." Since that time many questions have been raised as to a proper interpretation of the "policy," but very little has been accomplished in the way of clarification. Many members obviously do not understand the policy, and the same might be said of some members of the district committees. As a result, committees have frequently, as though it were a rule, substituted the 5 percent figure for their own judgment. There is little doubt that members have admitted guilt or been found guilty of excessive markups when in fact there has been no violation, simply because they did not understand the

<sup>311</sup> In this connection the counsel to the NASD testified as follows at the hearings on the legislation authorizing this study:

"\* \* \* where we can find that they have created a public demand by high-pressure tactics of selling and they, in turn, dominate the market, control the market themselves, we put people like that out of business. We have last year and the year before. If we can show they really dominate the market and their selling techniques are designed to artificially raise this price, and there is no reason for it, we have held that is manipulation under our rules and quite often we invoke the 5-percent policy we have because they are using as a base a cost that we quarrel with." 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. 81.

factors which should be considered and were thus unable to furnish information to support their actions.<sup>312</sup>

Confusions and misunderstandings about its interpretation and application are not, however, the only difficulties with respect to the markup policy. Although its enforcement has added to the protection of investors against the abuses and manipulations of marginal firms and "boiler rooms," it cannot supply (nor is it designed to supply) material facts to investors about the over-the-counter trading markets.

*c. Commission regulation of the over-the-counter retail markets*

Regulation of the conduct of broker-dealers in the over-the-counter markets by the Commission has been bottomed primarily upon the fraud provisions of the Securities Act and the Exchange Act.<sup>313</sup> On the basis of these provisions, the Commission has developed a number of fraud concepts particularly applicable to the over-the-counter markets, and through the use of these concepts the Commission has articulated standards of conduct concerning the relations of broker-dealers to their public customers.

The first of these concepts is the so-called "shingle" theory. Under this theory, a broker-dealer doing business with the public impliedly represents that he will deal "fairly and in accordance with the standards of the profession." It is based on the premise expressed in the *Hughes* case that—

[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do.<sup>314</sup>

The shingle theory was first applied by the Commission to markups charged by over-the-counter dealers<sup>315</sup> and over the years it has been extended to failure to deliver stock certificates promptly,<sup>316</sup> unauthorized transactions in a customer's account,<sup>317</sup> pledging of customer's securities without authority from the customer,<sup>318</sup> acceptance of customer's funds and securities while insolvent<sup>319</sup> and other situations in which the pertinent facts known only to the professional have not been disclosed to customers. Perhaps the most significant extension of the shingle theory has occurred recently in a line of Commission cases dealing with selling practices in connection with high-pressure tele-

<sup>312</sup> This statement was made to the NASD board of governors in September 1958 in connection with a recommendation to review the markup policy. The recommendation was adopted and culminated in a revision and condensation of the policy in 1960.

<sup>313</sup> These fraud provisions are sec. 17(a) of the Securities Act and secs. 10(b) and 15(c) (1) of the Exchange Act (and the rules thereunder). The Commission also has power under sec. 15(c) (2) of the Exchange Act to prescribe means reasonably designed to prevent acts of fraud, deceit, or manipulation in the over-the-counter markets. In addition to powers stemming from the fraud provisions, the Commission's regulatory power with respect to the over-the-counter markets includes the requirement of registration of broker-dealers engaged in an interstate over-the-counter business; rulemaking powers with respect to the financial responsibility of broker-dealers, fictitious quotations and broker-dealer books and records; and a visitatorial power over broker-dealers. See secs. 15(a), 15(c) (2) and (3), and 17(a) of the Exchange Act. Except for the areas of financial responsibility, fictitious quotations and books and records, the Commission's power over substantive rules of broker-dealer conduct in the over-the-counter markets are related to standards for the prevention of fraud, deceit, or manipulation in lieu of the general standards of the public interest or protection of investors as in the case of exchange markets under sec. 11. The fraud powers are themselves quite broad but not necessarily as broad as "the public interest or the protection of investors."

<sup>314</sup> *Charles Hughes & Co. v. S.E.C.*, 139 F. 2d 434, 437 (2d Cir. 1943). See ch. III.B.

<sup>315</sup> See, e.g., *Duker v. Duker*, 6 S.E.C. 386 (1939).

<sup>316</sup> See Securities Exchange Act release No. 6778 (Apr. 16, 1962) and ch. IV.B.3(b).

<sup>317</sup> See, e.g., *First Anchorage Corp.*, 34 S.E.C. 299 (1952).

<sup>318</sup> See, e.g., *Richard A. Sebastian*, Securities Exchange Act release No. 5876 (1959).

<sup>319</sup> See, e.g., *C. H. Abraham & Co.*, 186 F. Supp. 19 (S.D.N.Y. 1960).

phone solicitation of customers by "boiler rooms." In these cases the Commission has held—

that the making of representations to prospective purchasers without a reasonable basis, couched in terms of either opinion or fact and designed to induce purchases, is contrary to the basic obligation of fair dealing borne by those who engage in the sale of securities to the public.<sup>320</sup>

In another line of cases the Commission has imposed special obligations upon broker-dealers in those situations in which a relationship of "special trust and confidence" exists between the broker-dealer and his customer. The broker-dealer in this relationship is said to occupy the position of a fiduciary and as such is required to make scrupulously full disclosure of his adverse interest in a transaction. Most often this theory is applied where the broker-dealer acts nominally as principal in a transaction but because of the established relationship of trust and confidence the Commission imposes the obligations of an agent.<sup>321</sup> In one such case the Commission held that a dealer effecting crossing transactions on a principal basis between accounts of a 90-year-old widow and an 80-year-old spinster was under the obligations of an agent:

A firm which makes a purchase to fill an order solicited by it when it knew it did not have the securities on hand is making that purchase for its customers—in fact and within the meaning of the act. Such transaction is, therefore, a brokerage transaction under the statute, and it is a brokerage transaction apart from the fact that the particular customer may be (as was true in this case) especially reliant on the firm by reason of particular trust, confidence, or infirmity. Under these circumstances the firm must fulfill the obligations of brokerage in the transaction: among other things, to refrain from acting adversely, to refrain from taking secret profits, to make the best deal for the customer at the best price obtainable, and to confirm as agent making specific disclosure of the amount of the remuneration.<sup>322</sup>

This case imposed the obligations of an agent, including disclosure of remuneration, on a dealer engaging in a riskless principal transaction where there was special reliance by reason of "particular trust, confidence, or infirmity." While its language was broad enough to apply even apart from the latter circumstance, this broader reading may have been qualified in later cases and the Commission has never specifically held that a riskless transaction is a brokerage transaction without regard to special reliance.<sup>323</sup>

Another fraud concept which has been used in over-the-counter manipulation cases is based on the premise that it is a fraud for a dealer to sell without disclosing that he has manipulated the market

<sup>320</sup> *MacRobbins & Co.*, Securities Exchange Act release No. 6846 (1962), p. 4; see also *Brown, Barton & Engel*, Securities Exchange Act release No. 7063 (1963); *Heft, Kahn & Infante*, Securities Exchange Act release No. 7020 (1963); *Alexander Reid & Co.*, Securities Exchange Act release No. 7016 (1963); *W. E. Leonard & Co.*, Securities Exchange Act release No. 7070 (1963); *Ross Securities*, Securities Exchange Act release No. 7069 (1963). See ch. III.B.

<sup>321</sup> See, e.g., *Allender Co., Inc.*, 9 S.E.C. 1043 (1941). *Arleen W. Hughes*, 27 S.E.C. 629 (1948), aff'd sub nom., *Hughes v. S.E.C.*, 174 F. 2d 969 (D.C. Cir. 1949).

<sup>322</sup> *Oxford Co., Inc.*, 21 S.E.C. 681, 692 (1946).

<sup>323</sup> The Commission decided two cases shortly after the *Oxford* case both of which cited *Oxford* with approval. In *Investment Registry of America*, 21 S.E.C. 745, 757 (1946), the Commission agreed with the rationale of *Oxford*, but took care to point out the fact of customers' reliance on the dealer's giving of investment advice. In *Norris & Hirschberg*, 21 S.E.C. 885-886 (1946), aff'd 177 F. 2d 228 (D.C. Cir. 1948), the Commission quoted the *Oxford* language but pointed out that in the case before it the dealer could, with assurance of profit to itself, cover the sale by inducing another customer to sell at a low price or by buying from a discretionary account. One commentator concludes that fiduciary responsibilities are imposed upon the dealer only where he instills in his customer such confidence and reliance upon his advice that the customer feels—and the dealer knows the customer feels—that the dealer is acting in the customer's interest. *Loss*, Securities Regulation 1508 (1961).

or otherwise dominated it.<sup>324</sup> The Commission stated the theory in its first formal proceeding involving over-the-counter manipulation:

When a security is sold "at the market," the failure to disclose to purchasers that the market price has been artificially inflated by the seller's manipulation is an omission to state a material fact and constitutes a fraud on the purchaser.<sup>325</sup>

The same theory has been incorporated in rule 15c1-8 under the Exchange Act which makes it a "manipulative, deceptive, or other fraudulent device or contrivance" for a broker-dealer participating in a distribution to represent that a security is being offered "at the market" unless the broker-dealer "knows or has reasonable grounds to believe" that an independent market exists for the security.<sup>326</sup>

The Commission's use of the statutory fraud provisions, by its emphasis on disclosure and particularly as that emphasis has been expanded in recent cases, is a most important protective measure for investors in the over-the-counter markets, yet it has inherent limitations. It is at its most effective in dealing with flagrant situations, but the flagrant case can usually be discovered only after some public investors have been victimized so that the best that can be done is to protect others from becoming victims. Even so, detection is dependent on procedures for inspecting books and records and investigating complaints which are necessarily limited in relation to the scope of the securities markets.

In any case, the fraud approach, as developed in existing rules and decided cases, is not calculated to protect investors in respect of the much larger area where gross or flagrant abuse may not occur but investor protection is needed.<sup>327</sup> The Commission's enforcement program, together with the NASD's markup policy, are both important for investor protection, but each is subject to the important limitation of dependence upon surveillance of thousands of broker-dealers spread throughout the country and neither provides what the investor needs for self-protection—disclosure of minimal information on which the quality of markets and the quality of executions, and not merely the quality of the securities themselves, may be intelligently appraised when investment decisions are made.

### E. THE POSSIBILITIES OF AUTOMATION

"Automation" in the form of electronic data processing has in recent years had a significant effect on certain areas of the securities industry. Several firms have completely automated their clearance and bookkeeping operations, while a few have installed electronic computers to assist in regulation and supervision of branch offices.<sup>328</sup> It is clear that the potentialities of automation extend far beyond these

<sup>324</sup> See pt. C.2.c(3), above.

<sup>325</sup> *Barrett & Co.*, 9 S.E.C. 319, 329 (1941). See also, e.g., *M. S. Wien & Co.*, 23 S.E.C. 735 (1946); *Bruns, Nordeman & Co.*, Securities Exchange Act release No. 6540 (1961). It is not clear whether disclosure to customers of the fact of the manipulation, control or domination of a market would obviate the fraud in such cases.

