erning the payment of gratuities to employees of the Exchange and member firms, a rule applicable to both floor members and off-floor members which appears to raise most problems in the context of floor conduct.

a. Procedure of floor regulation

Although in October 1962 the Exchange revised its procedures for regulating conduct on the floor, there previously were and to some extent continue to be important differences between floor procedures and those employed to regulate conduct off the floor. The most significant distinction involves the role played by the Exchange staff.

As described in section 3 above, the department of member firms, in regulating conduct off the floor, deals directly with the members, allied members, and employees involved in its investigations, and takes action against the individuals involved either through a staff letter of caution or by reference to the advisory committee or the board of governors. Supervision of floor conduct, however, is complicated by the existence and activities of the floor governors described in section 2.d above, whose responsibility is the direct supervision of the floor. Since all the individual floor governors spend a substantial part of their time on the floor, they supervise floor activities on a minute-to-minute basis. The floor governors as a group also recommend policy changes affecting the operations of the floor and consider certain disciplinary matters.

The part of the Exchange staff devoted to regulating conduct on the floor is known as the floor department. The department is divided into two sections: floor operations, consisting of 580 employees in November 1962, engaged in operating the floor but having no regulatory responsibilities; and floor procedure, consisting of 37 employees engaged almost entirely in regulatory functions.

The Special Study questioned both Exchange staff members and past and present governors about the relationship between the staff and the floor governors in terms of the division of labor and responsibility prior to the October 1962 revision in procedures referred to above. A leading specialist and former chairman testified that the floor governors had the principal responsibility in administration of the floor, while another former chairman testified that the floor governors "do the supervising of the members on the floor of the Exchange" and that the staff "are the ones who collect the reports and examine the reports, and then bring them in to the floor governors if they believe they do not conform to the policy set down by the governors and the advisory committee."

When questioned regarding his function at meetings of the floor governors, the vice president in charge of the floor department stated that his department had not made recommendations to the floor governors regarding the banning of stop orders, disciplinary cases, allocation of securities, or any other matter coming before the group. He viewed his function as that of presenting facts.

In the relatively few formal disciplinary cases involving floor problems, six during the period from January 1, 1957, through December 31, 1962, the Exchange staff had the authority to take testimony from the members involved, inspect such records as were considered necessary, and prepare a report of the matter for the executive vice president, without obtaining the approval of the floor governors before proceeding with an investigation. Nevertheless, in the overwhelming majority of situations where irregularities or substandard performance were suspected by the staff, an informal procedure was employed. Under this procedure, which was in effect until October 1962, the staff prepared a memorandum for the executive vice president of its findings in a particular situation, based upon a review of various forms or records which were required to be filed. Generally, this memorandum was prepared without the staff's having discussed the matter with the member involved. Matters handled by the staff in this manner included failures by specialists to maintain the kinds of markets which the staff believed were proper, and failures by floor traders to comply with the floor trading rules. Generally, the executive vice president referred the floor department memorandum to the chairman,[131] who would either himself speak to the member involved or refer the memorandum to an individual floor governor to get the member's explanation. The staff would be advised of the results of the floor governor's investigation, either by the governor or the chairman. The vice president in charge of the floor department stated that upon rare occasions he was dissatisfied with the disposition of the matter reached by the floor governor or the chairman, but in the large majority of cases he accepted the determination made. Neither of the former chairmen mentioned above could recall a situation where the staff questioned a decision made by the chairman and a floor governor with regard to this type of floor violation. It was indicated that, if the chairman and the floor governor agreed upon a particular disposition, the matter was concluded, although a theoretical right of appeal did exist in the staff.

A typical example of the manner in which such matters were handled involved a market study conducted by the floor department into trading by the specialist in McGraw-Hill Publishing Co. in the spring of 1960. On the basis of its review, the staff felt that the spreads being quoted by the specialist in the stock were too wide. The matter was referred to the executive vice president, who referred it to the chairman, who referred it to three floor governors. The floor governors reported back to the staff that they were satisfied with the market being quoted by the specialist. The staff made no direct inquiry of the specialist nor did it examine the specialist book. The inquiry made by the staff was confined "to the statistics involved."

In another instance, in connection with a market study in Reliance Electric & Engineering Co., the chairman indicated that the participating role of the specialist as dealer was very poor and that the file should be given to a particular governor. This governor spoke to the specialist and also discussed the matter with other governors. He concluded that he could not criticize the specialist's market because there were no public orders in the stock. There is no indication that the staff participated in the discussion. The same governor also reached the conclusion that the market was satisfactory in another stock after the file had been referred to the chairman who felt that an improvement in the market was necessary.

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[131] The chairman is not involved in off-floor discipline except as a member of the informal committee, the advisory committee, and the board of governors.

This procedure for investigating "minor" irregularities raised a question whether the floor rules were administered in a uniform fashion. Since the chairman and the floor governors are a changing group, matters were referred to any one of 14 governors, and the staff did not participate in investigation of the cases. Furthermore, one specialist would be investigating the activities of his fellow specialists.[132]

Under the procedure formerly in effect, a determination that a specialist had failed to meet Exchange standards was frequently disposed of by an oral admonition by a floor governor or the chairman. The informality with which these incidents were handled created some likelihood that the members involved would lightly regard the admonition received, as would appear to have been the case with respect to various floor trading violations.[133] Another problem was that potentially serious violations might be disposed of by means of a handwritten note on a file by the chairman or a floor governor.

This method of handling "minor" violations was explained in various ways by witnesses before the study. A prominent specialist and governor was of the opinion that there would be "some resentment" on the part of a specialist if a staff member asked him why he was not making a better market in a particular stock. He also noted that he believed floor governors were better qualified to conduct these investigations because they knew the conditions under which these transactions took place. A former vice chairman of the board, when asked whether he had ever found any reluctance on the part of floor members to comply with decisions made by the staff, stated:

> It's like everything else, when you are the boss and somebody else suggests something to you, sometimes you are, let's say, a little reluctant to accept it although you would accept it from your chief. * * *

The attitude of the floor is highlighted by a former chairman's testimony to the effect that the chairman is "the chief on the floor." When asked whether the president had "any authority on the floor," he replied: "The president never comes to the floor, only to visit."

Subsequent to questioning by the Special Study of various floor governors, the Exchange changed its procedure with regard to these "minor" violations in October 1962. Under the new procedure, the staff is empowered to investigate possible irregularities without first referring the matter to the chairman and a floor governor. The staff can now go directly to the member and make its inquiry. If the staff believes that a minor infraction has occurred, it can write to the member and caution him or refer the matter to the advisory committee.

The vice president in charge of the Floor Department also testified that the Exchange had reappraised its system of policing specialists in the fall of 1961 and had increased its surveillance of their activities early in 1962. He indicated that developments at the American Stock Exchange were a factor in the increased consciousness of this aspect of the Exchange's activity.

b. Regulation of specialists

(1) *Registration of specialists and allocation of securities*

NYSE rule 103 requires that a member of the Exchange be registered as specialist in a security before he is permitted to act in that capacity

[132] In one instance, a chairman investigated the continuity of transactions and the spread in quotations in a stock in which his own specialist firm was registered.
[133] See sec. 4.c, below.

on the floor. Under a policy which became effective in January 1963, the Exchange does not permit a member to act as specialist until he has passed a written examination.[134] Prior to that time, the Exchange only required a member interested in acting as specialist to register with the Floor Department as an associate specialist for a specified period of time determined by the chairman, ranging from 30 to 90 days, depending on the background and previous experience of the applicant. During that period the applicant was permitted to act as a specialist under the guidance of a regular or relief specialist. At its end the applicant was given an oral test by the chairman or a floor governor selected by the chairman, and was questioned as to "his understanding of his responsibility as a specialist." According to one floor governor, no one failed this oral examination while he was a governor.

The allocation of securities to specialists (including newly listed securities and those, already traded, which are shifted from one specialist to another) is within the authority of the board of governors. Usually the board acts on the basis of recommendations made by the advisory committee, which in turn almost invariably follows recommendations made by the floor governors.

Specialists interested in allocation of a new security are invited to appear in person before the floor governors. At meetings to consider allocations, the Exchange staff presents factual data but makes no recommendation as to which specialist should receive the stock being allocated. The floor governors are advised of the number of shares reserved for options, the present market price and distribution, and the performance of each specialist-applicant on the Exchange participation and stabilization tests. Under present policy, no consideration is given to the efforts of any particular specialist in bringing about the listing or the recommendation of the company or its investment banker.

At hearings held in June 1961 on the bill to establish the Special Study, NYSE President Funston testified:

> * * * when it comes to allocating stocks at the Exchange, our board assigns stocks principally on the basis of the past performance of the specialist as dealer. In other words, on his record. On the American Exchange the procedure was more to allocate stocks, on the basis of how the listing was obtained.[135]

The latter consideration apparently entered to some degree into NYSE allocations prior to that time. Thus, a few months before Funston testified, the Exchange had allocated the newly listed common stocks of Hewlett-Packard Co. to a particular specialist firm. In connection with the listing, the president of Hewlett-Packard advised the Exchange that this firm had "been very helpful during the past several years in discussing with us the various aspects of listing on the New York Stock Exchange, and they have been helpful to us in moving to apply for listing at this time." For a period of approximately 2 years prior to listing, there were visits and discussions in California and New York between partners of the firm and representatives of Hewlett-Packard, of which the Exchange was kept advised, and the company named the firm as its first choice as specialist. The floor gov-

[134] See ch. II.B.2.c.

[135] Hearings before subcommittee of the House Committee on Interstate and Foreign Commerce on H.J. Res. 438, 87th Cong., 1st sess., at p. 114 (1961).

ernors recommended that it be allocated to this firm over 13 other specialists who applied for the stock, and the board approved.[136]

The fact that allocations formerly were affected by whether the specialist induced the listing is confirmed by the testimony of a prominent specialist and former NYSE chairman before the Special Study in September 1962 when he stated that under a policy in effect until "a year or two ago," if a specialist demonstrated that he had brought on a listing, the floor governors would recommend that the security be allocated to him. The Exchange had allocated to this specialist's firm the common stock of Coca-Cola Bottling Co. of New York, Inc., at the time of its listing in August 1960. The staff of the Exchange noted for the floor governors that the specialist had maintained close contact with the company and had given the staff advance notice of the public sale which qualified the company for listing, and added that "on this basis it would appear that he may have been helpful in securing the listing."

It should be noted that of the new listings in recent years, considerably fewer resulted from the efforts of specialists than was the case with the Annex.[137] The large NYSE staff charged with obtaining new listings gave less opportunity for specialists to obtain credit for inducing them.

The request of a company about to be listed, or of its investment banker, to allocate the stock to a particular specialist was also considered by the floor governors in recommending allocations prior to the middle of 1961. The Exchange appeared to have no clear policy on the matter, but there were numerous instances during the years 1959 and 1960 when specialists were allocated securities after they had been requested by issuers or their investment bankers.

The allocation of the common stock of Ampex Corp. in January 1959 illustrates what appears to have been the former Exchange practice with regard to the recommendations of company officials. The company successfully requested allocation of its stock to a particular specialist firm, stating that the firm had been recommended by its investment banker and that a partner had visited the company's plant, met its principal officials, and was well informed on the company's affairs.[138]

The former practice of allocating securities to specialists who brought about the listing or who were recommended by the company or its investment banker raised the question of whether the security was allocated in a manner likely to produce a well-balanced specialist system, and also presented the risk of establishing a relationship between specialist and issuer that might result in the improper exchange of confidential information or the contravention of specialist requirements.[139] The latter problem is illustrated by the allocation of the common stock of International Rectifier Corp. late in 1960.

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[136] The same specialist firm was allocated the common stock of Universal Oil Products Co. upon the listing of that company's shares on Apr. 1, 1959, after the company's board chairman advised the NYSE that a partner of the firm had encouraged the company to list.

[137] See the staff report on the Amex, app. XII–A.

[138] Other securities allocated during 1959 and 1960 to specialists recommended by a company or its investment banker include Avnet Electronics Corp., Crowell-Collier Publishing Co., First Charter Financial Corp., Holt, Rinehart & Winston, Inc., Perkin-Elmer Corp., and Transitron Electronics Corp.

[139] See the discussion of the Exchange's specialist-corporation liaison program in ch. VI.D.7.e.

The staff of the Exchange was responsible for the listing. However, at the request of officials of the company, Jefferson Marcus and Irwin Schloss, Exchange specialists associated in a joint account, visited the company's offices. The president of the company thereafter recommended to the Exchange that Marcus and Schloss be appointed specialists, and noted that Schloss had spent 1 week meeting persons connected with the company and giving suggestions in connection with the preparation of the listing application. The floor governors recommended allocation of the stock to Marcus and Schloss, and the recommendation was adopted by the board.

A subsequent investigation by the Exchange disclosed that the president of the company, prior to listing, had granted options to Marcus and Schloss to buy 10,000 shares each of the company's stock at a price near the then market. These options were neither reported to the Exchange nor canceled when the stock was admitted to trading. The matter was referred to the board, which determined that the failure of Marcus and Schloss to report their options constituted a violation of rule 424; the continued holding of the options was in violation of the spirit of rule 105; and their principal transactions as specialists while holding the options were in violation of rule 96. Each was fined $5,000 and their specialist registration in International Rectifier was canceled.

(2) *Specialist surveillance techniques*

Individual specialists and specialist firms are subject to particular Exchange surveillance with respect to both their capital position and their performance as specialist. Individual specialists are sent a financial questionnaire three times annually by the Floor Department to determine their compliance with the specialist capital requirement.[140] Specialists who are members of firms are checked by financial questionnaires and by visits conducted by the Department of Member Firms. During the period studied, from January 1, 1957, through December 31, 1962, the Exchange had no disciplinary cases for failure to comply with these requirements.

The Exchange employs elaborate procedures to measure the performance of its specialists. The standards by which the Exchange judges specialist performance and their adequacy are described in chapter VI.D. The discussion here will principally concern the techniques employed to determine whether specialists have complied with the Exchange standards as to rate of participation, percentage of stabilization, size of "carryover" positions, continuity of transactions, and size of spreads.

The basic document of specialist surveillance is Exchange form 81 (app. VI.E). Specialists are required to submit this form quarterly for all their transactions during 2-week periods selected by the Floor Department on a surprise basis. The forms require information as to date, time, number of shares bought or sold, price, tick, and position at the time of each transaction during the 2 weeks. On the basis of these reports, the Exchange compiles a rating for each specialist unit with respect to its rate of participation, extent of stabilization, and size of "carryover" position, a copy of which is sent to the unit. Failure to meet specified Exchange standards may result in a

[140] For a discussion of the specialist capital requirement and its adequacy, see ch. VI.D.4.c.

disciplinary action; two such actions were brought during the period from January 1, 1957, through December 31, 1962. The data are used by the Floor Department in determining specialist compliance with the Commission's short-selling rule. The Floor Department may also obtain a form 81 from a specialist unit covering dealings in a particular period, entirely apart from quarterly filings, in connection with any security about which the Floor Department has some question. The Floor Department uses these form 81's to prepare sequence sheets showing the extent and nature of specialist participation in such securities.

