months. As a result, many of the percentages shown in the text were determined by first aggregating the results for the 2 months; while these percentages, therefore, do not appear in the tables, they may be readily calculated from the data shown. Based upon these tables, a brief description is given of the stock transactions of the institutions during these 2 months with respect to the following five factors:

(a) *The proportion of total stock volume represented by each of the stock categories.*—Of the three categories of stocks, the institutions had considerably greater volume in the 2 months in "other" commons (87 percent of total aggregate volume) than in the two other categories of stocks. "Other" commons accounted for about the same proportion of the volume in NYSE-listed stocks (87 percent) as in stocks not so listed (85 percent). Ranking far behind the volume of "other" commons, the purchases and sales of public utility commons constituted about 9 percent of total volume (10 percent of volume in NYSE-listed stocks and only 3 percent of volume in non-NYSE stocks). Preferred issues absorbed only about 4 percent of total volume, and 2 percent of NYSE volume but 12 percent of the volume in non-NYSE stocks.

(b) *The proportion of total stock volume represented by NYSE-listed issues as opposed to those not so listed.*—The bulk of the institutions' activity was concentrated in New York Stock Exchange-listed stocks, which accounted for 85 percent of total aggregate volume for the 2 months. This dominance was most marked in the public utility commons, where NYSE issues represented 95 percent of the volume for the 2 months. Next in line were "other" commons, where NYSE issues accounted for 85 percent of the volume. In the preferred stock category, however, NYSE issues accounted for only 49 percent of total volume for the 2 months.

(c) *The market channels employed for stocks listed on the NYSE, and for stocks not listed on the NYSE.*—Of considerable interest was the extent to which the institutions failed to employ the NYSE as the market channel for stocks listed on that Exchange. Thus, for the 2 months, about 20 percent of the total transactions in these stocks was accomplished off the Exchange. When the three categories of stocks are examined separately, the results are even more striking. About 19 percent of the volume in "other" commons and 26 percent of the volume in public utility commons was transacted off the Exchange. In the case of the NYSE preferred stocks, the over-the-counter market plus underwritings—with about three-fourths of total volume—actually overshadowed the NYSE as a market channel.

In regard to the transactions in NYSE stocks executed off the Exchange, almost one-half of the overall dollar volume was directed to the over-the-counter trading markets, about 30 percent to the regionals, and more than 20 percent was done by means of secondaries, underwritings, and purchases from issuers. The over-the-counter markets were even more important for non-NYSE transactions in the two senior categories of NYSE-listed stocks; over 69 percent of the non-NYSE transactions in NYSE public utility common stocks and 78 percent of such transactions in NYSE preferred stocks were over the counter.

For stocks not listed on the New York Stock Exchange, the over-the-counter market was the most important market channel, account-

ing for 81 percent of total volume in non-NYSE stocks for the 2 months. The American Stock Exchange was the second most important (in every category of stock, except preferreds in April), with 9 percent of total volume for the 2 months. The regional exchanges, with the limited exception of the preferred stock category for April, were the least important, with 3 percent of total volume in non-NYSE stocks for the 2 months.

(d) *The relative importance of NYSE stocks in the institutions' usage of the over-the-counter trading markets and the regional exchanges.*—To a large extent the use that the institutions made of the over-the-counter markets and the regional exchange floor markets was for the purchase and sale of NYSE-listed stocks as opposed to non-NYSE stocks. On the regional exchanges, the great preponderance (93 percent) of all activity for the 2 months involved NYSE-listed stocks. In the over-the-counter market, on the other hand, the balance between NYSE and non-NYSE stocks was closer but, except in the category of public utility common stocks, non-NYSE stocks accounted for the greater volume—59 percent of total over-the-counter volume.

(e) *Use of special forms of transactions.*—For NYSE-listed stocks, the special forms of transaction—i.e., the special stock exchange plans, underwritings, and purchases direct from the issuer—accounted for 5 percent of the total volume in the 2 months,[80] with Secondary Distributions alone accounting for almost 4 percent of such volume.[81] For stocks not listed on the NYSE, the special forms of transaction accounted for 8 percent of total volume in March 1961 and 5 percent in April 1962—with underwritings accounting for more than half of this amount and purchases direct from issuer accounting for the rest.

As a further breakdown, it may be noted that the institutions in the sample took advantage of the special forms of transaction somewhat more for dollar purchases than for sales in the 2 months.[82] As among the three classes of stocks, the special forms of transaction were of the most importance in the preferred stock category, with underwritings and purchases from issuer accounting for fully 49.7 and 8.7 percent, respectively, of total purchases of preferred stocks in March 1961 and for 32 and 5 percent, respectively, of such purchases in April 1962.

(2) *Analysis by institutional type*

The above analysis concerned transactions for all of the institutions in the aggregate. Tables VIII–19a–i and VIII–20a–i contain breakdowns of the transactions in the 2 months for each of the different institutional groups. The most notable thing revealed is the contrast between the investment companies, particularly the open-end (load) companies, and the other institutions.

First, the investment companies had a higher dollar volume of transactions, relative to their holdings, than did the other institutions. Thus, the open-end (load) companies, open-end (no-load) companies and closed-end companies, while accounting, respectively, for only 28, 1, and 4 percent of the total stock held by those institutions in the IN–4 sample whose transactions are included in the Form A tables,

[80] Excluding the Secondary Distribution mentioned above.

[81] Because of the relatively small figures involved, Exchange Distribution transactions have been combined in tables VIII–19 and VIII–20 with other New York Stock Exchange floor transactions. In tables VIII–19 and VIII–19d, their amount is identified by footnote.

[82] Excluding the Secondary Distribution mentioned above.

accounted for 47, 5, and 8 percent of the total dollar volume of transactions reported on Form A. This, of course, reflects the higher rate of portfolio turnover of the investment companies than of the non-investment-company institutions, a matter discussed more fully in section 5, below.

Secondly, the open-end (load) investment companies were notable for their relatively high use of the regional exchange markets.[83] With respect to stocks not listed on the NYSE, for example, the load companies accounted for 50 percent of total dollar volume of transactions, but for 62 percent of the total regional exchange transactions in such stocks. For transactions in NYSE-listed stocks, the pattern was even more marked. Here, the open-end (load) investment companies, while absorbing only 46 percent of all transactions in NYSE stocks, accounted for 78 percent of all of the transactions in such stocks executed on regional stock exchanges. The pattern was most noticeable with respect to NYSE public utility common stocks, where the open-end (load) companies accounted for 50 percent of total transactions, but 95 percent of regional exchange transactions.

All of the other institutional groups, on the other hand, except closed-end investment companies in April 1962, made very little use of the regional exchanges for transactions in NYSE-listed stocks. The higher use of the regional exchanges by the load companies probably is related to their practice of rewarding broker-dealers who sell their shares with "reciprocal" portfolio brokerage business.

(3) *Analysis by size of individual transaction*

The average and median sizes of individual transactions reported on Form A were computed, in terms of both shares and dollars, for each of the different market channels and special forms of transactions (tables VIII-21 and VIII-22). For this purpose, the term "transaction" means—

> * * * the purchase or sale of one security at one price, at one time, from, to, or through one broker-dealer (or direct vendor or vendee), in one market, through one type of order.[84]

Purchases direct from issuer, as might be expected, produced the largest sized individual transactions. As among the trading markets, the average sized transaction on the NYSE in each of the 2 months was around 500 shares, and the median around 200 shares.[85] The Amex produced about the same picture. However, transactions on the regional exchanges in NYSE stocks were about twice as large, with an average size of about 1,000 shares and a median size of about 500 shares. The fact that individual transactions in NYSE stocks on the regional exchanges are larger than those on the NYSE itself suggests that prearranged crosses may be relatively more important on the regional exchanges. Individual transactions in NYSE stocks in the over-the-counter market were even larger, with an average size of

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[83] The load companies in the IN-4 sample indicated a greater use of regional exchanges for common stock transactions than was reported for periods in 1953 and 1958 for the larger group of open-end funds studied by the Wharton School. "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 191-210 (1962). See also id. at pp. 377-379. A comparison of the data for the 3 periods for the 15 funds which were in both the Wharton School study and the IN-4 load company sample revealed the same differences as the published data.

[84] See Questionnaire IN-4, p. 2, app. VIII-A.

[85] This is consistent with the data in NYSE, "1960 Public Transaction Study," pt. II, p. 13. See also "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 377-379 (1962).

about 1,600 shares and a median size of about 750 shares—over 3 times the size of those on the NYSE.

The IN-4 figures for size of transaction may contain some upward bias, since there may have been instances where the records maintained by some of the institutions reflected several transactions as a single transaction—for example, where the transactions were on one day, at one price, through the same market channel and broker. In addition, the figures for the exchange markets, particularly the figures for the average as opposed to the median size of transaction, are influenced by prearranged crosses consummated on the exchange floors. As mentioned earlier, these crosses are not identified by any special designation and thus could not be separated from other floor transactions in the IN-4 data. However, the Special Study's review of the forms and its followup discussions with some of the respondents confirmed the presence of crosses and the fact that their influence on the average-size-of-transaction figures could be substantial.

A relatively striking example of the influence of crosses appears from the transactions reported by an IN-4 respondent on Form B, involving a block sale of 85,000 shares of an NYSE preferred stock:

TABLE VIII-c.—*Block sale of 85,000 shares of NYSE preferred stock as reported by a respondent to Questionnaire IN-4*

Trade date, 1961	Number of shares	Price per share	Total price	Brokerage commission
Mar. 2	1,700	37⅛	$63,112.50	$638.52
3	200	36½	7,300.00	74.50
6	800	36	28,800.00	296.00
6	1,300	36⅜	47,287.50	438.47
6	200	36¾	7,350.00	74.76
7	400	35½	14,200.00	147.00
8	500	35	17,500.00	182.50
8	100	35⅝	3,562.50	36.81
8	100	35¾	3,575.00	36.88
8	400	36	14,400.00	148.00
9	900	35	31,500.00	328.50
10	500	35	17,500.00	182.50
Aug. 1	76,900	28	2,153,200.00	25,377.00
1	400	28½	11,400.00	133.00
1	300	28¾	8,625.00	100.14
1	200	29⅛	5,825.00	67.12
1	100	29½	2,950.00	33.75

NOTE.—All transactions were on the New York Stock Exchange, all used limit orders, and none were carried out under any special plan.

The last 5 transactions account for 77,900 of the 85,000 shares. The Special Study understands that the 76,900-share transaction represents a prearranged cross, and that apparently the 4 other transactions accomplished on the same day represented the public orders then on the specialist's book, i.e., the indicated actual "depth" of the public portion of the NYSE auction market in this stock at that time.

(4) *Analysis by type of order used*

The transactions in NYSE stocks which the institutions executed on the NYSE were analyzed by type of order used, that is, whether the order was a market, limit, or discretionary (as to time and/or price) order (tables VIII-23 and VIII-24). The institutions as a whole reported using limit orders for most of the dollar volume of their transactions (60 percent of total volume in March 1961 and 58 percent of total volume in April 1962). Discretionary orders were the next

most important type of order reported (20 and 22 percent of total volume) and market orders the least important (8 and 10 percent).[86] There appears to have been some tendency in each month for market orders to be used less for sales than for purchases. Pension funds, no-load investment companies, and colleges tended to show less use of discretionary orders, and more use of market orders, than the other institutional groups. Bank common trust funds, on the other hand, tended to show significantly higher use of discretionary orders for the 2 months than the other groups.

In addition to the above analysis of NYSE executions, all of the institutions' over-the-counter transactions (other than those involving underwritings, the special stock exchange plans,[87] or purchases from issuer) in all types of stocks for the 2 months were analyzed in terms of a breakdown between principal and agency transactions (tables VIII–25 and VIII–26). For all institutions in the aggregate, principal transactions accounted for about three-quarters of the value of all over-the-counter trades.[88] Pension funds, common trust funds, and foundations tended to have a higher proportion of the value of their over-the-counter trades as principal transactions during the 2 months than did the other institutions. Colleges and closed-end investment companies, on the other hand, had a higher proportion of the value of their over-the-counter trades as agency transactions than did the other institutions.

b. Large block transactions in 1961 (Form B)

The respondents in the IN–4 survey were asked to report on Form B, their block [89] transactions accomplished in 1961 as follows: (1) Their two largest block purchases and two largest block sales of *listed* stocks accomplished primarily (over 50 percent of the shares) on an exchange or exchanges; (2) their two largest block purchases and two largest block sales of *listed* stocks accomplished primarily (over 50 percent of the shares) over the counter; and (3) their two largest block purchases and two largest block sales of *unlisted* stocks.[90] Many of the respondents did not have block transactions in some of the categories requested; this was particularly true of category (2) above. The total dollar volume reported on Form B was roughly twice the institutions' monthly volume as indicated by Form A.

The purpose of Form B was to obtain data on how institutions accomplish large block transactions in listed and unlisted stocks. The transactions reported on Form B are thus representative only of such large block programs by the institutions sampled.

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[86] In some cases the records of the responding institutions did not preserve data concerning the type of order used. Such transactions are shown in tables VIII–23 and VIII–24 as "none or unspecified." Data for foundations are not included in these two tables, since most of their transactions fell in this category.

Review of the questionnaires and forms suggests that some of the transactions reported as market- or limit-order transactions may well have involved instructions to the executing broker which included some element of discretion.

Compare the data for open-end investment companies in tables VIII–23 and VIII–24 with the data in "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 377–379 (1962).

[87] That is, Secondary Distributions and Specialist Block Purchases and Sales, which are off-board transactions.

[88] For further data regarding the use of principal or agency form of execution in over-the-counter transactions by institutions as compared with individuals, see ch. VII.

[89] For the definition of a block purchase or sale, see sec. 2, above.

[90] Questionnaire IN–4, questions 5 and 6, app. VIII–A.

With respect to listed stocks, respondents were requested *not* to report block sales accomplished *entirely* through an Exchange Distribution, a Special Offering, a Specialist Block Purchase, or a Secondary Distribution.

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

The results of the analyses of the Form B transactions (table VIII–27) are notable for their similarity to the results of the Form A analyses. To the extent that differences occurred, they were in degree rather than in principle. Thus, "other" commons represent a somewhat lower portion of the Form B volume, 77 percent, than of the Form A volume for the 2 months, 87 percent. In addition, the percentage of the Form B volume represented by NYSE stocks was, in each category of stock, consistently below that for the 2 months.

With respect to the Form B transactions, use of channels other than the NYSE for NYSE-listed issues was even more striking than it was for the 2 months; such transactions amounted to 34 percent of total Form B volume in NYSE stocks, compared with 20 percent for the 2 months. In connection with the total Form B over-the-counter transactions, non-NYSE stocks accounted for 71 percent of the volume, as opposed to 59 percent for the 2 months. Finally, the institutions employed the special forms of transaction more extensively in connection with their Form B blocks, where the special forms' proportion of total volume amounted to about 15 percent [91] compared with only about 5 percent during the 2 months.[92]

(2) *Analysis by institutional type*

When the transactions on Form B are analyzed by type of institution, the most notable thing, again as in Form A, is the difference between the open-end (load) companies and the other institutions. As before, however, the variations between the results of the Form A and B analyses are in degree rather than principle (tables VIII–27a through VIII–27i).

(3) *Analysis by size of individual transaction*

The average and median size of individual transactions reported on Form B are shown in table VIII–28. Although these are in almost every instance larger than was true for the Form A transactions, the relationships between the market channels show generally similar patterns.

(4) *Analysis of blocks by size, time, transactions, and brokers used*

The blocks reported on Form B were analyzed, by institutional group, in terms of their median size (table VIII–29), and the number of trade days (table VIII–30), calendar days (table VIII–31), transactions (table VIII–32), and brokers (table VIII–33) used to complete the block program. The principal items of significance which appear are (1) that the open-end (load) investment companies tended to have larger-sized blocks than the other institutional groups; (2) that, as might be expected, the bigger the block, the more the time, the

[91] Actually, the only special stock exchange plans recorded in the Form B transactions were Secondary Distributions. As noted above, the IN–4 respondents were asked to exclude, from the reporting of block sales of listed stocks, any block sales accomplished entirely through an Exchange Distribution, a Special Offering, a Specialist Block Purchase, or a Secondary Distribution.

[92] The differences between the Form A and the Form B transactions, which lie primarily in a lesser emphasis on NYSE-listed stocks, and a greater emphasis on the over-the-counter market and special forms of transaction for all stock, were no doubt in large part caused by the definition of "blocks" selected for reporting on Form B, since the way the categories were chosen resulted in equal weight being given (*a*) to blocks of listed stocks executed primarily (over 50 percent) on an exchange or exchanges, (*b*) to blocks of listed stocks executed primarily (over 50 percent) over the counter, and (*c*) to blocks of unlisted stocks.

transactions, and different broker-dealers used for its execution; and (3) that block programs in which the over-the-counter market predominated took less time, fewer transactions, and fewer broker-dealers than those in the same size class in which the exchange markets predominated.

c. Transactions in new issues in 1961

The IN-4 respondents were asked to report separately on Form C, in addition to any reporting required on Forms A and B, all of their transactions in new issues of stocks during 1961. The term "new issue" was defined as "a class of equity securities of an issuer offered publicly for the first time during 1961." The transactions to be reported included allotments in the original underwriting, purchases in the trading markets after the offering, and any sales. The transactions reported on this form are summarized in tables VIII-34 through VIII-37.

