in depth. As indicated above, "price and cost" and depth of market were reported by institutions, in that order, as the prime reasons for doing business over the counter in listed stocks. It is now possible, in the light of this discussion of market mechanics, to discuss the application of these generalizations and, incidentally, to see that the two actually represent different aspects of a single factor—the institution's objective of realizing the best possible net cost or proceeds in each transaction.

(1) *The public commission schedule of the NYSE*

Institutions dealing in large blocks of stocks on the NYSE pay the same commission, computed on the dollar value of each round lot, as other public customers; they receive no adjustment or graduated discount for the number of round lots in multiple round-lot transactions. In specific terms, the commission on a single round-lot trade in a $40 stock is $39, and on a 10,000-share transaction it is $3,900. In contrast, institutional customers generally deal as principals on the third market and pay (or receive) a price net of commission fixed by a market maker who can adjust his markup to allow for all pertinent factors.

To simplify grossly for purposes of illustration, in a 10,000-share purchase of a $40 stock, the institution's total cost on the Exchange is $403,900, $400,000 being the price of the shares and $3,900 commission. A market maker on the third market with a share cost of $40 may quote less than $403,900 on a principal basis by a markup of less than $3,900. Conceivably, with a share cost of 40⅛, or even 40¼, he can produce a total customer cost of less than the Exchange total by settling for a lower markup.

This effect of the commission schedule was described in the testimony to the Special Study of an NYSE specialist. The response to a question as to why a sale might be handled over the counter was:

> He (i.e., the public customer) thinks he is saving the commission and trades net and gets a better price. He will ask you (i.e., the specialist) and you will say it is 40 bid for 300, and then he will sell it to the over-the-counter fellow at 39¾, and, in the big board he will only get 39⅝, because the commission would be three-eighths.

Though the commission rates on the Exchange approximate 1 percent at the level of shares priced at $40,[179] the area available for the operation of the market maker's flexible markup policy is at least double this size. The broader latitude results from the fact that the minimum total public cost of an exchange transaction is the sum of the commissions paid by buyer and seller.[180] The comparable cost on the third market is the spread realized by the market maker on his purchase and sale of the stock. Thus, if a stock is quoted at 39⅞–40⅛ on the Exchange, the net proceeds, after commissions, to a seller would be 39½ and the net cost to a purchaser 40½ (commission costs being rounded to three-eighths in each case). In this illustration, the 1-point net spread, representing the cost of transferring the shares from one public customer to another, is the market available for the

[179] The commission ranges from a higher percentage at lower price levels to a lower percentage for the higher priced shares. See ch. VI.I.2.
[180] The cost is greater if the specialist realizes a spread in transactions for his own account. See ch. VI.D.6.c.

market maker's negotiation of prices.[181] He may quote the seller 39¾ and the buyer 40¼ so that each realizes a quarter of a point more, net, than on the Exchange even while the market maker earns a gross spread of half point.

(2) *Depth of market*

Depth of market has been discussed and defined [182] at various points throughout this report. As used here in the particular context of negotiating transactions of depth, the term refers to the quantity of buying or selling interest in a stock at particular price levels.

Its relevance to institutions dealing in blocks is obvious. Assume a situation in which the institution wishes to buy 10,000 shares of a stock within a range of 40–42 when the last price on the Exchange was 40 and the current quotations there are 39¾–40¼. These quotes on their face mean no more than that, at the moment of the quotation, the first purchaser at the market can buy 100 shares at 40¼. The institution's broker can determine from the specialist the number of shares available at 40¼ but not the size of the market away from the quotes; i.e., the number of shares offered at 40⅜, 40½ and so on. He may often obtain a "cleanup" bid (or offer) from the specialist covering all or part of the order. As pointed out, however, in chapter VI.D, there is considerable variation in the willingness and ability of specialists to submit competitive quotations.

If the institution either does not wish to, or cannot, obtain a cleanup price, it must estimate the amount of stock likely to be offered on the Exchange at each price level. There are several sources: orders already on the specialist's books, new orders from the public or members, and the specialist's sales for his own account. The depth of a stock's market is obviously a unique characteristic, varying for each stock and constantly changing for the same stock. The market for one stock may be able to absorb, in the case of a sale, several thousand shares without driving down the price, while the price of another may drop appreciably on the sale of a few hundred shares. Experienced traders are able to make close estimates of the likely depth of an Exchange market, but they never know definitely. A vital element is the extent of the specialist's participation.[183] In the example given, he may supply part or all of the institution's order at the offering price of 40¼ or some higher figure. It is in this decision that his willingness to deal and resources became important. And it is at this point, after his fiduciary obligations as agent have been satisfied, that the specialist functions in the same way as a market maker in the over-the-counter market.[184]

In the final analysis, then, selection of the market or allocation of an order between the two may well depend, in any specific situation, upon the relative ability and willingness to deal of the specialist and the market maker. These attributes vary for individual units of each group, and even for the same units at different times. It is not the purpose of the Special Study to compare the two markets on this

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[181] This assumes a situation of simultaneous purchase and sale in which the market maker does not change his inventory position.

[182] See ch. V.B.4.

[183] For general discussion of the role of the specialist in handling large transactions on the exchange, see ch. VI.D.6.h.

[184] The specialist also operates, of course, under certain restraints governing the impact of his trading on the market.

level[185] but rather to point out what may often be the crucial factor in an institution's selection of a market for the trading of blocks of securities.

Its determination thus requires, first, an evaluation not only of all the factors making up the price situation of a stock on the Exchange at any time but, also, of the likely depth of its market, whether provided by the public, Exchange members or the specialist functioning as a market maker. It then compares this estimated price adjusted for commission cost, with the net price it can secure by direct negotiation with the off-board market makers. The result, depending on the particular facts of each case, is a decision to trade—if it decides to go forward at all—in either market or both. In each case its objective is normally to secure the best possible net price.

This discussion of some of the considerations which appear to underlie the designation by institutional investors of price and cost, and depth of market, as influencing their use of the third market necessarily has focused attention on regular-way executions on the auction market of the Exchange. It must be remembered, of course, that institutions also employ the Exchange's special plans discussed in part C.2.a(3), though these are generally instituted for the distribution of stock and not its accumulation. They also participate in prearranged crosses on the floor of the Exchange, discussed in part C.2.a(2), which correspond to the off-board agency transactions of the market makers as well as of broker-dealers not making markets. Here, too, the effect of the commission schedule is significant. A cross on the floor of the Exchange involves the payment of two full commissions, one by the seller and one by the purchaser, while the commissions charged in an agency transaction on the third market are negotiable, with the NYSE minimum generally constituting the ceiling. Often only a single commission, less than the Exchange commission, is charged.[186]

6. RELATIONSHIP WITH THE EXCHANGE MARKETS

The preceding portions of this part have already described certain aspects of the relationship of the over-the-counter market in listed securities to the exchange markets. In addition to these aspects and the general questions of depth of market and competition discussed below in section 7, there are several specific areas in which the markets impinge upon each other.

a. *Trading by the market makers on the exchanges*

Broker-dealers active on the third market may also, trade, of course, the same stocks on the exchanges. The market makers report utilization of the exchanges "to offset inventory positions resulting from over-the-counter business," "investment purposes," and in several instances, "customers' instructions." One of the largest market makers estimates that 30 percent of his exchange trading results from invitations to participate in crosses of stock on the NYSE and that his business of this kind is growing steadily each year.[187] Broker-dealer inter-

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[185] The specialist's resources and positions are discussed in ch. VI.D.4.c. For a discussion of the resources and positions of the market makers, see sec. 3.b above.

[186] See sec. 4.b, above.

[187] Despite the full commission paid on such transactions, the price is low enough so that the firm's cost after commissions is said to be substantially better than the previous tape price. For price action in this situation generally, see ch. VI.D.

mediaries generally cited "customers' instructions" and "to obtain a better execution for the customer" as their reasons for trading on the exchanges.

The seven largest market makers transacted on the exchanges a volume equal to an average of 4.8 percent of their off-board volume in the same stocks during the 3 base weeks of Questionnaire OTC-6. For six firms the portion ranged from 2.2 to 7.9 percent, while for the seventh it was 14.6 percent (table VIII-59). The transactions tend to be large in size, several being in 1,000-share lots, with a preponderance on the buy side. No other general pattern is discernible.

b. Exchange members in the over-the-counter market

The general NYSE prohibition against over-the-counter dealing by its members in listed securities [188] is followed with varying degrees of strictness by the other exchanges. The Midwest Exchange, for example, prohibits trading in—

> * * * issues admitted to dealings in the exchange off the floor of the exchange unless permission shall be requested in writing and obtained from the President. * * * [189]

The Pacific Coast Exchange varies this policy by distinguishing between agency and principal transaction. In the former, its members may go off board only under specific conditions, and then after receiving permission from a governor of the Exchange and member of the Floor Trading Committee.[190] Where members are trading as principals, however, this Exchange appears to have a more liberal provision than the others. It permits members to deal off board under specified conditions without prior approval. Members of this Exchange who are also members of the NYSE (i.e., dual members) are prohibited from such off-board trading by NYSE rules. But sole members of the Pacific Exchange, free of such restriction, have apparently availed themselves of the opportunity to do business off board with the market makers. The incentive is the same, of course, as that of broker-dealer intermediaries discussed in section 4.b above: to avoid payment of the NYSE public commission rates.[191]

c. The late tape

The importance of the NYSE tape to the off-board market makers has already been indicated. One market maker attributed his decision to cease trading industrial stocks and to concentrate on the more stable utilities at least in part to the fact that "when you ran into a late tape, we found that you could be hurt pretty badly," presumably by persons taking advantage of superior knowledge of prices on the floor of the exchange.

On the other hand, two of the larger market makers advised the study that the late tape of May 28, 1962, did not inhibit their market-making activities. One stated that despite this handicap, his quotes in American Telephone & Telegraph never exceeded a one-point spread throughout the day. The firms apparently relied on the so-called

[188] NYSE constitution, art. XIV, sec. 8, rule 394.
[189] Midwest Stock Exchange constitution and rules, art. XXII, rule 6. The rules also provide for an "unrestricted" list which is equivalent to the NYSE exempt list.
[190] Pacific Coast Stock Exchange, rule XIII.
[191] Compare the so-called "arbitrage" practice described in ch. VI.I.2.a(1), a device designed to permit regional specialists who were sole members to deal on the NYSE without paying the full commission.

"flash" quotes of the NYSE, which ran only slightly behind transactions, and on such information as it was possible to obtain from the floor of the exchange through a member firm. In addition, at least one firm transacts business both before the opening and after the close of the Exchange so that a portion of its trading is independent of the Exchange tape and quotes.[192]

d. Use of the exchanges to effect transactions over the counter

The widespread practice whereby open-end investment companies direct give-ups of brokerage commissions to broker-dealers selling their shares, which is discussed in chapter VI.I.2.b(2) and chapter XI.C, is responsible for what is perhaps the strangest relationship between the off-board and exchange markets.

Though give-ups are common in connection with exchange transactions, the principal market makers report no participation in equivalent practices on the third market.[193] The reason seems clear: the minimum commission on the exchange is fixed and the commission cost is the same to the investment company whether the executing broker retains the entire amount or pays a portion to another broker in accordance with the company's directions. Since there is no fixed markup or commission scale on the third market, direction by an investment company to a market maker to give up a part of his markup or commission would increase the cost of the transaction to the fund and thereby constitute a violation of the investment manager's duty to the fund shareholders to execute on the best available basis.

As a consequence of this difference, one broker, who had developed a substantial business of negotiating sizable transactions in listed securities over the counter but found that the over-the-counter market did not provide sufficient flexibility for effecting reciprocal arrangements, became a member of the Detroit Stock Exchange so that, for stocks dually traded on that exchange, he could accomplish a reciprocity purpose through such membership. His circulars to the trade announce, "40% Commission Allowable to Members of the NASD," and it appears that transactions which might otherwise be effected off board presumably, at less cost than the two commissions charged on the Exchange, are crossed on the floor of the Detroit exchange in order to effectuate give-ups.[194] The use of such channels to facilitate give-ups, if leading to higher execution costs, would appear to violate the fund manager's duty to execute at the best available price.

7. THE ROLE OF THE THIRD MARKET

From the point of view of the exchange market—for this purpose primarily the NYSE—an over-the-counter market in any of its listed securities must be considered a form of multiple trading; that is, it is a competitive market, and, insofar as it involves trading that would otherwise take place under the continuous auction process of the primary market, it affects that market's depth. Since a single market implies greater concentration of depth, whereas multiple markets

[192] A large part of the business before the opening of the NYSE is, however, pegged to the opening price there.

[193] Two of the broker-dealer intermediaries reported, however, that they had given up commissions in off-board transactions.

[194] The Detroit exchange extends a discount in commission rates to all NASD members and apparently permits the give-up on the same basis. Under its rules, the member must place the transaction on the exchange unless he secures permission to trade off board.

suggest greatest possibility of competition, the question of multiple trading in listed securities—whether over the counter or on another exchange—inevitably demands appraisal of the impact of the off-board market on the exchange market on both scales.

a. Effect on depth of primary market

Of the full group of 270 NYSE common stocks for which off-board markets were made in 1961, the off-board sales of 119, or 44 percent, were only 2.5 percent or less of sales on the Exchange (table VIII–60). Off-board sales of the 50 NYSE stocks with largest off-board sales in 1961, however, averaged 6.4 percent of sales on the Exchange (table VIII–80), and such sales of 43 of the total list of 270 stocks amounted to more than 10 percent of sales on the Exchange. But whether this volume would have been transacted on the Exchange or whether the diversion actually affected the operation of its continuous auction market requires the assessment of a number of factors:

(1) As pointed out above, most of the stocks traded on the third market enjoy substantial activity on the NYSE. Two hundred and seven of the 270 stocks for which markets were made in 1961, or 77 percent, traded over 600,000 shares on the Exchange in that year. Any diversion of trading in stocks of such activity, which is equal to a minimum average daily volume of 2,400 shares, would appear to be less serious than for the more inactive stocks. Actually, the diversion constituted by off-board volume in these stocks tends to be relatively low, and exceeded 10 percent of Exchange volume in the case of only 21 of the 207 stocks.

But even these figures are subject to further analysis which tends to minimize the effects of any diversion. Weight must be given to changes in volume of trading over a period of time. Though the percentage of off-board trading relative to NYSE volume has increased, the substantial growth in Exchange volume over the last 15 years points to the likelihood that the Exchange volume in the stocks traded on the two markets is substantially greater today than it was before trading on the third market reached present levels. It is also important to study volume trends for individual stocks traded on the third market. The Exchange's share volume in the stocks traded by one of the largest market makers increased 16.5 percent from 1961 to 1962 in the face of a substantial growth in the market maker's volume and a 5.8-percent decline in the Exchange's total share volume.[195]

(2) There is no way of determining, of course, the portion of third market volume in listed stocks that would be transacted on the exchanges in the absence of an off-board market. Probably a large part if not all, of the institutional volume would reach the NYSE if it were the sole market for the trading of its stocks. But at least some portion of the volume contributed by the broker-dealer intermediaries simply might not be transacted in listed stocks at all. Such broker-dealers are not likely to recommend the trading of securities on which they cannot, because of the public commission schedule of the Exchange, earn a commission.[196] Some portion of their volume may

[195] A possible explanation appears to be that the market break of May 1962 affected the volume of trading in stocks favored by institutions and featured on the third market much less than the trading in "popular favorites."

[196] They are disabled, as a practical matter, from charging a commission or markup in addition to the Exchange commission. As pointed out in ch. VI.I, however, these broker-dealers often receive some return on their business in listed stocks via reciprocal arrangements with Exchange members.

therefore be considered an addition to the total trading of listed stocks rather than a diversion from the primary market.

(3) An unqualified comparison of volume of trading on the two markets necessarily fails to take into account the trading by the market makers on the exchanges. As indicated above, this amounted to 4.8 percent of their trading in Exchange stocks during the base weeks of Questionnaire OTC–6, a figure substantial enough to warrant an adjustment in any comparison of relative volumes.

