CHAPTER VIII

TRADING MARKETS—INTERRELATIONSHIPS

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CHAPTER VIII

TRADING MARKETS—INTERRELATIONSHIPS

A. Introduction—Scope of Chapter

As mentioned before, chapters V, VI, VII, and VIII are a related group, dealing with the general topic of trading markets. In chapter V, the subject was introduced with a discussion of the underlying principles and the general characteristics of the two main types of trading markets, exchange and over-the-counter. It was there pointed out that despite the important differences between these two types, there are some basic similarities in needs and functions and also some important types of interaction and interplay between them. Chapters VI and VII then provided a detailed description and analysis of the exchanges (with primary focus on the NYSE and Amex) and the over-the-counter markets, respectively.

Based upon these discussions, the present chapter picks up the earlier threads to consider various interrelations of the markets. Since regional exchanges are at least as important for their interrelationships as for their separate operations, the main discussion of these exchanges appears here. Part B discusses the basic allocation of securities between exchanges and over-the-counter markets, as primary markets. The part enumerates the various factors entering into market allocation, including the listing concept as related to the needs of continuous auction markets. It also contains broad comparative data as to characteristics of securities traded in the principal markets or types of markets and their trading patterns.

Part C deals generally with the increasingly important role of institutional investors in the markets. It covers the handling of their relatively modest sized transactions, which constitute a significant portion of their total investment operations, as well as the handling of the larger blocks that are more characteristic of their trading than of trading on the part of the general public. The transactions of institutional investors have particular relevance in any discussion of market interrelationships because some aspects of multiple or competitive markets are seemingly responsive to the special impacts on individual trading markets caused by institutional investors' particular needs and characteristics.

The next two parts of the chapter deal with the two principal forms of markets competing with the major exchange markets. The first, the topic of part D, is over-the-counter trading in exchange-listed securities—a phenomenon that is not new but which has new dimensions and apparently growing importance. The other, "multiple" trading on regional exchanges, is considered in part E, which deals with this role of the regional exchanges as well as their separate role as primary markets, and also considers the total present and potential

status of the regional exchanges among securities markets. Part F is a summation of the more crucial market interrelationships and their consequences.

B. The Basic Allocation Between Exchanges and Over the Counter (as Primary Markets)

Perhaps the most obvious question as to market interrelationships is simply how primary markets are determined for particular securities. What factors and forces determine whether a specific security is to find its primary market on an exchange or over the counter? What considerations of policy, public or private, are involved? What are the characteristics—to the extent generalization is possible—of the securities traded in each major market or type of market, and what are their trading patterns? These are among the quetsions to be explored in this part, primarily with reference to corporate stocks.[1]

1. The basic dividing lines—the concepts of "listing" and "unlisted trading privileges" and the significance of exchange restrictions on members' trading

The determination of the market or markets in which any security is to be traded (here, "market allocation") is the result of interacting decisions by several parties, each having some power of decision, and none having complete freedom of choice. In the main, it is the individual exchanges and the respective issuers who decide, but significant influences are exercised by broker-dealers and perhaps in some circumstances by stockholders; and a supervisory role is performed by the Commission.

A crucial concept in allocation as between exchange markets and over-the-counter markets is that of "listing." Each exchange has its own rules and practices governing admissions to and removals from its list. These rules and practices vary greatly from exchange to exchange but in general they establish minimum standards as to quantity of shares outstanding and breadth of distribution, minimum standards relevant to earnings and assets, and controls over disclosure and corporate activity on the part of the issuer, the latter controls being embodied usually in a formal "listing agreement" with the issuer.[2]

Thus, listing is the principal gateway to exchange markets and serves to identify conclusively the securities and issuers admitted to such markets. There is no corresponding gateway into the over-the-counter markets, which simply include "all other" securities and issuers (as well as some trading in listed securities; see pt. D).

Before passage of the Exchange Act there was another important gateway through which an exchange market might become the primary market, that of "unlisted trading privileges." An exchange was then free to establish a trading market for any security, though listed

[1] U.S. Government, State and municipal bonds are traded almost entirely in over-the-counter markets. Corporate bonds, debentures, and preferred stocks are generally but with important exceptions, dealt in over the counter. Although some of the general observations in the following pages might apply to these categories, attention is focused primarily on common stocks.

[2] Present listing and delisting requirements of the principal exchanges are summarized in sec. 4, except that the continuing disclosure and other requirements imposed on issuers through listing agreements are discussed in ch. IX.

on no exchange at all, without consent of its issuer and, of course, without control over disclosures or corporate practices of such an issuer. This category is now limited by section 12(f)(1) to the relatively small and diminishing group of securities that had been admitted to it prior to 1934. However, the statute recognized two further categories of unlisted trading on an exchange: securities fully listed on another exchange, so that statutory and exchange-administered controls over issuers are applicable (sec. 12(f)(2), and securities not listed elsewhere but the issuers of which are subject, or agree to become subject, to equivalent requirements and restrictions (sec. 12(f)(3)). For the regional exchanges, where most of the business done is "multiple trading"[3] in stocks listed on one of the New York exchanges, securities admitted to trading under section 12(f)(2) may be even more important than those exchanges' own listings. There are very few securities in the section 12(f)(3) category.[4]

Market allocations and resulting trading patterns may also be affected by the concept of exchange membership, with the attendant controls exercised by an exchange over its members, and with the higher commission charges for nonmembers trading in scurities listed on that exchange. A member firm of a given exchange may also be a member of, and do business on, other exchanges; it may also engage in other aspects of the securities business, including over-the-counter business; but for securities listed on an exchange of which it is a member, exchange rules strictly limit its dealings outside that exchange. The New York Stock Exchange, for example, prohibits a member from being connected with or doing business on any other exchange located in New York which permits dealings in NYSE-traded securities. In addition, it generally prohibits him from dealing in any such securities anywhere outside the NYSE itself, except with specific approval or where he is dealing as a member of a non-New York exchange in securities admitted to trading on such other exchange. Once a security is listed on the NYSE, the membership, which includes a large proportion of the most important and influential broker-dealer firms in business with the public, is severely restricted in handling that security elsewhere, and nonmembers are at a disadvantage in handling it, because of the commission structure. Thus, the line between NYSE-listed securities and other securities is a boundary line of great importance, even though somewhat blurred by member firms' reciprocal arrangements with nonmember firms, by dual listings or unlisted trading on another exchange, and by over-the-counter trading in some listed stocks.

2. ROLES OF VARIOUS INTERESTED PARTIES IN MARKET ALLOCATION

In light of the above factors, the rights and powers of the various interested or affected parties in respect of market allocation my be summarized as follows:

(1) Each *exchange* has control over its own listing requirements, subject to supervisory control by the Commission. This gives it com-

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[3] The terms "multiple" and "dual" are used more or less interchangeably in this context, the former, of course, implying that the phenomenon of "dual" trading may extend to several different markets.

[4] The recommendations of ch. IX to extend the provisions of secs. 13, 14, and 16 to many over-the-counter securities would automatically make a large number of securities eligible for unlisted trading privileges under sec. 12(f)(3). For reasons set forth in pt. B.7 of that chapter, it is there recommended that sec. 12(f)(3) be repealed concurrently.

plete power to exclude any unwanted security in the first instance, but enables it to obtain any desired security only with the acquiescence of the issuer and subject to the competition of other markets. Ordinarily it may obtain a "dual" or secondary listing with the acquiescence of the issuer and without any consent by the primary market; or it may establish a dual market on an unlisted basis, upon application to the Commission and after opportunity for interested parties (including the primary market) to be heard. Each exchange also has power to delist any security after application to the Commission, which cannot deny the application if it comports with the exchange's rules but can impose limited terms, usually amounting only to delay in the date of delisting.

The New York Stock Exchange's unique prestige enables it to be particularly selective among securities gravitating toward some auction market; and by virtue of the fact that its membership encompasses an extremely important segment of the total broker-dealer community, its rules as to its members' outside dealings in listed securities have important bearing on the emergence or viability of secondary markets.

(2) An *issuer* (i.e., its controlling stockholders or management) has complete choice of whether to apply for listing on any exchange. This, of course, does not give it a right to be listed except as it satisfies an exchange's requirements, but does give it the right to bar its securities' being traded on any particular exchange or on any exchange at all, subject to the qualification of unlisted trading, as described above. An issuer has no control over the making of an over-the-counter market by any broker-dealer, except as it may induce or facilitate a particular broker-dealer's marketmaking by granting board representation or through an underwriting or advisory relationship.

(3) *Broker-dealers* have complete freedom to make or not to make an over-the-counter market for any security, including any security listed on an exchange, with the important qualification that members of an exchange are ordinarily precluded by exchange rules from outside dealing in listed securities. Broker-dealers also may exert considerable influence over issuers in the latters' exercise of the choices mentioned above.

(4) The *Commission* has certain regulatory powers in this general area but, in general, has not exercised them in such manner as to affect market allocations significantly. It has powers with respect to listing rules of exchanges but has never found occasion to institute a proceeding to require any change.[5] It has powers over unlisted trading on exchanges and over delistings but, at least in recent years, has exercised the powers primarily to protect stockholders in particular situations as distinguished from attempting to affect the market pattern broadly.

3. FACTORS AFFECTING MARKET ALLOCATION

The determination of the market allocation for a particular security is affected by factors and motivations as multifarious as the persons and groups with voices in the decision. The first question is whether a security is to have any primary exchange market, and if so, which:

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[5] It would be noted, however, that the Amex listing rules promulgated in April 1962 were part of the broad program of reformation instituted after the Commission's "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange" (1962).

(1) Since the various exchanges' requirements for listing are ordinarily expressed as minima, and sometimes very low minima, it frequently remains a matter of preference on the part of issuers, and thus of competition among markets, as to which market will best serve the needs of a particular security. As between exchanges and over-the-counter markets there is continuing rivalry both in terms of general "institutional" promotion and in the form of persuasion of particular issuers. While an exchange can and often does conduct the promotional effort itself, on the over-the-counter side there is no comparable institutional effort. But many individual broker-dealers are active proponents and are likely to exert important influence, especially if they previously managed an underwriting or presently stand in an advisory role toward the issuer. Such a broker-dealer may have a pecuniary interest in maintaining a market in which he has a prominent and profitable role, just as an exchange and its members have such an interest in preserving or adding to their markets, and such concerns may themselves become an important factor in the ultimate choice of markets.

(2) Undoubtedly the decisive factor in many cases is the sharp difference in statutory requirements governing issuers whose securities are traded in exchange markets and over-the-counter markets, respectively. Likewise, insofar as listing rules and agreements impose requirements and controls on issuers, these may be an important factor.[6] Given a freedom of choice, many issuers apparently choose to remain over-the-counter in order to avoid requirements and burdens associated only with listing, and some issuers perhaps choose one exchange over another for similar reasons.

(3) Corporate managements and controlling stockholders may also be strongly influenced by such objectives as wider distribution of their securities, "better" prices, advantageous publicity, and general prestige. Prestige in this sense frequently is associated with listing on one of the New York exchanges, especially the New York Stock Exchange. This is reflected in, and also in some degree caused by, the fact that price quotations for the New York exchanges are much more widely published throughout the country. Closely related to the prestige factor, although now far less significant than formerly, is the advantage of obtaining exemption from certain State blue-sky laws by virtue of being listed on an acceptable exchange.

(4) Market allocation may also involve a geographic factor. Assuming that a company cannot aspire to national prestige but still elects to have an exchange market, geography would naturally predominate in its choice. As a practical matter, however, the number of new listings of this kind in recent years has been negligible. In recent decades there has been an increasing tendency for regional exchanges to be squeezed between over-the-counter markets and the New York exchanges, with few issuers electing the middle ground.

The factors motivating establishment of a second (or third or fourth) exchange market may differ, depending on whether the first market is on a regional exchange and the second in New York, or vice versa.

(1) Where the regional listing is first, it is the factors of national distribution and prestige that would ordinarily induce an issuer to

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[6] For detailed discussion of these differences, see ch. IX.B.

move to New York whenever it could satisfy listing requirements. Where the New York listing is first, a geographical factor would presumably always be important in establishment of a second listed market, and section 12(f) of the Exchange Act expressly requires consideration of factors related to geography[7] if the second market involves unlisted trading privileges, created on the initiative of the exchange instead of the issuer.

(2) A most important factor, undoubtedly, where a regional exchange seeks unlisted trading privileges in a New York-listed security, is the quite understandable desire of the exchange and its (non-New York) members to obtain a share of the brokerage business, perhaps as an offset for the loss of primary listings to New York. As is seen below, a second exchange market does not involve competition in commission rates, but it obviously may affect who receives the commissions or how they are spread.

(3) The motivation for establishing dual or multiple exchange markets may also arise from special characteristics or attributes of individual exchanges as compared with other exchanges, including such matters as State taxes, proximity to transfer agencies, special nonmember commission arrangements, time differences, etc. Since these factors sometimes determine the most advantageous place of execution of an individual transaction, they may in the aggregate enter into the motivation for establishing secondary markets.

(4) A similar motivation, affording the decisive reason for executing many individual transactions in particular markets and undoubtedly leading to the establishment of dual or multiple markets in many instances, is the pervasive factor of reciprocity. This takes a variety of forms, the most obvious of which are the execution of a transaction in a particular market in order to give the commission to a broker-dealer who is a member of that exchange only, and the execution of a transaction in a market whose rules allow greater freedom in allocating or splitting commissions than might be possible elsewhere. Other manifestations of reciprocity and their impact on choice of markets are discussed in subsequent parts of this chapter and in chapters VI and XI.

The motivation for establishment of over-the-counter markets; i.e., the motivation of a broker-dealer who decides to "make" such a market, is in some instances a sense of obligation of "sponsorship" with respect to a security originally underwritten,[8] and presumably in all instances involves a hope for profitable interdealer trading or profitable retail business, or both. In the case of exchange-listed securities, a nonmember has the further motivation of providing an alternative to the exchange market in which he, and other nonmembers who deal with him, can do business only at nonmember commission rates.

4. PRIMARY LISTING AND DELISTING STANDARDS OF THE PRINCIPAL EXCHANGES

As indicated above, one important determinant in market allocations is the listing and delisting requirements of the various exchanges.