Initially, it is apparent that the dollar purchases of new issues were greater in the preferred than in the common stock category. One or more institutions in most of the institutional groups had purchases of new issues of preferreds, but the heaviest activity by far was by life insurance companies (62 percent of total purchases). The next largest purchasers of preferreds were open-end (load) investment companies, although one such investment company accounted, through one transaction, for $7 million or practically all of this volume. The third largest purchasers were nonlife insurance companies.

In the common stock category, the largest recipients of original allotments were two companies in the nonlife insurance category. These two companies alone accounted for 51 percent of the volume of all original allotments of new issues of common stock received by the entire IN-4 sample. The next largest recipients of such original allotments were one self-administered pension fund of a company, affiliated with one of the same two nonlife insurance companies, which received 14 percent of the total, and the college endowment funds, which received 11.9 percent of the total. After these groups fall the open-end (load) investment companies, with 9 percent of the total. This small percentage is rather interesting, since the load companies are not only the largest stockholders in the IN-4 institutional sample, but also have the highest turnover rate and thus the highest brokerage activity in stocks, and, as indicated below, were relatively heavy purchasers of new issues of common stocks in the post-offering trading markets. Yet the two nonlife insurance companies mentioned above alone received nearly three times the total dollar amount of original allotments of new common stock issues received by all three categories of investment companies combined. This differential does not appear to be explainable by any difference in the type of stock issues involved.[93]

Another major point in the common stock category of new issues concerns the relative importance of purchases by the institutions in the trading markets after the offering, compared to their purchases in the original offering. In the preferred stock category, purchases

[93] An additional interesting fact which appeared from the Form C responses was that all of the bank-administered funds in the sample were notable for their total absence of activity in new issues of common stock. This may well be related to the problems banks have in allocating limited opportunities among their many accounts.

in the original offering accounted for 96 percent of total purchases and later purchases for only 4 percent. On the other hand, in the common stock category purchases in the original offering accounted for only 29 percent of the institutions' total purchases and later purchases accounted for fully 71 percent.

When the participation in after-offering purchases of common stock is analyzed through a breakdown by institutional groups, an interesting contrast to the picture of the original offering purchases emerges. For in the area of after-offering purchases, the open-end (load) investment companies had the *highest* volume of purchases (37 percent of the total) among the institutional categories. In fact, the purchases by the open-end (load) companies and the closed-end companies, which had together accounted for only 17 percent of original-offering purchases of new issues of common stocks, accounted for 59 percent of the post-offering purchases, by all institutional groups.[94]

Post-offering sales, like post-offering purchases, were more important in the common stock than in the preferred stock category of new issues. In the former category their amount was slightly in excess of 10 percent of original-offering purchases. In the preferred stock category, however, the amount was less than 0.25 percent of original-offering purchases. The sales of the common stock new issues were attributable to one nonlife insurance company, three investment companies, and three colleges.

Two of the investment companies sold all of the stock they had received in underwritings within 2 months after purchase. These were not the only institutions, however, with relatively fast sales. Two universities each received 300 shares of Berkey Photo at $11¾ per share from an underwriter in the original offering; 6 days later they sold the same 300 share blocks back to the same underwriter at $27¾ per share. In fact, all of the new issues of common stock sold by the investment companies and the colleges, representing 53 percent of total sales, were sold within 40 days of the original offering. This contrast with the usual assumption that institutional investors tend to purchase for the long term.

Table VIII–35 analyzes the institutions' transactions in new issues in terms of their average and median size. As indicated therein, the median-sized allotment received from individual broker-dealers was relatively small; generally 100 shares or less. Both post-offering purchase and sales, however, tended to involve larger individual transactions.

[94] The Investment Company Act prohibits the purchase by an investment company during the existence of an underwriting syndicate of any security of which a principal underwriter is affiliated with the fund, except as the Commission may by rule or order exempt transactions or classes of transactions; sec. 10(f). The Commission by rule has exempted such transactions under certain conditions, including requirements that the securities purchased by two or more investment companies having the same investment adviser not exceed in the aggregate 3 percent of the offering and that the investment company not purchase the securities directly or indirectly from its investment adviser; Investment Company Act rule 10f–3. About 45 percent of the dollar value of the original-offering purchases of common stocks by the open-end (load) companies and 60 percent of such purchases by the closed-end companies, and 36 percent of the after-offering purchases of common stocks by the load companies and 71 percent of such purchases by the closed-end companies, involved issues as to which the purchasing companies had claimed exemption under this rule. In one of the four common stock issues which were involved in such original-offering purchases, the affiliated investment companies claiming such exemption purchased, in the original offering, 2.7 percent of the offering; in the other three issues, original-offering purchases by such companies constituted 1 percent or less of the offering.

Tables VIII–36 and VIII–37 analyze the prices paid by the institutions for new issues in the post-offering trading markets, and the prices they received for sales, relative to the original offering price of the issues. The figures show that the institutions' post-offering purchases of the 1961 new issues of common stocks tended to be at relatively high premiums over the offering price. The premium averaged 33 percent, with open-end (load) investment companies paying the highest average premium, 49 percent. The institutions' sales of new common stock issues were made at premiums even higher than those they paid, averaging 46 percent.

4. DECISIONMAKING AS TO HANDLING OF BLOCK TRANSACTIONS

The IN–4 respondents were asked about their procedures and criteria for executions of stock transactions and their relations with broker-dealers.[95] The procedures and criteria referred to were those involved in making decisions as to the manner of executing purchases and sales of stocks for their portfolios, as distinguished from decisions as to what purchases and sales should be made.

a. Procedures

One question raised was whether the respondents tended to have employees on their staffs (trading or order departments) with competence in market mechanics, who would handle the details of placing orders for transactions in portfolio stocks with various broker-dealers in various markets; or whether they lacked such employees and tended to rely solely on some broker-dealer, or other outside entity not acting as investment adviser of trustee for the institution, for this purpose. The responses show that orders for the institutions' portfolio stocks were either handled by their own employees (hereafter termed an "internal" trading department), or by the employees of the institution's nonbank investment adviser [96] or by those of the bank acting as trustee and/or investment adviser for the institution (hereafter termed an "external" trading department). In no case did an institution indicate that it ordinarily allowed such decisions to be made by a broker-dealer or other outside entity not acting as its investment adviser or trustee.

The questionnaire also inquired as to the composition of such trading departments and the kinds of authority delegated to them. In most cases the "internal" or "external" trading department was separate from the committee or board which made the decisions regarding the securities to be purchased or sold, although some of its members might serve on the latter. Normally the trading department received instructions from an investment committee or board, to which it also reported, concerning the securities to be purchased or sold, and then concentrated on the execution of such decisions. The investment committee and trading department ordinarily had a general understanding concerning the procedures the latter would follow, although the investment committee might influence this arrangement from time to time. Within this general framework the trading department normal-

[95] Questions 1, 2, and 8 to 11 of Questionnaire IN–4, app. VIII–A.

[96] In the case of investment companies, such investment advisers included broker-dealer firms serving under contract as investment adviser to the fund.

ly had fairly broad latitude with respect to the execution of particular transactions.

Thus, in most cases the trading department had substantial discretion to choose the broker-dealer, type of order, or market channel that would be used for a particular execution, although a majority of trading departments were given a list of selected broker-dealers among whom the business normally would be spread.[97] Few trading departments had discretion as to whether to use or take advantage of one of the special acquisition or distribution methods,[98] or as to which securities were to be purchased (including the allocation of new money). Authority to make decisions in these areas was usually retained by the investment committee. The discretion given to trading departments with respect to prices varied: the answers given by the respondents indicated that about half of the trading departments had either no discretion to vary from a stated price (except to better it) or had discretion within fairly narrow limits (about 3 percent or less); and that the remaining half of the trading departments were about equally divided between those which had discretion within a somewhat broader range and those which had substantially full discretion. Most institutions indicated that they did not give a single broker-dealer (or other outside entity) discretion to determine how and/or when to accomplish a block purchase or sale program but retained this decision in their trading departments, which would handle the total purchase or sale by giving a series of specific instructions to broker-dealers.

The study also explored the institutions' use of the over-the-counter market for listed stocks. In this connection, the institutions were asked [99] to estimate whether the proportion of their transactions in all listed stocks executed through over-the-counter dealers had been increasing, decreasing, or remaining unchanged over the past 5 years, in relation to their exchange transactions in such stocks. Their answers are reflected in table VIII–38. With respect to any one of the three categories of stocks, no more than 7 percent of the funds indicated that their use of the over-the-counter market for listed stocks was decreasing, whereas 20 percent indicated that such use had been increasing for preferred stocks, 41 percent that it had been increasing for public utility common stocks, and 43 percent that it had been increasing for "other" common stocks. The greatest tendency toward increase appeared in the pension funds, nonlife insurance companies, and common trust funds.

b. Criteria

The respondents were asked to describe the circumstances and considerations which affect their determinations as to whether purchases or sales of NYSE-listed stocks should be made on regional exchanges or over the counter. With respect to the over-the-counter market for such stocks, three-quarters of the respondents indicated price and cost considerations as determining factors. The other most frequent considerations mentioned were the size of the transactions or

[97] Certain of the investment companies with broker-dealer firms acting as investment adviser, however, have arrangements whereby the preponderance of orders are simply placed with such broker-dealer.

[98] The special exchange plans for blocks, or underwritings or purchases direct from the issuer.

[99] Question 13 of Questionnaire IN–4, app. VIII–A.

block program involved, the availability of bids or offers at the time in the over-the-counter market, and whether the NYSE market for the stock was "thin" or "disorderly."

Only about one-half of the respondents indicated what reasons, if any, would determine whether they would buy or sell NYSE stocks on regional exchanges. About one-third gave price as a reason. Other reasons included savings on State transfer taxes, the size of the transaction, the availability on the regional exchange of a block or a cross arranged by a broker, the request of a broker to use the regional exchange, and the "thinness" or "volatility" of the NYSE market.

It seems fairly clear that many of the respondents viewed the over-the-counter market as offering competition with the New York Stock Exchange for NYSE-listed stocks, in regard to price and depth, while the regional exchanges were less frequently so viewed.[100] For example, one institution, explaining the considerations which affect its use of the over-the-counter market or regional exchanges for NYSE stocks, stated merely that:

> When New York Stock Exchange listed securities are available in the over-the-counter market, they are usually offered at lower net prices and in greater volume. Other exchanges are rarely used.

Another said:

> [The] trading department has full discretion as to whether purchases or sales of listed securities are made on the New York Stock Exchange, on other exchanges, or through over-the-counter dealers. The sole consideration is price and such transactions are infrequently made on other exchanges and frequently made through over-the-counter dealers.

A third said that:

> Transactions in New York Stock Exchange listed securities are occasionally made through over-the-counter dealers. Alternate exchanges, however, are not used. Off-board transactions in listed securities are effected where thin or disorderly markets exist in a particular stock or where a price advantage is apparent.

The respondents were asked about their use of specialists or specialists' firms for a listed stock in which such specialists are registered. Three-fourths of the respondents indicated they never knowingly placed orders directly with the specialist, or his firm, for the purchase or sale of a stock in which the specialist is registered. Practically all of the others indicated they did so only very occasionally. To the extent this practice existed, the reason most frequently given was "to obtain better executions." One respondent said "such a case might occur when a broker-dealer recommended such a step." Another said: "Only when an extremely thin market pertains and an orderly execution seems impossible, [do we] make a direct contact." Still another institution, after stating it had used a specialist only twice in the past, added:

> These two situations occurred when it seemed to be impossible to buy the stock without pushing the market up. By giving the specialist the order, we felt he would give us first chance to buy a block if it should appear.

Yet another comment was:

> The trading department never places orders with a specialist as such. However, we do use the facilities of a few specialists by reason of the fact that they

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[100] This statement does not apply, of course, to the extent that New York State transfer tax savings might be possible for certain investors on sales of stock transferable outside New York.

are associated with firms handling institutional business and therefore are frequently able to execute orders for large quantities of stock.

Another question dealt with use of "not held" orders (orders discretionary as to time and/or price). About half of the institutions indicated they used "not held" orders occasionally. The other half was about equally divided between those who said they used such orders frequently and those who said they did not use them at all. The reasons given for using such orders varied. One respondent said:

> From time to time "not held" orders for listed securities have been used as an alternative to transactions away from the Exchange where the size of the order is, in our judgment, large relative to the size of the market then existing on the Exchange.

This was the most usual type of reason. A slightly different comment, however, was that "orders for amounts of 500 shares or less may, on occasion, be given on a 'not held' basis. * * * The occasion for a 'not held' order may occur when the markets are thin." Similarly, another respondent said:

> When an order is small (but in excess of a single round lot), relative to the overall volume in a particular stock, a "not held" order may be given with the further instructions to execute "carefully" and "orderly."

c. Relations with broker-dealers: "Reciprocal" business

The respondents were asked several questions about their relationships with broker-dealers and the criteria used in arriving at the distribution of portfolio business and portfolio commissions among them.

As indicated above, more than half of the institutions indicated they maintained a list or lists of broker-dealers who are to participate directly or indirectly in commissions from portfolio stock transactions. Thirteen of the respondents (nine of them investment companies) mentioned some form of affiliation with one or more broker-dealers, such as having a partner of the brokerage firm on its board. In almost all of the reported situations of affiliation, the affiliated broker was also either the largest or second-largest recipient of gross brokerage commissions from the institution's stock transactions in 1961.

About four-fifths of the institutions said that they received research or statistical materials from broker-dealers with whom they did business. A few institutions mentioned the receipt of allotments in underwritings as a reason for doing commission business with broker-dealers. Aside from quality of executions, the other relationships and criteria for allocating commission business to broker-dealers tended to vary by type of institution.

Banks, as trustees for pension funds and common trust funds and foundations, most frequently mentioned brokers' commercial deposit balances and loans with the bank as a reason for giving them participation in commission business. The banks were also practically the only institutions to mention the "financial responsibility" or "credit standing" of the broker-dealer as a consideration. Other factors indicated were tenancy of the broker-dealer in the bank's building and referral of business to the bank by the broker, including corporate transfer agencies, paying agencies, registrarships, and trustee and other commercial business. In a few cases involving pension trusts, the employer company had given the bank trustee a list of brokers to use in the fund's business.

Some of the banks had fairly specific formulas for allocating commission business. One of these was expressed as follows:

Balances and loans are the two determining factors in measuring the amount of commission business to be allocated to a broker-dealer. However, these two factors are unrelated. Our [brokers' relationship department] has arbitrarily selected a common denomination by translating loans to balances on a 1 to 10 ratio. It is planned to vary the loan ratio depending upon money market conditions.

Having established a common denomination an estimate was made of all commission business and net trades for 1961. When the balance/loan concept was applied to the estimate it became apparent that a base of $100,000 was the minimum for a broker-dealer to receive commission business. Once this was established, then all qualified broker-dealers were classified and assigned a quota in accordance with the following table:

Balance/loans (thousands)	Category	Annual commission	Balance/loans (thousands)	Category	Annual commission
$3,000 and up	A	$72,000	$400 to $500	F	$18,000
$1,500 to $3,000	B	54,000	$300 to $400	G	13,800
$900 to $1,500	C	36,000	$200 to $300	H	9,900
$700 to $900	D	30,000	$150 to $200	I	6,900
$500 to $700	E	22,800	$100 to $150	J	4,800

All broker-dealer accounts are reviewed monthly and appropriate changes in classification are made.

Broker-dealers doing business with us but who do not meet quota requirements are placed on a secondary list. They function largely as dealers in selling securities to and purchasing securities from us when such orders cannot be executed by broker-dealers enjoying commission quotas.

From time to time broker-dealers may direct paying agencies, trusteeship, transfer agencies, etc., to us. If practical some reciprocal business may be given in exchange. There is no formula for determining the amount.

One or two of the comments made in connection with allocation of bank commission business also serve to illustrate how the minimum commission rate structure of the exchanges has caused "reciprocal business" considerations to play a rather more important role in the allocation of exchange business than in the allocation of business among over-the-counter dealers, where price competition exists. One bank made the following laconic statement: "Portfolio business is allocated to listed brokers in amounts which correlate with their commercial deposit bank balances. Over-the-counter orders are placed on a best price basis." Another bank gave the following as its basis for allocating business:

In purchasing and selling securities for our trust customers, our primary objective is to obtain the most favorable terms and execution available. Subject to this objective, when the allocation of business is within our sole control, it is our practice to allocate securities transactions in listed stocks among qualified broker-dealers on a combination of these four factors:

1. Tangible and intangible services rendered through us to our trust customers, or to us, such as provision of research and statistical information concerning investments, quotation and evaluation of securities, assistance in procurement of desirable investments, and business referrals;
2. Profit on deposit balances maintained with us;
3. Interest received on borrowings from us; and
4. Tenancy of quarters in our building.

