TABLE XII–6.—*Membership of NASD and representation on board of governors and district committees by district and State (Dec. 31, 1961)*

District and State	Members		Branch offices		Registered representatives		Members of board of governors		Seats on district committee		Location of district office
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	
All districts	4,750	100.0	4,519	100.0	[1] 101,946	100.0	21	100.0	124	100.0	
District No. 1, total	123	2.6	188	4.2	2,885	2.8	1	4.8	7	5.6	Seattle.
Idaho	10		17		271						
Montana	10		21		242				1		
North Dakota	7		14		253						
Oregon	26		50		757				2		
South Dakota	4		16		224						
Washington	64		68		1,102		1		4		
Alaska	2		2		36						
District No. 2, total	395	8.3	692	15.3	11,098	10.9	3	14.2	12	9.7	San Francisco (north); Los Angeles (south).
California	362		650		10,245		3		11		
Nevada	4		20		149						
Hawaii	29		22		704				1		
District No. 3, total	140	3.0	128	2.8	3,034	3.0	1	4.8	9	7.3	Denver.
Arizona	17		31		405				1		
Colorado	69		50		1,438				7		
New Mexico	7		11		250		1				
Utah	39		17		716				1		
Wyoming	8		19		225						
District No. 4, total	167	3.5	214	4.7	4,378	4.3	1	4.8	9	7.3	Kansas City.
Kansas	30		50		932				1		
Missouri	81		103		2,630		1		6		
Nebraska	26		28		400				1		
Oklahoma	30		33		416				1		
District No. 5, total	139	2.9	169	3.7	1,967	2.0	1	4.8	6	4.8	New Orleans.
Alabama	39		58		607				2		
Arkansas	21		26		282				1		
Louisiana	36		39		652				2		
Mississippi	23		27		194		1				
Tennessee (west)	20		19		232				1		
District No. 6, total	186	3.9	201	4.5	2,887	2.9	1	4.8	7	5.6	Dallas.
Texas	186		201		2,887		1		7		

District No. 7, total	214	4.5	368	8.2	5,001	4.9	1	4.8	6	4.8	Atlanta.
Florida	117		221		3,191				2		
Georgia	38		79		817				2		
South Carolina	28		35		387				1		
Tennessee (east)	31		33		606		1		1		
District No. 8, total	419	8.8	689	15.3	9,862	9.7	3	14.2	12	9.7	Chicago.
Illinois	178		211		3,757		2		5		
Indiana	49		72		839				1		
Iowa	29		87		745				1		
Michigan	55		117		1,830				2		
Minnesota	65		112		2,041				1		
Wisconsin	43		90		650		1		2		
District No. 9, total	149	3.1	210	4.6	2,661	2.6	1	4.8	9	7.3	Cleveland.
Kentucky	15		25		494				2		
Ohio	134		185		2,167		1		7		
District No. 10, total	251	5.3	239	5.3	5,730	5.6	1	4.8	8	6.5	Washington, D.C.
District of Columbia	104		41		1,358		1		2		
Maryland	56		52		1,784				2		
North Carolina	45		62		1,044				2		
Virginia	46		84		1,544				2		
District No. 11, total	264	5.6	327	7.2	6,972	6.8	1	4.8	12	9.7	Philadelphia.
Delaware	18		7		249						
Pennsylvania	215		280		5,452		1		11		
New Jersey (south)	21		22		956						
West Virginia	10		18		315				1		
District No. 12, total	2,064	43.5	809	17.9	38,252	37.4	5	23.6	18	14.4	New York.
Connecticut	39		105		1,379		1		1		
New Jersey (north)	189		141		2,846				1		
New York City	1,490		315		27,795		4		15		
New York State	346		248		6,232				1		
District No. 13, total	239	5.0	285	6.3	7,219	7.1	1	4.8	9	7.3	Boston.
Maine	32		35		424				1		
Massachusetts	173		172		5,645		1		7		
New Hampshire	9		21		161						
Rhode Island	23		46		825				1		
Vermont	2		11		164						

[1] Does not include 359 registered representatives residing in foreign countries.

TABLE XII–7.—*Representation on NASD board of governors and district committees by district and State (Dec. 31, 1958)*

District and State	Number of members of board of governors	Number of seats on district committee
All districts	21	127
District No. 1, total	1	6
Idaho		
Oregon		2
Washington	1	4
District No. 2, total	2	10
California	2	10
Nevada		
Hawaii		
District No. 3, total	1	9
Arizona		1
Colorado	1	6
New Mexico		1
Utah		1
Wyoming		
District No. 4, total	1	9
Minnesota	1	9
Montana		
North Dakota		
South Dakota		
District No. 5, total	1	6
Kansas	1	2
Missouri (west)		3
Oklahoma		1
District No. 6, total	1	7
Texas	1	7
District No. 7, total	1	7
Arkansas		1
Kentucky (west)		
Missouri (east)	1	6
District No. 8, total	3	12
Illinois	2	5
Indiana		1
District No. 8—Con.		
Iowa		1
Michigan	1	2
Nebraska		1
Wisconsin		2
District No. 9, total	1	9
Alabama		1
Florida		
Georgia	1	2
Louisiana		2
Mississippi		1
South Carolina		1
Tennessee		2
District No. 10, total	1	9
Kentucky	1	2
Ohio		7
District No. 11, total	1	8
District of Columbia		2
Maryland		2
North Carolina	1	2
Virginia		2
West Virginia		
District No. 12, total	1	12
Delaware		
New Jersey (south)		
Pennsylvania	1	12
District No. 13, total	5	16
Connecticut		1
New Jersey (north)		1
New York City	5	13
New York State		1
District No. 14, total	1	7
Maine		1
Massachusetts	1	5
New Hampshire		
Rhode Island		1
Vermont		

TABLE XII–8.—*Composition and size of NASD staff (yearends, 1955–62)*

[Number of persons]

	1962	1961	1960	1959	1958	1957	1956	1955
National and district offices, total	160	130	112	106	99	88	69	61
National office, total	80	63	56	54	49	45	31	26
Executive director	1	1	1	1	1	1	1	1
Assistant to executive director	1	1	1	1	1	1	1	1
Legal staff [1]	2	1	1	1	1	------	------	------
National committee secretaries and other supervisors [2]	14	12	10	10	10	9	7	7
Examiners [3]	12	9	9	10	8	10	3	------
Clerical and others	50	39	34	31	28	24	19	17
District offices, total	80	67	56	52	50	43	38	35
District secretaries [4]	14	14	13	13	14	13	12	12
Assistant secretaries [5]	1	2	2	2	1	1	------	------
Legal staff (district 12) [6]	3	2	1	1	1	1	1	1
Examiner supervisors	4	2	1	1	1	------	------	------
Examiners	23	19	13	13	14	10	10	9
Clerical and others	35	28	25	22	19	18	15	13

[1] During 1955–57 outside counsel was utilized.
[2] Includes some national committee personnel stationed in New York City.
[3] Most were from time to time temporarily assigned to district offices on the basis of district needs.
[4] Most district secretaries also performed examinations and/or examiner supervisory work. In 1961–62, there were cosecretaries in district 2. See tables XII–6 and XII–7.
[5] Also perform examiner supervisory work.
[6] For a period prior to 1961 also had title of assistant secretary.

Source: NASD records.

TABLE XII–9.—*Activities of firms represented on NASD district committees (1961)*

[Number of firms]

	Primary activity	Secondary activity	Tertiary activity
All firms	[1] 123	[2] 121	[3] 115
Exchange commission	48	17	14
OTC retail	44	43	21
Underwriting	17	28	33
OTC wholesale	7	14	22
Dealer or principal underwriter of mutual funds	[4] 6	10	14
Other exchange	1	3	------
Miscellaneous	------	6	11

[1] 1 firm did not report a primary activity.
[2] 4 firms did not report a secondary activity.
[3] 9 firms did not report a tertiary activity.
[4] Includes 1 principal underwriter.

Source: Questionnaire OTC–3 and NASD records.

TABLE XII–10.—*Summary of NASD receipts and disbursements (for fiscal years, 1955–61)*

	1961	1960	1959	1958	1957	1956	1955
RECEIPTS							
Assessments:							
Membership	295,445	280,312	237,525	191,452	171,015	171,250	148,620
Personnel	384,653	385,672	428,644	285,111	240,256	147,390	182,884
Underwritings	198,469	200,061	260,232	264,333	236,110	364,612	209,315
Investment company underwritings	85,453	88,308	84,533	75,878	66,261	87,919	44,978
Less: Adjustment to conform to total assessments shown on audited financial statements						(3,490)	(1,181)
Total assessments	964,020	954,353	1,010,934	816,774	713,642	767,681	584,616
Registered representative and other fees:							
Registered representative application fees	411,980	379,280	321,970	231,070	222,200	177,700	123,230
Registered representative examination fees	292,200	277,990	237,420	158,940	157,255		
Branch office fees	54,503	50,209	40,419	30,554	26,370	25,310	16,770
New member admission fees	50,250	52,270	16,705	11,725	12,025	12,725	11,225
Total fees	808,933	759,749	616,514	432,289	417,850	215,735	151,225
Fines and costs	86,316	112,045	70,935	67,110	42,750	44,426	6,648
Interest and miscellaneous revenues	37,847	48,019	24,400	17,388	20,057	14,293	6,617
Total receipts	1,897,116	1,874,166	1,722,783	1,333,561	1,194,299	1,042,135	749,106
DISBURSEMENTS							
National organization:							
Executive office:							
Salaries	291,986	279,649	240,307	196,221	171,547	121,164	108,274
Other (including rent, printing, postage, travel to meetings, furniture, etc.)	227,694	205,264	232,980	193,132	142,617	115,542	79,650
Board of governors (travel and meetings)	70,384	64,943	59,545	58,996	54,283	57,250	40,740
National committees:							
Salaries	66,636	61,358	51,400	48,520	34,255	29,624	29,667
Other expenses	53,506	33,032	42,949	45,455	47,943	46,434	35,350
General expenses (including legal and accounting fees, taxes, public relations, retirement, etc.)	238,072	126,511	211,580	199,948	214,268	135,661	79,372
Total national organization	948,278	770,757	838,761	742,272	664,913	505,675	373,053

District committees:							
Salaries	473, 222	416, 191	373, 020	339, 330	275, 800	235, 249	183, 636
Other expenses	391, 800	445, 612	298, 771	248, 629	192, 372	154, 795	153, 915
Total district committees	865, 022	861, 803	671, 791	587, 959	468, 172	390, 044	337, 551
Total disbursements	1, 813, 300	1, 632, 560	1, 510, 552	1, 330, 231	1, 133, 085	895, 719	710, 604
Excess of receipts over disbursements	83, 816	241, 606	212, 231	3, 330	61, 214	146, 416	38, 502

Source: NASD reports of treasurer and finance committee for the fiscal years 1955–61.

TABLE XII–11.—*Findings in NASD disciplinary proceedings by type of violation (1959–61)*

[Number of violations]

Type of violation	All alleged violations			Violations based on examinations			Violations not based on examinations		
	Total	Found	Not found	Total	Found	Not found	Total	Found	Not found
All violations	1, 729	1, 506	223	1, 303	1, 207	96	426	299	127
"Free-riding"	261	211	50	27	23	4	234	188	46
Regulation T	199	191	8	197	189	8	2	2	
Books and records	184	176	8	177	171	6	7	5	2
Supervision	167	115	52	129	108	21	38	7	31
Markups	134	124	10	128	121	7	6	3	3
Fraud	111	95	16	86	80	6	25	15	10
Net capital	102	97	5	98	94	4	4	3	1
Nonregistered representatives	89	85	4	89	85	4			
Improper use of funds or securities	83	76	7	54	52	2	29	24	5
Required disclosures (confirmations)	78	77	1	77	76	1	1	1	
Statement of policy (mutual funds)	53	51	2	47	46	1	6	5	1
Unsuitable recommendations	44	35	9	30	28	2	14	7	7
"Commercial bribery"	27	14	13	21	13	8	6	1	5
Failure to furnish information to NASD	22	22		9	9		13	13	
Nonmember dealings	22	18	4	19	15	4	3	3	
Investment trust rule	18	12	6	16	11	5	2	1	1
General advertising and sales literature	17	14	3	16	13	3	1	1	
Improper use of NASD name	12	12		12	12				
Prompt payment (mutual funds)	9	8	1	9	8	1			
Miscellaneous	97	73	24	62	53	9	35	20	15

Source: NASD records. See app. B.

TABLE XII–12.—*Number and types of violations indicated in district 12 examinations (1959–60)*

Type of indicated violation	1960	1959 [1]	Type of indicated violation	1960	1959 [1]
All indicated violations [2]	305	617	Assessment report	3	8
			Free riding	2	4
			Nonregistered branch offices	2	1
Books and records	179	336	General advertising	1	10
Confirmations	41	77	Correspondence	1	3
Markups	23	51	Nonmember transactions	1	1
Regulation T	17	26	Churning		1
Nonregistered representatives	14	48	Discretionary accounts		1
Supervision	10	30	Miscellaneous	8	14
Net capital	3	6			

[1] A mass examination was conducted in this district in 1959.
[2] Violations found in a total of 360 examinations conducted in 1959, of which 213 contained indicated rule violations; and in a total of 281 examinations conducted in 1960, of which 150 contained indicated rule violations. The examinations analyzed represented a large majority of the examinations conducted in that district in the 2 years.

Source: NASD records.

TABLE XII–13.—*NASD free-riding decisions involving NYSE and other NASD firms (1959–61)*

[Number of cases]

	All NASD firms	NYSE firms	Other NASD firms
All cases [1]	279	118	161
Cases handled under minor violation procedure	39	28	11
Cases handled by formal complaint	240	90	150
Penalty assessed: [2]			
Censure only	60	42	18
Fined:			
$1 to $200	54	20	34
$201 to $500	88	23	65
$501 to $1,000	16	6	10
Over $1,000	8	2	6
Suspended			
Suspended and fined	2		2
Expelled			
Dismissed	51	25	26
Cases involving 1 issue	231	91	140
Cases involving 2 or more issues	48	27	21

[1] Includes only cases where free riding alone was alleged.
[2] Board of governors action has been taken into account.

Source: NASD records. See app. B.

APPENDIXES

APPENDIX XII—A

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE

Division
of
Trading and Exchanges

Special Study
of
Securities Markets

January 3, 1962

SECURITIES AND EXCHANGE COMMISSION,
Washington 25 D.C., January 3, 1962.

To the Chairman and Members of the Securities and Exchange Commission:

We are transmitting herewith a staff report on the organization, management and regulation of the conduct of members of the American Stock Exchange. This report contains the findings of the staff on such matters, based on a broader investigation of the American Stock Exchange which is being made by the staff pursuant to the Commission's order of May 12, 1961 and Public Law 87-196.

The investigation has been conducted and the present report has been prepared under the immediate supervision of Ralph S. Saul, Associate Director of the Special Study of Securities Markets and formerly Associate Director of the Division of Trading and Exchanges. Other staff members who have participated actively in conducting the investigation and drafting the report include: Robert Bretz, Edward C. Jaegerman, Martin Moskowitz, Stephen J. Paradise, Ira H. Pearce, Norman S. Poser, Arthur Rothkopf, Warren S. Shantz, and David Silver.

Respectfully submitted,

MILTON H. COHEN,
Director, Special Study of Securities Markets.

PHILIP A. LOOMIS, JR.,
Director, Division of Trading and Exchanges.

By IRVING M. POLLACK,
Associate Director.

Table of Contents

CHARTS

APPENDIXES

Introduction

On May 4, 1961, the Commission entered an order revoking the broker-dealer registration of Re, Re & Sagarese and expelling Gerard (Jerry) A. Re and Gerard F. Re from the American Stock Exchange ("Exchange"). The Commission found that between 1954 and 1960 the Res had violated numerous provisions of the federal securities laws in connection with transactions in various stocks in which the Res were registered as specialists on the Exchange.