In view of the importance attached to these form 81's by the Exchange, their accuracy is extremely important. In mid-1961, the Exchange began to spot check the data supplied on form 81 against the data supplied by specialists to the Exchange on form 121, a weekly form which includes, among other things, total purchases and sales effected by specialists in the course of performing their specialist function. In 1962 the Exchange also began to spot check the form 81's and form 121's against the statements of specialists' accounts maintained by clearing agents.

The Floor Department also conducts studies to determine the price variation between sales and the size of spreads in quotations. Such studies are conducted in the case of unusual trading situations and also during the first 90 days of a new listing. During the first 11 months of 1961, the Exchange conducted 3,939 studies of specialist performance, apart from the quarterly 2-week studies of all specialists. Approximately one-third of these were on sequence sheets and reflected trading by time, price, volume, and tick, while the remainder were market inquiries as to the size of variations between sales and the size of spreads between bids and offers, including 37 90-day studies, 984 30-day studies, and 1,520 1-day studies.

While the elaborate statistical system of specialist surveillance employed by the Exchange gathers considerable data concerning specialists' rates of participation, the extent of their "stabilizing" transactions (to the extent determinable by the "tick" test), and other indications of the kinds of markets made by them,[141] it is not generally geared to the detection of cases of major improprieties.

Since April 1962, however, the Exchange has required specialists to report weekly to the Floor Department all transactions in stocks in which they are registered by customers carried by their member organizations, serviced by them or any participants or employees in their member organizations, or introduced by them or their member organizations to another member organization on a disclosed basis.[142] An examiner-accountant has the responsibility, among other duties, for checking into transactions by public customers of specialists in stocks in which they are registered. These reports and the Exchange's examination of statements of specialists' accounts maintained by clearing agents provide not only a check on what specialists have reported to the Exchange but also the extent and kinds of activities in which they and their customers engage. It is noteworthy that the most

[141] For a discussion of the manner in which these various tests fall short of providing a full picture of specialist activity, see ch. VI.D.
[142] NYSE rule 111.

serious specialist disciplinary case discussed below developed from an examination of a specialist account by an Exchange accountant.

As part of its specialist surveillance program, the Exchange also relies on the stock watching program and expects governors, floor officials, and members to report unusual situations to the staff. In view of the nature of the floor operation, it is frequently difficult to detect rule violations unless a member who was an eyewitness is willing to report the matter.

Public complaints are referred to the Floor Department if the complainant raises a question as to the kind of market being maintained in a particular security or the conduct of members on the floor. In contrast to the procedure of the Department of Member Firms, a copy of the complaint is not sent to the specialist or member involved, soliciting his comments, and the staff members of the Floor Department do not discuss the allegations with him. While the Floor Department invariably investigates the facts surrounding the situation in question, generally preparing a study of the sequence of trading, it tends to defend the actions of the member against the public complaint. An example was the handling of a public complaint regarding the market in Collins Radio on May 11, 1962. A member of the public requested the Exchange to investigate the role of the specialist in a transaction involving 2,400 shares sold on that day. After being advised of the facts developed by the staff, the chairman was quoted in an internal memorandum to the effect that the specialist had done a "particularly bad job" in Collins Radio in buying stock for his own account at a low price and then permitting the stock to rise precipitously on 100-share lots. He also noted that this type of performance leads to complaints because customers are dissatisfied at selling at the bottom and then seeing the stock rise on small volume to the price at which it was selling prior to the execution of their orders. The Exchange, in its response to the complaint, described the market on that day and concluded that the sale of 2,400 shares was at a "fair price."

The need for a surveillance program with more emphasis on specialist practices is highlighted by the failure of the Exchange staff to be aware of the practice of more than two-thirds of the Exchange's specialists, revealed in the Special Study's questionnaire EX–1, of accepting "not held" orders in violation of the Exchange Act and a specific Exchange ruling.[143]

Furthermore, the Exchange's surveillance program has been largely ineffective in dealing with the conflicts of interest arising from the specialist's unique position. Until recently, the Exchange's examination procedures did not include the reconstruction of specialists' "books" to determine whether they have properly handled the situations which may arise from their dual role as principals and agents. In those instances uncovered by the Exchange staff where conflict problems were present, the Exchange paid little, if any, attention to this aspect of the cases.[144] The accumulation of statistical data on specialist performance must be combined with a greater sensitivity to the problems of the specialist system and a day-to-day knowledge of the kinds of activities and practices engaged in by specialists.

[143] See ch. VI.D.7.b.
[144] See ch. VI.D.

(3) *Specialist disciplinary cases*

During the 6-year period from January 1, 1957, through December 31, 1962, the Exchange brought five disciplinary cases against specialists. Two of these cases involved failure to meet Exchange standards of participation in transactions by the specialists. In one of them, one of two competing specialist units dominated transactions in a particular stock. The Exchange permitted the other firm to withdraw as specialist, but reprimanded its members for failing to perform their specialist dealer function. In the other, a competing specialist with an extremely low dealer participation rate indicated to the Exchange staff that this low rate was due to a capital problem. His specialist registration in that stock was canceled by the Exchange.

The three other specialist disciplinary cases dealt with more serious problems. One of these was the action against Marcus & Schloss, involving the retention by them of options in the common stock of a company in whose stock they specialized, which was described above in b(1).

A fourth proceeding was instituted against John K. Cloud, a specialist registered in 14 stocks, including Reynolds Metals. A commission broker had asked Cloud for a quote in Reynolds Metals and was told that stock was offered at 24. When he asked Cloud for the size of the offer, he was told that he could buy 300 shares at 24, but that 500 shares would print on the tape. The broker was not told that Cloud was purchasing 200 shares for his own account, and only when the broker happened to be in the crowd when names were being exchanged did he discover this and report it to a governor. In July 1962 the advisory committee censured Cloud and fined him $500. The action of the committee was based on Cloud's failure to offer to sell the broker 500 shares at 24 since he had that much stock to sell on balance, or to inform the broker of the fact that he was purchasing stock at the opening price for his own account.

Although in its investigation the Exchange staff developed that 900 shares had been traded but only 500 printed, this fact was not an element in the disciplinary action of the advisory committee. The minutes of its meeting indicate that the "size of the print was to cover the largest sell order." This apparently satisfied the committee of compliance with the policy that the tape must accurately reflect the transactions taking place on the floor.

In testimony before the Special Study, Cloud was asked why he failed to print all 900 shares. He stated that in arranging an opening, he does not pay too much attention to the orders that are paired off, and that his "responsibility is to see that the largest amount that's involved in a trade is printed." He went on to testify that he would arrange for the printing of a "round amount" of stock, such as 1,500, 5,000, or 10,000 shares, which was large enough to cover the largest orders. In answer to a question as to why he wouldn't print all of the shares which traded at an opening, Cloud answered:

> Well, it's just an arbitrary opening. It's a good opening. It's within a few hundred shares of actually what did take place. I didn't see any particular point in printing the full exact amount. I don't want to create any feeling that there is more activities probably than there is in the stock because a pairoff doesn't affect the market one way or the other. But I do want to print enough to protect the buyers and the sellers.

The last disciplinary action against a specialist during this period was taken by the Exchange in November 1962. Michael Rosenberg was suspended for 3 months and two of his partners were censured for accepting "not held" orders and for making a false statement to the Commission in connection with their answer to the Special Study's specialist questionnaire (EX–1) regarding the acceptance of such orders.[145] Rosenberg testified before the staff of the Exchange that he gave a false answer to the question regarding "not held" orders on EX–1, and that he did so because he did not wish to admit, in a questionnaire to be filed with the Commission, that he had been knowingly violating the Exchange Act since 1959, by executing "not held" orders. Rosenberg's statements before the Exchange staff were commendably candid:

Q. Is it to be understood you knew this at the time and therefore willfully filed a false answer on this question?
A. That would be correct.
Q. Do you have anything you would care to say concerning this?
A. No, sir.

The Exchange examiners returned to the matter later the same day:

Q. I just wanted to be sure I understood one thing. On this questionnaire you filed with the SEC, question 7, it says you did not handle orders on a "not held" basis.
A. On a "not held."
Q. In view of all these orders that have been shown to you, and the times that they were handled on a "not held" basis, do you mean that you deliberately made a misstatement on the questionnaire to the SEC?
A. The answer would have to be "yes."

And once again several days later:

Q. This is in summary on your own understanding. As I understand it you were clear in your own mind what was being referred to here, as you said before, was the type of orders that we call "not held" orders, and you just didn't want to incriminate yourself?
A. That is correct.

Based on these admissions, four charges were filed with the board against Rosenberg and his partners. The latter two charges, based on the incorrect answers, raised no issue of their being unintentional, since their intentional nature had been previously admitted to the staff. The minutes of the board meeting that considered the case do not reflect any finding that the false answer was unintentional. The first time the notion that the answer was "unintentional" appeared was in the press release issued by the Exchange in the case. In reply to a letter from the Commission's Division of Trading and Exchanges regarding the disposition of this matter, Exchange President Funston stated that the Board considered the testimony given before the staff and the members' defense in which they stated that they erroneously acknowledged giving an incorrect answer and in which they claimed their answer actually was correct; from this the Board concluded that the incorrect answer was unintentional.[146]

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[145] For a discussion of "not held" orders, see ch. VI.D.7.b.
[146] Of the two charges based on the false answer on the questionnaire, charge 3 alleged that the giving of the answer was conduct inconsistent with just and equitable principles of trade, while the fourth charge alleged that this conduct was an act detrimental to the interest or welfare of the Exchange. The Board dismissed charge 3 but found the members guilty under charge 4.

c. Regulation of floor traders

The role of the floor trader in the exchange market is described in chapter VI.F as a vestige of the former "private club" atmosphere of the Exchange which should not be permitted to continue. The discussion of their regulation in this subsection is confined to Exchange enforcement of the floor trading rules currently in effect.

One method employed by the Exchange to prevent violations of the floor trading rules is the supervision over traders exercised by floor governors, floor officials, and specialists. Each specialist has the power to disperse floor traders if he finds that they are "congregating" or "dominating" or are "conspicuous" in the market of one of his stocks. Floor governors and floor officials have similar powers. Since specialists, floor officials, and floor governors are conducting their own businesses on the floor, this kind of surveillance is somewhat less than systematic. None of the specialists, floor governors, or floor officials who testified before the Special Study could recall a situation in which they found floor traders engaging in these activities requiring action on their part.

The principal method of floor trader surveillance by the Exchange is through the use of form 82 (app. VI-G), which is required to be filed daily, by 10 a.m. on the next trading day, by every member who has initiated or originated a transaction on the floor other than as a specialist or odd-lot dealer. The form requires information as to the date and time of each transaction, stock symbol, number of shares bought or sold (long or short), price, tick, and opening position. Each day the staff of the Floor Department separates the reported transactions by individual stocks, and all transactions in a particular stock are then arranged chronologically and reviewed to determine whether the traders complied with the requirements of the floor trading rules. The forms are also checked to determine whether the Commission's short selling rule has been observed. Exchange surveillance over floor traders thus rests principally on a reporting system, under which members are expected to report their floor trades accurately and completely.

There have been instances in the past few years of members failing to file the required floor trading forms. In one case a member failed to file form 82's on 68 separate occasions in a 5-month period. He explained that an error was made by a clerk at his clearing agent.

In addition, many reports are filed late; for example, two members filed form 82's in 1962 covering floor trades for periods of more than 14 months and more than 12 months. The late filing of form 82's obviously creates complications for the staff in its review. The vice president in charge of the Floor Department testified that if a floor trading report were filed even a day late it would impede his department's review of floor trading activity. He did indicate, however, that if a report were received late the staff could go back to reconstruct the situation in those stocks for the days in question.

In light of the use to which the form 82's are put, the accuracy of the information supplied is materially important. The vice president in charge of the Floor Department also testified that for at least the past 15 years the figures supplied on form 82 by members have been spot checked against form 121.[147] Currently these two forms are spot

[147] See subsec. b, above, for a description of form 121.

checked by the Exchange four times annually for a 1-week period. However, even when form 82's and 121's check out against one another, a member may have failed to report floor trades on either form.[148] To determine whether the form 82's and 121's are accurate the Exchange commenced in 1962 to check the figures supplied on these forms against members' statements of account.

The Special Study spot checked the accuracy of form 82's (which are also filed with the Commission) by comparing them against form 121's and statements of account. Eight floor trading accounts were reviewed for periods ranging from 2 to 5 months, depending on the extent of activity in the account. These accounts were selected following a review of form 82's of approximately 175 members, and were taken from those who had filed late floor trading reports. At the time of selection the Special Study had no indication as to the accuracy of the form 82's filed by these accounts, only that certain of the reports had been filed late.

Of the eight accounts examined, four reported their floor trades on form 82 in a complete and accurate fashion, except for minor discrepancies. Of the remaining four accounts, an examination of the account of one floor trader for the period from October 30, 1961, through December 22, 1961, revealed 2 days on which form 82 reported fewer shares purchased than was reflected on form 121 and the statement of account. A check of forms filed by another trader indicated that on 4 days in June 1962 he had failed to file form 82 although his form 121 indicated floor trading activity on those days. In addition, there were discrepancies between the purchases and sales reflected on his statement compared to the transactions reported on his form 82 or form 121 on 6 other days in the month. A review of forms filed by a third trader indicated that on 1 day in the period from August 28, 1961, through December 29, 1961, he filed no form 82 despite the fact that his statement and form 121 indicated floor trading activity, and that on 10 other days within this period discrepancies appeared between purchases and sales reflected on his statement and those reported on his form 82.

The largest numerical discrepancies between form 82's and 121's were discovered in the account of a fourth trader. During the period from October 30, 1961, through December 29, 1961, the form 82's filed by this firm showed "on floor" purchases of 46,720 shares, long sales of 64,050 shares, and short sales of 15,800 shares. For the same period, form 121 reported *no* "on floor" transactions, but reported as "off floor" transactions 121,500 shares purchased, and 181,800 shares sold (of which 88,800 were identified as short sales).

The discrepancies in these accounts go to the integrity of the reporting system. In the case of the discrepancies in the fourth instance mentioned, although it appears that the problem was on form 121 rather than on form 82, the volume of transactions involved reflects on the firm's and the Exchange's procedures.[149]

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[148] In January 1962, the staff report on the American Stock Exchange (app. XII–A) revealed that floor traders on that exchange had substantial discrepancies between reports given to the exchange and their actual transactions.

[149] The Exchange has also accepted form 82's in which a particular member places a symbol in the column calling for the size of his position. The symbol is known to the Exchange staff as indicating a position in excess of 500 shares. In one stock with a relatively small floating supply, U.S. Smelting, Refining & Mining Co., the position of this member has been as large as 10,400 shares.

During the 6 years from January 1, 1957, through December 31, 1962, only one floor trader was disciplined by the Exchange. This occurred on September 19, 1957, when the chairman fined a member $100 for repeated late filings of form 82.[150] In no other case during this 6-year period was a member disciplined for failure to file floor trading reports, filing late or inaccurate reports, or violating the floor trading rules.