Stock exchange transactions are allocated as follows:

First, a value is placed on the tangible and intangible services noted in factor 1 above, and the attempt is made to allot business to the broker-dealers who have rendered such services so as to produce commissions for them equal to the value of their respective services.

Second, concerning broker-dealers to which factors 2, 3, and 4, above, are applicable the following formula is used: For a specific period of time we compute for each broker-dealer (*a*) 100 percent of the analysis profit on his deposit balances, (*b*) 50 percent of the interest paid by him on loans, and (*c*) 10 percent of his rental payments. The sum of these three figures forms the dealer's base. We then allocate the orders during the ensuing period among the broker-dealers in proportion to their respective bases.

Non-exchange transactions in bonds, unlisted securities, and certain listed stocks traded "off the board" are executed on a net price basis. Such transactions are handled separately from our commission business and are awarded on the basis of best price and execution without reference to whether the broker-dealer is among those mentioned above. In the event of a tie bid or offering, however, the business is awarded under the same criteria to a broker-dealer as described above.

Some of the responses in this area pointed out that for over-the-counter trades of unlisted as well as listed stocks, the institution tends to go directly to the dealers making the markets for the stocks. The comment of one bank was:

The [order department] has authority to select broker-dealers and types of execution through normal market channels. In the case of an unlisted security, the [order department] makes inquiries of various dealers known to maintain a trading market in that security, and enters into the transaction with the dealer offering the best price. In the case of listed securities, the [order department] executes orders in the over-the-counter market or on an exchange, whichever is found to be more favorable to the Trust. In the case of orders executed on an exchange, the [order department] places the order with a broker/dealer selected from a list of member firms approved by the bank's [brokers' relationship department]. This list (referred to hereafter as "Approved Names") is compiled on the basis of such factors as overall relationships with the bank, credit standing, competence, and the extent to which investment suggestions developed by research staffs of the broker/dealers are furnished to the bank. Approved Names at the present time are over 340 in number and names are added or deleted from time to time in accordance with the above-mentioned criteria for approval. There is, of course, no difference to the Trust in the commissions charged by the respective brokers/dealers. No Approved Names are assigned by the bank specifically to this Trust and normally orders are spread among the Approved Names. The bank's [brokers' relationship department] also makes checks as to the credit standing and competence of dealers with whom the bank transacts business in connection with unlisted securities and listed securities where the trade is made over the counter.

Another bank stated:

* * * For a specific order or transaction, the criteria used in placing business have been the most efficient execution and, where applicable, the most expeditious execution at the most advantageous price. An example of the latter would be a broker-dealer making an active primary market in size for an unlisted issue.

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There is no objection to execution of orders on regional exchanges or over the counter, provided the execution is at the same level as an execution on the New York Stock Exchange or better. For sale orders, the broker-dealer is asked to check other regional exchanges for simultaneous (same price) sales executions in order to save the expense of the New York State transfer tax on stocks which are transferable outside New York State. For listed securities which are also traded over the counter, the daily "pink sheets" of the National Daily Quotation Service are examined to determine if such stocks are traded over the counter.

Other institutions made similar comments. A university said:

Where the decision to purchase or sell is primarily the result of a strong recommendation of a broker, he receives all or most of the order, provided, of course, he is in a position to perform adequately.

Where a transaction is contemplated primarily as a result of internal efforts, our first concern is the greatest net advantage to the university. In the case of a listed security, this might result in the selection of an over-the-counter dealer

when he maintains a market. If the equity is unlisted, we go to a broker who maintains a market in this particular issue.

A foundation made the following comment:

> The manner in which an order is executed will depend upon the marketability of the stock, the size of the order and in some cases is governed by a specific limit objective. Thus, both limit orders and market orders are used. In some cases the broker involved is shown the whole order and in some cases only part of the order at a time. The order department is under instructions to make the best possible execution and will, therefore, effect transactions in the over-the-counter market through the broker-dealer making a primary market. In addition, "off-board" markets are used occasionally where listed securities are traded on a net basis when this is advantageous to the foundation. Otherwise, the order department is directed to place brokerage with a listed group of brokers who provide research information and other services to the foundation.

Life insurance companies mentioned that they try to allocate business to those broker-dealers who, as agent for the issuer or as principal, bring them private placements of various types of securities or give them participations in underwritings. Purchase of insurance from the company did not appear to be a significant factor. For colleges, consideration of the "old school tie"—the interest of the broker in the college and the help he gives it—plus the providing of opportunities for private placements were the most important factors mentioned.

Open-end (load) investment companies most frequently mentioned the sale by the broker of the fund's shares as a reason for allocating brokerage business. Other services listed were the provision of free wire services and of quotations to assist in computing the fund's net asset value. One fund described its policy for allocating commission business among broker-dealers selling the fund's shares as follows:

> While there is no agreement to do so, it is the practice of [the fund], consistent with seeking the most favorable prices and execution of orders, to place orders to execute purchase or sale transactions in portfolio securities with competent broker-dealers who sell its shares or whom broker-dealers who sell such shares have requested receive portfolio orders. No specific proportion of brokerage business or of brokerage commissions is allocated to such broker-dealers. As a general practice, however, and subject to the availability of orders in the normal conduct of the [fund's] business and the competence of the broker-dealers, such broker-dealers receive orders having a principal value approximating the net asset value of shares of the [fund] which they have sold. The amounts of commissions on such orders vary, of course, with the prices of the securities involved, but over a period of time they tend to average about 1 percent of the principal value of transactions. Variations from this general rule may occur if broker-dealers are found not to be competent in the handling of orders or in the case of broker-dealers who are especially competent in performing the brokerage functions, who perform special services such as offering or making bids for blocks of stock, or who have shown by experience that they produce particularly good quality sales of the [fund's] shares. Dealers who are not capable of performing the brokerage function receive no orders to execute portfolio transactions but may receive selling group concessions upon such occasions when the [fund] buys securities in a registered public offering. * * *

Another fund stated:

> While the fund has made no commitment to any broker-dealer, it is the practice of the fund, where possible, while endeavoring to obtain the most favorable prices in the execution of orders, to place a part of its portfolio transactions with broker-dealers or to permit them to participate in commissions thereon, using their relative sales of shares of the fund or estimates of the value of their services as factors in the allocation of such portfolio business. Commissions and/or give-ups are allocated, in the case of reciprocal business, as evenly as is practicable among the broker-dealers in relation to their sales of fund shares. Currently, the reciprocal rate is slightly in excess of 1 percent. This may vary

considerably depending on portfolio activity at any particular time. Furthermore, it should be noted that certain broker-dealers who do business only in the over-the-counter market may not receive any reciprocal business except through special arrangements such as participating in the selling groups of underwritings or secondaries or where a stock exchange permits give-ups to nonmember firms.

A third fund expressed its practice in this area as follows:

> Distribution of portfolio commissions and business * * * in recognition of broker-dealer efforts to distribute investment company shares, is not arrived at according to any specific system, formula, or ratio. However, as a general rule of thumb, an effort is made to keep these commissions at a level of approximately 2 percent of the particular broker-dealer's gross sales of the fund's shares.

No-load funds mentioned, as reasons for allocating commission business, research information, the provision of quotations and wire service to assist in computing and publishing the fund's net asset value and offering and redemption prices, and ownership of stock in the fund. As for closed-end investment companies, the general factors of broker-dealer affiliation and the provision of research and analytical material tended to apply. Some of the closed-end companies, however, have given orders to broker-dealers which also sell shares of, or provide quotation services to, an affiliated open-end (load) company or companies.

The IN-4 respondents were also asked[101] to name the 20 broker-dealers to whom they paid the largest amounts of gross brokerage commissions on their portfolio transactions in common and preferred stocks for the year 1961, and to supply, for each such broker-dealer and for all of the other broker-dealers with whom they did commission business during 1961, the gross commissions paid to them by the respondent, the give-ups paid or received by them at the direction of the respondent, and the net commissions retained by them on the respondent's business. The analysis of these responses is contained in tables VIII-39 through VIII-41. The tables reveal the following:

1. The institutions in the IN-4 sample paid $41.7 million in gross commissions[102] during 1961 on their portfolio business in stocks. More than half of this was generated by the investment companies in the sample. The lion's share of the institutions' gross commissions (more than two-thirds) went to NYSE member firms.

2. For the institutions other than investment companies, gross commissions paid averaged only 0.1 percent of the average value of their stock portfolio for the year. For investment companies the figures were three to five times as big, reflecting these companies' higher turnover rates.

3. For all institutions combined, give-ups paid averaged 8 percent of total gross commissions. The only significant users of the give-up device, however, were the open-end (load) companies and life insurance companies. For the open-end (load) companies, give-ups averaged 12 percent of gross commissions and for life insurance companies, 8 percent.

4. On the average, each open-end (load) fund gave commission business to 251 broker-dealers, a significantly higher number than used by the other institutions, where the average was close to 60. When the number of broker-dealers is related to the size of the institutions'

[101] See question 8 of Questionnaire IN-4, app. VIII-A.

[102] The figure for "commissions" excludes, as indicated by the wording of question 8 of Questionnaire IN-4, the cost of executing most principal transactions.

equity portfolios, however, a greater equality results. Thus, the open-end (load) funds used 0.68 broker-dealers per million dollars of stock assets compared with around 0.43 for the other institutions.

5. The institutions, although using a large number of firms, tend to concentrate their brokerage executions among a relatively few. Thus, on the average, over 55 percent of an institution's gross commission business was given by it to its favorite 10 firms.[103] To the extent the give-up device was used, it served to divert some of these commissions to other firms: on the average the individual institution's favorite 20 firms accounted for 88 percent of the give-ups paid, but only 20 percent of give-ups received.

5. PORTFOLIO TURNOVER

The IN-4 respondents were asked to report their total dollar purchases and sales of stocks during 1960 and 1961, and the market value of their stockholdings at the beginning and end of each of those years.[104] From these figures the turnover of each institution's stock portfolio for each year was computed.[105] The results of these computations appear in table VIII-42. For each institutional group and for each year, there are shown the weighted average turnover rate,[106] the unweighted average turnover rate,[107] the median turnover rate,[108] and the range between the lowest and highest turnover rates reported by institutions in each category.

The picture which emerges from the analysis is that the investment companies had strikingly higher turnover rates than any of the other institutional groups. The three investment company categories combined had weighted average, unweighted average, and median turnover rates, respectively, of 11.1, 15.6, and 11.8 percent for 1960, and 15.2, 17.1, and 13.1 percent for 1961. On the other hand, the comparable rates for all other institutions combined were 2.9, 4.1, and 2.3 percent for 1960 and 4, 5.8, and 3.5 percent for 1961.[109]

By way of comparison, the turnover rate on the New York Stock Exchange for all stocks listed there[110] was 12 percent in 1960 and 15

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[103] The favorite 10 of course varied from institution to institution; but even so, the 10 firms receiving the largest amounts of commission business from the total IN-4 sample received 40 percent of the total commissions.

[104] Question 12 of Questionnaire IN-4, app. VIII-A.

[105] The formula used for this purpose was the lesser of purchases or sales divided by the average market value (beginning value plus ending value divided by 2) of stockholdings for the year. Use of the lesser of purchases or sales as the numerator in the formula is based on the assumption that the excess of purchases over sales represents the investment of money newly devoted to stocks, not the turnover of stock investments; and that any excess of sales over purchases represents elimination of stock investment rather than turnover.

The same formula was used (along with two other more elaborate formulas) in the Wharton School report on mutual funds. "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 230-234 (1962).

[106] The weighted average turnover rates for institutional groups and for all groups combined were computed by weighting the rate for each fund by the average value of its stock portfolio for the year involved.

[107] The unweighted average turnover rate is the average of the turnover rates reported by the individual funds in the category.

[108] The median turnover rate is the median of the turnover rates reported by the individual funds in the category.

[109] Figures for the year 1935 contained in the Commission's "Report on Investment Trusts" showed a similar differential in turnover rates between investment companies and common trust funds, the only other institutional group studied. The weighted average turnover rate for the total portfolios of the common trust funds for that year was only about half that for the investment companies. SEC, "Report on Investment Trusts and Investment Companies," pt. 2, ch. VIII, p. 633 (1939); id., "Commingled or Common Trust Funds Administered by Banks and Trust Companies," p. 19 (1939).

[110] This was computed by dividing the total value of stocks sold on the NYSE by the average value of stocks listed on the NYSE during the year.

percent in 1961. While these rates are higher than the average turnover rate of the institutions in the IN–4 sample as a whole, the two sets of figures are not strictly comparable. Thus, the institutions' net purchases or net sales of stocks are excluded from consideration in their turnover rates, but these purchases or sales, in addition to their turnover, contribute to the liquidity in the trading markets.

A further point which emerges from the analysis is the variation of turnover ratios within each of the institutional groups. Thus, the median turnover rate for the pension funds in 1960 was 1.8 percent, but one of the funds had a turnover rate of 22.9 percent, while all of the other respondents in the pension fund sample had rates 10 percent or under. In 1961, the median turnover rate for the pension fund group was 3.6 percent, but five of the individual funds had rates over 10 percent and three of these had rates over 18 percent. For the common trust funds, the median turnover rates were 3 and 5 percent for the 2 years; all of the common trust funds had turnover rates under, and most well under, 9 percent, except for two funds administered by a single bank which had turnover rates of 34.5 and 39.6 percent in 1960 and 24.9 and 26.4 percent in 1961. Among the investment companies, turnover rates for even the biggest of the open-end (load) funds varied from 4.3 percent for one fund to 30.9 percent for another.

6. RECOMMENDATIONS BY INSTITUTIONS ABOUT THE SECURITIES MARKETS

The institutions in the IN–4 survey were asked to state any suggestions they might have for changes in the practices, procedures, or structures of the various securities markets which in their opinion would make them better adapted to their use and needs.[111] Fourteen of the institutions responded to this question, with comments covering a number of different subject matters. The most important of these comments are quoted in the various segments of the report to which they are most pertinent, and they are summarized only briefly here.

The most frequent suggestion was for a volume discount or lower commission rate for large blocks on the New York Stock Exchange; several of these comments are quoted in chapter VI.I. Two institutions (joined by a number of other persons, in correspondence or interviews) discussed the inadequacy of the present Exchange ticker system, one of them specifically pointing out that tape delays place individual and institutional investors at a "substantial disadvantage" compared with a specialist or floor trader. One institution commented on the "thinness" of the market for most stocks—attributed to institutional activity plus the unwillingness of investors to pay the capital gains tax on profits—and the resulting difficulty and expense of acquiring a substantial block on the Exchange. Another pointed out that some specialists were "not active enough" in their assigned stocks and questioned whether the Exchange's standards for judging a specialist's fulfillment of his responsibilities are sufficient; see chapter VI.D.

The same institution suggested that it might be desirable for the NASD to designate certain dealers as "specialists" in major over-the-

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[111] Question 14 of Questionnaire IN–4, app. VIII–A.

counter stocks, defined as stocks having a market value in excess of $25 million; see chapter VII. Still another institution felt that "more official information on actual trading volume and prices" in the over-the-counter market would be desirable, since "considerable research is required to develop such information which frequently is quite general in nature;" see chapter VII. Other institutions commented on such diverse subjects as the desirability of preserving competitive markets (see pt. B of this chapter); the desirability of wider use of registered as opposed to bearer bonds; and the contribution to liquidity that might result from permitting a short sales up to 100 shares of any issue, without restriction. Finally, one institution made the following suggestion for an informal conference procedure as a means for working out improved procedures in the securities markets which would be helpful to the institutional investor:

> We believe that constructive suggestions for changes in practices, procedures, or structures of the various securities markets might emerge from an informal conference or series of conferences among institutional investors, representatives of the securities industry, and representatives of the Commission.
> We would be willing to be represented at such a conference.

7. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Although institutions are still considerably less important than individuals as holders and as buyers and sellers of stocks, their importance is increasing. In addition, institutions have special importance to the trading markets since their unit holdings and buying and selling programs tend to be larger than those of individuals; and decisionmaking, for the bulk of institutional holdings and transactions, is concentrated in relatively fewer investor units.

Because of the increasing importance of the institutions in the trading markets, the Special Study conducted a survey among 91 different institutions concerning their procedures for executions and their transactions in common and preferred stocks. The major specific results of this survey may be summarized as follows:

1. The transactions of the institutions sampled showed a concentration in NYSE-listed issues, with a minor amount of activity on the Amex, and negligible activity on the regional exchanges in stocks listed only on such exchanges.
2. Most of the transactions executed on regional exchanges involved NYSE-listed issues, and most of them were by the open-end (load) investment companies. The other institutions made considerably less use of the regional exchanges. Such higher use of regional exchanges by the investment companies may well be related to the investment companies' desire to give "reciprocal business" to regional exchange members and, in some cases, to nonmembers.
3. For transactions by the institutions in NYSE-listed stocks, the NYSE is the most important market channel (except for preferred stocks), and the over-the-counter markets are the second most important.
4. Relative to the New York Stock Exchange market, the importance of the over-the-counter markets for NYSE-listed issues is greatest for preferred stocks, second greatest for public utility commons, and least great for "other" commons. This pattern no doubt reflects

the relative degree of "institutionalization" of the markets for each of these categories of stocks.