(4) Finally, and perhaps most importantly, the third market, whatever its effect on the depth of the primary market, provides the public customer with overall markets of greater depth. The institutional customer with an order too large to be transacted on the auction market without effect on price and too large to be handled in its entirety by the specialist, can, and often does, trade with the market makers. It thereby derives the benefit of their resources as well as those of the specialist. In this respect, the market makers function as quasi-specialists or auxiliary specialists [197] and add depth to the markets available to the institutional trader. As indicated above, the off-board market may be viewed as competitive from the perspective of the NYSE, but from the reference point of the institutional customer, who is able to utilize the combined resources of both markets, it is complementary.

A cognate consideration in the trading of the larger sized transactions is the capacity of the off-board market to absorb them. The relatively large size of institutional transactions in the third market has already been pointed out.[198] If such transactions were not divided into a number of smaller trades and spread on the auction market of the Exchange over a period of time—a pattern which might not always fit into the trading plans of the public customer—they might tend to produce a temporary imbalance of demand and supply rather than contribute to the balance, and the removal of such transactions from the auction market might therefore be regarded as enhancing rather than impairing depth. Indeed, the major exchanges themselves, as well as the Commission, have recognized the need for special plans to handle large transactions, and the larger over-the-counter transactions may be considered as competing more with these plans than with the regular auction markets.

b. Function as a competitive market

The aspects of the third market's operation which are competitive to the exchanges have been indicated, in part, throughout much of the previous discussion. Nor has the Exchange been unaware of this competition. A 1953 committee, whose recommendations are discussed in chapter VI.I, concluded an analysis of the rate structure with the observation that—

> A rate structure which did not consider the competition could result in a loss of business to NYSE members.

While this comment merely implies the existence of an off-board market, a 1955 subcommittee specifically studied "the competitive position of members of the Exchange as compared with nonmembers * * *." It reported a study by consulting engineers of trading

[197] Cf., ch. VI.F.5.
[198] See sec. 3.c, above.

both on and off the Exchange, noting that trading effected by nonmembers of the Exchange "* * * was apparently not large in relationship to total Exchange transactions—best statistical approximations reflecting a relatively small percentage." More recently, the president of the Exchange has expressed concern over the competition of other markets, which he holds responsible for "erosion" of the Exchange's auction market.[199]

Exchange specialists, who are perhaps in most direct competition with the third market, seem to be somewhat less aware of the extent of the rivalry. One specialist testified to the study:

> I doubt that the over-the-counter competition for listed securities would be a broad one and one that would encompass those [which] have sizable amount of fluctuation.[200]

Yet, as indicated above, the competition is substantial. It takes several forms:

(1) In the important area of price paid by the public customer, the competition appears to vary with the size of the transaction and nature of the customer. There is little price competition in the smaller sized transactions effected by broker-dealer intermediaries. Odd-lot prices on the third market are approximately the same as on the NYSE. In the smaller round-lot transactions, the broker-dealer intermediaries also appear content to secure as good an execution as on the Exchange, and not to strive for a better one.

In the largest sector of third market trading—transactions involving consideration of depth or size of market, generally of institutions—comparision may be made between equally large transactions on each market, or between a large off-board transaction and smaller ones making up the same volume on the Exchange.[201] In either case, the factors constituting competition in price are approximately the same. As indicated above, the institutional trader must compare the price at the known depth of the off-board market with the price at the estimated measure of the depth of the Exchange market (or the prices at different levels), and then adjust for the Exchange commission as an ingredient not present in off-board trading.

The responses of the institutional investors to Questionnaire IN-4 quoted in chapter VI.I.2.b(4) confirm the third market's keen competition in this area. Many institutions assert a volume discount in the Exchange commission schedule as the most important need of the securities markets generally; the absence of such a discount has obviously been a major factor in stimulating the growth of off-board trading in listed stocks by institutions. Moreover, included in the cost structure underlying public rates are the costs of the various services performed by brokers for their public customers in addition to the basic brokerage function. These services, described in chapter VI.I.2.c, are of little use to many institutional investors possessing

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[199] Another specialist reflected the same attitude concerning the nature of the off-board trading, stating at one point:

"If you are talking about a Xerox stock, I will question very seriously whether you will find any dealer dealing in Xerox over the counter."

He likewise questioned whether Union Carbide was the kind of stock to be dealt in actively over the counter. Yet at the time of this testimony one firm was making a market for Xerox while two were making markets in Union Carbide.

[200] See pt. F.2, below.

[201] The latter comparison accords with the fact that institutions tend to trade larger units off board than on the Exchange.

their own advisory staffs, facilities for security safekeeping, and the like. It might be said that in this respect the market makers, who incur none of the costs involved in performing these services, compete with the Exchange by *not* performing the services and by *not* charging for them. But there is evidence that research and statistical services furnished to broker-dealers are important to some institutional customers who cite them as a reason for placing business on the Exchange.[202]

The competition appears to be keenest in utility stocks likely to be of interest mainly to institutions, where the trading is in large-sized transactions. The market makers assert that even though the Exchange may trade a greater volume than the third market, the off-board quotes in such stocks often tend to be closer, off-board prices subject to less fluctuation, and the off-board market more capable of offering or taking up transactions of size. A degree of corroboration of this view may be provided by a situation in 1961 when a floor governor of the NYSE admonished the specialist in a listed utility stock showing substantial off-board trading that "* * * to compete with the over-the-counter market they would have to close up the market"; i.e., narrow their quotations and reduce the variations between sales. "They said they would do their best to do so." [203]

(2) The off-board market allows a totally different type of competition with the NYSE by permitting professional nonmembers of the Exchange to do business in listed securities without paying the Exchange public commission. Except as reciprocal arrangements may sometimes moderate the impact of the commission rate structure in this regard, such nonmember broker-dealers may be motivated to recommend other than listed securities if they can deal in listed securities only by paying the same commission that they charge their customers. On the other hand, by dealing in the off-board market, the nonmember may have opportunity for profitable handling of customers' orders in listed stocks while charging regular commissions. Off-board trading of listed stocks, like the multiple trading on the regional exchanges discussed in part E below, thus operates to permit nonmember broker-dealers to offer their public customers a more complete line of securities than would be possible in the absence of such a market. It encourages a sharper competition among broker-dealers which should redound to the benefit of their public customers.

An interesting offshoot of this competition is its ultimate effect in some instances of generating trading volume for the exchanges. A number of broker dealers who formerly dealt in listed stocks on the third market are reported to have built up sufficient off-board volume in such stocks to warrant their joining regional exchanges and, in at least one case, the NYSE itself.

(3) In addition to the major sectors of price and market access, the third market competes with the NYSE in a number of other respects, stemming mainly from its character as a negotiated market. The market makers assert their ability to provide speedier executions, since they can close a transaction immediately while orders on the Exchange

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[202] See pt. C.4, above.

[203] It appears that because of the claimed comparative advantages of the third market in the trading of these less active stocks, institutions splitting their trading between the two markets tend to trade these issues on the third market and the more active ones on the Exchange.

must go to the floor and are subject to the impact of forces there. Apparently some investors agree with them, as indicated by the response to Questionnaire IN-4. Further, where secrecy is important, over-the-counter executions can provide a veil of obscurity. And the institutional customer interested in maintaining tight control over its trading operation can apparently do so more easily in the off-board market where it deals directly than in the Exchange market where it deals through an agent. In addition, dealers with offices outside of New York may be able to provide immunity from that State's transfer tax,[204] a significant item where other factors are equal.

8. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The past 20 years have witnessed a striking growth in the trading off the floor of the exchanges of securities listed on the exchanges, primarily those of the NYSE. The market appears to have developed to service the special needs of two groups of customers: (1) institutional investors, which are becoming increasingly larger holders and traders of common stocks, and (2) broker-dealers not members of an exchange and therefore without direct access to the trading of listed stocks. In 1961 this off-board market in listed stocks, which may be designated as the "third market," traded an estimated volume in NYSE stocks of $2 billion, equal to 3.8 percent of NYSE volume.

While considerable off-board trading occurs in agency trades, much of it by brokers not making markets, the bulk of it is handled through firms which make markets generally similar to the wholesale over-the-counter markets described in chapter VII. The firms tend to have strong financial resources, several being among the largest in the securities business, and to stress their trading function to the exclusion of other activities. Catering almost solely to the professional securities traders of institutions and to other broker-dealers, they eliminate the ancillary services rendered for their customers by exchange commission houses.

The market makers, free to make or discontinue markets in listed securities as they see fit, have been generally expanding their lists of markets. Where formerly markets were made only in utility stocks and others of equivalent stability, the aggregate markets, at least 270 in 1961 and now numbering many more, encompass a wide variety of industrial and other equities. The major criterion employed in selecting a listed issue for an over-the-counter market is its interest to potential customers; i.e., institutions and broker-dealers representing public customers, in that order. As compared with stocks in other markets, including the NYSE, these issues appear at the higher end of the spectrum in terms of financial size of issuer, number of shares outstanding, breadth of share distribution, and, for all but a number of utility issues, volume of activity in the NYSE as well.

The twofold division of customer in the off-board market is reflected in every aspect of the market's operation. Some market makers specialize in business with institutions, some with broker-dealers, and some with a combination of both. The securities traded include not only institutional favorites but many which may be considered popular primarily with individuals (trading through broker-dealers). The

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[204] This is possible for corporations maintaining transfer offices outside New York State.

range of transaction size shows a preponderance of large deals, reflecting the interest of institutions, but also a surprisingly high percent of odd lots, apparently transacted by broker-dealers for individual public customers.

Comparison of the operations of the third market and exchange market must not be construed as suggesting any equivalence in capacity to trade stocks. Though the off-board market has been growing, it is still small when compared with the NYSE's trading of its own stocks. The focus here is on the question of why even part of the trading in Exchange stocks should be effected over the counter.

The different characteristics of the negotiated off-board market and the continuous auction market of the Exchange are responsible for certain distinctions in trading practice. Institutions deal directly with the market makers on the third market and do not require the services of a broker. Their market interest and trading receive no publicity. Their transactions, which tend to be large, are not likely to affect prices on the Exchange in a way detrimental to the satisfactory completion of the remainder of a large block transaction.

The market makers closely follow the tape and quotations of the NYSE and quote prices which aim to be competitive with those of the Exchange on at least one side. Institutional customers, dealing directly with the market makers, find it advantageous to deal in the third market when the price of the stock, net of commissions, is less than the total price on the Exchange (even though slightly better than the off-board price) adjusted for commission cost. The off-board market maker is able to determine prices within the broader range permitted by the total of the commissions paid on the Exchange by both buyer and seller, since this total represents the cost of transferring shares from one public customer to another on the Exchange.

The importance of the public commission schedule of the NYSE must be emphasized. By not providing nonmember broker-dealers preferential access to trading in the exchanges, it encourages the existence of a market which will permit them to trade listed stocks profitably. It affects institutional customers in two respects: first, it provides no graduated discount for the larger transactions in which they tend to deal and, second, it is based on a cost structure which includes the cost of services other than the basic brokerage function—services often of little interest or value to an institution. The consequence of these characteristics is that the off-board market maker has considerable latitude in quoting prices to institutions net of commissions that are better than the combination of Exchange price and commission.

Depth of market, which is important to institutions in large transactions, is easily and definitely ascertainable on the third market. The market makers generally possess the capability of taking large positions. For their largest transactions they often act as agents for both parties, bringing together institutional sellers and purchasers of the same stock, generally at a commission substantially less than NYSE rates.

While the third market is competitive with the NYSE market in effecting individual trades, it is generally complementary to it in the execution of an entire block transaction. Institutional traders make optimum use of both markets, utilizing the resources of the market makers on the third market and the public trading and re-

sources of the specialist on the Exchange. Larger trades appear to be effected off board while smaller ones, being less likely to exert an effect on price, are transacted on the Exchange.

Broker-dealer intermediaries in the off-board market are far less concerned with depth of market and far more with securing a price for the stock equivalent to the price on the NYSE, net of commissions. In odd-lot trading the practice of some of the market makers appears to be to gear the price to the last round-lot price on the Exchange, plus or minus the odd-lot differential charged on the Exchange, and differs from the Exchange practice only in that the latter gears the odd-lot price to the *next* round-lot price.

There is more question concerning the equivalence of price in the round-lot transactions because the third-market price may be determined immediately upon placement of an order while the price on the Exchange cannot be known until after the execution of an order and may well vary from the quotations and the previous tape price. Since the broker-dealer intermediaries generally charge their public customers a commission, individuals do not enjoy the price margin of the institutional customers, dealing net of commissions. It appears, however, that broker-dealers "shop" competitively among the market makers, and many utilize the NYSE when they can obtain a more advantageous execution there.

As applied to over-the-counter trading in listed securities, it appears to the Special Study that the advantages of competition generally outweigh any concern over impairment of depth in the primary market. It would appear that the third market has developed in the shadow of the NYSE only by dint of its ability to perform a useful function. Unlike the unlisted stocks traded over the counter, freedom from investor safeguards[205] is not a factor in the case of the listed stocks traded off board. Broker-dealers trade on the third market because they have no other practical access to listed securities. Institutions trade on this market only when they are able to secure better executions. The very existence of this market to satisfy needs not met by the exchange market is indeed affirmation of the inherent strength and viability of a system of free markets.

The usefulness of the functions performed by the third market does not, of course, lessen the public interest in its operations, an interest which extends to all markets for the trading of securities. It is important that the off-board market for listed securities, taken both independently and in its relationship to other markets, operate to achieve the objectives of the Exchange Act. A minimum need, particularly for the informational purposes described below, is identification of the firms making off-board markets in listed securities in the same way as is recommended for the "primary market makers" in chapter VII. Transfer to market makers on the third market of any of the regulations governing the activity of the primary market makers generally, however, should depend on the applicability of these regulations to the special facts of the third market.[206]

Similarly, the inherent differences between the off-board market and the exchange markets preclude their being placed in the same

[205] See the discussion of the reporting, insider trading, and proxy requirements of the Exchange Act in ch. IX, pp. 2–7 (pt. 3).

[206] See discussion in pt. F, below, of the question of quality of execution presented by the existence of competitive markets.

mold. Regulations are not to be transferred from one to the other in the name of uniformity. At the other extreme, it would be difficult to justify differences in trading practice and operation, if any should develop, which may merely serve as loopholes in exchange regulation. For example, though there appears to be little short selling on this market at the present time, short sales by customers of the market makers should be identified. But the applicability of restrictive rules should depend, in each case, entirely on their need.

The rapid growth of the third market and its possible effect on other markets requires, at the very least, observation, understanding, and evaluation of its activities. The market is altogether too important, even apart from the strong indications that its growth has not necessarily come to an end, to be permitted to continue in relative and absolute obscurity. Because of its very direct impact on auction markets this would seem to be true of over-the-counter markets in listed securities even if it is not found appropriate to impose comparable requirements on over-the-counter markets generally. Specifically, there should be reporting of volumes and prices (including market makers' trading on the auction market), as well as of short sales by customers of the market makers, in each listed security. The focal point of such reporting would be the market makers, but the requirements should be broad enough to cover off-board trading, at least in transactions of size, taking place outside the established markets.

Stress on the present effects of off-board trading in listed stocks on the primary market and on the need for additional data concerning such trading points to the further question of the long-run consequences of current trends. The institutionalization of the bond and preferred stock markets has already led to a notable shift away from the auction market to a dealer or over-the-counter market in these securities. The concentration of off-board trading in the common stocks generally most active on the Exchange should not becloud the fact that a number of these stocks, mostly utilities, are of less than average activity on the principal exchange and therefore potential candidates to continue that shift. Maintenance of present trends toward increasing utilization of the over-the-counter market for the trading of these stocks by institutions—which appear to be more interested in these stocks than individuals—could result in the off-board market's becoming the dominant market in the trading of these stocks. The extension of such a development to a larger number of stocks could ultimately transform present patterns in the trading of common stocks.