The procedure followed by the staff when it locates an apparent violation of floor trading rules is to refer the matter to the chairman.[151] Normally, if it is determined that a violation of the rules has taken place, the chairman sends a letter to that effect to the member. If multiple violations are involved, the member may be called to the chairman's office for an additional warning.

There is an apparent reluctance, however, to impose disciplinary sanctions on floor traders, despite repeated violations of the floor trading rules. For example, a floor trader violated the floor trading rules on three separate occasions in 1959 in less than 3 months. Another floor trader violated the floor trading rules on two occasions in 1958 and two other occasions in 1959. Still another trader had separate violations of the floor trading rules in 1959, 1960, and 1961. Following the 1961 violation, the chairman advised him that he should be careful that all his transactions were made in accordance with the floor trading rules. In January 1962, he violated the same provision of the floor trading rule that he had violated in 1961 and about which he had been warned. In another floor trading situation, a member was found to have violated the floor trading rules five times in 1958 and in May 1959. The Exchange took no disciplinary action against any of the floor traders mentioned.

d. Enforcement of the gratuities rule

Although the applicability of the Exchange's regulation of the payment of gratuities to Exchange and member firm employees is not confined to the floor, it is particularly significant in connection with floor supervision. Rule 350 prohibits the payment of gratuities to Exchange employees without the consent of the Exchange, or to member firm employees without the consent of the firm and the Exchange. The rule is intended to preclude payments by members to obtain business or receive preferential treatment or favors, and other practices which approach or amount to commercial bribery.

The Exchange has had only two cases involving this rule in recent years. The first case involved a floor member, Stanley M. Roth, who in December 1959 asked J. Truman Bidwell, then vice chairman and subsequently chairman, whether he could give 39 Exchange pages who worked in a particular area of the floor $5 each as a Christmas gratuity. Bidwell, after consulting with the chairman, informed Roth that he could not give the proposed gratuity. Despite this decision, Roth distributed $195 in Christmas gifts. He was censured and fined $1,000.

The second case involved Bidwell himself. Enforcement of rule 350 figured prominently in his recent trial in the U.S. District Court for the Southern District of New York on charges of tax evasion, which

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[150] The constitution does not give the chairman authority to impose a fine.

[151] This procedure was in effect until October 1962, when it was modified in the manner described in sec. 4.a, above.

resulted in his acquittal. Involved in the charges against him was his claim of more than $28,000 as deductions for bonuses and gratuities on his 1956 and 1957 Federal income tax returns.

At his trial Bidwell testified that he rewarded employees of member firms and employees of the Exchange for their assistance to him with gifts of cash, gift certificates, and liquor. He described his practice as follows:

> I would say that it has been my habit and the habit of many, many members of the Stock Exchange to give gratuities and from time to time liquor, money, to help people out who have in turn helped me out in the operation of my business.

In accounting for claimed bonuses and gratuities which were not reflected on the worksheets maintained in his office, Bidwell explained:

> Well, there is always an occasion to give money away downtown. These people are human, they have their problems, they have their anniversaries, they have their children, and it is a custom in Wall Street to reward people that help you; and during the year retirements take place. There is any number of reasons that you can disburse money. There is football games, there is baseball games—things that you do for boys.

When questioned about the applicability of rule 350, he answered:

> I think all members of the Stock Exchange live up to the rule, but in addition to that there is a rule of reason. I have written the Stock Exchange asking for approval for gifts. I have done that. On the other hand, if I know some boy is in trouble and needs a $50 bill I am not going to bother writing the Stock Exchange.

When asked whether other Exchange members gave liquor and gifts on occasion to employees of member firms without seeking Exchange permission, Bidwell replied: "I think they have been doing it from time immemorial." He also testified that other Exchange members who were in business for themselves probably gave gratuities of comparable amounts.

Bidwell was also examined at the trial regarding his participation in the Roth disciplinary case. When asked whether Roth was penalized for violating his instructions, Bidwell testified:

> * * * I don't know of any members, giving gratuities, that would even bother talking to the chairman or the vice chairman. In this instance, Mr. Roth happened to do it.

After the trial, the Exchange investigated Bidwell's apparent violations of rule 350. The Exchange found 44 instances of not obtaining consent for gratuities of $3,135 for Christmas gifts, as well as 7 cash gifts, 53 liquor gifts, and an undetermined number of gifts of sports tickets. The board of governors imposed the penalty of censure by the chairman (Bidwell's successor after his resignation) for violation of rule 350. It was satisfied that his activities did not constitute "buying business," and that his violations were "careless and technical in nature, but nevertheless serious, particularly in view of his former position of leadership."

Bidwell's testimony suggests wholesale violations of rule 350 by himself and others,[152] and his own violations were substantiated by the Exchange's investigation. His testimony emphasizes the importance of order clerks as having the authority to originate business

[152] In response to an inquiry from the Commission's Division of Trading and Exchanges, the NYSE advised that as a result of examinations of individual members conducted in 1962, it had found "some laxity" among members in obtaining Exchange permission for gifts. The Exchange advised, however, that it determined the amounts given without permission were in general of a size and nature it would have approved.

for floor brokers; they were among the principal recipients of his largesse. In light of Bidwell's participation in the Roth case and in view of the penalty assessed in that case, the disposition of Bidwell's violations raises doubts about the consistency with which the Exchange assesses penalties.

5. ARBITRATION

The Exchange maintains facilities for the arbitration of disputes between nonmembers and member firms, as well as between members and other members. The arbitration procedures for both categories are in most respects similar; the procedures for nonmember disputes are especially important to the public because the Exchange generally refers public complainants to arbitration for determination of their claims against member firms.

For nonmember arbitration there are different groups from which a five-man arbitration panel can be selected. The nonmember may have the panel selected from the board of arbitration, which is composed of 15 members and allied members who are not members of the board of governors and are appointed annually by the chairman.[153] The board of arbitration sits only in New York City. Alternatively the nonmember may have his claim decided by the so-called "mixed panels." There are securities (consisting of persons connected with the Exchange community) and nonsecurities panels (consisting of corporate executives, lawyers, etc.) in 10 cities,[154] whose members are selected by the chairman.[155] If the nonmember chooses to have his case heard by a mixed panel sitting outside New York City, the tribunal consists of two members of the securities panel and three members of the nonsecurities panel from that city. If the nonmember chooses to have his claim heard by a mixed panel sitting in New York City, the tribunal consists of one member of the board of arbitration, one member of the New York securities panel, and three members of the New York nonsecurities panel. Controversies between parties who are members, allied members, or member organizations must be submitted to the board of arbitration.[156]

The following table XII–a indicates the cases heard by the various tribunals during the years 1957–61. Of 127 cases, only 14 were heard outside New York City (11 percent of the total).

TABLE XII–a.—*Number of NYSE arbitration cases before various types of tribunals, 1957–61*

	1957	1958	1959	1960	1961	Total
Board of arbitration	11	11	16	11	14	63
Mixed panels:						
New York City	8	8	11	9	14	50
Out of town	3	2	1	3	5	14
All tribunals	22	21	28	23	33	127

153 NYSE constitution, art. VIII, sec. 4.

154 Baltimore, Boston, Chicago, Dallas, Los Angeles, New York City, Philadelphia, Pittsburgh, Richmond, and San Francisco.

155 NYSE constitution, art. VIII, sec. 4.

156 NYSE constitution, art. VIII, sec. 5. The right of the nonmember to select his tribunal is contained in art. VIII, sec. 6. For a discussion of arbitration before the Exchange Act, see report of the Committee on Banking and Currency; "Stock Exchange Practices," 73d Cong., 2d sess. 78–9 (1934).

Most arbitration controversies involving nonmembers come to the Exchange's arbitration director through the public complaint procedure.[157] A complainant who responds to the Exchange's letter advising him of its arbitration facilities is sent a pamphlet outlining the procedures, together with a sample submission form. At that point the matter is regarded as an open arbitration case on the records of the Exchange. To proceed, the complainant must submit a statement of claim setting forth the matters to be arbitrated and, if possible, the amount claimed.[158] If the nonmember fails to submit a statement of claim within approximately 6 weeks, the arbitration director sends him a letter stating that his file is being considered inactive.

When a statement of claim is filed, the opposing party is furnished a copy and given 10 days in which to file his reply. Once a submission is properly executed and filed, the case is set down for hearing by the arbitrators who are selected by the arbitration director by lot. Either party is entitled to challenge an arbitrator for cause, and the decision on the challenge is made by the arbitration director.

The nonmember is entitled to be represented by counsel. Only if he so elects is the member firm similarly entitled to be represented.[159] Hearings are generally set promptly and at the hearing the statements of the parties are read to the arbitrators and each is entitled to make an opening statement. Each party is also entitled to present witnesses, documentary evidence, and such closing arguments as may be determined by the arbitrators, and to cross-examine opposing witnesses.[160] The personal appearance of the initiating nonmember is required.

Written awards are made by the aribtrators; no opinions are written. There is no right of appeal to the board of governors from a decision of any Exchange arbitration panel.[161] The arbitrators assess costs in their awards.

Table XII–b indicates the manner in which arbitration cases were disposed of during the years 1957–61, between members and the public, and between members and other members: [162]

TABLE XII–b.—*Disposition of NYSE arbitration cases, 1957–61*

	1957	1958	1959	1960	1961	Total
Inactive for failure to proceed	20	20	19	27	43	129
Withdrawn by claimant before hearings	10	5	7	1	6	29
Settled	5	12	13	9	15	54
Award:						
Claimant successful	8	9	13	6	17	53
Claimant dismissed	14	10	15	17	13	69
Parties referred to remedies at law					1	1
Jurisdiction declined			3			3
All cases	57	56	70	60	95	338

[157] In rare situations the Exchange declines to accept jurisdiction over a controversy on the ground that the controversy did not arise out of the member's business, or that the matter had already been adjudicated by a competent tribunal. The Exchange declined to accept jurisdiction in three instances during the 1957–61 period.

[158] NYSE rule 481.

[159] NYSE rule 483.

[160] NYSE rule 485.

[161] NYSE constitution, art. VIII, sec. 7.

[162] In analyzing these statistics, it should be noted that not all of these cases involve claims by investors against member firms. For instance, during the years 1960–61, 5 cases were heard involving controversies between members, allied members, and member organizations. During the same period, 8 controversies between registered representatives (considered "nonmembers") and member firms were heard by different tribunals.

It is noteworthy that 129 cases of a total of 338 were considered inactive because of failure on the part of the claimant to proceed, and that 29 cases were withdrawn by the claimant before hearings. Thus, approximately 46 percent of the total arbitration cases during this period did not reach a hearing. Many of these inactive or withdrawn files involved allegations of selling abuses which were first considered by the Department of Member Firms before they were referred to the arbitration director. In most instances it was impossible to determine why the investor failed to follow through on his original intention to arbitrate the dispute, but it would seem that dissatisfaction with the handling of complaints by the Exchange was a factor. Another reason given by some complainants for failure to proceed was the expense involved, particularly if the nonmember was not from one of the 10 cities in which panels sit and would have had to travel a considerable distance to have his case heard.

A review by the Special Study of arbitration cases disposed of during the years 1960 and 1961 indicates that the arbitration director acting for the Exchange performed his ministerial functions without favoring either side and that there was no lack of impartiality on the part of the arbitrators. During these 2 years, claimants were successful in 23 cases which went to arbitration and unsuccessful in 30 cases.

Although the procedures at the various hearings resembled legal proceedings in a general way, different panels followed different procedures. The arbitrators also varied in the amount of assistance which they offered to the investor. Investors who did not appear with counsel were occasionally at a disadvantage because of their unfamiliarity with the proceedings. Several complainants were unable to understand the proper method of eliciting information from witnesses by means of questioning. They were also at a disadvantage by virtue of the fact that their opponents were generally partners of member firms who might have previously participated in such proceedings.

The arbitration procedure was most frequently used during the 1960–61 period by more sophisticated investors, many of whom were active traders with margin accounts dealing in speculative securities. In several cases, a margin trader was sold out by the member firm and was protesting the procedures employed by the firm. In other cases, active traders either sought to avoid transactions or hold member firms to transactions which they claimed should have been made. Other arbitration hearings involved alleged failure to execute orders properly and, in relatively few instances, selling abuses.

The arbitration program is a worthwhile and creditable one but is little utilized by the public, particularly outside of the New York City area. The costs and technicalities of such proceedings should be held to a minimum so that the small investor, who may feel in a particular instance that he has been treated unfairly, has a convenient, impartial, and inexpensive forum.

6. PUBLIC RELATIONS AND ADVERTISING PROGRAMS

While the Exchange has conducted an advertising and public relations program since 1945, the scope of this program has increased dramatically during President Funston's tenure. This increase was foreshadowed by the Committee of 17 which, in 1949, questioned "the adequacy of the present advertising program and suggest[ed] that an appraisal be made of the most effective methods of public relations and consideration be given to the advisability of securing expert counsel in this field." In his testimony before the Special Study, the chairman of that committee stated that the group felt a more ambitious program was called for and "we felt that we should get going and try to do a selling job."

The program is administered by the Exchange's public relations and market development group, under the supervision of a vice president. The group is composed of five separate departments: advertising and promotion, investors' information, public information and press relations, research and statistics, and special services. The vice president in charge testified that research and statistics perform certain functions in the public relations area, such as conducting studies of public opinion, but does not engage exclusively in these activities. He estimated that $1 to $1.5 million were spent on public relations and advertising in 1953; almost $2.9 million were spent on these activities in 1961.[163] In 1953, 40–45 employees were under his jurisdiction; 105 were in these departments in 1962.

The theme of the Exchange's current program is "Own Your Share of American Business." It has many facets, including the use of motion pictures, booklets, newspaper and magazine advertising, radio and television, a national speakers bureau, material prepared for the press, work with schools and colleges, a magazine, and various exhibits. An illustration of the extent of these activities is the fact that an estimated 30,000 separate programs were conducted by the national speakers bureau in 1961.

The Exchange takes part of the credit for the substantial increase in the number of public shareholders from 1952 to 1962. In 1952 a census of shareholders indicated that approximately 6.5 million Americans owned stock in public corporations. By early 1962 the Exchange estimated this number at 17 million individuals.[164] In a public opinion survey released in 1960 the Exchange stated that its "broad educational program" has contributed to the rapid increase in the number of shareowners.[165]

An exchange between President Funston and Senator Fulbright at the hearings on the stock market held in March 1955 reflects the Exchange's views on this program:

> The CHAIRMAN. * * * Mr. Funston, as I understood your statement, the function of the exchange is to make a marketplace for the buying and selling of corporate securities. Your role is that of a manager in this marketplace, merely to provide facilities for marketing. Do you think it is proper for a manager to do a public relations selling job to induce more people to come into the market, or do you think your proper role is merely to provide that marketplace?
>
> Mr. FUNSTON. We believe, Mr. Chairman, our proper role is to provide the marketplace, and we also believe that we have an interest in maintaining the marketplace. The exchange in no way is doing anything as an institution to encourage, as you phrased it, I believe, that people should come into the marketplace. The only thing the exchanges does through its public relations program is to carry on a basic educational program with the public of the country to try to tell them what common stocks are about, and how the market operates, and what our institution is. We do that because we want the people to know the exchange and to help them to have confidence in it.