<sup>326</sup> See ch. IV.B.3.c(3).

<sup>327</sup> In this connection, the Government committee formed by the Secretary of Commerce in 1933 to study the securities markets was not sanguine about an approach based on policing of the over-the-counter markets by a Government agency:

"\* \* \* It [the Committee] has not yet found any method of controlling [the over-the-counter] markets which it considers feasible or which could be applied without building up a Federal policing agency on such a scale as to be impracticable." "Report to Secretary of Commerce of Committee on Stock Exchange Regulation," p. 20 (1934).

<sup>328</sup> See ch. III.B.

limited uses. Part J of chapter VI describes some of the potentialities with respect to the exchange markets; the discussion of the industry and public interest in automation in section 1 of that part is broadly applicable here. The present discussion explores the existing and possible uses of automation in the over-the-counter markets, particularly with regard to the dissemination of quotations and the execution and reporting of transactions.

Electronic data processing devices are currently being used in the over-the-counter markets to disseminate "retail" quotations (i.e., quotations made available to customers in broker-dealer offices) on selected securities. These electronic systems are manufactured and operated by the Teleregister Corp., Scantlin Electronics, Inc., and Ultronic Systems Corp. As of December 31, 1962, there were approximately 610 subscribers to the over-the-counter service of one or more of these systems. Although all three systems' primary use at present is in regard to listed securities, increasing attention has recently been given to quotation of over-the-counter securities.

In all three systems, quotations are fed into electronic equipment which transmits them by Western Union wire to the offices of broker-dealers subscribing to the service. Receiving units are installed in the board rooms of the subscribers and public customers are able to obtain quotations by activating the receiver sets. As with other retail systems<sup>329</sup> only a single quotation is provided for any given security and the names of the dealers furnishing the quotations are not supplied.

One of the systems, Teleregister, obtains retail bid and asked quotations twice daily from the NASD in New York in the same manner as do the newspapers. Thus, subscribers to this system obtain, for some over-the-counter securities, the same information as appears in major newspapers, but usually before the latter are available.

Scantlin lists about 1,350 over-the-counter stocks, most of which are included in an NASD national or regional list. In response to requests from various firms, the company has added certain other issues to its list, mostly recent public offerings.<sup>330</sup> Scantlin quotes only the bid price. Quotations are received at periodic intervals from a number of dealers, but on each stock only one dealer quotation is obtained. Scantlin has experienced some difficulty in obtaining quotations from wholesale dealers.

Ultronic disseminates bid and asked quotations (retail) received twice daily from the NASD on about 500 stocks. It also disseminates bid quotations only on approximately an additional 600 stocks; it receives all of these quotations from one large wholesale dealer which makes markets in the securities. The quotations are furnished by a direct telephone line between Ultronic and the trading room of the firm, which permits Ultronic to overhear quotation changes as they are called out to the firm's board clerk. However, the dealer has an understanding with Ultronic that the latter will delay transmitting a quotation over its system for 30 minutes so that it is not a "live" quotation. Ultronic, unlike Scantlin, pays the dealer a negotiated monthly fee for this service. Ultronic desired to transmit wholesale bid and

<sup>329</sup> See pt. D.4, above.

<sup>330</sup> Scantlin has no set standard for determining which securities it will quote, but on new issues it has a general policy of not quoting those which sell for less than \$7, or which have less than \$1 million in total value of outstanding stock. The interest of its subscribers appears to be the main consideration in determining whether to add or delete securities.

asked quotations but the dealer stated that it was advised by the NASD not to permit publication of its asked quotations.

These systems for disseminating quotations point to the possibility of other uses of automation which could have the effect of vastly increasing the flow of market information and of insuring better executions for the public.

There is strong reason to believe that expanded electronic systems, similar in principle to those used by the quotation companies, would be technically capable of processing information on every stock traded over the counter. These devices could receive and store, among other things, all bids and offers in each stock and reports of all consummated transactions. The information could be made instantly available for professional and public dissemination and compilation relating to price and volume could be prepared in permanent form.

The Special Study consulted with several firms specializing in electronic data processing systems and one of them, the Univac Division of Sperry Rand Corp., performed a preliminary analysis of such a system for over-the-counter markets based on assumptions supplied by the Special Study.<sup>331</sup> Univac stated that one centrally located computer would "have sufficient capacity, speed, and capability to accommodate the reporting of the listed markets as well as the over-the-counter market. \* \* \* Information can be retrieved \* \* \* in terms of a few thousandths of a second and transmitted to any remote location, via the communications network, in a matter of only a few seconds." Univac noted that the cost would consist of two parts, the cost of the computer and the cost of communication to and from the computer. It is estimated that monthly rental of a centrally located computer to receive and supply quotations and store and produce data would be \$24,000, but it did not estimate communication costs.

Some electronics engineers and a broker-dealer conversant in this area have described to the study the potentiality of a system which would select the best bids and offers, execute orders, and clear transactions. Transmitting and receiving units would be installed in the offices of all subscribing broker-dealers. Wholesale dealers and other broker-dealer subscribers could enter quotations (and size of market) into a central computer for indexing under the appropriate security and could interrogate the computer to determine the highest bid and lowest offer, selected by the computer, together with the number of shares bid and offered at such prices.

This would enable a broker-dealer to execute at the best prevailing price or, if he chose, to enter his own limit order in the hope of bettering that price. Thus, in their view the principal barrier to the crossing of public orders—namely, lack of central location—could be overcome by the use of a single, central computer. While portions of the wire and voice systems now in use obviously would still be required, and the Special Study has not attempted to evaluate fully all of the economic and technical considerations involved, it seems clear that the kind of automated system described would perform many of the functions of current communication systems and would substantially

<sup>331</sup> The Special Study requested that Univac base its analysis on the assumptions of a projected over-the-counter volume of 100,000 transactions per day, 200,000 quotation changes per day, and 400,000 quotation requests per day. It was also assumed that approximately 2,000 broker-dealers participated in over-the-counter trading with a fair degree of regularity, another 3,000 firms participated infrequently, the active over-the-counter market consisted of approximately 2,000 to 3,000 issues traded throughout the country, and an additional 20,000 to 25,000 issues were traded sporadically.

increase the flow of information about the trading markets to both the professional dealer and the public.<sup>332</sup>

Apart from the possible utilization of a computer for the crossing of orders, the information supplied by a computer system could be expected to confer important benefits on broker-dealers and on the public. It would permit the immediate identification of the highest bid and lowest offer, and thus facilitate the task of a broker-dealer in obtaining the best market for his customer. Another advantage would be the compilation of complete data relating to quotations and transactions, so that actual price and volume data could be made public as in the case of listed securities, thus improving the ability of investors, lending institutions, and other interested persons to evaluate over-the-counter securities and markets. The data could also be speedily and comprehensively retrieved for surveillance or study purposes by the Commission and other regulatory bodies to which access would be granted. The capabilities in the latter regard were described in this way by one computer manufacturer:

One example of this type of operation would be for a study or report which might require sorting out for analysis all transactions relating to a given individual stock on a certain day or a given hour. Another example would be where it might be desirable to sort a group of transactions recorded on magnetic tape, by broker-dealer, giving the number of individual transactions, the maximum, minimum, or average volume per transaction and the price for each sale.

Times required to sort the tapes could vary depending on the total number of recorded transactions to be sorted. As a rough estimate, sorting times might be as little as 15 minutes up to a minimum [sic] of 1 hour or 1½ hours.

Sponsors of computer systems have reported that electronic systems have met with resistance from those same firms which are opposed to publication of wholesale prices and from wholesale dealers whose participation between public customers might be reduced by a system which would centralize bids and offers. While such opposition to basic changes is to some extent inevitable, the potential benefits of technological developments, both to the industry and the public, makes it imperative that these avenues be thoroughly explored.<sup>333</sup> A recent chairman of the board of governors of the NASD recognized the necessity for a constructive approach at the board's May 1961 meeting:

\* \* \* Mr. Clafin advised the board that other electronic devices, as they become available, will make pushbutton execution feasible and were they here today there would be no problem in handling trading volume.

Growing trading volume subject to electronic handling will bring about a form of revolution in the execution of over-the-counter orders, Mr. Clafin said, and "this will present new problems for the NASD. The board," he advised, "should attempt to steer this period of change, not only to promote the advancement and modernization of our industry but also to predetermine that the end result is controllable. Otherwise, we may well see leadership fall into the wrong hands and thereby lose our ability to supervise. Let us be sure," he said, "that the result lends itself to an era of high standards and ever-increasing morality in our industry." \* \* \*

The relevance of automation to standards of performance and conduct and to the quality of over-the-counter markets generally is the point of ultimate significance. Despite inertia or even resistance, the

<sup>332</sup> Ultronic has indicated that it would be feasible for a computer continuously to provide current quotations for 5,000 securities, and that the computer could handle a 100 million-share day. According to this firm, lease of an interrogation unit would cost a firm from \$35 to \$365 a month, plus a charge (of perhaps 5 cents) for each call made.

<sup>333</sup> Compare the discussion of automation in connection with odd-lot executions in ch. VI.E.



industry must ultimately take advantage of technological progress where considerations of efficiency and economy so dictate, as in any other field of endeavor. On the other hand, the potential of automation is quite obviously a potential for removing or alleviating some of the fundamental problems and limitations that have historically characterized both the operation and the regulation of over-the-counter markets. Thus both business interest and public interest point to the need for constant attention and effort toward realization of this potential.

#### F. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The term "over-the-counter" encompasses all business in securities that is not done on an organized exchange. This definition is sufficient to suggest two of the most important characteristics of over-the-counter markets: first, their diffuseness—the absence of a centralized marketplace and the resulting strong dependence on dealer participation and on communication systems; and, second, their heterogeneity—the variety of securities, participants and practices that results from their being a residual category encompassing "all other," i.e., all non-exchange, business in securities.

The heterogeneity of the over-the-counter markets is stressed at many places in this chapter. It means, among other things, that generalities in description are difficult and sometimes dangerous, and that recommendations that may be essential in some sectors may be unnecessary or inapplicable in others. As in other parts of the report, more attention is necessarily concentrated in this chapter on problem areas than on areas of achievement and strength. Where, for example, there is discussion of diligence in obtaining best executions, it is not to be overlooked that many firms scrupulously discharge their obligations in this regard. Where there is discussion of varying costs of execution, it is not to be overlooked that within the indicated range of variation most transactions are handled on an agency basis with disclosed commissions or on a principal basis within the guidelines of the NASD markup policy. By the same token, however, there are significant deviations and problems in these and other respects, and it is to these that attention needs to be given. With the hope of bringing marginal performance closer to the level of the best performance and generally improving the functioning of over-the-counter markets in the interest of investors, a number of different types of measures are recommended below.