5. Most transactions and "block" programs in listed common stocks take the form of a series of relatively small transactions on the exchange auction market, or involve prearranged "crosses" on the floor of an exchange.

6. The average size of individual transactions tended to be smaller on the NYSE and Amex than on the regional exchanges, suggesting that prearranged crosses (mostly in NYSE issues) are of relatively greater importance on the regional exchanges. The over-the-counter market produced the largest sized transactions.

7. For transactions on the NYSE in March 1961 and April 1962, the institutions reported using limit orders for most (about 60 percent) of the dollar volume of their transactions. They reported using discretionary orders for about 20 percent, and market orders for less than 10 percent.[112]

8. For over-the-counter transactions in the 2 months, the institutions reported using principal transactions for about three-fourths of their volume and agency transactions for the rest.

9. For block purchase or sale programs, the bigger the block, the more the time, transactions, and different broker-dealers used for its execution. Block programs in which the over-the-counter market predominated took less time, fewer transactions, and fewer broker-dealers than those in the same size class in which the exchange markets predominated.

10. Most of the institutions had no transactions in new public issues of stocks in 1961. Of those that did, quite a few, particularly life insurance companies, concentrated their new issue transactions in purchases of preferreds. In the preferred stock category, the institutions made few purchases or sales of new issues in the trading markets after the original offerings. In the common stock category, however, the institutions' trading market purchases were nearly two and one-half times their original allotments, and sales were slightly in excess of one-tenth of the original allotments. The investment companies received only 17 percent of the original allotments (to the institutions) of new issues of common stock, but accounted for 59 percent of the post-offering trading market purchases. The institutions' post-offering market purchases of new issues of common stocks were, on the average, made at a premium of 33 percent above the original offering price, and their sales at a premium of 46 percent. About 60 percent of the institutions' sales of new common stock issues were made within 40 days of the original offering. The median-sized allotment of new stock issues received from individual broker-dealers, even by these institutions, was relatively small (generally 100 shares or less). Both post-offering purchases and sales, however, tended to involve larger individual transactions.

11. Virtually all of the institutions had trading or order departments which retained control over the details of executing purchases and sales of stocks. These normally had limited discretion as to price and no discretion as to the stocks to be purchased or sold, but substantial discretion as to the broker-dealers and market channels to

[112] As indicated in sec. 3.a(4), above, however, some of the orders reported as "limit" or "market" orders may well have involved some element of discretion.

be used for individual executions, though "approved" lists of broker-dealers, among whom the trading departments were expected to spread the business, were common.

12. Few institutions reported going directly to specialists or specialists' firms for executions in stocks in which the specialist was registered.

13. Many institutions estimated that their use of the over-the-counter markets for listed stocks had been increasing, relative to their use of the exchange markets, over the past 5 years. Few indicated that it had been decreasing. More institutions reported such an increase in the "other" common stock category than in the public utility common stock or preferred stock categories.

14. Price, cost and volume were the factors most frequently mentioned by the institutions as factors determining use of the over-the-counter markets rather than the NYSE market for NYSE-listed issues. These factors were less frequently mentioned as reasons for using the regional exchanges.

15. "Reciprocal business" considerations were more important in the allocation of commission business among stock exchange member firms than among dealers in the over-the-counter market, where price competition exists. With respect to the unlisted stocks, several institutions indicated that they prefer to execute transactions directly with market makers.

16. Research and analytical materials were the most frequently mentioned reasons for giving "reciprocal business" to brokers. Other factors tended to vary by type of institution. Reciprocal business has been given by banks in relation to deposits and loans, by mutual funds in reward for sales of shares of the funds, by universities because of "old school tie" considerations, and by insurance companies to reward broker-dealers who bring (as agent for the issuer) desirable private placement issues to the company.

17. The institutions tend to concentrate their commission business among a relatively few firms: for each institution, its favorite 10 broker-dealers tended to account for more than 50 percent of its commission business for the year 1961. Moreover, New York Stock Exchange firms received more than 60 percent of the total commissions paid by the institutions for the year 1961. The give-up device was used principally to divert commissions from an institution's favorite 10 or 20 brokers to others. Its principal users were the open-end (load) companies.

18. Investment companies have noticeably higher stock turnover rates than other institutions. The institutions, as a whole, have lower turnover rates than the New York Stock Exchange market. While the net new purchases of stocks by the institutions as well as their turnover are presently both contributing to liquidity in the securities markets, the institutions' lower turnover rate raises questions concerning the consequences of possible further increase in institutionalization of the markets for stocks.

An important purpose of the Special Study's institutional investor survey, apart from contributing to general understanding of the institutional investors' role in the trading markets, was to supplement and throw light on data obtained through other means about various other phenomena or problems within the scope of the total study. Recommendations in those areas, reflecting the institutional survey and

other data, are contained in the appropriate chapters. Certain recommendations which flow directly from the findings as to institutional transactions specifically are, however, made here.

The principal one is that the growing importance of institutional investors, the pattern of their present market activity, and the probability of a trend toward greater "institutionalization" of markets for stocks suggest the need for continuing data and attention with respect to such areas. In addition to obtaining and publishing fuller data on institutional transactions, the Commission should have programs for more continuous study of, and better lines of communication with institutional investors and others with regard to changing needs and emerging problems regarding the handling of block transactions and their special impact on the securities markets.

While pension funds are one of the most important institutional groups in the securities markets, and are growing at the fastest rate, they are notable for the dearth of information publicly available on their holdings. Investment companies are required by the provisions of the Investment Company Act to disclose their holdings of individual stocks in their periodic reports. Insurance companies are required by various State statutes or regulations to make similar disclosures. Pension funds, however, have not been subject to any corresponding disclosure requirement. Although the Federal Welfare and Pension Plans Disclosure Act [113] applies a disclosure concept to pension funds, the act does not require that the holdings of individual security issues be revealed unless they are securities of an employer or other "party in interest," and are not securities listed on a national securities exchange or securities of a registered investment company or public utility holding company.

Recommendations have been made in the past by others that the Federal Welfare and Pension Plans Disclosure Act should require greater disclosure of individual security holdings of pension funds, with the purpose of informing, and protecting the interests of, the beneficiaries of such plans. In view of the general importance of the pension funds in the securities markets, however, there appears an independent reason of public policy favoring such disclosure.

It is apparent that any study of a possible volume or block discount in stock exchange commission rates, as recommended in chapter VI, must take into account the patterns and practices revealed by the present survey. Should a volume discount be considered, it should take a form which would be meaningful in terms of the sizes of transactions and block purchase and sale programs of the institutions. It should not, on the other hand, take a form which would have unstabilizing effects, such as giving the institutions incentives toward making larger single transactions on the exchange than the auction markets can readily absorb.

The Special Study concludes and recommends:

1. Institutional participation has become increasingly important in the total business of securities markets and, since the institutions tend to deal in larger blocks and for other reasons, such participation presents special problems from the point of view of the exchanges and in relation to the public interest and

[113] 29 U.S.C. 301–309.

protection of investors. In view of the growing importance of institutional transactions and the probability that needs and problems associated with them will not remain static, it is particularly important that there be an adequate body of information about them on a continuous basis for the use of the Commission, the self-regulatory bodies and the investing public. The Commission should institute programs to obtain, and to publish on appropriately aggregated bases, more continuous data concerning institutional participation in the securities markets, including securities held, amounts of gross and net purchases over periods of time, and turnover rates. From time to time the Commission should hold conferences with, or otherwise invite the views and suggestions of, institutional investors, the principal exchanges and representatives of the securities business with regard to changing impacts of institutional transactions on securities markets, related needs of institutional investors, and questions of public policy involved.

2. Inasmuch as pension funds represent an increasingly important institutional group for which data on securities transactions are lacking, the Commission should recommend, from the point of view of the securities markets and independently of any other purpose, that the Federal Welfare and Pension Plans Disclosure Act be amended to require periodic disclosure by pension funds of their holdings of individual corporate securities, or that equivalent information be otherwise required to be made public.

3. Any study of possible modification of commission rate structures to provide a volume discount or lower commission rate for institutional or other large investors should take into consideration the practices of the institutions in handling large purchase or sale programs. Any volume discount or lower rate adopted should be meaningful in terms of the sizes of transactions and block programs of the institutions as they exist in actual practice, but should not create incentives toward instability in the markets such as, for example, through encouraging larger single transactions in auction markets than such markets can readily absorb.

D. Over-the-Counter Markets in Exchange-Listed Securities

1. INTRODUCTION

One of the more striking developments in the securities markets in recent years has been the growth of a market away from the floor of the stock exchanges for securities traded on the exchanges. For NYSE stocks alone, this market has grown from an estimated dollar volume of $84 million in 1941 to an estimated $2 billion 20 years later, a relatively greater expansion than that of the NYSE. Though the methods and structure of the off-board market require its classification as part of the over-the-counter markets, its prices are necessarily related to exchange prices. Its unique character distinguishes it from both and has suggested its designation as the "third market," a term used in this part as a shorthand reference to the composite of all over-the-counter trading in listed securities.

Off-board trading in listed securities takes place in several ways. Most important is the trading in the markets made by broker-dealers

who deal in such securities on a continuous basis in much the same way as the wholesale dealers in the over-the-counter market generally, as described in chapter VII.C.1. These firms, here referred to as the "market makers," as well as other broker-dealers not engaged in the business of making markets, also negotiate transactions, often large in size, on a pure brokerage basis in which they act as agent for both parties.[114] The aggregate of all such trading in listed securities off the floor of an exchange, whatever the channel, constitutes the off-board or third market.

The very existence of such trading prompts inquiry into the basis for a market which appears to duplicate the function of the exchanges, and into its particular structure and operation and impact upon the primary market. Because much of the description of the mechanics of the over-the-counter markets in chapter VII also applies to the third market, this part in examining these questions necessarily concentrates upon the special attributes of the over-the-counter market in listed securities. The discussion is largely limited to over-the-counter trading in certain NYSE stocks which, on January 18, 1962, accounted for 85 percent of the value of trading in the third market.[115] It is further limited to such trading by nonmembers of the NYSE. NYSE members, though generally prohibited from trading away from the exchanges in stocks listed on the Exchange, may deal over the counter in listed securities on a special exempt list or upon receipt of special permission from the Exchange or in the course of an approved Secondary Distribution; trading under these exemptions accounted for 15 percent of the value of over-the-counter trading in NYSE stocks on January 18, 1962.[116] Finally, the discussion focuses chiefly on the off-board trading which takes place in the markets made by the firms engaged in this business since their activities account for the bulk of the third market's volume.

2. METHOD OF STUDY

As in the case of other over-the-counter markets, the transactions of the third market are entirely outside the glare of publicity in which price and volume data are reported on a continuous basis for exchange transactions, individually and in the aggregate. Therefore, in deciding the broker-dealers who were appropriate recipients of a questionnaire it was necessary to work on a trial basis. After analysis of the responses to the basic Questionnaire OTC-3,[117] a supplemental questionnaire, OTC-6, was prepared and, on August 17, 1962, mailed to 31 broker-dealers.[118] These included all those whose OTC-3 questionnaires showed a total of $60,000 or more of over-the-counter purchases and sales of listed securities, whether as principal or agent, on January 18, 1962, the sample day of Questionnaire OTC-3.

The questionnaire elicited information concerning the size, growth, and constituency of each firm's off-board business in listed stocks, various aspects of market practices and methods, and specific information on every transaction in selected securities during the weeks ending

[114] Transactions in listed securities can also occur, of course, directly between public investors, without the services of a professional intermediary.
[115] See ch. VII, app. A, table 7.
[116] See ch. VIII, app. A, table 8.
[117] See ch. VII.A.2.
[118] See app. VIII–B.

March 24, 1961, and January 19 and June 1, 1962. Five firms were eliminated [119] and the questionnaire was sent to 11 additional firms known to be active in this field though not among the most active on January 18, 1962. Information on over-the-counter trading of Exchange stocks was thus obtained from a total of 37 broker-dealers, accounting for approximately 75 percent of the volume and value of over-the-counter trading in NYSE stocks by nonmembers on January 18, 1962.[120]

The firms divided into two groups. One consisted of 17 firms making off-board markets for NYSE-listed securities in 1962. Thirteen were making such markets in 1961 and were able to submit statistical data for that year, which was the base year for much of the statistical data required under Questionnaire OTC-6. These firms comprised, to the study's best information, all those doing any substantial business as market makers in listed stocks in 1961. Seven of the 13 were responsible for 96 percent of the group's dollar volume in 1961, and a large portion of the discussion and of the tables in this part is based on their reports.[121] The other group, referred to here as the "broker-dealer intermediaries," consisted of 20 firms which dealt with the market makers on behalf of public customers. It included the firms doing the largest amount of such business on January 18, 1962, but represented only a sample of the more than 400 firms active in this capacity in the third market on that day.

Members of the Special Study staff also visited a number of the larger firms operating in this market, both market makers and their broker-dealer customers, and received supplemental information by observation and by interview of the principals of these firms. Since Questionnaire OTC–6 supplied only limited information concerning the general nature of the public customers of the third market, information on business transacted by individuals was derived chiefly from this source and much of the data on institution's participation in the market was drawn from Questionnaire IN–4, discussed in part C, above. It is important, however, to note the distinction in coverage of the two questionnaires. The data collected under Questionnaire IN–4 include transactions by NYSE members and therefore provide information on a wider trading area than that accounted for by nonmembers who were the sole subjects of Questionnaire OTC–6.[122]

The data concerning the off-board market for NYSE-listed securities have thus been brought together from a number of sources; the limitations of these sources have necessarily restricted the scope and depth of the inquiry. At times the data only suggest, rather than document, some of the observations. In some instances, where statistical verification would have been desirable, it was necessary to rely on information obtained from interviews of participants in the third

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[119] Two firms were out of business by August 1962, one firm had an unusually large transaction in an exchange stock on Jan. 18, 1962, but did not normally trade over the counter in listed securities, one firm concentrated in exchange stocks other than NYSE issues, and one firm failed to report.

[120] See sec. 4.c, below, particularly the first footnote, with respect to the extent of the 37 firms' third market participation.

[121] These seven firms were: American Securities Corp.; Blyth & Co., Inc.; A. W. Benkert & Co.; The First Boston Corp.; J. S. Strauss & Co.; Weeden & Co.; and Stewart, Miller & Co. (which was active during the period covered by the questionnaire but not at the time of the publication of this part). The firms are not identified in the tables but are designated by letter.

[122] The indications are, however, that NYSE members were responsible for no more than the 15 percent of off-board volume in Exchange securities contributed by them on Jan. 18, 1962. (See p. 871, above.)

market, chiefly market makers. Because of the almost complete dearth of information previously available concerning this rapidly developing segment of the securities markets and the indicated limitations in the study's collection of data, it is important to understand that this part is less a definitive study than an exploratory survey.

3. DIMENSIONS OF THE MARKET

a. Volume and growth

The size of the off-board market for listed securities may be measured in several ways. On January 18, 1962 (based on Questionnaire OTC–3), over-the-counter purchases and sales of all exchange stocks amounted to $26.9 million, or 6.3 percent, of total estimated stock trading of $429.4 million on all exchanges on that day.[123] The $26.9 million may also be compared with the estimated value of purchases and sales on all regional exchanges that day, which amounted to $30.4 million. If the over-the-counter trading in NYSE stocks only is considered (excluding stocks on the Exchange's exempt list), $19.5 million of such stocks were bought and sold over the counter, constituting 5.3 percent of total trading on the NYSE on January 18, 1962.

Estimates based on full-year results show a slightly smaller proportion of off-board trading in NYSE stocks than does this 1-day study. The broker-dealers responding to Questionnaire OTC–6 who had off-board sales of listed stocks in 1961 accounted for 75 percent of the off-board volume in NYSE securities on January 18, 1962. An extrapolation of their dollar volume for 1961 based on this percentage indicates total over-the-counter sales of NYSE securities for that year of just under $2 billion (table VIII–43). This figure constitutes 5.1 percent of the value of all over-the-counter sales and 3.8 percent of the value of sales on the Exchange (table VIII–44), or slightly less than half the dollar value of such trading accounted for by the regional stock exchanges in 1961. The result appears to be confirmed by the extrapolation of the 1962 sales of one of the largest market makers, based on his reported allocation of the total third market volume in 1961. This measure indicates that sales in the off-board market in listed securities for 1962 were 4 percent of the dollar value of sales on the NYSE. The dollar value of all trading on the regional exchanges in 1962, including securities not traded on the NYSE, was 7.3 percent of dollar value of sales on the Exchange.