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[163] See table XII–1.
[164] NYSE, "1962 Census of Shareowners in America" (1962).
[165] NYSE, "The Investors of Tomorrow" (1960).

The CHAIRMAN. * * * I thought the main purpose of this educational campaign was to induce more people to buy common stock. You said in your statement that as a result of this campaign nearly 1 million new customers have been added to the list of owners of common stocks.

Mr. FUNSTON. I am sorry, Senator. I did not make myself clear. The function of the exchange is to provide, if you will, a climate, which is favorable for the actual merchandising opportunities of our member firms. In other words, the exchange does not sell stocks at all. Our member firms do.

The CHAIRMAN. But your program of advertising is intended, is it not, to induce more people to purchase common stocks?

Mr. FUNSTON. No, sir. Our advertising is an institutional program based on education and what we aim to do there is to tell people what common stocks are; where brokers are located; and how they can go about finding out and deciding for themselves, with the advice of our member firms or qualified people, whether common stocks play a part in the picture or not * * *.

The CHAIRMAN. Perhaps that distinction is too subtle for me to understand. You describe it as if you were a public school and had no duty other than the enlightenment of the public about what the stock [market] is. But back in the recesses of your mind I suppose it would not disturb you if these people came into the market and bought more stocks.

Mr. FUNSTON. No, sir. The slogan used by our members is, "Own your share of American business." And we hope on a sound basis that in a few years instead of having 7½ million shareowners, we will have many, many more.

The CHAIRMAN. That is what I thought it was. The real purpose your members are interested in is profit. The more sales, the more profit they make. I see nothing wrong with this and I was not trying to make it appear that was anything bad, but I am trying to understand it. It seems to me the very obvious objective and intention and motive for this program is not merely public service, but to generate more sales of stocks for the benefit of your members, is it not?

Mr. FUNSTON. But the exchange does not sell the stock. It is to create a climate in which we hope our members——

The CHAIRMAN. But your members sell stock.

Mr. FUNSTON. Will be able to sell stock. That is correct.[166]

Among the techniques employed by the Exchange to encourage public share ownership is the annual distribution of millions of booklets, brochures, pamphlets, and reprints. For example, the Exchange publishes a booklet which, among other things, lists common stocks traded on the Exchange that have paid a cash dividend every 3 months for more than 20 years. A similar booklet, entitled "Dividends Over the Years," contains some textual material on the planning of an investment program, together with a list of all Exchange common stocks that have paid a cash dividend in each year for 25 years or more. The Exchange encourages investment clubs in various pamphlets and also distributes an "investment guide" in booklet form. This booklet contains a series of articles explaining the mechanics of investing and suggests that investors tailor their investments to the risks they can afford, obtain the necessary facts, keep some money available for emergencies, and get good investment advice from member firms. The Exchange also provides its member firms with folders, similar to greeting cards, in which shares of stock may be inserted as gifts. One such folder reads: "Happy Birthday . . . Here's Your Share of American Business."

One of the key aspects of the Exchange's public relations and advertising program has been the Monthly Investment Plan (MIP). This program, which began in 1953, permits investors to purchase listed securities on a periodic basis and does not require that a full share be purchased in each installment. Periodic payments, not less

[166] Hearings before the Senate Committee on Banking and Currency, "Stock Market Study," Mar. 3, 1955, at pp. 12–13.

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[166] Hearings before the Senate Committee on Banking and Currency, "Stock Market Study," Mar. 3, 1955, at pp. 12–13.

than $40 every 3 months, are made through member firms for the purchase of a security agreed upon in advance. Dividends may be automatically reinvested.

In promoting this program, the Exchange makes available to member firms several pamphlets describing the operations of an MIP plan. One of these pamphlets, entitled "How To Invest on a Budget," has a purchase order application attached. If the recipient is interested, he simply sends in the purchase order to the firm from which he received the pamphlet. The Exchange advises its members that this booklet "is especially suitable as an offering piece by direct mail."

The Exchange also has a program of advertising in newspapers and national mass-circulation general and women's magazines. In connection with its fall 1962 advertising program, the Exchange placed advertisements in 13 mass-circulation magazines and 700 newspapers. For the most part this program is of a general institutional nature, but provision is made for tie-in advertisements by member firms who wish to capitalize on the Exchange program.[167] For example, the fall 1962 campaign included four advertisements which were devoted to the subjects of self-regulation, operation of the floor, listing requirements, and admissions requirements. In addition the Exchange prepared three other advertisements aimed at advising the reader on methods of investing, and encouraging the investor to examine a company carefully before buying, to invest only surplus funds, and to invest through a member firm. These advertisements all included a return coupon for a free Exchange booklet. Prior to 1960 the Exchange distributed to member firms the names of persons who filled in the return coupons, of which approximately 110,000 are returned annually.

The Exchange also distributes and exhibits various motion pictures on the advantages of investing through member firms. Two of these films are aimed at institutional investors. The Exchange's most ambitious film effort was the production of a 27½-minute motion picture, at a cost of $125,000, entitled "The Lady and the Stock Exchange." The film received wide distribution by the Exchange during 1962; it was made available free to member firms and was shown in several cities on television.

The public relations and market development group also offers member firms the opportunity of discussing their advertising programs with Exchange staff members, including suggestions as to whether the material is good advertising copy. Member firms also receive memorandums from the Exchange soliciting them to buy various Exchange booklets and letters to be distributed to current or prospective customers, as well as "stuffers," or small brochures intended to be placed in the monthly statements sent by firms to their customers. The stuffers distributed in the fall of 1962 were based upon the Exchange's institutional-type advertising program. More than 4 million of them have been ordered by member firms in the years 1960–62.

As part of its service to member firms, the Exchange also distributed 10,000 copies of a 16-page booklet entitled, "How You Can Use Direct Mail To Enlarge Your Securities Markets," which states that direct-mail promotion is one of the most effective, economical, and easily managed means of enlarging a firm's prospect list and of following up

[167] See ch. II.B.2.a.

leads. The booklet suggests in detail how direct mailings should be handled, and concludes with a four-point checklist for direct-mail success:

1. *Choose Your Names Carefully*

   Select individuals whose income, financial status, and need recommend them as prime prospects. Where possible, tailor the approach (letter) to a specific prospect group (e.g., doctors).

2. *Let Prospects Select Themselves*

   Send offering mailings with reply feature, and let prospects' response indicate which are ready for an immediate personal followup.

3. *Followup Leads Promptly*

   Don't let a warm prospect cool off. Fulfill requests promptly. Followup leads while they're still live and interested.

4. *Keep Mailing—Continuity Pays Off*

   Work out a systematic program—and stick to it. A minimum of three mailings, spaced 2 to 3 weeks apart, will give you excellent mileage from a given list.

Public relations and market development also assists and encourages listed companies in their public relations activities. It has prepared a booklet for listed companies, entitled "Telling Your Corporate Story," which includes a compilation of various public relations techniques for issuers.[168]

The public relations and market development group also participate in the legislative area, with respect to legislation directly involving both the securities industry and tax policies. The group's activities include research for statements by President Funston before congressional committees and circulation of reprints of his speeches, and distribution of copies of articles taking positions similar to those of the Exchange.

That aspect of the Exchange's public relations and advertising program which advertises the quality of the Exchange's market and its member firms raises questions of possible conflict with its regulatory responsibilities. For example, it was noted in chapter III.C. that the Exchange provided members with promotional material encouraging investors to use the services of member firms because of their research facilities, even though the Exchange had no program for determining the qualifications and standards of member firms research departments. This kind of public relations activity by its nature involves emphasizing the favorable and minimizing the unfavorable. Self-regulation, on the other hand, may sometimes involve using the sanction of publicity for improper conduct, with the effect of tarnishing the favorable image. The Exchange's seeming leniency in disciplining its members combined with its reluctance to announce disciplinary results—so that a "censure" or even a "severe censure" is somewhat less formidable a penalty than if publicly known—seems more in keeping with strong public relations than with strong self-regulation. The same may be said of a public relations approach which emphasizes the quality of specialists' performance in the aggregate without any hint of variations for different specialists and different securities. A more suitable and realistic approach to public relations as well as self-regulation—and one that in the long run might build more solid public confidence—would more candidly display the

[168] See ch. IX.C.6.

Exchange's awareness of and concern for such weaknesses and problems as may exist in its mechanisms and among its members.

7. CONTROLS OVER LISTED COMPANIES

Although the Exchange disclaims that it is "regulating" the conduct of companies whose shares are listed, it exercises broad controls over them in some areas. The standards governing conduct of listed companies are found in the listing agreements executed by them and in the company manual published by the Exchange. The company manual is in the nature of a guide for listed companies, and the Exchange expects these companies to comply with its policies. Ultimately the enforcement of the Exchange's requirements flows from the power of the board of governors to suspend and delist securities.[169]

Enforcement of listed company requirements is handled by the department of stock list. Within the department, approximately 12 listing representatives are each assigned to a number of companies (about 110) and are expected to maintain liaison with those companies. Liaison consists of keeping current of corporate developments, reviewing filings, and periodically visiting the companies' offices. Approximately 45 companies, including those that are approaching the delisting criteria or having a high frequency of rumors circulating about them, are given special attention. This group of issuers changes with developments in the various companies.

The listing agreement, which was first adopted by the Exchange in 1899, has developed from a simple three-item agreement to one which imposes a wide variety of requirements on listed companies. A new agreement must be executed by a company whenever additional shares are listed. As a result, different companies are bound by different agreements, depending upon when they last listed shares. However, the Exchange urges companies which have not signed the current listing agreement to comply with its provisions, and asserts the authority to take action for failure by these companies to comply.

The listing agreement requires that companies publish immediately any action or lack of action with regard to the declaration of a dividend.[170] In interpreting "immediately," the Exchange takes the position that news of a dividend declaration or omission should be communicated to the national press by the fastest available means. Release to the local press is not considered sufficient, and the press release embodying the information regarding the dividend should not be restricted in any way as to time of distribution, such as "hold for release." [171]

Exchange policy also requires listed companies to release promptly information regarding important developments which might affect security values or influence investment decisions of stockholders or the investing public, although this policy is not incorporated in the listing agreement. Acquisitions, mergers, stock splits, new contracts, and new products or discoveries are the types of corporate developments which are expected to be released as promptly as possible. The Exchange advises listed companies to exercise extreme care in keeping such information confidential prior to public release.[172]

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[169] NYSE constitution, art. III, sec. 7.
[170] NYSE listing agreement, III.4.
[171] NYSE company manual, A37–40.
[172] NYSE company manual, A20–22.

This policy of timely disclosure is designed to prevent insiders from trading on the basis of advance knowledge of corporate developments. As pointed out in chapter IX.C, this policy has been criticized on the ground that financial writers are given little opportunity to do independent research on news of a major corporate development since the news must be promptly released. However, this must be considered in light of the fact that timely disclosure is a powerful weapon to prevent insiders from benefiting from advance knowledge.

In the course of its stock watching program or through other methods the Exchange may find that a security is reacting to a corporate development which has not yet been announced. Under these circumstances the Exchange, through a listing representative, contacts the company to determine the facts of the particular situation. The listing agreement requires a listed company to furnish the Exchange on demand such information concerning the company as the Exchange may reasonably require.[173] Depending upon its assessment, the Exchange may then request the company to issue a public announcement affirming or denying the rumors. For example, in the situation described in chapter IX.C involving trading in the common stock of Sperry Rand in December 1960, the Exchange requested the company to release immediately information regarding a new product which was not scheduled for release for another few days when prepublic disclosure of the product to various members of the press and security analysts had resulted in a sharp rise in the price of the stock on heavy volume. This action by the Exchange is not an isolated case. About 50 times a year the Exchange suggests that companies make public announcements regarding rumors which are circulating and apparently affecting the price of the company's stock.

Most of the problems involving timely disclosure of corporate developments are handled informally by the staff of the Exchange. Occasionally, trading is halted in a security when an influx of buy or sell orders has come in because of rumors of a major development in the company's affairs. The ultimate weapon of delisting would be available if a company were habitually to violate the timely disclosure provisions, but the Exchange has never found occasion to go this far.

The listing agreement requires listed companies to publish and submit to their stockholders an annual audited balance sheet, income statement, and surplus statement,[174] at least 15 days before the annual meeting, and not later than 3 months after the close of the company's fiscal year. The Exchange may extend the 3-month requirement in unusual circumstances, but the 15-day provision is inflexible. In addition to distributing the statement to stockholders, the company must also submit it, or a news release based upon it, to newspapers of general circulation in large cities or to national news services. Annual reports are review by listing representatives and changes are occasionally suggested to the company. In addition, the listing representatives check for any possible inconsistencies between the annual report and Commission forms 8–K and 10–K.

The listing agreement also requires companies to publish unaudited quarterly statements of earnings, except for companies where peculiar

[173] NYSE listing agreement, I.13.

[174] NYSE listing agreement, II.1. The requirements as to these annual reports are contained in the NYSE company manual at A64–9.

conditions, either in the industry or in the company itself, would make quarterly statements impracticable or misleading; e.g., a company dependent upon the growth and sale of a single crop in an annual cycle. Many companies that have not agreed to this requirement in their listing agreements have complied voluntarily, and approximately 96 percent of listed companies now comply. Although there is no required time of publication for these quarterly reports, they are generally published between 3 and 6 weeks after the close of the fiscal period. They are not required to be furnished directly to stockholders.

The current listing agreement requires listed companies to solicit proxies for all meetings of stockholders.[175] Until April 1959 companies which had not signed listing agreement requiring them to solicit proxies for all meetings were not bound by this requirement. Nevertheless, at that time more than 97 percent of the active listed companies on the Exchange solicited proxies for all meeting and the Exchange announced a policy of delisting the common stock of any company which did not solicit proxies. Only one company, Cannon Mills, Co., refused to comply, and its common stock was delisted on February 12, 1962.

Since 1926 the Exchange has refused to list nonvoting common stock or any nonvoting stock, however designated, which by its terms is in effect a common stock.[176] It requires issuers to submit important corporate decisions to stockholders for their approval. For example, stockholder approval is a prerequisite to listing securities in connection with stock options or special remuneration plans for directors, officers, or employees; actions resulting in a change in the control of a company; or the acquisition of a business, company, assets, porperty, or securities from an officer, director, or subtsantial security holder, or where the issuance of stock or other consideration for an acquisition could result in an increase in outstanding common shares of 20 percent or where the issuance of common stock and other consideration has a fair value of 20 percent or more of the market value of the outstanding common shares.[177]

The NYSE requires that immediate publicity and notice be given in respect of any corporate action which will result in, or which looks toward, the redemption in whole or part of a listed security.[178] In connection with stock dividends, the Exchange requires that an amount equal to the fair value of the shares issued be transferred from earned surplus to the permanent capitalization of the company if the stock dividend represents less than 25 percent of the number of shares outstanding prior to the distribution.[179] The Exchange also urges listed companies to have at least two outside directors on their boards, particularly if the company's stock is closely held.[180]

The requirements imposed by the Exchange on listed companies have a significant public impact. Periodic financial reports, proxy solicitation, and timely disclosure are among the safeguards intended to supply stockholders with prompt and accurate information, as

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[175] NYSE listing agreement, III.5.
[176] NYSE company manual, A–280. The Exchange will not list the common voting stock of any company which also has outstanding in public hands any nonvoting common stock.
[177] Id., A–284.
[178] Id., A–170.
[179] Id., A–235.
[180] Id., B–23.

well as the opportunity to participate in corporate affairs. The promulgation and enforcement of these controls by the Exchange have been an important contribution to greater investor protection.