##### 1. NATURE AND GROWTH OF OVER-THE-COUNTER MARKETS

In recent years the volume of over-the-counter trading has grown dramatically. In 1961, the dollar volume of stock sales in the over-the-counter markets was approximately eight times as great as in 1949. This increase in growth was accompanied by an increase in the number of issues traded in the over-the-counter markets—issues which varied widely among themselves in numerous respects.

Broker-dealer participation as principal is more conspicuous and important in the over-the-counter markets than in exchange markets. There is a significant dichotomy between the wholesale (or inter-dealer) market and the retail (or public) market, but with important

interaction between them. The broker-dealer firms doing business in the over-the-counter markets may be broadly classified into wholesale dealers, retail dealers, and integrated firms. Wholesale dealers buy and sell selected securities for their own account, dealing with other broker-dealers. Retail firms executive purchases and sales with or for public customers by dealing with wholesale dealers. Integrated firms conduct both retail and wholesale activities. Any given firm conducting wholesale or interdealer business, whether classifiable as a wholesale or integrated firm, conducts such business with respect to only a fraction of all over-the-counter securities. Thus an integrated firm may strictly be regarded as such only in respect of securities in which it makes an interdealer market; if it does retail business in other securities, it does so in the capacity of a retail rather than an integrated firm as here described.

The professional participation of the wholesale dealer (including the integrated firm acting as wholesale dealer) is necessitated by the absence of a central location for the collection, matching and execution of orders. By announcing his willingness to buy and sell for his own account, he makes it possible for a member of the public to dispose of securities without himself attempting to locate an ultimate public buyer, and for a buyer to acquire shares without searching out the ultimate public seller. By performing this intermediary function the wholesale dealer lends marketability to securities traded over the counter; and to the extent that he purchases or sells on balance for his own account, his participation adds depth to the market.

Over-the-counter business is done by a large number of broker-dealer firms but volume is concentrated in a relatively small percentage of broker-dealers both at the wholesale level and the retail level. The retail concentration features a predominance of NYSE member firms, which account for more than half of the dollar volume in corporate stocks. Many NYSE members also act as wholesale over-the-counter dealers in corporate stocks but in this area nonmember firms do a greater volume. In fact, seven of the nine largest wholesale dealers are not members of the NYSE.

## 2. WHOLESALE MARKETS

Trading in over-the-counter markets necessitates extensive communication among firms. In recent times communication facilities have been vastly expanded and improved; there now is a large network of connecting links between individual firms in the over-the-counter markets, with New York City in many cases acting as a communication center. Many of these communication links are private lines in which the firms on either end are known as correspondents of one another and have established a course of doing business with each other. Communication systems now permit dealers to keep rapidly informed of market situations and also permit facile and inexpensive contact by broker-dealers throughout the country with other broker-dealers.

The qualifications of individual traders conducting wholesale trading for broker-dealer firms vary widely throughout the industry. They are compensated in different ways, in some cases being paid a straight salary while in others receiving a percentage of the profits resulting from their trading activities. Traders may be responsible

for handling anywhere from a few to more than 80 stocks. In general, supervision of traders is quite limited.

Wholesale dealers commence trading primarily because of the expectation of activity. When activity falls off, the wholesale firm may lose interest and discontinue trading unless it feels an obligation as a matter of good business practice to continue to provide a market for customers to whom the security has been sold by the firm itself, its correspondents, or other firms with which it does significant business. Some firms, particularly integrated ones, make markets in securities as an aftermath of serving as managing underwriter of a public offering, in which case a continuing obligation of "sponsorship" may be felt. Some firms may commence to make markets upon the promise of reciprocal business or the grant of options or cheap stock by underwriters or issuers, which may result in a deceptive appearance of broadness of the market and may create incentives and possibilities for manipulation.

Once having commenced trading, the market maker's performance is governed by competitive considerations in many situations and by general provisions against fraud and manipulation in all, but is subject to few specifically defined obligations or restrictions. Some firms feel that the function of the wholesale dealer is simply to make a profit by adjusting to supply and demand and reflecting the market's opinion. Others assert that the wholesale dealer has an obligation to maintain a fair and orderly market. Most members of the industry would regard a good wholesale market as one in which firm two-way quotations are maintained by several competing dealers, spreads between bid and asked prices are reasonably narrow, quotations are "good" for a substantial number of shares, and price fluctuations are kept to a minimum. The extent to which these criteria are met in practice is subject to wide variation, however, primarily because of the wide differences in securities and participants in over-the-counter markets, and also because such pertinent regulatory standards as exist, e.g., the NASD's standards regarding fictitious quotations or "backing away" from presumably firm quotations, have not been supplemented by adequate surveillance and enforcement measures.

The ultimate safeguard for the integrity of interdealer markets is often said to be the factor of competition among dealers. Where competition does exist among several or many dealers, as in the more prominent and active stocks, each competing dealer tends to make a closer market. Moreover, because of the diversities in positions, resources, and expectations among dealers, there may be an even smaller spread between the highest bid and lowest offer in the total market for a security. Thus, competition presents both an opportunity and an obligation for the customer's broker to obtain, upon the exercise of reasonable diligence and care, considering the kind and size of the order, the best market for the customer.

The very breadth and variety of over-the-counter markets means, however, that they include many securities for which at any given time only one or two dealers at most are actively making a market, so that the factor of competition is minimal or nonexistent. Moreover, the appearance of several dealers' active interest in a security may not be a reliable indication of a competitive market, either because most of them are in fact appearing for one and thus making a single market or

because "holding hands" or similar practices may restrain actual competition. Regulatory measures appropriate for genuinely competitive markets may thus be quite inappropriate or inadequate for those where competition is lacking, whether this fact is readily apparent or is disguised under an appearance of competition. A minimum need is to provide better means for the investor and the regulatory agencies to distinguish the latter situations.

The problems of the noncompetitive market partially overlap with those arising out of the role of the integrated firm—the firm which actively engages in both wholesale and retail dealing in a security. There is considerable variation in concepts and practices as to the relationship between wholesale and retail activities in integrated firms, but there are typically two characteristic features that differentiate the integrated firm from either the "pure" wholesale or exclusively retail firm. First, the integrated firm may and often does use its retail department as an outlet for disposing of inventory positions resulting from trading; in other words, unlike the pure wholesale firm it is not limited to using its interdealer quotations and transactions to adjust positions but may conduct its wholesale trading with the expectation of disposing of positions "away from" the wholesale market through retail channels. Second, retail transactions, particularly on customers' purchases, are likely to be on a principal basis out of inventory with the customer frequently acting on the dealer's recommendation. The potential conflict of interest inherent in the dual role, although normal in all merchandising activities including the securities business, may present particular difficulty where, as frequently occurs, the integrated firm is especially active in the immediate after-market of an underwriting which it has managed, or where it is the sole or dominant market maker in an issue at any later stage. Existing requirements or disclosures to retail customers at the time of solicitation and in confirmations do not appear adequate in light of possibilities of abuse.

The wholesale dealer is frequently used by institutional investors in handling large distributions and acquisitions in the over-the-counter markets. The dealer's ability to handle such transactions is partly a result of the fact that other broker-dealers may be expected to channel their inquiries to it and deal on the basis of its quotations, so that the price impact of even a large transaction often may be kept to a minimum. There is considerable flexibility in methods of handling dispositions of blocks, reflecting the fact that various merchandising and distribution methods are available in the over-the-counter markets. There is also evidence that some regulatory requirements that might appear to be applicable, particularly in respect of making a market while handling a block disposition, are often not observed and presumably not understood to apply.<sup>334</sup>

During the early months of 1962, preceding the severe market break at the end of May, some wholesale dealers discontinued certain of their markets, particularly in speculative issues, and there was a general tendency among wholesale dealers to reduce inventories, to quote wider spreads, and to reduce the "size" of the quoted market or quote only on a "subject" basis. During the actual market break days the latter tendencies were sharply accentuated, partly as the result

<sup>334</sup> See the recommendations in ch. IV.B and C with respect to clarification of the application of rule 10b-6.

of communication difficulties. The inability of many wholesalers to perform in anything like their normal fashion apparently reduced the level of liquidity in the over-the-counter markets to a substantial degree.

Wholesale over-the-counter markets are generally characterized by an absence of specific regulatory standards governing the conduct of trading. The commencement and termination of trading activity, the kind of markets maintained, the extent of participation by market makers, the supervision and compensation of traders and other matters of crucial import depend mostly upon the varying economic interests and business practices and standards of individual firms rather than specific regulatory standards. It is not meant to suggest that uniform or detailed standards would be feasible or appropriate for all of these matters, but it would seem that greater attention should be given to this general subject by the NASD and the Commission, in some respects immediately and in others on a longer range basis.

Wholesale dealers advertise their buying or selling interests in securities by placing quotations in wholesale quotation systems. As recognized by Congress in section 2 of the Exchange Act, there is a vital public interest in the fairness and integrity of quotation systems, both wholesale and retail. At present, there is one significant wholesale quotation system, operated privately, possessing monopoly power, and subject to no direct regulation. It is operated by the National Quotation Bureau, Inc., and consists of daily mimeographed "sheets" containing listings for each security of wholesale bid and asked quotations (or in some instances merely indications of interest on one or both sides of the market, without price) supplied by subscribing broker-dealers who elect to do so for any security. The sheets are generally available only to subscribing broker-dealers but some banks and investment advisers are subscribers and some institutions and other sophisticated investors have ready access through broker-dealers.

The Bureau exercises final control over who may enter quotations, and thus, in large degree, over who may do wholesale business in the over-the-counter markets; what minimum capital may be needed to do such business; what securities may be listed; and what kind of listings may be made. The Bureau appears to have operated with a conscientious regard for the responsibility which its function and dominant position entail. It investigates the past business history of those who wish to insert quotations and requires that applicants have a certain minimum capital commitment to the business. It reserves the right to cancel a subscription for inserting nongenuine listings or for engaging in "any unethical business practice" and it is understood that the insertion of suspect listings has played a tacit part in some cancellations. Finally, the Bureau has cooperated with the Commission by turning over evidence of misuse of its facilities. In short, while hampered by insufficient authority and procedures, the Bureau has sought in various ways to insure the integrity and reliability of the sheets.

Experience and study indicate that scrupulous and well-intentioned efforts of the Bureau are not enough. In case after case broker-dealers have abused the wholesale quotation system through inserting fictitious quotations in connection with "boiler rooming" worthless

securities to the public.<sup>335</sup> Fictitious quotations have been inserted in the sheets to give an illusory value of stock to be pledged or to be distributed to the public in a registered offering. Some schemes have been utterly lacking in subtlety: quotations even of nonexistent companies have on occasion slipped by the Bureau's controls. Moreover, in significant ways the quotations published by the Bureau are not as informative as they could and should be. For example, the Bureau does not require a designation of the fact that one broker-dealer is quoting on behalf of another. This has resulted in exploitation for manipulative purposes, although there are legitimate uses also. Its significance in manipulation cases, its separability from other problems, and its ease of correction, make it a matter which should be acted upon at once. Furthermore, the quotations of the Bureau do not indicate whether a company is in bankruptcy or furnish other highly pertinent data about it, and despite the efforts of the Bureau, many companies quoted have been liquidated, dissolved, or merged without notation of this fact in the sheets.