[7] On June 3, 1963, the Commission recommended a legislative amendment to delete the "vicinity" test now in sec. 12(f)(2).
[8] In this connection see ch. III.F (pt. 1) and ch. IX, pp. 49–51 (pt. 3).

These are adopted separately by each exchange, subject to supervisory control by the Commission. In almost all instances they include minimum standards of distribution and floating supply, but are not necessarily confined to those standards.

The New York Stock Exchange's standards for original listing include certain minimum distribution and financial tests in line with the principle that the "particular securities for which listing is sought must have a sufficiently wide distribution to offer reasonable assurance that an adequate auction market in the securities will exist." [9] The standards may be summarized as follows:

(1) Net tangible assets of at least $10 million;

(2) Net earnings demonstrated under competitive conditions of $1 million annually;

(3) For common stock issues, a minimum public distribution of 500,000 shares (exclusive of concentrated holdings), held by at least 1,500 shareholders (after "substantially discounting" for odd lots); and

(4) Outstanding common stock of a minimum market value of $10 million.

These particular provisions, announced on April 20, 1961, represent the fourth in a series of modifications in the "minimum yardsticks" for original listing which had first been set forth formally in 1944. The various modifications have all been in the direction of increased stringency. For example, the net earnings standard has been increased from $500,000 in 1944 to $750,000 in 1947 and then to $1 million in 1950. The net tangible assets standard was first adopted in 1950 at $7 million and raised to $8 million in 1958 and to $10 million in 1961. The requirement for aggregate market value of common stock followed the same pattern as the assets test, except that as early as 1947 Exchange policy called for a minimum of $5 million. The shareholder requirement rose from 1,000, the 1944 figure, to 1,500 in 1947, and since 1950 that number must be met, for the most part, exclusive of holders of odd lots. The rules governing distribution of shares were originally set at 200,000 shares in 1944, rose to 300,000 in 1950, 400,000 in 1958, and the present standard of 500,000 in 1961.

The Exchange's adoption of its present listing standards in 1961 was described in an Exchange release as having been done "after a review of existing criteria in the light of a generally expanding economy, accumulated experience in maintaining fair and orderly markets, and the substantial appreciation in securities values since the time of the last such changes in 1958." The changes that took place in 1947, 1950, and 1958 were accompanied by similar explanations. The Exchange has emphasized that the yardsticks "are not intended to be inflexible mathematical formulas but are merely guides," and that—

> while the amount of assets and earnings, and the aggregate market value of the company's junior securities are considerations, greater emphasis is placed on such questions as degree of national interest in the company, its standing in its particular field, the character of the market for its products, its relative stability and position in its industry, and whether or not it is engaged in an expanding industry, with prospects of maintaining its position.[10]

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[9] NYSE Guide, par. No. 2495A.10.
[10] Ibid.

Since 1926 the Exchange has refused to list nonvoting common stock; and it—

also takes into account, when considering listing, the effect of concentrated holdings upon the voting position of the publicly held stock, the proportionate distribution of voting power as between classes of stock, and unusual voting provisions which, in effect, tend to permit one class to nullify or veto the vote of another class.[11]

An issue may be delisted by the Exchange on its own initiative when the issue fails to satisfy the delisting standards, which tend to parallel those for original listing but are far less stringent.[12] The Exchange characterizes its delisting policies in a fashion almost identical to its original listing policies:

The New York Stock Exchange seeks to provide the foremost auction market for securities of well-established companies that have kept pace with the expanding economy and in which there is a broad public interest.[13]

Again, it is emphasized that "appropriateness of continued listing * * * cannot be measured mathematically."[14]

The present delisting standards provide that delisting will be considered where—

(1) Net tangible assets available to the common stock or aggregate market value of the outstanding shares fall below $2 million;

(2) A company has had average earnings of less than $200,000 for 3 years, although this requirement is reviewed in light of the aggregate market value of the shares outstanding and the net tangible assets available to the common stock;

(3) There are fewer than 300 shareholders (after discounting odd lots) and 100,000 outstanding shares, exclusive of concentrated blocks; and

(4) Aggregate market value of the outstanding shares (exclusive of block concentration) is less than $1 million.

There are also requirements of a broader nature which if not met can lead to delisting, for example: where the Exchange has received "authoritative advice" that a security is without value; where registration on the Exchange or under the Exchange Act is no longer effective; where a class of nonvoting common stock is created; or where proxies are not solicited for all shareholder meetings.

The delisting yardsticks were last revised in 1961, at the same time as the listing requirements. Although both contain standards of distribution and floating supply as well as financial tests, the minimum delisting tests are only 20 percent (in one case, 10 percent) of the minimum listing standards. Thus, in the absence of other lapses, the Exchange will continue a listing even though the issue's qualifications fall far below what would have been acceptable in the first instance.

The American Stock Exchange listing requirements, which became effective on April 5, 1962,[15] focus like the NYSE standards on the financial status of the company and the distribution of its shares. In

[11] NYSE Guide, par. No. 2495C.10.

[12] Between 1936 and 1961, 636 delistings took place by application of the various exchanges, including 339 by the NYSE, 65 by the Amex, and 232 by the regional exchanges. Issuers requested 286 delistings, including 6 from the NYSE, 25 from the Amex, and 255 from the regional exchanges.

[13] NYSE Guide, par. No. 2498A.

[14] NYSE Fact Book, 1961, p. 6.

[15] Prior listing and delisting standards and practices are discussed in the Commission's "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange" (1962).

place of the flexible listing standards previously in effect, the Amex specified the following minimum financial and distribution standards:

(1) Net tangible assets of at least $1 million;

(2) Net earnings of at least $150,000 in the fiscal year immediately preceding filing of the application, and net earnings averaging at least $100,000 for the past 3 fiscal years (in special cases, the exchange may consider applications of companies which do not meet the net earnings standards but which have a substantially larger net worth than $1 million;

(3) Minimum public distribution of 200,000 common shares (exclusive of the holdings of officers and directors and other concentrated or family holdings) among not less than 750 holders, of whom not less than 500 must be round-lot holders; and

(4) Outstanding common stock must have a minimum aggregate market value of $2 million, and publicly distributed shares must have a minimum aggregate value of $1 million.

Certain exceptions to the earnings requirements are available to companies having a net worth of substantially more than $1 million which are licensed small business investment companies, real estate trusts qualified under the Internal Revenue Code or real estate companies having cash-flow incomes substantially greater than the after-tax income required of other companies. Listing may also be given to fully financed companies which are not yet producing but "are engaged in the development and/or construction of plants or other facilities * * * provided that such companies submit satisfactory evidence of their ability to [meet the minimum] earnings standard within a reasonable period of time after completion of the fully financed program." [16]

The American Stock Exchange minimum listing standards are generally far less demanding than those of the NYSE, ranging from 10 to 40 percent of the latter and indicating that the two exchanges are not, for most stocks, in direct competition for original listings. Issues often shift to the NYSE from the Amex, however, after having traded on the latter for a time. Between 1939 and 1961, 254 issues were transferred to the NYSE, and trading in such issues in 1961 amounted to 16.25 percent of NYSE volume. There is no dual listing of issues on the American and New York Stock Exchanges; unlike the situation of regional exchanges, Amex listing is always terminated when NYSE listing becomes effective, and vice versa. The Amex will consider delisting when the financial condition and/or operating results of the issues are such as, in the opinion of the exchange, do not warrant continuation of the security on the list, or "when it appears that the extent of public distribution of the security has become so reduced as to make inadvisable further dealings therein upon the Exchange." [17] Its policies "will be applied with due consideration of the nature of the company's business." [18] Delisting criteria (also adopted on April 5, 1962) under which the exchange considers suspending or removing a security from listing or unlisted trading, include:

(1) Failure of a company to operate at a net profit in at least one of the last 3 fiscal years;

(2) Publicly held shares (exclusive of management or other concentrated holdings) of 70,000 shares or less;

(3) Less than 250 stockholders or less than 150 round-lot holders; or

[16] American Stock Exchange, "Listing Standards, Policies, and Requirements" (1962).
[17] Ibid.
[18] Ibid.

(4) Aggregate market value of common stock of less than $1 million or aggregate market value of publicly held shares (exclusive of management or other concentrated holdings) of less than $500,000.[19]

On the National Stock Exchange, the newest of the registered exchanges, the issuer must have a minimum net worth of $1 million, 150,000 shares outstanding and 500 stockholders. The issuer must also have a suitable corporate record of achievement.

When asked by the Special Study to specify present listing requirements several of the regional exchanges replied to the effect that the question was somewhat academic because practically no companies now seek primary listings on their exchanges. As has been noted above and is further discussed in part E below, the major business of the regional exchanges today (apart from the three "mining" exchanges) is in multiple-traded stocks; these include some stocks which had first been listed on the regional exchange and retained that status after becoming listed in New York, and some New York-listed stocks in which the regionals have obtained unlisted trading privileges. Of all the regional exchanges other than the mining exchanges, the Midwest and Pacific Coast Stock Exchanges currently seem the most successful in obtaining original listings. Their listing and delisting standards, in brief, are as follows.

Companies receiving Midwest Exchange listings must have at least $2 million in net tangible assets as well as 250,000 common shares held by 1,000 shareholders (a substantial majority of whom must own at least 100 shares, and must have been actively engaged in business for three consecutive years; there are no stated earnings requirements. Broad listing policies are defined as follows:

The prime requisite for listing on the Midwest Stock Exchange is the quality of the corporation. Its products and services must enjoy public acceptance and good reputation. Its management must operate the company in the public interest. Its securities must also meet the technical requirements for an auction market.[20]

The exchange has no specific delisting yardsticks, but will delist if it determines that the issuer is one which—

engages in practices not in the public interest, or whose assets have been depleted to the extent that the company can no longer operate as a going concern, or whose securities have become so closely held that it is no longer feasible to maintain a reasonable market in the issue. Furthermore, the exchange reserves the right to delist the securities of any corporation which has drastically changed its corporate structure and/or its operations.[21]

To qualify for listing on the Pacific Coast Stock Exchange, a company must have demonstrated net earnings of $100,000 or total assets of $1 million, and have at least 250,000 equity shares outstanding (exclusive of concentrated or family holdings). For relatively new companies, financing adequate to attain successful production is required, but the general rule is that a company must be an established concern or successor thereto. Companies in an exploratory or development stage are considered for listing only in unusual cases. Companies whose securities sell below $1.00 a share are not listed. Delisting standards are not defined.

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[19] During 1962, 62 companies were removed from listing and unlisted trading on the Amex, compared with 47 removed during 1961. Of the 1962 delistings, 25 were attributable to the new delisting standards.

[20] Midwest Stock Exchange, "Listing Policy" (1960).

[21] Ibid.

5. THE DISTRIBUTION OF STOCKS AMONG MARKETS AND THEIR TRADING PATTERNS

a. Characteristics of stocks

The listing and delisting requirements summarized above are important in determining what stocks may or may not be traded on a national securities exchange; they, of course, do not automatically determine what securities are traded there rather than in the over-the-counter markets. As of June 30, 1962, there were 1,565 preferred and common stock issues traded on the NYSE, 1,033 on the Amex, and 493 exclusively on other exchanges, a total of 3,091 (table I-2). At the same time there were an estimated 14,000 stocks, not listed on any exchange, in which some indication of broker-dealer trading interest appeared in the over-the-counter markets (ch. I, p. 14 (pt. 1) and app. VII-A.4.a). These are mutually exclusive groups but their characteristics are by no means mutually exclusive: the prevailing characteristics of securities in each market or type of market can be broadly defined and differentiated, but there are substantial gray areas where the categories overlap. Another way of saying this is that there are substantial numbers of over-the-counter securities which cannot readily be distinguished, in outward characteristics relevant to choice of markets, from many securities listed on exchanges.

This pattern—of broad differentiation but considerable overlapping—is evident in respect of several different characteristics, all pertaining to NYSE listing requirements, including number of shareholders, shares outstanding, market value, and issuer's assets. For each of these features, there is shown in tables VIII-1 through VIII-4 the distribution of stocks in five market categories as of the end of 1961: (i) all NYSE-listed common stocks, (ii) all Amex-listed common stocks, (iii) all common stocks solely listed on seven major regional exchanges,[22] (iv) "actively traded" over-the-counter stocks—those stocks in the study's total OTC-4 sample (described in ch. IX) for which four or more dealers entered a "bid" and "offer" price quotation in the January 1962 National Quotation Bureau Summary, and (v) "inactively traded" over-the-counter stocks—those in the same sample having less than four such quotes.[23] The same data are plotted in charts VIII-a through VIII-d, except that the regional listings have been omitted from the charts, and the ranges used for the other categories are somewhat different from the tables, to permit smoothing of the curves.[24]

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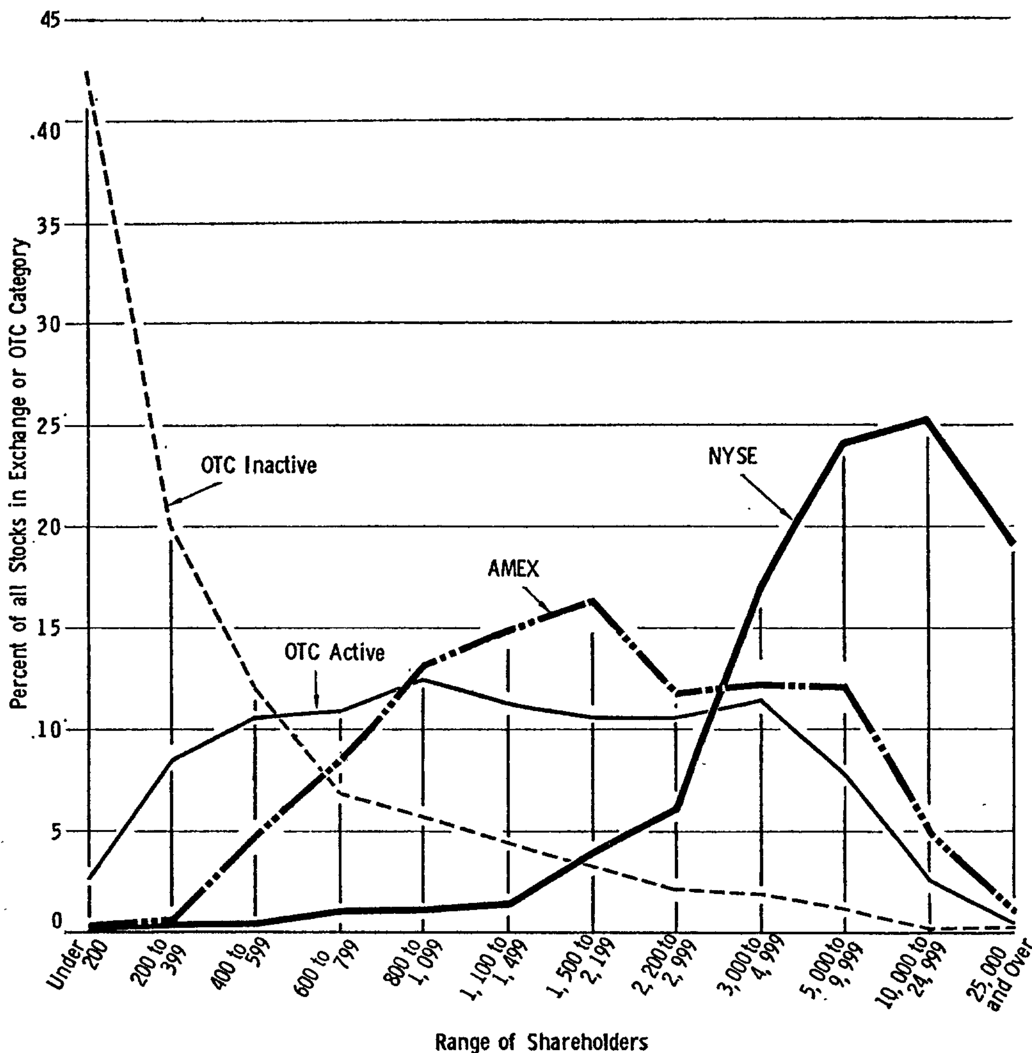
[22] These seven regional exchanges are the Boston, Cincinnati, Detroit, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh.