8. RECENT DEVELOPMENTS

During the period in which the Special Study has been in existence the Exchange has adopted numerous changes in its regulatory practices and procedures. In the course of this part and other chapters of the report, particularly chapters II and III, some of the more significant of these changes have been noted. However, it is believed useful to present a compilation of them at this point in order to reflect the extent to which the Exchange's regulatory program has been affected. It is not suggested that these changes are directly attributable to the activities of the Special Study, but at the least it would appear that the Exchange has been engaged in a self-examination of its own performance. This compilation does not describe the changes in detail but merely indicates their general nature and, where appropriate, the section of the report in which they are discussed more fully.

1. The Exchange has increased substantially the number of persons engaged in regulatory activities in the department of member firms, the floor department, and the branch of public relations and market development.
2. The Exchange now requires written examinations for members and allied members who intend to work in the offices of member organizations (as well as an additional examination for a member or allied member with supervisory responsibilities or who service customers' accounts), for floor members, and supplementary questions for specialists and odd-lot brokers (ch. II.B.2.c).
3. New qualification standards for branch managers have been adopted (ch. II.D.3.c).
4. Additional requirements have been added to the system of limited registration of salesmen (ch. II.C.3.c).
5. The Exchange has expanded its program of assisting member firms in the selection, training, and supervision of registered representatives (chs. II.C.3.c and III.B.6.b(3)).
6. The Exchange has instituted a program of inspecting the branch offices of member firms in order to check on supervisory and selling practices (ch. III.B.6.b(3) and sec. 3.b(3) of this part).
7. Registered representatives are now entitled to broad review of penalties imposed against them, and the procedures in disciplinary cases involving registered representatives have been made more closely parallel to those involving members and allied members. Additional staff review procedures of such cases have been instituted. The Exchange may now fine registered representatives up to $2,000, in addition to the penalties which it previously imposed (sec. 3.d of this part).
8. A program for examining the books and records of members not affiliated with member organizations has been initiated (sec. 3.a(1) of this part).
9. The Exchange has adopted various procedural changes in its machinery for processing complaints from members of the public against its member firms (sec. 3.a(2) of this part).

10. In its program of reviewing market letters, sales literature, and advertising by member firms, the Exchange now checks for trading by firms against investment advice and concerns itself with the qualifications of individuals rendering such advice. Market letters and sales literature are reviewed more frequently, and educational efforts in this area have been expanded (ch. III.C.8.a(2) and secs. 3.b(4) and (5) of this part).

11. The staff of the floor department has been given increased authority in the investigation of floor irregularities (sec. 4.a of this part).

12. Specialists are now required to report transactions by their public customers to the Exchange (sec. 4.b(2) of this part).

13. In connection with the surveillance of specialists and floor traders, the Exchange has initiated a program of checking the statements of account of these members against their forms filed with the Exchange (secs. 4.b and 4.c of this part).

14. The Exchange has agreed with other self-regulatory agencies to adopt cooperative programs to help eliminate duplication of regulatory efforts (ch. XII.J).

9. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The influence and prestige of the New York Stock Exchange among the self-regulatory institutions are unrivaled. It occupied a singular position in the securities industry when the Securities Exchange Act of 1934 was adopted, and this is at least equally true today. The Exchange is uniquely important as an agency of self-regulation not only because of its outstanding importance as a securities market but also because of the dominant position of its membership in the entire securities business. Thus, the quantity and quality of its self-regulatory activities are of special significance: Considered by themselves and in comparison with other self-regulatory agencies, they are the most important single measure of the strengths and weaknesses, the accomplishments and limitations, of the self-regulatory concept.

It is appropriate to repeat here as to the NYSE's self-regulatory activities what has already been said in part A on self-regulation generally—that it has basically proved itself in practice despite the shortcomings pointed out below. The study's discussion of the latter is not intended to overshadow or disparge the record of accomplishment but to point toward an even stronger future role. That some of the problems of self-regulation have their counterparts in the Commission's performance of its total role may be seen at various places in the report and particularly part I of this chapter.

The Exchange has conceived of its regulatory role very broadly; it has regarded very few, if any, aspects of its members' business—and therefore of the entire securities business—as being outside the sphere of its concern, and to one degree or another it has addressed itself to the most important of them.

The Exchange has provided constructive leadership and excellent results in many important areas. Its regulatory performance must be rated unsatisfactory in others, however, sometimes seriously so. The Exchange's accomplishments impressively illustrate its ability and potential to raise industry and corporate standards. This and other chapters of the report, however, also reflect areas where the Exchange has been willing to accept the status quo uncritically, where it has failed to perceive new needs for self-regulatory intervention, or where its intervention has been halfhearted or its methods have become outmoded. It has sometimes seemed to be excessively concerned with defending its members from public criticism and insufficiently concerned with governing their conduct in a public market as the Exchange Act requires it to do. That the Exchange has failed to bring its accomplishments in all areas to the level of quality achieved in some is the more regrettable in view of the opportunity afforded by its dominant position and influence.

The unsatisfactory performance in some spheres of self-regulation undoubtedly has many explanations. Among them, there appears still to be a disproportionate influence of floor professionals in the government of the Exchange, stemming ultimately from the allocation of voting power in the Exchange constitution. Only regular members; i.e., holders of "seats," are entitled to vote at Exchange elections and on matters requiring approval by a vote of the membership. Only 97 seats, or 7 percent, are held by those firms providing 50 percent of public commission business, 48 percent of the registered representatives, and 42 percent of branch offices, whereas at the other end of the scale, over 800 seats, or 60 percent, are held by members whose firms do 10 percent of public commission business, have 10 percent of the total registered representatives and 13 percent of the total branch offices. Of 29 elected governors, 17 are required to be regular members, and 14 of them, including the chairman and vice chairman, are generally floor members. The floor members control the important advisory committee, while the nominating committee, which in effect selects the elected members of the board of governors and the next nominating committee, has twice as many regular as allied members. An increasing number of specialists have served as governors, floor governors and floor officials in recent years, and specialists with a limited amount of public business have been elected to the board of governors as partners of firms "engaged in a business involving direct contact with the public." The influence of the floor professionals was most clearly demonstrated by the adoption of the floor-oriented program of the Committee of 17 in 1949–50.

The seat concept has deep roots, reflecting the original private-club concept of the Exchange. It is only natural to think of those having a substantial investment in a seat as being proprietors and therefore holders of the franchise. Yet it is anomalous that voting power is so closely tied to floor participation that, on the one hand, a firm whose function involves floor operations—the prime example is an odd-lot firm—must have seats, i.e., votes, in proportion to its floor business, whereas, on the other hand, a firm whose business is with the public and primarily away from the floor may build a massive and farflung exchange business around a single or very few seats. The anomaly is emphasized by the fact that many seats held in the names of individual members are actually owned and controlled by their firms and that frequently the office partners of a member firm have a larger financial stake in the firm than the floor partners.

The floor has ceased to be a place where the most important members of the Exchange community trade with one another. The floor professionals—specialists, odd-lot dealers and brokers, and floor brokers—are not necessarily the most talented for administration or regulation or the most responsive to public needs, even though the nature of their operations requires them to own seats and to be at the Exchange during the working day. Office partners located in New York or in offices throughout the country may be more sensitive to the public character of the Exchange and more cognizant of the needs of public investors, even though they have fewer seats and little occasion to be in the actual marketplace. In light of this, it would seem that full or partial voting rights should be extended to allied members; i.e., partners or voting stockholders of member firms. Also, the composition of the governing bodies of the Exchange should be altered to give increased representation to firms without specialist affiliation doing business directly with the public.

In most respects, the organizational structure of the Exchange as a self-regulatory agency seems basically sound. The reforms recommended by the Conway Committee in 1938 and adopted by the Exchange have proved to be effective on the whole. Policymaking authority is properly vested in the board of governors which is also the repository of regulatory power.

The chairman of the board, who is required to be a regular member and is invariably a floor member, plays an important part in the disciplinary mechanism of the Exchange. Apart from his board membership he is also a member of the informal committee, which screens major disciplinary cases before they are referred to the board. In addition, the chairman has special responsibilities in supervising floor conduct and is considered "chief on the floor."

The president is the Exchange's chief executive officer and its official representative in all public matters. The full-time staff is responsible for administering the Exchange and is generally of adequate size and quality. With regard to regulation of members' and member firms' conduct off the floor, the staff has sufficient authority and responsibility to carry out its regulatory duties. The regulation of conduct on the floor is complicated, however, by the existence of the floor governors, who resemble in material respects the standing committees who governed the Exchange prior to the adoption of the reforms recommended by the Conway Committee. Because the floor governors are considered to be the experts on floor matters, there has been a tendency for the staff and even the board to defer to the judgment of the floor governors or an individual floor governor in resolving specific questions, and the authority and responsibility of the staff with regard to floor matters have tended to be limited accordingly. The recent action of the Exchange in giving the Floor Department greater authority in floor regulation should be followed by additional steps in the same direction, so that the role of the Floor Department in this area will be equivalent to that of the Department of Member Firms in off-floor regulation.

As already indicated, there is great diversity in the Exchange's initiative and effectiveness in taking hold of different kinds of regulatory problems. To mention a few examples at the high end of the scale: In respect of the all-important matter of qualifications of those entering the securities business, its contribution has been of a high order. The administration of its net capital rule has been generally vigorous and resourceful. Its promulgation and enforcement of controls relating to listed companies, such as periodic financial reports, proxy solicitation, and timely disclosure, have significantly contributed to increased investor protection, and it also took the initiative in establishing and enforcing standards in the area of underwriters' compensation.

On the other hand, its leadership has been much less noticeable and its accomplishments much less noteworthy in respect of selling and advisory practices. Until recently it seems to have devoted little attention to selling practices and supervision by its member firms of their branch offices despite disturbing evidence that serious abuses were occurring. The concept of suitability was largely subsumed under the "know your customer" rule, where emphasis has traditionally been on protection of firms rather than of customers. And at least until recently its concern with market letters and investment advice has been focused more on questions of good taste than on the qualifications and standards of research departments of its member firms. Moves recently undertaken by the Exchange to strengthen its programs in these areas are no less welcome for being belated, but great opportunities remain.

A different kind of illustration of the Exchange's failure to exercise regulatory initiative is described in chapter VI.E in connection with odd-lot trading on the Exchange. Although two member firms dominate this important aspect of the exchange market and the Exchange acknowledges it has full power to regulate such trading, this power has not been exercised in the last 25 years.[181]

The surveillance techniques employed by the Exchange likewise differ widely. The visitation program of Exchange examiners is an excellent factfinding mechanism and an effective means of detecting irregularities, particularly those related to net capital and other areas where books and records are themselves revealing. On the other hand, its surveillance techniques in respect of market letters and selling activities and of its members' supervision in these areas have been minimal. Only recently has it begun to pay close attention to conduct in branch offices.

Another surveillance technique, stock watching, is a pioneering effort by the Exchange in utilizing automation to detect market irregularities. The stock watching procedure should become increasingly sophisticated as the Exchange's automation program advances. Nevertheless, the Exchange has not been as resourceful in adapting automation to the surveillance of member conduct on the floor. As presently constituted, floor surveillance is an arduous and time-consuming task with the final product subject to numerous inaccuracies because of the volume of statistics involved. Increased use of automation might result in more accurate data and permit the staff to devote less time to clerical duties and more to analysis of the subtle and complex problems involved in floor regulation.

With regard to the regulation of specialists, the Exchange's efforts have been intensive and systematic within the limits of its own concepts, yet they have been inadequate in total effect. They have tended to be mechanical and generalized, and have failed to focus adequately

[181] Similarly, the Commission has not exercised its authority under section 11 of the Exchange Act to regulate odd-lot trading.

on concrete problems, such as the applicability of the specialist's conflicts of interest in specific instances, and disparate performances among specialists. The fact that responsible officials of the Exchange were unaware that two-thirds of its specialists were accepting "not-held" orders for many years in violation of law is an indication of the limits of its program. The facts that inaccuracies in floor trading reports have gone undetected, that late filings have been tolerated, and that repeated violations have been disposed of without disciplinary sanctions, are further examples.

A significant limitation in the Exchange's self-regulatory functioning is its handling of public complaints involving its member firms. Instead of using this source of information to advantage as an important tool of self-regulation, the Exchange has performed essentially a buffering function. Complaints of serious impact have gone uninvestigated, while complaining customers have been led to believe that an investigation had been made when this was not the case. Furthermore, in contrast to its professed impartiality in such matters, the Exchange's responses have occasionally been made in such a manner as to strengthen the member's defense. It is to be hoped that the recent changes adopted by the Exchange in the handling of these complaints will result in more effective utilization of them as a surveillance device.

Related to the handling of public complaints is the Exchange's arbitration machinery. It appears to operate efficiently and fairly—indeed, with respect to the machinery itself, geographic expansion to make it more conveniently available to customers throughout the country would seem desirable. The arbitration machinery should not, however, operate as a substitute for, or a limitation on, the Exchange's exercise of its own disciplinary responsibilities where the serious import of a complaint indicates the need for investigation and action by the Exchange itself.

In the disciplinary area—the handling of revealed violations—the Exchange leans toward tenderness rather than severity, but with some unevenness in respect of different types of violations. The Exchange appears more willing to impose severe disciplinary sanctions where the interests of its membership are directly at stake, such as cases involving enforcement of the minimum commission schedule, than where violations involve ethical standards in dealing with customers, such as supervision of salesmen or trading against advice given in a market letter. Admonitions and censures ("severe" or otherwise) are often the extent of punishment meted out, even for substantial infractions; an illustration is the Exchange's recent disposition of a disciplinary matter involving massive violations of its gratuities rule by a leading member.