While the Bureau has acted conscientiously, it is anomalous, in markets so affected with a national public interest that it is "necessary to provide for regulation and control of \* \* \* transactions and of practices and matters related thereto,"<sup>336</sup> that private hands hold such crucial powers without public regulation or review. In exercising these powers, the Bureau has inevitably had to leave much undone because of its limited authority as a private body. It is true that many of the problems that it has faced have not been merely matters of wholesale quotations, but rather, aspects of wider problems that have come in the wake of the enormous growth of over-the-counter markets. The end result, in any event, is that a crucial feature of the over-the-counter markets—indeed, their nerve center—has had inadequate controls.

Recent electronic developments leading to the possibility of competing systems, and the fact that the Bureau will eventually pass into other hands, only serve to emphasize the need for regulation. The power that lies in running a wholesale quotation system for the entire over-the-counter market is far too important to the industry, to investors and to the economy, to be entrusted to the hazards of changing ownership or management. There are many ways in which major harm to the integrity of the market could be accomplished by the entry of an unscrupulous operator of a quotation system, and there is no assurance that competition among private systems would be competition for higher standards of performance in the public interest.

The study of wholesale quotations points also to the necessity for a greater recognition of responsibility on the part of the NASD. As the self-regulatory agency for the over-the-counter markets, the

<sup>335</sup> In a statement to the study, the then chairman of the NASD's board of governors indicated that the Bureau has not been able to deal with abuses by certain broker-dealers:

"I would like to broaden your statement. You mentioned a while back certain underwriters, I think we should also include boiler shop types who have operated in New York in the last 5 years. Many of their quotations we know were not very accurate. This is a bit hard to supervise, and I do not think that Walker is able to supervise that. Sometimes these operators go in the sheets for another and quote a market 9½ to 10—but if you want to sell any stock at 9½ you can't do it. Any time that has come up we have called Walker and tried to rectify the situation."

The chairman of the National Quotations Committee also indicated doubts about the Bureau's ability to cope with the task.

<sup>336</sup> Exchange Act, sec. 2.

NASD should at least maintain continuous surveillance and supervision over its members' use of wholesale quotation systems. The task of regulating and policing wholesale quotations might be eased considerably if the NASD itself were to operate the system. However, regardless of the role the NASD may in the future take with regard to wholesale quotation systems, such systems are at the heart of the over-the-counter markets and an appropriate regulatory scheme should be established vesting legal responsibility and authority in the operators of such systems and supervisory controls in the Commission.

### 3. RETAIL MARKETS

A broker-dealer may act as either principal or agent when dealing with a public customer. The study's data show that the majority of over-the-counter transactions of public customers in corporate stocks are handled on an agency basis but that institutions tend to deal on a principal basis to a greater extent than individuals. The proportion of agency transactions in individual stocks tends to decrease as one moves from less active to more active stocks. On the study's sample day there were approximately three times as many firms which acted only on an agency basis in transactions with public customers as there were firms acting only on a principal basis; and for purchases by individuals there was no tendency for small firms to act more frequently on a principal basis than large firms.

Firms with inventory positions in a stock usually act as principal when handling customer orders. This tendency appears to be more pronounced in sales to customers than in purchases from them. In general, the public has a greater volume of transactions with firms which do not have inventories in the particular security than with firms which do.

As seen above, competition in the wholesale markets tends to result in narrower interdealer spreads, while diversities among wholesale dealers may often result in differences in price for either a purchase or a sale of a given security at a given time. For the investor to receive the advantages of diversity and competition, his broker must check markets or "shop around" pursuant to his obligation to obtain the best price discoverable in the exercise of reasonable diligence. The results of diligently checking markets and negotiating for customers is apparently reflected in the generally more favorable executions received by institutions and broker-dealers who buy and sell in larger amounts and who may be assumed to expect diligent executions while the NASD and the Commission have broadly recognized the principle of best execution, there has been little delineation through explicit standards of what it is supposed to mean in practice except insofar as individual firms have established standards for their own personnel. Less favorable executions may be caused in particular instances by a failure to check markets, by channeling of business to certain firms on the basis of reciprocal obligations or patterns of doing business, by **indifference, incompetence or venality** of order clerks, or by the practice of interpositioning which in many cases involves an unwarranted payment to a third firm interposed by the retail firm between itself and the market maker.

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. The spread between net prices paid and net prices realized by public customers appears to be largely related to whether the transactions are executed on a principal or agency basis. Customers placing similar orders for the same security under similar wholesale market conditions may have significantly different costs of execution depending upon the type of firm executing the order and how the firm handles it.

Principal markups ordinarily run higher than agency commissions and they are even higher in so-called riskless transactions (where the dealer sells as principal to his customer and concurrently buys the security sold), which constitute a substantial proportion of retail transactions by dealers as principal. One effect of using the principal form in what is essentially an agency execution is that the broker-dealer's cost and his markup are not disclosed. Not only does the customer typically pay more in a riskless transaction than he would in an agency execution, but he also usually pays more than he would pay in a principal transaction with a firm having a position.

The use of a higher markup in principal transactions has traditionally been justified by the fact that the firm is taking an ownership risk, but this obviously does not apply to the riskless transaction. Another justification has been that a higher markup is necessary to cover the expenses involved in making retail sales of over-the-counter securities, including both costs of solicitation and costs of research. However, where principal dealing would appear more justifiable on these grounds—namely, in the case of small, inactively traded issues—agency transactions are somewhat more prevalent than elsewhere. Moreover, as noted above, the study's data show no greater tendency toward principal executions among firms doing low volumes of business (presumably those with higher proportional expenses) than among those with higher volumes.

The retail quotation system for over-the-counter securities, sponsored by the NASD, is closely related to the problem of retail executions, both as cause and consequence. The present system involves publication of a single "bid" and "asked" quotation for each security listed, the former usually being the inside bid as supplied by a single dealer for each security and the latter being the inside offer supplied by the same dealer but adjusted upward under a "rule of thumb" generally predicated on the NASD markup policy discussed below. The inside quotations are not necessarily supplied by an actual market maker and frequently do not reflect the best inside market. As adjusted, they characteristically show a 7- to 10-percent spread between bid and asked and do not necessarily reflect the "range" within which retail transactions have actually occurred.

The NASD has stated that the supervision of retail quotations "is properly an industry obligation and responsibility."<sup>337</sup> Pursuant to this conviction the NASD has been successful in substantially eliminating the former practice whereby individual firms supplied newspaper quotations under their own bylines and in reducing the excessive spreads that often appeared prior to its assumption of responsibility in this area. However, the NASD has not succeeded in creating a

<sup>337</sup> NASD Manual, G-53.



quotation system that can be regarded as sufficiently reliable, informative, or objective. A long history of discussing and revising the system and of rewording the explanatory legend has produced what appears to the Special Study to be an indefensible result: a "quotation" system that quotes neither actual bids and offers nor a range of actual prices. Such a system must be confusing if not deceptive to many investors, quite apart from the explanatory masthead that appears in some newspapers, and may be even more misleading with that masthead, which fails to explain what the terms "bid" and "asked" mean, and ties them confusingly to a price "range" as if they related to a "high" and "low" in a trading day.

The heart of the difficulty stems from the NASD's statement that the system is "designed \* \* \* to assist retail dealers in *selling* [emphasis in original] securities as *principal* [emphasis supplied]." Such assistance to retail dealers takes the form of showing a substantial range between the "bid" and "asked"—terms which are themselves misnomers. Within that range, sales to customers may be made on a "net" basis without guidance as to the inside trading market and without disclosure of the amount of markup or even that any markup is involved. It should be noted that, under present practices, a majority of over-the-counter purchases by individuals are executed on an agency basis and with disclosure of the cost of execution. However, the fact that a customer always has the right to purchase on an agency basis and that securities can ordinarily be bought at less than the published "asked" price is not universally understood. In these circumstances the system encourages the handling of purchase transactions on a principal "riskless" basis, with increased cost to the customer, and provides no basis for evaluating the quality of executions.

Moreover, the NASD and many of its members have consistently opposed the release of wholesale quotations to the general public, yet institutions and other favored investors have gained regular access to the sheets through NASD members. This situation has prevailed despite the policy expressed in section 15A(b)(7) of the Exchange Act, that an association's rules "are not [to be] designed to permit unfair discrimination between customers \* \* \*."

A standard justification for the present system is to the effect that the public would misunderstand any other system, but it may not be assumed that the over-the-counter markets can function only by withholding what in other contexts is deemed essential information. The NASD and other industry organizations can and should undertake further efforts to educate the public as to the mechanisms of the over-the-counter markets, in this and other respects. While a change from the present quotation system may create special need for educational efforts, it is believed that little explanation will be needed for a system which does not hold itself out to be something more than or different from what it is in fact.

There may be various appropriate substitutes for the present system. The evolution of electronic techniques may substantially increase the possibilities but change should not be deferred. There should be a system of publishing, for the use of the general public, the best bid and the best asked price quotations of primary market makers appearing in the wholesale sheets, with an indication of the number of

market makers. Such publication should be accompanied by an appropriate masthead such as:

The following prices are dealers' (wholesale) bid and asked prices as of (the time of compilation). Retail transactions ordinarily may involve a markup, a markdown, or a brokerage commission, which may result in higher costs of purchases or lower proceeds from sales than the quoted dealers' prices.

In regard to quotations which do not appear on any national or regional list, the NASD has recently authorized closer supervision over local quotations committees. While the role of such committees may be diminished or modified in the future, to whatever extent they continue to function, the need for closer national supervision is clearly indicated. There is also need to make the Commission's responsibility and authority over the NASD's quotations activity as clear as its role with respect to broker-dealers' use of quotations.

The markup policy of the NASD, on which principal reliance is now placed to protect the public against overreaching in retail prices, is closely related to the retail quotation system in its history and concept. While the Commission had originally proposed a disclosure approach for dealing with unreasonable markups—an approach normally considered less drastic than substantive regulation—the NASD opposed disclosure and turned instead to a regulatory solution. In the administration and enforcement of the markup policy, there appears to be considerable confusion and misunderstanding as to when the base of computation is the dealer's own contemporaneous cost and when it is the prevailing wholesale offer. Its enforcement depends on postsurveillance in the course of routine inspections of NASD member firms. Such inspections take place on an approximately 3-year cycle and include making a computation of markups on a sample of each firm's transactions.

The NASD markup policy has served an important purpose in preventing excessive spreads in retail quotations and in setting outer limits of permissible retail pricing. However, it does not meet the needs of investors for additional disclosures about the trading markets, on the basis of which informed decision and evaluations may be made.