[23] For each issuer in the over-the-counter sample, the data concern the class of stock having most shareholders—usually common stock.

[24] In tables and charts, each percentage is based upon all stocks in each market category, excluding a small number for which the applicable data were not available.

Chart VIII - a

PERCENT OF STOCKS IN EACH EXCHANGE OR OVER-THE-COUNTER CATEGORY FALLING INTO EACH RANGE OF SHAREHOLDERS *
End of 1961



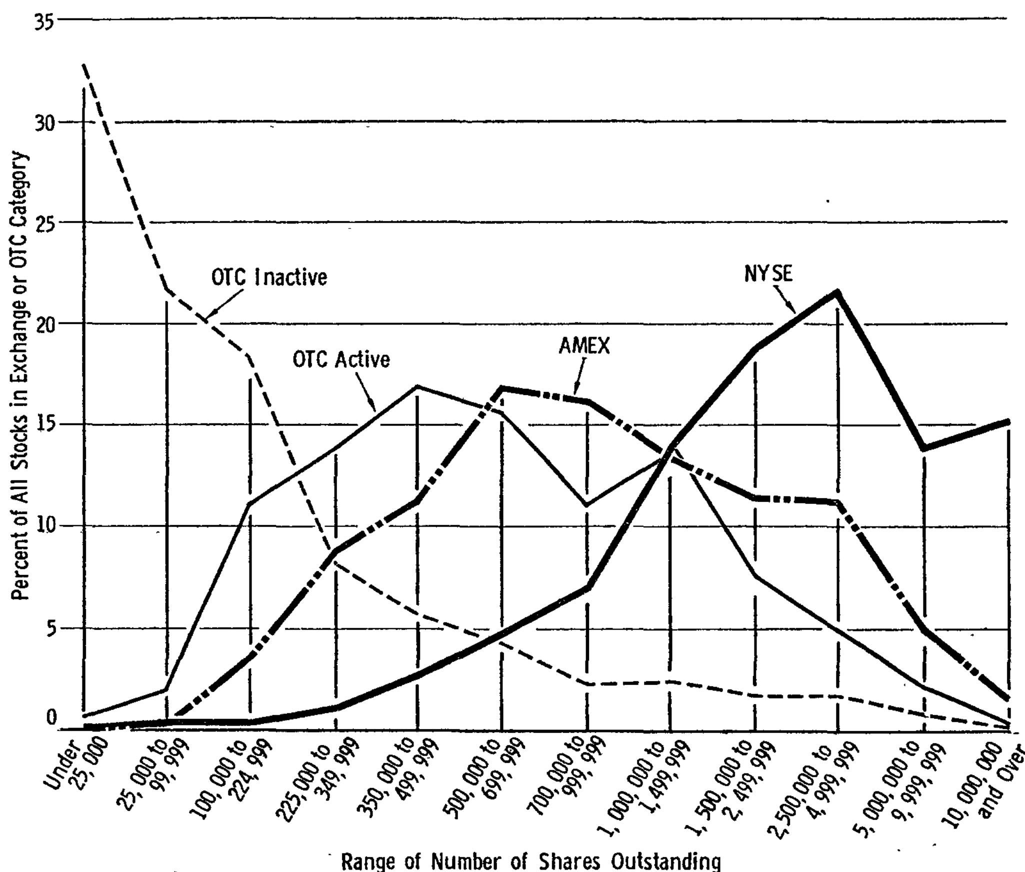
* Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

OS-4471

Chart VIII-b

PERCENT OF STOCKS IN EACH EXCHANGE AND OVER-THE-COUNTER CATEGORY FALLING INTO EACH RANGE OF NUMBER OF SHARES OUTSTANDING ★
End of 1961



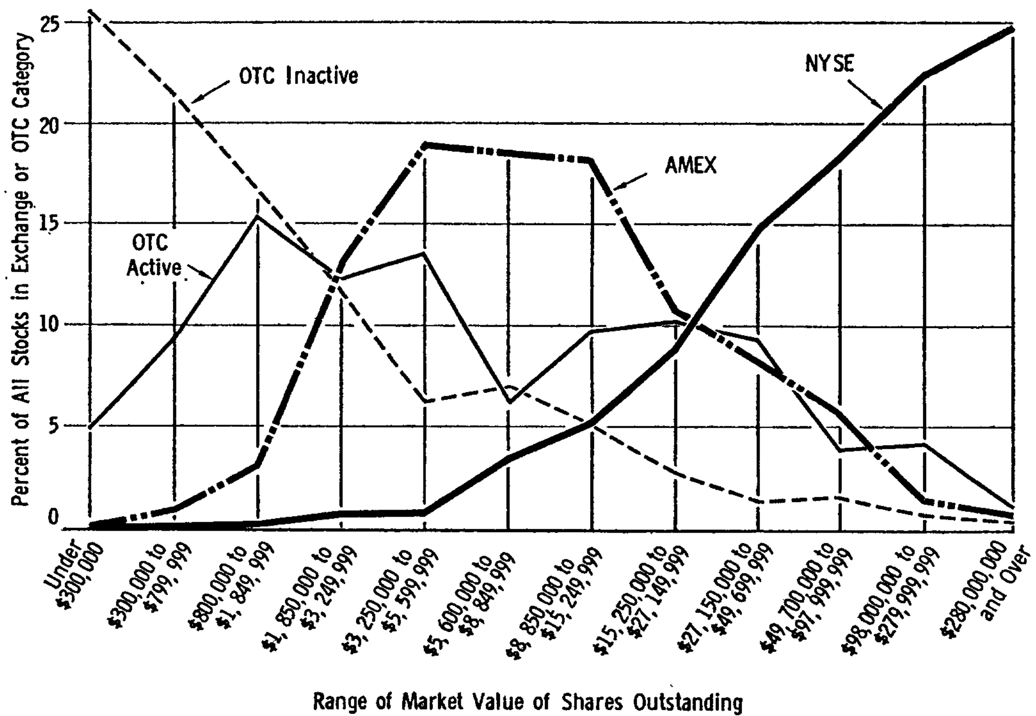
★ Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

OS-4472

Chart VIII-c

PERCENT OF STOCKS IN EACH EXCHANGE AND OVER-THE-COUNTER CATEGORY FALLING INTO EACH RANGE OF MARKET VALUE OF SHARES OUTSTANDING ★
End of 1961

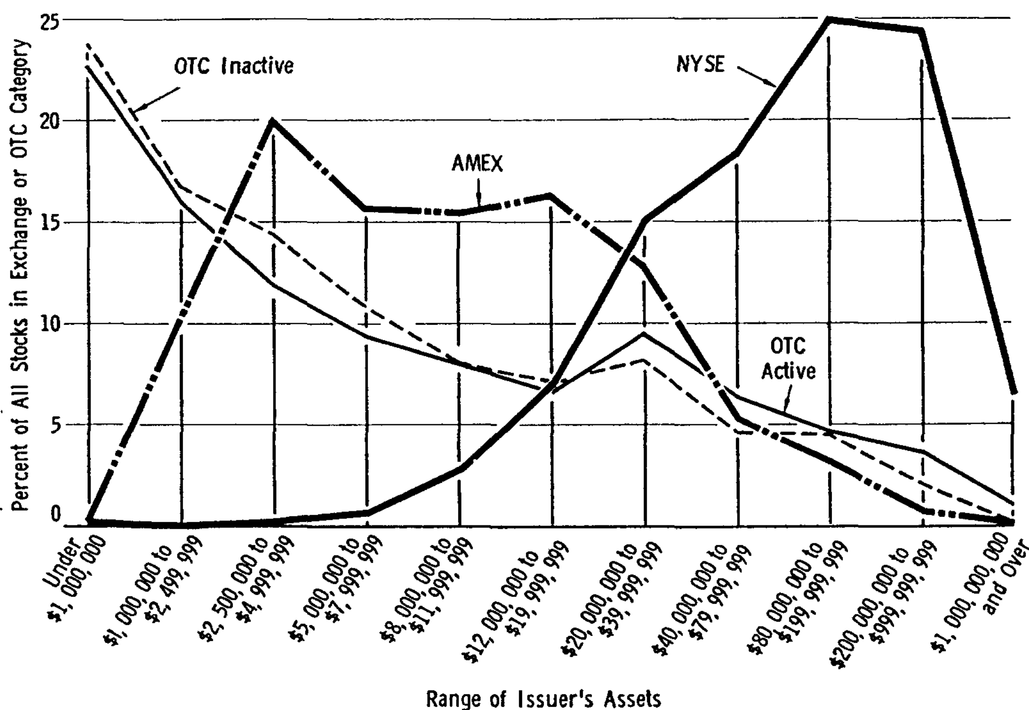


★ Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

Chart VIII-d

PERCENT OF STOCKS IN EACH EXCHANGE AND OVER-THE-COUNTER CATEGORY
FALLING INTO EACH RANGE OF ISSUER'S ASSETS *
End of 1961



* Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

The broad pattern of distribution may be seen most readily from these charts. Its clearest feature, as would be expected, is the sharp polarization which puts NYSE-listed stocks in the highest size ranges and stocks in the OTC-inactive category in the lowest. Between the two lie the bulk of the Amex issues, while spread broadly across the whole spectrum, with a concentration, if any, below the Amex issues, are stocks in the OTC-active category. Only in assets is this pattern broken, as stocks in the OTC-active category show assets generally no higher than those that are inactive. Stocks listed solely on the major regional exchanges (shown in the tables though not on the charts) fall generally between the active and inactive over-the-counter issues in shareholders and shares outstanding, and between the Amex and active over-the-counter issues in market value and issuer's assets.

This picture of differing, but not mutually exclusive, characteristics for the bulk of stocks in each market category is further shown in table VIII-5, which defines the limits within which the central two-thirds (i.e., excluding the one-sixth at each extreme) of each group of stocks fall. By relating these limits to the NYSE's minimum listing "yardsticks," [25] it may be seen that while most NYSE stocks have from 2 to 20 times the NYSE requirements as to shares and shareholders, Amex stocks have from one-half to 5 times the NYSE minima, OTC-active one-third to 2½, regionals one-fifth to 2, and OTC inactive from less than one-fiftieth to about three-quarters of the NYSE minima levels. In market value and assets, the contrast is a little different. While most NYSE stocks have from 2 to 45 times the minima, most Amex stocks have from one-third to 2½, OTC active from less than one-tenth to 3½ times, regionals from one-tenth to 3 times and OTC inactive from a fiftieth to about 2½.

Although, in general, the central two-thirds of stocks in each group occupy the same relative position on each scale, there are significant variations. The over-the-counter stocks range relatively higher in the scale of assets than of shareholders or shares, possibly reflecting the presence of banks and insurance companies. The Amex stocks on the other hand range relatively higher in shares and shareholders than in assets or market value. Indeed, it is of interest that the Amex was the only category to range relatively lower for value of assets than for number of shareholders.

These characteristic distributions are only part of the picture; of at least equal significance are the wide differences within each market, evident from the broad and overlapping limits which enclose even the central two-thirds of each market category's stocks (table VIII-5). It is plain, too, from charts VIII-a through VIII-d that there are stocks in most market categories representing virtually every part of the size spectrum.

This diversity is highlighted by the presence in each market category of issues so large and widely held as to meet most of the "yard-

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[25] See sec. 4, above. It should be noted, however, that NYSE requirements refer to shares outstanding exclusive of concentrated or family holdings rather than the total used here; to shareholders of over 100 shares rather than all shareholders as used here; and to net tangible assets rather than the total assets figures used here. (Also, the NYSE "yardstick" requirements include an earnings test with which comparisons could not be made from the Special Study's available data. Nor could analysis be made of "the degree of national interest in the company, its standing in its particular field, the character of the market for its products and whether it is engaged in an expanding industry with prospects of maintaining or improving its relative position." NYSE Guide, par. No. 2495A.10.

sticks" for listing on the NYSE, including those for shares outstanding, shareholders, market value, and assets.[26] All these tests for NYSE listing are met by stocks constituting 23 percent of those on the Amex, 22 percent of OTC active, 15 percent of the regionals, and 2 percent of the OTC inactive (table VIII–6). In terms of numbers of stocks, this would be equivalent to some 140 on the Amex, 20 on the major regionals, and an estimated 645 and 100 in the OTC-active and OTC-inactive categories, respectively.[27] Considerably more stocks in each market category meet various parts of the NYSE requirements. For example, the $10 million minimum market value requirement is met by stocks representing 41 percent of the Amex list, 36 percent of the OTC actives, 30 percent of the regionals and 11 percent of the OTC inactives. Quite a number of stocks on other markets even meet requirements twice the NYSE minima. These include stocks constituting some 8 percent of the Amex, 9 percent of the OTC-active category, 6 percent of the regionals and 0.5 percent of those in the OTC-inactive category (table VIII–7).