On May 12, 1961, the Commission entered an order directing that its Staff make an investigation of the facts, conditions, and practices related to the conduct shown by the record in the *Re* case, and of the adequacy for the protection of investors of the rules, policies, practices and procedures of the Exchange concerning the regulation and conduct of specialists and other members. Pursuant to the order of the Commission, the investigation has been conducted in private. The Staff held hearings at which sworn testimony was taken from the President, the Chairman of the Board of Governors, governors, specialists, floor traders and other members of the Exchange, members of the Exchange staff, and officials of companies whose securities are traded on the Exchange. The Staff also studied the minutes of meetings of the Board of Governors ("Board") and standing committees of the Exchange, transcripts of trading accounts, questionnaires completed by Exchange members and listed corporations, and other documents relating to Exchange business. It should be noted that the Exchange, its members and officials have cooperated fully with the Staff in the conduct of this investigation.

Under the Securities Exchange Act of 1934 ("Exchange Act"), national securities exchanges are entrusted with primary responsibility for the regulation and disciplining of their own members—a responsibility that the Exchange assumed when it became registered as a national securities exchange on September 28, 1934. The principal emphasis of this investigation to date has been on the organization and management of the Exchange in order to determine how effectively the Exchange has regulated the conduct of its members. The report sets forth the facts determined in this phase of the investigation, and certain conclusions of the Staff with respect to these subject matters.[1]

This report does not contain any final recommendations of the Staff on these matters. Nor does it attempt to evaluate the proposals made by the Special Committee for Study of American Stock Exchange[2] in their Interim Report dated December 21, 1961, regarding the organization and administration of the Exchange. The findings in the present report should, however, be helpful to the Commission, the Exchange membership, and the public in evaluating those proposals and in formulating such alternative or additional proposals as may be required to deal with the problems disclosed.

This report contains five sections. The first section describes the organization and government of the Exchange with particular emphasis on the respective roles of the Board of Governors, the committees of the Board, and the officers and staff in the actual administration of the Exchange.

The second section discusses the manner in which listings have been brought to the Exchange, the listing policies and their administration, and some resulting problems as to the quality of certain listings.

---

[1] On September 5, 1961, while the investigation was in progress, H.J. Res. 438, which became Public Law 87-196, was enacted. It directed the Commission to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, and to report to Congress on or before January 3, 1963. Accordingly, the Commission directed that the pending investigation be carried forward as part of the study and investigation pursuant to Public Law 87-196. It is contemplated that additional findings concerning the Exchange and its rules and practices will be made in connection with other phases of the study and investigation.

[2] On October 12, 1961, the President of the Exchange appointed, with the approval of the Board, a committee of nine members to make a "review of the organization, rules, policies and procedures of the Exchange" and "to recommend such revisions, additions or eliminations which it believes would increase the effectiveness of the operation of the Exchange and enhance the service to the public."

The third section of the report explores the role of the specialist in relation to the problems of government of the Exchange. After describing the pivotal position of the specialist in the auction market of the Exchange, the report discusses in some detail the activities of Gilligan, Will & Company, a member firm. This firm was chosen for investigation because of its unique relation to the Exchange: it is one of the most important and influential specialist firms and its activities exemplify several important problem areas relating to specialists on the Exchange. Other problem areas are discussed with reference to the activities of other specialist firms. The present report examines these problem areas, not primarily to resolve them as such at this time, but in relation to the immediate topic of organization and managment of the Exchange.

The fourth section of the report relates to the conduct of floor traders and the Exchange's regulations in that area. In 1959, the Exchange, after discussions with the Division of Trading and Exchanges of the Commission, adopted a set of floor trading rules and developed elaborate procedures for enforcing them. This section of the report examines the effectiveness of Exchange regulations in an area where the Exchange affirmatively indicated its willingness and ability to control certain activities of its members.

The final section of the report describes the regulatory scheme within which the Exchange operates and considers the effectiveness of its supervisory and disciplinary procedures.

During the course of this investigation, i.e., since May 12, 1961, the rules and policies of the Exchange have undergone many important changes. These changes have come in rapid fire succession and have affected such diverse areas as listing policies, allocation of securities to specialists, floor procedures, audits of the books of member firms, capital requirements of specialists, over-the-counter trading by specialists, reporting by specialists of their trading, placing of discretionary orders, and floor trading. The first of the changes was adopted on May 18, 1961, two weeks after the Commission's order expelling the Res from the Exchange, and the most recent on December 12, 1961.[8] Many of these changes appear to have been adopted in direct response to, or in immediate anticipation of, the Staff's inquiry into specific subject matters. The report takes cognizance of all these changes but does not attempt to assess their effectiveness or adequacy.

---

[8] The following rules and amendments were adopted between May and December 1961: Rule 154 (August 7); Rule 170(b) (June 15); amendment of Rule 175 (July 6); amendment of Rule 187 (May 18); amendment of Rule 190 (May 18); and Rule 191. (August 17). In addition a new policy governing the allocation of stocks to specialists became effective on September 1; changes in listing policies were announced on December 7; a new interpretation of floor trading rules was announced on December 12; and new auditing procedures became effective during the latter part of the year.

I. Organization of the Exchange

A. The Exchange

The American Stock Exchange is a national securities exchange. It is an important part of the nation's financial community and the conduct of its members has effects extending beyond the narrow confines of its trading floor. Indeed, the Exchange itself has attempted through its listing and public relations policies to be recognized as a major national institution.

The growth of the Exchange in recent years has been quite remarkable. The reported total volume of stocks traded on the Exchange, which was 111 million shares in 1951, was approximately 500 million shares in 1961. (See Chart A.) The total market value of securities traded on the Exchange was approximately $30 billion in December 1961; ten years ago it was $16.5 billion. (See Chart B.) The number of companies whose securities are traded on the Exchange has also increased: there were 763 such companies in 1951; the figure reached 1,000 in December 1961. (See Chart C).

The gross income of the Exchange, which was approximately $2.75 million in 1956, is expected to exceed twice this figure in 1961. Net profits and capital contributions,[1] which totaled approximately $43,000 in 1957 and $38,000 in 1958, are expected to exceed $1.5 million in 1961. The increase in income is due in large part to the steep rise in the volume of trading. The Exchange's income from the transactions charge (1½ percent of net commissions earned from the trading of securities on the Exchange) has increased from approximately $766,000 in 1956 to an estimated $2.1 million in 1961.

In contrast to these increases, members' annual dues or assessments, which were $500 in 1956, are unchanged today. Specialists' registration fees also are unchanged at $200 annually, regardless of the number of stocks in which a specialist is registered.

[1] In years in which regular members' dues are not required to meet operating expenses, the Exchange, instead of requiring members to pay dues, has assessed $500 from each regular member as a capital contribution; these assessments may be used only for capital improvements. Such assessments in lieu of dues were made in 1960 and 1961.

B. Membership

The regular membership of the Exchange, consisting of 499 members,[2] can be broken down functionally into four categories: specialists, commission brokers, "$2 brokers" or floor brokers, and floor traders. Out of the total membership, 160 members are currently registered as specialists, representing 62 different specialist accounts. There are 139 commission brokers, partners of member firms, whose primary function is the execution of orders on the floor of the Exchange on behalf of their member organizations. One hundred forty members are $2 brokers, whose main function is the execution of orders on behalf of member firms who either do not have floor partners or whose floor partners are unable to handle the orders. Generally, the $2 brokers have working relationships with one or more regular or associate member firms whereby these brokers handle all or part of the floor business of these firms.

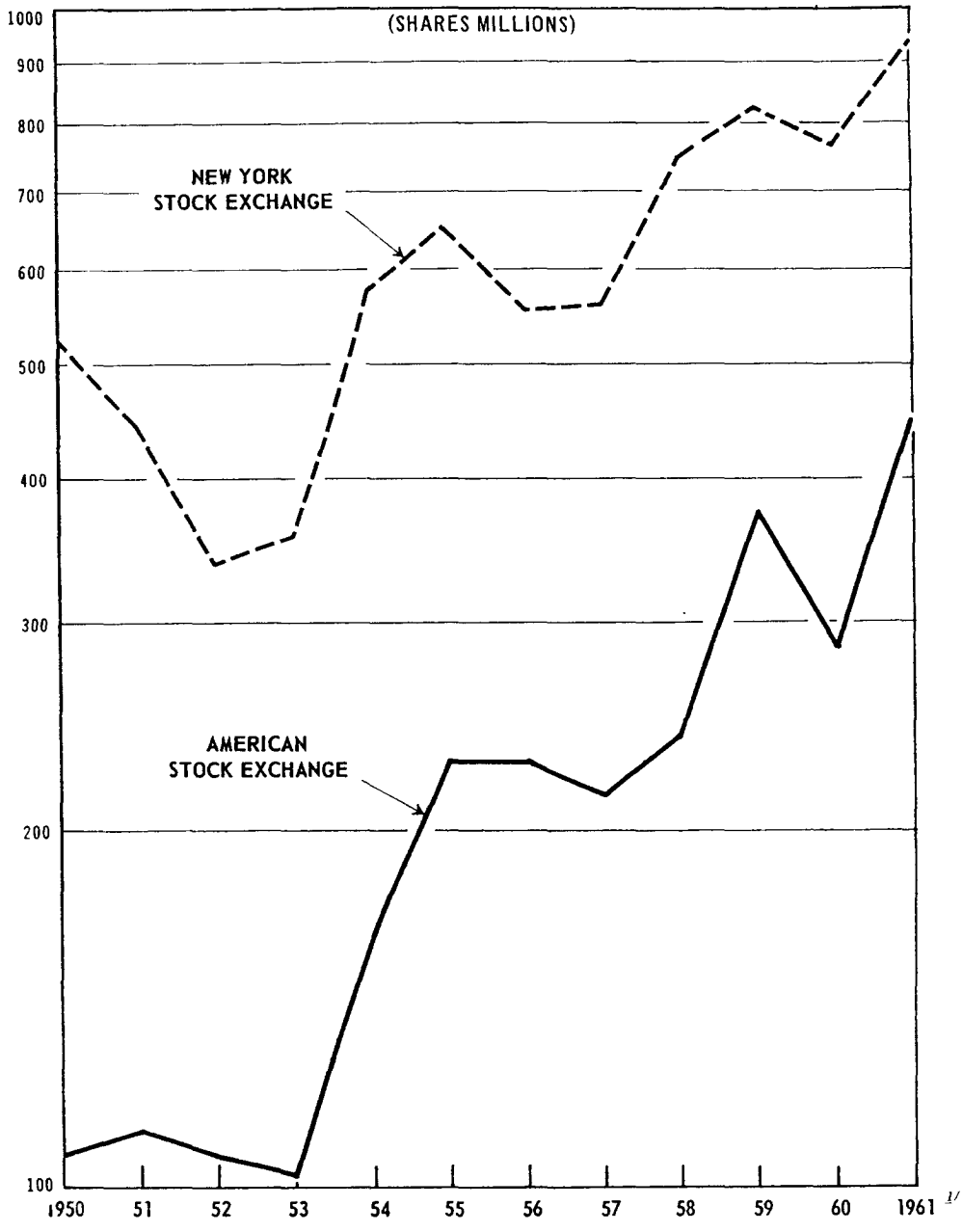
There are approximately 30 members of the Exchange who spend most of their time on the floor trading for their own account. Frequently, a floor trader will execute orders as a $2 broker. A $2 broker may trade for his own account when he finds that his commission business is slack. Finally, there are approximately 30 regular members who are inactive. The average number of members in attendance at trading sessions is 325.

In addition to the regular members, the Exchange has a large number of allied members and associate members. Allied members are general partners in partnerships or holders of voting stock in corporations which are regular member firms—i.e., firms one or more of whose partners or voting stockholders are regular members of the Exchange. Associate members are persons engaged in the securities business who have applied and been accepted for associate membership and are thereby

[2] There were 550 members until the early 1940's, when the Exchange retired 51 seats.

CHART A

GROWTH OF REPORTED STOCK VOLUME ON THE NEW YORK AND AMERICAN EXCHANGES

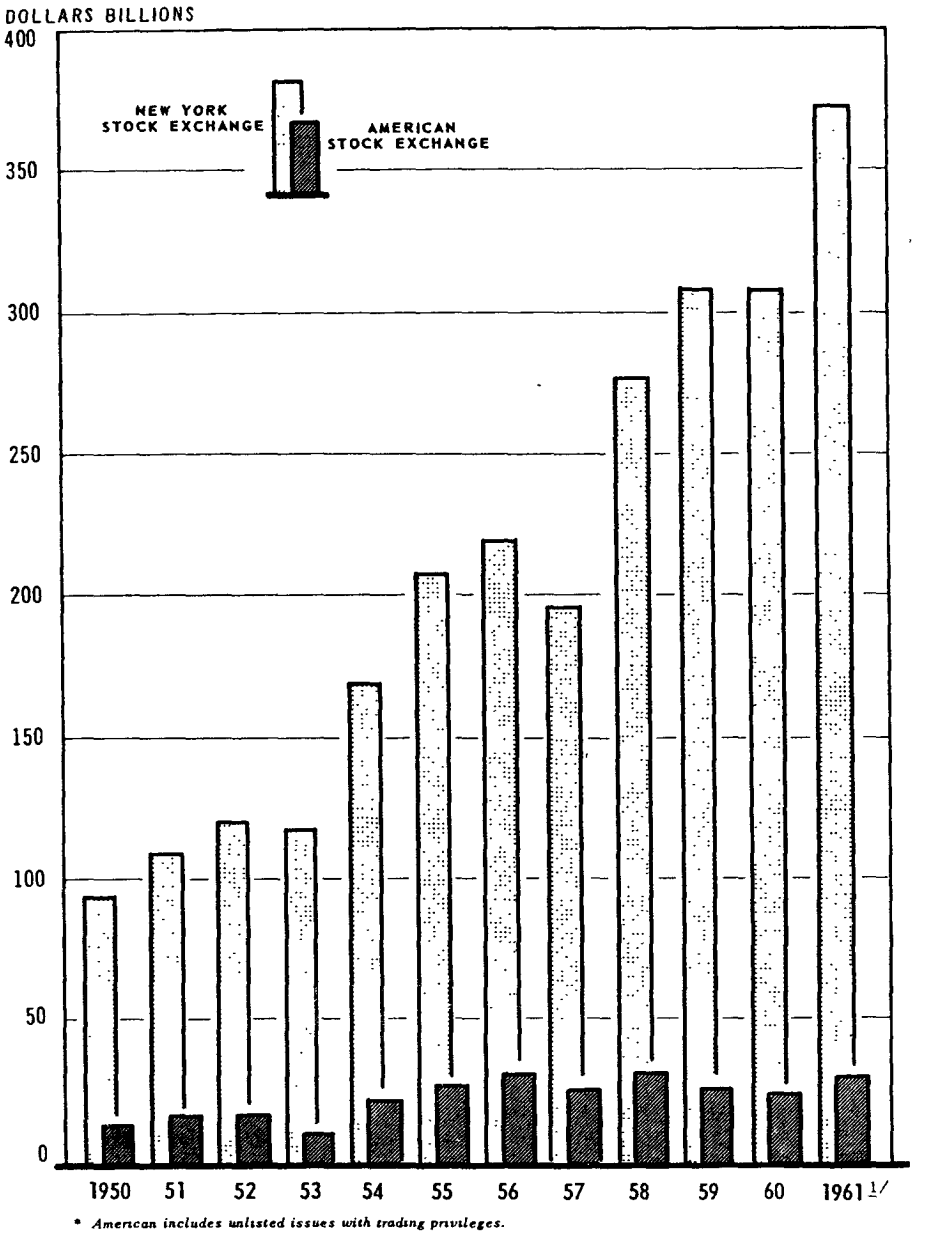


1/ Through November 1961.