The plotting of future trends in this area depends, of course, on a number of independent developments. More individuals own common stocks directly today than ever before, but a larger number is also constantly participating in such ownership through the medium of pension funds, insurance companies, investment companies, commercial banks, and other institutions serving as conduits between individuals and the ultimate investment of their funds.[207]

Much depends, too, on the capacity of the exchanges, primarily the NYSE, to adapt themselves to any shift in the nature of their customers and in the pattern of their trading. The various special plans of the NYSE for the handling of transactions considered unsuitable for

[207] The evidence does point, however, toward a progessively larger relative participation by institutional investors. See pt. C.1 above.

the regular auction market constitute a step in this direction but, alone, represent no final answer to the challenge. The effect of the commission schedule has been shown to be of great importance. Yet the Exchange has shown little inclination in recent years to reexamine the schedule's assumptions and to measure its adequacy in light of today's market conditions.

The challenge to the primary market represented by the third market calls for imagination and statesmanship in the interest of enhancing the usefulness of each, not for measures in the direction of destroying competitive markets. Only a withering of the needs which have given rise to the third market can justify the "elimination" of that market, as recently suggested by the NYSE's president. In the competition of markets for the trading of securities, it is surely not too much either to expect that each will put forward its strongest efforts to retain and capture the largest possible trading volume or to believe that, absent unreasonable discriminations and within the necessary bounds of investor safeguards and the public interest, the best markets will be those whose performance in that interest sanctions their claim to existence.

The Special Study concludes and recommends:

1. The rapid growth in recent years of an off-board market for the trading of listed common stocks has made this an increasingly important segment of the national securities markets. Although the stocks are listed on the exchanges, the market operates as a part of the over-the-counter markets. It thus has elements of each market but is distinguishable in important respects from both (and for this reason has been designated in this part as the "third market"). As in the case of multiple markets generally, the third market requires evaluation of the advantages of competition with reference to possible impairment of the depth of the primary market. Under existing circumstances, it appears that the over-the-counter market for listed stocks has been beneficial to investors and the public interest.

2. The study found an acute lack of data concerning the third market. Correction of this deficiency is an indispensable prerequisite to understanding and evaluating this market. As a basis for the gathering of essential information concerning the off-board trading of listed securities, the broker-dealers who hold themselves out to other broker-dealers and others as being willing to buy and sell listed stocks for their own accounts should be identified. The system of identification should generally follow the pattern recommended for "primary market makers" in the conclusions and recommendations in chapter VII, but there is no need to await the establishment of mechanical arrangements for such identification; the relatively small number of market makers and securities involved in the third market should permit the institution of the necessary identification program with a minimum of delay.

3. Pursuant to section 17(a) of the Exchange Act, the Commission should, by appropriate rule or regulation, secure information concerning the third market on a continuous basis from at least two sources. The market makers (as identified under paragraph 2) should be required to file reports on their trading in listed secu-

rities in such detail as to volume and price as the Commission may find reasonably necessary. Other broker-dealers engaged in off-board trading in listed securities, but not making markets, should be required to file periodic reports of transactions in listed securities of (say) 300 shares or more; i.e., transactions effected as agent for both buyer and seller, not involving a listed market maker.

4. There appears to be no more basis for broker-dealers to engage in riskless principal transactions with public customers in listed stocks than in unlisted stocks, discussed in chapter VII. Broker-dealers trading in listed stocks for which they are not making markets officially identified under paragraph 2 or without a bona fide inventory should be required to effect the orders of public customers for listed stocks on an agency basis, in accordance with the recommendations in chapter VII.

5. Short selling by the customers of the market makers, though apparently limited in extent at the present time, contains the seeds of a problem if utilized to escape the regulations governing the exchange markets. All sales to market makers should be marked either "long" or "short" in conformance with such regulations as the Commission may issue, and the market makers should report such sales to them under paragraph 3 above.

6. The trading of market makers directly with individuals in the third market also appears to be negligible in amount. At the same time, however, expansion of this area of operation in the future contains the potential of a situation requiring regulation to safeguard the interest of investors. The market makers should be required to file with the Commission data concerning such transactions necessary to permit adequate oversight and anticipation of regulatory needs.

E. Allocation Among Exchanges—the Regional Exchanges as Primary and Secondary Markets

1. INTRODUCTION

There are 14 stock exchanges which are referred to as "regional exchanges," i.e., exchanges outside of New York City. Four of these—the Colorado Springs, Honolulu, Richmond, and Wheeling exchanges—have been exempted from registration under the Exchange Act pursuant to the provisions of section 5 of that act. Three of the remaining 10 exchanges—Salt Lake, San Francisco, and Spokane—are so-called mining exchanges and differ in many respects from the others. The remaining seven exchanges—Boston (BSE), Midwest (MSE), Philadelphia-Baltimore-Washington (PBWSE), Pacific Coast (PCSE), Cincinnati (CSE), Detroit (DSE) and Pittsburgh (PSE)—may be considered the major regional exchanges.[208] This part focuses on these seven regional exchanges—with special attention to the first four—although the historical section below may be read as generally encompassing all of the regional exchanges.

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[208] An additional registered national securities exchange, the Chicago Board of Trade, has not traded securities since 1953, but is an important commodities exchange.
One other registered exchange, the National Stock Exchange, is located in New York City. Although not a principal exchange, it is not a regional exchange in the normal sense, and is not discussed in this part, except that it is included among regional exchanges rather than principal exchanges in table VIII-61.

The significance of the regional exchanges in the national securities markets transcends their volume of trading. While the $3.75 billion in trading effected on the regional exchanges operating in 1962 is hardly insubstantial as an absolute figure, it constituted only 6.9 percent of the total dollar volume transacted on all exchanges in that year (table VIII-61).

The regional exchanges have elicited far more attention from governmental authorities than these figures would seem to warrant. They were the subject of considerable interest in the congressional hearings preceding both the enactment of the Exchange Act and the amendment of section 12(f) of that act in 1936. The early volumes of the Commission's decisions and reports devote pages of opinions to cases involving these exchanges. Their continued importance today is highlighted by the attention given to them in various other portions of this report.

The prominence of the regional exchanges derives from their unique place among national securities markets—one explained by such factors as their role and development in the past; their relationship to other sectors of the securities industry; the impact of technological developments and economic forces generally; and the influence, both direct and indirect, of Government regulation and considerations of public policy. Mere enumeration of these factors is sufficient to show that they are not amenable to simple treatment. Their complexity as individual factors and their interrelationships demand careful analysis and assessment and point to the likelihood of no easy generalizations concerning them. This part views the regional exchanges historically in terms of their evolution, and functionally in terms of the roles they play today; and then considers potential future courses of development. The subject of regional exchanges as self-regulatory agencies is reserved for chapter XII.

a. Methods of study

A primary source of this part was the responses to the Special Study's Questionnaire EX-4 (app. VIII-C), which was sent to all members of the four largest regional exchanges: Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Boston. These were supplemented by interviews with the presidents of the Midwest, Pacific Coast, and Boston exchanges, testimony of a leading specialist on the Philadelphia-Baltimore-Washington exchange, and observation of operations of the Midwest and Pacific Coast exchanges. The constitutions and rules of all the regional exchanges, as well as pertinent Commission files and reports, were examined.

b. The regional exchanges prior to 1934 [209]

An understanding of the regional exchanges must begin with a brief review of their colorful history, which is intimately related to the development of the geographical areas of which they are part. Their story, marked by sudden changes in fortune, demonstrates that the problems confronting them today are not superficial but fundamental, engendered by economic and technological forces which were beginning to take shape by the end of the First World War.

[209] Materials collected by Charles A. Cole of the Division of Trading and Exchanges provided the primary source of this discussion.

(1) *Growth of the regional exchanges to 1920*

The organization of stock exchanges has tended to occur whenever securities have been distributed to the public in significant amounts. In New York in the early 1790's the flotation of the new Federal Government's securities and of the stock of the first Bank of the United States led to the first organized New York exchange. At about the same time, citizens of Philadelphia meeting in coffeehouses to deal in securities, currency, and specie established the first Philadelphia board of brokers. Some 40 years later, in 1834, the first organized Boston exchange was formed to create active markets for the stocks of local banks and early railroads.

Other organized exchanges developed following expansion to the West. Financing of mining stocks led to the development in 1862 of San Francisco's first mining exchange, followed by exchanges in Sacramento, Virginia City, and other localities. In 1882, as the traction (street railways and the like), banking, and other industries of the west coast developed, the precursor of the San Francisco Stock Exchange was organized. And in 1900, with the expansion of California's oil fields, the Los Angeles Stock Exchange was organized, largely to trade in mining stocks.

Exchanges also emerged in other parts of the country as an inseparable aspect of the growth of regional capital markets. With the development of local financing in Chicago, an exchange finally was organized in 1882, after a number of unsuccessful starts. In New Orleans stock exchanges were formed and reorganized at various times after the 1850's. Pittsburgh, responding to the local financing of the Appalachian oil fields and local banks and tractions, organized an exchange in 1894. And in like manner, Baltimore, Cleveland, Cincinnati, Detroit, St. Louis, and other cities developed exchanges to accompany expanding regional financing.

The regional exchanges emerged simultaneously with the growth of capital markets because of their function in the initial flotation of securities. Without modern communication facilities, face-to-face bargaining on the floor of an exchange had to be used to effect transactions in newly offered securities, as well as those already outstanding. The regional exchanges served as the necessary central meeting place.

In the early years of the exchanges, securities were not formally listed pursuant to agreements with issuers nor did the exchanges make formal grants of unlisted trading privileges. Any security with local interest could be traded on the floor, simply upon the request of a member. Practically every regional exchange employed the "call" system, described in chapter V, until 1885, when the Boston Stock Exchange, followed gradually by the others, abandoned it in favor of the "continuous auction" method.

The Boston exchange also appears to have been the first regional exchange to give publicity to its transactions, initiating the practice in 1844. The publication of security prices at a time when financial statements were scant and financial services nonexistent constituted some evidence (not necessarily accurate) to the prospective investor of the reputability and stability of the corporations. The price publicity afforded by the exchange became an excellent advertisement for securities. Indeed, rising prices insured the success not only of the

issues of established enterprises but also of new and unknown corporations, particularly in the same lines of endeavor. This simple policy of providing price information helped to finance railroads in New England, copper mines in Michigan, gold and silver mines on the west coast, and local traction companies and banks throughout the Nation.

The discovery that rising markets could sell securities was, however, only a short step away from the realization that manipulated markets could sell securities as easily as honest ones. Accounts of manipulations in the public press were not uncommon in the 19th and early 20th century. These activities tended to accentuate the rise and fall of securities prices characteristic of changes in the business cycle. These cyclical movements were manifested by rises and declines in the amounts of new securities flotations, with corresponding effect on the fortunes of the regional exchanges. In their early years, in fact, before the exchanges had attained the stability of mature organizations, they sometimes suspended operations or dissolved in periods of softness in the new-issue market, only to resume operations when capital market activity revived.

The exchanges were affected by factors other than cyclical movements in capital market activity. Certain basic shifts in the Nation's economic and financial structure were also altering the scope and functions of the regional exchanges. The consolidation of local railroads into national systems, of local factories into national industries, and of local utilities into national groups, created new needs for financing these aggregates on a nationwide scale. Many issues whose flotation and early life had been closely identified with regional financial communities thus passed out of existence as they were absorbed into larger systems.

The regional exchanges all felt the consequences of this growth of business organization on a national scale. Outstanding illustrations are the Philadelphia Stock Exchange's loss of the issues consolidated into the Pennsylvania Railroad and the Pittsburgh exchange's loss of the natural gas stocks merged into the Oil Fuel Supply Co. Another reason for the displacement of the regional exchanges as primary markets was the "seasoning" of local enterprises and of their securities. Successful local companies, developing a desire or need for national financing and national distribution, would seek listing on one of the New York exchanges, which obtained a large proportion of their leading issues by this process, and became the markets for the securities of the Nation's largest publicly owned corporations.

The loss in trading of local securities resulting from these trends was offset by the growth in trading on the regional exchanges of nonlocal issues. Such trading had originally started because poor communication facilities compelled investors to trade in the area of their residence. Wherever there was enough local interest in an issue, even though traded on another exchange, the regional exchange offered facilities for such local trading. This practice of trading a security on more than one exchange is known as "multiple trading." Much of this trading was "unlisted"; i.e., there was no agreement between the issuers and the exchanges.

Changes also took place in the membership of the regional exchanges. As communications improved and business grew, many

brokerage firms, originally regional in character, purchased seats on the New York exchanges and began to divide their interests between the regional area and New York. The current also flowed in the opposite direction; New York firms began to join the regional exchanges. Staffed largely with local personnel, drawing business from local customers, and relying for part of their income upon the local exchange, many of these firms came to be closely identified with the regions of their branch offices. Such members of both a principal exchange and one or more regional exchanges are hereinafter referred to as "dual members."

The flow of local issues to the New York markets and the drift toward dual memberships tended to spur the regional exchanges to increase multiple trading. One method of accomplishing this objective was to assure investors as good an execution on the regional exchange as they might receive on the principal market. This led to the development of systems to gear prices on the local exchange to those reported on the NYSE ticker tape. In 1923, the Boston Stock Exchange began the system of multiple trading of odd lots as it is known today, mechanically tying its prices to those of the principal exchange. But it was not until the following decade that the real growth in multiple trading occurred, for the 1920's brought enough business in local issues to the regional exchanges to obscure temporarily the drift toward New York.

(2) *The zenith of the twenties*

The regional exchanges almost universally enjoyed their most successful years in the 1920's. Their record volume of trading, however, was far from an unmixed blessing, for it precipitated changes in the scope and functions of the regional exchanges which were to limit their growth profoundly in the years which followed.

The financial developments of the period are too well known to require restatement. Insofar as the regional exchanges were concerned, a flood of security offerings created unprecedented capital market activity of which they were direct beneficiaries. Between July 1, 1925, and July 1, 1930, for example, Boston increased its listed stocks from 300 to 437. Chicago's issues more than doubled from 237 at the close of 1926 to 535 at the end of 1929. Detroit acquired 90 new issues in 1928 alone. The lists of the other regional exchanges expanded with similar rapidity.

Some of the factors which led to the listing of new securities on the regional exchanges during this period were the same as in prior decades. Unchanged was the desire of issuers to obtain the stamp of reputability attached to an exchange listing. By the close of the twenties practically every exchange had developed formal listing standards and imposed listing agreements commonly requiring issuers to file annual financial statements in varying detail, to provide certificates which were proof against easy forgery and to maintain a local transfer office. Issuers would accept these burdens to improve an issue's salability. In the same way, the appearance of exchange securities' prices in the press continued to facilitate distribution of new issues by bringing them to the attention of prospective security buyers.

Perhaps the most important single reason for many listings on the regional exchanges, however, was the desire of issuers to secure the special privileges afforded to listed securities by many State blue sky

laws. Such laws generally required registration of securities offered for sale in the State, but accorded exemption to securities listed on an approved securities exchange. In 1930, for example, securities listed on the Chicago Stock Exchange were exempt from registration under the laws of more than half the States. Issuers and underwriters, therefore, frequently sought an exchange listing as the most convenient entry into the "blue sky" States.

These forces sprouted an unsurpassed volume of trading on the regional exchanges, an even greater increase relatively than that of the NYSE. In Philadelphia, share volume rose from 2,336,000, 1 percent of NYSE, in 1923 to 35,521,000, 3.1 percent of NYSE, in 1929. In Chicago, share volumes increased from 716,000—0.41 percent of NYSE, in 1915, to 13,337,000—5.6 percent of NYSE, in 1923 and 82,216,000, 7.3 percent of NYSE, in 1929. For purposes of this review, perhaps the most significant aspect of this activity was that a large part of it consisted of trading in securities which had been initially distributed through the facilities of the regional exchanges. Underwriters appear to have had no strong desire to "make a market" over the counter once an underwriting was complete, leaving the trading function to the exchanges.