The Commission's regulation of over-the-counter markets has relied essentially on the fraud provisions of the Securities Act and the Exchange Act. In rules and administrative proceedings pursuant to these provisions the Commission has defined obligations inherent in doing business with public customers. This approach has been most successful in dealing with flagrant situations. It puts emphasis on disclosure in limited circumstances, expanded in recent cases, but still falls short of providing the full protection needed by investors in over-the-counter markets. The basic need of the investor in such markets, which neither the NASD's markup policy nor the Commission's use of its fraud powers has adequately provided, is for timely disclosure of information useful in appraising the quality of markets and the quality of executions—information that is needed no less than information relevant to the quality of the securities themselves.

#### 4. AUTOMATION

Automation has only slightly touched the over-the-counter markets, present uses being largely concentrated in servicing back office operations. Recent, rapid advances in technology now offer the prospect

of major new applications in over-the-counter markets, in the handling of quotations and otherwise.

It appears to be technically feasible to use a central computer to record and report interdealer quotations for some or all over-the-counter securities on a continuous basis. In addition to providing a method for instantaneously determining best quotations, such a system might provide wholly new means of matching buy and sell orders and even accomplishing their execution in some circumstances. The same system might be used for reporting and storing actual transaction information, thus for the first time making price and volume data available on a current and continuous basis.

The possibilities of automation are of great importance to the industry itself, because of the potential for improved efficiency and economy. They are of at least equally great importance to the public, because of the potential for solution of basic problems that have historically characterized both the operation and regulation of over-the-counter markets.

##### 5. NEEDS OF THE OVER-THE-COUNTER MARKETS

The over-the-counter markets are large and important, they are heterogeneous and diffuse, they are still relatively obscure and even mysterious for most investors, and they are also comparatively unregulated. These characteristics are not unrelated: The obscurity stems in part from the markets' very size, variety, and diffuseness, while the relative lack of regulations reflects a failure to keep pace with their growth and change since enactment of the original securities laws plus the difficulty of encompassing their wide variety in uniform regulatory measures.

An important step toward better understanding and regulation would be better identification and classification of what is involved in these markets—what securities, what broker-dealers, what practices. With appropriate identification and classification of components it should become feasible to devise substantive measures appropriate for particular categories, rather than uniform and undifferentiated measures that inevitably must be inappropriate for some categories in the total over-the-counter markets. These comments apply both to the variety of securities traded in over-the-counter markets and the variety of broker-dealer participants and their functions and practices.

Most over-the-counter securities presently live in an entirely different regulatory world from exchange-listed securities, even though many of them are quite indistinguishable from many securities in the other world and bear almost no resemblance to others in their own. To provide more logical differentiations, it is recommended in chapter IX that there be a defined group of over-the-counter securities (there referred to as "OTC listed")<sup>338</sup> which would be treated substantially like exchange-listed securities, rather than like other over-the-counter securities, for purposes of reporting, proxy solicit-

<sup>338</sup> Subsequent to the publication of ch. IX it has been suggested that the particular designation of "OTC listed" would be an unfortunate one because of possible confusion with "listed" (on a stock exchange). If this is deemed a valid objection, an alternative designation could readily be found (e.g., "OTC special," "OTC disclosure list," "OTC registered," "OTC public") without impairing the principle that there should be a special designation.

ing, and insider trading. By the same token, this category would be identified and recognized for various purposes relevant to this present chapter and chapter III.B (selling practices). Similarly, it is recommended in chapter X that separate categories of over-the-counter securities be recognized, and treated more like exchange-listed securities than like other over-the-counter securities, for purposes of extension of credit by broker-dealers and banks.

Similar needs exist with respect to broker-dealer participants in the over-the-counter markets—needs for clearer identification of those making markets for particular securities and for a degree of categorization of the markets. Some 3,300 separate broker-dealers have reported (in Questionnaire OTC-3) doing some kind of over-the-counter business (apart from those exclusively in mutual funds, municipals and governments, and other specialized categories). The study has found that in over-the-counter markets broker-dealers advertised interests in at least 14,000 corporate stock issues (see ch. IX.B), and there is little information as to the real nature, composition or operation of the market in any security at any time. It is not much of an exaggeration to say that a Special Study, or at least a special market quiz, is needed to find out exactly which dealers are engaging in transactions—and if so, in what volumes, at what prices, and in what manner—in any particular security during a particular period. Because of the large numbers and varieties of securities and participants involved, the nature of the market for any particular security and the reasonable expectation of investors in such security, as well as the needs and possibilities for protection of investors, are intimately related to the number and identity of dealers making an interdealer market in such security.

Establishing a continuous system of identifying “primary market makers”—those dealers who have undertaken to make an independent market for a particular security at any given time—would enable other broker-dealers, the public, the NASD and the Commission to know what kind and how competitive a market exists for such security and where to turn for active market interest, for reliable interdealer quotations and for information as to actual volumes and prices. In addition, regulatory authorities would have an established source of information as to commencement of trading in unregistered issues, as to sources of buying and selling in critical periods, as to significant long and short positions, and similar matters; and members of the industry would have more solid knowledge of where to turn for the working out of abnormal transactions, handling of limit orders, and other special situations.

Beyond this data-supplying function, a system of continuous classification and identification would serve as a basis for whatever degree of further regularization and regulation of over-the-counter markets may seem warranted, now or in the future, in what should be a continuing effort to improve and strengthen such markets generally. In order to have a reasonable basis for selectively applying and enforcing appropriate standards, the necessary starting point is a reliable means of differentiating markets according to the number of independent market makers and of identifying those market makers.

While the establishment of such a system of identifying primary market makers should be a goal of high priority, certain reforms of over-the-counter mechanisms and practices can and should be under-

taken whether or not such a system is established. Likewise, although developments in automation would tend to facilitate some of these reforms and might tend to make others academic, the reforms can and should be undertaken regardless of the manner or pace of applying automation in the over-the-counter markets. These reforms are of various kinds but most of them have essentially the same objective, in response to essentially the same need. The need is one arising out of the multiplicity and heterogeneity of markets and professional participants that have been apparent throughout this discussion of over-the-counter markets. The objective is to meet this need by means of disclosure—providing more reliable and more readily available information about markets and prices than exists under present rules and practices.

It has been seen that the securities and markets constituting the broad over-the-counter category range from well-known, established companies with a substantial number of dealers making a close and competitive market at one extreme, to obscure, recent issues with a single dealer dominating the market, quoting widely spread bid and asked prices, and combining wholesale and retail trading at the other extreme, and with many variations and gradations between the two extremes. An investor's reasonable expectation when he buys an over-the-counter security necessarily depends on where in the broad spectrum the particular security falls. Just as he needs basic disclosures about over-the-counter securities themselves, he needs basic disclosures about their markets. He should be afforded information about the depth of dealer interest and the identity of the dealers making the market,<sup>339</sup> so that he may have some conception as to the prospect for continuous marketability. He should have access to information about price spreads in the interdealer market so that he may have some conception of the level at which a sale may be expected to occur in relation to the level at which a purchase can be made. He should have access to information about prices in the interdealer market—on which the retail market in which he deals is ultimately dependent in a most fundamental sense—so that, in addition, he may have a basis of knowing how good an execution was obtained, and what cost of execution was charged by his own broker-dealer. Such disclosures are not only needed for intelligent investment decision by the customer, however; as in all other areas of disclosure, they serve the important prophylactic purpose of silently policing the performance of the broker-dealer himself.

One such reform, or set of reforms, relates to the reliability and informativeness of the wholesale quotation system. Such a system provides information that is basic to everything else because it tells at any given time and over spans of time what dealer interest exists,

<sup>339</sup> One NASD official described the importance of the identity of dealers making markets in this way:

"I had been on the Business Conduct Committee now for the past year and come to grips quite frequently in the markup cases. I do not want to sound ethereal, but I think there are several abstractions that I have looked to and I suspect others have.

"No. 1 is the security question. If I see the Bankers Trust, First National City Bank, Dun & Bradstreet, large, reputable companies, that is a factor in my judgment. I know I can trust the market. I look to the people who are making the market, if you please. Are the firms reputable; are they knowledgeable; what is the background of their interest; do they have traditional underwriting relationship, and so forth and so on; or are these firms part of a group which are known in trade as to operate on the fringe and go hand-in-hand and work in concert with each other and what not?

"These are all factors that I have tried to utilize to determine what I think is one of the pivotal things; the validity of this market."

the basic price levels at which particular securities are capable of being bought and sold, and the spread between these levels. In its present form, however, it fails to reveal important information that can and should be readily disclosed. In particular, it fails to differentiate in any way the quotations of an independent market maker from those of another broker-dealer who may, for convenience or with insidious purpose, be quoting merely a carbon copy of someone else's market. Other significant improvements in the wholesale quotation system are recommended below but unquestionably the most important single reform would be to impose a requirement for clear differentiation of quotations entered for correspondents and quotations representing multiple expressions of the same market.

Another needed change, of especial value after the quotation system has been made more reliable and informative but independently useful apart from that, is to make the wholesale quotation system publicly available. Of all the mechanisms of the over-the-counter markets it is the most crucial. It is crucial because everything else that occurs in the over-the-counter market ultimately depends on what that system most clearly and conveniently shows—the number of interested dealers and the prices at which they are willing to buy and sell. Although reflecting the wholesale level, it is the most reliable indication of what can be done at the retail level, and thus the best measure of the quality and fairness of what happens there. Some non-broker-dealers now have access to the sheets although it is denied to most, a form of discrimination that itself seems highly dubious in a fair market or a free and open one. But apart from this, under a regulatory system founded on disclosure as basic to the protection of investors, the policy of nondisclosure of the most vital single source of information about over-the-counter markets should no longer endure.

The same conclusion, for similar reasons, applies to the retail quotation system of the NASD. This system starts with a selection, out of the welter of over-the-counter securities, of those commanding sufficient public attention to be included in what must necessarily be a more selective newspaper (or electronic) listing. The present retail system provides a convenient source of information beyond what is available for most over-the-counter securities, but it has the effect of masking the interdealer market rather than disclosing it. As a result, it provides no means of testing the quality of execution or ascertaining the service charge imposed for the execution at the retail level. It may be granted that the range of variation in the handling of transactions is kept within limits by the NASD's markup policy—the variation would not ordinarily be a matter of several points but perhaps a point or two at the most—but in buying and selling securities the latter range, or even fractions of points, may be the all-important difference between a favorable and an unfavorable result. The investor should not be denied, through the retail quotation system or otherwise, the ability to perceive such differences.