DS-4246

CHART B

TOTAL MARKET VALUE OF SHARES LISTED ON THE NEW YORK AND AMERICAN* STOCK EXCHANGES



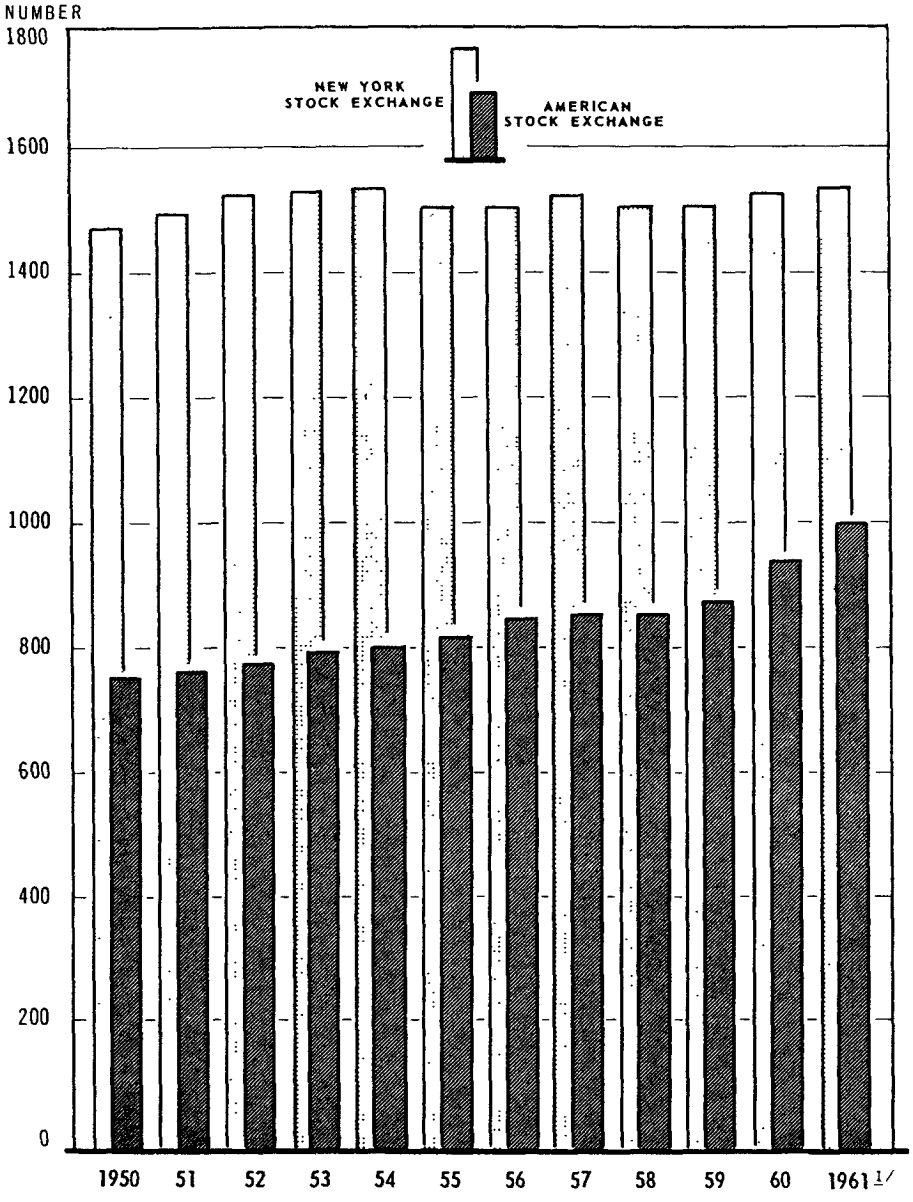
* *American includes unlisted issues with trading privileges.*

1/ *Approximate*

DS-4249

CHART C

TOTAL NUMBER OF ISSUES LISTED ON THE NEW YORK AND AMERICAN* STOCK EXCHANGES



* *American includes unlisted issues with trading privileges.*

1/ *Approximate*

DS-4245

entitled to lower commission rates than nonmembers. There are 411 associate members. Allied and associate members are not entitled to trade on the floor of the Exchange.

C. Admission of New Members

A person wishing to become a regular member of the Exchange must arrange to purchase a "seat" from an existing regular member, and he must obtain the approval of the Board by the affirmative vote of nineteen governors. The only qualifications that the constitution of the Exchange requires of new members are that they be citizens of the United States and at least twenty-one years of age, and that they have the approval of the Committee on Admissions.[3] In practice the power to decide whether an applicant will be approved rests with a four-man subcommittee of the Committee on Admissions which must act favorably upon an application before the application may be placed on file with the full Committee. This subcommittee consists of the chairman of the Committee, who is a specialist, and three other members, two of whom have in recent years been specialists. The full Committee on Admissions currently consists of seven members in addition to the President and chairman of the Board (who are *ex officio* members), four of whom are specialists. In the admission of new members to the Exchange, as in many other areas of Exchange government, specialists are in virtually complete control.

An applicant for regular membership is not required to have any experience or knowledge of the securities business. No examination of any kind is given to determine his qualifications. The Exchange does take the position, however, that an applicant for regular membership is expected to make actual use of his seat. In other words, the Exchange would probably not approve an applicant who announced to the subcommittee of the Committee on Admissions that he wished to purchase a seat in order to speculate on its value. In a few cases, however, individuals have held their seats for so short a period as to indicate that speculation may have been an important motivation for the transaction. The Exchange also obtains an investigatory report on every new member from the Proudfoot Commercial Agency.

During 1961 the price of a seat on the Exchange reached $75,000, the highest in more than 30 years.[4] The majority of members purchased their seats under one of a number of different kinds of financing arrangements. One of the more frequently used of these arrangements is termed an "ABC" agreement, under which a firm purchases a seat for a member. Under such an agreement, the member may at any time purchase another seat at the then market price for the firm and thereby obtain the outright ownership of his seat. The firm, on the other hand, may at any time transfer the seat to another of its members.

A substantial number of the regular members of the Exchange have held membership for periods of over 25 years. About 50 were members as far back as 1921 when the Exchange, then known as the New York Curb Exchange, did its trading on the New York sidewalks. The typical pattern of the "oldtimers," the interrogation of Exchange members revealed, was to start as messengers or clerks on the Exchange. A large number of the younger members, particularly among the specialists, have close family connections with other members of the Exchange, who teach the newer members the procedures on the floor of the Exchange after their applications for membership have been approved. For example, among the specialists there are a number of father-son and father-in-law/son-in-law combinations in joint accounts. The father or father-in-law generally finances the purchase of the younger member's seat. The Exchange requires that an applicant have two sponsors, and that one of the sponsors, or a member appointed by him, accompany a new member on the floor of the Exchange until he is able to function by himself.

The Committee on Admissions also passes on partnership agreements of member firms, the admission of new members to such firms, and applications of individuals and firms for allied or associate membership. It is very rare that any such application is disapproved by the Committee.

D. Government of the Exchange

In 1935 the Commission, pursuant to authorization given by the Exchange Act,[5] conducted a study and investigation of the government of securities exchanges and rendered a report to Congress. This report[6] made eleven recommendations, which it suggested be put into effect by

[3] Const., Art. IV, Sec. 1(a).

[4] See Appendix I.

[5] Section 19(c).

[6] "Report on the Government of Securities Exchanges," H.R. Doc. No. 85, 74th Cong., 1st Sess. (1935).

voluntary action of the exchanges without resort to legislation.

No action upon the Commission's recommendations was taken until December 1937, when the New York Stock Exchange appointed the so-called Conway Committee to study the government of that exchange. The Conway Committee's report,[7] which incorporated several of the recommendations of the Commission and introduced a few new ones, became the basis for the new constitutions of both major exchanges. The constitution of the Exchange, adopted in February 1939, introduced some important changes, such as the inclusion of twelve office partners of member firms and three representatives of the public on the Board and the transformation of the office of President from an unpaid position held by a member to a paid administrative post. Certain recommendations which the Commission had made, such as the abolition of the Nominating Committee in favor of election of governors by petition, were not adopted by the Exchange. The structure of the government of the Exchange has changed very little since 1939.

1. The Board of Governors

The Board of Governors, consisting of 32 members, is the governing body of the Exchange. The membership of the Board is required by the constitution of the Exchange to be constituted as follows: fifteen regular members; twelve allied or associate members; three non-member representatives of the public; and the President and chairman of the Board.[8] There is no requirement that the fifteen regular members be proportionally representative of the various activities performed by members, although the constitution directs the Nominating Committee to "give due consideration to the various phases of Exchange activity in making its nominations."[9] Nor is there any requirement that any of the governors be from outside the New York City area. The regular members of the 1961–1962 Board consist of eleven specialists and four commission brokers. After serving for two consecutive three-year terms, an elected governor must wait one year before he can be a candidate for re-election.[10]

The chairman of the Board must be a regular member of the Exchange. He is elected by the membership for a one-year term, with no limit on the number of times he may be re-elected. The vice-chairman of the Board is elected by the Board at its first annual meeting. He must be a member of the Board who is a regular member of the Exchange. The vice-chairman assumes the functions and discharges the duties of the chairman if the latter is absent or unable to act.[11]

Under the constitution the Board is charged with the duties of operating the Exchange and regulating the business conduct of its members. In practice, these duties are performed largely by standing committees.[12] Only members of the Board, however, are eligible to serve as regular members of the standing committee.[13] Neither the chairman nor the members of the Board (with the exception of the President) receive any compensation. The Board holds regular meetings twice a month and special meetings on an average of once or twice a month, at which it passes on actions of the committees relating to admissions of new members, listing and delisting of securities, Exchange finances, changes in the constitution or rules of the Exchange, and conduct of other Exchange business. While the Board as a unit does play a part in disciplinary matters of a serious nature, its chief function is to review (and, in practice, to approve of) actions taken by the standing committees.

The 27 elected governors and the chairman of the Board are chosen by a complex procedure. The Nominating Committee, consisting of four regular members (at least one of whom must be a commission broker) and three allied or associate members, is in theory elected by the membership each year from among candidates who have been nominated by petitions signed by at least 25 members. The constitution provides that if there is an insufficent number of petitions for any class of member (e.g., fewer than three associate or allied members, four regular members, or one commission broker), the Board shall nominate enough candidates to constitute a full slate.[14] In practice, the Board has delegated this task to the Executive Committee. Since it is unusual for members to nominate a full slate of candidates to the Nomi-

[7] "Final Report of the Committee for the Study of the Organization and Administration of the New York Stock Exchange," January 27, 1938.
[8] Const., Art. II, Sec. 1(a).
[9] Const., Art. III, Sec. 2(c).
[10] Const., Art. III, Sec. 1(a).
[11] Const., Art. II, Sec. 2(b).
[12] See Sec. I D (3), *infra*.
[13] The Nominating Committee is not considered a standing committee. Its members may not be members of the Board.
[14] Const., Art. III, Secs. 2, 4(h).

nating Committee by petition, the normal procedure in recent years is for at least some of the members of the Nominating Committee to be picked by the key officials of the Exchange. Every member of the 1961 Nominating Committee, which will nominate candidates for the Board to take office in February 1962, was chosen in this manner. No member of the previous year's Nominating Committee may be elected to the Nominating Committee.

After holding hearings at which any member of the Exchange may appear to propose or comment upon candidates for nomination, and at which the President and chairman of the Board are always invited to testify, the Nominating Committee names a slate of candidates to replace the chairman and the five regular members and four allied or associate members of the Board whose terms expire, as well as to fill any vacancies which may have occurred. Members of the Exchange may by petition containing at least 25 signatures nominate competing candidates. At the annual election, the membership chooses among the official slate nominated by the Nominating Committee and any candidates nominated by petition. If, as often happens, no petitions are filed, the official slate is automatically elected. Even when there are petitions, it is unusual for the candidates on the official slate to be defeated, although a few governors have from time to time been elected by petition through the efforts of an organized group.[15] The ballot shows clearly which candidates were nominated by the Nominating Committee and which by petition. There has been no contested election for the Board since 1956, and no contested election for chairman in the past ten years. The only governors elected during the past ten years who were nominated by petition were Thomas H. Hockstader in 1954 and John J. Mann in 1956.

The Nominating Committee method of election tends to perpetuate in office a closely knit group, consisting largely of specialists, which in effect controls the government of the Exchange. It is easy to see why this is so, since the Nominating Committee is partially or totally chosen by the Executive Committee, where specialists are well represented.[16] The 1935 report to Congress recommended that nomination to the Board be solely by petition, but this recommendation was not followed.

Allied and associate members on the Board do not exercise an influence on the government of the Exchange commensurate with the size of their representation on the Board. Whatever the reason, they are often unwilling or unable to devote the time required to take an active part in the government of the Exchange. In addition, it would appear that the Exchange lacks the prestige to attract many leaders of the financial community to serve on its Board. Service as a governor, which usually involves membership on one or more standing committees, consumes at least one afternoon a week and often considerably more time than this. Specialists and other floor members, whose business headquarters is the floor of the Exchange, are more readily available than office partners to participate in running the Exchange, and they naturally tend to dominate its government. For example, in 1960 the regular members of the Board attended an average of 35 of the 43 Board meetings, while the average for the allied and associate members was 21. Among the regular members of the Exchange, specialists overshadow in influence commission brokers, who are in many cases transferred by their firms to other duties after a few years of service on the floor. It is also significant that one of the four commission brokers currently on the Board is a partner in a firm which has a 10% interest in three joint accounts of specialists.

The dominant group of the Exchange has included Joseph F. Reilly, chairman of the Board; 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. All of these men are specialists, with the exception of Reilly, who is a $2 broker and a former specialist. By virtue of their official positions, all except Bocklet are members of the Executive Committee. For approximately ten years they have held the key positions in the government of the Exchange in rotation and have thus been able to maintain continuous and effective control. By being elected chairman of the Board after serving for a few years as a member, and then being re-elected as a member upon relinquishing the chairmanship, both Dyer and Mann have avoided the prohibition against a governor serving for more than two consecutive terms. Thus Dyer has been a member

[15] Such an election occurred in 1951, when Jerry Re was instrumental in effecting the election of three out of four candidates on a petition which he circulated.

[16] See Sec I D (3), *infra*.

96-746 O—63—pt. 4——50

(or chairman) of the Board for eleven consecutive years and Mann for fourteen consecutive years. Reilly spent a year off the Board after serving two three-year terms, but he retained his place on the Executive Committee by election to the post of President of the American Stock Exchange Clearing Corporation during his sabbatical year.[17]

The following table illustrates the system of rotation of four of the principal posts in the government of the Exchange during the years 1952-1962 among these four members.

	Chairman of the Board	Vice-Chairman of the Board	Chairman, Committee on Floor Transactions	Chairman, Committee on Finance
1952–53	Mann	Dyer	Dyer	
1953–54	Mann			
1954–55	Mann		Dyer	
1955–56	Mann		Dyer	
1956–57	Dyer	Bocklet	Reilly Bocklet [1]	Mann
1957–58	Dyer	Bocklet	Bocklet	Mann
1958–59	Dyer	Reilly	Reilly	Mann
1959–60	Dyer	Reilly	Reilly	Mann
1960–61	Reilly	Bocklet	Mann	Dyer
1961–62	Reilly	Bocklet	Mann	Dyer

[1] Reilly resigned as chairman of the Committee on Floor Transactions on May 24, 1956, and Bocklet was appointed in his place.

2. Public Governors

Three of the members of the Board are persons not engaged in the securities business, whose responsibility it is to represent the interests of the public.[18] The inclusion of public governors on the Board was first recommended in the report of the Conway Committee, as a result of its finding that "the public interest is the paramount consideration." [19] The present public governors are George R. Collins, Dean Emeritus of the New York University School of Business Administration, Mary G. Roebling, the president of a bank in Trenton, New Jersey, and William Zeckendorf, a real estate executive. There is no prohibition against a public governor being an officer, director, or controlling stockholder in a company whose securities are traded on the Exchange. Zeckendorf is in fact an officer, director, and/or controlling stockholder of three such companies, Webb & Knapp, Inc., Gulf States Land & Industries, Inc., and Roosevelt Field, Inc. He has recently acquired an option to purchase a controlling interest in another such company, Yonkers Raceway, Inc.

The public governors are appointed by the President of the Exchange, with the approval of the Board of Governors, for a term of one year.[20] There is no limit to the number of consecutive terms which they may serve. Collins has held office for twelve terms, Mrs. Roebling for four, and Zeckendorf for six. They receive no compensation other than a fee of $20 for each meeting of the Board which they attend.

The present public governors all consented to serve upon the informal understanding that they would not be required to attend all meetings of the Board. Under an arrangement between the President of the Exchange and each of the public governors which has been in effect for several years, they are not expected to attend meetings of the Board unless they receive a telephone call from the President or from someone acting for him, requesting their attendance. Such a request is made only when the Board is to consider a piece of unusual business, such as a serious disciplinary action against a member. This happens an average of half a dozen times a year.

Even by the unexacting standards set by the Exchange, the attendance of the public governors at Board meetings has been poor. During the two and a half years beginning January 1, 1959, Collins attended one meeting and Mrs. Roebling and Zeckendorf each attended four. The public governors receive notice of all meetings of the Board. If they do not attend any meeting, including those which they are specially requested to attend, they are automatically excused. This practice has grown up despite the provision of the constitution of the Exchange which states that any governor who is absent from three consecutive regular meetings without having been excused by the chairman of the Board may be removed from the Board.[21] It does not appear that this provision has ever been enforced. Despite their failure to attend meetings, the present public governors have been reappointed year after year by the President.