(3) *Post-1929 decline*

The burst of the speculative bubble at the end of the decade inevitably brought public recrimination in its wake. The regional exchanges were widely criticized; like the primary exchanges, they had lent their facilities and prestige to the perpetuation of practices harmful to investors and the public generally. One of the most important of the remedial measures for the regionals was elimination of their function in distributions of new issues. Some States prohibited trading on the exchange where "such trading is being done for the purpose of original financing." Certain exchanges meanwhile took similar action on their own initiative. State securities commissioners expedited the process of withdrawal of the blanket exemption from blue sky registration.

While having their role in the field of new financing sharply reduced, the regional exchanges also began to lose some of their old listings. Bank stocks, the backbone of the regional exchanges' lists half a century earlier, were withdrawn in large numbers, and many of those remaining after 1932 disappeared in the 1933 banking reorganizations. The Baltimore Stock Exchange, for example, lost 16 bank issues between 1929 and 1935. The regional exchanges also lost in the period of the early 1930's many of the securities which originally had been listed primarily for blue sky purposes. Often closely held and comparatively inactive, these issues tended to drop out of sight after completion of their initial distribution. Mergers, reorganizations, and dissolutions also took their toll.

The exchanges were thus hard pushed to find the business necessary to meet the larger overhead costs incurred as a result of their expansion of the twenties. An obvious method, recapture of the local business being routed to the New York exchanges, led to a revived interest in multiple trading. The Detroit and Pittsburgh exchanges set up multiple trading systems in 1932, and Los Angeles early in 1935.

But the net effect of the abrupt drying up in new listings, coupled with a tapering off in public trading in seasoned issues, was a steep

drop-off in regional exchange volume. Chicago's trading volume declined from its 1929 peak of 82,216,000 shares, 7.3 percent of NYSE, to 15,642,000 shares, 3.7 percent of NYSE, in 1932; Philadelphia's volume declined from 35,521,000 shares, 3.1 percent of NYSE, to 6,592,000 shares, 1.5 percent of NYSE, for the same years; and the San Francisco Stock Exchange's totals declined from 32,172,000, 2.8 percent of NYSE, to 8,460,000 shares, 2 percent of NYSE. Equivalent losses were also recorded on the smaller regional exchanges.

This, then, was the situation of the regional stock exchanges at the time of the enactment of the Securities Exchange Act of 1934: the entire economy was functioning at a low level; volume of stock trading had fallen drastically after the unprecedented heights of a few years earlier; a main source of regional exchange business, the distribution of new issues, was now dry; listings of securities which the regional exchanges alone had traded were being lost, and the exchanges were endeavoring to replace them with stocks already listed on one of the principal exchanges.

2. THE SECURITIES EXCHANGE ACT OF 1934

In discussing the development of the regionals since 1934, first attention is given the administration of the Exchange Act, because of its importance as a totally new influence upon these exchanges. But this concentration upon a single factor should not dim the significance of other influences, discussed in section 3.

a. Provisions affecting the regional exchanges

(1) *Registered exchanges*

The instrument by which stock exchanges are placed under Federal regulation is the concept of the registered national securities exchange. Exchanges employing any means of interstate commerce to effect or to report transactions must register with the Commission unless exempted under the provisions of section 5 of the act because of their limited volume of transactions. The statute does not distinguish between the principal exchanges in New York and the exchanges described here as "regional," but classifies all registered securities exchanges as "national" securities exchanges.[210] Of the 24 registered exchanges and 12 exempt exchanges on October 1, 1934, the effective date for the registration of exchanges, 31 were exchanges in the continental United States classifiable as "regional" within the meaning of this part.

(2) *Registered securities*

The law requires securities traded on a registered exchange to be, with limited exceptions, "registered" securities. The issuer must file an application with the Commission, setting forth extensive data concerning the company, and must thereafter keep the original filing current by periodic statements.[211] The act also imposes limitations on the trading of registered equity securities by so-called "insiders"[212] and authorizes the Commission to prescribe regulations governing the

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[210] Sec. 11 of the act (entitled "Segregation and Limitation of Functions of Members, Brokers, and Dealers") provides for exemptions of registered securities exchanges from rules adopted thereunder.
[211] Exchange Act, secs. 12 and 13.
[212] Exchange Act, sec. 16; see ch. IX.B.

solicitation of proxies by issuers of registered securities.[213] The act thus created an important new line of demarcation between securities traded on the exchanges and those which were not.[214]

This distinction had a twofold effect on the regional exchanges. As noted, their listing standards, generally less stringent than those in New York, had formerly operated to induce firms to list with them. But since the reporting standards of the new statute exceeded the equivalent standards of the principal exchanges, companies meeting these standards might well seek the greater publicity and prestige of a listing on the New York exchanges in preference to a regional listing. This factor accelerated the exodus of corporations from the regional exchanges at an earlier stage of their development than had been customary under the usual seasoning process described in section 1 above.

The new statutory requirements for registered securities under the 1934 statute also tended to shift the trading of securities from the regional exchanges to the over-the-counter market. As already pointed out, one aftermath of the market collapse on the regional exchanges had been the loss of listings, such as bank stocks, to the over-the-counter market. Here was a substantial new incentive to such a movement: securities traded over the counter were free of the requirements now attached to securities traded on an exchange. The development of the over-the-counter market as a competitive market for the trading of securities is considered more fully below, but it is obvious that the 1934 statute operated to make the regional exchanges less attractive and the over-the-counter market more attractive to many security issuers.

(3) *Multiple trading*

Section 1 has described the early efforts of the regional exchanges to trade in securities already traded on another exchange. Unlisted trading, the practice largely responsible for such multiple trading, was not provided for in the original draft of the Exchange Act. While the regional exchanges were still able to secure listings of stocks already listed on another exchange, it was far less of a burden for them to trade such securities without convincing the issuer to list regionally.

The statute, as enacted, contained a compromise on unlisted trading. Section 12(f) authorized the Commission to prescribe the conditions under which an exchange might continue existing unlisted trading until June 1, 1936. The section also empowered the Commission to permit unlisted trading upon an exchange until July 1, 1935, in securities then listed on another exchange. Because these were temporary measures, the Commission was directed to study trading in unlisted securities upon the exchanges and to report its recommendations to Congress.

Pursuant to this directive, on January 3, 1936, the Commission submitted to Congress a comprehensive report on "Trading in Unlisted Securities Upon Exchanges." Expressing grave concern over the future of the regional exchanges if unlisted trading were not continued, the report pointed out that two-thirds of the shares then

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[213] Exchange Act, sec. 14.
[214] See ch. IX.B.

available for trading on these exchanges were not listed, that many of the regional exchanges depended upon unlisted issues for more than half their trading activity, and that impairment of the regionals would accelerate concentration in New York City of control over the movement of capital in the Nation. In generally following the Commission's recommendations for continuation of unlisted trading under certain conditions, the Senate committee said that the amendment to section 12(f) which became effective on May 27, 1936:

> * * * may be described as an endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets and to allow each type of market to develop in accordance with its natural genius and consistently with the public interest.[215]

This amendment provided for three numbered categories of unlisted trading privileges. Clause 2 is of chief interest here, but the others also require mention. Clause 3 permitted the Commission to extend unlisted trading privileges under certain circumstances for unlisted securities complying substantially with the requirements for securities registered under the 1934 act. Only four stocks presently traded on the exchanges have been sanctioned under this clause.[216] Of more importance is clause 1, the "grandfather clause," permitting an exchange to continue unlisted trading privileges to which a security had been admitted prior to March 1, 1934. Congress' expectations that the number of securities traded on this basis would gradually diminish have been substantially fulfilled, and exclusively unlisted securities on the registered exchanges, not excluding duplications where the same issue is traded on more than 1 exchange, have declined from 817 issues on December 15, 1935, to 187 on June 30, 1962.[217]

b. Administration of clause 2 of section 12(f)

The provision of section 12(f) which was anticipated from the outset to cause the Commission its greatest administrative problems was clause 2. This empowered the Commission to—

> * * * extend unlisted trading privileges to any security duly listed and registered on any other national securities exchange, but such unlisted trading privileges shall continue in effect only so long as such security shall remain listed and registered on any other national securities exchange; * * *.

The statute provided for hearings on applications for extension of the unlisted trading privilege. Applications were not to be approved—

> * * * unless the applicant exchange shall establish to the satisfaction of the Commission that there exists in the vicinity of such exchange sufficiently widespread public distribution of such security and sufficient public trading activity therein to render the extension of unlisted trading privileges on such exchange thereto necessary or appropriate in the public interest or for the protection of investors.

The history of the administration of this clause 2 since 1936 may be briefly summarized as one of strict interpretation immediately after its enactment which gave way to very liberal construction during the past two decades, to the point where essentially the only limitation

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[215] S. Rept. 1738, 74 Cong., 2d sess., p. 3 (1936).
[216] See pt. B of this chapter and ch. IX.B.
[217] 28 S.E.C. Ann. Rept. 9 (1962). The American Stock Exchange accounted for 83.2 percent of all trading in exclusively unlisted (clause 1) stocks, and the Pacific Coast Exchange 15.3 percent in the year ending June 30, 1962. These figures also include two clause 3 stocks.

on a regional exchange as compared with the situation prior to 1934 is that it may extend unlisted trading privileges only to securities listed elsewhere—a relatively minor limitation since even before 1934 few regional exchanges traded on an unlisted basis securities not listed elsewhere.

Two of the early cases decided by the Commission in 1937 under clause 2 are important in giving content to the "public interest" and "protection of investors" standards contained in section 12(f). In both cases the Commission examined the applications in light of the section's requirement of "sufficiently widespread public distribution" in the "vicinity" of the exchange, but went beyond this factor. In the first case, which concerned an application of the Pittsburgh Stock Exchange,[218] the Commission noted that the odd-lot trading mechanism of the applicant exchange mechanically geared prices to the primary market. Since the primary market in turn geared its odd-lot prices to its round-lot market, the Commission did not analyze the impact of such dual trading on either investors or on the primary market. In deciding whether trading privileges should be extended to round lots the Commission found that the Pittsburgh exchange maintained an independent market for round-lot trading of dually traded stocks, and went on to consider whether the proposed Pittsburgh market would be adequate to protect investors who entered orders there. Since the applicant exchange permitted brokers to take a customer's order to the primary market if a better execution could be obtained there, no impediment to the proposed market was found.

However, in a later case involving an application of the Boston Exchange,[219] the Commission went beyond this criterion. In this case it appeared that the Boston Exchange geared executions in *both* round-lots and odd-lots of dually traded stocks directly to the tape of the principal market. Under its holding in the *Pittsburgh Exchange* case, the Commission might have granted the application after finding that the vicinity test had been met since the best execution principle would be satisfied by this mechanical procedure. Instead, the Pittsburgh case was, in effect, distinguished. In line with the earlier cases, it was pointed out that the diversion of odd-lot trading from the primary exchange to a secondary exchange market would have no substantial impact on the primary market since the odd-lot orders would be executed outside of the round-lot price-setting mechanism in either market. But it was held the diversion of round-lot trading from the primary market was a different matter. The Commission went on to consider the impact on the primary market of the diversion of round-lot trading:

> The distinction [between odd lots and round lots] is fundamental, and derives its significance from the very nature of our system of securities markets. In their proper operation securities markets are designed to reflect, so far as possible, the individual judgments of value of all buyers and sellers of securities; the market price should represent, so far as possible, the summation of these judgments. Yet, if a secondary round-lot market of the kind herein under consideration were permitted to be established, the judgments of many buyers and sellers which would otherwise be reflected in the determination of the market price would in the main lose such effect. In regard to their effect on the price mechanism, these transactions would be practically sterilized.

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[218] 2 S.E.C. 178 (1937).
[219] 2 S.E.C. 513 (1937).

We do not mean to suggest that all round-lot transactions in a security ought to be concentrated in a single national market. If an exchange maintains a bona fide independent secondary market in a security, supported by adequate distribution and adequate public trading activity in the vicinity of such exchange, the round-lot trading thereon will determine the price on such exchange, and, through the force of competition and the mechanism of arbitrage, will have a bearing upon the price on the primary exchange. If the applicant exchange should undertake to establish such a bona fide independent secondary market in the securities herein considered, and should file applications for unlisted trading privileges in these securities on that basis, there would be presented a different question from that before us.[220]

This language stresses the fine balance, on the one hand, between the public policy considerations involved in maintaining competitive securities markets and, on the other, the effects on the primary market of a diversion of trading that might otherwise be concentrated there.[221] The requirement of a "bona fide, independent secondary market" is not to be found in the statute but rather represents, implicitly, the Commission's interpretation of the type of trading "necessary or appropriate in the public interest or for the protection of investors."

The mechanics of trading in round lots thus became, briefly, another standard for the determination of applications for extension of unlisted trading privileges. In the case of the Philadelphia Exchange a few months later, the Commission again found the evidence on the nature of the round-lot trading insufficient to warrant extension of the unlisted trading privileges to round-lot trading.[222] But in the application of the San Francisco Curb Exchange later that year, it reached a contrary result where it appeared that the exchange constantly checked its prices against those of the principal exchange without accepting them mechanically.[223]

The Commission finally approved extension of unlisted trading privileges in round lots on the Boston Exchange in August 1938. The Boston Exchange had adopted a new set of trading rules "with the object of effecting a reconciliation between the requirements of our prior decisions and the exigencies of the Boston market."[224] After detailing these rules, which afforded the possibility of a better round-lot execution in Boston than on the principal market though investors could still insist on executions automatically based on the principal market, the Commission continued:

It is desirable to encourage independent secondary markets. But where the exchange * * * is willing to do everything in its power to encourage an independent secondary market, we do not believe that the act requires us to withhold the privilege of unlisted trading because local investors decline execution at a price determined by a local auction market and demand a price established in New York. It suffices, we believe, that the local exchange supplies the facilities, and encourages the use, of an independent auction market. * * * We are likewise not unmindful of the desirability of maintaining the smaller exchanges, and the importance to them of opportunities to expand their volume. Confining our remarks to unlisted trading in securities listed on other exchanges which provide a primary market * * * we hold that it is appropriate in the public interest and for the protection of investors to extend the privileges of unlisted trading [in this case].[225]

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[220] 2 S.E.C. 513, at p. 522 (1937).
[221] See pt. B of this chapter for a discussion of market depth and competition among markets.
[222] 2 S.E.C. 566 (1937).
[223] 2 S.E.C. 653 (1937).
[224] 3 S.E.C. 694 (1938).
[225] 3 S.E.C. 694 at pp. 699–700 (1938).

The need for a bona fide, independent secondary market of the type contemplated in the first *Boston* case thereafter evaporated. In the same way, in a second case involving the Pittsburgh Exchange, the Commission dismissed altogether the distinction between extension of the unlisted trading privilege for round lots and for odd lots. What remained in each case was a determination of the "vicinity" of the exchange, and of "sufficiently wide public distribution * * * and sufficient public trading activity." The Commission's opinions continued to present data on these elements, but by the middle of 1939 they began in some cases to omit figures on trading activity in the principal market, so that the relationship of activity in the vicinity of the regional exchange to such trading, previously a salient factor, was now disregarded.