The wide overlap among stocks in different market categories is even greater than suggested by these comparisons, for 1 out of 10 stocks on the NYSE itself do not meet all of the NYSE minimum listing requirements. This results from the considerably lower delisting levels, which permit stocks, once listed, to remain on the Exchange though they fall appreciably below the levels initially required for listing.[28]

The picture which emerges from quantitative analysis, therefore, contains two basic elements. Out of the welter of choices and decisions exercised by issuers, broker-dealers, exchanges and investors has come a broad tendency for stocks with certain characteristics to move into certain market categories. Clearly other factors, however, have affected the distribution among markets, for the diversity within each group is wide indeed and the overlap among groups is perhaps even more striking. Given this diversity within and overlap among market categories, it is clear that any regulatory measure or approach cannot be expected to reach all stocks having certain characteristics if directed solely at market categories.

b. Trading volumes

The pattern of stock allocation among markets is broadly reflected in the pattern of trading activity. This is to be expected, of course, since differences in ranges of activity among market categories reflect not only the general range of characteristics of the stocks within each category, but also the influences upon the stocks of the market itself—prestige, publicity, markup and commission rate structure, trading and distributive facilities, and the community of broker-dealers handling the stocks. Again, the ranges are quite noticeably different, but with considerable breadth in each range and considerable overlapping among them.

Thus in 1961, the central two-thirds of common stocks in the NYSE fell within a range of 161,000 to 1,309,000 shares traded for the year; those in the Amex fell within a range of 70,000 to 883,000 shares and those traded exclusively on the major regional exchanges, within a

[26] Data to test for compliance with the $1 million annual earnings requirement were not available. See note 25, above, for other variances, particularly as to assets.
[27] The numbers for the OTC categories are estimated by multiplying the OTC–4 sample figures by 5.5; see ch. IX, p. 31 (pt. 3).
[28] See sec. 4 above.

range of 3,000 to 136,000 shares (table VIII–8 and chart VIII–e).[29] It is more difficult to make a direct comparison with the over-the-counter market, for which data are available only in terms of record transfers rather than transactions. While volume of transactions presumably would exceed volume of record transfers in most instances, the ratio between the two cannot be definitely determined. On the other hand, as pointed out in chapter VII, the nature of over-the-counter markets is such that total transaction figures are likely to involve a higher proportion of dealer transactions, as distinguished from public transactions, than in the case of listed securities. With these caveats in mind it may be noted that the 89,000-to-713,000 range of shares transferred within which the central two-thirds of OTC-active stocks fall is distinctly higher than the range of shares transacted for most solely listed stock on the major regionals and reaches only moderately below the shares transacted for those in the Amex. The 2,000-to-116,000 range of shares transferred for most OTC inactives covers all but the top of the shares-transacted range for most stocks on the major regionals, but is generally below that of the stocks in the OTC-active and other exchange categories (table VIII–8 and chart VIII–e).

No definite minimum of activity is formally required of stocks listed on the NYSE, but the other established standards are expected by the Exchange to produce a minimum level of 100,000 shares traded a year. Failing to reach this level in 1961 were about 9 percent of NYSE common stocks, 24 percent of Amex stocks and 79 percent of those on the major regionals. Only 19 percent of OTC-active stocks had less than 100,000 shares transferred, in contrast to the 81 percent of OTC-inactive stocks falling below this level (table VIII–8 and chart VIII–e). A corresponding distribution is evident at the other extreme, of high activity. The relative position of various market categories of stock as regards trading activity, therefore, appears to conform generally with those of the other characteristics examined.

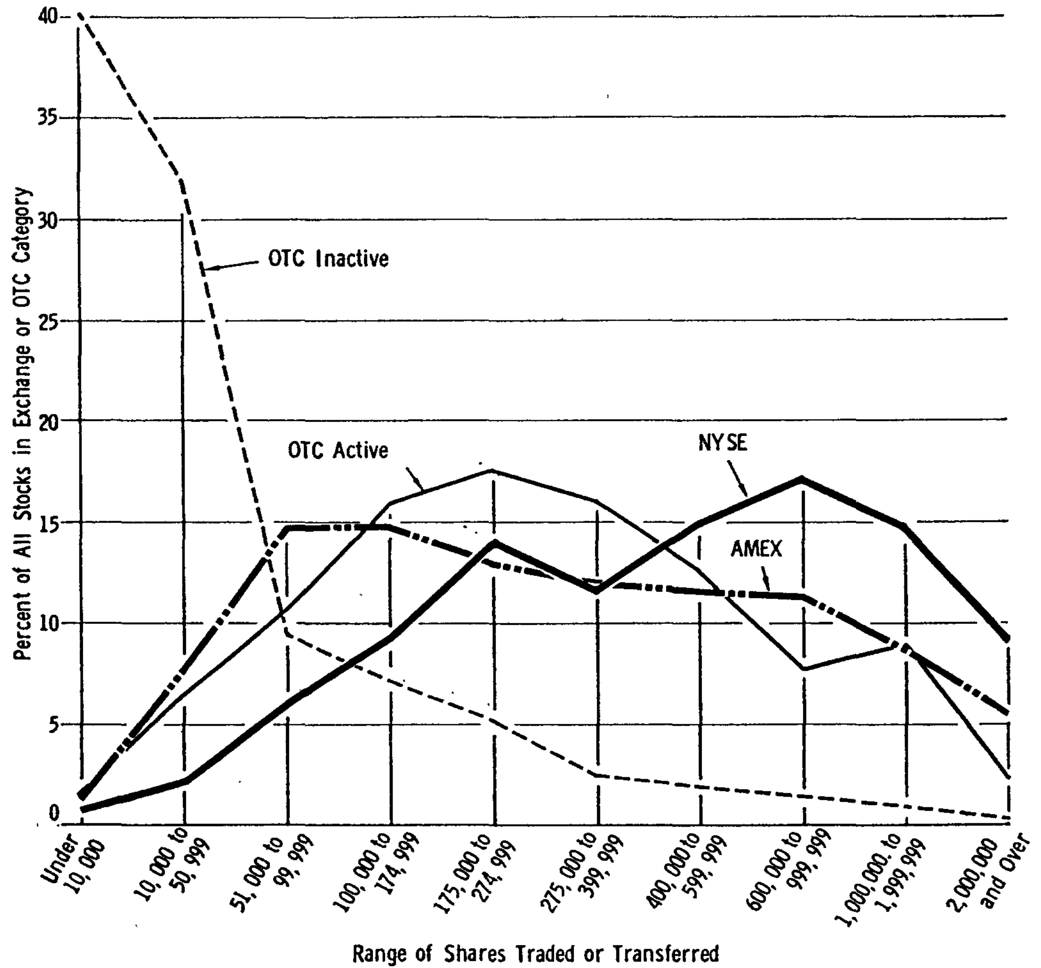
The pattern is generally the same in dollar volume, altered only slightly by price differences among stocks on the different exchanges (chart VIII-f and table VIII–9). Thus, while the median price of common stock on the NYSE is $35, it is $9 on the Amex, $17 on the major regionals, $10 among OTC-active stocks and $27 among OTC-inactive. As a result, the range of dollar volume for stocks on the NYSE, for example, would be brought even further above the issues in the other market categories.

Despite the influence of similar stock characteristics and similar market facilities upon the trading activity of stocks in each market, the differences in volume within each market are extremely wide, as is illustrated by chart VIII–e, showing the distribution of stocks in each market category by trading activity. The wide differences evident in stocks on the Amex and in the OTC-active category are present to only a moderately lesser extent in stocks on the NYSE. And table VIII–8 reveals that, although the stocks traded exclusively on the major regionals are predominantly in the lower range of activity, their lists include a few issues at the very highest trading levels.

[29] It should be noted that these volume figures are for shares reported traded on the particular exchange; they exclude odd-lot volume in the case of the NYSE, Amex, and Midwest Exchanges, and in all cases exclude transactions in the over-the-counter market.

Chart VIII - e

PERCENT OF STOCKS IN EACH EXCHANGE OR OVER-THE-COUNTER CATEGORY FALLING INTO EACH RANGE OF SHARES TRADED OR TRANSFERRED ANNUALLY *
1961



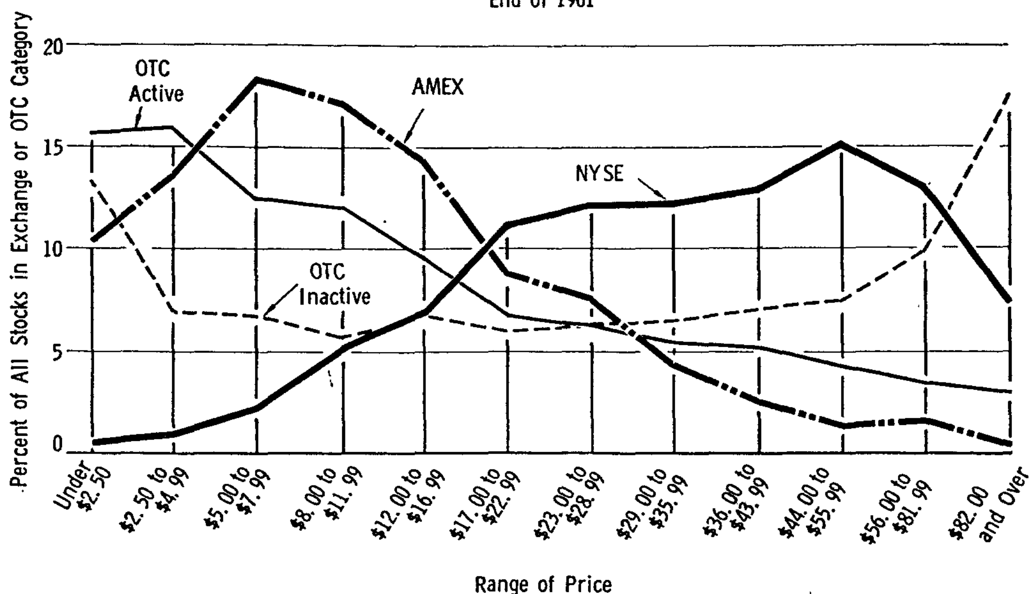
* For exchanges, data are for shares reported traded on that exchange; for over-the-counter categories, data are for shares transferred, as shown on the Questionnaire OTC-4.

Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

Chart VIII-f

PERCENT OF STOCKS IN EACH EXCHANGE OR OVER-THE-COUNTER CATEGORY
FALLING INTO EACH RANGE OF PRICE ★
End of 1961



★ Over-the-counter categories are based on the Questionnaire OTC-4 sample. OTC-Active category includes stocks with four or more dealers entering a "bid" and "offer" in the National Quotation Bureau's Monthly Stock Summary of January 1962. OTC-Inactive category includes stocks with fewer than four such quotations.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For each exchange or over-the-counter category, the sum of its percentages in all ranges combined equals 100 percent.

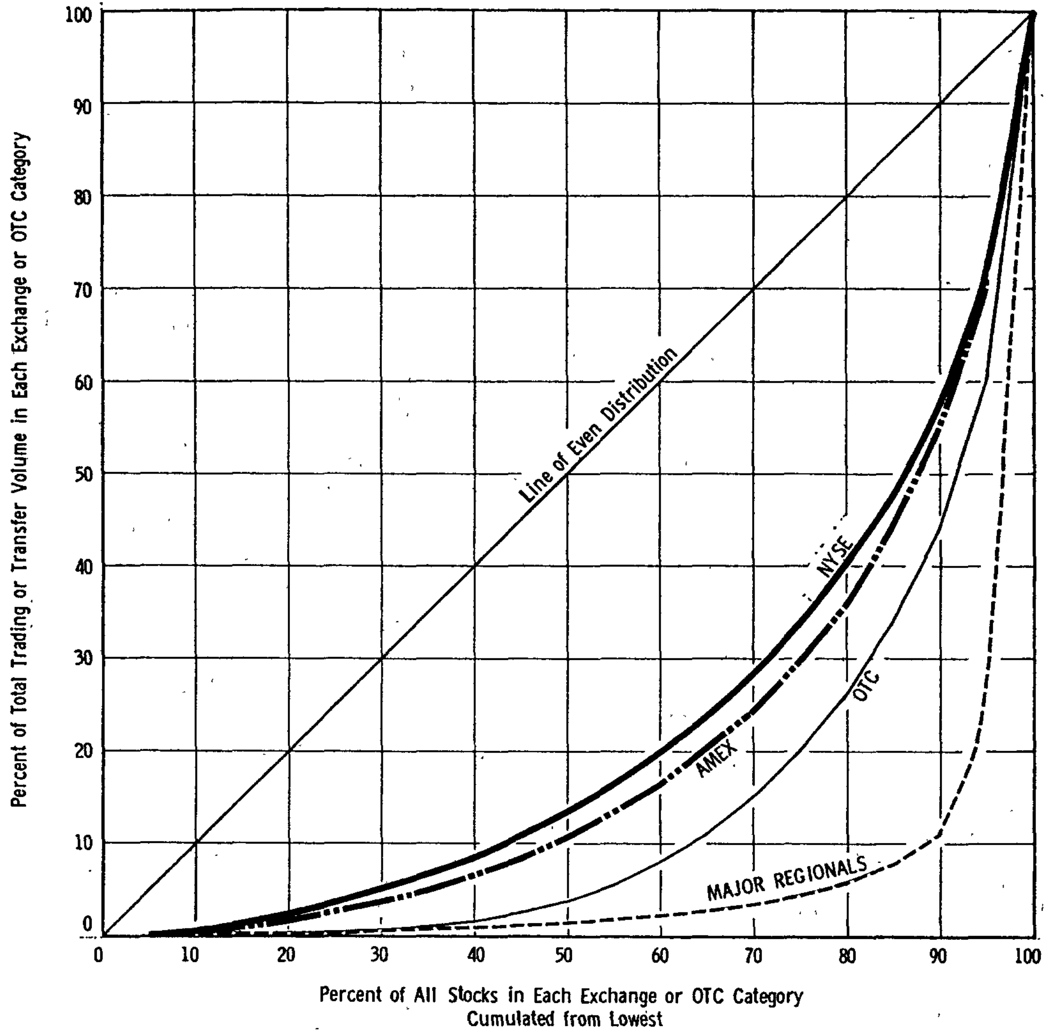
Another approach to this question, focusing on the concentration of activity among stocks in each market, is presented in chart VIII–g and table VIII–10. The greatest concentration—and disparity—in trading activity is seen to exist in the major regionals, where the top 10 percent of the stocks account for 89 percent of the trading activity and the bottom 50 percent of stocks for only 1½ percent. The NYSE volume of trading activity is most evenly distributed, with the Amex showing slightly more inequality and the over-the-counter market, taken as a whole, somewhat more. Even within the NYSE, however, a significant degree of concentration is evident—the top 10 percent of the common stocks accounting for 42 percent of total share volume, the bottom 50 percent of stocks for only 14 percent. In the over-the-counter market, some 56 percent of the total share transfer volume is accumulated in the top 10 percent of stocks, and only 4 percent by the bottom 50 percent of the stocks.