Although the present public governors appear to be individuals of ability, their influence on the government of the Exchange has been nil. Much of the responsibility for this must rest on the Ex-

[17] It is worthy of note that on December 11, 1961, when the Board requested Edward T. McCormick and Michael Mooney to resign as President and General Counsel respectively, Reilly was in the chair, Dyer moved that the resignation be accepted, and Mann seconded the motion. Reilly then relinquished the chair to Bocklet, Dyer moved that Reilly be appointed President *pro tempore*, and Mann seconded the motion.

[18] Const., Art. II, Sec. 1(a).

[19] "Final Report of the Committee for the Study of the Organization and Administration of the New York Stock Exchange," January 27, 1938, p. 1.

[20] Const., Art. II, Sec. 1(a).

[21] Const., Art. III, Sec. 4(b).

change and its officials. Little effort has been made to bring the public governors into the active government of the Exchange. No justification has been shown for restricting the expected attendance of the public governors to meetings involving extraordinary business such as disciplinary actions. The public interest is involved in all activities of the Exchange and demands greater participation of the public governors.

3. Standing Committees

The regular work of governing the Exchange is performed by nine standing committees: the Executive Committee and the Committees on Securities, Outside Supervision, Floor Transactions, Finance, Admissions, Arbitration, Public Relations, and Business Conduct. . The chairmen and members of the standing committees are appointed by the President of the Exchange with the approval of the Board, except for the Committees on Admissions and Arbitration, which are appointed by the chairman of the Board.[22] Only members of the Board may be so appointed, but the chairmen of most of the standing committees may, with the approval of the President, appoint additional committee members who need not be governors.[23] There is no requirement that the membership of any of the standing committees be proportionately representative of the activities performed by members of the Exchange. The President is an *ex officio* member of all standing committees except the Committees on Admissions and Arbitration; the chairman of the Board is an *ex officio* member of all standing committees.[24]

The Executive Committee, which is composed of the President, chairman of the Board, chairmen of the Committees on Securities, Outside Supervision, Floor Transactions, and Finance, and the President of the American Stock Exchange Clearing Corporation, is in charge of the overall direction of Exchange policy.[25] The Executive Committee acts in an advisory capacity to the President and the Board, and has such other duties and powers as the Board may delegate. In practice, the Executive Committee has handled such matters as setting commission rates, fixing the salary of the President, fixing the salary of the General Counsel, and, as stated above, choosing the Nominating Committee in the absence of members' petitions. The Executive Committee also has the responsibility of making recommendations to the Board concerning amendments to the constitution. The chairman of the Board is chairman of the Executive Committee.

The Committee on Floor Transactions enforces the rules governing trading on the floor of the Exchange and, through its members who are designated as floor governors at particular posts, it supervises the conduct of trading. The floor governors have the sole power to delay an opening or halt trading in a stock in the event of unusual activity. The Committee on Floor Transactions, nine of whose ten members are specialists, also allocates newly listed stocks to specialists[26] and has an important role in the initiation of disciplinary proceedings.[27]

The Committee on Outside Supervision, whose chairmanship is usually held by an office partner of a member firm, has responsibility in connection with the conduct of business by members off the floor of the Exchange. It enforces compliance with the regulations relating to margin requirements and minimum net capital requirements of members. In addition, this committee supervises the ticker system, conduct of customers' accounts, branch offices of member firms, commission rates, registration of registered representatives, and secondary offerings of listed securities.

The activities of the Committee on Admissions are described above under "Admission of New Members." The Committee on Securities, which concerns itself with the listing and delisting of securities traded on the Exchange, is discussed below in Section II. A discussion of the Committee on Business Conduct, which concerns itself with serious cases of misconduct by members, and a more detailed discussion of the Committees on Floor Transactions and Outside Supervision will be found below in Section V.

4. The President

The President of the Exchange is the principal officer and chief executive of the Exchange and its official representative.[28] The President is pro-

[22] Const , Art. II, Secs 2(c), 3(d).

[23] Const., Art. II, Sec. 3(c). There are five additional members on the 1961–62 standing committees—three on the Committee on Floor Transactions, all of whom are members of the Board; and two on the Committee on Public Relations, neither of whom is a member of the Board.

[24] Const , Art. II, Secs. 2(a), 2(c).

[25] The 1961–62 Executive Committee had only six members instead of seven, because Edward T. McCormick was both President of the Exchange and President of the Clearing Corporation.

[26] See Sec. III, *infra* for a discussion of Exchange allocation policy.

[27] See Sec. V, *infra*.

[28] Const., Art. II, Sec. 2(c).

hibited from having other business interests during his incumbency; if a member of the Exchange is elected President, he must transfer his membership.[29] The President is elected by the Board but the constitution does not provide for any specific term of office. Edward T. McCormick held the office of President from 1951 until his resignation on December 11, 1961.. During the latter part of his incumbency, McCormick received a salary of $75,000 a year, plus expenses.

The duties and powers of the President under the constitution are extremely broad. He has the care of all the interests of the Exchange; he serves as *ex officio* member of most of the standing committees; he has the power to appoint, dismiss, and fix the salaries of all Exchange employees, and to interrogate members and member firms and inspect their books and records, but he is not given any further disciplinary powers.[30] In his testimony, McCormick stressed that the Board, not the President, is charged with the duties of operating the Exchange and regulating the conduct of its members. Despite his disclaimer of responsibility over disciplinary matters, McCormick has on certain occasions taken an active part in disciplinary proceedings. On one occasion, McCormick called Louis Lober, an Exchange member, to his office and, in the presence of chairman of the Board Reilly and another member of the Board, chastised Lober for sending a letter to all regular and associate members of the Exchange criticizing certain aspects of the Exchange's clearing operation which, according to Lober, favored specialists over other members.[31] It would not appear, however, that McCormick ever considered it his responsibility to supervise trading on the floor of the Exchange.

The most publicized and perhaps principal activity of McCormick during his tenure of office was to obtain new listings of securities on the Exchange.[32] On a number of occasions, McCormick had become a stockholder in the companies by the time that they were listed. Among his purchases prior to listing were: 100 shares of American Tractor Corp. (purchased September 1954, listed January 1955); 300 shares of Chromalloy Corp. (purchased January 1956, listed October 1957); 500 shares of El-Tronics, Inc. (purchased August 1955, listed November 1955); 1,000 shares of Prairie Oil Royalties Company, Inc. (purchased November 1955, listed May 1956); 300 shares of F. C. Russell Co. (purchased August 1954, listed November 1954). Gilligan, Will & Co. became registered as specialists of the securities of each of these companies, with the exception of Prairie Oil Royalties.

McCormick testified that in 1955 he was the guest in Miami and Havana of Alexander L. Guterma, who was attempting to obtain the listing on the Exchange of the stock of Shawano Development Corporation, a company of which Guterma was then a controlling stockholder. According to McCormick, Guterma paid gambling debts of McCormick in Havana amounting to approximately $5,000.[33] Guterma has since been convicted of violations of the Exchange Act for failure to file required reports.

On at least three occasions, McCormick purchased securities on the recommendation of Jerry Re. One of these securities was later listed on the Exchange; another, Jerry Re unsuccessfully attempted to list.[34] Several of McCormick's transactions were in securities in which James Gilligan was or later became registered as specialist.[35] A number of the transactions were made on the recommendation of Edward L. Elliott, who was a close associate of Gilligan and whose firm acted as financial adviser for many of the companies involved.[36] One of those companies was The Crowell-Collier Publishing Company ("Crowell-Collier"). In August 1955, McCormick purchased from the issuer, and through Elliott, $15,000 face amount of Crowell-Collier convertible debentures. McCormick has testified that at

[29] *Ibid*

[30] *Ibid*

[31] Lober was subsequently reprimanded by the Committee on Outside Supervision for violation of Exchange Rule 10, which provides: "No communication shall be read or statement made to the Exchange without the consent of the President or the Chairman of the Board"

[32] See Sec. II, *infra*.

[33] The Shawano stock was never listed on the Exchange.

[34] The three stocks were the common stock of American Leduc Petroleum Co. and Virginia Mining Corp., and the preferred stock of Thompson-Starrett Company, Inc. Of these, only Thompson-Starrett preferred was ever traded on the Exchange. According to McCormick, he divested himself of his Thompson-Starrett preferred stock prior to listing. With respect to these purchases, Reilly stated before the Board: "I might say there are those amongst our members, and also throughout the Street who feel Mr. McCormick should have known better than to accept tips from anyone while he is President . . . ."

[35] In addition to the Gilligan stocks listed on the preceding page, these stocks included Consolidated Diesel Electric Corp., Continental Uranium, Inc. (now called Continental Materials Corp.), Guild Films Co., Inc., New Idria Mining and Chemical Co., and New Pacific Coal & Oils Ltd (now called Consolidated New Pacific Ltd.).

[36] These stocks included American Tractor Corp., Chromalloy Corp., El-Tronics, Inc. and New Pacific Coal & Oils Ltd. (now called Consolidated New Pacific Ltd.).

the time of the purchase it was his "very fond hope" that the common stock, into which the debentures were convertible, would be admitted to trading on the Exchange. McCormick subsequently discussed the listing of the Crowell-Collier stock with Elliott since, as he stated, "one of my principal jobs is to get listings for the American Stock Exchange." According to McCormick, it is also very likely that he discussed the subject of listing of the stock with James Gilligan, who later was registered as specialist in it. Furthermore, McCormick, as an *ex officio* member of the Committee on Securities, reviewed the Crowell-Collier listing application and participated in the discussion in the Committee concerning it. He has testified that he did not, however, participate in the vote on listing of the stock and that the other members of the Committee were aware of his ownership of the debentures.[37]

The Crowell-Collier common stock was admitted to trading on the Exchange in October 1955. McCormick subsequently converted his debentures into common stock. The distribution of these debentures and the underlying common stock later became the subject of administrative proceedings by the Commission against Gilligan, Will & Co. and two other broker-dealers for violation of Section 5 of the Securities Act of 1933 ("Securities Act").[38]

McCormick also traded in securities already admitted to trading on the Exchange, a practice that was not prohibited by the constitution or rules of the Exchange. McCormick testified that he has made very few such trades since 1956.

The 1935 report of the Commission, in suggesting that the presidency of the Exchange be made a paid post, expressed the view that the President would have the duty to be an impartial administrator who could consider not only the interest of the Exchange as a whole but also the public interest.[39] This view is as valid today as it was then. A President who is in debt to, or who owes favors to, members of the Exchange or persons connected with issuers of listed securities can hardly be an impartial administrator.

[37] In the matter of *The Crowell-Collier Publishing Company* (1-3911) Record, pp. 2721-29, 2745

[38] In the matter of *Gilligan, Will & Co.*, 38 S.E.C. 388 (1958), aff'd 267 F. 2d 461 (2d Cir. 1959), *cert. denied* 361 U S 896 (1959); in the matter of *Elliott & Company*, 38 S.E.C. 381 (1958); *in the matter of Dempsey & Company*, 38 S.E C. 371 (1958).

[39] "Report on Government of Securities Exchanges," H R Doc. No. 85, 74th Cong., 1st Sess. (1935), p. 12.

5. General Counsel

During the past ten years the Exchange has relied upon the services of a single lawyer to provide it with legal counsel. This attorney, Michael E. Mooney, resigned his position as General Counsel of the Exchange on December 11, 1961, the same day as McCormick's resignation.

The Exchange has rarely requested an opinion from counsel on legal questions of vital importance to the Exchange and its members. For example, neither the Committee on Floor Transactions nor any other official or committee of the Exchange asked Mooney for advice on the question of whether it was permissible for specialists to maintain long-term investment accounts, although the chairman of the Committee on Floor Transactions had told the Committee that counsel's advice would be sought.[40]

During his tenure as General Counsel, Mooney became so closely associated with certain specialists as to raise conflict-of-interest problems. In 1955, Mooney requested Gilligan to arrange for the sale to him of some of the Crowell-Collier convertible debentures[41] which Gilligan's firm was acquiring from the issuer in a purported private placement. Gilligan accordingly allocated to Mooney $5,000 principal amount of the debentures.

In June 1956, Mooney, while counsel for the Exchange, wrote an opinion letter to Gerard F. Re on his personal stationery, for compensation, stating that a proposed distribution by Re, Re & Co. "on the open market" of 33,250 shares of I. Rokeach & Sons, Inc. stock which the Re firm had obtained from the issuer would not violate the Securities Act. The letter stated that Re was not a controlling person within the meaning of that Act. The stock was listed on the Exchange at the time and the Res were registered as specialists in it. The Res' distribution of the stock on the Exchange approximately three years later became the subject of proceedings before the Commission. It should be noted that, according to a recent statement by Mooney, he was authorized by the Exchange to engage in private practice at the time he wrote the opinion letter.

6. Staff

The Exchange has a paid staff of 496 persons of whom 65 are executive or supervisory employ-

[40] See Sec. III C(2), *infra*.

[41] This was the same issue of debentures discussed in Sec. I D(4), *supra*.

ees.[42] A breakdown of the Exchange staff is shown on Appendix II. It will be seen that the vast majority of the Exchange staff are engaged in the necessary mechanical operation of the Exchange. Thus, 108 are employed by the American Stock Exchange Clearing Corporation, 63 are pages, 56 are floor reporters, 39 are building maintenance personnel, 108 work in the telephone quotation section, 18 are in the tube room, and the remainder perform miscellaneous tasks.

The number of staff members engaged in regulatory work is remarkably small. Exclusive of clerical and similar personnel, there are only thirteen Exchange employees whose duties are connected with the regulation of the conduct of Exchange members. Five are in the Department of Floor Transactions, which has the duty of keeping a continuous surveillance over trading on the Exchange, including reviewing of reports required to be filed by specialists and floor traders; and eight are in the Department of Admissions and Outside Supervision, whose duties include reviewing applications for admission of new members, partnership agreements of member firms, and applications for registration of registered representatives, ensuring compliance with margin and minimum net capital requirements of members, and assisting the Committee on Business Conduct in investigations and in prosecuting disciplinary actions. In 1961 the total budgetary allowances (including salaries) for these departments were $155,000 and $141,000 respectively.

The Exchange has not given its staff members any significant degree of authority in the regulation of the conduct of members, including the investigation of possible violations of Exchange rules. For example, a staff member attends meetings of the Committee on Floor Transactions, but is not expected to speak; his function is merely to take the minutes of the meetings. Arthur Bellone, who held the position of Director of the Department of Floor Transactions until January 1, 1961, and is currently Vice-President in charge of the Division of Floor Supervision, testified that his duties were of a clerical and mechanical nature; he never had authority to look for violations of Exchange rules by specialists, floor traders, or other Exchange members; and he never recommended to the Committee on Floor Transactions whether disciplinary action should be taken against a member. It is his opinion that no member of the Exchange staff has authority to tell any member to do or not to do anything.

Cameron Dunlap, the present Director of the Department of Floor Transactions, testified that he has no authority independently to follow up reported violations or customer complaints which have been referred to the Committee on Floor Transactions. Unless he receives instructions from the chairman of the Committee, he is not expected to take further action.[43]

H. Vernon Lee, the Director of the Department of Admissions and Outside Supervision, testified that he has no authority over the conduct of Exchange members. His duties are ministerial and clerical, and, at least in one area within the jurisdiction of his department, he is not expected even to make recommendations to the Committee on Outside Supervision.

The lack of authority of the Exchange staff leaves the standing committees, and particularly the Committees on Floor Transactions and Outside Supervision, without adequate assistance and with practically unrestricted discretion with respect to the investigation and regulation of member conduct. The existing standing committee system tends to discourage staff initiative and to deter qualified persons from becoming staff members. The working relations between the standing committees and the staff in connection with member supervision and discipline are discussed below in Section V.

[42] The total size of the Exchange staff has increased considerably in recent years; in 1956 there were 388 staff members, of whom 49 were executive or supervisory employees.

[43] Dunlap has, however, brought a matter to Reilly's or McCormick's attention when the chairman of the Committee failed to take any action in connection with a reported violation.