While deciding specific cases in light of the quantitative data contained in the application, in no case did the Commission set forth any generalized quantitative standards as to the relative or absolute distribution and trading volume necessary to support an application. The closest it came to establishment of a guidepost was its statement in several cases that—

> * * * the standards of sufficiency for local trading activity may be somewhat lower in the case of the securities of a local issuer, particularly if there is a substantial local distribution, since these factors would normally indicate a commensurately greater public interest which would be served by the existence of a local exchange market.[226]

Later it was to find that, where the exchange was unable to supply figures on public distribution within the vicinity of the exchange, a showing of large volume of trading activity in the vicinity of the exchange might satisfy this requirement.[227] After the first flurry of denials of applications under clause 2, which appeared with diminishing frequency from 1937 until 1943, none has been formally denied in close to 20 years. At least one strong basis for the Commission's action in this field is indicated by the frequent repetition of the thought expressed in one of its last cases of the decade of the thirties:

> It appears that the applicant exchange has suffered seriously during recent years because of loss of listings and a lack of income resulting in substantial net losses during 6 out of the last 9 years. It was testified that expansion of trading on the applicant exchange is essential if the exchange is to continue in operation.[228]

By 1946, the Commission had instituted a simplified procedure to eliminate hearings on these applications where none was demanded by an interested party, and it has tended to accept the data filed by the applicant exchanges on a relatively routine basis. Moreover, it has become quite unusual for opposition to the grant of unlisted trading privileges to be formally voiced either by an exchange having the primary market or by dealers maintaining an over-the-counter market.[229] Although the NYSE has expressed concern over impairment of its markets by trading away from that exchange in its listed stocks,

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[226] 6 S.E.C. 296 at p. 306 (1939), referring to 3 S.E.C. 293 (1938).
[227] 7 S.E.C. 274 (1940).
[228] 6 S.E.C. 296 at p. 304 (1939).
[229] The procedure under sec. 12(b) requires notice and opportunity for a hearing. Notice is required to the "issuer of the security involved * * * and to the exchange * * * on which such security is listed and registered. * * *" Furthermore, "any broker or dealer who makes or creates a market for such security * * * shall upon application be entitled to be heard."

it does not intervene in applications by regional exchanges for unlisted trading privileges under clause 2. The lack of such intervention has been explained by the president of the NYSE as being motivated by a concern for the continued existence of the regional exchanges. Thus there are no longer adversary proceedings under clause 2.

The administration of clause 2 of section 12(f) has thus turned substantially from the assumption in 1936, when the Congress agreed with the Commission's recommendations that neither the issuer through its management nor the exchanges "should have the right to create an exchange market in a security," and that the Commission should make this determination in terms of the public interest.[230] From 1944 on, the exchanges' abilities to trade securities listed on another exchange appear to have been, for practical purposes, substantially the same as prior to the enactment of the 1934 statute.

c. The Multiple Trading Case

The so-called *Multiple Trading Case* of 1941 [231] is one of the Commission's landmark decisions. It was the only proceeding ever held by the Commission under section 19(b) of the 1934 statute to determine whether a rule of the NYSE should be changed. The "rule" in question was a constitutional provision, under the terms of which members of the NYSE acting as odd-lot dealers or specialists on other exchanges, or otherwise publicly dealing "outside the exchange in securities deal in on the exchange," would be subject to proceedings for suspension or expulsion from exchange membership. Because of the important role of NYSE members to the regional exchanges (see sec. 4 below), the immediate effect of the rule would have been curtailment of multiple trading on the regional exchanges.

The Commission pointed out that many securities traded on the NYSE were also traded on 1 or more of the 17 regional exchanges in existence at the time, that 9 exchanges had facilities for executing odd-lot transactions in dually traded securities at NYSE prices, and that on 6 of these exchanges NYSE members who were also members of the regional exchange (i.e., dual members) either handled or financed the odd-lot or specialist function. It then found that the NYSE rule had already exerted disrupting effects on odd-lot trading in dually traded issues on the regional exchanges and that even more serious effects were portended by the inability of the regional exchanges to replace dual members performing the vital odd-lot dealer-specialist function with regional-only (sole) members possessing adequate financing. The Commission found that "irreparable damage" would result to these exchanges, by delistings and loss of memberships:

> * * * Furthermore, deleterious economic consequences to trade and industry, particularly to growing industries located in areas surrounding the regional exchanges, can be expected to ensue. For many years the regional exchanges and the market facilities which they maintain have been important factors in the financial lives of their communities. They have lent vitality to such communities by facilitating the financing of local enterprises and by providing a seasoning mechanism for the security issues of expanding companies, thus assisting them to attain financial stability. If, as a result of enforcement of the rule, these important functions now performed by the regional exchanges are materially impaired, the Nation's trade and industry would be adversely affected.

[230] SEC, "Report on Trading in Unlisted Securities Upon Exchanges," p. 10 (1936).
[231] 10 S.E.C. 270 (1941).

In view of the foregoing discussion, the harm which investors would suffer from enforcement of the rule needs little elaboration. * * * If the regional markets in dually traded issues are destroyed or materially decreased, the public investor who wishes to buy or sell such securities will have to trade on the NYSE and pay the higher costs attending such transactions. Even if the issues affected by the rule continue to be traded on the regional exchanges, the customer can expect slower deliveries and poorer service in many cases. The debilitation of regional exchange services in dually traded issues will also permeate their trading services in local issues as well. The investor may therefore be faced with the alternative of trading only in the centralized market located in New York or in the over-the-counter market.[232]

The Commission thus declared its basis for ordering the insertion of a "clarifying amendment" in the NYSE constitution specifically authorizing members to continue the activities which the rule had sought to prohibit and thereby immunizing the regionals against loss of participation by their dual members.

3. OTHER INFLUENCES SINCE 1934

a. Loss of solely traded securities

While the Commission was able to protect the regional exchanges against attack by the NYSE in the trading of dually traded securities, these exchanges were suffering a less spectacular but continuing attrition in the area of solely traded or local stocks, which in earlier years had been the keystone of their existence. The major attack came from the over-the-counter market, whose growth is detailed in chapter VII. The second, which is, in part, connected with the first, was the virtual termination of the process by which an issue would be listed in a regional exchange for "seasoning" for a time prior to being listed on one of the major New York exchanges.

As already noted, the regionals suffered a substantial loss of trading volume in solely traded issues following the market crash of 1929 when bank, insurance and other stocks delisted and went over the counter. The trend was then expedited by the provisions of the 1934 Act imposing reporting, proxy, and insider-trading restrictions on exchange-listed securities but not on those traded over the counter. To aggravate this situation, the exchanges no longer distributed new issues, a function now the exclusive province of the over-the-counter market. This last development also meant that when the distribution was over, the regionals were forced to struggle to capture the market from those already entrenched in it, an obviously more strenuous assignment than retaining a market they had originally created.

Other considerations magnified this competition from the over-the-counter market. For example, the historic advantage of the exchanges in bringing buyers and sellers together was lessened by the inauguration in 1935 of the open-end teletype system enabling thousands of over-the-counter dealers all over the country to contact each other directly and immediately.

Overshadowing such technological advances, which merely tended to offset advantages previously enjoyed by the exchanges, was the broker-dealer's relative freedom from limitation in the amount of markup charged on an over-the-counter transaction. The ceiling adopted by

[232] 10 S.E.C. 270 at pp. 283–284.

the NASD for these markups was considerably higher than the commission rates charged on the exchanges.[233] The greater profit potential in trading securities over the counter created an incentive for broker-dealers to discourage issuers from listing on an exchange. This motivation appears in a case in which an issuer which filed a delisting application because of its president's belief—

* * * that if the stock were withdrawn from the exchange, over-the-counter brokers not limited to the 7½-cent commission permitted to brokers on the exchange, would stimulate activity in the stock, widen its market, and raise its prices.[234]

This was not all. Exchange members were circumscribed by rules governing trading on an exchange. The specialist was a relatively passive market maker who, although responsible for making a market for a security generally, could not promote its sale or purchase. The over-the-counter market maker possessed much more flexibility; he could acquire a block of stock and actively merchandise it while making a market, or he could discontinue his market at will.

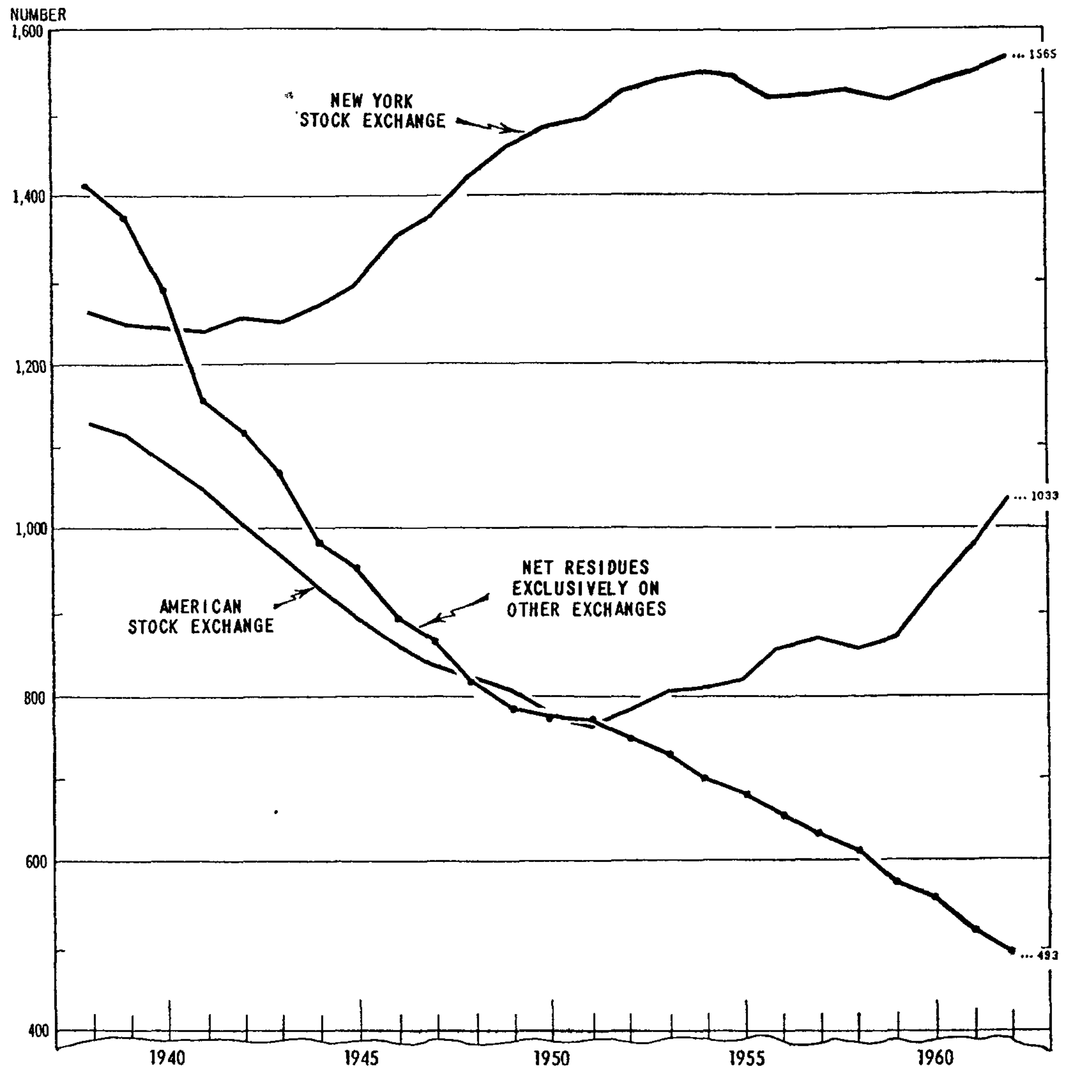
The regionals also continued to face the direct competition of the principal exchanges for original listings. Indeed, as a result of the reporting, insider-trading, and proxy requirements of the 1934 law, which in some respects exceeded those on the regional exchanges, there was a much stronger tendency to list directly on a major exchange instead of first going through a period of "seasoning" on a regional. In fact, a study of the listings on the major New York exchanges from 1955 through 1961 showed that these exchanges had 704 new common stock listings but that only 54 of these had first been traded on a regional exchange (table VIII–62). Furthermore, the regionals' loss of sole listings by transfer of the primary market to a major exchange had not been offset by new sole listings (chart VIII–j and table VIII–63). Thus, the regionals, while maintaining a fairly steady proportion of the dollar volume of trading on exchanges as a result of the extension of multiple trading, continued to lose primary listings by transfer of the primary market to New York and also lost potential sole listings of many securities directly to the principal exchanges.

The trend may also be seen in terms of the value of stocks traded exclusively on the regional exchanges. The dollar value of such stocks increased from $3.2 billion in 1951 to $4.1 billion in 1960, but this 28-percent increase was less than one-fifth the 163-percent increase enjoyed by the principal exchanges during the same period (table VIII–63). Stated relatively, the market value of stocks exclusively on the regional exchanges dropped 50 percent from 2.4 percent of total share value on exchanges in 1951 to 1.2 percent in 1960. The net number of issues traded exclusively on the registered regional exchanges dropped from 620 in 1952 to 440 in 1960.

[233] See ch. VII.
[234] 6 S.E.C. 995, 998.

Chart VIII-j

NET NUMBER OF STOCKS ON STOCK EXCHANGES



NOTE: All data as of June 30 and taken from the Commission's Annual Reports.

With the exception of 88 stocks in 1938, 87 in 1938, 87 in 1939 and 84 in 1940, on the New York Real Estate Securities Exchange and 9 stocks on the National Stock Exchange, all stocks in "Net Residues Exclusively on other Exchanges" were on Regional Exchanges.

Many of the stocks on the New York Exchanges are also available for trading on one or more of the Regional Exchanges.

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b. The public commission schedule of the NYSE

The sweeping coverage of the public or "nonmember" commission schedule of the NYSE exerts a direct influence on the regional exchanges. Because that schedule recognizes neither nonmember broker-dealers nor large volume or "block" purchasers as special classes of customers, it has encouraged establishment of a variety of reciprocal commission and directed split or "give-up" arrangements which often can be worked out only on the regional exchanges. These exchanges thus constitute a kind of relief valve for pressures resulting from the inflexibility of the public commission schedule of the NYSE. Reference is made to part I of chapter VI for a discussion of these arrangements, which are there treated as a function of the NYSE commission schedule but which are equally important here for their impact on the regional exchanges.

Responses to the Special Study's Questionnaire EX-4 reveal the extent of reciprocal business arrangements of various kinds between sole and dual members (tables VI-z, VI-aa, and VI-bb). One-half the reporting regional sole members have such arrangements, generally returning the regional-only member $1 of commissions for each $2 he refers to the NYSE member. Approximately 60 percent of the 285 members polled receive more than 20 percent of their income from reciprocal business, 30 percent receive more than 30 percent, and 14 percent receive more than 40 percent.

c. The merger of regional exchanges

A final factor in the development of the regional exchanges, perhaps one largely caused by the combination of the others discussed above, has been their tendency to merge into larger units. The improvements in communications which have accentuated the competition of the over-the-counter market have also made it possible for regional exchanges in different cities to combine forces and to operate either through the mechanism of a single trading floor or through several.

The present Midwest Exchange represents the consolidation in 1949 of the Chicago, Cleveland, Minneapolis-St. Paul, and St. Louis Exchanges. The Philadelphia and Baltimore Exchanges united in the same year and were joined by the Washington Exchange in 1953. The Philadelphia-Baltimore-Washington Exchange has established mutual trading privileges with Boston, Pittsburgh, and Montreal, to extend to members of each exchange the benefits of the market provided by the others. And in 1957, the San Francisco and Los Angeles Exchanges combined to form the Pacific Coast Exchange.

d. Summary

The result of the trends and forces since 1934 described in sections 2 and 3 are clearly shown by the statistical data. These data show that the regional exchanges as a group have sustained a loss in relative share volume since 1935 of securities traded on all exchanges (table VIII-64), although in terms of the more significant index of dollar volume the regional stock exchanges as a group have increased their share from 5.53 percent in that year to 6.87 percent in 1962 of total exchange dollar volume. But the character of trading on the regional exchanges has shifted, and they have become increasingly dependent on multiple trading. Since 1940 the number of stocks traded solely on regional exchanges has declined by 60 percent, while the proportion

of trading in solely listed stocks on the regionals has diminished from 15.7 percent in 1948 to 7.2 percent in 1961 (tables I–2 and VIII–65).

Although the regional exchanges are often treated as a group, it is important to note the substantial differences in their individual development. The dollar volume percentages in the lower half of table VIII–64, which are more significant than share volume, reveal that since the consolidation of its four forerunner exchanges into the Midwest Exchange in 1951, its portion of overall dollar volume of trading has increased and that during the past 5 years it has remained relatively stable. The same is generally true of both the Pacific Coast Exchange, which assumed its present form in 1957, and the Philadelphia-Baltimore-Washington Exchange, in 1953. Over the last 10 years Detroit has also maintained its share of the total, but the other exchanges have relatively lost ground. These differences in fortune stress the need for considering each regional exchange as a separate entity with separate needs even while treating them as a group for some purposes.