In comparing volumes on the off-board and exchange markets, it is important to note that the relatively high degree of professional participation in the over-the-counter market means that the estimated value of sales by the public in the third market amounted to only 2 to 2½ percent of such sales on the Exchange.[124] On the other hand,

[123] See app. VII–A, table 2.

[124] The method of computing the volume of purchases and sales in the over-the-counter market tends to obscure the extent of participation by public and professionals. The problem is complicated by the different channels for effecting a transfer from one public customer to another. An institution may sell to a market maker who, in turn, sells to another institution. An individual may sell to a broker-dealer intermediary, who sells to a market maker, who sells to another broker-dealer, and thence to another public customer; often, however, the individual trades with the market maker through his broker-dealer as agent. There may be various combinations of these steps in each transfer from one public customer to another, all of which influence total volume and affect the proportions of total volume represented by public and professional activity. See ch. VII, app. A.1.a, for discussion of this apportionment as it relates to the over-the-counter market generally.

since NYSE stocks accounted for 85 percent of all over-the-counter trading in listed securities on January 18, 1962, the total of trading of all listed stocks over the counter actually exceeded $2 billion for 1961.

The sharp growth of the third market may be seen by reference to a Commission staff study in 1941. This reported sales of NYSE stocks over the counter by nonmember broker-dealers for a 6-month period as 1 percent of the volume and 1.6 percent of the value of sales on the Exchange. Thus, despite the tenfold increase in the value of shares traded on the NYSE between 1941 and 1961, the over-the-counter market for NYSE stocks in 1961 had increased its size more than 20 times over the two-decade interval. The responses to Questionnaire OTC–6 reveal the extent of the third market's recent expansion; dollar volume of over-the-counter trading in listed securities increased 185 percent from 1955 to 1961, some 10 percent more than the increase in over-the-counter trading generally, and three times as much as the 60-percent increase in volume for the same period reported by the Exchange.

The growth of the third market may also be measured by the increase in number of market makers. Of the 17 firms reporting activity as market makers in late 1962, only 3 had made markets in the early 1940's, 9 had begun in the 1950's, and 5 had started in 1961 or 1962.[125] Though there have been some withdrawals, the net effect of the changes appears to be a proliferation of the firms making markets. Nor is the expansion limited to the number of firms alone: as indicated below, the market makers have been constantly increasing the number of stocks for which they make markets.

b. The securities

Unlike the trading of securities on the exchanges,[126] listed securities may be traded off-board without restriction by broker-dealers who are not members of an exchange, and over-the-counter markets for listed securities can be made or discontinued, also without restriction.[127] Many transactions over the counter involve listed securities lacking an established dealer market.[128] But even if attention is limited to those NYSE stocks which possess formal markets, it is apparent that the list of Exchange securities traded over the counter is large, diversified, and steadily expanding.

The 1941 study referred to above found that the outstanding characteristics of the listed stocks then being traded over the counter were both their high quality and inactivity on the NYSE. Stress was on preferred stocks and, to a considerably lesser extent, on the common stocks of financial, real estate, and utility groups. The attributes of these stocks supported the aphorism that active stocks gravitated toward an exchange market while inactive stocks sought a negotiated market.[129]

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[125] Source: Questionnaire OTC–6. By June 1963, 9 months after circulation of the questionnaire, a large wholesale over-the-counter dealer, formerly engaged in trading only unlisted securities, had also begun to make markets for listed stocks. As indicated above, one of the firms engaged in making such markets in 1961 and 1962 discontinued its operations in 1963.

[126] For discussion of trading requirements on the principal exchanges, see pt. B, above, and on the original exchanges, pt. E, below.

[127] See ch. VII.C for a description of the over-the-counter marketmaking function generally.

[128] See sec. 4.a and b, below.

[129] Thus, the NYSE's list of exempt issues, which its members may trade off the Exchange, consists of listed securities with less volume of activity than is apparently considered essential for an auction market.

The roster of NYSE stocks traded over the counter has changed radically in size and character since that time. Whereas at the earlier date no dealers appear to have been making over-the-counter markets for these stocks, at least to an extent requiring comment, in 1961 13 firms were making 712 markets in 270 different common stocks (table VIII-45). By September 1962 the 7 largest of these firms had added 44 new markets (table VIII-46). The third market continues to be the favored market for the handling of preferred stocks,[130] but such securities, less important relatively to institutions today than in 1941, were the subject of only two off-board markets in 1961 and were reported by almost all market makers to be of declining importance. Markets were made, however, in 1961 for 82 utility and 18 railroad issues, classes which had also been important in the over-the-counter trading in 1941. A striking change from the earlier year is the prominence of industrial equities, extending from established "blue chips" to comparatively less seasoned stocks. The range of selection may be seen in a small but representative sample of NYSE issues in which off-board markets were made in 1961 (table VIII-47).

Some of the 270 NYSE common stocks traded in the third market are among the most active on the Exchange—74 of them ranking in the top 100 in 1961. And while only one-fourth of all NYSE common stocks traded a million shares or more in that year, almost three-fifths of the third market stocks reached that mark. Since the regional exchanges tend to engage in the multiple trading of stocks actively traded on the NYSE, it is not surprising that all but nine of the third market stocks were traded on one or more of the regional exchanges in 1961.[131] Volume was not uniformily high among all third market stocks, however, as almost one-fifth of them—generally utility issues—traded less than the median of 465,000 shares for all NYSE common stocks in 1961, and 13 issues traded less than 200,000 shares (table VIII-48, chart VIII-h).

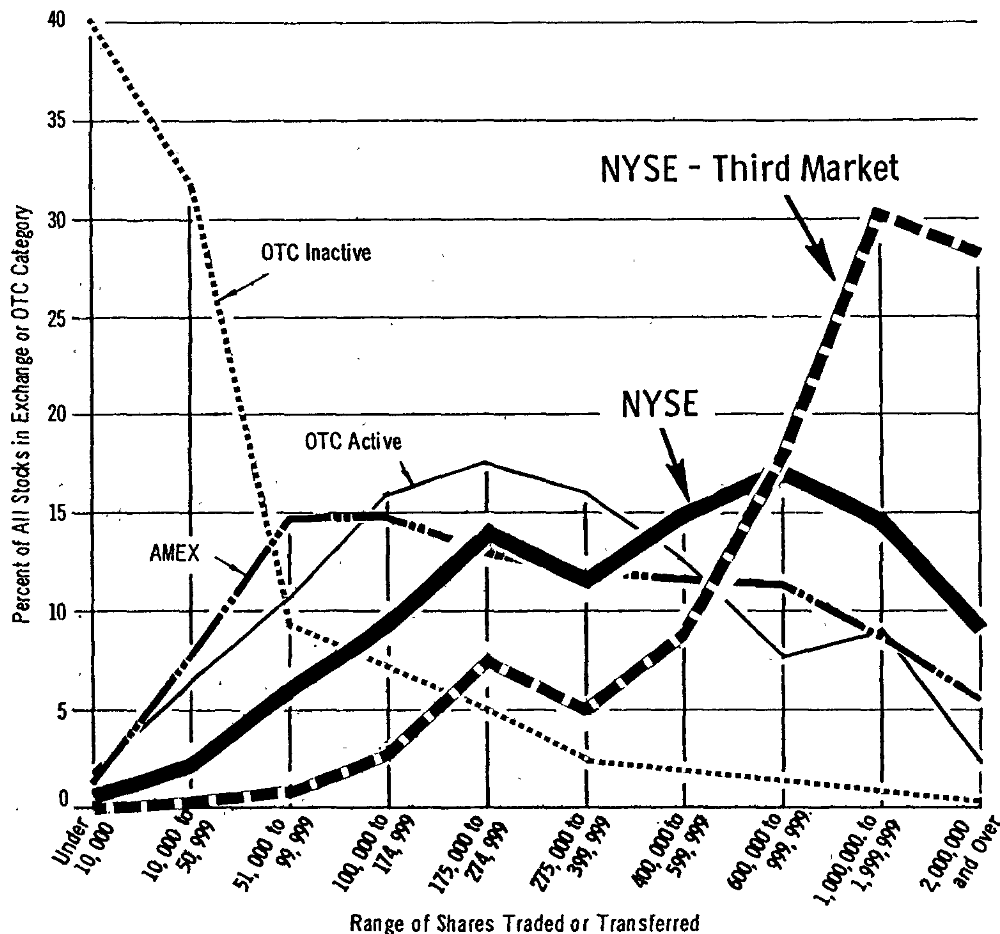
In other characteristics too—in financial size of issuer and in breadth of stock distribution—NYSE common stocks traded on the third market stand in the very highest size ranges. A comparison of the 270 common stocks for which markets were made in 1961 with (1) all common stocks listed on the NYSE, (2) those listed on the Amex, and (3) stocks traded exclusively over the counter shows the 270 in the very upper NYSE size levels—far higher than all but a small percentage of stocks in the other market categories (table VIII-49, chart VIII-i). Thus, while some 56 percent of all NYSE common stocks have fewer than 10,000 shareholders, only 3 percent of the 270 fail to meet this level of distribution. And while roughly half of all NYSE common stocks have fewer than 2½ million shares outstanding, less than $100 million in issuer's assets, or under $100 million in market value, only 5 to 10 percent of the 270 fall below these levels.

[130] See pt. C.3.a, above.
[131] See pt. E, below.

Chart VIII-h

PERCENT OF ALL NYSE STOCKS, NYSE STOCKS TRADED IN THE THIRD MARKET AND STOCKS IN OTHER EXCHANGE AND OVER-THE-COUNTER CATEGORIES FALLING INTO EACH RANGE OF SHARES TRADED OR TRANSFERRED ANNUALLY*

1961



* For exchanges and for NYSE - Third Market, data are for shares reported traded on the particular 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. NYSE - Third Market category is based on Questionnaire OTC-6.

For exchanges, and for NYSE-Third Market, 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.

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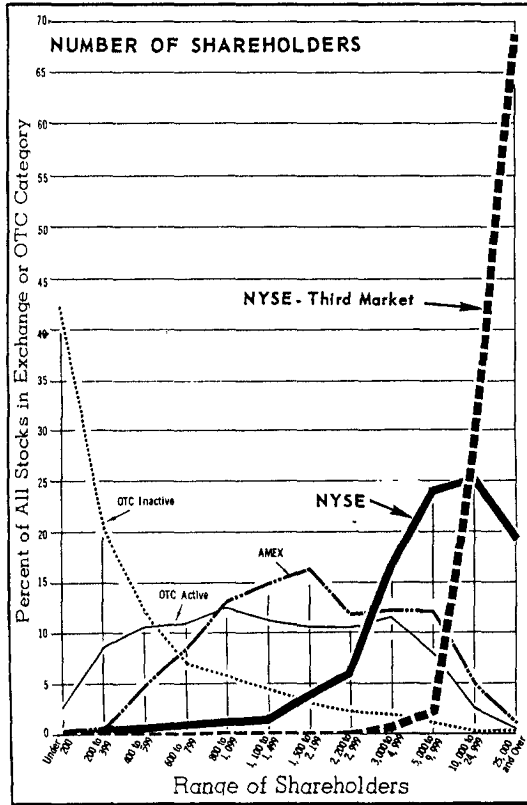
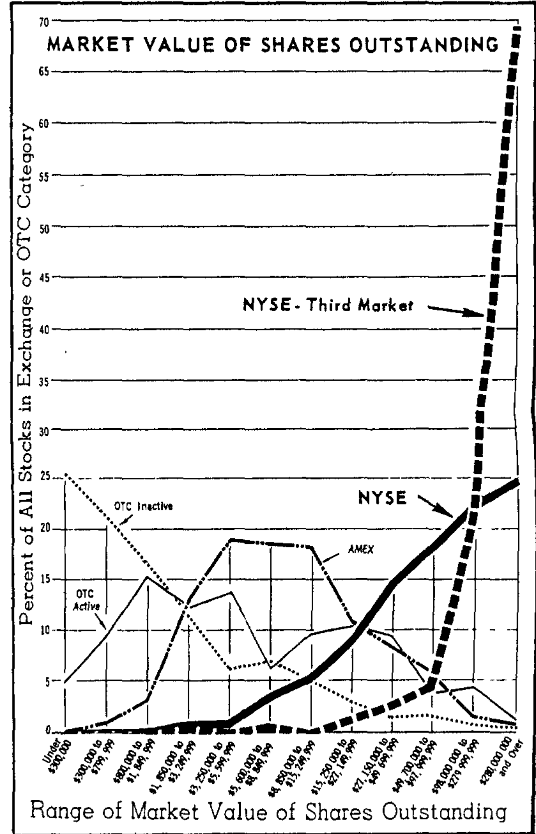
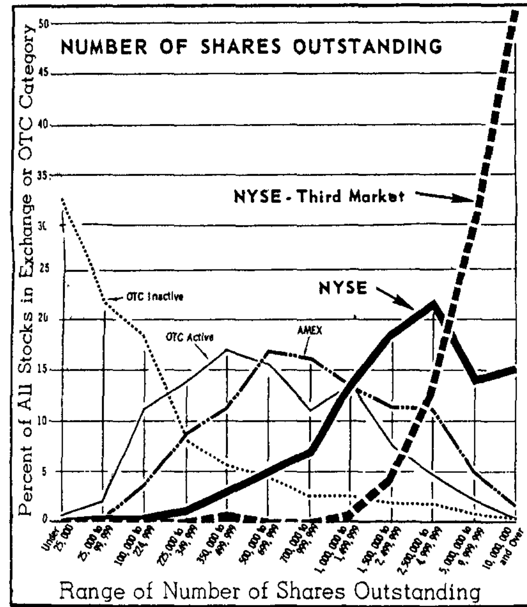
Chart VIII-i

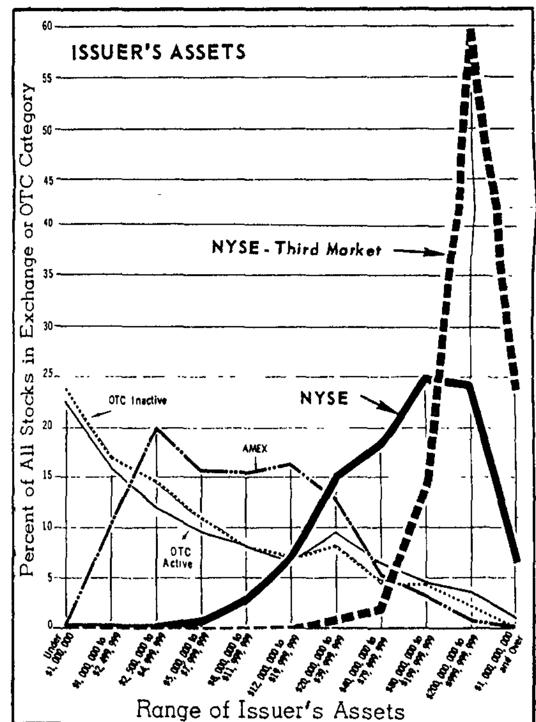
PERCENT OF ALL NYSE STOCKS, NYSE STOCKS TRADED IN THE THIRD MARKET, AND STOCKS IN OTHER EXCHANGE AND OVER-THE-COUNTER CATEGORIES FALLING INTO EACH RANGE OF SHAREHOLDERS, NUMBER OF SHARES OUTSTANDING, MARKET VALUE OF SHARES OUTSTANDING AND ISSUER'S ASSETS★

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. NYSE - Third Market category is based on Questionnaire OTC-6.

For exchanges and NYSE-Third Market, 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.

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This pattern may be seen also in the high range within which the central two-thirds of the 270 stocks fall. While the central two-thirds of all NYSE common stocks have shareholders and shares outstanding equal to from 2 to 20 times the minimum listing requirements, most of the 270 have from 10 to 60 times these requirements. And while most NYSE stocks meet from 2 to 46 times the minimum NYSE listing requirements as to issuer's assets and market value, most of the 270 have from 13 to 130 times these requirements.[132] Comparison with the central two-thirds of stocks in other markets is even more striking and underlines the very great dimensions of most, though not all, NYSE stocks for which off-board markets are made (tables VIII-5 and VIII-49).

As in the case of many other aspects of the third market, there is no identity, and often little similarity, in the lists of stocks in which each firm makes markets. The lists of the 7 largest firms vary greatly in composition and in 1962 ranged in size from 44 to 167 securities. Two firms make markets only for utilities. Their lists are much smaller and more static than those of the diversified firms. But there were substantial differences even in the markets made by the diversified market makers, some apparently concentrating in securities likely to be of interest to institutions, with others concerned more with securities likely to be of interest to individuals. The range encompasses 1 stock (American Telephone & Telegraph Co.) selected by 8 market makers to 90 securities in which only a single market is made (table VIII-45).