II. Listing of Securities on the Exchange

A. Pursuit of Listings

During the past ten years the Exchange has placed great emphasis upon obtaining new listings and as a result of this effort a large number of companies have listed their securities on the Exchange. There were 110 new listings in 1960 and approximately 120 in 1961. This increase in the number of new listings has been partially responsible for a concomitant increase in the volume of trading on the Exchange and in the income of the Exchange and its members.[1]

As President of the Exchange, Edward T. McCormick played a key role in obtaining new listings. His efforts to persuade companies to list their securities on the Exchange were recognized and appreciated by the Exchange. In fact, McCormick's principal duty as President would appear to have been the generation of new listings.[2] Members of the staff were instructed to read the financial press and report new underwritings to McCormick. He would obtain a copy of the prospectus, and if he thought that the company was suitable for listing he would write or telephone the underwriter to suggest that the company apply for listing on the Exchange. McCormick's duties in connection with obtaining new listings included traveling throughout the country to make contact with officials of prospective issuers. According to Reilly, McCormick was "constantly on the go working on listings." It would seem that McCormick was considered by the membership principally as a salesman rather than as an administrator.

It is questionable whether the time and energies of the President of the Exchange should be channeled almost exclusively into obtaining new listings, as they were during the presidency of McCormick. It is not unlikely that the Exchange's encouragement of McCormick's efforts to bring in new business precluded him from acting effectively as an administrator and prevented him from devoting a substantial amount of his time to the government of the Exchange.

Specialists were also encouraged by the Exchange to obtain new listings and indeed under Exchange policy had a strong pecuniary incentive for engaging in this activity. Under a written policy of the Exchange in effect until September 1, 1961, a specialist whose efforts had led to the listing by a company of its stock on the Exchange was entitled to be registered as specialist in such stock.[3]

The methods used by specialists in pursuing new listings were varied. Many sent letters out to prospective issuers;[4] some mailed out brochures which set forth the advantages of listing and of having the stock allocated to the sender; some traveled extensively to meet officials of companies and on occasion to appear before corporate boards of directors.[5] James Rafferty, who was particu-

[1] See Sec. I A, and Chart C, *supra*.

[2] At a meeting of the Board held on July 7, 1960, Chairman Reilly told the Board:

"The Chair is not in the habit of giving out bouquets but is known only to speak from the record Therefore, the Chair reminds the Board our President stated early in January our listings would reach one hundred this year. I know from many arguments that I have had pertaining to floor procedure and back office problems, Mr. McCormick is not blessed with a magic mirror, therefore, his statement was based on results he expected from his own labor Directly and indirectly, he has played the major role since 1951 in starting this trend as far as listings are concerned, which will set a new record for this Exchange during the last twenty-five years."

[3] James Gilligan testified that more than half of the 40 stocks in which he was registered as specialist were listed as a result of his efforts In the matter of *The Crowell-Collier Publishing Co.* (1-3911) Record, p. 2604. See Sec. III A(3), *infra* for a discussion of exchange policy with respect to allocation of stocks to specialists.

[4] One specialist testified:

"And I then proceeded to avail myself of the library of the exchange, namely, securing the complete information on advantages of listing and so forth.

"I had in my favor the fact that I could read a balance sheet. I availed myself of prospectuses wherever I could and I also spent practically as much time as I possibly could in our library with all of Moody's books, et cetera

"I took down as many as ten, fifteen companies a week that I would write down . . . companies that would meet with the requirements of listing on the American Exchange.

"My weekends practically [were devoted] . . . to nothing but correspondence, sending out letters, trying to induce listings on the American Stock Exchange, which my files at one time I would assume contained almost 600 or 700 companies that I had contacted"

[5] One specialist testified that he once appeared before the board of directors of a company, one of whose members was an over-the-counter securities dealer. Despite the strong opposition of this member, the company ultimately listed.

larly interested in being registered as a specialist in science stocks, not only used the techniques described above but also attended a convention of the Institute of Radio Engineers for the purpose of inducing corporation officials who might be present to list their companies. Rafferty also introduced prospective issuers to underwriters for the purpose of facilitating the financing of a public issue of stock so that the company could be listed.[6]

The competition among specialists for new listings was keen. Sometimes a number of specialists would attempt to contact officials of a company which was suitable for listing and special rules had to be adopted to prevent undue harassment. There is evidence to suggest that certain specialists who became Exchange governors used their official position to have stocks listed and allocated to themselves. According to Reilly, "Once they [specialists] became officials, they became high powered salesmen." In 1953, Reilly was instrumental in effecting the removal of a specialist as chairman of the Committee on Floor Transactions for improperly using his position to have a newly listed stock allocated to his post.[7]

In many instances, McCormick and specialists pursued parallel and complementary courses of action in seeking new listings.[8] After listing, specialists were encouraged to maintain contact with issuers. On one occasion, a specialist was censured by the Exchange government for refusing to meet with officials of a company in whose stock he was registered.[9]

A continuing difficulty facing the Exchange and its specialists is the transfer of seasoned issues to the New York Stock Exchange. This attrition has amounted to some 69 issues with almost 150,000,000 shares outstanding between 1955 and June 1961. In many instances the issues involved have been active and their loss was resented by Exchange specialists. This fact may well have contributed to the pressure to obtain new listings and to the somewhat flexible standards and perfunctory procedures discussed below.

B. Administration of Exchange Listing Requirements

The administration of Exchange listing requirements is complicated by the manner in which listings are brought to the Exchange and by the flexibility of the requirements themselves.

In keeping with the Exchange's traditional character as a market for smaller and newer companies, the Exchange has stated that it has "no rigid policy as to size of applicant corporations from the viewpoint of either assets or earnings power." [10] The application of each issuer is to be "considered on its own merits." If an issuer is "in the development stage," a record of earnings might not be required after considering such factors as the "management of the company, the adequacy of its financing and its future prospects."

Listing requirements are also flexible with respect to the public distribution of shares of applicant corporations. Each case is "considered separately," taking into consideration such factors as the total outstanding shares, the number of shares publicly held, the number of public shareholders and the price of the security. As a yardstick the Exchange has indicated that a minimum public distribution of a common stock issue should be not less than 100,000 shares distributed among not less than 500 public stockholders.

Applications for listing are processed by the Division of Securities, which consists of fourteen members of the Exchange staff, nine of whom have clerical or similar duties. The other five are Martin J. Kenna, Vice President in charge of the division, Bernard Maas, Director of the Department of Securities, and three listing examiners. These persons have the duties of examining applications, obtaining additional information when needed from the issuers, and presenting the applications to the Committee on Securities. The accounting firm of Peat, Marwick, Mitchell & Co., examines all listing applications and gives an opinion as to whether they are prepared in proper form. Although no examination is made by the Exchange of an applicant's books, an applicant is

[6] Rafferty stated that he had a file of more than 1,000 companies that he investigated as prospects for listing.

[7] See also Sec. III A(3), *infra*.

[8] One specialist testified: "I would crisscross around the country and on some occasions I would run into McCormick . . . ."

[9] On November 18, 1958, McCormick sent a memorandum to the chairman of the Committee on Floor Transactions relaying the complaint of an official of an issuer that the market spread on the stock was too wide and that the specialist had refused invitations to visit the plant and to have lunch or dinner with him. The Committee requested the chairman to inform the specialists in the stock that it "expects them to show a better spirit of cooperation in the future from a specialising standpoint as well as with the officials of the company."

[10] "Advantages of Listing," American Stock Exchange, February 1961. On December 7, 1961, the Exchange announced changes in its listing policy, the effects of which it is too early to judge.

required to file certified financial reports.[11] While engineers' reports are required to be submitted as part of the application in the case of certain kinds of applicants, such as companies in the extractive industries, no professional evaluation is made of these reports.

Applications for listing are presented by the Division of Securities to the Committee on Securities at its weekly meetings. Both Keena and Maas regularly attend these meetings. The Committee on Securities consists of five members, all of whom at the present time are allied or associate members on the Board. Adolph Woolner, an office partner of Bache & Co., has been chairman since 1959. McCormick, who was an *ex officio* member of the committee, regularly attended meetings and participated in the discussion of listing applications.

Keena and Maas usually present listing applications to the Committee on Securities in capsule form, either by showing the members a written precis of the applications or by pointing out specific parts of the applications which the staff members consider relevant.[12] At an average meeting the committee reviews ten or more applications (including applications for additional shares of companies whose securities are already listed). Since meetings of the committee apparently last an average of about one and a half hours, it is clear that the committee can give no more than cursory attention to any listing application.

Under the constitution, all original listing applications require the approval of the Board.[13] In practice, however, the Board's approval of original listings is merely formal; no application brought before it in recent years has been rejected.[14] The Board is not required to pass on applications for the listing of additional securities issued by companies having securities already listed on the Exchange; the Committee on Securities may admit such securities to listing without the approval of the Board.

On occasion companies have been able to achieve listing on the Exchange without compliance with its formal listing policies, through mergers. Such "back door" listings most often occur when a listed company is in financial difficulty or has virtually ceased operations and become a shell. Corporate officials and others desirous of listing their companies may shop for such shells and "finders" may peddle them. In some instances, the Exchange may suspend trading in the securities of an inactive shell; in others, the Exchange may permit trading to continue in such securities. Where trading has been suspended the Exchange may require the merged company to meet the standards for an original listing before lifting the suspension. However, there appears to be no consistent procedure for reviewing mergers where the corporate shell has not been previously suspended from trading.

C. Quality of Listed Stocks

The emphasis placed by the Exchange on obtaining listings and the somewhat perfunctory administration of the flexible listing policies are perhaps reflected in the quality of certain stocks listed on the Exchange. While undoubtedly the great majority of issuers of listed stocks are sound business enterprises, the Exchange has appeared to be reluctant to suspend or delist issues whose "future prospects" have proved to be dim. A large number of these have been stocks of Canadian mining or oil companies. As of December 31, 1960, there were 104 issues of Canadian corporations dealt in on the Exchange. Of these companies, during the period from January 1, 1958, through December 31, 1960, 77.3% had earnings deficits for one year, 54.4% had earnings deficits for two of the three years, and 32.7% had earnings deficits for all three years.[15]

Strict application of listing standards would tend to exclude from the Exchange the stocks of marginal companies and to conflict with the interests of specialists and others who expended time and effort in soliciting prospective issuers. This conflict appears to have led to otherwise inexpli-

[11] Certified financial data are also required by the Commission as part of a company's application for registration under the Exchange Act. Stock may not be traded on the Exchange until such registration has been effected.

[12] The procedure followed in reviewing listing applications is illustrated by the following testimony of Woolner:

"Q. You said, Martin Keena gives a verbal discussion?

"A. Yes, he reads it off very very rapidly.

"Q Do you read the form off?

"A. We try to.

"Q Sometimes you don't get a chance to read all the form?

"A. We glance through them. I was trying to tell you about the amount of work. He would say, on page 4 of the prospectus, you will find the last earnings, on page 3 you will find the net worth. He will call the things by telling you where to look for the important point."

[13] Const., Art. II, Sec. 1(b).

[14] The only objections on record in recent years were by one governor, who opposed the listing of Cinerama, Inc. and All-State Properties, Inc., which were listed on May 5, 1958, and January 14, 1960, respectively.

[15] Many Canadian issues were listed during the early 1950's, 12 such issues having been listed in 1952 alone.

cable relaxation of listing requirements. For example, in 1954 and again in 1955 Gilligan appeared before the Committee to request that it act favorably on a listing application filed by New Pacific Coal & Oils, Ltd. Although the company had no income from operations for the previous three years, and the company failed to define clearly its expected course of operations, the Committee acceded to Gilligan's request and listed its stock.

Listed companies have been permitted to list large blocks of additional shares on the Exchange under circumstances which reasonably should have raised questions as to the need for registration under the Securities Act.[16] For example, Guild Films Co., Inc. listed 1,898,376 shares of its common stock after its original listing in May 1956, none of which shares were covered by a registration statement; and El-Tronics, Inc. listed 2,340,079 shares of its common stock after its original listing in November 1955, none of which shares were covered by a registration statement. In many of the listing applications covering Guild Films and El-Tronics shares, Gilligan and persons affiliated with him were disclosed as purchasers of stock pursuant to a claimed private offering exemption.

Although the Exchange has sometimes insisted that unregistered shares be stamped with a legend stating that they may not be transferred until there has been a valid registration, or that an opinion of counsel be given that no registration is required, there is no consistent policy in this area. Moreover, the Exchange never insists on such a legend on unregistered shares of issues admitted to unlisted trading privileges.

A slightly different situation in which the Exchange permits listing of shares not registered under the Securities Act involves Canadian issues traded both in Canada and on the Exchange. For example, in 1958, 1,000,000 unregistered shares of Canadian Northwest Mines & Oils, Ltd.[17] were listed "to be sold exclusively in Canada and possibly in Continental Europe."[18] Shares of Canadian Northwest were also admitted to trading on the Toronto, Canadian, and Vancouver Stock Exchanges. No wholly effective procedure has been adopted to prevent these shares from filtering into the United States.

[16] The listing applications filed with the Exchange covering the listing of additional shares should have placed the Exchange on notice of such questions under the Securities Act. Prior to an amendment of the Commission's Rule X–12D1 in January 1954, an issuer of additionally listed shares was also required to register these shares with the Commission. Even after the amendment, the Commission would still have information concerning possible questions under the Securities Act through current reports in Form 8–K (to the extent that any 5% increase was involved) and from copies of listing applications which it received informally. Our criticism of the Exchange in this regard must be tempered accordingly.

[17] The company was formerly known as Galkeno Mines, Ltd.

[18] For the three years prior to listing, Canadian Northwest had losses. Throughout the period it was listed, the losses continued. The issue was suspended by the Exchange on January 18, 1961, for issuing unlisted shares.

III. The Specialist in Relation to Problems of Organization, Management, and Regulation of Members of the Exchange

A. Rules, Policies and Procedures Governing Specialist Conduct

1. Importance of the Specialist's Role

Specialists have been shown to be the dominant group in the government of the Exchange.[1] They have also been shown to be closely involved in the generation of new listings of securities on the Exchange.[2]

The specialist is also the critical figure in the floor operation of the Exchange. Under existing law and regulations and the rules of the Exchange he is permitted to act both as a broker on behalf of others and as a dealer for his own account in all securities in which he is registered. In contrast to the other members of the Exchange, the specialist remains stationary at his assigned post while performing his functions.

A specialist is not permitted to effect any transaction as broker except upon a market or limited price order.[3] In the overwhelming majority of cases in which the specialist acts as a broker he executes limited price orders given to him by other brokers for members of the public. These limited price orders are orders to buy or sell a security at a specific price or at a better price if obtainable. The commission broker or $2 broker leaves a limited price order with the specialist in the hope that the market will reach the figure quoted or a better figure at some future time. This relieves the broker of the necessity of waiting at the post. Occasionally, and usually at openings, a specialist executes a market order, which is an order to buy or sell at the best possible price as soon as reasonably practicable, on behalf of another member. The specialist receives a portion of the commission when he executes a limited price or market order on behalf of a broker.

The specialist is required to keep all of the orders which he receives as broker on his "book," which is maintained at his post. He is specifically barred under the provisions of Section 11(b) of the Exchange Act from disclosing "information in regard to orders placed with [him] which is not available to all members of the exchange to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for [him]." Under Exchange practice, a member is entitled to know only how many shares are bid for and how many shares are being offered at the market and the price of the last sale. If he inquires, the member will also be told whether the bid and/or offer are the specialist's.

Under the common law, the specialist, in his capacity as broker, acts as an agent on behalf of the broker for whom he executes orders and as such he is held to the obligations which the common law places upon all fiduciaries.[4] The rules applicable to self-dealing by fiduciaries also have application to specialists.[5]

Specialists on the Exchange also act as odd-lot dealers in all securities in which they are registered. The odd-lot orders are filled from the specialist's trading account. The odd-lot price is determined by the last preceding round lot sale price. The specialist is compensated by receiving a specific price differential, based upon the price per share.

Every security listed on the Exchange is assigned to at least one specialist. The specialist who is registered in the security generally is a participant in a "joint book" which is a joint account or joint venture entered into by two or more members for the purpose of acting as specialists in one or more securities. One joint book on the Exchange, the Mann-Farrell-Greene-Jacobi joint book, is currently registered in 69 securities; others are registered in varying numbers down to only one security.