Related to the above, as cause or effect, is the high degree of informality and privacy surrounding Exchange disciplinary proceedings. It may be argued that under the theory of self-regulation these qualities, or at least the former, are preferable to their opposites, but it is still a question of drawing lines. Unlike the case of the NASD, where the Exchange Act expressly provides for certain formalities in disciplinary cases, there is no statutory provision applicable to exchanges. In practice the NYSE does not hold formal hearings except in proceedings before the board. In rendering disciplinary decisions the board of governors and the advisory committee do not write opinions containing either findings of fact or reasons for the decision.[182] The member or allied member is not entitled to be represented by counsel. Registered representatives are subject to a more summary procedure, although the Exchange has recently adopted changes designed to make these proceedings more closely parallel those involving members. The Supreme Court has recently emphasized the crucial significance of fair procedures in self-regulatory actions affecting nonmembers and it would seem that similar considerations might broadly apply to cases affecting registered representatives, applicants for membership, and members.[183]

The Exchange's policy regarding publicity of disciplinary actions may be assumed to be attributable, at least in part, to a natural reluctance to publish anything adverse about any of its members. Also, publicity about a sanction imposed may itself constitute an additional sanction. These considerations must be balanced, however, against the public's interest in the conduct or misconduct of firms or persons with whom it deals and in the integrity of a public marketplace. As a general principle, with such general or specific exceptions as the Commission may approve, Exchange disciplinary actions resulting in the imposition of a penalty by the advisory committee or the board of governors should be publicly reported.

In the background of many of the Exchange's self-regulatory activities is its interest in public relations. Basically three elements are involved, promotion of share ownership by an ever-larger segment of the public, informing potential investors about securities and securities markets and counseling them about good investment practices, and advertising the quality of the Exchange's market and its member firms. The more that the Exchange does to encourage share ownership by "little" investors, who tend to be new and unsophisticated investors, the greater its obligation to provide rules and practices that are actually in accord with the needs of such investors, and the greater also its obligation to avoid exaggerations and misunderstandings of what the actualities are.

While it would be unfair to suggest that the Exchange has been unmindful of its substantive obligations to the people it invites to deal with its member firms in its market, in recent years it appears to have been disproportionately concerned with the image of itself and its members that it projects. A good example is in the area of research and investment advice as discussed in chapter III.C; the Exchange has devoted very little attention to the research capacity of its member firms but considerable attention to assisting them in advertising that capacity. Similarly, the Exchange misses few opportunities to praise its specialists as a group but does miss many opportunities to improve the performance of individual specialists whom the praises do not fit.

Even if the publicity were always justified by the facts, it may be open to question whether advertising the quality of its market and member firms is wholly compatible with the Exchange's statutory role as self-regulator. From the point of view of the public interest, the best that can be said for this emphasis is that competition among markets is beneficial and this publicity is a superficial form of competition.

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[182] Of the disciplinary cases handled by the Exchange during 1957–61, approximately 70 percent were decided by the advisory committee.

[183] See pt. I, below.

It would seem, however, that this role might more fittingly be performed by the members themselves, through their Association of Stock Exchange Firms,[184] for example. In its role as self-regulator the Exchange stands in the shoes of the government itself, and must have an appropriate degree of aloofness from those it is regulating. To be sure, the very concept of self-regulation involves a merging of regulator and regulatee, but nevertheless the effectiveness of self-regulation is certain to be dulled where the same individuals who are responsible for policing an organization and elevating its practices and standards are simultaneously concerned with advertising how good it already is.

The Special Study concludes and recommends:

1. The influence and prestige of the New York Stock Exchange and the importance of its membership in all sectors of the securities business have provided it with a unique opportunity and responsibility as a self-regulatory agency. Fittingly, it has been foremost among self-regulators in the breadth of its activities, and in many areas it has provided vigorous leadership and produced excellent results. Its record, nevertheless, is an uneven one. Although it has viewed its regulatory role broadly, it has fallen considerably short of its own best levels of achievement in many specific areas critically affecting the public, both in formulating rules and standards to meet changing needs and circumstances and also in providing effective enforcement of its rules and standards. Other chapters, particularly chapters II, III, and VI, contain substantive conclusions and recommendations pertinent to the Exchange's role as self-regulator. The following are confined to the organizational and procedural aspects of this role.

2. A disproportionate influence of floor professionals in the government of the Exchange stems ultimately from the concept of "seats" and the allocation of voting power in the Exchange constitution, since only the holder of a seat ("regular" member) may vote in elections or on constitutional changes. This should be corrected by extending full or partial voting rights to allied members. In addition, the composition of the board of governors, advisory committee, nominating committee, and other governing bodies of the Exchange should be altered to give increased representation to firms without specialist affiliation doing business directly with the public.

3. In respect of floor regulation, the role of the floor department of the staff should be strengthened in relation to the floor governors. In particular, its investigatory authority and responsibility should be expanded in the manner of the department of member firms in respect of off-floor regulation. Specific actions taken by a member on the authority of a floor governor should be regularly reported to the floor department.

4. The enforcement and surveillance techniques of the Exchange range from highly effective ones to quite inadequate ones. Through expansion of the present use of automation or otherwise, more significant and sensitive techniques of surveillance of mem-

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[184] For a discussion of the activities of this organization, see pt. H, below.

bers' conformity with rules and standards applicable to floor activities can and should be developed, along lines recommended in chapter VI. As to off-floor activities, the Exchange's programs for surveillance of market letters, selling activities, and members' supervision of branch offices should receive early and substantial attention, along lines recommended in chapter III.

5. The Exchange's handling of customers' complaints against member firms should be reoriented. Complaints of serious import should occasion serious investigation of facts, to determine whether disciplinary action is warranted. In cases of this kind, the Exchange should act in a self-regulatory role and not in a protective role toward its members; it has recently made moves in this direction. The Exchange's arbitration machinery, generally efficient and fair though it appears to be, should not be used as a substitute for or in derogation of the Exchange's exercise of its disciplinary responsibilities.

6. For self-regulation to be effective the Exchange should impose punishments that fit the infractions involved, particularly those involving ethical standards in dealing with the public, where marked leniency has sometimes been shown. While formality in disciplinary matters should not be sought for its own sake, there should be enough of it to provide basic fairness and also to assure adequate accountability at all levels of the self-regulatory process. As a general principle, with such general or specific exceptions as the Commission may approve, disciplinary matters resulting in the imposition of a penalty by the advisory committee or the board of governors should be publicly reported; staff-imposed sanctions should be periodically reported to the Commission.

7. The Exchange's program of encouraging widespread investment in listed securities by the general public entails a heavy responsibility to see that its own rules and standards and the practices of its members are in keeping with reasonable protection of unsophisticated investors. The Exchange's public relations efforts directed toward informing potential investors about securities markets and counseling them about good investment practices should be continued or even increased, as should its publication of significant economic and statistical data. On the other hand, public relations efforts directed toward emphasizing the merits of the Exchange's mechanisms or members are not wholly compatible with the Exchange's self-regulatory role and should be left to individual members or their unofficial organizations.

C. The American Stock Exchange as a Self-Regulatory Institution

1. Staff report on the organization, management, and regulation of the conduct of members

On January 5, 1962, the Commission released a staff report on the organization, management, and regulation of the conduct of members of the American Stock Exchange (Exchange or Amex), prepared by the Special Study and the Division of Trading and Exchanges. This report appears at the end of this chapter as appendix A.

The staff found that a closely knit group of members, consisting largely of specialists, controlled the government of the Exchange. The dominant group included Joseph F. Reilly, chairman of the board of governors; Charles J. Bocklet, vice chairman of the board; James R. Dyer, chairman of the committee on finance; and John J. Mann, chairman of the committee on floor transactions. During the period 1952–62, these members held the key positions in the government of the Exchange in rotation and were thus able to maintain continuous and effective control.

The staff also found that the attendance of the three public governors at meetings of the board of governors was extremely limited. During a 2½-year period, two of the public governors attended four board meetings and one attended one meeting. It was found that their influence on the government of the Exchange was nil.

The Exchange was operated under a standing committee system in which nine committees in effect administered the Exchange. Of these committees, which were responsible for different areas of Exchange business, those of particular regulatory importance were the committee on floor transactions and the committee on outside supervision. The committee on floor transactions, which was responsible for enforcing the rules governing trading on the floor of the Exchange, was completely dominated by specialists. Of its 10 members, 9 were specialists.

The staff of the Amex was principally involved in the mechanical operation of the Exchange. There were remarkably few staff members engaged in regulatory work, and those who were so engaged were not given any significant degree of authority. Staff functions were principally of a clerical or ministerial nature. It was found that the staff's lack of authority left the standing committees with practically unrestricted discretion with respect to the investigation and regulation of member conduct. The standing committee system also tended to discourage staff initiative and to deter qualified persons from becoming staff members.

Because of specialist domination of the Exchange and in light of the *Re* case,[185] the report devoted a great deal of attention to the specialist in relation to the organization, management, and regulation of the conduct of members of the Exchange. Special attention was given to the firm of Gilligan, Will & Co. (Gilligan, Will), which was one of the more influential specialist firms on the Exchange. That firm was examined in detail from the viewpoint of specialist problem areas exemplified by its activities. It was found that the firm had an integrated vertical operation whereby it brought listings to the Exchange; maintained close contact with the companies listed, and thereby obtained inside information about corporate development; acquired blocks of stock from the issuers, officers, directors, and principal stockholders and their associates prior to and after listing; and participated in numerous distributions of these securities on the Exchange.

[185] On May 4, 1961, the Commission entered an order revoking the broker-dealer registration of Re, Re & Sagarese and expelling Jerry A. Re and Gerard F. Re from the exchange. The Commission found multiple violations by the Res of the Federal securities laws in stocks in which they were registered as specialists. On July 11, 1963, the Res were convicted in the U.S. District Court for the Southern District of New York of violations of the securities laws arising from their activities in the stock of Swan-Finch Oil Corp., in which they were specialists.

The staff concluded that Gilligan, Will was apparently immune from disciplinary action by the Exchange despite a pattern of activities clearly contrary to the specialist function as set forth in the statute and the rules of the Exchange. It was further concluded that any program of reform of the Exchange must concentrate heavily on the dominant role of the specialist.

The report also discussed the floor trader in relation to problems of organization, management, and the regulation of members of the Exchange. The staff found substantial failures by floor traders to file the required reports necessary for the regulation of their activities, and deliberate evasions by members of the rule restricting floor trading. Despite Exchange statements to the contrary, it was determined that the floor trading rule and its enforcement were not effective in controlling floor trading activity.

The staff report concluded:

> There can be little doubt that in the case of the American Stock Exchange the statutory scheme of self-regulation in the public interest has not worked out in the manner originally envisioned by Congress. The manifold and prolonged abuses by specialists and floor traders and other instances of misconduct described in this report make it clear that the problem goes beyond isolated violations and amounts to a general deficiency of standards and a fundamental failure of controls.

2. DEVELOPMENTS SINCE JANUARY 5, 1962

a. Management of the Exchange

In releasing the staff report, the Commission indicated its hope that correction of the abuses found at the Exchange could be accomplished promptly within the statutory framework of self-regulation.[186] The reform movement had begun in October 1961 with the appointment by the president of the Exchange of a special committee of nine members "to make a comprehensive review of the organization, rules, policies and procedures of the Exchange." This committee came to be known as the Levy Committee, for its chairman, Gustave L. Levy, a partner of Goldman, Sachs & Co. The Commission worked with this committee as well as with the new administration of the Exchange, which assumed control in early 1962. Numerous constitutional and organizational changes and other actions stemming from the staff report and the work of the Levy Committee were carried forward by the Exchange community itself with active encouragement from and in consultation with the Commission.

The four members of the Exchange's "dominant group" resigned their positions in January 1962. Edwin Posner was elected chairman of the board and president pro tem. In March, the board elected Edwin D. Etherington president, to take office in September. Etherington had been special consultant to the Levy Committee and had assisted in the preparation of the three reports issued by that committee. When Etherington assumed office, a new board also took office and a new constitution became effective. During the year, three new public governors were selected by the president and approved by the board.

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[186] Securities Exchange Act release No. 6699, Jan. 6, 1962.

b. Constitutional changes

The new constitution of the Amex is quite similar to the constitution of the New York Stock Exchange. Under the new system, the administrative authority for operating the Exchange is centered in the president. The standing committee system has been eliminated. The staff has assumed many of the functions formerly performed by the standing committees and need no longer obtain the approval of a group of members before taking action. For example, the president has the power to examine, or to authorize the examination or production of books and records of, members and member organizations. He and his staff also have the power to require the testimony of any member, his partners, or employees in connection with matters pertaining to the business of the member or his member organization.[187]

The Exchange followed the recommendation of the Levy Committee in eliminating the standing committee system. The Levy Committee pointed to the following weaknesses in the system:

> (1) It results in a division of authority and an absence of well-defined responsibility;
> (2) In certain basic areas standing committees tend to assume greater powers than are exercised by the president or the board;
> (3) Policies developed by standing committees are often presented to the board in such a manner that it is unable to make informed judgments;
> (4) The system delays decision upon difficult problems, particularly disciplinary matters; and
> (5) It has proved an obstacle in the development of necessary staff initiative.[188]

Under the new constitutional structure the board is the sole policy-making body. It is the repository of disciplinary power, except that it may delegate limited disciplinary authority to the advisory committee. Decisions of the advisory committee in disciplinary cases must be reported to the board, and the board may reverse or modify such decisions.[189]

The new constitution has specific provisions aimed at preventing a recurrence of specialist domination of the Exchange. Out of a total of 32 members of the board, specialists and their partners can have a maximum representation of 6. The new composition of the board also provides for 15 office partners as compared with 12 regular members. For the first time the board must have governors located outside the New York City area. Five non-New York City office partners are required to be represented on the board.[190]

Other changes embodied in the new constitution include a new procedure for nominating candidates to the board, as well as various amendments relating to the disciplinary procedures of the Exchange.[191]

c. Staff

In order to cope with its new responsibilities for operating the Exchange, the staff has been reorganized and strengthened. As required under the new constitution, the staff has assumed a large number of the functions previously performed by the standing committees and it was necessary to alter the staff structure drastically to

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[187] Amex constitution, art. II, sec. 2(c).
[188] Report, Special Committee for Study of American Stock Exchange, Dec. 21, 1961, 4.
[189] Amex Constitution, art. V, sec. 2.
[190] Id., art. II, sec. 1.
[191] Id., art. III; art. V.

handle these new duties. The staff reorganization was also made with the view of separating service functions performed by the Exchange on behalf of its members from regulatory functions.

During 1962 the Exchange added 26 staff members performing administrative, executive or professional work. The operations branch, which is the group principally responsible for regulatory duties, added 10 new employees, including investigators and examiners.

d. Specialist regulation

During 1962 the Exchange adopted additional requirements involving a tightening of existing controls relating to specialist activities. The Exchange required that specialists report to it transactions in securities in which they are registered for accounts of public customers carried by their member organizations or introduced by them to other member organizations. This requirement went into effect on April 30, 1962.[192]

Two of the new requirements relate to specialist capital and financing. Both of these rules went into effect on May 25, 1962. Under one of the new requirements, each specialist must maintain a cash or liquid-asset position of $50,000 or an amount sufficient to assume a position of 10 trading units in each security in which he is registered, whichever is greater.[193] The previous requirement was $10,000 or four trading units.