While difficult to demonstrate statistically, there also appears to be some relationship between the distribution of transactions by size discussed below [133] and the nature of securities traded by the individual market maker. Thus, the firms doing a relatively larger part of their volume in smaller trades make markets for some of the less stable market performers, while those stressing the larger sized transactions concentrate on issues of relatively higher investment grade.

The returns to Questionnaire OTC-6 show the prime factor in each firm's decision to make a market for a stock is the interest of customers or potential customers, five specifying institutional interest as being of primary importance. One large diversified market maker stated its basis for selection of securities as follow:

> The policy of the firm is to add a security to our trading list only if it is felt that the security has a sufficiently broad and continuous investor interest to justify it being traded on a permanent basis. The issue must also be of a type in which we feel we will be able to maintain a competitive net market.
>
> Taken into consideration are the number of institutional investors holding the security in portfolio, as well as the nature and frequency of inquiries for the security by our customers. Also considered are the number of shares outstanding, daily volume, past market action, and price level.

Another diversified market maker stated simply, "Dealer activity is our guide in adding or dropping stocks." Still another diversified firm doing a large dealer business cited a number of specific measures for interest and activity:

> 1. Total number of shares outstanding (we usually require minimum of 6 million shares).

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[132] See pt. B.4, p. 11, at note 1, and table VIII-5.
[133] See sec. 5, below.

2. Volume on NYSE (usually demand average volume greater than 150,000 shares per month over 5-year period).
3. Number of shareholders (normally look for at least 20,000 shareholders).
4. Price and ratio of volatility to price.
5. Number of shares closely held (we deduct number of shares known to be closely held from total outstanding to determine whether first factor satisfied).

One firm specializing in utilities bases its decision on "* * * an analysis * * * to determine if a broad interest exists in the security." Another firm, also specializing in utilities, stated:

In determining to make a market in a particular security, we take into consideration the volume of institutional trading and degree of interest in that particular security.

The market makers generally discontinue their markets by applying the standards used to initiate them. One firm discontinues trading listed securities "if the volume * * * [is] small," another if a stock "no longer has sufficient activity," a third "where institutional interest declines over a period of time. * * *" A fourth firm applies a different emphasis: "It is possible that we would drop a security from our list if we decided it was trading at a level which involved great danger in being long."

c. Size of transactions

An analysis of the size of transactions reported by the largest firms making over-the-counter markets in listed securities for the 3 sample weeks of Questionnaire OTC–6 reveals a polarization into very large and very small transactions to a far greater extent than on the NYSE.

The prevalence of the larger sized transactions is hardly unexpected since the handling of block transactions by institutions has long been accepted as a prime function of the third market.[134] Trades of 500 shares and over were thus responsible for 14 percent of transactions of over 100 shares in size and 57 percent of share volume of the 7 largest market makers during the 3 base weeks of Questionnaire OTC–6 (tables VIII–50a and VIII–50b). The equivalent ratios on the NYSE in a 1-day sample in January 1963 were 4.5 and 21.8 percent, respectively. The concentration of larger transactions in the third market is even more dramatically illustrated in the analysis of transaction sizes in part C.[135] Whether measured by dollars or shares, individual transactions on the third market reported by institutions on the IN–4 questionnaires were substantially larger than their transactions on the NYSE and regional exchanges. The median dollar value of the over-the-counter transactions for the 2 base months (March 1961 and April 1962) covered by the questionnaire was more than three times that of transactions on the NYSE and about double that of transactions on the regional exchanges.

The consequence of this stress on the larger sized transactions is, of course, that the over-the-counter market has 86 percent of its round-lot transactions [136] and 43 percent of round-lot volume in the middle range of 100 to 499 shares, while the NYSE reports (for 100- to 500-share trades) 95.5 percent of its round-lot transactions and 78 percent of round-lot share volume in this size range. The third market

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[134] "Is the Stock Market Obsolete?" Fortune, February 1954, pp. 129, 158.

[135] See tables VIII–21, VIII–22, and VIII–28. These statistics include transactions by NYSE members in exempt stocks.

[136] For purposes of this analysis, round-lot transactions on the third market are defined as those involving 100 shares or more, though they are not (as is required by the NYSE) in even multiples of 100 shares.

is thus relatively less active in the middle area from which the NYSE draws its greatest volume.

Surprisingly, the third market had a greater share of its transactions and volume in the smallest sized transactions—those of less than 100 shares, i.e., odd lots—than did the NYSE. Thus, the third market had 74 percent of its transactions and 19 percent of its share volume accounted for by odd lots.[137] On the other hand, it is estimated that odd lots on the NYSE made up 48 percent of the total of nonmembers' round-lot and odd-lot transactions and 9.1 percent of the total share volume in 1961. The relatively high proportion of share volume in odd lots on the third market—approximately double that of the NYSE—is not inconsistent with the importance of larger transactions; rather, it points to a different kind of market utilization, for reasons which are considered below.

The size distribution pattern among the market makers varies substantially, with share volume being concentrated at either pole of transaction size. Odd lots constituted 84.0 percent of the trades and 50.8 percent of the share volume for one firm, but only 32.9 and 1.8 percent, respectively, for another (tables VIII–50a and VIII–50b). In the same way, the firm emphasizing odd lots had only a single transaction, amounting to 0.9 percent of its share volume, in trades involving over 500 shares while the other firm did 88.5 percent of its share volume in the higher range, 62.8 percent in transactions of over 2,000 shares.

The same heterogeneity is reflected in comparisons of size of transactions for the individual market makers in specific issues. One firm did 60.3 percent of its share volume in American Telephone & Telegraph Co. in odd lots and only 3.9 percent in transactions of 300 shares or larger, while another did only 19.4 percent of its volume in this stock in odd lots but 46.5 percent in the larger sized transactions (table VIII–51). Despite the differences in distribution characteristics among firms, however, no firm reported less than 64.5 percent of total transactions in this stock in odd lots. In the lower priced but less active Southern Co. common, odd lots made up a considerably smaller portion of both transactions and shares for each of the three firms making markets in the stock. A comparison of the transactions of two of the firms, which made markets in both stocks, for the 3-week test period indicates that the distribution of business by size of transaction varies both for market makers and securities.

4. THE PARTICIPANTS

a. The public customers

The reason for the existence of an over-the-counter market in listed stocks—in the face of a highly organized, established exchange market in which the same securities are traded—would appear to lie in its capacity to satisfy needs not met by the exchange market. It is therefore important to know the nature of the customers of the third market and the reasons for their utilization of this market.

The inquiry is complicated by the fact that some customers of record; i.e., institutions, generally deal directly for their own accounts

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[137] This is the minimum percentage of odd-lot trading because odd lots traded in combination with round lots were not considered as separate odd-lot transactions. See note 136, above.

while others, such as broker-dealers and commercial banks in some of their trading, represent the ultimate public customers as intermediaries. The Special Study secured data concerning the customers of the third market from three independent sources, each supplying a different type of information. Questionnaire OTC-3 permitted a 1-day division of trading on the third market between individual and other public customers, but without analysis of the latter class into subgroups. Questionnaire IN-4 obtained data on trading in the third market by designated classes of institution. The information secured by questionnaire OTC-6 from broker-dealers in the third market revealed the class of customer of record, not necessarily the ultimate public customer, in transactions effected during 3 base weeks. Within the bounds of these varied data, it is possible to set down some general observations concerning the customers of the third market.

The OTC-3 sample of January 18, 1962, lends support to the commonly held notion that the third market exists largely to service the needs of institutional investors. On that day public customers other than individuals transacted 62 percent of the dollar value of the public trading in the third market.[138] This class of customer was thus substantially more important to the third market in terms of dollar value of trading than to the NYSE, and far more important than in the trading of unlisted stocks (table VIII-d). Although the classification of "other public customers" includes such entities as partnerships and estates, it consists largely of institutions.[139]

TABLE VIII-d.—*Percent of individuals' and other public customers' trading*

Type of stock	Individuals		Other public customers	
	Share volume	Dollar value	Share volume	Dollar value
Exchange listed, traded over the counter [1]	68	38	32	62
Over the counter	91	79	9	21
NYSE listed, traded on the NYSE	69	64	31	36

[1] Includes all stocks available for trading on NYSE, Amex, and regional exchanges.

Source: For listed stocks traded over the counter and unlisted stocks, responses to Questionnaire OTC-3 for Jan. 18, 1962; for share volume (NYSE) distribution, the Exchange's "11th Public Transaction Study," Sept. 13, 1961, adjusted to eliminate trading by NYSE members and nonmember intermediaries. NYSE dollar value distribution was computed by weighting share proportions by the average share price on Sept. 13, 1961 ($48 for institutions and intermediaries and $39 for public individuals) as reported to the study by the NYSE.

The high average price of shares traded by other public customers in the third market—$60 as compared with an average of $17 for individuals—explains the relatively smaller portion of share than dollar volume traded by other public customers in this market.

There is other evidence of the importance of institutions in the third market. Though estimated sales of NYSE stocks over the counter amounted to 3.8 percent of sales on the Exchange in 1961, the institutional investors canvassed by Questionnaire IN-4 traded over the counter for 10.2 percent of their dollar volume in NYSE securities in March 1961 and 9.5 percent in April 1962. The relatively heavy utilization of the third market by institutions is emphasized by their

[138] See app. VII-A, table 9.
[139] See app. VII-A.2.a for a discussion of the classification of "other public customers."

lesser use of the regional exchanges: 5.3 and 6.4 percent of NYSE dollar volume, respectively, for the 2 months.[140]

The returns of Questionnaire IN–4 also reveal some interesting facts concerning the relative utilization of the third market by institutional customers (table VIII–52). Pension funds did a high portion of their trading in NYSE stocks on the third market—18.7 percent in March 1961 and 15.7 percent in April 1962. Insurance companies, both life and nonlife, and common trust funds also tended to be relatively heavy users of the third market. But open-end investment companies (load) effected only 6.0 percent of their NYSE business on the third market in March 1961 and 6.1 percent in April 1962, as against 10.5 and 9.2 percent for the same months on the regional exchanges. The investment companies were the sole institutional groups to utilize the regional markets more than the over-the-counter market for listed stocks in the 2 months; the basis for this preference appears to lie in the "give-up" or directed split of commissions described in chapter VI, part I, and discussed in detail in chapter XI, part C.[141]

The study of trading on January 18, 1962, in Questionnaire OTC–3 showed that two-thirds of transactions by "other public customers" were on a principal basis, and one-third with broker-dealers as agents. Over-the-counter trading by the institutions responding to Questionnaire IN–4 was, by share volume, three-fourths on a principal and one-fourth on an agency basis.[142] The bulk of the institutions' principal business appears to take place within the markets of the market makers, and its mechanics and motivation are described below. The greatest portion of the agency volume does not appear, however, to channel through the markets of the market makers. Much of it consists of transactions in which a broker-dealer brings together an institution desiring to sell (or buy) a security with another institution desiring to buy (or sell) the same security, in what may be termed an "off-board cross" of a listed security. Such transactions are considered briefly in the next subsection.

The institutions responding to Questionnaire IN–4 most frequently cited price and cost and, less frequently, depth of market—or lack of it—as reasons for trading in the third market. Both grounds involve some complex considerations requiring an understanding of the mechanics of operation of the third market and their detailed examination is deferred to section 5.c, below.

Perhaps one of the most surprising aspects of the third market brought to light by the returns to the study's questionnaires is the high portion of the market's volume transacted for the account of individuals, largely through broker-dealers but also through commercial banks. The market is by no means a wholly institutionalized one; individuals contributed 38 percent of dollar value and 68 percent of share

[140] See tables VIII–19 and VIII–20.

[141] It is important to note that tables VIII–53a and VIII–53b are based on transactions of record in securities in which the seven largest market makers made markets during the base weeks of Questionnaire OTC–6. The tables show a proportion of share volume transacted by institutions almost identical with that shown for other public customers in table VIII–d. No comparable analysis of dollar value was practical. Questionnaire OTC–6 required, however, a different classification of institutions from that employed under questionnaire IN–4 and shows the institution effecting the transaction, in many cases a commercial bank, rather than the institution for whose account the transaction was effected, as in the data secured under Questionnaire IN–4 and summarized in table VIII–52.

[142] This trading involved both listed and unlisted stocks. See pt. C.3.a(4).

volume on January 18, 1962 (table VIII-d). This participation appears to correspond with the finding of the high proportion of odd-lot transactions on the third market, discussed above, since it is reasonable to assume that the smaller sized transactions are generally for the account of individuals and the larger ones for institutions.[143]

The importance of individuals as customers is also suggested by an analysis of the customers of record of the seven largest market makers in the transactions reported under Questionnaire OTC-6. Broker-dealers accounted for 76.0 percent of the transactions and 60.8 percent of the share volume (tables VIII-53a and VIII-53b).[144] Here the relationships referred to above between the customer of record and ultimate public customer become significant. Since institutions can deal directly with the market makers and do not require the services of an intermediary,[145] it seems reasonable to assume that the larger part of this volume was for the account of individuals.

Individuals generally deal on the third market through broker-dealers and not directly with the market makers. Only two of the seven largest market makers handled any appreciable volume of round-lot business with individuals. Since these two firms specialize in institutional business and their volume with individuals was in large-sized transactions, this volume probably corresponds in character to the trading of institutions and is distinguishable from the normal trading of individuals on the third market with its stress on relatively small sized transactions. Another market maker handles odd lots, but on a fixed-fee basis,[146] for the employees of certain companies in whose stock he maintains markets. Such transactions, an imperceptibly small fraction of the total volume of the third market, appear to constitute the only trading directly between the market makers and public customers who might be classified as nonprofessional or unsophisticated traders.

In the absence of a public transaction study, only limited information is available concerning the individual customers of the third market who deal through broker-dealer intermediaries. The returns to Questionnaire OTC-6, confirmed by interviews with broker-dealers, point to a stress by individuals on the smaller sized transactions, although many involve 100 shares or more. Individuals also appear to trade in those off-board stocks with the greatest activity on the Exchange. As is the case generally, the public individual customer appears to be passive in selecting the trading market, and to rely on the advice and action of his broker-dealer.

b. The professional intermediaries

The term "professional intermediaries," for purposes of this description of the participants in the third market, is limited to professionals

[143] The NYSE report on institutional trading for Sept. 26-30, 1960, showed odd lots as accounting for only 5.5 percent of institutional trading. This is approximately 60 percent of the ratio of odd lots to Exchange volume generally. Commercial banks are undoubtedly responsible for a large portion of the institutional odd lots.

[144] It was not feasible to analyze returns by dollar volume but the returns to Questionnaire OTC-3 point to the probability that the proportion of share volume transacted by broker-dealers on behalf of individuals is greater than their share of dollar value. See ch. VII, app. A, table 9.

[145] Several broker-dealer intermediaries appear to do a substantial third market volume as agents for foreign banks engaged in arbitrage of American stocks also traded on the European exchanges. These would seem to be exceptions to the general rule.

[146] The fees are less than exchange commissions. The service is restricted on the employee's company's stock.

trading on that market in a representative capacity for public customers; it excludes the participation on a principal basis of market makers, who are described in the following subsection.

The activities of broker-dealers as representatives of public customers on the third market take two forms. One is the function described above with reference to the "crossing" of orders of public customers, generally institutions. Here the professional performs the pure brokerage function of locating a public customer in order to consummate a trade with another public customer. Most of the market makers appear to engage in such agency transactions (which take place outside the firm's "market") while several broker-dealers who do not make markets appear to specialize in these institutional agency transactions.

The commission charged by broker-dealers in these large-volume agency transactions was generally said to be no more than the NYSE rate, but often negotiable at some lesser figure. One of the firms specializing in large agency transactions for institutions reported its commission policy as follows:

> Various commissions—maximum would be the equivalent of the NYSE commission—in general the commission is negotiated with each customer and sometimes with each transaction on the value of the service performed.

Another, engaged in the same type of business, reported:

> Maximum charge, stock exchange commission rate when obtainable. What traffic will bear otherwise. When acting as agent for buyer and seller charge both sides commission.

A large market maker stated that its commissions in agency transactions, a small portion of its total volume, varied from one-eighth to one-half point;

> Variation in the price of the stock, size of the transaction, and other expense in clearing the transaction determine the size of our commission. In the majority of cases a ¼-point commission is charged.

Still another large market maker doing a greater agency volume described its commission policy as follows:

> The commission * * * varies with the transaction. It is seldom larger than the New York Stock Exchange commission or smaller than one-eighth of a point.

Another market maker doing a large agency volume reported that the commission is normally the same as in the NYSE, but that exceptions are made "in which case the commission is mutually agreed upon."

The second, and more important, type of representational activity by professionals on the third market consists of the trading of the broker-dealer intermediaries, representing public customers, with the market makers, dealing as principals for their own accounts.