Both for securities in a retail quotation system and for the larger mass of securities not so quoted, certain disclosures are so important that they ought to be regularly made in confirmations of transactions or, where practicable, at the time of solicitation. Of particular consequence, for reasonable investor awareness of what he buys and how

his transaction is handled, is knowledge of whether the broker-dealer is executing a retail transaction out of its own inventory or another firm's and whether an independent market does or does not exist. Where the executing broker-dealer is in reality acting as agent as in a riskless transaction, in the sense of buying or selling in the inter-dealer market to accomplish the customer's transaction, the agency form should be required so that the price and commission will be disclosed. The problems of disclosure and fair dealing are more difficult where the broker-dealer has an inventory through which the customer's transaction is handled, but it is precisely here that the markup policy is most difficult of application and in greatest need of supplementation through disclosures. The investor should have the means of appraising the quality and cost of execution, even though merged in a single net price charged by the integrated broker-dealer, through knowledge of the approximate level at which the transaction might have occurred in the interdealer market if it had been executed on an agency basis.<sup>340</sup>

In these and other respects specified below, the full disclosure philosophy needs to be given new meaning and vitality in over-the-counter markets. It seems quite inconsistent with that philosophy that broker-dealers, whether or not making a market or having an inventory position in a security, may engage in principal transactions with public customers but not disclose whether they are dealing with their own inventory, whether and what kind of an independent market exists, or the amount of their markups in relation to the independent market.

Quite paradoxically, the NASD has resorted to a theory of direct regulation rather than disclosure in this area, in the form of its markup policy. This approach, as supplemented by the Commission's use of its fraud powers in regulating over-the-counter markets, sets important outer limits of conduct and undoubtedly precludes gross overreaching. These limits are still wide enough to be important, however, and within such limits, as in other areas of the securities markets, there is no satisfactory substitute for full and reliable disclosure to investors of facts essential for intelligent appraisal and self-protection.

The merchandising character of the securities business is recognized at various points in this report, and it is a necessary corollary that selling and other costs as well as entrepreneurial profit must be adequately provided for in any pricing system.<sup>341</sup> Nothing herein is intended to contravene these facts of business life or to suggest that any particular level of commissions or markups, equivalent to stock exchange commission rates or based on a "5-percent policy" or otherwise, is appropriate or inappropriate for over-the-counter transactions generally or any particular type of transactions, security, broker-dealer firm or geographical or other circumstance. Whatever the appropriate level of markup or commission for a particular transaction and assuming that it may vary in different circumstances, it is difficult to see why

<sup>340</sup> It has already been seen that many firms in the entire volume spectrum now use agency executions (with disclosed commissions) for many securities of varying degrees of activity. See 2.a, above.

<sup>341</sup> Carrying out the recommendations of ch. IX to provide regular reporting data for over-the-counter securities should considerably reduce the dealer's burden of research which has often been cited as a reason for higher costs of doing business in such securities.

it should be necessary to conceal what elsewhere in the securities business is considered essential to be disclosed. It is a standard requirement, for example, that there be complete disclosure of the spread in underwritten offerings, often amounting to as much as 10 percent or more on common stock issues, and of the sales load on mutual fund shares, typically amounting to 8½ or 9 percent. Disclosure in these situations has not discouraged merchandising activity or successful selling, and it is not apparent why it should do so in the over-the-counter markets generally.

#### 6. CONCLUSIONS AND RECOMMENDATIONS

##### **The Special Study concludes and recommends:**

**In view of the heterogeneity of over-the-counter securities and markets and the need for categorization of components, as emphasized in the above discussion, the following program is put forth with recognition that the measures recommended are not necessarily equally applicable to all securities, broker-dealers, or markets, so that the appropriate scope and limitation of particular measures may require a more exact definition in the process of implementation. It is also recognized that, while the following recommendations are designed as a total integrated program, the form and timing of the implementation of certain of them might have the effect of lessening the need for others.**

**1. In the over-the-counter markets, there is a dichotomy between interdealer (wholesale) and public (retail) markets in many important respects, but there is a close and continuous relationship between wholesale and retail markets for any particular security. Interdealer and public quotation systems are vital to the operation of these markets and, whether handled by private enterprise or by a self-regulatory agency, they are vested with a public interest and should be brought under appropriate supervisory control of the Commission. At the same time, the operator of any such system would be vested with authority and responsibility to regulate the use of its system by broker-dealers through appropriate rules and procedures consistent with the rules of the NASD and the Commission.**

**2. Broker-dealers, although entirely free to change their interdealer quotations in the course of trading as at present, should be positively obligated to buy or sell 100 shares (or other indicated "size") of a quoted stock at their prevailing quotations, unless clearly designated as not firm, and should be required to keep a timed record of changes in quotations. All quotations entered in an interdealer quotation system should be firm, unless otherwise designated, when supplied. The NASD should establish appropriate programs for surveillance and enforcement of these obligations. The NASD and/or the Commission should have the power and responsibility to deny or temporarily suspend any broker-dealer's right to enter quotations in an interdealer quotation system with respect to a particular security or all securities, for willful abuse of a quotation system (e.g., by entering other than bona fide quotations) or willful violation of any special rules applicable to interdealer quotations.**



3. Other rules applicable to interdealer quotation systems and/or to broker-dealers using such systems should require (a) that quotations entered by one broker-dealer on behalf of another be so designated by appropriate symbols, with clear differentiation between correspondent arrangements and other arrangements involving this practice, and with clear indication where two or more quotations in different names represent a single quotation; (b) that "OTC listed" securities (see ch. IX)<sup>342</sup> be differentiated from all other securities by appropriate symbols, and that securities eligible for extension of credit (see ch. X) be designated by separate symbols; and (c) that, consistent with the recommendation in paragraph 9, persons other than broker-dealers be eligible to become subscribers to interdealer quotation systems, and that broker-dealers be required to make available to their regular public customers, upon request, any quotation system to which they may be subscribers. In addition, upon establishment of a system for identification of "primary market makers" as recommended in paragraph 4, consideration should be given to a further rule providing that primary market makers for a particular security should have the exclusive right (subject to possible defined exceptions) to enter two-way quotations in any interdealer quotation system; whereas any other broker-dealer, although free to enter one-way or OW or BW quotations, should be permitted to enter two-way quotations only as correspondent for an identified primary market maker.

4. Because of the large numbers and varieties of securities and participants involved in the over-the-counter markets, the quality and depth of the market for any particular security and the reasonable expectations of investors in such security are intimately related to the number and identity of dealers making an interdealer market. As a foundation for various immediate or longer term improvements in the operation and regulation of over-the-counter markets, a system for official identification of the "primary market makers" in each security (tentatively defined for this purpose as "any broker-dealer who, with respect to a particular security, holds himself out, by entering two-way quotations in any interdealer quotation system or otherwise, as being willing to buy from and sell to other broker-dealers for his own account on a continuous basis") should be established by the Commission or the NASD as promptly as necessary mechanical arrangements can be worked out. Such a system would contemplate that each primary market maker in a particular security would file, prior to or promptly after becoming such, a data card showing the name of the security and the dealer's relation to the issue or issuers (as underwriter, director, optionee, etc.); that a primary market maker ceasing to act as such, either permanently or temporarily, would give notice to that effect; and that the Commission or the NASD would maintain, for public inspection or circulation, an official "primary market list" of those dealers who are primary market makers for each security at any given time.

<sup>342</sup> See note 338, above.

5. The Commission and the NASD should make it part of their continuous agendas to seek further possibilities for strengthening the mechanisms of interdealer markets and the protection of investors in relation thereto, particularly in light of the possibilities of automation referred to below. Among other subjects for possible coverage in future rules, interpretations or statements of policy, to be applied either generally or in respect of specified categories of securities or of broker-dealers, would be: rights and obligations of primary market makers in maintaining competitive, fair and orderly markets; the grant of "cheap stock," warrants or options to primary market makers (see ch. IV.B); standards of supervision and methods of compensation of traders; intrafirm responsibility for and supervision of the insertion of quotations in an interdealer quotation system; provisions for the handling of limit orders; and possible special requirements or exemptions for primary market makers in broker-dealer capital rules, including a possible exemption from "haircut" provisions in respect of limited amounts of inventory of securities traded by a primary market maker (see ch. III.D).

6. While a public investor must ultimately rely upon the competence and probity of his broker-dealer for a good execution, under present rules and standards in over-the-counter markets the price paid or realized by an investor on the purchase or sale of a security may depend, to an excessive degree, on the diligence of the broker-dealer and the capacity in which he acts and/or on the identity of the investor. The NASD and/or the Commission should adopt rules and standards requiring all broker-dealers executing retail transactions, whether or not they are primary market makers in the particular security and whether the transaction is on a principal or agency basis, (a) to make reasonable effort, in light of all circumstances including the kind and size of order, to ascertain the best interdealer quotations (and to show in their permanent records the number of markets checked), and (b) to provide an execution as favorable as may reasonably be obtained in light of the kind and amount of securities involved and other pertinent circumstances.

7. Under present rules and standards in over-the-counter markets the disclosure of facts on which the investor may judge the price and quality of an execution depends in part on whether the broker-dealer acts as agent or principal. So-called "riskless" transactions, i.e., those in which a broker-dealer who neither is a primary market maker nor has a bona fide inventory position elects to execute a customer's purchase order by buying from another broker-dealer and reselling to the customer (or the reverse in the case of a customer's sale order) on a "net" basis without disclosure of markup or commission, are inherently susceptible to abuse and (subject to possible defined exceptions) should not be permitted to take that form; that is, a broker-dealer who neither is a primary market maker nor has a bona fide inventory position should be required (subject to defined exceptions) to execute customers' orders on an agency basis.

8. The NASD's markup policy is in need of substantial clarification and strengthening in respect of other than "riskless" transac-

tions. In particular, an integrated broker-dealer's obligation and standards of retail pricing in relation to its contemporaneous cost or its current interdealer quotations, especially in the case of securities for which there is no independent market, should be defined, by the Commission and/or the NASD, more clearly and positively than has been done in the interpretations or administration of the present markup policy.

9. As a further basic improvement in retail over-the-counter markets the present retail quotation system of the NASD should be supplanted by a system designed to show generally (with appropriate exceptions to deal with exceptional categories of securities or situations, if any) the best prevailing interdealer bid and asked quotations that can be reasonably ascertained and the number of primary market makers for each security. Any other quotation system designed for public dissemination, including electronic systems, should be required to conform to the same provisions. By appropriate explanatory legends and by NASD-sponsored educational efforts the investing public can and should be advised that published quotations in such form are interdealer quotations rather than retail quotations and hence are subject to markups, markdowns, or commissions in retail transactions.

10. The NASD should reexamine and strengthen, in a manner consistent with the above, its methods of handling "local" quotations, the functioning of its local quotations committees, and its procedures for coordinating and supervising the work of such committees.

11. The NASD should also give consideration to ways and means of improving its retail quotation system in other respects, including, but not necessarily limited to, supplying indications of dividends, ex-dividends, insolvency or reorganization proceedings, etc., in the manner of stock exchange quotations.

12. To the extent that space limitations prevent inclusion in any newspaper or similar quotation system of more than a fraction (presently about one-sixth) of all securities quoted in interdealer systems, the privilege of being included in the NASD's "national" or "regional" lists should be limited to the "OTC listed" category (see ch. IX),<sup>348</sup> and within that category the selection should be based on appropriate rules of the NASD or other operator of the particular quotation system.