The other new requirement resulted from disclosures contained in the staff report concerning financing agreements between Gilligan, Will and other specialist firms. Under these agreements, Gilligan, Will not only financed these accounts but also participated in the profits and losses, giving the firm an element of control over the accounts with no corresponding responsibility for trading practices. The Exchange rules now provide that a member organization may not participate in the profits or losses of a specialist joint account for which it clears, unless a general partner of the firm or a voting stockholder of the corporation is registered and active at the post as a specialist in such joint account.[194]

e. Listing and delisting requirements

The second Levy Committee report made recommendations as to the standards of eligibility for listing on the Exchange and for delisting securities already traded. The committee also made recommendations in the area of requirements which should be included in listing agreements and subsequent listing applications.[195]

On the basis of the Levy Committee recommendations, the board adopted new requirements in the listing and delisting area on April 5, 1962. These requirements, which are discussed in chapter VIII.B.4, replace the flexible original listing standards previously in effect, and focus on a company's financial status and share distribution. The board also adopted criteria under which the Exchange will give consideration to suspending or removing a security from listing or unlisted trading. These criteria are also described in chapter VIII.B.4.

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[192] Amex rule 190(c).
[193] Amex rule 170(b).
[194] Amex rule 365.
[195] "Report on Standards for Listing Securities," Special Committee for Study of the American Stock Exchange, Jan. 30, 1962.

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

In addition to these changes in listing and delisting standards, the Exchange's current listing agreement requires companies to solicit proxies for all meetings of shareholders and to publish quarterly earnings reports.

f. Disciplinary actions

The Exchange took disciplinary action in 1962 against various members and allied members whose activities were discussed in the staff report. The most significant of these disciplinary cases are summarized here.

As noted previously, the extensive operations of Gilligan, Will were described in detail in the staff report. On February 1, 1962, the Exchange suspended the specialist registrations of James Patrick Gilligan and Albert Will, partners of the firm, pending investigation of the charges contained in the report. An intensive investigation was conducted by the Exchange. On September 25, 1962, the board suspended James Patrick Gilligan and Albert Will from regular membership in the Exchange for periods of 3 years and 1 year, respectively. In addition, Gilligan was fined $5,000 and Will was fined $2,500. James Will, another partner of the firm, was fined $5,000, of which $2,500 was to be paid by the firm. The board further directed that none of the three may be registered as a specialist for a period of 5 years from February 1, 1962. Gilligan was found guilty of conduct inconsistent with just and equitable principles of trade and violations of Exchange Act requirements in connection with his purchases and sales as a specialist. Furthermore, all three were found liable for the acts of James Gilligan, Sr. (a former partner of the firm who sold his seat in June 1961), who was found to have violated the Exchange Act and Exchange rules relating to specialist activities.

In addition to the penalties imposed on partners of the firm, the Exchange also disciplined three members who specialized in joint accounts with Gilligan, Will. Benjamin Samson, Francis Alter, and Lloyd Howard were severely censured by the Exchange in connection with violations committed by Gilligan, Will in joint specialist accounts in which they participated. Samson was also fined $1,750 for violating rule 411 (the "know your customer" rule) in connection with accounts introduced by him to Gilligan, Will.

The staff report also discussed the specialist activities of James F. Rafferty at length, from the standpoint of his financing arrangements, relationships with underwriters in connection with secondary distributions, and overall performance as a specialist. On October 3, 1962, the Exchange suspended Rafferty as a member for a 2-year period based upon a finding of willful violations of Regulation T in connection with purported "nonpurpose" loans made by Rafferty.

The Exchange also took disciplinary action in 1962 against four floor traders who were mentioned in the staff report with regard to their apparent violations of the floor trading reporting requirements and/or the floor trading rules. The first such action was taken on May 17, 1962, when William J. Halpern was found guilty of acts detrimental to the interest or welfare of the Exchange; failure to keep true and complete books and records; and material misstatements to the Exchange. He was suspended for 1 year and fined $2,500. On June 15, 1962, the Exchange fined Eugene F. Dunn $250 for discrepancies in the information reported by him to the Exchange in connection with his floor trading activities.

The Exchange suspended Stephen W. Denman for 90 days and fined him $2,000 on October 11, 1962, for submitting reports to the Exchange containing misstatements in connection with his floor trading activities, and for acts detrimental to the interest or welfare of the Exchange. On December 13, 1962, the Exchange suspended Waldemar T. Wuestehube for 6 months and fined him $5,000 for acts detrimental to the interest or welfare of the Exchange and for filing reports with the Exchange containing misstatements.

In addition to these actions, the Exchange also disciplined members in connection with circumstances arising out of the *Re* case.[196] On March 14, 1962, Anthony J. Cordano was expelled from allied membership in the Exchange. Two of his partners in the firm of Josephthal & Co. were each fined $5,000, with the penalty to be paid by the firm. The violations involved misstatements to the Exchange in connection with accounts introduced by Josephthal & Co. by Jerry Re.

On July 17, 1962, Townsend E. Allen, regular member and partner in the firm of Ira Haupt & Co., was found guilty of conduct inconsistent with just and equitable principles of trade and violations of rule 411. He was suspended for 10 days and fined $5,000, which fine was to be paid by the firm. The board found that Allen and Ira Haupt & Co. had negligently and without sufficient alertness, inquiry, and independent judgment executed or permitted to be executed orders introduced to the firm by the Res in stocks in which the Res were registered as specialists. The Exchange also found that Allen and his firm had failed to use due diligence in learning the essential facts about their customers.

g. Conclusions

The picture revealed at the American Stock Exchange prior to January 1962 was a complete distortion of the self-regulatory system embodied in the Exchange Act. The "general deficiency of standards" and "fundamental failure of controls" noted in the staff report required prompt and drastic remedial action for the protection of the public interest.

During 1962 the Exchange made major moves in the direction of establishing a regulatory system sufficient to meet its responsibilities under the act. A new management, committed to establishing and enforcing high standards of commercial honor and integrity, assumed control of the Exchange's government. A new constitution was put into effect embodying provisions aimed at providing responsible self-government. The standing committee system was discarded and a staff system of administering the Exchange was substituted. Stricter listing and delisting standards were adopted, and existing specialist controls were strengthened. Disciplinary action was taken against members who were found to have violated Exchange rules and Federal law.

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[196] See the brief of the Division of Trading and Exchanges, *In the Matter of Re, Re & Sagarese*, dated Apr. 28, 1961.

The Exchange has thus undergone a major constitutional and organizational reform. In contrast to the prior breakdown of self-regulation described in the staff report, the accomplishment of this reform appears to be an excellent demonstration of the effectiveness of self-regulation under responsible Exchange leadership and active Commission oversight.

D. The Midwest Stock Exchange as a Self-Regulatory Institution

1. Introduction

In 1962 the dollar value of securities traded on the Midwest Stock Exchange (MSE or Exchange) was the highest of all the regional exchanges and its volume of shares traded was second only to that of the Pacific Coast Stock Exchange. In view of these facts and the discussion in chapter VIII.E of its present and potential role, a separate examination of the MSE's organization and regulatory practices and procedures is warranted.

The MSE is the result of the consolidation in December 1949 of the former Chicago Stock Exchange and exchanges located in Cleveland, St. Louis, and Minneapolis-St. Paul. Its trading floor and principal office are in Chicago, with branches in Cleveland and St. Louis connected to Chicago by wire. The branches are principally communications centers for members in those cities.

The inquiry by the study, which was considerably more limited than the study conducted of the NYSE, took various forms. The president of the Exchange, James E. Day, testified at the public hearings held in May 1962 on qualifications to enter the securities business and supervision of selling practices. He also conferred with Special Study staff members on various subjects affecting the MSE. A review was made of Commission files relating to the MSE and the Exchange supplied various data on its operations. The inquiry also included a visit to the Exchange, interviews with Exchange officials responsible for its regulatory program, and inspection of various Exchange files relating to disciplinary actions, examinations of member firms, and public complaints.

The importance of the relationship between the MSE and the New York exchanges must be emphasized. As of May 21, 1962, 121 of the 306 member organizations of the MSE, including some of the largest commission houses, were also members of the NYSE. As of June 30, 1962, approximately 85 percent (433) of the issues traded on the MSE were also traded on either the NYSE or the Amex.[197]

2. Government of the Exchange

The government of the MSE is vested in the board of governors consisting of the chairman, vice chairman, president, and 24 governors, of whom 12 must be from the Chicago area, 3 each from the Cleveland, Minneapolis-St. Paul, and St. Louis areas, and 3 from elsewhere.[198] The board generally meets four times annually.

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[197] The reasons underlying trading on the MSE in stocks listed on New York exchanges are considered in ch. VIII.E. Other data concerning the Exchange and its market mechanisms appear there and in various parts of ch. VI.

[198] MSE constitution, art. III.

Members of the board, except for the president, are elected under a nominating committee procedure which permits independent nominations.[199] In selecting nominees, the committee generally accepts the recommendations of regional committees (see below) for nominees from Cleveland, St. Louis, and Minneapolis-St. Paul. An independent slate has not been proposed for at least 17 years. Only regular members (seatholders) are entitled to vote at Exchange elections.[200] The board in office in February 1963 consisted of 17 regular members and 8 partners of member firms, with two vacancies. Of the regular members, 7 were specialists.

The MSE also has six public "advisers," nonmembers who represent the public at meetings of the board and in the affairs of the Exchange, three of whom are from Chicago and one each from Cleveland, Minneapolis-St. Paul, and St. Louis. They may attend board meetings but are not entitled to vote.[201] The advisers have generally been prominent businessmen such as bank presidents and executives of major corporations located in the Midwest. Their attendance at board meetings has been infrequent. Of the 13 most recent advisers, 7 attended no board meetings during their terms of office and 5 attended only 1 meeting. The Exchange has indicated that the advisers' principal contribution has been in connection with such matters as keeping listing standards high and obtaining new listings. It has also indicated that it would not be able to obtain the same type of prominent individual if advisers were required to attend board meetings and given the right to vote.

The executive committee, which is composed of the chairman, the president, and seven board members, of whom four are from Chicago and one each from Cleveland, Minneapolis-St. Paul, and St. Louis, generally meets three times monthly and has the powers of the board between board meetings, except for the power to propose constitutional amendments.[202] It seldom makes final policy decisions, but leaves such matters to the board. It has no disciplinary responsibilities.

There are regional committees in Cleveland, Minneapolis-St. Paul, and St. Louis. These regional committees, each composed of five members, of whom three are the governors from the particular city, are charged with advising the manager of the MSE branch office located in the area. The committees recommend candidates for the board of governors to the nominating committee, and also receive and review complaints from members located in their cities.

There are five other standing committees, the admissions, finance, and investment committees, and the committees on floor procedure and public relations.[203] The committee on floor procedure has general supervision over conduct on the floor and, through the president, enforces those rules and regulations relating to the transaction of business on the floor. The committee selects specialists and odd-lot dealers.[204] It hears disciplinary cases and recommends decisions to the president, who may accept, reject, or modify the recommendations. Approximately 50 percent of the recommended decisions are accepted by the president. The committee also reviews complaints by the public

199 Id., art. IV.
200 Id., art. IV, sec. 7(b).
201 Id., art. VI.
202 Ibid.
203 MSE rules, art. III.
204 Ibid.

or members regarding executions of orders, and occasionally directs an adjustment to be made.

The chairman presides at board meetings, and may call special meetings of the Exchange, the board, or any committee.[205] He has no special disciplinary authority. The present chairman, Norman Freehling, is the first since 1949 who has been active on the floor.

The president of the MSE is its chief executive officer. James E. Day has held this position for 17 years. He is charged with the supervision and management of the Exchange's operations and with carrying out the orders and directions of the board and the various committees of the Exchange.[206]

The staff of the Exchange is responsible to the president. In some respects he has more authority in disciplinary matters than nonmember presidents of other exchanges, including the NYSE and Amex.[207] As of March 1962, the staff of the Exchange consisted of 64 employees. Of these, 13 were in executive or supervisory positions and 51 were in clerical positions. Eight MSE employees, principally on the executive or supervisory level, were engaged in regulatory activities of one form or other. In addition, the MSE utilizes the services of a national public accounting firm in its regulatory activities.

During 1961, apart from the operations of its subsidiaries, the MSE had income of $765,402 and expenses of $671,491, giving it a net operating profit before taxes of $93,911.

3. DISCIPLINARY PROCEDURES

The staff of the Exchange has the initiative in disciplinary matters. The only committee with regulatory responsibility, the floor procedure committee, cannot take disciplinary action on its own except in minor cases involving such matters as the use of abusive language.[208]

The president of the Exchange is at the center of its disciplinary mechanism. If he hears of any misconduct or offenses alleged to have been committed by a member or member firm, he is required to arrange for the investigation of the matter by an officer of the Exchange.[209] If in the judgment of the president there has been a violation, charges are preferred. If, as almost invariably happens, the member or member firm admits the truth of the charges, the president may impose the penalty.[210] President Day has indicated that he has had little "second-guessing" by members on his exercise of disciplinary authority.

If a firm does not want the president to set the penalty, it may admit the truth of the charges but request a hearing on the penalty by a judiciary committee appointed by the chairman of the board. If a firm does not admit to the truth of the charges, a trial is held before the president or a judiciary committee. If, after such a trial, the president imposes a penalty, the member or member firm is entitled to review by a judiciary committee. Any decision of a judiciary committee is reviewable by the board on its own motion or on the demand of the member or member firm.[211]

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[205] MSE constitution, art. VII, sec. 2.
[206] Id., art. VII, sec. 4.
[207] See sec. 3, below.
[208] MSE rules, art. III, rule 6.
[209] MSE rules, art. XXI.
[210] Ibid. The presidents of the NYSE, Amex, and PCSE do not have equivalent authority.
[211] MSE rules, art. XXI.

It is rare for the Exchange to hold any sort of formal hearing in disciplinary proceedings. Although the member has the right to counsel, this right is rarely exercised. Registered representatives are entitled to the same procedures in disciplinary cases as members.

The president decides in each case whether the decision will be made public. His decision depends on whether the public is "affected" by the action. Where a member is suspended or expelled for a violation "affecting the public" (e.g., manipulation), a press release is issued with the name of the member. If a member is suspended for a violation of the net capital requirements but is not in serious financial difficulty, the decision is put on the MSE tape but no press release is issued. President Day does not recall any instance where a disciplinary action involving a less serious penalty than suspension was made public although this would be possible if the public were "affected."

4. SURVEILLANCE AND ENFORCEMENT OF OFF-FLOOR REQUIREMENTS

Surveillance of off-floor activity by the MSE is based principally on financial questionnaires, audits, and visits to member firm offices. Member firms that are not also members of the NYSE are required to submit two financial questionnaires annually, one of which must be audited on a surprise basis. The surprise audit requirement has been in effect since July 1962. Firms within $5,000 of the MSE's net capital requirement[212] are also required to file monthly financial reports. The MSE leaves surveillance of NYSE firms to that exchange, and NYSE members are required only to file copies of their NYSE financial questionnaires with the MSE. The MSE might not learn of a violation of its rules by an NYSE firm since the NYSE does not advise the MSE of its disciplinary actions unless the matter is made public. For example, the MSE did not learn that the NYSE had taken disciplinary action against a dual member for a net capital violation which came about because the firm had an excessive position in its MSE specialist account. The member agreed to limit its MSE specialist operations, but the MSE was not advised of the case.[213]

The MSE's program of visiting the offices of member firms is conducted by a vice president, an examiner, an analyst, and a national accounting firm. This firm has trained six accountants in various cities to examine the procedures and controls of MSE firms. They are expected to make the same kind of examination as MSE employees. During periods of sharp market declines, they also perform capital computations.