4. THE REGIONAL EXCHANGES TODAY

a. Identity

Of approximately 100 regional exchanges in existence at various times through the years and of the 35 remaining in 1928, only 14 are active today.[235] Their identity and relative size may be seen in table VIII–61. This section is concerned with all of them but treats specially the four largest—Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Boston—which accounted for 92 percent of the dollar volume of all the regionals in 1962.

The discussion is broadly applicable to some of the others—Cincinnati, Detroit, and Pittsburgh—but less so to the so-called western mining exchanges—Salt Lake, San Francisco Mining, and Spokane—which have characteristics and problems largely dissimilar from those of the other regional exchanges.

b. Membership

Membership on regional stock exchanges may be classified by those holding memberships solely on a regional exchange ("sole members"), and those holding memberships on a regional exchange and either or both the NYSE and the Amex ("dual members"). Two hundred and thirty-eight firms are members of either or both New York exchanges as well as one or more regional exchanges, while 449 are sole members of regional exchanges (table VIII–66). For the rest of this section "dual members" refer to those who are members of the NYSE and a regional exchange.

The dual members are clearly the most important members of the larger regional exchanges. They have the largest sales organization and constitute the most important source of business for each exchange.[236] From responses to Questionnaire EX–4, the study was able to determine the gross income of each member or member firm which was derived from transactions on the regional exchange. The data

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[235] The count excludes the Chicago Board of Trade which, although registered under the Exchange Act, has had no securities transactions since 1953 and the National Stock Exchange in New York which, although smaller than most of the regional exchanges, attempts to list companies of national interest.

[236] In 1940 a Commission study found that dual-member firms were better capitalized than sole members. This is probably still the case; dual members in order to be such must own a membership on the NYSE, which is at present worth about $200,000. Membership on regional exchanges usually cost below $20,000.

were analyzed by ranking the members according to the gross income they received in 1961 from the regional exchanges. An examination of the results indicates that, for the four principal regional exchanges, dual members were the most significant (table VIII-67).

Thus, dual members on the Midwest, the largest of the regional exchanges, accounted for 58 percent of all exchange income, which includes income from odd-lot dealing, specializing, floor trading, etc., and also includes commissions received as give-ups to one exchange member from another. These dual members also produced 71 percent of the gross commission income earned by all Midwest members in 1961 (table VIII-67). On the PCSE, dual members accounted for 55 percent of all exchange income and 70 percent of the gross commission income.

Dual members of the Boston Stock Exchange accounted for the highest proportion of total exchange income of those of all the exchanges studied—74 percent. These members also produced 74 percent of gross commission income, unlike dual members of other exchanges, who accounted for lesser percentages of total exchange income than of gross commission income. The greater dominance of Boston dual members is perhaps explainable by the fact that the geographical area of the Boston Stock Exchange is also serviced by the major New York exchanges to a large extent. On the other hand, the Philadelphia-Baltimore-Washington Exchange, while geographically closer to New York, has extended its influence to many areas of the South which are fairly remote from New York.

As to each of the four major regional exchanges, when members were ranked according to amount of income received on such exchange, those in the top one-fifth were found to have received the great bulk of all exchange income. The range was from 58 percent on the PCSE to 68 percent on the MSE. Moreover, in the case of each of the exchanges the top fifth was dominated by dual members, the range being from 69 percent in the case of PBWSE to 83 percent in the case of BSE (table VIII-68).

Relatively important as are the dual members to the regional exchanges, the reverse is not equally true. The great majority of these members earn the major part of their income from sources other than the regional exchanges; table VIII-69 shows that income from activities of dual members on the regional exchanges was overshadowed by commission income from the NYSE and profits from over-the-counter transactions and underwritings. For example, the firm that had the largest income from the MSE placed its MSE activities as fourth in producing income for the firm's offices in the vicinity of that exchange. However, as the table also indicates, for some dual members, their activities on the regional exchanges were their most important source of business. Four dual members of the 4 exchanges ranked commission business on the regional exchange as their most important source of income, while 22 members ranked it as their second most important source of income.

As a group, sole members, who control a smaller share of the business on each regional exchange than do dual members, also find their major source of income outside the regional exchanges, in their case from activities in the over-the-counter market [237] and from the sale of

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[237] One sole member in a memorandum to salesmen stated: "* * * one listed sale of a company the customer knows might lead to five unlisted sales! WHY NOT TRY IT?"

mutual funds (chart VIII-2). However, a much larger number of sole than dual members draw from the regional exchange their most important source of income (table VIII-70). Seventy sole members of the four major regional exchanges listed public commission business on these exchanges as their most important source of income.

Dual members receive most of their regional exchange income from public commissions, while sole members rely heavily on "give-ups" of commissions which are often connected with some reciprocal business relations (tables VIII-71 through VIII-74). For example, on the PBWSE only 2 dual members received income from "give-ups," while 55 sole members received this form of income. For 26 sole members, give-ups accounted for between 10 to 29.9 percent of their total income from that exchange, while 2 members stated that it accounted for over 80 percent of their income (table VIII-74). The relationship was the same for the members of the Midwest and Pacific coast exchanges, where sole members earned greater percentages of their income from give-ups than did dual members (tables VIII-72 and VIII-73). Members, both sole and dual, of the Boston Exchange earned small percentages of their income from this source (table VIII-71).

The membership of the regional exchanges is thus made up of two groups, dual and sole members, neither of which obtains its major source of income from regional exchanges, the former depending primarily on the NYSE and the latter on the over-the-counter market or other fields of activity.

c. Securities

For purposes of this part, the method of qualifying a security for trading on a regional exchange—either through formal listing by the issuer or under unlisted trading privileges obtained by the exchange—is less important than the distinction resulting from the trading of some securities ("solely traded securities") on only a regional exchange, and of others ("dually traded stocks" or "multiple traded securities") on a primary exchange and one or more regional exchanges. There are several avenues to a stock's becoming dually traded. The stock may be listed originally on a regional exchange and subsequently secure a listing on a New York exchange.[238] The stock may be listed on a New York exchange and then become listed on a regional exchange, or, as is far more often the case, a regional exchange may apply for unlisted trading privileges. As section 3 above makes clear, the Commission's extension of unlisted trading privileges has become an important gateway to multiple trading on the regional exchanges.

(1) *Dually traded stocks*

In total, 93 percent of the dollar volume of trading on the major regional exchanges is represented by stocks which have their primary markets on the NYSE or the Amex. Dually traded securities have thus become the major business of the regional exchanges.

As can be seen from table VIII-75, most of the common stocks traded on the NYSE are also traded on one or more regional stock exchanges. It can also be seen that the number of regional exchanges on which a stock is dually traded tends to be greater as there are a greater num-

[238] When a stock solely traded on a regional is listed on a New York exchange, there is typically a rapid decline in volume on the regional exchange, coupled with a reduction of the number of orders on the specialist's book within a short time after the primary market is firmly planted in New York.

ber of shares outstanding, a greater number of shareholders and a larger volume on the NYSE.

The stocks that are dually traded are thus the most active stocks on the NYSE. As might be expected there is a tendency for volume in dually traded stocks to be heaviest in the securities of companies closely connected with the region in which the exchange is located. Thus, the Midwest Exchange does a relatively high portion of all of the regional exchange trading in such stocks as Borg Warner, Commonwealth Edison, Montgomery Ward, and Sears, Roebuck, while the Pacific Coast Exchange tends to do more trading in such stocks as Pacific Gas & Electric, Southern California Edison, Standard Oil of California, and Union Oil of California.

A further discussion of dual trading appears below in section 5.a(2) and part F of this chapter.[239]

(2) *Solely traded stocks*

Sections 2 and 3 traced the development of the regional exchanges from their establishment as primary markets to their more recent dependence on multiple trading. During the past 30 years many factors have operated to curtail the relative importance of solely traded stocks until in 1960 such trading represented 32.6 percent of the share volume, 11 percent of the issues, and only 7 percent of the dollar volume of all trading on the seven major regional exchanges (table VIII–76). The decline in relative importance of sole trading has been continuous. From 1948 to 1961, solely traded stocks dropped from 15 percent of the dollar volume of trading on regional stock exchanges to 7 percent (table VIII–65).

Closer analysis of the figures reveals an even more startling decline in the relative importance of sole trading. Of the 440 issues traded solely on the regional stock exchanges in 1961, 295 were traded on the 7 principal regional exchanges, and of these only 102 had an annual share volume greater than 25,000 shares, or 100 shares a day. These 102 issues accounted for 92 percent of the share volume and 86 percent of the dollar volume of all solely traded issues on these exchanges.

Solely traded stocks represent a higher portion of total business—whether measured in number of stocks, number of shares traded, or dollar volume of trading—for the Midwest, Pacific Coast, Cincinnati, and Philadelphia-Baltimore-Washington Exchanges than for the other regional exchanges (disregarding, of course, the three mining exchanges where they constitute the bulk of the business).

d. The mechanics of trading

(1) *Round-lot trading*

Solely and dually traded stocks are each traded in a different manner on the regional exchanges. Solely traded stocks appear to be traded in much the same way as on the principal exchanges, with the specialist doubling as odd-lot dealer, as on the Amex. However, many of these stocks are quite inactive when measured by NYSE standards, and the specialists' books show the characteristics associated with inactive stocks. As is indicated by table VIII–77, comparing a sample of regional exchange books with a sample of NYSE books, the regional exchange books are relatively quite thin. The thinness of these markets has the effect, of course, of increasing the need for the spe-

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[239] For a discussion of the trading of NYSE-listed securities over the counter, see pt. D of this chapter.

cialist's participation as dealer, but by the same token most of the securities in question lack the attributes which will motivate specialists to take significant positions or make close markets. They have neither an assured flow of public orders nor a "book" through which a specialist can reverse his position.[240] Therefore, a seller with a block of even moderate size may find difficulty in selling it on the exchange, and consequently takes his business to the over-the-counter market.

For dually traded issues, it must be remembered that the regional exchanges are not primary but secondary markets. The dual trading system effectively ties the regional market to the NYSE tape. Because the regionals must be competitive in price with the primary markets, which do the great bulk of trading in dually traded securities, a different type of trading has developed. Its salient characteristics are the following:

(a) The executions on the regional exchanges are based on the prices and quotations of the primary market.

(b) The specialist participates as a dealer in approximately 90 percent of all multiple trading on the regional exchanges.

(c) The specialist is under no obligation to quote both sides of the market, although certain of the exchanges require him to quote at least one side competitively with the primary market. He may deal or refuse to deal as he chooses, with his willingness to trade generally depending on his position in the stock at the moment and his opinion concerning its price trend. He prefers to deal in orders permitting him to adjust his position to fit his needs.

(d) An executing broker who cannot effect a satisfactory trade on the regional exchange can always send the order to the principal exchange, although his economic incentive is often to execute it on the regional exchange.

The basic trading pattern implicit in these characteristics expresses itself in many variations on each regional exchange. The following brief description of major patterns is not intended to be exhaustive but rather to indicate the variety and flexibility of current practice.

Most orders on the MSE are executed on the basis of the last transaction on the primary market. Orders received before the opening of the NYSE are executed at the opening price there. The broker handling a customer's order normally secures quotations from both the MSE specialist and the principal exchange, and will effect the transaction on the better market, taking his choice if both are the same. For example, if the broker has 100 shares to sell and the NYSE market is 50 to 50½ while the MSE market is 50⅛ to 50¾, the broker would sell his 100 shares on the MSE at 50⅛. The MSE requires its specialists to quote a price on one side of the market which is at least as good as that on the NYSE. If, in this example, a broker wanted to buy 100 shares he would execute on the NYSE rather than on the MSE because the NYSE offer (50½) was one-fourth less than the MSE offer.

The MSE specialist will occasionally "stop" an order, permitting the executing broker to seek a better price on the primary market but guaranteeing him a price if he is unsuccessful there. Since communication with the primary market is extremely fast, these practices appear to assure the conscientious Midwest broker of at least as good a price as on the primary exchanges, and sometimes a better one.

[240] See ch. VI.D.

When larger orders come into the market there are various possible methods of handling the order. The specialist may be willing to fill the entire order or, in the alternative, he may fill part of the order and send the balance on to New York. He will then base the MSE execution on the price received in New York, filling his portion of the order at that price.

Neither the MSE nor the PCSE (described below) has a systematic method of assuring that their round-lot markets are in line with the New York market, and that executions are at least as good as they would have been in New York. The exchanges depend on the servicing broker to test the two markets and select the best one for his customer's order.

Trading on the Pacific Coast Stock Exchange is similar to that on the MSE with the added element of its two floors, San Francisco and Los Angeles, which are closely linked by fast communication systems. Generally, dual stocks are traded on both floors and there are specialists in both San Francisco and Los Angeles for these listings, although in certain instances when all of the interest in a particular dual stock is in one of the two divisions there will be only one specialist. The specialist on one floor negotiates with the executing broker on the basis of the New York tape largely in the same way as on the Midwest Exchange, but if he is unable to make a satisfactory offer to the executing broker, he calls his counterpart on the other floor. The entire process of checking both floors to determine how the quote compares with the New York market requires approximately 30 seconds. Though the specialists on PCSE tend to quote one side of the market "as good as New York," they are not required to do so. Many transactions are effected on the basis of the last New York sale, since the specialists prefer the certitude of this form of execution, but some are on the basis of the next New York price.

A specialist is able to keep in touch with the New York market by checking the NYSE tape and by obtaining quotes through his own office (if an NYSE member) or through an NYSE firm with which he has arrangements. Frequently the office will have a Quotron or similar device to give the last sale in New York and the current quote.

An apparently unique form of order on the PCSE is the "keep-in-line" order, said to be aimed at obtaining for the exchange a portion of block orders of mutual funds on a basis permitting execution at prices in line with the primary market. This means that the specialist will quote the order in line with New York, waiting for a counter public order to come into the market. For example, on a Monday morning the last price in New York was 45 and a commission house broker desires to sell 500 shares but the specialist does not desire to buy. The commission house broker, rather than send the order to New York, will keep the order on the PCSE and have the specialist offer the order in line with New York. The specialist may offer this order at 45 all day Monday. Assuming no public buyer comes in, the order will be carried over to the next day. If the price in New York declines, the keep-in-line order will be offered at the New York price.[241]

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[241] This type of order presents a problem of both customer protection and a possible conflict with the provisions of sec. 11 of the Exchange Act. The problem is whether such an order is a discretionary order and is somewhat similar to the problem concerning the so-called "not-held" order discussed in ch. VI.D. The matter is presently being studied by the Commission's Division of Trading and Exchanges.

The Philadelphia-Baltimore-Washington Exchange has also developed various methods of relating its markets to those of the NYSE. On that exchange the commission house order clerk calls the specialist and checks the market. If the firm is an NYSE member he will tell the specialist, "GM is 56 to an 1/8 in New York; I have 100 to sell." The specialist may buy the 100 at the New York bid or may say, "I am not interested at 56." If a local member firm is told that the New York market is 56 to an 1/8 and the best bid in Philadelphia is 55 7/8, he may then limit his order to sell at 56. If the stock should sell thereafter at 56 1/8 in New York, i.e., "sell through" the limit, the order will then be executed at 56. The firm may also receive an execution "on volume." If there are a great many "prints" of GM at 56 on the NYSE tape the specialist will execute the order at 56 without waiting for the stock to sell in New York at 56 1/8. The transaction "on volume" will occur when the volume of sales in New York at the limit price is such as would indicate that the firm can receive an execution at 56 in New York. However, if there should just be one sale in New York at 56, the specialist would not be required to give an execution at 56 under this arrangement. Another arrangement on the PBWSE is known as an order "with an adjustment." The purpose of this order is to assure that the execution will not be outside the NYSE range for the day though the tentatively agreed-upon price is not as good as the previous execution in New York. A PBWSE specialist testified that if the customer wanted to buy 100 shares of, say, General Motors when that stock was quoted at 55 7/8–56 in New York and the high sale of the day has been 55 7/8:

We will tell the broker: "We will sell a hundred General Motors at 56, with an adjustment."