13. The NASD and/or the Commission should reexamine present requirements with a view to improving disclosures, at the time of soliciting a retail purchase or in confirmations, of essential information relevant to particular types of retail transactions. Among other possibilities that should receive early consideration in this connection would be rules of the following kinds: (a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20 percent or more in prevailing interdealer bids and offers, should be required to disclose such fact or facts at the time of solicitation. (b) The confirmation of a customer's purchase or sale involving 100 shares or less (or, in the case of securities priced

<sup>348</sup> See note 338, p. 669, above.

at \$5 per share or less, involving say, \$1,500 or less), if handled on a principal basis, should be required to show the best interdealer quotation on the opposite side of the customer's transaction (i.e., the interdealer bid in the case of a customer's sale or the interdealer offer in the case of a customer's purchase) reasonably ascertainable at time of execution. (c) The confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between interdealer bids and offers by showing a representative bid quotation.

14. With an already strong communications network, there is on the horizon the likelihood of a computer system that would assemble all interdealer quotations and instantaneously determine and communicate best quotations for particular securities at any time. If such a system were established, the further possibility of using it in connection with executions and to compile actual price and volume data for over-the-counter transactions would exist. Any such automated system would clearly be affected with a public interest and should be under regulatory supervision. The NASD is the natural source of leadership and initiative in dealing with matters of automation in respect of over-the-counter markets. It should actively carry forward the very limited study of automation possibilities applicable to over-the-counter markets that the Special Study has been able to undertake and should report to the Commission from time to time as to the progress and programs of the industry in this area. The Commission and the NASD should jointly consider possibilities for developing and coordinating automation programs in such manner as to fulfill their respective regulatory needs, as well as operational needs of the markets, with maximum effectiveness and minimum duplication and expense.

15. In the absence of a completely automated system for recording transaction data, consideration should be given by the Commission and the NASD to the feasibility of establishing a reporting system designed to obtain maximum price and volume data, without undue burden, for actual transactions in over-the-counter securities or for specified categories of transactions and/or securities.

16. Interdealer or retail over-the-counter transactions in exchange-listed securities present special problems because of their actual or potential interaction with auction markets. In implementing the recommendations in this chapter for over-the-counter markets generally, appropriate exceptions and/or special requirements should be provided for over-the-counter transactions in exchange-listed securities. Other recommendations on this subject appear in chapter VIII.D.

## TABLES

TABLE VII-1.—Distribution of number of markets made in over-the-counter stocks by registered broker-dealers (as of Feb. 28, 1962)

Number of markets made:	Number of broker-dealers making markets
Total.....	1,098
Over 200.....	11
151 to 200.....	9
101 to 150.....	21
91 to 100.....	10
81 to 90.....	17
71 to 80.....	8
61 to 70.....	11
51 to 60.....	24
41 to 50.....	18
31 to 40.....	45
21 to 30.....	100
11 to 20.....	184
6 to 10.....	211
1 to 5.....	406
Not available <sup>1</sup> .....	23

<sup>1</sup> Broker-dealer firm reported that it made markets but did not give the number of stocks in which markets were made.

TABLE VII-2.—Transactions as principal in over-the-counter stocks by 25 largest wholesale dealers with other broker-dealers and with the public (Jan. 18, 1962)

[Value of transactions in thousands of dollars]

Broker-dealer	Transactions with other broker-dealers			Transactions with the public			Number of markets made
	Total	Purchases	Sales	Total	Purchases	Sales	
<b>Firm:</b>							
A.....	4,557	2,449	2,108	2,738	1,317	1,421	201
B.....	3,303	1,594	1,709	65	65	-----	535
C.....	2,339	1,095	1,244	29	13	16	747
D.....	1,974	981	993	1,014	423	591	123
E.....	1,853	956	897	1,821	865	956	100
F.....	1,828	982	846	18	4	14	500
G.....	1,763	1,438	325	837	168	669	67
H.....	1,289	636	653	5	-----	5	183
I.....	1,145	518	627	117	63	54	301
J.....	1,126	787	339	829	339	490	353
K.....	1,112	649	463	15	15	-----	100
L.....	1,081	493	588	317	273	44	116
M.....	1,044	546	498	39	8	31	-----
N.....	1,021	668	353	368	46	322	144
O.....	1,009	807	202	680	202	478	40
P.....	950	537	413	325	142	183	-----
Q.....	778	382	396	-----	-----	-----	210
R.....	764	377	387	63	9	54	98
S.....	708	318	390	183	125	58	75
T.....	703	349	354	484	192	292	73
U.....	677	101	576	580	525	55	13
V.....	659	347	312	120	73	47	85
W.....	621	383	238	250	30	220	163
X.....	617	323	294	12	3	9	-----
Y.....	530	231	299	-----	-----	-----	299
All selected dealers...	33,451	17,947	15,504	10,909	4,900	6,009	4,526

NOTE.—Broker-dealers were selected on the basis of their principal purchases from and sales to other broker-dealers on Jan. 18, 1962.

680 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS

TABLE VII-3.—Spread between inside bid and offer classified by number of dealers listed and price of stock (212 selected stocks<sup>1</sup> on Oct. 31, 1961)

Percent spread between inside bid and inside offer <sup>2</sup>	All stocks	Number of dealers listed <sup>3</sup>						
		1 to 2	3 to 4	5 to 6	7 to 8	9 to 10	11 to 14	15 and over
a. Number of stocks priced from \$0.01 to \$3.00								
Total.....	54	25	11	6	5	3	1	3
0 to 9.9.....	5	3			1		1	
10.0 to 19.9.....	9	3	2		2			2
20.0 to 29.9.....	13	7	3	2		1		
30.0 to 39.9.....	13	6	1	1	2	2		1
40.0 to 49.9.....	8	4	2	2				
50.0 and over.....	6	2	3	1				
b. Number of stocks priced from \$3.01 to \$10.00								
Total.....	68	22	18	13	5	6	3	1
0 to 4.9.....	6	1	2	2			1	
5.0 to 7.4.....	23	10	2	5	2	1	2	1
7.5 to 9.9.....	12	4	1	3	3	1		
10.0 to 12.4.....	11	4	4	2		1		
12.5 to 14.9.....	7	2	2	1		2		
15.0 and over.....	9	1	7			1		
c. Number of stocks priced from \$10.01 to \$20.00								
Total.....	32	6	11	8	2	1	2	2
0 to 2.4.....	1			1				
2.5 to 4.9.....	13		4	4		1	2	2
5.0 to 7.4.....	11	3	5	3				
7.5 to 9.9.....	4	1	2		1			
10.0 and over.....	3	2			1			
d. Number of stocks priced from \$20.01 to \$35.00								
Total.....	31	6	11	6	5	1	1	1
0 to 2.4.....	4			1	1	1	1	
2.5 to 4.9.....	17	3	4	5	4			1
5.0 to 7.4.....	7	2	5					
7.5 and over.....	3	1	2					
e. Number of stocks priced from \$35.01								
Total.....	27	6	9	7	1	3	1	
0 to 2.4.....	12		4	3	1	3	1	
2.5 to 4.9.....	10	3	3	4				
5.0 to 9.9.....	4	2	2					
10.0 and over.....	1	1						

<sup>1</sup> Sample of 212 stocks, beginning with the letter "A," which appeared in National Quotation Bureau, Inc., the National Quotation Service, Eastern Stock Section, which were quoted on Oct. 31, 1961, and which had at least 1 dealer quoting a 2-way market.

<sup>2</sup> Based on the 1st 2-way quotation for each selected stock. Percent spread was computed as the difference between the bid and offer expressed as a percent of the offer.

<sup>3</sup> Includes all dealers listed for each stock in National Quotation Bureau, Inc., the National Quotation Service, Oct. 31, 1961, irrespective of type of quotation inserted.

TABLE VII-4.—*Spread between average prices of purchases and sales by market makers (including sponsors) in over-the-counter transactions with other dealers (96 selected stocks classified by value of shares sold,<sup>1</sup> Jan. 18, 1962)*

[Number of stocks]

Percent spread between average purchase price and average sale price <sup>2</sup>	All stocks	Total value of shares sold (in dollars)							
		Less than 2,000	2,000 to 4,999	5,000 to 9,999	10,000 to 19,999	20,000 to 49,999	50,000 to 99,999	100,000 to 199,999	200,000 and over
Total.....	96	7	8	15	16	15	10	16	9
Less than 1.0.....	26		2	1	4	2	1	9	7
1.0 to 1.9.....	26		1		6	7	4	6	2
2.0 to 2.9.....	17	1		4	3	4	4	1	
3.0 to 3.9.....	5			2	2	1			
4.0 to 4.9.....	5	1	1	1	1		1		
5.0 to 9.9.....	10	2	2	5		1			
10.0 to 14.9.....	5	2	1	2					
15.0 and over.....	2	1	1						

<sup>1</sup> All stocks in the sample of 200 stocks in which there were both purchases and sales by market makers or sponsors as principal with other broker-dealers on Jan. 18, 1962.

<sup>2</sup> Percent spread was computed for each stock as the difference between average price received by market makers and average price paid by market makers expressed as a percent of the latter price. Transactions where the broker-dealer acted as agent are excluded.

TABLE VII-5.—*Spread between average prices of purchases and sales by market makers (including sponsors) in over-the-counter transactions with other dealers (96 selected stocks classified by number of dealers quoting a 2-way market,<sup>1</sup> Jan. 18, 1962)*

[Number of stocks]

Percent spread between average purchase price and average sale price <sup>2</sup>	All stocks	Number of dealers quoting a 2-way market <sup>3</sup>							
		None	1 to 2	3 to 4	5 to 6	7 to 8	9 to 10	11 to 14	15 and over
Total.....	96		8	17	18	25	8	15	5
Less than 1.0.....	26		3	3	2	8	3	7	
1.0 to 1.9.....	26		2	3	2	7	2	7	3
2.0 to 2.9.....	17		1	3	6	4	2		1
3.0 to 3.9.....	5			3	1	1			
4.0 to 4.9.....	5		1	1	3				
5.0 to 9.9.....	10			2	3	3		1	1
10.0 to 14.9.....	5		1	2		1	1		
15.0 and over.....	2				1	1			

<sup>1</sup> All stocks in the sample of 200 stocks in which there were both purchases and sales by market makers or sponsors as principal with other broker-dealers on Jan. 18, 1962.

<sup>2</sup> Percent spread was computed for each stock as the difference between average price received by market makers and average price paid by market makers expressed as a percent of the latter price. Transactions where the broker-dealer acted as agent are excluded.

<sup>3</sup> Based on quotations in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962.