In each of the markets, there clearly are extremely wide differences in activity, separating the bulk of the stocks from those which are most active or least active. Many of the stocks at the extremes overlap far into the level of activity characteristic of other markets, underlining once more that while broad differences exist among major market categories, important differences within categories as well as overlapping among categories are also characteristic.

Chart VIII-g

DISTRIBUTION OF TRADING OR TRANSFER VOLUME AMONG STOCKS IN EACH EXCHANGE OR OVER-THE-COUNTER CATEGORY*

1961



* Over-the-counter categories are based on the Questionnaire OTC-4 sample. The Major Regionals category includes stocks solely listed on any of the following Regional Exchanges: Boston, Cincinnati, Detroit Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh.

For exchanges, data are for common stocks only; for over-the-counter, data are for issuer's class of stock with most shareholders. For exchanges, data are for shares reported traded on that exchange; for over-the-counter, data are for shares transferred, as shown on the Questionnaire OTC - 4.

6. THE SPECIAL DEMANDS OF A CONTINUOUS AUCTION MARKET

a. The importance of "depth"

In chapter V, the concept of "depth" was defined, with some indication of its varied meanings but with particular emphasis on the use of the term as referring to the degree of continuing public interest and potential activity in a particular stock. It was there pointed out that depth has certain fundamental quantitative aspects as well as more incidental or ephemeral qualities. From the summaries of listing requirements in section 4 above, it is obvious that depth of public interest, at least as reflected in the quantitative terms of amount of shares outstanding and degree of distribution, is a universal theme. All of the exchanges have thus recognized that, apart from all other criteria, this type of quantitative measure is fundamental in selecting securities for admission to their markets.

The reason for this emphasis is inherent in the nature and needs of a continuous auction market, in which buyers and sellers (or their brokers) meet face to face to match their wants and offerings.[30] The public conception and expectation of such a market, based on long tradition and considerably nurtured by the exchanges themselves, is that it is characterized by continuity and fluidity. If this expectation is to be fulfilled, spontaneous meeting of buyers and sellers must occur on a reasonably continuous basis or, under present circumstances, must be supplemented by specialist trading. In stocks with inadequate depth a successful auction market may depend on abnormally high participation of the specialist, at least if a high premium is put on continuity and fluidity; and still further down the scale, depth may be so inadequate that a specialist system cannot be expected to bear the burden and a continuous auction market is not feasible.

The president of the New York Stock Exchange has recently made similar comments, with emphasis on an expanded specialist role:

> To accomplish this [that every buyer and seller should be able to find his opposite number quickly, and at a price reasonably close to the last sale], you need, among other things, a large floating supply of stock, issue by issue, and a concentration of orders—either on the floor or entered in the specialists' books. Unfortunately, however, neither the floating supply nor the orders on the books today create the kind of market liquidity the public has a right to expect.[31]

A somewhat different emphasis is possible, however: an exchange purporting to operate as a continuous auction market must maintain sufficiently high listing standards so that a continuous auction is reasonably assured without undue reliance on specialist participation. It is thus a matter of appropriate public concern, and not exclusively a concern of the exchanges themselves, that listing requirements and practices be reexamined and adjusted from time to time, in light of long-range developments affecting depth of markets, and with a view to maintaining an acceptable balance between public and professional trading in a continuous auction market.[32] Essentially the same point was made by the then Chairman of the Commission, James M. Landis, in 1936:

> * * * One obvious instance where an exchange market may not be desirable is where there is a very small outstanding supply. Now, under those circumstances

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[30] See, generally, ch. VI, and particularly pts. B and D.

[31] G. Keith Funston, letter, Harvard Business Review, September–October 1962, pp. 7, 8.

[32] This is apart from the public interest in maintaining competitive primary exchange markets, as discussed in pts. D, E, and F of this chapter.

there is not enough in the way of offers to buy and sell being made at a central point, and consequently the process of regulation has to be entered into in order to establish fair and not too fluctuating prices with reference to securities.[33]

b. Long-range factors affecting depth

Existing yardsticks in respect of amount of shares outstanding and floating supply, as embodied in the exchanges' listing requirements, are merely rules of thumb for common stocks generally. As already mentioned in chapter V, a number of variables may result in above-average or below-average public interest and activity in particular securities, or in all securities at particular times, with any given requirement of distribution and floating supply. In addition, certain long-range tendencies and forces appear to have affected or to be affecting the actual amount of spontaneous market activity that can be expected from any given amount of distribution and floating supply. Among these tendencies and forces, some tending in opposite directions from others, are:

(1) Over the years, the degree of speculative or investment interest in the market tends to change for various reasons such as tax considerations, margin level, the extent and characteristics of public participation, and prevailing attitudes toward the economy. On an overall basis, the rate of turnover of outstanding stocks has tended to decline. In 1934, the New York Stock Exchange had an average turnover rate of 25 percent, the lowest percentage to that date, and in 1962 it was 13 percent. Under any assumed circumstances, however, a high degree of speculative interest may be directed toward particular securities, and in these cases trading activity may be high relative to shares outstanding.[34] As a result, a number of stocks on the NYSE have annual rates of turnover considerably above the overall average—some 100 common stocks, or almost 10 percent of the total, having 1961 turnover rates of 55 percent or more.

(2) There is an increasing concentration of stocks in the hands of institutional investors. In general, these institutions probably have channeled into the market a substantial quantity of savings that might otherwise have been applied elsewhere, but their rate of turnover varies considerably and may be higher or lower than that of the public. Institutions also have tended to be buyers on balance and sometimes deal in large blocks that may be handled outside the regular auction market, or if within, that may tend to unbalance supply and demand at any given time and thus complicate the problem of maintaining continuity and liquidity. This subject is more fully discussed in chapter VI.D and in parts C and D of this chapter.

(3) There has been a tendency for some years toward splitting the primary exchange market either through multiple exchange trading or through over-the-counter trading in listed stocks. In theory this would tend to reduce depth in the primary market except insofar as the multiple markets would tend to bring about a larger total market interest than would otherwise exist. In practice, because multiple trading tends to occur in the most active stocks, its impact on depth in the primary market does not appear to have been significant, although

[33] Hearings before House Committee on Interstate and Foreign Commerce on S. 4023, "Unlisted Securities," 74th Cong., 2d sess., p. 10 (1936).

[34] As an extreme example, in the first 6 weeks of 1963, U.S. Smelting & Refining had a turnover rate of more than 200 percent.

undoubtedly varying for different securities. These considerations are further discussed in parts D and E of this chapter.

(4) New issues of stock or convertible securities to finance expansion of business, together with widespread use of additional blocks of stock in accomplishing mergers and acquisitions, in paying dividends, and as a basis of employee purchase and executive compensation programs, have significantly increased the outstanding and floating supply of stock of many companies. Many companies have also effected recapitalizations and stock splits with the precise purpose of increasing the number of shares and correspondingly reducing the price per share. In a noteworthy recent instance in 1962, the Amex required a stock split as a condition for continued listing.[35]

(5) A considerable spreading of branch offices by many member firms, a marked improvement of communications, and a growing tendency to centralize recordkeeping, and therefore processing of orders, in New York, all taken together, have presumably tended to stimulate public interest and activity and channel it to the primary market.

(6) In the past decade, the NYSE has engaged in a substantial publicity campaign, supplemented by its Monthly Investment Plan, to encourage wider public participation in the markets. Indications are, however, that the broadened public interest resulting from these efforts tends to focus on stocks which are otherwise most widely publicized and popular.

(7) The NYSE has also engaged in a continuing and increasing effort to inform institutional investors of available procedures and mechanisms for handling their transactions without turning to over-the-counter markets. As shown in part C, a perhaps surprisingly large share of all institutional transactions handled under NYSE procedures and mechanisms are done in the regular auction market.

(8) The prestige associated with an organized exchange that has minimum listing requirements and facilities for effective dissemination of stock information may itself tend to enhance depth in the sense here considered. This is suggested by data showing that within the same asset categories of issuers, the proportion of stocks with wider stock distribution increases progressively depending upon the type of market. In the $10 to $50 million asset category, for example, the proportion of stocks having 3,000 or more shareholders rose from 13.7 percent among over-the-counter stocks and 25.0 percent of those solely listed on the major regionals, to 37.2 percent of those listed on the Amex and 66.3 percent of those listed on the NYSE.

The enumeration of these tendencies is sufficient to indicate that the factors and circumstances affecting suitability of particular securities for continuous auction markets are not static. In the aggregate they do not change the initial proposition that the particular nature and needs of a continuous auction market impose special demands in terms of public interest and activity. They do, however, indicate the need for a dynamic and flexible approach, including periodic reexamination of listing and delisting yardsticks in relation to existing market mechanisms of the separate exchanges, without prejudice to pos-

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[35] The stock of New Process Co. was suspended from trading because of its "limited distribution * * * and its recent price action." The Exchange reinstituted trading after the stock was split five for one.

sibilities for improvement and adaptation of the mechanisms themselves in light of changing circumstances and technologies.

c. Listing and delisting standards

The listing and delisting standards designed to assure depth need not, indeed should not, be the same for every exchange. Such factors as geographic concentrations of investor interest in particular securities may permit one exchange to function—and to hold itself out as functioning—at levels that would be insufficient for another. Among other factors would be differences in trading rules and practices applicable to the various exchanges, as presently in effect or as they might be modified in recognition of differing needs.[36] It would still be true, however, that each exchange should have rules and practices designed to admit and retain securities capable of being successfully traded within the kind of market that the particular exchange is and purports to be.

By the same token, if listing minima are important in relation to the nature of a particular auction market, it may be questioned whether there should be so wide a discrepancy between listing and delisting requirements as presently exists, especially in the case of the NYSE. The president of that exchange has emphasized that:

> The job [of self-regulation] begins for us with the critical question of listing. Is a company which applies for listing of the standing that we think should characterize a stock on the big board? Are its assets, its earning power, its stock distribution up to the standards prescribed by our board of governors? If not, we must decline to lend our facilities to that company. Let me point out too, that once a company has met our initial listing requirements we expect it to meet certain lesser criteria for continued listing.[37]

It may be granted that a security admitted to listing should not lightly be removed, but it seems doubtful that delisting yardsticks equal to only 20 percent of listing standards are in keeping with the purpose as expressed in these quoted remarks or with the public interest in allocating securities with due regard for what kind of market a particular exchange purports to provide and is capable of providing.

d. The round-lot unit

Whatever the amount of distribution and floating supply for a given security, the depth of public buying and selling interest in the auction market is directly affected by what is selected as the round-lot unit of trading—presently 100 shares for most stocks. This is because, as discussed in chapter VI, transactions in smaller units, or odd lots, are handled outside the regular auction market, in the NYSE almost entirely by separate odd-lot dealers and in the Amex and certain regional exchanges, by specialists doubling as odd-lot dealers. Under either system, but most clearly under the NYSE system, odd-lot transactions are handled mostly in the form of purchases and sales by the odd-lot dealers, with the auction market reflecting only the balances in the form of odd-lot dealers' offsetting transactions. Even the latter may be, and in some degrees are, timed and handled by the odd-lot dealer to serve his own needs and benefit,

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[36] In this connection, see pt. E of this chapter.

[37] "Policing the Securities Industry: More Regulation or More Responsibility?" Remarks of G. Keith Funston before the New England Council, Boston, Mass., Nov. 17, 1961, pp. 5–6.

so that they are one step removed from being reflected as normal supply and demand.

If the round-lot trading unit were reduced to perhaps 25 or 50 shares for some or all securities, the automatic effect would be to remove a substantial segment of all present odd-lot trading from the special handling and bring it into the flow of buy and sell orders constituting the depth of the market at any given time.[38] As seen in chapter VI, the total quantity of odd-lot transactions is a very significant part (averaging about 10 percent) of all NYSE business and even more on the principal regional exchanges, so that the contribution to depth might be quite substantial.

This is by no means a novel suggestion; indeed it is already in effect for about 270 relatively inactive securities on the NYSE. Wider extension of the same principle has been considered from time to time in the past, but has been rejected basically for the reason that the mechanics of doing business would be greatly complicated.[39] It would seem quite conceivable, however, that already accomplished or foreseeable advances in technology would eliminate any serious difficulty on this score. In any event, the public interest would seem to be sufficiently involved in this kind of question so that it should be the subject of Government-industry study in the near future. In such study, the potential impact on the regional exchanges' multiple trading business will need separate attention; however, the potential advantages of reducing the trading unit presumably would be the greatest in less active stocks, where multiple trading would be least likely to exist. It would also be necessary in such study to consider the ramifications of present commission rates and the odd-lot differential.

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[38] In a case arising in 1951, an issuer requested the Commission to terminate unlisted trading privileges in its stock on the then New York Curb Exchange. The Commission found that "the character of the trading" of the security on the Exchange was unsatisfactory, but stated that if the trading unit of the stock were reduced from 100 to 25 shares it would not grant the company's request until after a trial period for the new trading unit (10 SEC 675 (1941)). After a 6-month trial period had elapsed, the company again requested that the unlisted trading privileges be terminated. However, on the basis of data furnished by the Exchange the Commission again denied the request. The Commission found that the reduction in the unit had diverted substantial trading activity into the Exchange's auction market because of the execution in the round-lot market of orders which formerly would have been handled on an odd-lot basis. This was evidenced by the facts that 55 percent of the shares traded in the round-lot market during the trial period were in blocks of less than 100 shares and there was a sharp reduction in odd-lot trading and an increase in the public's round-lot trading in the test period over the previous periods (12 SEC 961 (1943)).