Q. What does that mean?

A. If General Motors does not sell—the rest of the day—higher than 55 7/8 that price will be adjusted to 55 7/8.

Q. In other words, he wants to buy with a limit now at 56?

A. That is right.

Q. And the New York Stock Exchange high for the day has been 55 7/8 ?

A. And is quoted 55 7/8–56. We will say, "You bought a hundred at 56, with an adjustment."

Q. You will give him 55 7/8 ?

A. If it does not go higher than 55 7/8.

Q. But if it [reaches] 56——

A. Then the price remains 56.

None of these arrangements is considered by the PBWSE broker to create any question of fiduciary responsibility to their customers. With respect to the "sell-through" order, if the New York market is 56 to 56 1/8 and the customer wants to sell 100, he is guaranteed an execution on the PBWSE at 56 if the stock sells at 56 1/8 in New York. The reasoning is that, had the order been sent to New York, there is no certainty that the quote is the market in which the customer would have dealt since there might have been orders ahead of his or the market might have changed by the time his order arrived, i.e., he might have "missed the market." When the customer is guaranteed an execution at 56 when the stock sells at 56 1/8 it is considered certain that the order could have sold at 56 in New York. In the "on-volume" situation, if the stock sells repeatedly at 56 in New York there is also a clear indication that the order might have been executed at 56 in New York had it been sent there.

This brief exposition suggests that there are many variations of trading practices in multiple traded stocks on the regional exchanges, the limiting factors being the willingness of the specialist to meet the competition of the principal exchange, his capital resources, and his imagination in working out deals.

(2) *Odd-lot trading*

Odd lots constitute a more substantial portion of total trading volume on the regional exchanges than on the primary exchanges. In 1961, odd-lot trading amounted to only 9.1 percent of total share volume on the NYSE, but to 19 percent of the share volume of the Midwest Exchange. During sample periods in 1961, it amounted to 48 percent of share volume on the Boston Exchange and 11.7 percent on the Pacific Coast Exchange; this latter figure equaled 34 percent of dollar volume on that exchange.

Odd lots in solely traded stocks are handled in much the same way on the regional exchanges as on the Amex, with the odd-lot dealer doubling as specialist for the same security. The regionals' trading of odd lots in dually traded stocks, however, differs from such trading on the primary exchanges. Odd-lot orders are executed at the round-lot price appearing on the NYSE tape, plus or minus the odd-lot differential, 3 minutes after receipt of the order. This practice aims to assure the odd-lot customer that the price on the regional exchange is the same as he would have obtained had the order been sent directly to the NYSE. The 3 minutes approximates the time that it takes for the tape to reflect an execution on the floor of the NYSE.[242] Because the system aims at achieving the same price as an NYSE execution, there is no reason for the broker to check the New York market. Even in the primary market the odd-lot order is mechanically executed based against a round-lot sale and there is no brokerage judgment exercised.

The NYSE tapes are time-stamped by the regional exchanges and are used to determine whether an odd-lot order was properly executed. As a part of the MSE's surveillance procedure a record is prepared by MSE employees of the time of transaction in each dual stock, in addition to the timed tape.

Besides executing odd-lot orders against the tape, regional exchange odd-lot dealers may occasionally, on request, execute such orders on the bid or offer, although the rules do not require them to do so. Such executions usually require approval of a governor.

An odd-lot dealer can reduce a position in several ways. One is by improving his round-lot quote over the New York quote; thus he may expedite liquidation of a long position by making his offer one-eighth lower than the New York offer.[243] He can also offset his position on other regional exchanges. Specialists on the Boston, Philadelphia-Baltimore-Washington, Pittsburgh, and Montreal stock exchanges are in communication with each other by direct wires linking their floors and each may trade on the other exchanges at member rates. Odd-lot dealer-specialists on one floor of the PCSE may offset positions with their counterparts on the other floor. Specialists who are sole mem-

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[242] The timelag of 3 minutes is adjusted for any lateness of the NYSE tape.

[243] At the same time he might lower his bid beneath the NYSE quote so that he would not buy any round lots.

bers also offset with the over-the-counter houses dealing in listed securities.[244]

Many of the offsetting transactions are done on the primary market, the NYSE, with the odd-lot dealer-specialist buying or selling on that exchange as his needs dictate. As discussed below, this use of the primary market by regional exchange members apparently has little effect on NYSE markets. Of more interest is the fact that when the regional exchange odd-lot dealer-specialist does engage in an offsetting transaction on the NYSE, he must, unless his firm is a member of that exchange, pay the full commission, even though his transaction is that of a professional dealer. Since a specialist's dealer transactions are generally not speculative in nature, and his dealer profits come from small spreads and high volume,[245] the full NYSE commission represents a high fixed cost. At times the pressure of specialists who are not members of the NYSE to circumvent the NYSE public commission schedule leads to such devices as the sham arbitrage situation described in part I of chapter VI. Typically, however, the specialist is in some reciprocal business relationship with an NYSE member, as explained in that part, and often is financed by such a member. Many regional odd-lot dealer-specialists have become NYSE members to avoid payment of nonmember commissions, in some instances acquiring membership after becoming odd-lot dealer-specialists and building up a volume of offsets to make such membership profitable, in others entering the odd-lot dealer-specialist business as an adjunct to an existing commission business.

e. The public customers

In the absence of public transaction studies of the regional exchanges, it is possible only to speculate on the nature of their public customers. They appear to differ from the public customers of the principal exchanges in at least two respects. First, as just indicated, a large portion of their business, represented by odd lots, is transacted with small investors. Second, the Special Study's Questionnaire IN-4 revealed a high utilization of the regional exchanges by open-end (load) investment companies. Such companies transacted 78 percent of all institutional business placed on the regional exchanges, whereas they accounted for only 47 percent of institutional business on the NYSE. On the other hand, all other institutional groups (except closed-end investment companies) placed a negligible amount of business in the regional exchanges.[246]

The nonmember customer, regardless of classification, however, pays commission rates identical to those in effect on the NYSE, except on the Pacific Coast, Detroit, and Cincinnati exchanges, which have extended commission discounts to specified classes of professionals—generally broker-dealers in securities who are also members of the NASD.

5. THE PLACE OF THE REGIONAL EXCHANGES

The preceding discussion has traced the dramatic decline in the importance of the regional exchanges as primary markets and their conversion to secondary markets, not truly of the auction type, for dually

[244] See pt. D of this chapter.
[245] See ch. VI.D.6.c.
[246] See pt. C.3.a(2) of this chapter.

traded securities. The major factors accounting for the absolute and relative decline of the regional exchanges as primary markets have been shown to be: (1) freedom from controls over issues in the over-the-counter markets as compared with issuers of listed securites; (2) greater flexibility of trading, "merchandising" and pricing practices in over-the-counter markets; (3) improvements in communication that have both accentuated the gravitational pull of New York and permitted the growth of the over-the-counter markets; and (4) the vicious circle of declining business and declining prestige of regional exchanges.

The regionals, as occupants of the difficult middle ground between the major exchanges and the over-the-counter markets, have had the unhappy experience of generally feeling the adverse impacts, and never the favorable impacts, of these various developments. The notable decline of their role as primary markets has been accompanied by a very substantial increase in their role as "dual" markets for securities traded on the New York Stock Exchange and, to a limited extent, the American Stock Exchange. Not the least of the factors, of course, accounting for this change has been the sheer struggle for survival of regional exchanges in the face of their declining function as primary markets. By the same token, if and to the extent the latter trend might be reversed, the reliance on multiple trading would be tempered.

The purpose of this section is to examine the role of the regional exchanges in the securities markets under existing conditions and to consider some of the possibilities for their development in the future. Consideration is first given to the two specific trading functions of these exchanges, as "multiple" and primary markets, and to the general considerations affecting their overall performance as institutions for the trading of securities in the regions of which they are part and in the national securities markets.

a. Regional exchanges as "multiple" markets

In their important area of trading of stocks also traded on the principal exchanges, the regional exchanges do not operate as independent auction markets but, as already pointed out, as negotiated markets within limits set by the tape of the principal exchange. Their functioning in this area can perhaps best be evaluated in the reference frame, on the one hand, of their contributions to the public generally and to professionals in the securities business and, on the other, of their impact upon the primary markets.

(1) *Functions of multiple trading*

(a) *Broker-dealers.*—For professionals in the securities business, multiple trading on the regional exchanges is a gateway to an important segment of the securities markets otherwise closed to many,[247] and it may permit larger earnings even for NYSE members, who enjoy that access. Because of the impact of the NYSE public commission schedule, discussed in section 3 above, a sole member of a regional exchange may place an order for a dually traded security on the regional exchange and retain most of the commission, rather than place it on the NYSE through an NYSE member and, technically,

[247] See pt. D of this chapter for a discussion of a similar function performed by the over-the-counter market in listed securities.

keep no part of the commission or, practically, retain a portion via a reciprocal commission or equivalent arrangement. The regionals also serve a somewhat similar function for dual members lacking executing and clearing facilities in New York. Such members must yield some 25 to 40 percent of their commission to another NYSE member to perform these functions for them on the NYSE, but may retain a larger part of the commission by handling the transaction directly on the regional exchange. Dual members possessing executing and clearing facilities in New York have a more balanced choice, some favoring the principal exchange because of such considerations as cost savings resulting from centralized bookkeeping systems, and others selecting the regional exchanges either to generate reciprocal commission business or to "keep the business local."

Where, for any of several reasons, a sole member places orders on the principal exchange via a member of that exchange, such orders become the basis for the reciprocal commission business given to the sole member to be transacted on the regional exchange. The regionals thus serve a double purpose for a sole member: they become the instrument by which he may handle some orders directly or through which he may receive business reciprocating for business that he has placed on the primary exchange. The role of the regional exchanges in serving these purposes for their sole members highlights the need for carefully evaluating and administering any changes in the public commission schedule of the NYSE which may be designed to recognize nonmember professionals in the securities business as entitled to preferential treatment.[248] A conflict of public purposes may result from, on the one hand, any future determination that modification of the commission schedule is in the public interest and, on the other, the possible effect of any such modification in reducing the volume of trading on the regional exchanges. This is not to say that the conflict is irreconcilable, but it is important that any fundamental changes in the commission schedule be worked out with due regard for the need of the regional exchanges to accommodate themselves to the revision.

(b) *Public customers.*—The regional exchanges also relieve the sweeping impact of the NYSE public commission schedule on such large-volume or large-block public customers as open-end mutual funds. The funds utilize the device of the "give-up" or directed split of commissions to reward broker-dealers for selling mutual fund shares or supplying statistical and research services. The NYSE limitation of cash give-ups to exchange members in the case of NYSE transactions has led funds to funnel out some portfolio business for execution on the regional exchanges, where the commission may be given up not only to sole members but, in the case of the Pacific Coast, Cincinnati, and Detroit exchanges, even to nonmembers of those exchanges.[249] Thus the caveat just expressed with respect to the need for care in evaluating the impact of changes in the NYSE public commission structure to give access to the nonmember professional also applies to any changes designed to recognize block and volume customers.

[248] See ch. VI.I.
[249] See pt. C, above.

Other functions performed by the regional exchanges for public customers rest on a firmer foundation. Some of these have already been noted in the quotations from the Commission's early section 12 (f) (2) cases, as well as the *Multiple Trading Case*. One is the incentive to save the New York State stock transfer tax. Normally paid by the seller, this tax is calculated as follows:

Stock value per share:	*Tax per share (cents)*
Less than $5	1
$5 to less than $10	2
$10 to less than $20	3
$20 or more	4

The tax in any round-lot transaction may thus reach $4. It is clear from the responses to Questionnaire IN–4 that some institutions take this factor into account in transactions of sales,[250] and responses to Questionnaire EX–4 indicate that many member firms consider it a significant factor in executing agency orders for public customers (table VIII–78).[251]

It has also been suggested that the regional exchanges may excel the principal exchanges in speed of reporting execution of transactions,[252] and in reduction of both mailing charges on securities and time required for investors to secure stock certificates. Reference is also often made to the function of the Pacific Coast Exchange in providing, because of the time differential, trading facilities after the closing of the primary exchanges. Thus one respondent to the institutional questionnaire, extolling the benefits of regional exchange competition generally, referred specifically to the time differential.[253] In general, however, Pacific Coast trading in dually traded stocks actually appears to drop off sharply when the primary exchanges suspend operations for the day.

By giving their sole members preferential access to dually traded stocks, the regional exchanges help to widen the public customer's field for the selection of a broker able and willing to do business in a large spectrum of stocks. This benefit to the customer is the complementary aspect of the function described above from the reference point of the professional. But the enlarged competition thus made possible in the selection of a broker does not extend to commission rates; public rates on the regional exchanges are the same as those of the principal exchanges.[254]

In the important area of price, there are no reliable data measuring accurately the quality of executions in multiple traded stocks on the regional exchange against the yardstick of the principal exchange. Price competition with respect to a given security at a given time is within very narrow limits at best. In odd lots, as seen, the regional

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[250] See pt. C, above.

[251] The basic advertising of the Boston Stock Exchange, presently and for some time past, emphasizes that:

"There is no state stock transfer tax in Massachusetts. * * * If your sales confirmation shows a state stock transfer charge * * * your order was *not* executed on the Boston Stock Exchange! Tell your broker to make this saving for you whenever possible!"

This is in contrast to the position taken by the Boston Exchange with respect to advertising the lower differential for certain odd-lot transactions that prevailed briefly in 1958; see ch. VI.E.

[252] Several dual members indicated, in response to Questionnaire EX–4, that the fact that "reports of executions are received more quickly" is a significant reason for executions on regional exchanges (table VIII–78).

[253] See pt. A.2.6, above.

[254] See ch. VI.I.1.a(2).

exchange prices are directly based on the New York tape; in round lots there is slightly greater flexibility but the practical results do not greatly differ—in fact all of the regionals have mechanisms and procedures to assure correlation with New York prices. Nevertheless, it should not be assumed that the existence of the dual market has no effect on the primary. The president of the Midwest Stock Exchange cited, as one example, a situation in which, after that exchange had developed a substantial share of the market in Commonwealth Edison common stock, there was a noticeable improvement in the NYSE specialist's bid and asked quotations. This view was in a sense corroborated by papers in the files of the NYSE which showed that, several years later, its officials were concerned with the volume of transactions in the same stock on the Midwest Exchange and requested that the specialist carry larger positions and provide closer quotations; the specialist promised to do so. The Special Study has found other instances where the files of the NYSE reflect suggestions or cautions to NYSE specialists occasioned by regional exchange competition. A considerable number of dual members of regional exchanges, in answer to the study's Questionnaire EX-4, gave "better price available" as a major reason for executing transactions in dually traded stock on the regional exchange (table VIII-78).

(2) *Effect on primary market*

A full evaluation of the function served by the regional exchanges in multiple trading requires a consideration of the impact of such trading upon the primary market. The concept of "depth" has been discussed in relation to price continuity and fluidity in a continuous auction market, and it becomes important to consider the possible impact of a diversion from the primary market of trading in a given security.

In an effort to gage, if only in a general way, the effect of multiple trading on the primary market, the Special Study compared the trading on the Midwest, Pacific Coast, Baltimore-Philadelphia-Washington, and Boston exchanges of 207 stocks traded on at least 3 of these 4 exchanges as well as on the NYSE. These issues accounted for between 42 and 47 percent of the NYSE round-lot volume in the three 1-week test periods [255] and were among the most active stocks on the principal exchange. Total round- and odd-lot trading on the four regional exchanges amounted to 11.4 percent of the equivalent total on the NYSE for 2 of the 3 weeks and 10 percent the other week. But the extent of regional trading in individual stocks was quite varied, ranging from more than 40 percent of NYSE volume in some cases to less than 5 percent in many.[256]

A further study was made of the trading in 1 week of 50 stocks for which the amount of round-lot and odd-lot trading on the regionals was greatest compared to that on the NYSE. Round lots alone were considered, however, in this smaller study because odd-lot trading does not directly affect the depth of the primary market. After elimina-

[255] These were the weeks ending Jan. 27, Mar. 24, and June 16, 1961—the same weeks for which various studies of NYSE member trading were made. See ch. VI. C. D, F, and G.