[1] Section I, *supra*.
[2] Section II, *supra*.
[3] Section 11(b) of the Exchange Act.
[4] See *Restatement, Second, Agency*, Section 387.
[5] See *'Helfhat* v. *Whitehouse*, 258 N.Y. 274, 179 N.E. 493 (1932); *Hall* v. *Paine*, 224 Mass. 62, 112 N.E. 153 (1916); Leah, "Regulation of Over-the-Counter Brokers and Dealers in Securities," 59 H.L. Rev. 1237, 1259 (1946); *Restatement, Second, Agency*, Section 389. Comment (d).

In order to act as specialist in a particular security, a member must first be registered in such security, which registration may be revoked at any time by the Committee on Floor Transactions.[6] Under current rules, the specialist must maintain a cash or liquid asset position equal to $10,000 or an amount sufficient to purchase four units (round lots) of each security in which he is registered as specialist, whichever amount is greater.[7]

2. Qualifications of Specialists

The rules of the Exchange do not define the qualifications of specialists except as to their cash or liquid asset position. Officials of the Exchange and members of the Committee on Floor Transactions have stated that members will not be registered as specialists unless the Committee is satisfied that the member can properly perform the complex and technical duties required of a specialist and meet the financial requirements as specified in the rules. It was emphasized that the Committee had to be satisfied that a prospective specialist was completely proficient or was going to be trained under the auspices of a qualified specialist.

The record indicates that this policy has not always been carried out in practice. For example, George De Martini, a floor trader, was offered the specialist book in Sperry Rand warrants by Reilly in April 1961 despite the fact that he had never previously been a specialist, nor was he to train under the auspices of a qualified specialist.[8] In addition to his lack of qualifications, he had been called before the Committee on Floor Transactions a few days earlier for dominating a security as a floor trader in violation of Rule 110 and cautioned for affiliation with one specialist (Gilligan).[9]

In another instance, the Committee permitted Michael Horowitz to remain registered as specialist in Canadian Northwest Oils and Mines, Ltd., despite the fact that Horowitz had been found guilty of violating the Exchange's constitution and rules.[10] Although Horowitz did not actively handle the book in this stock, he was free to do so at any time.

The investigation has disclosed that it is a common practice to register a new specialist without any prior apprenticeship, on the theory that he will be trained under the supervision of an experienced specialist. Moreover, many of the specialists at particular posts are related to one another as father and son or father-in-law and son-in-law. The question obviously arises whether the father or father-in-law is in all such cases the best person to undertake such such training and supervision.

3. Allocation of Securities to Specialists

Under the previously existing allocation policy, specialists and underwriters were active in bringing new listings to the Exchange.[11] Under this policy, all securities were classified in one of three categories. Category 1 included those securities which were listed as the result of the efforts of a specialist. If the specialist could prove to the satisfaction of the Committee that it was through his work that the issuer decided to seek listing and if the specialist kept the Committee on Securities advised of his efforts, then that specialist would be allocated the stock under Category 1. This category provided an inducement to specialists to spend their time off the floor of the Exchange in soliciting new companies for listing on the Exchange. The specialists became salesmen for the Exchange in bringing in new listings, since they had a direct pecuniary interest in such listings. This policy also contributed to establishing an early, and sometimes close, relationship between the officers, directors, and principal stockholders of the issuer and the specialist.

Category 2 of the former allocation policy provided that a member or member firm other than a specialist was permitted to designate the specialist for a newly listed security when such member or member firm showed to the satisfaction of the Committee that it was responsible for the filing of a listing application. This category was modified in recent years by prohibiting the specialist who received such an allocation from receiving an additional security under Category 2 upon request of the same member or member firm for a period of 12 months. The member or member firm who requested a particular specialist was generally the underwriter or financial adviser for the company.

[6] Rule 170 of the Exchange.

[7] Rule 170. Prior to June 15, 1961, the rule required only $10,000 or an amount sufficient to purchase *one* unit of each security in which the specialist was registered. Financing arrangements are discussed *infra* in III C(3)

[8] De Martini began his duties as specialist on the day of his conversation with Reilly.

[9] De Martini was an office partner in Cohen, Simonson & Co. until 1956 when he became an officer and director of Guild Films. He left Guild Films in late 1958 when he became a floor trader. See Section IV, *infra*, for a discussion of De Martini's activities as a floor trader prior to his designation as specialist.

[10] Horowitz's violations are discussed *infra* in Section V.

[11] Discussed *supra* in Section II.

The third category of the former allocation policy of the Committee comprised those listing applications which were filed as the result of the voluntary and independent action of the issuer or by reason of the efforts of the Exchange staff. Such securities were considered as "naturals" and were supposed to be allocated by the Committee in its best judgment to the specialist in accordance with the standards now employed to allocate all newly listed securities.

The Committee also had an additional policy which cut across these three categories—if the security being allocated had been previously listed, then the specialist who handled the stock at that time was entitled to it on relisting.

Since September 1, 1961, the policy of the Exchange has been to allocate securities to a particular specialist "in the best interests of the Exchange." In practice, the security is allocated in accordance with the Committee on Floor Transactions' views as to which specialist should handle the stock. The Committee theoretically considers such matters as the financial ability of the specialist, his specialist talents, the relative activity of the stock and the length of time which had elapsed since the specialist last received a "natural."

Chairman Reilly testified that the rule of thumb currently being used by the Committee is to select the specialist for a newly listed stock from the five specialist accounts that have not received new securities for the longest period of time. Chairman John J. Mann of the Committee on Floor Transactions indicated that the three or four specialist accounts which have not received new securities for the longest period of time are considered. It remains to be seen, however, whether the standards are sufficiently well defined and the procedures sufficiently well established to ensure that allocations are made on objective rather than subjective bases. From Reilly's testimony, it seems that favoritism was not unknown in the process of allocating "naturals" under Category 3 in the past. He stated that in the early 1950's specialists on the Committee, particularly Dyer, would contact the managements of companies which had already filed listing applications to solicit them to request allocation of their stocks to particular Committee members.[12]

[12] It should be noted that the Dyer-Maguire joint account received 16 new stocks from July 1, 1956 through September 30, 1961, second only to Gilligan, Will (Appendix III).

Whatever the standards of allocation may have been at a particular time, it appears that, upon occasion, the applicable standards were sacrificed to expediency. For example, in February 1961, the Committee on Floor Transactions bowed to pressure in allocating the stock of Struthers Wells Corporation to Joseph Petta, a specialist. Struthers Wells had been formerly listed on the Exchange and traded at the Herman post, and under Committee policy, as noted above, that post would be entitled to the stock upon relisting.[13] However, a corporate official called the Exchange and indicated the company would file an application for listing only if assured that Petta would be designated as specialist. The chairman of the Board and the Committee then put pressure on Petta and Herman to effect a "switch" whereby Petta received the Struthers Wells book in exchange for the stock of Calgary & Edmonton Corporation which Petta gave up. It is noteworthy that Herman was specialist in the stock of another company with which this particular corporate official was connected, and that, according to Herman, the official constantly wanted to know why Herman failed to "support" the stock. Herman stated that, in his opinion, this official "thought I was going to be the demand and he was going to be the supply".

Although there appears to be no express Exchange policy with regard to having more than one specialist account registered in a particular security, recent practice has been to absorb competing books into a single joint account. At the present time, there are no competing books on the Exchange. The testimony of Charles Bocklet, vice chairman of the Board, and Gerald Sexton, a governor, indicates that a member is not permitted to open a competing book unless he can prove to the satisfaction of the Committee on Floor Transactions that large commission houses are committed to bring their orders to him. Bocklet emphasized that the Exchange did not want to register specialists who were not going to be able to service a large number of accounts and who simply wanted to take advantage of the more favorable margin rule applicable to specialists. Thus, as a practical matter it is extremely difficult to establish a competing specialist book, which tends to further entrench the existing specialists.

[13] This policy has apparently remained in effect despite the new allocation policy.

4. Duties in Relation to "Fair and Orderly Market"

A specialist on the Exchange is required to quote a market in all stocks in which he specializes. This market may consist of a bid and offer placed by members of the public, but the Exchange requires the specialist to inject himself into the market on either the bid or offer side, or both, if in his judgment there is too wide a spread between the public bid and offer.[14] Thus it is inherent in the specialist's duties, as presently envisaged in the rules and practices of the Exchange, that he engage or be prepared to engage in transactions for his own account, i.e., as dealer, in the securities in which he is registered as specialist.

Section 11(b) of the Exchange Act, which is the basic statutory authority governing the activities of specialists, provides that:

> . . . if under the rules and regulations of the Commission a specialist is permitted to act as a dealer or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market, and/or those necessary to permit him to act as an odd-lot dealer.

The Commission has promulgated no rules or regulations under Section 11(b), but in 1935 it recommended sixteen rules to the Exchange (as well as other exchanges) to govern trading on the floors of these exchanges, six of which dealt with the regulation of specialists.[15] These rules, all of which were adopted by the Exchange, were designed to place basic record-keeping and anti-speculation requirements on the specialists.[16]

The legislative history of the Exchange Act reveals that permitting the specialist to act as both broker and dealer in his Exchange activities aroused considerable controversy in the Congress.[17] Subsequently, when the Commission was directed to make a study of the feasibility and advisability of the complete segregation of the functions of brokers and dealers (Section 11(e) of the Exchange Act), the subject of specialists was considered in detail. Pending further study of the specialist system, the Segregation Report recommended that restrictions be developed governing the conditions under which the specialist may trade with his book.[18]

To clarify further the proper functions of a specialist, the Commission in 1937 issued an interpretation which has come to be known as the Saperstein interpretation (named for the Director of the Division of Trading and Exchanges who prepared it).[19] This interpretation is the most recent Commission pronouncement on the dealer activities permitted of specialists and should have served as a guide since that time for specialists and the exchanges. The essence of this interpretation is that the specialist is prohibited from making any principal transactions other than those which are properly part of a course of dealings reasonably necessary to maintain a fair and orderly market, and it is not sufficient merely to show that a particular transaction had no undesirable effect, or even discernible effect, upon the market. Each transaction by a specialist for his own account must meet the test of reasonable necessity; he may not trade as principal unless such trade affirmatively contributes to the maintenance of a fair and orderly market.

Specialists participated as dealer in 21.6% of all transactions on the Exchange during the year 1960. From the viewpoint of profits, these dealers activities seem to have become more important to many Exchange specialists than their broker activities. Various specialists were asked during the course of this investigation to estimate the percentages of their specialist income arising from their activities as broker and as dealer. The answers differed considerably, depending on the type of security handled, since an active stock with an abundance of public orders will emphasize the brokerage aspect of a specialist's business. One specialist estimated that in 1960 his commis-

[14] In any case where there is a public bid or offer at the market such bid or offer must be filled before the specialist may buy for his own account. The specialist is permitted to buy or sell stock named in a customer's order for his own account, provided he makes a bid or offer in the open market at a price which is better than his by the minimum variation permitted in the stock (generally ⅛). The order may be repudiated by the member giving it if he is dissatisfied with the execution, but this is almost never done. (Rule 152).

[15] S.E.C., *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* (hereafter *"Segregation Report"*), Appendix O-1.

[16] See Exchange Rules 170, 174, 175, 180.

[17] "No issue has been more disputed than that centering about the function of the specialist. There are many who believe that the Exchange mechanism would function better without the specialist, that the work done by the specialist could be done more effectively by a clerk or official of the exchange clearing the orders in a purely mechanical way, much as they are cleared today on the New York Stock Exchange in the 'bond crowd.' There are others who believe that a specialist should be obliged to act either as a dealer or as a broker and should not be permitted to combine the functions of dealer and broker. . . . Inasmuch as the stock exchanges objected to the laying down of any statutory rule governing specialists, their suggestion has been adopted of giving the Commission effective power to control the activities of specialists and to experiment with various devices of control." H R. Rep. No. 1383, 73rd Cong., 2d Sess. 14–15 (1934); 78 Cong. Rec. 7706 (1934).

[18] *Segregation Report*, Page 111.

[19] Securities Exchange Act Release No 1117 (1937).

sion profits were approximately equal to his trading profits. However, he estimated that in 1961 his trading profits amounted to 75% of his total profits from specializing. The estimates given by other specialists ranged from 65% to 80% of total profits arising from dealer transactions.

In his unique capacity the specialist stands at the heart of the Exchange market mechanism. He has intimate knowledge of the past market action of the stocks in which he specializes. He also has sole access to the specialist book showing outstanding orders both below and above the market, which affords him a great competitive advantage over the public.[20] In addition, he exercises a significant influence on the public appraisal of a security, since he is the one who quotes the market. For all these reasons, it is a matter of tremendous importance in the maintenance of a fair and orderly market that a specialist's transactions as principal be only of such kinds and in such amounts as are consistent with his function of acting as broker at the vital center of the auction market.

The statutory scheme and the rules of the Exchange have attempted to establish a workable regulatory pattern whereby the specialist is permitted to trade for his own account in addition to acting as a broker. These provisions were designed to resolve the inherent conflict arising from the combination of functions by maintaining the fiduciary standards which are expected of a broker and yet permitting him to trade as a principal to maintain the continuity of a fair and orderly market.[21]

In the course of the present Special Study of Securities Markets we intend to inquire further into the functioning of this regulatory pattern on the Exchange and other exchanges. In this report, the discussion is limited to the aspects that are particularly relevant to the topic of organization, management and the regulation of the conduct of members of the Exchange.

[20] The specialist is barred from disclosing such orders under Section 11(b) of the Exchange Act.

[21] For further information on the functions of specialists, see Vernon, *The Regulation of Stock Exchange Members*, (New York, 1941) pp. 58–96; *Segregation Report*, pp. 9, 25–50; Meeker, *The Work of the Stock Exchange* (New York, 1930) pp. 202–30; Twentieth Century Fund, Inc., *The Security Markets* (New York, 1935) pp. 402–42.

B. Problem Areas as Exemplified by Gilligan, Will & Company

During the course of this investigation, many specialists were interrogated and their records examined in order to measure the performance of Exchange specialists against the rules, policies and procedures governing their conduct. The activities of one specialist firm, Gilligan, Will & Company (hereafter "Gilligan, Will") were singled out for closer and more intensive scrutiny. It should be emphasized that this firm was not selected for detailed examination because it is considered typical of specialists on the Exchange; it was selected because it appeared to be one of the most important and influential specialist firms on the Exchange [22] and because its activities exemplify several important problem areas relating to specialists on the Exchange. On the other hand, although the firm was not chosen as a typical one, some or all of the problem areas discussed in this section are not unique to it. Other problem areas which are exemplified more clearly in the activities of other specialists are discussed in section C below.

1. Background—The Business of the Firm and Its Relationship to Other Members

The predecessor firm of Gilligan, Will was registered as a broker-dealer with the Commission effective February 11, 1940. For many years and during most of the period covered by the following discussion the senior partners of Gilligan, Will were James Gilligan and William Will. Gilligan was a charter member of the New York Curb Exchange (which later became the American Stock Exchange); he was elected to membership on June 25, 1919. He resigned as a member of Gilligan, Will on April 28, 1961 and his seat was transferred on June 15, 1961. After his retirement, Gilligan lent $400,000 to the firm under a subordinated loan agreement for five years at 6% interest. William Will, until his death in early 1961, was the partner in charge of the office operations of Gilligan, Will. The current partners of the firm are James

[22] In the years 1959 and 1960, the stocks in which Gilligan, Will specialized accounted for 10.31% and 7.5% of all Exchange volume, respectively. In addition, the firm is an important source of financing to other specialists.

Patrick Gilligan (son of James Gilligan), Albert Will, James F. Will (sons of William Will), John H. Coen, James M. Gathercole, and John J. McLaughlin.

Gilligan, Will currently specializes in 44 securities representing 42 different issuers.[23] The joint specialist book of Gilligan, Will-Howard-Alter is currently registered as specialist in 33 of the 44 securities. The firm of Gilligan, Will receives 65% of the profits from this book, and the remaining 35% is split between Lloyd Howard, who receives 20%, and Francis Alter, who receives 15%. Lloyd Howard is the son-in-law of James Gilligan; he received his 20% interest as a gift from his father-in-law. Francis Alter is the son of Louis Alter, a former specialist and floor trader who was closely associated with Gilligan, Will during his many years on the floor of the Exchange. Francis Alter was asked to come into the joint book by James Gilligan after having been trained in the Gilligan, Will offices. The Gilligan, Will-Howard-Alter joint book is completely financed by Gilligan, Will.