Every MSE-only firm is visited at least once every 2 years. Some firms, including those that carry large inventories or trade in speculative securities, are visited at least once a year. In 1962, the MSE conducted 93 examinations of member firms; in 1961, it conducted 64; and in 1960, it conducted 65. The increase was due to the added facilities of the outside accounting firm.

An MSE examiner is expected to review the member firm's capital computation and to spot check various matters, including Regulation

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[212] See ch. II.B.3.a(4). Rule 15c3–1(b)(2) under the Exchange Act exempts the MSE from the application of the Commission's net capital rule, since its "rules and settled practices are deemed by the Commission to impose requirements more comprehensive than the requirements" of the Commission's rule.

[213] See pt. B.3.c(4), above.

T and margin maintenance. Customers' accounts are checked for overactivity and the kinds of securities contained in the account. The examiner is expected to look at markups, over-the-counter executions, and the most recent selling literature of the firm. If the firm is a specialist on the MSE, its specialist account is checked as well as trading by its public customers in issues in which it is registered.

If the firm is found to be in violation of the MSE's capital requirements, it is given a specified period of time (generally a week) to correct the deficiency. If the capital is not restored within the specified time, the matter is referred to the president for appropriate disciplinary action. Seven of the MSE's 21 disciplinary cases in the years 1953–62 were for violations of its net capital rule. Four of the violations occurred in 1962.

The visits by Exchange examiners are the principal surveillance technique in respect of compliance with Regulation T and margin maintenance. Requests for extensions of time under Regulation T are processed in Chicago, Cleveland, St. Louis, and New Orleans. Non-Chicago extension requests are periodically reviewed in Chicago. Approximately 5 percent of the requests are denied and the third request on a particular transaction is generally the last approved by the Exchange. The MSE charges $1 per extension, which resulted in $55,000 income in 1961. An MSE official indicated he did not believe the Exchange was more lenient in granting extensions than the NASD, which does not charge for handling them. The Exchange had one Regulation T disciplinary case, which resulted in a $200 fine, in the 1953–62 period.

The visits made by Exchange examiners are considered by the MSE to be of some help in supervising selling practices of member firms. In addition, President Day visits member firms in the course of his duties and checks on their supervisory practices. No visits are made, however, to branch offices of MSE-only firms. The MSE has had almost no cases of selling abuses, which Day attributed in part to the difficulty of detecting such abuses.[214] The MSE accepts NYSE surveillance over dually registered salesmen "almost 99.99 percent."

In the course of their visits, Exchange examiners review market letters and sales literature. They look for exaggerations and overselling. Frequently MSE-only firms distribute literature prepared by their New York correspondents. The MSE advised the study that it is concerned in its regulatory program with the qualifications and standards of its member firms' research departments; this is principally President Day's responsibility.

The MSE requires its sole firms to submit advertisements in advance for approval. In reviewing advertisements, the Exchange is concerned with overselling and the expression of opinions concerning the merits of securities.

5. SURVEILLANCE AND ENFORCEMENT OF FLOOR REQUIREMENTS

The MSE devotes little attention in its market surveillance program to trading in dually listed securities. Its efforts are concentrated on the sole listings and more specifically, on the approximately 30 sole listings that are reasonably active.

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[214] See ch. III.B.6.b(4) for a discussion of MSE supervision over selling practices of its sole members.

The MSE employs a system whereby a trading situation is brought to the attention of the senior staff members if a stock has fluctuated more than usual during a particular period. The Exchange then checks the source of the orders in the stock and contacts the member firms involved. If it appears necessary to contact public customers the matter is referred to the Chicago regional office of the Commission.

Questions concerning the conduct of specialists originate either with the staff or the floor procedure committee. The facts are gathered by the staff and presented to the committee. The committee acts in an advisory capacity to the president rather than as a disciplinary body. During the years 1953–62, 7 of the MSE's 21 disciplinary cases were based upon specialist violations, 3 of them occurring in 1962.

The Exchange has no systematic method of determining whether the execution of an order in a dually traded stock on the MSE is as good or better than it would have been on the NYSE or Amex.[215] It expects the servicing broker to police this. The MSE receives occasional complaints from sole members and nonwire dual members unable to execute as many orders as they want on the MSE, urging that MSE specialists should participate more in the market.

The only regular report that MSE specialists are required to file is a monthly report of their total odd-lot and round-lot purchases and sales on the MSE as well as their offsetting transactions in New York. The MSE does obtain daily information, however, as to trading by approximately two-thirds of its specialists whose records are kept by the Exchange. This information is available for surveillance purposes.

To become an active floor member, a member must pass a written examination administered by the Exchange. This requirement has been in effect for approximately 3 years. There is no special examination to become a specialist, but generally a new member cannot become a full-time specialist until he has been on the floor for at least 1 year.

Under the system of allocating securities to specialists, members are told of new listings and invited to apply to the floor procedure committee. The committee is advised of the volume of transactions at each applicant's post, his manpower, capital, and performance in the following respects:

1. MSE volume as a percentage of NYSE or Amex volume;
2. Specialist's precentage of MSE volume; and
3. Odd-lot activity compared to round-lot activity.

President Day attends floor procedure committee meetings and expresses his views as to which specialist should receive a particular stock. If a specialist induced a listing, the committee considers this as a factor. Recommendations by the company or its underwriter as to specialists are discouraged, but the committee is advised of any such recommendations.[216] Allocation decisions of the committee may be appealed to the board, but this is rarely done.

The MSE discourages contact between specialists and issuers except for a periodic letter by the specialist to the issuer concerning the market maintained in the stock. The letter is in the nature of a statistical study.

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[215] For a discussion of MSE trading practices, see ch. VIII.E.
[216] For a discussion of NYSE specialist allocation procedures, see pt. B.4, above.

An Exchange official stated that there are six "small" floor traders on the MSE. He did not know the extent of their trading since members are not required to report their floor trades on a systematic basis. The MSE has no special rules governing floor trading.

6. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

As one of the largest regional exchanges, the Midwest Stock Exchange occupies an important position in the securities markets with the potential for an expanded role in future years.[217] In assessing the MSE's self-regulatory performance it should be emphasized that its regulatory efforts are directed principally at sole members and securities traded only on that exchange. The MSE does not examine firms that are also members of the NYSE, and it leaves market surveillance of dually traded stocks to the primary market.

The government of the MSE is vested in the board of governors; the executive committee performs board functions between board meetings. The Exchange's organizational structure also includes regional and standing committees; the regional committees represent the cities whose exchanges were merged into the MSE, and the standing committees have regulatory and other responsibilities in specified substantive areas.

The Exchange staff plays a crucial role in the administration of the MSE and in regulating member conduct, again highlighting the importance of a paid staff, with sufficient authority and responsibility, to accomplish effective self-regulation. The important role played by the MSE president in the Exchange's disciplinary machinery and in its total administration contributes to the efficient performance of the Exchange's role as a self-regulatory agency.

The impact of the public advisers on MSE affairs appears to be minimal, thus giving the appearance of public representation in Exchange affairs more than the actual fact. The public advisers rarely attend board meetings, do not have the right to vote at these meetings, and are more involved in matters of listing than in the regulatory process.

The MSE has taken leadership in various significant ways including qualification examinations for members, centralized automated bookkeeping for member firms, and clearance of transactions by mail. Its self-regulatory program devotes considerable effort to the enforcement of its net capital rule, but seemingly inadequate attention to the supervision of member firm selling practices.

The Special Study concludes and recommends:

1. Certain recommendations in other parts of chapter XII, especially part B, may apply directly or with appropriate adaptation to the MSE; e.g., the recommendation as to publicizing disciplinary actions. Commission and Exchange representatives should undertake to determine the possible applicability of such recommendations and the Exchange should proceed to implement such recommendations or adaptations as may be found appropriate.

2. The Exchange should undertake a reassessment of the institution of public advisers to determine whether it can become a

[217] See ch. VIII.E.

more effective instrument for representation of the public in Exchange affairs.

E. The Pacific Coast Stock Exchange As a Self-Regulatory Institution

1. INTRODUCTION

The Pacific Coast Stock Exchange (PCSE or Exchange) had the largest volume of shares traded and the second largest dollar volume of all regional exchanges in 1962. Only the Midwest Stock Exchange had larger dollar volume. In view of its present volume of trading and its potential for growth, a separate analysis of the organization and regulatory mechanism of the PCSE is warranted.

NYSE member firms are of considerable importance at the PCSE, just as they are at the Midwest Stock Exchange. As of March 21, 1962, 45 of the 133 PCSE member firms, including some of the largest commission firms, were also members of the NYSE. Of the 564 stocks traded on the PCSE as of January 1, 1963, approximately 7 percent (40) were traded solely on the PCSE. The remaining stocks were also traded on either the NYSE or the Amex.[218]

The PCSE came into existence in January 1957 as a result of the consolidation of the San Francisco and Los Angeles Stock Exchanges. It has two separate divisions, one in San Francisco and the other in Los Angeles, each with its own trading floor. The floors are connected by an elaborate communications system. Until March 1961, there were separate governing boards and separate presidents.

When the two exchanges were consolidated, painstaking efforts were made to keep the two divisions on an equal basis and each division still retains a considerable degree of autonomy. The position of chairman of the board and the location of the principal office of the Exchange rotate annually between San Francisco and Los Angeles;[219] and the president, Thomas P. Phelan, divides his time betwen the two cities. Each division retains control over its own finances, and a prospective member applies for admission to one of the two divisions rather than to the Exchange as an entity. The purchase of a membership entitles the holder to an equity interest in the assets of that division.

The regulatory practices of the two divisions differ somewhat and, except for the president, staff members are assigned to either San Francisco or Los Angeles. Some of the traditions of each of the predecessor exchanges have been continued. For example, members of the Los Angeles division are entitled to designate employees or associates as floor representatives to exercise trading privileges on their behalf,[220] whereas members of the San Francisco division do not have this prerogative.

The Special Study's inquiry into the regulatory activities of the PCSE was not as intensive as the one conducted of the NYSE. It included a visit to the Exchange, at which time responsible staff officials at each division were interviewed and various files pertaining to the PCSE's regulatory program were inspected. In addition, the

[218] Other data concerning the Exchange and its market mechanisms appear in ch. VIII.E and various parts of ch. VI.
[219] PCSE constitution, art. I, sec. 4; art. III, sec. 3.
[220] Id., art. IX, sec. 2(b).

president of the Exchange conferred with study staff members on matters affecting the PCSE, a review was made of Commission files relating to the PCSE, and the Exchange supplied various data pertaining to its operations.

2. GOVERNMENT OF THE EXCHANGE

The government of the PCSE is vested in its board of governors, consisting of five governors elected by the Los Angeles division, five governors elected by the San Francisco division, and the president.[221] In February 1963, the board consisted of seven regular members and three partners or stockholders of member firms. Of these, eight were office partners and two were floor members. There are no public governors or advisers on the PCSE board.

Candidates for the board are selected by nominating committees in each division.[222] An independent nominating procedure is available but rarely used. Only regular members (seatholders) are entitled to vote at Exchange elections.

Each division has a management committee composed of the five governors elected by that division. According to the constitution, these committees "shall act on any matter that solely concerns the internal fiscal affairs, or assets of that division." [223] As a practical matter, however, the division management committees have considerable authority in operating the divisions and they play key roles in the regulation of members. Since it is difficult for the board to meet frequently because of the distance between the cities, the division management committees have assumed authority for overall supervision of the affairs of their respective divisions. The board generally follows recommendations of the division management committee on matters affecting only that division, including the disciplining of members. In disciplinary cases, the staff presents its findings to the division management committee which makes a recommendation to the board.

The PCSE operates under a standing committee system.[224] The committees must be composed equally of representatives of the two divisions and at least one governor must be a member. They are the auditing, clearing, ethics and business conduct, floor trading, listing, and public relations committees. The auditing, ethics and business conduct, and floor trading committees are the most important of these from the standpoint of the regulation of the conduct of members.

The auditing committee considers matters of policy relating to financial requirements of members and member firms. The members of this committee in each division are responsible for supervising the financial condition of member firms.

The ethics and business conduct committee considers a variety of matters, including the business conduct of member firms, admissions applications, and matters submitted for arbitration. It is an important regulatory committee, since a broad range of disciplinary cases are referred to it before they are sent to the division management committee or the board.

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[221] Id., art. III, sec. 1(a).
[222] Id., art. IV.
[223] Id., art. III, sec. 2(a).
[224] Art. V of the PCSE constitution describes the standing committees and their functions.

The floor trading committee is responsible for recommending rules to the board for governing transactions on the Exchange. Its members have a wide variety of responsibilities in supervising floor conduct. Among their duties are the enforcement of floor rules, allocation of stocks to specialists, and imposition of fines for violations of floor rules. The staff presents matters for possible disciplinary action to the committee, which then either takes action itself or refers the case to the division management committee.

The chairman of the board, with the vice chairman, appoints the members of all standing and special committees of the Exchange, subject to board approval. The chairman is an ex-officio member of all committees and presides at meetings of the board and the Exchange.[225] He has no special disciplinary responsibilities.

The president, who cannot be a member or partner of a member firm, is the PCSE's principal executive officer. He is charged with the responsibility of enforcing the provisions of the Exchange's constitution and rules and fostering its general interest.[226] The president is a member of the board and both division management committees but is not entitled to vote at meetings of either. This latter provision is unusual—the presidents of the NYSE, Amex, and MSE, who also are nonmembers, may vote at board meetings. The president is charged with coordinating "the activities in the best interests of the Exchange of all committees of which he is a member." [227] Phelan, while he has been president, has attempted to weld the two divisions into an Exchange with a single set of practices and requirements.

As of March 23, 1962, the staff of the Exchange and its subsidiaries consisted of 223 employees, including the president, 129 employees in Los Angeles, and 93 in San Francisco. Of the 223, approximately 150 were involved in the process of clearing transactions, while 7 were in executive and 11 in supervisory capacities. Most staff members concerned themselves with the mechanical operation of the Exchange and its facilities. Eight staff members, including four auditors, were engaged in regulatory activities.

The staff officers of the PCSE are expected to "perform the customary duties of their offices subject to the direction and control of the president and of the board of governors." [228] The fact that staff officers are responsible to the board as well as the president is a reflection of the substantial participation of the board and the standing committees in the day-to-day operation of the Exchange.

During 1961, the two divisions of the PCSE had total income (apart from the operation of the clearing corporation) of $639,683 and total expenses of $579,726.

3. DISCIPLINARY PROCEDURES

The disciplinary mechanism of the Exchange revolves around its standing committees and the division management committees. All disciplinary matters are processed by one or more of these committees, and the final decision of the board generally incorporates the recommendations of the committees that considered the matter.

[225] PCSE constitution, art. III, sec. 3.
[226] Id., art. III, sec. 5.
[227] Ibid.
[228] PCSE constitution, art. III, sec. 6.