[39] Perhaps the most recent expression by the NYSE was in a letter dated Sept. 21, 1961, replying to a suggestion by a member of the public, in which the Exchange said:

"The basic 100-share unit of trading was adopted, and has been retained, because it fulfills the requirements of the market more satisfactorily than any other unit. In other words, the unit is most convenient, desirable, and economical. It is sufficiently large to involve a sum of money adequate to represent a reasonable appraisal of a security's worth and also to accommodate the transaction of a reasonable volume of business within the hours of trading and the physical space available. It is adequate in ordinary markets to permit the recording of transactions on the stock ticker tape without unreasonable delays because the volume per transaction does not have to be shown on the ticker tape when 100 shares are involved—only the symbol and sale price need be shown. And, when the volume in a transaction is less than 1,000 shares, only the number of units traded need to be shown instead of the total volume. In periods of great activity, it is possible to show the volume in a transaction involving a block of 1,000 shares or more by dropping the last two digits of the volume—showing only the number of units.

* * * * * * *

"The cost of executing an order of one unit—whether the unit be 100 shares or a lesser unit—is substantially the same. There might be a material increase in the cost of doing business because of additional help that would be needed to handle the tremendous increase in the number of transactions if smaller units than 100 shares were applied to active stocks. Such additional cost might eventually mean that the public would be charged higher commissions."

7. THE GREATER ADAPTABILITY AND VARIETY OF OVER-THE-COUNTER MARKETS

In general, over-the-counter markets, being "shopping around" markets, are designed to explore and reach whatever buying or selling interest may exist, and, in the case of a "thin" market, they are presumably better equipped than continuous auction markets to seek out such interest. Another way of saying this is that over-the-counter markets are based on the principle and procedure of advertising one's buying or selling interest and/or seeking interested parties on the other side, in contrast to continuous auction markets, which are more dependent on spontaneous meeting of buying and selling interests. In this connection the heterogeneous and residual character of over-the-counter markets may be considered both cause and consequence: certain securities are in over-the-counter markets precisely because the mechanics of the latter are suitable where those of an exchange market are not; and over-the-counter securities are heterogeneous precisely because they include a wide spectrum of securities ranging from those for which a continuous auction market would be perfectly suitable to those—far more numerous—that could not be traded on a continuous auction basis.[40]

The fact that over-the-counter markets are capable of serving for the latter segment, where an exchange market would be incapable, does not mean that a degree of continuity or liquidity comparable to that of a strong auction market will be achieved. Even the most aggressive merchandising or seeking of buying and selling interests must be in the framework of the amount of stock outstanding and its distribution, and the potential for continuity and fluidity of the market for any particular security is limited accordingly. At the higher end of the scale, the participation of numerous broker-dealers in an active over-the-counter market can provide continuity and fluidity equal to what is found in the strongest auction markets, together with a kind and degree of competition that is not provided by the specialist system itself. At the opposite end of the scale, any degree of continuity and fluidity, in fact the existence of any market at all, may depend on whether some dealer—under no obligation to do so—is willing to advertise its interest and take positions in a particular security. An apparently widespread illusion that needs to be dispelled is that every security distributed to the public can and does thereafter enjoy a continuous and fluid market. Here as much as anywhere else, a "silk purse" must start with the right raw materials.

In any event, the fact that auction markets are more demanding and over-the-counter markets more adaptable in respect of depth does not necessarily say anything or require anything in respect of the quality or "soundness" of securities in the two types of markets. The discussion goes only to the relevance of depth in market allocation, with emphasis on the necessity of minimum standards of depth if an exchange market is to operate successfully on a continuous auction basis, and the necessity of adequate identification of factors bearing on the quality of market for a particular security in the more kaleidoscopic over-the-counter category.

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[40] See, generally, ch. VII, and particularly pt. B and app. VII-A.

8. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The allocation of securities among trading markets, including the determination of the primary market and the establishment of dual or multiple markets for a particular security, is determined by a number of interacting factors and forces. A crucial concept in allocation as between exchange and over-the-counter markets is that of "listing," the process by which securities are first admitted to trading on an exchange. Securities may also be admitted to trading on an exchange through "unlisted trading privileges" but this now applies primarily to securities already listed on another exchange. There is no corresponding gateway to trading in over-the-counter markets, either primary or multiple.

The most stringent listing requirements are those of the New York Stock Exchange. These include "yardsticks" as to minimum amounts of net tangible assets, net earnings, share distribution, and market value of stock. Delisting standards, while paralleling the listing standards, are far less stringent. Listing and delisting standards of the Amex and other exchanges tend to reflect similar factors but at substantially lower quantitative levels.

There is a broad tendency for securities traded in a particular market or category of markets to show generally similar characteristics; yet there are wide diversities within each category and considerable overlapping among categories. NYSE-listed stocks generally are in the highest size ranges, and stocks in the "OTC-inactive" category (defined by the study as those showing fewer than four dealer quotations in the February 1962 Monthly Stock Summary) are in the lowest. The bulk of Amex issues lie between these two categories, while the "OTC-active" category (stocks showing four or more dealer quotations in the Monthly Stock Summary) is spread broadly across the whole spectrum with a slight concentration below the Amex issues. Stocks listed solely on the major regional exchanges tend to fall between the active and inactive OTC groupings. Only in assets is this pattern broken—stocks in the OTC-active categories show a range of assets generally no higher than those that are inactive. Most NYSE stocks have characteristics considerably in excess of the Exchange's minimum yardsticks for original listing, but about 10 percent do not meet these requirements. While stocks not listed on the NYSE generally are smaller in relation to those yardsticks, significant percentages of stocks listed on the Amex or solely on regional exchanges and of stocks in the OTC-active category substantially meet all NYSE listing requirements.

A generally similar pattern appears in respect of trading activity. Thus in 1961 the central two-thirds of common stocks in the NYSE were in a range higher than the Amex and considerably higher than the major regional exchanges. While no direct comparison with over-the-counter securities is possible, it would appear that the central two-thirds of OTC-active stocks show a range of trading volume higher than that of most stocks listed solely on major regional exchanges and only moderately below the range of the central two-thirds of the shares traded on the Amex. Notwithstanding these general patterns, the differences in volume within each market category are exceedingly wide, even for the NYSE (where trading activity is most evenly distributed), and there is a considerable overlapping among market categories.

For a security to be well suited for trading in a continuous auction market, spontaneous meeting of buyers and sellers must occur on a reasonably continuous basis without undue reliance on specialist participation; the market in other words must have adequate "depth." The degree of market depth in this sense is affected not only by transient variables with respect to given securities or markets but also by a number of long-range tendencies and forces. Listing and delisting standards should be designed to admit and retain securities capable of being successfully traded in the kind of market that a particular exchange is and purports to be. The wide discrepancy now found between listing and delisting yardsticks seems questionable in light of these considerations, particularly with respect to the NYSE.

The depth of buying and selling interest reflected in the auction market is directly affected by the round-lot unit of trading, presently 100 shares for most stocks, since odd-lot transactions are largely handled through dealers and not directly in the auction market. Thus, a reduction in the round-lot trading unit would tend to add to the flow of buy and sell orders constituting the depth of the market at any given time and should receive consideration for all or some securities.

Since exchange markets, as continuous auction markets, are more demanding in terms of depth than are over-the-counter markets, a primary public concern is to assure that each security admitted to an exchange market is suitable, in such terms, for the kind of market that the exchange purports to conduct. Indeed, the best clue to appropriate allocation between exchange markets and over-the-counter markets may lie in the difference in warranted expectation on the part of public investors. An exchange market is generally regarded and frequently advertised as assuring a high degree of continuity and fluidity through the continuous auction process. It follows that each exchange should reasonably live up to the expectation created by its image and should not maintain listings that are incompatible.[41] There nevertheless remains room for a degree of variation and experimentation, as discussed in part E of this chapter, with certain of the regional exchanges perhaps operating under a modified set of assumptions intermediate between those of continuous auction markets in the fullest sense and over-the-counter markets.

The legitimate expectation for over-the-counter markets is quite different from that of the classic auction market. It is not and need not be the opposite; it is simply more kaleidoscopic. What the sophisticated professional expects, and the public investor is entitled to expect, is only such degree of depth, continuity and fluidity for a particular security traded over the counter as is implied by the number of dealers making a market at any time or from time to time. This may range from 20 or more on a continuous basis to 1 or 2 on a more spasmodic basis. The over-the-counter markets have room for all of them and there need be no disappointment of legitimate expectation as to any of them, since the range of dif-

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[41] The same kind of point was made by the Commission in 1936, in relation to unlisted trading:

"Admitting a security to trading privileges on an exchange amounts to a representation by the exchange that an appropriate and adequate market for that security exists on that exchange. It does not necessarily amount to a representation that the best market from the standpoint of buyer or seller exists on the exchange, but it is a representation that an adequate and an appropriate market may be found upon the exchange."

SEC, "Report on Trading in Unlisted Securities Upon Exchanges," p. 10 (1936).

ference is ascertainable and expectation can be adjusted to particular facts. What is essential, in these terms, is that there be clearer recognition and identification for public investors of the wide variations that necessarily exist within the broad over-the-counter category, and better adaptation of regulatory measures to suit the varying needs.

For the considerable category of securities that would be suitable for an exchange or over-the-counter markets, there appears to be no reason of public policy why an issuer should not have freedom to decide, as at present, either to remain entirely in the over-the-counter sector or to seek an exchange listing.[42] This necessarily presupposes, however that public investors in either type of market are afforded, through requirements of fair trading practices and disclosures, the maximum protection consistent with the character of that type of market. Chapters VI and VII contain both immediate and longer range recommendations as to trading practices and market disclosures to meet this objective, and chapters IX and X contain recommendations for greater equalization of disclosure and credit requirements for securities traded in the two types of markets. Implementation of the chapter VI and VII recommendations is imperative if each type of market is to provide, within the assumptions in which it operates, appropriate safeguards for investors and the public interest. Implementation of the chapter IX and X recommendations, on the other hand, will eliminate discriminations that may now affect market allocations artificially and arbitrarily.

The Special Study concludes and recommends:

1. Continuous auction markets are by their very nature more demanding than over-the-counter markets in respect of the depth of public interest and activity required for the degree of continuity and fluidity generally associated with them. Since various factors affecting depth are dynamic rather than static, listing and delisting standards and practices of the several exchanges require reexamination from time to time to assure that the entire list of securities being traded is in keeping with the kind of market that the particular exchange purports to provide and is capable of providing. Present delisting standards and practices appear disproportionately low in relation to listing standards, particularly in the case of the NYSE, and should be strengthened.

2. Reduction in the round-lot unit of trading would significantly add to the depth of auction markets by bringing a portion of present odd-lot trading directly into the balance of available supply and demand. Technological advances, as of the present or the foreseeable future, may well be found to have obviated what were previously felt to be practical impediments. A Government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities should be undertaken in the near future.

3. Over-the-counter market mechanisms are generally more adaptable than exchange market mechanisms in their capacity to provide for the heterogeneous types of securities that are traded

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[42] In this connection, see p. 809, note 4, above, and ch. IX, pp. 56–57 (pt. 3), on the recommended repeal of sec. 12(f)(3), under which proposed change all "OTC listed" issues would not automatically be eligible for unlisted trading.

over the counter, including some that would be suitable for continuous auction trading but a great many more that would not. On the other hand, the very heterogeneity of over-the-counter securities makes it impossible to assure markets of the same quality (in depth, continuity or otherwise) for all such securities. Hence a pressing and continuing need is to provide more specific identification of crucial facts about individual markets, so as to assure more realistic understanding on the part of public investors as to the kind and quality of market that may be expected for any particular security. Reference is made to certain recommendations of chapter VII directed to this end.

C. Institutional Participation and Block Transactions

In this part attention is focused on the participation in trading markets on the part of institutions, including pension funds,[43] insurance companies, investment companies, college endowments, foundations and common trust funds. The discussion is concerned with the importance of the institutional investor relative to the individual investor, and the ways in which the institutions execute stock transactions and utilize the facilities of the various trading markets. Consideration is given to such factors as the methods by which institutions handle large purchase and sale programs, the institutions' turnover of stocks in their portfolios, and the institutions' relations with the broker-dealer community.

At the close of 1961, domestic individuals (including nonprofit organizations) are estimated to have held about $413.5 billion or 76 percent of the outstanding common and preferred stock in the United States, compared with $120.8 billion or 22 percent held by institutional investors, including bank-administered personal trust funds (table VIII–11).[44] Despite the much smaller portion owned by the institutions, they have special importance to the trading markets. For one thing, decisionmaking is concentrated in relatively few hands with probably no more than several hundred institutions owning a majority of the stock in all such portfolios. Then again, the substantial size of many of the institutional investors and their relatively large unit holdings mean that investment decisions and the methods of executing them could have major implications for the depth and liquidity of the trading markets. Finally, institutions have been growing in importance relative to individuals as investors in stocks.

For these reasons, the Special Study conducted an inquiry into institutional investors' common and preferred stock transactions and procedures through a questionnaire designated IN–4, which was sent to and answered by a sample of 91 different institutions.[45] Table VIII–a, below, shows the relationship of the sample to the universe for the groups covered.[46]

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[43] The term "pension funds," as used throughout this part, includes deferred profit-sharing plans.

[44] For estimated institutional holdings of New York Stock Exchange-listed stocks only, see New York Stock Exchange Fact Book, 1962, p. 29.

[45] The respondents were selected primarily from among the largest in each institutional category studied, but also with some effort to include coverage of different sizes and geographical locations of institutions within each category. A copy of the questionnaire appears in app. VIII–A.

[46] As a comparison of tables VIII–a and VIII–11 will show, the groups covered by the IN–4 sample and table VIII–a do not include all types of institutional investors. The most notable exclusion is of the bank-administered personal trust funds, which were not included in the IN–4 survey because of the difficulty of obtaining an appropriate sample and of ascertaining in each instance the extent of authority exercised by the bank.