682 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS

TABLE VII-6.—Spread between high bid and low offer in over-the-counter "inside" quotations (163 selected stocks classified by number of dealers quoting a 2-way market,<sup>1</sup> Jan. 18, 1962)

[Number of stocks]

Percent spread between high bid and low offer <sup>2</sup>	All stocks	Number of dealers quoting a 2-way market <sup>3</sup>						
		1 to 2	3 to 4	5 to 6	7 to 8	9 to 10	11 to 14	15 and over
Total.....	163	42	35	25	31	10	15	5
Less than 1.0.....	23	2	1	1	6	5	7	1
1.0 to 1.4.....	16	3	3	3	5	1	4	1
1.5 to 1.9.....	16	5	2	5	5	1	2	1
2.0 to 2.9.....	20	1	5	5	6	1	1	1
3.0 to 3.9.....	12	2	3	3	2	-----	-----	2
4.0 to 4.9.....	12	8	1	2	-----	-----	1	-----
5.0 to 7.4.....	24	6	9	4	4	1	-----	-----
7.5 to 9.9.....	13	5	2	4	1	1	-----	-----
10.0 and over.....	27	18	6	1	2	-----	-----	-----

<sup>1</sup> All stocks in the sample of 200 stocks in which 1 or more dealers quoted a 2-way market in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962.

<sup>2</sup> Percent spread was computed for each stock as the difference between highest bid and lowest offer expressed as a percent of the bid.

<sup>3</sup> Based on quotations in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962.

TABLE VII-7.—Average prices of principal transactions of selected market makers in over-the-counter transactions with other broker-dealers (9 selected stocks, Jan. 18, 1962)

Stock	Number of dealers quoting a 2-way market <sup>1</sup>	Transactions by market makers as principal with other broker-dealers <sup>2</sup>				
		Number of market makers	Total number of transactions	Lowest average price <sup>3</sup>	Highest average price <sup>3</sup>	Relative difference between average price <sup>4</sup> (percent)
Advance Industries, Inc.....	22	-----	-----	-----	-----	-----
Purchases.....	-----	7	11	\$1.875	\$2.125	13.3
Sales.....	-----	-----	11	2.125	2.175	2.4
Anheuser Busch, Inc.....	17	-----	-----	-----	-----	-----
Purchases.....	-----	8	20	48.375	50.000	2.3
Sales.....	-----	-----	31	49.326	50.000	1.4
Bank of America N.T. & S.A.....	19	-----	-----	-----	-----	-----
Purchases.....	-----	<sup>5</sup> 11	<sup>6</sup> 63	60.438	61.000	.9
Sales.....	-----	-----	<sup>6</sup> 48	60.938	61.438	.8
Boston Capital Corp.....	24	-----	-----	-----	-----	-----
Purchases.....	-----	7	18	16.375	16.909	3.3
Sales.....	-----	-----	28	16.778	17.000	1.3
Glickman Corp., class A.....	20	-----	-----	-----	-----	-----
Purchases.....	-----	8	14	15.000	15.250	1.7
Sales.....	-----	-----	38	15.250	15.375	.8
Hartford Fire Insurance Co.....	11	-----	-----	-----	-----	-----
Purchases.....	-----	4	7	72.000	73.333	1.9
Sales.....	-----	-----	9	73.000	73.500	.7
Koehring Co.....	24	-----	-----	-----	-----	-----
Purchases.....	-----	7	21	12.125	12.292	1.4
Sales.....	-----	-----	20	12.250	12.562	2.5
Pacific Intermountain Express.....	28	-----	-----	-----	-----	-----
Purchases.....	-----	<sup>5</sup> 4	8	16.500	16.625	.8
Sales.....	-----	-----	6	16.750	16.812	.4
Producing Properties, Inc.....	19	-----	-----	-----	-----	-----
Purchases.....	-----	<sup>5</sup> 6	36	10.750	10.875	1.2
Sales.....	-----	-----	27	10.854	11.000	1.3

<sup>1</sup> Based on quotations in National Quotation Bureau, Inc., the National Quotation Service, Eastern, Pacific, and Western Stock Sections, Jan. 18, 1962.

<sup>2</sup> Includes all market makers who had both purchases and sales as principal with other dealers on Jan. 18, 1962.

<sup>3</sup> Average price of shares purchased or sold by each market maker.

<sup>4</sup> Difference between highest and lowest average price as percent of lowest average price.

<sup>5</sup> Includes 1 market maker who did not enter any listing in National Quotation Bureau, Inc., the National Quotation Service on Jan. 18, 1962.

<sup>6</sup> Includes 1 market maker who had 30 purchases and 13 sales.



TABLE VII-8.—*Proportion of all market makers' purchases and sales effected over the counter by sponsors (62 selected stocks classified by dealers quoting a 2-way market,<sup>1</sup> Jan. 18, 1962)*

[Number of stocks]

Ratio of shares purchased or sold by sponsors to purchases or sales by all market makers <sup>2</sup> (percent)	All stocks	Number of dealers quoting a 2-way market <sup>3</sup>							
		None	1 to 2	3 to 4	5 to 6	7 to 8	9 to 10	11 to 14	15 and over
Purchases, total.....	62	1	7	16	11	12	4	8	3
0.....	15			3	4	4	2	2	
0.1 to 19.9.....	11			1		2	1	4	3
20.0 to 39.9.....	9			1	2	3	1	2	
40.0 to 59.9.....	2			2					
60.0 to 79.9.....	4			1	3				
80.0 to 99.9.....	3			1		2			
100.0.....	9		6	2	1				
No comparison <sup>4</sup> .....	9	1	1	5	1	1			
Sales, total.....	62	1	7	16	11	12	4	8	3
0.....	14	1		3	4	3	1	1	1
0.1 to 19.9.....	15			2	2	3	1	5	2
20.0 to 39.9.....	7			1	3	1	1	1	
40.0 to 59.9.....	2					1		1	
60.0 to 79.9.....	2					2			
80.0 to 99.9.....	5			4		1			
100.0.....	10		5	3		1	1		
No comparison <sup>4</sup> .....	7		2	3	2				

<sup>1</sup> All stocks in the sample of 200 stocks in which 1 or more broker-dealers reported that they were sponsors.

<sup>2</sup> Excludes purchases or sales by market makers or sponsors as agent.

<sup>3</sup> Based on quotations in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962.

<sup>4</sup> Includes stocks in which neither sponsors nor market makers had transactions as principal.

 TABLE VII-9.—*Proportion of public volume effected over the counter with sponsors (62 selected stocks classified by dealers quoting a 2-way market,<sup>1</sup> Jan. 18, 1962)*

[Number of stocks]

Ratio of shares purchased and sold by public with sponsors to all public purchases and sales <sup>2</sup> (percent)	All stocks	Number of dealers quoting a 2-way market <sup>3</sup>							
		None	1 to 2	3 to 4	5 to 6	7 to 8	9 to 10	11 to 14	15 and over
Total.....	62	1	7	16	11	12	4	8	3
0.....	34		2	9	8	6	1	5	3
0.1 to 19.9.....	15		2	1	3	4	2	3	
20.0 to 39.9.....	3			2		1			
40.0 to 59.9.....	2			1			1		
60.0 to 79.9.....	4		2	1		1			
80.0 to 99.9.....									
100.0.....	2		1	1					
No comparison <sup>4</sup> .....	2	1		1					

<sup>1</sup> All stocks in the sample of 200 stocks in which 1 or more broker-dealers reported that they were sponsors.

<sup>2</sup> Includes public transactions with sponsors and other broker-dealers both as principal and as agent.

<sup>3</sup> Based on quotations in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962.

<sup>4</sup> Includes stocks in which there were no transactions by the public.

TABLE VII-10.—Public and dealer spreads between average prices of purchases and sales in sponsored and nonsponsored stocks in over-the-counter transactions (135 selected stocks,<sup>1</sup> Jan. 18, 1962)

[Number of stocks]

Percent spread between average purchase price and average sale price	Purchases and sales by public <sup>2</sup>		Purchases and sales by sponsors or market makers <sup>3</sup>	
	Sponsored stocks <sup>4</sup>	Nonsponsored stocks	Sponsored stocks <sup>4</sup>	Nonsponsored stocks
Total <sup>5</sup> .....	50	58	20	52
Less than 1.0.....		1	4	12
1.0 to 1.9.....	2	6	6	16
2.0 to 2.9.....	4	5	5	6
3.0 to 3.9.....	2	5	1	2
4.0 to 4.9.....	9	4	2	4
5.0 to 5.9.....	7	7		3
6.0 to 6.9.....	7	7	2	
7.0 to 7.9.....	3	3		2
8.0 to 8.9.....	4	2		
9.0 to 9.9.....	3	1		2
10.0 to 14.9.....	3	8		2
15.0 and over.....	6	9		3

<sup>1</sup> All stocks in the sample of 200 stocks in which there were transactions on Jan. 18, 1962.<sup>2</sup> Includes transactions with broker-dealers as principal and as agent. Percent spread was computed for each stock as the difference between average purchase price and average sale price expressed as a percent of the latter price.<sup>3</sup> Sponsors' spreads in sponsored stocks and market makers' spreads in nonsponsored stocks. Includes only purchases and sales as principal by the sponsor or market maker in transactions with other broker-dealers. Percent spread was computed for each stock as the difference between average purchase price and average sale price expressed as a percent of the former price.<sup>4</sup> Includes all stocks in which 1 or more broker-dealers reported that they were sponsors regardless of whether or not the sponsor had transactions on Jan. 18, 1962.<sup>5</sup> Total number of stocks for which there were both purchases and sales in the category.TABLE VII-11.—Proportion of individuals' purchases and sales effected over the counter through broker-dealer as agent (130 selected stocks classified by price,<sup>1</sup> Jan. 18, 1962)

[Number of stocks]

Ratio of shares purchased or sold by individuals through broker-dealer as agent to all purchases or sales by individuals (percent)	All stocks	Price of stock per share (in dollars) <sup>2</sup>					
		Less than <sup>5</sup>	5 to 9 $\frac{7}{8}$	10 to 19 $\frac{7}{8}$	20 to 29 $\frac{7}{8}$	30 to 49 $\frac{7}{8}$	50 and over
Purchases, total.....	<sup>3</sup> 117	25	20	25	16	17	14
100.0.....	41	16	8	9	2	4	2
80.0 to 99.9.....	8	2	2	1	2	1	
60.0 to 79.9.....	9		1	4	1	1	2
40.0 to 59.9.....	10	2	4	2		1	1
20.0 to 39.9.....	15	1	2	3	3	2	4
0.1 to 19.9.....	13		2	3	3	3	2
0.....	21	4	1	3	5	5	3
Sales, total.....	<sup>4</sup> 119	26	20	24	16	18	15
100.0.....	55	22	7	8	8	6	4
80.0 to 99.9.....	16	1	4	4	3	3	1
60.0 to 79.9.....	20	2	3	6	4	3	2
40.0 to 59.9.....	9		1	3		3	2
20.0 to 39.9.....	9	1	2	1	1		4
0.1 to 19.9.....	3		1	1		1	
0.....	7		2	1		2	2

<sup>1</sup> All stocks in the sample of 200 stocks in which there were transactions by individuals on Jan. 18, 1962.<sup>2</sup> High bid in National Quotation Bureau, Inc., the National Quotation Service, Jan. 18, 1962, or nearest date thereto.<sup>3</sup> Excludes 13 stocks which had sales by individuals but no purchases.<sup>4</sup> Excludes 11 stocks which had purchases by individuals but no sales.