There are two other joint accounts at Post 23 in which the firm of Gilligan, Will participates. They are the Samson-Gilligan, Will and Yachnin-Sgambat-Gilligan, Will joint accounts. The former divides profits and losses between Benjamin Samson and Gilligan, Will on a 50%–50% basis. It currently specializes in six stocks. All of the financing for this joint account comes from Gilligan, Will. The Yachnin-Sgambat-Gilligan, Will joint book specializes in 5 stocks. Irving Yachnin has a 40% participation in the profits and losses, Raymond Sgambat 20%, and Gilligan, Will 40%. Yachnin has approximately $100,000 on account with Gilligan, Will to finance this book and anything above that sum needed for the operation of the book is supplied by Gilligan, Will. Sgambat became a participant in this book at the request of James Gilligan in 1959 when Lefcourt Realty Corp. stock became extremely active.

In addition to conducting an active specialist business of its own, Gilligan, Will also acts as banker for other specialists by extending credit to these specialists for operation of their books. These credit arrangements take either one of two forms. Under the first arrangement, Gilligan, Will clears for the other specialist, i.e., takes care of the bookkeeping and other office requirements, and also extends credit up to 75% of the value of the securities held by the specialist. Under the second arrangement, Gilligan, Will extends credit up to 100% of the account's total financing and participates in 10% of the trading profits.

The first of these arrangements, i.e., the straight clearing arrangement, is not uncommon on the Exchange since most specialists do not maintain office facilities. In addition to collecting the normal clearance charge on each transaction, Gilligan, Will also collects interest on any sums advanced under the margin rules. The interest charged is 1% above the rate which Gilligan, Will would pay to a bank to borrow the money. The following specialist accounts currently clear their transactions through Gilligan, Will: Adriance-Finn; Bernhardt-Bocklet; Bertuzzi-Fisher; Abruzzo-De Martini; M. L. Weiss; Kaufman-Kaufman; and Jackson-Tobin-Segal.

Four specialist accounts are financed by Gilligan, Will under the second arrangement wherein Gilligan, Will participates in the trading profits of these accounts. The accounts financed in this manner are Dyer-Maguire; May, Borg; Max Streicher; and Daniel Schwartz. These firms also clear their transactions through Gilligan, Will and are charged the normal clearance rates. They borrow funds from Gilligan, Will to operate their books based upon a prearranged line of credit. For example, the Dyer-Maguire joint account is free to draw upon a $500,000 line of credit. In return for extending this credit, Gilligan, Will is a 10% partner in all of the profits realized from dealer transactions by these accounts. In addition to the 10% partnership interest, Gilligan, Will also charges these accounts interest on outstanding balances.

Gilligan stated that if an account which his firm financed, such as the Dyer-Maguire account, were approaching its credit limit, he would check the account to see if it were overextended in any stocks. He stated that he might request the account to sell out certain stocks to reduce its position. He also indicated that if one of these accounts had been extended credit up to its limit, the participants would have to get his approval to purchase an additional block of stock. He asserted that if the Exchange required the account to purchase this block in order to maintain a fair and orderly market, he might require the account

[23] During the period from July 1, 1956 through September 30, 1961, Gilligan, Will was allocated 17 newly listed securities, more than any other specialist account (Appendix III). A list of all Gilligan, Will stocks from July 1, 1956 through June 30, 1961 appears as Appendix IV.

to sell other stocks to lighten its position. In response to a question whether such selling might artificially disrupt the stability of the market in the other stocks, Gilligan replied: "Maybe at my insistence he wants to sell these stocks." On one occasion, the Dyer-Maguire joint account moved two stocks to another clearing agent for a period of time because Gilligan insisted that they sell these stocks which they refused to do.

It is apparent that the ability of a specialist to maintain a fair and orderly market depends in large measure upon his financial condition. It is also apparent that as a financier for other specialists, Gilligan, Will may often be in a position to control the exercise of their judgment as to transactions necessary to maintain a fair and orderly market.[24]

Gilligan, Will also does a thriving public business, although the firm has no board room and no retail salesmen. The accounts which the firm maintains and which will be referred to hereafter as "agency accounts" consist of the accounts of numerous relatives, friends, and business associates; officers, directors and principal stockholders of companies in which Gilligan, Will specializes; and individuals introduced by these persons. These agency accounts are particularly active in the stocks in which Gilligan, Will is registered as specialist and, as discussed below, have been used on numerous occasions to facilitate distributions by the specialists' joint account and persons associated with it.

In connection with its specialist activities, Gilligan, Will has had a completely integrated vertical operation whereby the firm and its associates have brought listings to the Exchange; maintained close contact with the companies listed, and thereby obtained inside information about corporate developments; acquired blocks of stocks from the issuers, officers, directors, and principal stockholders and their associates prior to and after listing; and participated in numerous distributions of these securities over the Exchange. These matters will be discussed in detail in the immediately following subsections.

2. New Listings

The new listings acquired in the last ten years by the various Gilligan, Will specialist accounts were obtained, for the most part, through the efforts of James Gilligan and various persons and brokerage houses with whom he was closely associated. Category 1 of the previously existing allocation policy of the Exchange [25] encouraged specialists to induce companies to list their shares on the Exchange so that the newly listed stock would be allocated to them. Category 2 encouraged the establishment of close business relationships with other members of the Exchange, particularly underwriters, who might be able to bring about the listing of new companies and request allocation of the stock to a particular specialist.

Gilligan was on close personal and business terms with Edward L. Elliott, now deceased, formerly a partner in the member firm of Van Alstyne, Noel & Co. and later the senior partner of his own member firm, Elliott & Co. Elliott's protege, Richard C. Pistell, who was with Elliott at both Van Alstyne, Noel & Co. and Elliott & Co. and who is presently Chairman of the Board of Pistell, Inc., a member firm, has also been a participant with Gilligan in several ventures involving stocks traded at the Gilligan, Will post.

Elliott and/or Pistell were influential in the financing of the following companies in which Gilligan, Will specialized: American Tractor Corp., Audion-Emenee Corp. (now Emenee Corp.), Capital Cities Broadcasting Corp. ("Capital Cities"),[26] Chromalloy Corp., Crowell-Collier, Howell Electric Motors Co., El-Tronics, Inc., Molybdenite Corporation of America and New Pacific Coal & Oils, Ltd. (now Consolidated New Pacific). These stocks were all assigned to the Gilligan, Post under either Category 1 or 2 in that the listing was either induced by Gilligan or else the member firm with which Elliott or Pistell was associated requested Gilligan as specialist. Upon occasion, Elliott appeared together with Gilligan before the Committee on Securities to argue for the listing of a stock in which they were interested.

Gilligan also was on close business terms with Richard Noel, now deceased, formerly a partner in Van Alstyne, Noel & Co. This relationship led to numerous new listings at the Gilligan, Will post. Van Alstyne, Noel & Co. had underwritten

[24] The joint accounts which Gilligan, Will finances currently specialize in 85 securities of 76 issuers. This gives Gilligan, Will participation in specialist trading accounts in 129 securities of 118 issuers, including those securities traded at Post 23.

[25] Discussed in Sec III A(3), *supra*

[26] In the case of Capital Cities, Elliott and Pistell arranged for a Regulation A underwriting of 52,000 shares through an over-the-counter trading firm, although all of the customers were supplied by Elliott & Co., and the over-the-counter firm was simply used as a dummy underwriter. At the time of this underwriting in December 1957, Gilligan had filed a letter with the Exchange with regard to the listing of Capital Cities

96-746 O—63—pt. 4——51

offerings of Consolidated Diesel Electric Corp., Continental Aviation and Engineering Corp., Continental Materials Corp., Servomechanisms, Inc., F. C. Russell Co., and Guild Films Co., Inc., securities traded at the Gilligan, Will post. All of these stocks were allocated under the provisions of Categories 1 and 2. According to Gilligan, Van Alstyne, Noel was also interested in Kobacher Stores, Inc. (now Kostin Corp.), another Gilligan, Will stock. In addition, the stock of New Idria Mining and Chemical Co. (hereafter "New Idria") of which David Van Alstyne, Jr. is Chairman of the Board, is registered at the Gilligan, Will post.

Gilligan was also able to obtain new listings through the efforts of persons connected with companies in which he already specialized. For example, Harry Harris, who was a founder, officer and director of Chromalloy, was responsible for the listing of North Rankin Nickel Mines, Ltd., at Gilligan's request, and he was also a director of Silver-Miller Mines, Ltd., another Gilligan, Will stock. Gilligan initially became friendly with Harris because of the latter's connection with United Aircraft Products, Inc., another stock traded at the Gilligan, Will post.

Joseph Friedman, currently Chairman of the Board of Chromalloy, recommended to the management of Banner Industries, Inc., that that company apply for listing, and when the stock was listed Gilligan, Will became the specialist under Category 1. Marvin Hayutin, who was a finder in Guild Films, and who played an important role in New Idria, was introduced to Gilligan by Richard Noel. Hayutin was responsible for putting Gilligan in touch with the management of Occidental Petroleum Corp., which resulted in the listing of that company's stock and its trading at the Gilligan, Will post.

In partial return for the introduction of new listings, Gilligan stated that he would call the underwriter, e.g., Noel, Elliott or Pistell, to advise that a large block was being offered for sale with few bids on the book so that the underwriter could buy the stock if he wished. Gilligan offered this service to his underwriter friends because:

> Well, and because lots of times they may not care if it sells down an eighth or a quarter, but they don't want to see the stock break a half dollar, you know, because it might upset the whole market in the thing, so they have a right to—after all, they have got a lot of customers in it. They have a right to know what is going to happen just as well as I have.

3. Purchases of Stock Prior to Listing

One of the features which often characterized securities listed at the Gilligan, Will post was that prior to listing the companies sold stock to the prospective specialists, partners of Gilligan, Will, and agency accounts maintained at Gilligan, Will, generally at prices below the current market.

A classic case of such a sale occurred in Guild Films. In November 1955 the company sold 200,000 shares of its common stock to Gilligan, Will & Company, Cohen, Simonson & Co., and Helen De Martini.[27] The shares were immediately resold on an "investment" basis to 172 persons connected with Gilligan, Will and Cohen, Simonson. Of the 200,000 shares, 70,000 were sold at $2.00 per share to 20 persons closely associated with Gilligan, Will, including partners and their wives, and 39,800 shares were sold at $3.00 per share to 74 other individuals designated by Gilligan, Will, many of whom were members of the Exchange. The remaining shares were allocated to persons designated by Cohen, Simonson.

On February 29, 1956 a listing application for Guild Films was filed. Included in the allocation log maintained by the Exchange was a letter dated December 1, 1955 signed by James Gilligan in which he stated that he and George De Martini had visited with officials of Guild Films with reference to listing; that Gilligan and De Martini suggested that Guild Films increase its cash position; and that "in order to do this quickly and without any fuss, George and myself bought $500,000 worth of stock." The partners of Gilligan, Will began to sell their shares on the Exchange approximately six months after issuance and the shares were sold out by August 1, 1957.

One of the many long-term investment accounts[28] maintained by the Gilligan, Will-Howard-Alter joint account purchased 30,000 shares of Occidental Petroleum Corp. prior to the listing of the stock on the Exchange. These 30,000 shares were originally allocated by the company to a business associate of the company's president, as part of a 200,000 share offering. This business associate testified that he was unable to make payment for these shares and sold them on an "investment" basis to Gilligan, Will at $3.00 per share. It is interesting to note that these 30,000 shares

[27] Helen De Martini is the wife of George De Martini, then a partner in Cohen, Simonson & Co. See Section IV *infra* for a discussion of George De Martini's activities as a floor trader.

[28] A more complete discussion of long-term investment accounts appears *infra* in Section III C(2).

were the only shares in the offering which did not include an option to purchase additional shares. The rules of the Exchange prohibit a specialist from holding an option in any security in which he is registered.[29]

In the instance of Chromalloy, Gilligan, Will purchased $100,000 principal amount of convertible debentures from the company prior to the listing of the underlying stock in October 1957. After the stock was listed and Gilligan was designated as specialist, the Gilligan, Will-Howard-Alter long-term account converted these debentures into common stock in November 1957 and May 1958. The shares were sold on the Exchange from June 1958 through January 1959.

Audion-Emenee Corp. was admitted to trading on July 19, 1960 and assigned to the Gilligan, Will post at the request of Pistell, Crow, Inc., the principal underwriter of a 100,000 share offering on May 20, 1960. Among the 100-share purchasers of this offering were Francis M. Alter, Louis W. Alter, Jean S. Gilligan (wife of James Patrick Gilligan), Veronica V. Gilligan (wife of James Gilligan), Joan Howard (daughter of James Gilligan), Benjamin Samson and Raymond Sgambat. James Gilligan indicated that these purchases were made to assist the company in obtaining a sufficiently broad public distribution so as to qualify under the listing requirements.[30]

Before the listing of North Rankin Nickel Mines, Ltd. and the allocation of that stock to Gilligan, Will, the specialists' long-term account purchased 25,000 shares on October 20, 1958. These shares were subsequently sold on the Exchange, approximately two years after the purchase and eighteen months after the listing.

Prior to the listing of Capital Cities on the Exchange and its allocation to Gilligan, Will as specialist, the president of the issuer, Frank Smith, offered Giligan the opportunity to purchase 20,000 shares of stock. Gilligan bought these shares from the company for the Gilligan, Will trading account and they were received into this account on April 7, 1960. When the Exchange objected to this purchase, under a new policy prohibiting such transactions, Gilligan was forced to either dispose of the shares or give up the book in Capital Cities. Gilligan decided to dispose of the shares and he sold them at cost to Richard Pistell.

[29] Rule 175.

[30] At the time 500 public shareholders were required. Listing requirements are discussed in Section II *supra*.

Prior to the listing of Crowell-Collier common stock in October 1955 Gilligan, Will purchased $50,000 principal amount of debentures, which were convertible into common stock. The disposition of these debentures, as well as an additional $150,000 in debentures purchased after listing, will be discussed in further detail below.

4. Relationships Between the Specialist and Issuers

Once the securities were listed and trading began at the Gilligan, Will post, it was common practice for Gilligan and his associates to maintain close business relationships with the officers, directors and principal stockholders of the issuers. Company officials would frequently report to Gilligan on significant corporate developments before such information became public.[31] It was Gilligan's opinion that the specialist should have contact with management or the underwriter, in order to "know just exactly how the company is doing."

A prime example of this occurred in the case of Guild Films, where Gilligan not only received information from officers in the normal course but had the further advantage of De Martini's being an officer and director for almost three years. De Martini retained his seat during this period and on his return to the floor in late 1958, as is more fully discussed in Section IV, *infra*, he traded almost exclusively at the Gilligan, Will post.

The president and treasurer of Guild Films have stated that they constantly advised Gilligan of developments in their unsuccessful fight to stave off bankruptcy and sought his advice on such matters as voting a reverse split of the stock. In the case of the company's abortive merger attempt with Vic Tanny, Inc. they advised Gilligan of the merger agreement before it became public.

In addition to receiving reports on the progress of Guild Films from company officials, Gilligan, Will also lent $36,000 to the company in October 1957, secured by 34,000 shares of Guild Films stock in the name of the wife of the company's president. In 1960 when the company filed a registration statement seeking to register all of its shares which

[31] Gilligan's attitude on this subject is shown in the following testimony:

"Q Do you think a specialist is entitled to inside information about occurrences that are about to happen in a corporation?

"A. Yes, I think he should be kept fully informed, because he has a duty to maintain a market.

"Q. This being fully informed would be prior to informing the general public?

"A. Yes."

had previously been issued without registration, Gilligan personally guaranteed the payment of $20,000 in counsel fees, provided that 600,000 shares of stock issues by the company in January 1959 were effectively registered. Gilligan, Will had purchased 100,000 of these shares.[32]

Another close relationship between specialist and issuer was present in El-Tronics. On December 29, 1958, the trustees in bankruptcy of El-Tronics petitioned for permission to borrow $20,000 from James Gilligan in order to meet the immediate needs of the company. Gilligan advanced $20,000 and he also lent the company an additional $15,000 to meet a payroll for which he received 1,500 shares of stock.