TABLE VIII–a.—*Questionnaire IN–4 sample's coverage of selected institutional groups (Dec. 31, 1961)*

[Dollars in billions]

Selected institutional group	Number of institutions in sample [1]	Estimated market value of stockholdings		Holdings of sample as percent of holdings of all institutions
		All institutions	Sample institutions	
Total	91	$80.7	$28.8	36
Noninsured pension funds	15	21.0	7.1	34
Life insurance companies	10	6.3	3.1	49
Nonlifeinsurance companies	10	[2] 9.3	[2] 2.8	30
Investment companies:				
Open-end	21	21.9	[3] 8.3	38
Closed-end	7	7.2	1.2	17
College endowments	10	5.0	1.4	28
Foundations	11	7.8	4.4	56
Common trust funds	7	2.2	.5	23

[1] The number of separate funds covered is larger than the figures shown here since some of the institutions have more than 1 fund.
[2] Excludes stockholdings in affiliated companies.
[3] Companies which charge a sales load account for $7,900,000,000 of this amount.

Most of the stockholdings of the institutional groups covered are in stocks listed on the New York Stock Exchange. This is apparent from the table below.

TABLE VIII–b.—*Ratio of NYSE stocks to total stocks owned by all institutions in selected groups (Dec. 31, 1961)*

[Dollars in billions]

Selected institutional group	Market value of stockholdings		NYSE stocks as percent of all stocks
	NYSE stocks [1]	All stocks	
Total	$63.8	$80.7	79
Noninsured pension funds	17.0	21.0	81
Life insurance companies	4.5	6.3	71
Nonlifeinsurance companies	7.5	[2] 9.3	81
Investment companies:			
Open-end	17.0	21.9	78
Closed-end	5.3	7.2	74
College endowments	3.9	5.0	78
Foundations	6.8	7.8	87
Common trust funds	1.8	2.2	82

[1] NYSE Fact Book, 1962, p. 29.
[2] Excludes stockholdings in affiliated companies.

The results of this survey, together with relevant background data, form the subject matter of this part of chapter VIII.

1. THE GROWING IMPORTANCE OF INSTITUTIONAL INVESTORS

Among institutional investors, the most important by far are bank-administered personal trust funds which, at the close of 1961, held over $50.9 billion or 42 percent of the total amount of stock in the portfolios of all institutions, other than nonprofit organizations.[47] Next in importance are the noninsured private pension funds and open-end investment companies which, together, had about 36 percent,

[47] For the reasons indicated above in note 46, p. 837, personal trust funds were not included in the IN–4 survey.

while the remaining 22 percent of the stock held was distributed among the other types of institutions (table VIII-11).

Although the noninsured private pension funds do not have the biggest holdings of stock, they have experienced the most rapid increase in such holdings of any investor group in recent years, with a rise of five times between 1954 and 1961. They were followed in this respect by open-end investment companies, whose stockholdings rose about four times. Compared with these rapid rates of growth, the stock investments of all institutions combined grew during this period by about two and one-half times, while the amount owned by individuals, together with nonprofit organizations, rose by only about two times.

Contributing to this shift of investment patterns has been the increasing diversion of individuals' savings to institutions rather than to the direct purchase of equities. Indicative of this tendency, during the 11-year period 1951-61, individuals, together with personal trust funds and nonprofit organizations, were net sellers of stock other than investment company shares in the amount of $0.4 billion [48] (table VIII-12). Institutions (other than personal trust funds and nonprofit organizations), in their turn, not only have been the recipients of enlarged money flows but have directed a greater portion of these streams toward buying equities. For example, the proportion of the net receipts of noninsured private pension funds invested annually in common stocks has steadily increased from 22 percent in 1951 to 55 percent in 1961.[49] As a result, between 1951 and 1961, institutions, excluding personal trust funds and nonprofit organizations, had net acquisitions of common and preferred stocks of $26.1 billion, a figure slightly in excess of the amount of total net new issues of stock of corporations, other than investment companies, during this period. Almost three-fourths of this net buying was done by the noninsured pension funds, which were the most important net buyers, and by investment companies, the second most important.

Turning from holdings and net purchases to overall transactions in stocks (purchases and sales combined), one finds that in addition to the institutions' becoming more important stockholders, they are absorbing a larger portion of the public transactions in listed stocks. According to the New York Stock Exchange, institutions and intermediaries accounted for 24.6 percent of total share volume in the Exchange market on 2 selected days in September 1952, and 19.3 percent on 2 selected days in March 1953, compared with 26.2 percent on 1 selected day in September 1961. On the other hand, during the same period, the participation by individuals declined from 57 to 51.4 percent.[50]

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[48] Between 1954 and 1961, individuals were net buyers of investment company shares, and the proportion of their total stockholdings represented by investment company shares rose, through appreciation in value as well as net purchases of new shares, from 4.4 percent or $9 billion to 7.2 percent or $29.9 billion.

[49] Accordingly, the proportion of the pension funds' total assets invested in common stocks has grown during the same period from 11.8 to 36.5 percent in terms of book value (30.2 to 49.9 percent in terms of market value). The proportion in preferred stocks, however, has declined from 4 to 2 percent in terms of book value (3.3 to 1.5 percent in terms of market value).

[50] NYSE, "1961 Public Transaction Study," p. 3. Intermediaries include principally commercial banks and nonmember broker-dealers. If dollar rather than share volume were used, the relative importance of the institutions and intermediaries would be even greater: according to the NYSE, the average price of the shares traded on the selected day in September 1961 was $48 for institutions and intermediaries and $39 for public individuals. On the 5 selected days in September 1960, average per share prices were $37 for total NYSE volume and $46 for institutions and intermediaries. NYSE, "1960 Public Transaction Study," pt. II, p. 14.

Among the institutions and intermediaries, commercial banks account for by far the largest proportion of transactions (40 percent of institutional and intermediary share volume on the 5 selected days in 1960), followed by investment companies (19.3 percent) and nonmember broker-dealers (11.0 percent).[51]

Ordinarily, the Exchange does not break down the commercial bank classification into the various types of accounts for which the bank is acting, but in 1955 it did go behind the commercial bank figure and found that about 20 percent of the total commercial bank volume was executed for individual (nonfiduciary) customer accounts, 41 percent for trusts and estates, and the remaining 38 percent for institutions—18 percent was for pension funds alone, and 10 percent for investment companies.[52] When the institutional investor transactions through banks were combined with those made directly through member firms, the three institutional groups having the largest share volume of transactions (excluding nonmember broker-dealers) in the 1955 Stock Exchange study became: trusts and estates (with 28 percent of institutional volume), investment companies (with 22 percent), and pension funds (with 11 percent).[53]

Actually, averages such as the above, which show the percentages of institutional to total transactions on the New York Stock Exchange, obscure the even greater influence that the buying and selling of institutions may exert on individual issues. The common stockholdings of institutional investors tend to be concentrated in relatively few securities.[54] More important, however, the Special Study's analysis of the New York Stock Exchange 1961 public transaction

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[51] NYSE, "1960 Public Transaction Study," pt. II, p. 10; see also "1957 Public Transaction Study," p. 12. This breakdown is not available in the "1961 Public Transaction Study." Nonmember broker-dealers and, as indicated below, commercial banks, may in many instances be acting as agents for individuals.

[52] NYSE, "Institutional Investors and the Stock Market—1955," p. 17. On an overall basis, two-thirds of all transactions for trusts and estates, and almost three-fourths of all transactions for pension funds, were channeled through the banks. Id., at p. 9; see note 43, above. In view of the importance of commercial banks in handling personal funds and the difficulty of ascertaining in each instance the extent of authority exercised by the bank, the Special Study did not treat them as a separate institutional category in its survey. Discretionary common trust funds administered by banks, however, were employed to reflect the decisions taken by commercial banks when freed from outside investment influences. Also, the pension funds surveyed included both bank-administered and self-administered plans.

[53] Id. at p. 7.

[54] For example, a survey of bank-administered pension funds made in 1954 by the New York State Banking Department showed that 60 stocks accounted for two-thirds of all holdings. Mooney, "Pension and Other Employee Welfare Plans" (1955); see Andrews, "Pension Funds in the Securities Markets," Harv. Bus. Rev., November–December 1959, pp. 99–100. Several months later, a staff report was released by the Senate Committee on Banking and Currency on the trading activities of a sample of 210 different institutional investors in 25 common stocks during the 34-month period starting January 1953 and ending October 1955. It was revealed that for the period, the proportion of total net stock acquisitions by these institutions which was represented by the 25 stocks ranged between 17 and 35 percent for the various types of institutions. Staff of Senate Committee on Banking and Currency, 84th Cong., 2d sess., "Report on Institutional Investors and the Stock Market, 1953–55," pp. 25–35 (committee print, 1956). Moreover, 24 percent of the total net acquisitions of the 25 selected stocks by the 7 institutional groups was concentrated in 10 of the 25 stocks. Id. at p. 26. It does appear, however, that the concentration of institutional holdings in a relatively small number of stocks reflects in large part, at least in the New York Stock Exchange, the fact that a relatively small number of issuers account for a disproportionately large amount of the value of shares outstanding. (See Miller, "Concentration in Institutional Common Stock Portfolios," 16 J. Finance 38, 40 (1961). But cf. the figures on concentration of investment company ownership of individual issues contained in "Vickers Favorite 50" and "Vickers Over-the-Counter Favorites," published by Vickers Associates, Inc.) Moreover, in 1961 the reported volume in the 50 most actively traded stocks on the New York Stock Exchange accounted for 25 percent of the reported share volume in all issues, New York Stock Exchange Fact Book 1962, p. 19; but this list of 50 stocks is by no means the same as the list of the institutional favorites. See also, generally, the report prepared for the SEC by the Wharton School of Finance and Commerce, "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 11–13, 167–191 (1962).

survey [55] and of the 1962 market break [56] show that the institutions tended to account for a significantly greater proportion of the buying or selling in some issues than in others for the periods involved.[57] Thus, so long as institutional transactions predominate from time to time in purchases or sales of particular stocks, the major influence of the institutions on the market, as a whole, may be transmitted through the activity of these particular issues, especially when they are "market leaders."

Because of the substantial amounts of equity securities institutions buy and sell, they are likely to exert an increasing effect on the methods of handling large-scale transactions in the stock markets. In this connection, a page may be taken from the history of bond trading. The "institutionalization" of the corporate bond market is a well-known phenomenon. In 1938, the "consumer" sector—along with the "rest of the world" sector—held about 65 percent of outstanding corporate bonds, life insurance companies held approximately 17 percent, and the banking system 10 percent.[58] By 1961, however, holdings of individuals had dwindled to some 18 percent of the estimated total of $107 billion outstanding; institutions as a whole held 82 percent, with life insurance companies alone holding 47 percent (table VIII-11).

Such "institutionalization" has been accompanied by an increase in importance of new issue acquisitions and private placements as opposed to trading in outstanding issues. Also, for bonds as a whole, the negotiated over-the-counter market, rather than the auction market on the exchanges, has become by far the more important trading market. A similar phenomenon appears to have been happening in preferred stocks. And the importance of the over-the-counter trading market, relative to the exchange auction markets, appears also to have been growing in the common stock area, starting with the higher grade, more stable investment-category commons.[59]

This can be expected to continue as pension funds and institutions as a whole continue to grow in relative importance as common stock investors. Not only are the institutions large investors who often prefer to deal in large transactions, but pension funds (and other institutions except investment companies) appear to have had a lower turnover rate for their equity portfolios than the market—at least the New York Stock Exchange market—as a whole, and therefore may contribute to the thinning of the markets in particular issues.[60] Accordingly, an understanding of how institutions handle block transactions is important in order to evaluate the implications of a probable continued growth in the stockholdings of these institutions to the trading markets.

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[55] See ch. V.
[56] See ch. XIII.
[57] See also in this connection, note 54, above, "A Study of Mutual Funds," at pp. 11–12, 21–22, 262–282, 359–397; and "Report on Institutional Investors and the Stock Market; 1953–55," at pp. 36–44, 47, 52, 83–137.
[58] Andrews, "Pension Funds in the Securities Markets," Harv. Bus. Rev., November-December 1959, pp. 90, 94.
[59] For a discussion of the trading of NYSE-listed stocks in the over-the-counter market, see pt. D of this chapter.
[60] For a discussion of portfolio turnover, see sec. 5, below.

2. METHODS OF HANDLING BLOCK TRANSACTIONS

For purposes of the Special Study's survey, the expression "block purchase or sale" was defined as follows:

> The terms "block purchase" and "block sale" mean a change of position resulting from a single primary investment decision. A block purchase or sale may involve more than one transaction.[61]

Thus, in studying "block" transactions the Special Study started with a decision by the institution to buy or to sell a given quantity of stock. Its interest was in how this decision was carried out. There are a number of different methods by which block purchases or sales can be accomplished, and an actual block program may involve one or a combination of these.

a. Listed stocks

(1) *Through the auction market on an exchange*

By far the most common way of buying and selling listed stocks, even by institutions working on a large block purchase or sale program, is through a series of relatively small individual executions in the regular auction market on the floor of an exchange.

(2) *Through prearranged crosses on the floor of an exchange*

The "auction market" on the floor of an exchange assumes, in the usual sense, a situation where buy and sell orders meet through the process of bidding and offering on the floor. However, an important method used by large investors for executing part or all of a block purchase or sale has become the simple "crossing" on the floor of prearranged matching buy and sell orders. The matching orders may have been assembled off the floor by the broker retained by the investor initiating the block purchase or sale. The assistance of the specialist may have been used in locating the matching orders. Crosses normally are larger transactions than the pure "auction market" transactions involved in block programs, but there is no requirement that they be given any distinguishing identification on the tape or on confirmation slips, and they were not distinguishable from other floor executions in the transaction data collected through Questionnaire IN–4. In effect, when a cross is involved, the exchange market is being used to consummate a "negotiated" rather than a pure "auction" transaction.[62]

(3) *Through special stock exchange plans*

The New York Stock Exchange has adopted seven special plans for executing purchase or sale orders considered too large for execution in the regular auction market within a reasonable time. (Special acquisition or distribution plans exist also on other exchanges.) Four of the plans, all adopted before 1956, are designed to assist the holder in selling large blocks.[63] The three other plans, adopted in 1956, are designed to assist in the purchase of large blocks; but these have proved less popular than the distribution plans.