[256] To measure the net effect of regional trading on the NYSE, it is necessary to reduce the latter's indicated volume by the volume accounted for by offsetting transactions on the NYSE by regional specialist-odd-lot dealers. The offsets averaged 2 percent for the 3 test weeks.

tion of regional offsets on the NYSE, round-lot trading on the MSE, PCSE, and PBWSE[257] constituted 13.45 percent of the total round-lot trading in these securities in their multiple markets, or 15.54 of NYSE volume. But again the range for individual stocks was wide, exceeding 20 percent of NYSE volume for 10 stocks and in one isolated case reaching 83.2 percent (table VIII-79).

A further study conducted of 50 of the most active stocks on the NYSE during the market break in May 1962 disclosed that regional exchanges had little effect on the NYSE at that time. Regional round- and odd-lot volume, as a percentage of NYSE round- and odd-lot volume for May 28, 29, and 31, was a little over 8 percent, compared with between 10 and 11 percent in the 3-week study. Offsets on the NYSE by odd-lot dealer-specialists were small compared to NYSE volume in these 50 stocks; on May 28 the percentage was 1.05, on May 29, 1.08, and on May 31, 1.83.

The tendency for multiple trading to be concentrated in stocks active on the principal exchange[258] lessens the likelihood that such trading will seriously impair the depth of that market. Certainly, in none of the 3 weeks did the trading on the NYSE drop even close to the mark of 400 shares a day, which the exchange seems to view as the bare minimum necessary to support its auction market.

Against the possible diversionary effects of multiple trading must be weighed a possible increase in overall volume; the whole market's being split into multiple exchange markets in different parts of the country may itself engender public interest and activity that would not otherwise be reflected in any market. In one or more early cases under section 12(f)(2) the Commission recognized this stimulating effect as a reason for granting the application for unlisted trading privileges,[259] and the earlier staff studies referred to above tended to support the conclusion that multiple trading in its totality does not reduce round-lot volume on the primary market, but may actually increase it. The fact that the New York and American Stock Exchange members have retail offices throughout the country, including the vicinities of the regional exchanges, and the further fact that the membership of many regional exchanges is significantly if not predominantly made up of New York and/or American exchange members, would tend to limit the potential for increases. On the other hand, the inability of the still substantial group of "sole" members of the regional exchanges to handle retail orders in the primary market except on the basis of nonmember commission rates[260] would indicate that the contention has some validity.

A substantial part of regional exchange business in multiple traded stocks is in odd lots rather than round lots.[261] Odd-lot transactions, since they take place outside the round-lot auction market, whether effected on the NYSE or on the regional exchange, do not directly affect the depth of the primary market except insofar as the odd-lot dealers effect offsetting round-lot transactions. The significant differences between execution of an odd-lot transaction on a regional exchange and the NYSE relate to the broker's costs, the amount of the

[257] Boston's figures were eliminated because its trading is principally in odd lots.
[258] See discussion above and table VIII-75.
[259] 6 S.E.C. 296 (1939).
[260] The situation may be different on the American Stock Exchange because of its provision for associate membership.
[261] See sec. 4.d, above.

commission he retains, and which odd-lot dealer earns the odd-lot differential. If a sole member of the regional exchange places the odd-lot order with an NYSE member, he pays the full nonmember NYSE commission, generally subject to a return of reciprocal commissions or special services. If he executes the order directly on the regional exchange or places it with another member of that exchange for execution, he retains all or most of the commission. In the one case, the odd-lot differential is earned by one of the two large NYSE odd-lot dealers, while in the other it is earned by the specialist-odd-lot dealer on the regional exchange.

At the other end of the spectrum, there is evidence that some round-lot executions on regional exchanges consist of portions of large orders which, if traded en bloc, would not necessarily contribute to the smooth functioning of an auction market.[262] To state this another way, since any large block may tend to produce a temporary imbalance of demand and supply, reduction of a block by handling part of it on a regional exchange may be considered, in a broad sense, as enhancing rather than impairing depth. It is to be noted in this connection that several dual members of regional exchanges, in responding to Questionnaire EX-4, gave "reduce market impact on NYSE" as a major reason for executing transactions on a regional exchange (table VIII-78).

Section 12(f)(2) has focused major attention on the justification for multiple trading on the regionals in terms of the "vicinity" test,[263] not on its effect on the primary market. As applied, the clause has exerted minimal effect in inhibiting the extension of the unlisted trading privilege to the regional exchanges. The application has nurtured the important role served by the regional exchanges as competitive markets and as a separate channel for the trading of listed stocks by professionals who would otherwise be denied practical access to dealing in these stocks. But whatever objective standard may be employed to give content generally to the vicinity test, it would seem that care should be exercised in applying this test in situations in which the consequence of extension of the unlisted trading privilege would be to reduce the depth of the existing market beyond the minimum necessary to support an auction market.[264]

b. Regional exchanges as primary markets

If there can be differing viewpoints concerning the multiple trading function of the regional exchanges, the value of their role as alternative primary auction markets—at least in the case of the best and strongest of them—cannot be doubted. The difficulty here is the very real and practical one that their long struggle for survival as primary markets has been a losing one. If multiple trading had not been allowed to flourish to the extent it has, the names of additional regional exchanges would undoubtedly have been added to the casualty list by now.

In the performance of their function as primary markets, of course, the regional exchanges compete not only with the principal exchanges but with the over-the-counter market. It has been seen in part B of this chapter that auction markets are more demanding than over-the-

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[262] See pts. C and D of this chapter.
[263] See sec. 2.b, below.
[264] In June 1963 the Commission recommended legislation which would remove the vicinity test, leaving a broad "public interest" test.

counter markets in their criteria for securities to be traded, but it has also been seen that there is a wide overlapping in criteria among presently listed (exchange-traded) and presently unlisted (over-the-counter-traded) securities. Current potential for additional regional listings must not be exaggerated, of course; James Day, president of the Midwest Stock Exchange, has advised the Special Study that an analysis of the 14-State area considered by the MSE to be its "vicinity" reveals only 185 potential new listings for that exchange, of which two-thirds appear to possess, without reservation, the qualifications for a good regional auction market of the conventional type.[265] Nevertheless, the potential for expanding the role of regional exchanges as primary markets—reversing the trend of recent decades—remains very real. A number of different factors may or could contribute to this potential if industry and governmental efforts are pointed in this direction.

A factor of prime importance in the development of the regionals as primary markets would be the removal by appropriate legislation of present discriminations in requirements imposed on issuers of listed and unlisted securities, as recommended in chapter IX of this report. This recommendation stands on its own footing entirely apart from any collateral effects—to achieve basic protections for investors in unlisted stocks—but it is also clear that, as regulatory distinctions have undoubtedly been a factor in issuers' choice of markets, elimination of these distinctions would bring an additional quantity of securities to the listed markets including the regional exchanges.

Secondly, there may be further important possibilities for strengthening regional exchanges through mergers, mechanical interconnections, and/or reciprocal membership arrangements between two or more existing exchanges. Such combinations have proved highly useful in the past, particularly in the case of what are now the Midwest Stock Exchange, the Pacific Coast Stock Exchange, and the Philadelphia-Baltimore-Washington Stock Exchange. With ever-improving means of rapid communication, measures of this kind may hold even greater promise for the future. It is quite conceivable that some or all of the present 14 "regional" exchanges, themselves representing the survivors of approximately 100, could be greatly strengthened if corporately or mechanically combined into a smaller number of entities. The potential advantages would be of at least three different kinds. First, a combined, larger membership would bring greater breadth and depth of interest in all securities traded.[266] Second, the capacity of combined units to provide market facilities and self-regulatory mechanisms of high quality would obviously be greater than that of any of their component markets. Third, the prominence and prestige of the larger units and thus their capacity to attract listings, to gain investor acceptance, and to obtain broad publication of their transactions and quotations, would inevitably be enhanced.

Another method of increasing the role of the regionals as primary markets might be to seek a greater degree of flexibility in their trading methods and practices than is presently found. Present rigidity ap-

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[265] Day's estimate is based on more rigorous standards, however, than others have adopted or expressed.

[266] The present arrangements between the PBWSE, the PSE, the BSE, and the Montreal Stock Exchange under which members of each exchange can execute orders on the others at member rates is a step in this direction.

pears to stem from pre-1934 history and from the Exchange Act's treatment of all "national securities exchanges" as a single regulatory category. On the other hand, section 11(c) of the act expressly confers authority to make distinctions among exchanges, and similar authority is implied in various sections' authorization of substantive Commission rules "necessary and appropriate in the public interest or for the protection of investors" and section 19(b)'s authorization of Commission modification of an exchange's rules where "necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange * * *." Notwithstanding this potential for flexibility and variety, there are many important respects in which all exchange markets are distinguished from all over-the-counter markets for regulatory purposes. So sharp a distinction may be quite valid when over-the-counter securities as a total class are broadly compared with listed securities as a total class. But for purposes of establishing adequate trading practices, the broad category of listed stocks may well be subject to a degree of subdivision, ranging from those stocks unquestionably possessing all the characteristics associated with most active trading in the continuous auction market to those possessing the minimum attributes for trading on an exchange. For the latter group at least, it might be realistic and constructive to permit greater flexibility in trading practices, at least if this category could be clearly identified in the public mind so that investor expectation could be appropriately attuned to the facts.

Along these lines, it might be possible, for example, for certain of the regional exchanges to recognize a distinction between "national" and "regional" listings, with somewhat different standards and trading practices applicable to each category. Assuming that "national" listings on regional exchanges would be comparable to those on the New York exchanges, the practices and procedures applicable to the "regional" category might be intermediate between those prevailing in the largest exchanges and those prevailing in over-the-counter markets; i.e., some form of call market [267] or an auction market with modified ground rules.

During the course of the Special Study, conferences were held between members of the staff of the study and representatives of the Midwest and Pacific Coast exchanges concerning problems faced by the regional exchanges with respect to their markets in solely listed stocks, and the two exchanges presented a plan which they believe would help to create active, liquid exchange markets in certain of their sole listings. The plan, called the "Exchange Dealer Plan," basically provides that exchange member retail firms could acquire stock on the exchange, in the regular way, which they could then resell to solicited customers as principal, charging a net price which would include a markup. The maximum amounts of these markups would be set by the exchange. Before the transaction would be consummated, the "crossing" [268] mechanism would be utilized on the floor of the exchange; if there were a lower offer available on the floor, the customer would receive the benefit of such lower price. Various antimanipulative restrictions are also proposed with respect to the trading of the member firm engaged in retailing stock. If a retail firm with which

[267] See ch. V.
[268] See ch. VI.D.7.a.

a specialist is associated decided to participate in the plan in a stock in which the specialist is registered, the specialist would be required to withdraw as such while the firm operated under the plan.[269]

There are several considerations which militate in favor of the adoption of some variant of the proposed plan, including the fact that it would provide some safeguards not characteristic of over-the-counter markets in respect of otherwise similar mechanisms. Its principal advantage, if the negative aspects mentioned below are not found to be preponderant, is that it might provide some relief from the dilemma in which regional exchanges find themselves, in that they are restricted from allowing members the latitude permitted in over-the-counter transactions, but at the same time cannot offer them the prestige of the major New York exchanges.

Considerations against the plan in its present form may be summarized as follows: First, the plan would permit markups in excess of the commissions which now prevail on exchange markets and the amount of the markup would not be disclosed to the customer. Second, the net price including the markup would appear on the exchange tape and, although distinguished from regular tape prices, might create confusion as to what the actual market prices were. Third, the customer might find it easier to buy securities under the plan than to sell since the dealer involved in the plan could leave the market at will. Certain of these difficulties may also be present, of course, and in greater degree, in many over-the-counter markets, but they take on new aspects when considered in relation to an "exchange" category.

The Special Study is unable to recommend approval of the specific plan in the precise form presented, but believes that regional exchanges should generally be given encouragement in adapting conventional mechanisms for handling special categories of securities, and should be afforded reasonably wide latitude to demonstrate, under carefully controlled conditions, whether the balance of benefits and dangers of any particular plan is acceptable. With respect to the specific "Exchange Dealer Plan," additional study of its details should be undertaken by the staff of the Commission, together with the exchanges involved, to consider whether further refinements and safeguards would improve the balance. As a minimum, these safeguards should not be less than would result from the recommendations in chapter VII as to over-the-counter markets; in other words, even if some form or forms of intermediate trading mechanisms should be permitted or even encouraged, there is no reason to tolerate any form that is inferior in any manner or degree to what is expected of over-the-counter markets. Upon satisfactory conclusion of such a study, and with such modification of the plan as may seem necessary, Commission approval in the form of appropriate temporary exemptions from rules 10b-2 and 10b-6 should be granted. The plan might then be adopted for a limited period of, say, 12 months, during the last 3 months of which prior to any renewal of the plan, the Commission should undertake a comprehensive evaluation of the plan and the practices which developed in connection with it. The particular

[269] A variant of the plan, mentioned in the course of conferences but not embodied in the plan as filed, would confine retail activity on the above basis to the specialist firm itself.

plan may or may not prove workable, but efforts in this direction under carefully controlled conditions would seem worthwhile to strengthen the regional exchanges as primary markets.

c. General considerations

In addition to the specific trading functions of the regional exchanges described in the two previous subsections, these markets were described by the Commission 20 years ago as "important factors in the lives of their communities * * * functionally interlocked * * * with the facilities of brokers, dealers, and bankers."[270] The point undoubtedly has validity today: aside from the intangible consideration of prestige accruing from the existence of a stock exchange in a financial community, the regional exchanges stimulate banking business by creating loans, deposits, stock transfer and registry operations; provide employment directly and indirectly; and may otherwise contribute to the health of a region's economy. Perhaps not least in public importance, they serve as resistance points against what might otherwise be an irresistible and ultimate gravitation of securities markets and surrounding activities to New York.[271]

Competition among exchanges in dually traded stocks has already been listed as an element in the protection of the public customer. But a more generalized type of competition between regional and primary exchanges may also operate ultimately, if less directly, in the public interest. The trailblazing potential of the regionals in introducing new methods of doing business has been demonstrated in various ways. Thus, the Midwest Exchange proudly claims to have instituted the practices of—

> * * * (1) the admission of corporate members which broadened service to the public and permitted many fine investment banking and dealer firms to trade in listed securities for the first time; (2) clearing by mail, which provided better service to investors and substantially cut operating costs of out-of-city members; (3) the exchange's own wire system that speeded up information to investors and cut communications costs to members; (4) the present centralized bookkeeping system plan that will offer substantial savings in the cost of the members' back-office procedures and will improve service to investors.

The Midwest Exchange also claims to be responsible for—

> * * * establishment of Midwest transfer offices, cutting time, mailing expense, and New York State transfer tax, for the benefit of Midwest residents and establishment of a pool to supply stock on loan to members wanting to speed up deliveries on sales to customers.

In the same way, the PBWSE claims credit for establishing the first stock clearing corporation in 1870 (as the Philadelphia Exchange), some 20 years before the NYSE followed suit.

So brief a summary of such measures may tend to understate their importance. Thus, the Midwest centralized bookkeeping system referred to above is a large-scale project designed to attain the benefits of automation—in terms of speed, efficiency, and economy—for brokerage firms which, individually, could not be expected to be able to afford such elaborate and extensive services. The system performs a substantial portion of the back-office work of its participating members—wherever they may be located—at a cost estimated to be approximately one-third the members' previous average expense for

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[270] 10 S.E.C. 270 at pp. 283–284 (1941).

[271] In 1936, the Commission pointed out to the Congress that regional exchanges helped to prevent "the further concentration in New York of control over the movement of capital in the Nation." SEC, "Report on Trading in Unlisted Securities Upon Exchanges," p. 15 (1936).