The responses to Questionnaire OTC–6 of the respondent broker-dealer intermediaries revealed that in 1961 83.3 percent of this business was transacted as agent and the remainder on a principal basis, apparently of the riskless variety described in chapter VII. Twelve firms did all or practically all their business with public customers as agent, three practically all on a principal basis, and five a combination of the two. Commission rates for the intermediaries' agency transactions with the market makers were reported to be generally the same as NYSE minimum commission rates. Several firms indicated exceptions, one charging "occasionally less on large lots," another reporting

that commissions "vary from two-thirds of the regular stock exchange commission where detail is small, to occasionally the full regular stock exchange commission where detail is greater, as on estate transfers." At least one recent entrant in the business has announced a flat $5-per-transaction charge. The meager evidence available to the study on markups in principal transactions points to a higher customer cost than the commissions charged in agency transactions and suggests the existence of the same markup pattern as in riskless principal transactions in unlisted stocks generally.[147]

The motivation for utilization of the third market by broker-dealer intermediaries seems clear: professionals in the securities business who are not members of an exchange must deal on the exchange through an exchange member and pay the same minimum rates as the public generally. Such payment leaves no room for the nonmember to impose an additional charge for his own services. The repercussions of this aspect of the NYSE public commission schedule have already been discussed.[148] It has been shown that in order to ameliorate the impact of this characteristic of the schedule on professionals, exchange members and nonmembers enter into various types of reciprocal and special service arrangements, and that the regional exchanges have developed the multiple trading of securities listed on the principal exchanges, thereby permitting regional-only members to trade in those securities.

Yet there remains a substantial number of broker-dealers not members of any exchange who apparently desire to deal gainfully in listed securities. The third market provides such nonmember broker-dealers with an economically feasible market for doing so, and 435 had dealings in listed securities over the counter on January 18, 1962.[149] This motivation apparently explains the great bulk of the trading by broker-dealer intermediaries on the third market. These broker-dealers are distributed in communities ranging from small to large throughout the country and, while including some sizable firms, generally consist of the smaller ones.

Also participating in the third market as intermediaries for public customers are commercial banks representing individuals with whom the bank enjoys only an agency relationship. A NYSE transaction study in 1955 reported 20.4 percent of commercial bank share volume on the Exchange was of this type.[150] A leading market maker, doing a considerable volume of business with commercial banks, expressed the opinion to the study that approximately the same portion of bank volume on the third market today consists of this type of transaction.

The banks appear to charge from $5.00 per transaction to, in some cases, the full NYSE minimum commission charge *plus* a small transaction charge. The Special Study made no exhaustive study of the matter and obtained details on such charges from only a few banks. It found that one large metropolitan bank charges its custodial and investment advisory accounts on each security transaction, wherever

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[147] See ch. VII.D.3.

[148] See ch. VI.I.2.a and also pt. E, below.

[149] See ch. VII, app. A, table 18. The OTC–6 sample of such broker-dealers consisted of less than 5 percent of this number, presumably the larger firms, and furnished little information concerning their operations. The generalizations concerning this group are based, not only on the questionnaire response, but on personal interviews with the principals of several of these firms as well as with the market makers.

[150] NYSE, "Institutional Investors and the Stock Market," September 1955. The customers are described as "individuals (nonfiduciary)."

executed, an activity fee of $2.50, and on each over-the-counter principal transaction, including third market transactions, an additional special charge equal to the NYSE minimum commission.[151] This bank states it trades on the third market only when it can secure a price equal to the last sale on the NYSE. Banks which impose fees of this type thus seem to have, for the accounts to which the fees are applicable, the same incentive as broker-dealer intermediaries on the third market: they are able to charge more for their services in handling third market transactions than exchange transactions.

c. The market makers

At the core of the third market are the broker-dealers actively engaged as principals in buying and selling NYSE-listed securities over the counter on a continuous basis and holding themselves out to institutions and other broker-dealers as making markets in such listed securities. As indicated above, the data available do not permit a quantitative definition of their participation in the market, but the market makers appear to participate in some stage of almost every transfer between two public customers.[152] Though listed stocks are also traded outside the formal markets, the market makers are the third market transactions than exchange transactions.

Each market maker is free to make a market or discontinue a market in a listed security at will, and its trading is subject only to regulations applicable to over-the-counter trading and not those governing trading on exchanges. None of these firms, with a single exception, is a member of an exchange.[153] They have followed different routes in entering the business, though the original purpose appears to have been to service the needs of institutions. For example, one large market maker specializing in utility stocks states that, in the 1920's, it continued to trade over-the-counter the stocks of companies in which it was interested after their listing on an exchange. Another large diversified market maker embarked upon the trading of listed stocks to meet the expanding needs of institutional customers which it had formerly served only in the field of bonds. The real growth of the third market has taken place in the last 20 years, and, as indicated above, 14 of the 17 firms actively making markets in 1962 had entered the field since 1950.

The discussion of securities and size of transactions above has indicated the substantial differences among the market makers which persist in many areas of their structure and operation. The firms range from several of modest financial resources to some of the largest in the securities business. There is a similar span in the relative im-

[151] The bank describes this additional special charge in its published fee schedule as follows: "A charge equal to the usual broker's commission will be made when we negotiate transactions in securities without employing a broker." This is apparently intended to mean that the bank will collect the special charge when it buys or sells stocks over-the-counter through broker-dealers on a principal basis, but not when the transaction is made with the broker-dealer on an agency basis. Apparently because of State law, the special charge is applied only to the bank's custodial advisory accounts, not to its trust accounts.

[152] The transaction reports of the 37 firms reporting under Questionnaire OTC–6 point to the probability that the market makers participated in approximately 97 percent of transfers from one public customer to another in 1961. Only 2 of the 37 firms did any substantial business outside the markets of the market makers, and their 1961 volume of this type was 3 percent of estimated 1961 off-board volume in NYSE stocks.

[153] One market maker reported membership on a regional exchange and an associate membership on the Amex. As stated above, NYSE members are generally prohibited from trading NYSE securities over the counter. See sec. 6.b, below, for discussion of similar rules on the Amex and regional exchanges.

portance of third market activities to other aspects of their operations. Two of the seven largest firms, specializing in markets for utility stocks, are sizable, departmentalized securities houses doing a considerable volume with institutional customers; their third market activities are heavily overshadowed by other departments. Two smaller firms also do a substantial volume in over-the-counter securities, in each case equivalent to about three-fifths of their third market volume. The other three rely much more heavily on their third market trading (table VIII-54).

An analysis of the characteristics of the market makers reveals some general patterns of orientation. The concentration by three firms on institutional business is reflected not only in the nature of their customers as reported in response to Questionnaire OTC-6 but in their emphasis upon markets in utility issues [154] and the relatively large size of their transactions. Two firms doing business mainly with broker-dealer intermediaries make markets for many of the more active issues on the Exchange and do a relatively much greater volume in the smaller transactions. Two firms appear to blend both types of business.

As indicated above, the market makers trade almost exclusively with institutions and with broker-dealers. Since institutions trade largely through skilled trading departments,[155] the market is almost exclusively a professional one.[156] Some 7.5 percent of the seven largest market makers' trading appears to be with each other (table VIII-55), but an analysis of that trading reveals no consistent patterns. There is evidence that the market makers are more interested in doing business with institutional and broker-dealer intermediary customers than with each other.

The professional character of the market is evidenced by the media employed by the market makers to merchandise their services. The approach used is designed to attract the attention of professional customers. A majority of the makers advertise their markets by maintaining bids and offers in the sheets of the NQB. Virtually all firms advertise their marketmaking by means of circulars or "trading cards," with two firms relying solely on this type of communication. Some mail only to institutions, some only to broker-dealers, some to a list including both classes of customer. Some give bids or offers subject to change, and some the range within which transactions will probably be effected.[157] Most distribute the circulars on a weekly or monthly basis, but a few do so daily.

Also in keeping with the professional character of their customers is the stress of the market makers, at least those relying most heavily on third market activities,[158] on the trading of securities and the omission of the various customer services performed by the public commission houses on the exchanges and described in chapter VI.I.2.c. The market makers appear to have no security research or investment counsel staff, sales representatives, customers' rooms or similar per-

[154] One of the firms, previously concentrating on utilities but also making markets for some oil issues, initiated markets for a large number of industrial stocks in 1963.

[155] See pt. C.4.

[156] The term "professional" is defined in ch. V.A.1 to include persons earning their livelihood directly in the securities business. It is employed here, more broadly, to encompass also those engaged in the occupation of trading securities on behalf of public customers of the securities markets.

[157] As the discussion of pricing methods in sec. 5, below, makes clear, such general indications of price appear to have little meaning.

[158] It is difficult to separate the services related to the third market performed by the larger departmentalized firms from those associated with other aspects of the business.

sonnel and facilities devoted to the merchandising of listed securities. Nor do they engage in margin financing, safekeeping of securities or many of the auxiliary service functions usually provided by stock exchange firms for customers. These market makers thus tend to correspond to the purely wholesale firms in the over-the-counter market generally, although the bulk of their dollar volume is "retail" business with institutions which are the public customers, as distinguished from "wholesale" business with other broker-dealers or banks representing public customers.

The importance to the market makers of the prices and quotations on the NYSE is shown by their communications channels. All the larger market makers subscribe to the NYSE ticker service. Each also has direct wire connections to NYSE member firms, the number of such connections ranging from 15 to 141 for the 7 largest firms,[159] with the cost apparently being generally shared by market maker and member firm. These wires are used to transact business on the Exchange, but are also employed to obtain the current NYSE quotations, via a member firm. The market makers also possess the elaborate communications networks employed by the wholesale over-the-counter dealers generally as described in chapter VII, linking them to each other and, in some cases, to their customers. The largest market makers operate branch offices, and the others have strategically located correspondents to facilitate communication by potential customers at minimum expense.

As indicated above, the market makers engage in some agency transactions, but 93.3 percent of the volume of the seven largest in 1961 was for their own account as principals, such dealing being the essence of their market making activities (table VIII–56). The emphasis on principal trades establishes the capital resources of each market maker as an important element of its capacity to function. Though not the subject of specific inquiry by the Special Study, and despite the variation among firms, the evidence is that these resources tend to be substantial. As stated above, several of the seven market makers rank among the large firms in the securities business. One holds itself out as ready to buy or sell 1,000-share blocks in many issues. For the 3 base weeks reported on by the 7 largest market makers under Questionnaire OTC–6, 21.7 percent of the share volume was in principal transactions of 2,000 shares or larger, many in stocks priced higher than the average share price of $60 paid by institutions on January 18, 1962.

It was also possible to obtain some insight into both the financial capacity and the method of operation of the market makers by comparing their daily dollar volume in securities in which they made markets in 1961 with their trading inventories in the same securities as reported to the Commission in the annual broker-dealer reports for 1961 (table VIII–57). Fluctuations in size and value of inventory limit the usefulness of such one-time statements of inventory. Furthermore, the statements report actual inventory positions on a particular date and not capital or ability to take a larger position as required. Subject to these important limitations, the data reveal a broad range of dollar inventories as well as a considerable

[159] Of this latter total, 80 were employed in whole or part in connection with third market business.

variation in ratio of inventory to trading volume, ranging from one firm whose inventory was only 1.3 times its average daily sales to another whose inventory represented 12.5 times such sales.

The returns by the seven market makers of Questionnaire OTC–6 also permitted an examination of inventory patterns in a limited number of stocks at the end of the 3 base weeks in relation to average daily volume of trading in the same stocks. It reveals notable disparities in position taken by each market maker in each security and for the same security at different times. Thus, to cite an extreme example, one firm had a long position of 45,711 shares in one stock on one of the inventory dates, and virtually no position on the other two. The ratios of inventories to sales of specific stocks reported under Questionnaire OTC–6 generally tended to be considerably lower than the firms' equivalent ratios for total inventories and sales. The difference seems to be due to the questionnaire's request for information concerning the most actively traded stocks, while the market makers are apparently compelled to maintain their largest inventories in the less active issues.

The market makers' willingness and ability to take a large position, long or short, is discussed below in connection with the mechanics of market operation. At this point, it is enough to say that the substantial overall positions of most of the market makers are apparently maintained in relatively low average inventories distributed among all the stocks in which they make markets, and that these are capable of sharp increase to handle large-sized transactions, purchases or sales, as the situation requires.[160] One market maker testified that it "could be long a very small amount or * * * could be long 10,000 or 15,000 shares."

Nor is lack of inventory a bar to a sale. The market makers sell short—

> when customers wish to purchase in the offering side of our market and we have an insufficient number of shares on hand to fill all, or part of the order.

Inventories include substantial short as well as long positions.[161] Despite the general variation in securities positions among market makers, at times most or all firms making a market in the same stock may be short in it (table VIII–58). The market makers do not determine whether customers' sales to them are short, but generally asserted the opinion that their customers seldom sell short on the third market.[162]

5. OPERATION OF THE MARKET

It may be stated as a general rule that the price of a stock on the third market rarely deviates from the price obtainable on the NYSE by more than the Exchange commission. While the off-board price is thus related to that of the NYSE, the connection normally is not, with the single exception of odd lots discussed below, an automatic or mechanical one. The market makers have developed a wide variety of pricing and trading practices to govern the operation of their

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[160] The relatively lesser need for such flexibility in the case of the two firms catering to (nonmarket maker) broker-dealers is reflected by their lower turnover ratios.

[161] Long and short positions have been aggregated to arrive at total inventory for purposes of the discussion in this part.

[162] There was said to be no evidence of short sales by institutions, while broker-dealer intermediaries and their customers sell short on this market only infrequently.

markets. They will be examined in this section, particularly from the reference point of a comparison with practices on the NYSE.

The responses of the market makers to Questionnaire OTC-6 revealed perhaps a more consistent approach, in theory, to the problem of pricing than most other aspects of their business. One large diversified market maker described his pricing method as follows:

> The pricing of a stock or making of a market at any given moment involves a combination of factors. Those factors include the firm's current inventory position, the trader's attitude toward the market, the nature of the inquiry, and other inquiries received in that specific security. After all those considerations, there must be added the desire and the willingness to be competitive. Normally, we try to maintain a ⅜- or ½-point spread between bid and offer price with a minimum of 100 shares bid and offered. In the process of being competitive the following factors are considered:
>
> The last public transaction price as reported on the NYSE ticker tape.
>
> The bid and asked quotations as provided by the facilities of the NYSE.
>
> The off-board market being made in competition to our market.

Another firm, specializing in markets for utilities, added other relevant considerations:

> Any one or any combination of the following would have a bearing on the pricing of listed securities:
>
> 1. Last sale on the New York Stock Exchange.
> 2. Current bid and asked quotations.
> 3. Range for the day.
> 4. Size of the block may make it desirable for the buyer and seller to agree mutually upon price.
> 5. Our judgment as to the relative value of the security involved.

Still another firm, a diversified market maker, cited specific examples of its pricing policy:

> We deal in stocks selling below 30 with a total spread of ¼ of a point; e.g., 24⅞ bid—offered at 25⅛. On stocks selling between 30 and 100 a spread of ½ of a point; e.g., 89¾ bid—offered at 90¼.
>
> Eastman Kodak—¾-point spread; e.g., 99¾ bid—offered at 100½.
>
> Du Pont de Nemours—1-point spread; e.g., 199 bid—offered at 200.
>
> IBM—2-point spread; e.g., 399 bid—offered at 401. We purchase blocks of stock from professional sellers at prices which are arrived at by negotiation.

Since it appeared that this firm generally "straddles" the last price on the NYSE, the previous sale on the Exchange in its first example given above might well have been at 25. The market makers do not, however, uniformly straddle the Exchange price. An officer of one of the firms, stressing the competitive nature of the market, testified to the Special Study that the market made—

> * * * depends on your feeling in the market for one thing, your position for another thing. But normally * * * one side of our market has to be in line with the board or else we are not going to be competitive. In other words, on the board Telephone [might be offered] at 123. My market might be 123 to a half if I was a better buyer than a seller. Or vice versa, I could make the market at 122½–3, if I were selling.

The combination of a realistically narrow spread between the quotes and a balanced straddle, in which the last price on the Exchange falls halfway between the market maker's quotations, appears to be the type of quotation most likely to produce a maximum volume of balanced trading activity. A market maker able to draw the same interest on both sides of the market by quotes equally attractive to both buyers and sellers would theoretically realize a gross trading margin equal to the spread between his quotes without affecting his position in

the stock. The hypothetical situation in Telephone in the testimony quoted above represents a quotation of interest only to one side of the market. A quotation presumably cannot deviate from the price available on the NYSE by more than the amount of the Exchange commission; a greater deviation would tend to shunt the business, if not to a competitior, then to the Exchange.

The off-board market available to a customer is, of course, the combination of the best bid and best offer in all markets for the stock being made by competing market makers at the time of inquiry. It corresponds to the wholesale or inside market in the over-the-counter markets generally.[163] In the example cited above, three firms might quote Telephone as 122½–123¼, 122–123, and 122¼–122¾. The high bid of 122½ and the low offer of 122¾ would then constitute the best market at that moment. The off-board volume would be expected to gravitate to the two firms making these quotes, sales to one and purchases to the other, so that the third would be compelled to adjust one or both of its quotes to become competitive.