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[61] See Questionnaire IN–4, p. 2, app. VIII–A.

[62] The cross is executed in the public auction market on the floor, and intervention in the cross by other broker-dealers is possible. In addition, when a single broker represents both sides of the cross, NYSE rule 76 requires him, before executing the cross, to offer the security publicly at a price which is higher than his bid by the minimum price variation permitted in that security.

[63] Certain of the distribution plans are also described and discussed from another point of view in ch. IV.C.

The seven New York Stock Exchange plans are:

(a) *Distribution plans.*—(i) *Specialist Block Purchase.*—With prior approval of a floor governor, the specialist in a stock may purchase a block of that stock from the holder, off the Exchange floor.[64] The floor governor, to approve the purchase, must determine that the regular auction market on the floor of the Exchange cannot, within a reasonable time and at a reasonable price or prices, absorb the particular block of stock, and also that the purchase will aid the specialist in maintaining a fair and orderly market. If the purchase is approved, the specialist can purchase the block, without executing the purchase orders on his book at prices at or above the per-share price he pays for the block. By means of the purchase, the specialist takes the block into his inventory, and then sells shares from it from time to time in the course of his regular activities as a specialist. The purchase is an off-board trade, and is not reported on the tape. The price at which the purchase is made may be away from the price then current on the floor.

(ii) *Exchange Distribution.*—This plan essentially involves a cross on the floor, with the added feature of a special selling effort. Once Exchange approval for the distribution is obtained, the seller's broker is able to offer his own registered representatives and other broker-dealers extra compensation as an incentive to find the matching buy orders. Normally, to provide an incentive to the prospective buyer as well, the seller pays the equivalent of a double commission or more, while the buyer pays no commission. When sufficient buy orders have been accumulated to cover the block (or a portion of it, if the seller is willing to execute the block in stages), they are crossed with the block sell order on the floor of the Exchange, between the bid and asked quotations. The cross is printed on the tape, with a special symbol designating it as an "Exchange Distribution." The distribution must include all of the security which the seller intends to offer within a reasonable time.

(iii) *Special Offering.*—Following Exchange approval for use of this plan, the seller offers the block at a fixed price (not above the last sale or current offer on the floor, whichever is lower) and the terms of the offer are flashed on the tape in advance. The offer is open to all members and their customers, and includes an agreement to pay a special commission to the brokers who produce buy orders. Here too the seller normally pays the equivalent of a double commission or more, and the purchaser pays none. The offer must ordinarily remain open for at least 15 minutes. It must be subject to acceptance in part as well as in whole, and the offeror must include all of the security which he intends to offer within a reasonable time. Transactions effected pursuant to the Special Offer are printed on the tape. Price-stabilizing purchases and sales by the offeror are permitted to a limited extent.[65]

(iv) *Secondary Distribution.*—The Exchange permits its member firms to participate in a Secondary Distribution [66] of a listed stock only

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[64] For a discussion of this plan and for the specialists' role in handling blocks generally, see ch. VI.D.

[65] See NYSE rule 391 and Commission rule 10b–7.

[66] A Secondary Distribution, in the stock exchange sense, may or may not be the kind of "secondary distribution" sometimes requiring registration under the Securities Act of 1933. Whether registration under the 1933 act is required depends on the relationship of the seller to the issuer, irrespective of whether the method of distribution is a Secondary Distribution in the exchange sense, one of the other special stock exchange plans, or takes some other form.

upon a determination that the regular auction market on the floor cannot, within a reasonable time and at a reasonable price or prices, absorb the block, and also that a Special Offering or Exchange Distribution is not feasible. Usually, a selling group or syndicate is formed and the distribution is handled like an underwriting; distribution is accomplished after the close of the market; the offering price does not exceed the last sale price on the floor; the seller pays a commission or spread equal to twice the regular commission, or more; and the buyer pays no commission. The terms and conditions of a Secondary Distribution, which is an off-board trade, are announced on the tape when the distribution commences.[67] Stabilization is permitted.

(b) *Acquisition plans.*—(i) *Specialist Block Sale.*—This plan is the same as the Specialist Block Purchase plan described above, except that it involves an acquisition from the specialist rather than a sale to him.

(ii) *Exchange Acquisition.*—This is the same as the Exchange Distribution plan described above, except that the initiator is a purchaser rather than a seller.

(iii) *Special Bid.*—This is the same as the Special Offering plan described above, except that the initiator is a bidder rather than an offeror.

(4) *Through special off-board requests*

Under NYSE rules, member firms may not trade listed stocks[68] over-the-counter without first obtaining Exchange approval (or approval of a regional exchange where the stock is traded). Transactions accomplished off-board through such requests do not constitute a formal Exchange plan for accomplishing block transactions, but they are a not insignificant means used for such transactions.

(5) *Through transactions (in listed stocks) in the over-the-counter market*

A number of nonmember broker-dealers make over-the-counter markets in listed stocks.[69] For the listed stocks in which such markets are made, they provide one of the methods available to institutions for executing part or all of their block programs.

(6) *Other methods*

Underwritings, of course, provide a source of purchases for institutional investors, as for other investors. Institutions also sometimes purchase common stock, but more frequently preferred stock, directly from the issuer through private placements. At times, institutional investors purchase or sell blocks of securities through direct transactions with other large investors, without going through a broker-dealer as intermediary. Such direct arrangements appear, however, to be relatively infrequent.

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[67] In some cases, when the distribution does not become effective until sometime after the close of the market, announcement may be made by some other means, such as the broad tape or the tape of a regional exchange which is still open for business.

[68] This does not apply to certain "exempt" stocks listed in a supplement following NYSE rule 394. These are all guaranteed or preferred stocks, and their "exempt" status reflects the "institutionalization" of the markets in these stocks.

[69] See pt. D of this chapter.

(7) *Relative importance of the methods*

As indicated above, the most common method of handling block transactions appears to be the regular auction market on the floor of an exchange. While no precise data are available, prearranged crosses on the floor may rank second or close to second in importance.

The figures for 1961 indicate that the number of shares handled through the seven special New York Stock Exchange plans was equivalent to less than 2 percent of total NYSE reported round-lot floor volume. Despite this small overall percentage, the number of shares in any single special-plan distribution may be large in relation to floor volume in the particular stock involved.[70] For example, the number of shares offered during 1961 in NYSE-Secondary Distributions ranged from 17 to 1,000 percent, and averaged 180 percent,[71] of the reported round-lot floor volume in the same stock during the month of the distribution. For NYSE-Exchange Distributions during 1961, the ranges were 7 percent and 150 percent, and the average was 55 percent, of such monthly floor volume (excluding the shares sold in the distribution) in the same stock.[72]

By far the most popular of the special plans is the Secondary Distribution, with slightly more than 16 million shares being offered in 1961 through some 96 distributions approved by the New York Stock Exchange. Eighty-eight percent of these 96 distributions (and 90 percent of the shares involved) were accounted for by institutional sellers, 53 percent of the distributions (and about 35 percent of the shares) by investment companies alone.[73]

There were 26 Exchange Distributions (the second most popular plan) on the NYSE in 1961, involving a total of 1.2 million shares. Twenty (77 percent) of these distributions and 87 percent of the shares were from institutional sellers, eight (31 percent) of the distributions and 41 percent of the shares were from investment companies alone, and five (19 percent) of the distributions and 19 percent of the shares were from banks.

There were three NYSE-Specialist Block Purchases (involving a total of 19,400 shares), one NYSE-Specialist Block Sale (involving 15,000 shares), one NYSE-Special Offering (involving 10,000 shares), and no Special Bids or Exchange Acquisitions in 1961. In contrast, a Special Study tabulation of special requests (involving a minimum of 1,000 shares and/or $25,000 in value) by member firms to trade NYSE stocks off-board shows that in 1961, 32 such requests covering a total of 375,000 shares were approved. Twelve of these requests involving 120,360 shares involved transactions with institutions.[74]

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[70] Other data on several of the methods of distribution are found in ch. IV.C.3.

[71] The averages given in the text and the next footnote with respect to the Exchange plans are unweighted averages.

[72] NYSE-Specialist Block Purchases in 1961 averaged 6 percent and Specialist Block Sales 5 percent, of the monthly floor volume in the stock involved.

[73] In two of these disrtibutions, banks participated with investment companies as sellers. Three investment company complexes, Wellington, Fidelity, and Massachusetts Investors Trust, were the sellers (in two cases with banks) in 39 (41 percent) of the 96 distributions. Banks accounted for only 17 (counting the 2 in which they participated with investment companies) or 17 percent of the distributions, involving about 10 percent of the shares.

[74] During 1961, the NYSE received 293 requests to trade stocks off-board. Of these, 25 requests were made to offset errors; 84 involved charitable donations; and 45 involved control stock with an investment letter. All of these 154 requests (except 1) were approved by the Exchange and were not considered in this tabulation. Of the remaining 139 requests, 51 were disapproved, and no action was taken on 4; of the 84 which were approved, only 32 involved blocks as large or larger than 1,000 shares or $25,000 in amount.

b. Unlisted stocks

Four methods are available for handling "block" transactions in unlisted stocks: (1) purchases or sales through the regular over-the-counter markets maintained by dealers; (2) purchases or sales through secondary distributions; (3) purchases through underwritings of new public offerings of stocks; (4) purchases through private placements from the issuer; and (5) transactions made directly with other large investors, without the intervention of an intermediary broker-dealer.[75]

3. ANALYSIS OF INSTITUTIONAL TRANSACTIONS REPORTED THROUGH QUESTIONNAIRE IN-4

The Special Study asked the respondents in its institutional survey to report their transactions in common and preferred stocks by two methods. First, by time period: they were asked to record on IN-4 Form A every transaction which took place during the months of March 1961 and April 1962. Second, by block program: they were asked to record on IN-4 Form B their two biggest block purchase and sale programs, within each of six separate categories, which were accomplished during 1961.[76]

a. Transactions in March 1961 and April 1962 (Form A)

The Form A "slice-of-time" transactions provide a more representative picture than the Form B transactions of certain aspects of the respondents' overall stock activity—for example, the proportion of overall volume accounted for by different types of stocks or by different market channels. The Form B transactions, on the other hand, were obtained to provide data (which the Form A selection would not adequately provide) on the handling of large block transactions in various selected categories. The Form B results are thus influenced by the categories of transactions selected.

While it would have been desirable to obtain transactions on Form A covering a longer period than 2 selected months, the shorter period was chosen to reduce the burden on respondents to the minimum possible without invalidating the portrayal of how transactions are conducted. The months of March 1961 and April 1962 were selected for the Form A survey in order to obtain differences in both time and market conditions. March 1961 was a month of rising prices and heavy volume in the midst of a strong bull market. April 1962, on the other hand, was a month of lower volume and declining prices in a generally downward market period.

The transactions of the Form A respondents for the 2 months are shown in tables VIII-13 through VIII-26. It should be noted that the figures in the Form A tables do not, however, include on the sale side one unusually large Secondary Distribution[77] which was initiated in April 1962 by a foundation included in the IN-4 sample. This Secondary Distribution was excluded from the sales figures because it was sufficiently large and unusual as to have impaired the use of the IN-4

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[75] For a discussion of the way dealers handle blocks of unlisted stocks, see ch. VII.C.

[76] The Form A and B transactions of one large pension fund, which held stock at the end of 1961 with a total value of $1.1 billion, were not reported in such a way as to be readily includible in the Form A and B tabular analyses in the time available.

[77] When capitalized hereinafter, the term "Secondary" or "Secondary Distribution" means a Secondary Distribution in the stock exchange sense.

sales figures for April 1962 for other comparative purposes. Purchases in this Secondary by institutions in the IN-4 sample have, however, been included in the figures.

To some extent the differences in the character of the 2 months under study are reflected in the purchases and sales of the institutions (as reported in tables VIII-13 and VIII-14). But of equal interest are the individual differences that occurred. For example, in March 1961 when market conditions were generally buoyant, the dollar purchases of each institutional group exceeded sales[78] by a substantial margin with, however, two exceptions: no-load investment companies, where sales slightly exceeded purchases, and college endowment funds, where sales were more than twice as great as purchases. Indeed, during this month the gross sales of the college endowment funds—one of the smaller institutional groups in the sample—were the second most important among all the institutional groups. On the other hand, in April 1962, when attitudes were relatively pessimistic, the institutions as a group contracted their gross dollar purchases by about 12 percent under their March 1961 level; yet four of the institutional groups expanded their gross purchases to more than those in March 1961, three of them modestly, and the foundations by over 60 percent.[79]

Also of interest is the difference between the total and net effects of the market actions of the various categories of institutions. Thus, they open-end (load) investment companies, conspicuous by the amount of their trading relative to the size of their portfolios, in March 1961 had total dollar purchases and sales that were almost three times as great as those of the pension funds, the next highest institutional group. Their net acquisitions, however, were slightly less than one and a half times as great. And in April 1962, when the total dollar purchases and sales of the open-end (load) companies were more than three times those of the pension funds, their net acquisitions shrank to less than 90 percent of those of the pension funds.

(1) *Analysis by type of stock and type of transaction*

For each of the 2 months, tables VIII-19 and VIII-20 contain, for all of the institutional groups combined, separate breakdowns for transactions in preferred stocks, public utility common stocks, and "other" common stocks. These categories were selected because they represent major types of equity securities that the institutions have tended to trade through different channels. While the institutions' volume in preferred stocks and public utility common stocks was small in relation to their volume in "other" commons, the former groups were considered of particular interest to this analysis because of their more "institutional" nature. With respect to each of the three categories, and for the total of all categories, there are shown the dollar amounts, as well as percentages, of purchases and sales, for stocks listed and not listed on the New York Exchange, classified by market channel.

The analysis that follows concentrates on describing the method of handling these transactions rather than on the differences between the

[78] Excluding the Secondary Distribution mentioned above.

[79] An even more striking illustration of individual departures from the general pattern was the already mentioned April 1962 Secondary Distribution, by a foundation in the IN-4 sample, of 2,250,000 shares of "other" common stock for a total of $218.25 million, an amount greater than that month's aggregate dollar sales, as well as net purchases, of all the other institutions in the sample combined.