While pricing principles are basically the same for all types of trading on the third market, there are important differences between the application of these principles to the trading of broker-dealer intermediaries, generally in odd lots and small round-lot transactions, and the direct dealing of institutions, generally in the larger transactions. It must be understood of course, that any hard distinction is an oversimplification: institutions also deal in odd lots and smaller round-lot transactions on the third market, and individuals may occasionally trade in large-sized orders through broker-dealer intermediaries. But the difference is essentially a valid one, and the market mechanics have been fashioned to meet the needs of each type of transaction and customer. Consideration is given first to the smaller transactions, which involve the simplest form of utilization of the market, before taking up the more complex factors involved in the larger transactions.

a. Odd lots

The pricing of odd lots, which have been shown to constitute a surprisingly large portion of the share volume of the third market, is comparable to the practice on the NYSE. As described in chapter VI.E, market orders for odd lots on the Exchange are priced at the next round-lot price *following* receipt of the odd-lot order on the floor of the Exchange, plus or minus the odd-lot differential of ⅛ point on shares priced up to $40 and ¼ point on higher priced shares. The market maker transacting the largest volume of odd-lot business in the third market advised the study that he generally applies the same differentials but bases the odd-lot price on the *last* round-lot price on the Exchange, rather than the next price. Because of the difference in pricing the two types of transactions, an odd-lot customer may sometimes receive a better price than a round-lot customer. This seemingly incongruous result occurs when the market maker is quoting a regular round-lot market that is further away from the last Exchange price than the amount of the odd-lot differential. To avoid confusion resulting from this difference in basis for quotation, this market maker may identify its quotes to prospective customers as "round-lot quotes."

[163] See discussion of wholesale markets in ch. VII.C.

Another large market maker makes no distinction between round-lot and odd-lot prices, using the same quotes for both. The spread between his quotes, which straddle the previous Exchange price, results in an odd-lot price that also tends to approximate the last round-lot price on the Exchange plus or minus the Exchange odd-lot differential. The remaining firms seem to reach roughly the same result.[164]

b. Smaller round-lot transactions

While there is a notable difference between third-market pricing practices for smaller and larger round-lot transactions, the terms are relative and the dividing line is fluid. But there is no need to draw a quantitative distinction. This subsection considers trading in round lots where depth of market is not significant, while the following subsection takes up transactions in which it is important.

Absent depth of market as a factor, price becomes the only important area left for competition in the market makers with each other and with the principal exchange. Here, as indicated above, they seek to be competitive on both sides of the market and, in any event, to do business, must be competitive on at least one side.[165] The market makers are dealing with professionals possessing access to the latest and best price information and who are usually aware not only of the last Exchange price and current quotations but also of the quotations of other market makers dealing in the same stock.

The evidence is that this information is used. The returns to Questionnaire OTC–6 showed that the broker-dealer intermediaries generally do business with a number of market makers in stocks which have multiple markets. One of the largest of these firms visited by the Special Study had direct telephone lines to three market makers and stated that it consistently "shopped" all firms making markets in a particular stock in order to get the best execution. From the other side of the market, one of the large market makers advised the study that, aside from calls regarding odd lots—which generally resulted in orders—at least half of all inquiries for round-lot quotes did not result in trades but represented the inquiries of customers shopping for the best price.

Nor are the trades necessarily completed on the third market. The returns of Questionnaire OTC–6 and interviews with broker-dealer intermediaries reveal that a substantial portion of their business in listed stocks is transacted on the NYSE. They trade there when none of the market makers is quoting a market competitive with the exchange.[166]

While the third market is a "shopping" market, there is obviously less room for negotiation in the smaller transactions than in the larger ones. The market makers prefer, of course, to trade at their quotations; negotiation away from the quotes can only shave their spread.[167] At the same time, however, they are eager to do business where feasible

[164] The Special Study did not secure detailed information on odd-lot pricing from the other market makers, and this generalization is based on the transaction reports to Questionnaire OTC–6.

[165] The market maker will generally advise its customer that it "is not making a good market" if an inquiry is directed to the side of the market in which it is not competitive.

[166] In such cases, of course, the broker-dealer, not being a member of the Exchange, must pay the full public commission.

[167] Where the customer does not accept the market maker's quotes but chooses to negotiate, the market maker is relieved of the obligation of dealing at his quotes.

and do engage in limited negotiations, even in small round-lot transactions, to make a deal. Thus, where the market maker is quoting 29¾–30⅛, a buyer will normally have to pay 30⅛. But if, at the time of inquiry, the highest price on the Exchange for the day has been 30, the market maker may agree to the lower price.[168]

Negotiations may take other forms. A broker-dealer intermediary may hold an order to buy 100 shares at 49 when the market maker is quoting 48¾–49¼. The market maker may, if he is interested in closing a trade, shave his quote to 49⅛ and attempt to trade on this basis, though such shaving appears rare in the smaller transactions. He is more likely to offer to sell at 49 "plus a quarter." Such a price enables the broker-dealer intermediary to confirm to his public customer at 49 plus commission, thereby filling the order at the customer's price but with the sacrifice of one-quarter of a point from his commission.

Important to an understanding of trading in the smaller round-lot transaction on the third market is an awareness of the different bases upon which institutions and broker-dealer intermediaries trade with the market maker. The institution trades directly for its own account as principal. This means that it is generally interested only in the comparative net cost or proceeds of the transaction, the price paid or received on the third market, net of commissions, versus the price paid or received on the Exchange, plus or minus commissions. Thus, the institution may find it worthwhile to trade off board where the price is inferior to the price on the Exchange but better than the total of price and Exchange commission.

But the broker-dealer or bank dealing as agent represents a public customer and must therefore also take into account the effect of the commission charge (or markup) on the customer's final cost. If the off-board price is inferior to the price realizable on the Exchange, and if the intermediary adds a commission or service charge equal to the Exchange minimum commission, the public customer may pay a higher total price (or receive lesser proceeds) off board than if the transaction had been handled on the Exchange through a member. The broker-dealer is generally not presented, of course, with any clear-cut selection of executions on the two markets. The off-board quotes tend to be competitive with those of the Exchange. Further, execution of an order by a market maker is immediate and definite, while the price on a market order transmitted to the Exchange cannot be known until after its execution, often at a price other than either the quotes or the previous price. But it is obvious that in weighing prices on the two markets, the broker-dealer concerned with the ultimate cost of the transaction to his customer and charging the Exchange commission does not enjoy the margin of that commission which is available to the institutional public customer dealing directly with the market maker.

c. Large round-lot transactions

The large-sized transactions, involving the market's depth, presumably constitute the type of trade for which the third market originally came into being. And while the smaller transactions discussed above have become increasingly important as this market has expanded

[168] See discussion of order "with an adjustment" in pt. E.4.d(1) below.

its business with broker-dealer intermediaries, the relatively larger block transactions [169] of institutions continue to provide the greatest part of the dollar value of trading on the third market. For this reason in addition to the added dimension of depth of market involved in such transactions, they present the most important and intricate aspects of pricing and trading mechanics on the third market.

The trading follows many different patterns and variations, all apparently subject to certain general underlying principles.[170] An institution initiating a large block purchase places a telephone call to the market maker. The institutional trader may merely ask for the quotes, without revealing the "side" (buyer or seller) or "size" (amount) of his interest; he may indicate the side and not the size; he may show both. The market maker's answer often depends on the information given him by his customer. He may state only the quotes; i.e., the bid and asked prices, and wait for an indication of the customer's interest as buyer or seller, or he may quote and give the size of his market at the same time, as; e.g., "48¾–49¼. We are 500 by 1,000," thereby indicating a bid of 500 shares at 48¾ and an offer of 1,000 shares at 49¼. The institution may accept the offer, or express no interest at this price, or attempt to purchase at a lower price. The parties often bargain at this juncture, the buyer claiming a weak market on the Exchange, a lower price being charged by other market makers, or a variety of other considerations to justify a lower price, while the market maker replies in kind. Each party seeks to make the best trade possible; if they agree, the transaction is closed.

An institution interested in more stock than the quantity offered by the market maker may show its interest either generally or by a precise statement of size. The market maker must then evaluate the net effect of the relevant pricing considerations discussed above as applied to this specific situation. He is not limited by lack of inventory, and may sell short to fill all or part of the demand. The decision often depends on the information divulged by the customer. If shown only a general buying interest, the market maker must guess whether or not the order is the begininng or the "cleanup" of a larger transaction—the difference being significant to his assumption of risk. Thus, he may sell short to help clean up a small order but not to fill the opening orders of a larger buying program, which may also be effected on the Exchange and tend to drive up the price there.

But much as the market maker may desire to know his customer's precise interest, a custom of the business is to ask no questions but to trade within the limits of the information supplied by the customer. The most that a market maker may ask (of a buyer) is the general question: "Do you want to see any more stock if we run into it?" Many institutions regard secrecy of plan as an important tool in securing good executions and deal in small portions of a larger program without divulging the entire program, sometimes spreading the trading over a relatively long period of time. Other institutions, more communicative, may acquaint the market maker with the gen-

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[169] The term "block" transaction is used here, as in pt. C above, to refer to a change in position resulting from a single primary investment decision. A block purchase or sale may involve a number of individual trades.

[170] Much of the following discussion on pricing and trading methods is based on the study's interviews with two of the largest market makers.

eral range of their interest. When this occurs, the market makers assert that it is an unwritten rule that they will not prejudice the customers' dealings with others by "shopping" the deal around.[171]

A market maker who knows or calculates that an institution is phasing a block transaction over a period of time will generally try to satisfy a maximum portion of the program. If the market maker has reason to think that a particular purchase may be part of a larger block, he may endeavor to locate additional sources of stock, which he may purchase and offer to the institution in the hope that it is still a buyer. A large institutional program may thus involve the market marker in a number of smaller trades over an extended period.

At times the negotiations may take a different turn, particularly when an institution involved in a block transaction is unwilling to make advance commitments and the market maker chooses not to take the risks of a principal transaction. In such cases, the market maker may seek out potential sources of the stock, which it often knows because of its continuous dealings with large investors, and secure a firm commitment before offering the stock to the institutional customer on an agency basis.[172] Such trades appear to constitute the greatest part of the agency volume transacted by the market makers in the stocks in which they make a market.[173]

A few generalizations may be made about the market maker's activities in the larger sized transactions. The larger the deal, the more negotiation is likely to be required; the greater is the deviation from the last price on the Exchange likely to be; the less likely is the market maker to make the deal for his own account and the more likely to handle it on an agency basis. On the other hand, the greater the market maker's knowledge of his customer's needs, the greater the likelihood of his assumption of the risks of a dealer transaction, and the greater his customer's expectation that the market maker will not compete with him in trading the particular stock but will "show" any stock to him (in the case of a purchase) before offering it to another customer.[174]

These generalizations are all subject to qualification to suit the varying individual policies and practices of each market maker. One market maker indicated to the Special Study that it had engaged in principal transactions for individual blocks of securities involving outlays in excess of $1 million. Another stated that it engaged in the larger transactions only on an agency basis, indicating a definite difference in trading philosophy from one of its competitors: "There trading is entirely different from ours * * *. We believe in buying something and selling it * * *. I believe they will take a heavy position in a stock and just stay with it." Yet the market makers catering to institutional business generally appear to do both: turn over their inventory rapidly and take a heavy position, as required. This ability to take a heavy position, or to negotiate a large deal on an agency

[171] Exchange specialists also testified to the study that they refrained from competing with customers who "show their hand."

[172] Exchange specialists will often act as "finders" in this kind of situation, and if a trade is consummated as a result of their efforts they will often be rewarded with floor brokerage, See ch. VI.D.6.i.

[173] As indicated above in sec. 4.b, several broker-dealers who do not make markets specialize in agency transactions of this kind.

[174] It is not intended to suggest that expectations or practices are different in these respects from those in respect of transactions effected under exchange mechanisms.

basis, undoubtedly constitutes the single attribute of the market makers most important to their institutonal customers.

Since the tape and quotes of the Exchange are so influential in the pricing policy of the market makers, it is not surprising to find that they consider institutions to be circumspect in guarding against activity on the Exchange which may prejudice their off-board operations. Thus, an institution trading a large block on both markets may normally be expected to complete as much of the transaction as possible off board before "cleaning it up" on the Exchange. A reversal of priorities can lead to the institution's own activities pushing up the price on the Exchange in the case of an accumulation of stock, or driving it down in the case of a liquidation, in either instance tending to prejudice the off-board price.[175]

The fundamental differences in character between the continuous auction market of the Exchange and the negotiated over-the-counter markets are defined generally in chapter V and are considered with respect to each market individually in chapters VI and VII, respectively. Here, in this discussion of the over-the-counter market in listed securities, it is possible to examine these differences as they may specifically affect the utilization of market by institutional customers dealing in blocks of securities and free to deal in either market.

Any such examination must avoid several dangers. One is that it not overstress the bounds of competition. Block transactions are often programed out, on a dollar-cost-averaging or equivalent basis, over a period of time, regardless of whether handled entirely on one market or the other, or both. The markets are likely to be complementary in executing the block as a whole, even though competitive for the individual trades making up the block program. In this respect, the inherent attributes of each market—the auction market of the Exchange and the negotiated off-board market—may suggest differences in method of operation. Thus, while the comparison here is made of the execution of transactions of depth on each market, the choice in any specific case may be between such a transaction on the third market and a larger number of smaller sized transactions on the Exchange. The skilled institutional trader, interested in securing the best average net price for the entire transaction, utilizes the best of each market throughout each trading situation, which is continuously changing to reflect the impact of a variety of forces.

Comparison of the markets is also not to be construed as intimating an equal capability for handling of all block transactions. The great preponderance of institutional trading in NYSE stocks takes place on the Exchange and only some 10 percent on the third market. The limited purpose here is to consider why any of it is handled away from the Exchange. For purposes of that consideration, attention is focused upon the regular trading of the auction market of the Exchange and not upon crosses of stock or any of the Exchange's special plans for execution of orders considered too large for execution on the regular auction market within a reasonable time.

An essential difference between the two markets is reflected in the two functions of the specialist on the Exchange: as a broker, to hold

[175] Though the transaction data supplied under Questionnaire IN-4 generally reveal a pattern supporting the opinions of the market makers on this point, they also show that institutional investors sometimes use both markets simultaneously and occasionally even trade on the Exchange before going to the third market.

and execute orders for the public and as a dealer, to make a market and trade for his own account. The trading of others, whether the public or other members of the Exchange, constitutes, of course, the added dimensions of the Exchange market not available to the market maker on the third market.[176] The specialist possesses the intimate knowledge of the market made possible by his book and his central position in the trading of the stock on the floor of the Exchange, while the over-the-counter market maker looks to the Exchange's tape and quotations as a basis for his own trading. The specialist, however, is subject to certain restrictions in permissible trading activity stemming from the regulation of the conflict between his agency and dealer functions: he must give due regard to intervening orders from others and to his fiduciary obligations to members of the public whose orders he holds as agent or subagent. The market maker on the third market, dealing for his own account, is free of such limitations.

The differences in market structure account for differences in mechanics of trading. Institutions can, and in most instances do, deal directly with the market makers on the third market. While they also possess the right, at least theoretically, to communicate directly with the specialists on the Exchange, many specialists will not deal this way, and most institutions, whether for this reason or otherwise, do not deal directly with specialists but trade through another member.[177] The significant difference is that in one case the institution, which often possesses a skilled trading department, deals directly with the market makers; in the other, it negotiates through an intermediary.

An institution's dealings with the specialist may also be influenced by awareness of his power to influence prices of all markets. Failure to make a deal with a market maker over the counter presumably does not prejudice the institution's opportunity to deal advantageously elsewhere. The specialist, however, occupies a key position affecting all markets on which the security is traded. His knowledge of large interest on either side of the market, evidenced by a substantial order overhanging the market or by continuous dealing by a single broker or even a group of brokers, may in itself lead to an adjustment of quotations to anticipate the effect of that interest on the market.[178] As a consequence, there appears to be a tendency for institutions to be more secretive in their dealings on the Exchange than on the off-board market. One NYSE specialist responded to a question concerning the difficulty of getting a firm bid on the Exchange for a large block, as follows:

> I think the problem is that the person doesn't open to you and tell you what he wants to do.

The differences in market characteristics merely provide part of the setting for the basic question of the reasons for preference, in any situation, of the over-the-counter market for the trading of listed stocks

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[176] Subject, of course, to a qualification for agency transactions in which, as a broker, he seeks to pair buyer and seller.

[177] In either case, of course, they pay the full commission rate. In ch. VI.D, it is recommended that specialists not be permitted to deal directly with public customers because of the problems which arise from the mingled broker-dealer functions of the specialist system. At present this problem does not seem to exist with respect to over-the-counter dealings in listed stocks.

[178] It should be noted that an analysis covering 3 sample weeks, though admittedly not conclusive, indicated that when specialists dealt in blocks they seemingly did so at a fair price considering the prices of transactions immediately prior and subsequent to the block trade. See ch. VI.D.6.h.