In the case of Electronics Corporation of America (hereafter "ECA"), this company had little contact with Gilligan, Will prior to a trip which its president and vice president made to New York in November 1959 to visit with Gilligan. Before they left Gilligan's office, negotiations had begun for the purchase by the specialists of 25,000 shares of ECA stock at $7.50 a share from the company on an "investment" basis. The purchase price was 85% of the current market on the Exchange, and the transaction was consummated on February 26, 1960. The Exchange required Gilligan to give up the book in ECA to retain these shares under a new policy prohibiting such purchases. Gilligan also suggested at this meeting that the ECA officials contact Joseph Friedman, who is currently the chairman of the Board of Chromalloy, to see whether Friedman might help ECA. As a result of Gilligan's introduction, Friedman was hired by ECA as Director of Acquisitions at a salary of $15,000 per year and was granted a 50,000 share restricted stock option as an employee of ECA.

With regard to the stock of New Idria, Gilligan was permitted to buy 20,000 shares of Beaver Petroleum stock from Marvin Hayutin at 1¢ per share so that Gilligan would use his influence at Van Alstyne, Noel & Co. to put through a merger between Beaver and New Idria. This merger did become effective and Gilligan received 10,000 shares of New India for his 20,000 shares of Beaver.

Another illustration of the participation of Gilligan in the affairs of a company in which he specialized occurred in Occidental Petroleum. Gilligan personally participated in joint drilling ventures with Occidental Petroleum and expended a total of $89,600. Such participation gave Gilligan information regarding the progress of the company's business affairs which was not available to the general public. Gilligan stated that he resigned from his firm rather than give up this joint venture interest. He still retains the interest and Gilligan, Will, the firm of which his son is now senior partner and in which Gilligan retains a substantial financial interest, remains registered as specialist.

The relationship between Capital Cities and Gilligan, refered to above, was further strengthened by the fact that Randall Smith, son of the president of Capital Cities, was employed by Gilligan, Will in various capacities. When the Exchange objected to having Smith working on the floor for Gilligan, Will, Gilligan testified that ". . . I put him over with Dyer, then." Gilligan, Will finances the joint specialist account of Dyer-Maguire.

The question arises whether it is ever necessary or proper for a specialist to have access to information not known to the general public or to be privy to advance leaks or inside information whereby he may increase his inherent competitive advantage over the public in his trading activities. The Exchange has had no formal policy and the specialists themselves have differed on its propriety. As indicated above, Gilligan was of the opinion that he was entitled to advance information from issuers. On the other hand, Charles Bocklet testified that once a company's stock was admitted to trading at his post he had no business dealings whatsoever with the company and its officials, and he knew of the latest developments in the company's affairs only from what he read in the newspapers. Another specialist, Louis Herman, testified that a specialist can do a better job if he does not know insiders, since he can operate as he sees fit and need not worry about complaints from such insiders. Herman revealed at least three instances where corporate officials sought to have him support a stock in which he specialized, and in one case he was offered a put by an insider to guarantee him against loss.

A related problem area concerns the relationship between the specialist and financial consultants for companies registered at the specialist's post. In the case of Victor Grande, a specialist,

[32] On August 18, 1961, the Commission issued a stop order suspending this registration statement because of various deficiencies contained in the company's statement and prospectus. The statement was filed in May 1960 and sought registration of 17,664,891 shares of Guild Films stock.

the testimony indicates that he is on close terms with the financial consultant to three companies whose securities are traded at his post. In one of these companies, Acme Missiles & Construction Corp., the consultant arranged for the purchase by Grande of 1000 shares of stock in an underwriting prior to listing. When the stock was admitted to trading, the consultant was influential in having Grande designated as specialist.

The close relationship between specialist and issuer, which was encouraged and fostered by the Exchange's prior allocation policy, was not unique to Gilligan, Will. Certainly the activities of Re, Re & Sagarese involved many such relationships.[33] To mention one further example, James F. Rafferty, a specialist, appears to have advised the management of Cubic Corporation, a stock in which he specialized, as to the timing and pricing of a registered secondary offering [34] of its stock in the summer of 1960. In so doing, he disclosed the condition of his book to the company and the principal underwriter in advance of the effective date of the offering.

Under a recent rule change, the Exchange forbids a specialist from purchasing or selling off the floor of the Exchange any security in which he is registered for any account in which he is directly or indirectly interested, except to offset another transaction made in error.[35] Also, the Exchange now bars a specialist from effecting any business transactions with a company or officer or director of a company in whose stock he is registered as a specialist.[36] It remains to be seen whether these rules are adequate or whether more stringent measures are required in this area.

5. Off-Board Purchases of Stock After Listing

Frequently, after securities had been admitted to trading at the Gilligan, Will post, the specialists and various individuals who maintained agency accounts at Gilligan, Will purchased large blocks of stock off the Exchange from the issuers or their officers, directors and principal stockholders and, in some cases, from factors who held such stock as collateral. Gilligan never obtained approval of such purchases from a floor governor under Rule 187 (when that Rule was in effect), although upon occasion the consummated purchases were reported to the Exchange.

In the case of Guild Films, purchases were made by long-term investment accounts of the specialists and by individual partners and agency accounts from the company and factors. For example, in January 1959, the specialist long-term account acquired 100,000 shares stamped "for investment only." This long term account delivered out 100,000 shares for sale on the Exchange in 1960 and the participants in the account received the proceeds of sale. In addition, the Gilligan, Will-Howard investment account acquired 68,768 shares in late 1958, which shares were placed in the specialist's trading account on December 23, 1959 and eventually distributed to the public. In January and February 1959, Gilligan, Will acquired an additional 172,467 shares of Guild Films stock, which had been issued for investment, from two factors; 127,000 of these shares originated with a company controlled by Alexander L. Guterma. These 172,467 shares were placed in the specialist's trading account and in the accounts of George De Martini, Louis Alter, and others.

In another instance, the partners of Gilligan, Will and Lloyd Howard acquired 15,000 shares of El-Tronics in 1956 from an officer of the company and an additional 441,428 shares were placed in various agency accounts at Gilligan, Will in the period from April 10, 1956 through October 16, 1958.

A specialists' long-term account at Gilligan, Will purchased 25,000 shares of Occidental Petroleum stock from the brother of the company's president on November 24, 1959 at 3¼ and the same account purchased 30,000 shares on January 29, 1960 at 5½ from one of the largest stockholders of the company. Another long-term account acquired 5,000 shares of the common stock of Howell Electric Motors from two of the officers of that company, in a transaction arranged by Richard Pistell. All of the above transactions were off the Exchange and in many instances were followed by distribution on the Exchange.[37]

6. Insider Agency Accounts

It was common practice for officers, directors, and large stockholders of the companies whose securities were registered at the Gilligan, Will post to maintain active trading accounts at Gilligan,

[33] See brief, Division of Trading and Exchanges, April 28, 1961.

[34] See Sec. III C(4) for applicable definition of secondary offering.

[35] Rule 187, effective May 18, 1961.

[36] Rule 190, effective May 18, 1961.

[37] Distributions are discussed in III B (7) *infra*.

Will. It was also common practice for these corporate insiders to recommend that their friends and relatives open accounts at Gilligan, Will, since an introduction was prerequisite to opening such an account. Until May 18, 1961 specialists were permitted to have corporate insiders as public customers, and these persons actively used the facilities of Gilligan, Will to execute their brokerage orders.[38] Most of the trading conducted by these corporate insiders through Gilligan, Will was in shares of their own companies or in other stocks in which Gilligan, Will was registered as specialist.

In the case of Chromalloy, Harry Harris and Mortimer Gordon, two of the original control parties of the company, maintained accounts at Gilligan, Will. They both left the company in early 1959, and were able to dispose of large blocks of stock in January and February 1959 by selling their shares on the Exchange and to Gilligan, Will. In addition, Harry Harris introduced the benefits of an account at Gilligan, Will to the Value Line Special Situations Fund, and large blocks of Chromalloy and Crowell-Collier stock were sold by that fund through Gilligan, Will.[39]

Corporate insiders and other individuals close to the management of Occidental Petroleum also used the facilities of agency accounts at Gilligan, Will. For example, Gilligan, Will acted as agent for the president's brother and another large stockholder in selling large blocks of Occidental Petroleum shares over the Exchange in 1959 and 1960. In early 1961, five persons close to the management sold 32,000 shares at $5 per share through Gilligan, Will, over the Exchange. Most of these shares were purchased by Pistell, Crow for its customers after arrangements for the transactions had been made by the president of the company, Pistell and Gilligan.

The principal stockholder of Acme-Hamilton Manufacturing Co. had a large block of Acme-Hamilton stock to sell, which shares were covered by an effective registration statement. He was under pressure to sell the shares promptly or file new financial information. He was able to sell 60,500 shares on the Exchange through Gilligan, Will and 72,400 shares directly to Gilligan, Will in March and April 1961.

An officer of Cenco Instruments Corp. and his attorney introduced numerous accounts to Gilligan, Will through Benjamin Samson, who participated in the specialist's joint account. The officer sold 2,000 shares of Cenco stock through Gilligan, Will in early 1961. A vice president of Consolidated Diesel Electric Corp. maintains an account at Gilligan, Will and has traded in other stocks registered at the Gilligan, Will post. A director of Nickel Rim Mines Ltd., disposed of a large block of Nickel Rim stock through Gilligan, Will in July–September 1957. Associated Food stores Cooperative, Inc., the principal shareholder of Associated Food Stores, Inc., another security in which Gilligan, Will is registered as specialist, purchased 5,500 shares of Associated Food stock through Gilligan, Will on the Exchange from October 1956 through December 1957.[40]

7. Distributions

Many of the securities acquired by Gilligan, Will interests and agency accounts, as described in the preceding subsections, found their way into public hands through distributions conducted by Gilligan, Will on the floor of the Exchange. The securities distributed fall into two major categories: stock purchased by the participants in the specialist's trading account or by partners of Gilligan, Will and held in long-term investment accounts for at least six months; and stock sold by Gilligan, Will as broker for agency accounts.

In making these distributions, neither Gilligan, Will nor the persons for whose benefit the distributions were being made availed themselves of the formal distribution techniques provided for in the rules of the Exchange.[41] Rather, the methods of distribution were informal and varied according to the needs of the particular situation. Thus, a large-scale distributive machinery flourished outside of the formal procedures set forth by the Exchange in its rules.

In certain instances, the shares which were being distributed were apparently subject to the regis-

[38] Rule 190, amended May 18, 1961, has been interpreted by the Exchange to prohibit such insider accounts.

[39] During six months in 1959, Gilligan, Will sold approximately $1.8 million worth of these two securities for the fund. From May 1, 1959 through August 5, 1959, Value Line Special Situations Fund sold 54,300 shares of Crowell-Collier stock through Gilligan, Will and from February 13, 1959 through May 8, 1959, it sold 16,000 shares of Chromalloy through Gilligan, Will. At least some of these orders were given directly to Gilligan for execution, and Gilligan was given discretion to execute these orders, using his best judgment.

[40] The subject of public customers generally is discussed in III C (1) *infra*.

[41] The rules governing secondary distributions are set forth in Exchange Rules 550 and 552 (also see Sec. III C (4) of this report). Exchange Rule 560, governing special offerings, was adopted pursuant to Rule 10b-2(d) under the Exchange Act, and Exchange Rule 570 governs formal Exchange Distributions.

tration requirements of the Securities Act but registration was not effected. Crowell-Collier is an illustration.[42] Prior to the listing of this stock in October 1955, Gilligan, Will purchased $50,000 face amount of debentures convertible into common stock. The purchase was from the company and was arranged by Edward L. Elliott as part of a purported "private placement." After the stock was listed [43] and Gilligan, Will was designated specialist, an additional $150,000 face amount of the debentures were purchased by the specialist account in May 1956 under similar circumstances. All of these debentures were converted into common stock while Gilligan, Will was registered as specialist. The 10,000 shares resulting from the conversion of the $50,000 block of debentures were sold on the Exchange in a two-week period in May 1956. The 30,000 shares resulting from the conversion of the $150,000 block of debentures were sold on the Exchange from May 1957 through October 1958. On May 7, 1958 this Commission suspended Gilligan, Will from membership in the National Association of Securities Dealers, Inc. for a period of five days based upon the purchase and sale of the above Crowell-Collier debentures.[44]

Upon occasion, the shares being distributed were registered with the Commission and Gilligan, Will acted as broker in order to facilitate distribution on the Exchange, while still maintaining the specialist book. The sale by the controlling stockholder of 60,500 shares of Acme-Hamilton stock through Gilligan, Will as described in the previous subsection is illustrative of this type of distribution.

During all of the distributions in which Gilligan, Will retained the specialist book while it was acting as underwriter or was distributing its own shares, e.g., Crowell-Collier, the specialist trading account placed bids and made purchases in violation of Rule 10b–6 of the Exchange Act.[45]

Upon occasion, the specialist's trading account distributed large blocks of stock to the public by selling short. The account then covered by transferring stock from specialists' long-term investment accounts or by purchasing stock from persons close to the company.

The trading pattern in Chromalloy during the first months of 1959 provides an excellent illustration of the Gilligan pattern of operation in effecting distributions on the Exchange. The specialists' long-term account had a long position of 29,600 shares of Chromalloy, resulting from the conversion of debentures which had been purchased from the company prior to listing. These shares were distributed in a two-week period in January 1959, resulting in proceeds in excess of $1 million. On one day in the early stages of the distribution (January 12, 1959), when the long-term account was selling 8,900 shares, the James Gilligan trading account bought 3,500 shares, and the James P. Gilligan trading account sold 2,000 shares and Veronica Gilligan sold 1,500 shares. These transactions canceled each other out, but contributed to increased volume on the Exchange at rising prices. Shortly afterwards, while the specialists were selling their 29,600 shares, Mortimer Gordon, a former officer who had an agency account, as stated above, came to Gilligan, Will to sell a block of 20,000 shares. Gordon was able to sell these shares in one day on the Exchange through Gilligan, Will, resulting in total proceeds in excess of $600,000.

During the same period, when the price of Chromalloy stock was rising rapidly in heavy volume and at least two distributions were taking place on the Exchange, the specialist's trading account was short almost 36,000 shares. In January 1959, this account purchased 10,000 shares from Elliott & Co. and in February 1959, it purchased 20,000 shares from Harry Harris, another

[42] With respect to the participation of Edward T. McCormick and Michael E Mooney in Crowell-Collier, see Sec I D (4) and (5), *supra*. It is Gilligan's current opinion that he is free to sell stock purchased for "investment" if held for thirteen months

[43] At the time of the listing, both the Exchange and the Commission apparently accepted the company's representation, together with a written opinion of counsel, that the stock being listed (including the shares issuable on conversion of debentures) was exempt from registration under the Securities Act.

[44] In the matter of *Gilligan, Will & Co.*, 38 S.E.C. 388 (1958), *aff'd.* 267 F. 2d 461 (2d Cir. 1959), *cert. denied* 361 U.S. 896 (1959). Also see Securities Act Release No. 3825 (1957). In its opinion, the Commission considered only the question of whether the transactions involved had amounted to violations of Section 5 of the Securities Act. The Commission did not concern itself with other possible violations or with the question of whether Gilligan, Will was acting in accordance with the regulatory scheme governing specialists in engaging in these transactions, i e, whether these transactions were "reasonably necessary to permit [Gilligan, Will] to maintain a fair and orderly market." It is interesting to note that when Mooney was questioned in this case on the subject of whether there were any rules prohibiting a specialist from acting as an underwriter as well, he replied: "What bearing that has on this particular case, I don't know" (In the matter of *The Crowell-Collier Publishing Company* (1–3911) Record, p. 2709).

[45] An exception occurred in Hazel Bishop, Inc when the Gilligan, Will-Samson account was required to give up the book during the pendency of a distribution in which the specialists were interested to the extent of 20,000 shares. This offering was the subject of a stop order issued by the Commission on June 7, 1961 (Securities Act Release No 4371).

former officer and director of the company who had an agency account.

Guild Films is another security in which numerous distributions took place on the floor of the Exchange through the facilities of Gilligan, Will. For example, 12,300 shares which were held in the accounts of partners and relatives of partners of Gilligan, Will were sold on the Exchange on a single day, August 2, 1956. All these shares had been issued for "investment" by the company nine months earlier and all the purchasers had executed investment letters.[46] Other distributions of Guild Films have been mentioned in previous subsections.

It has been seen that, in the case of Occidental Petroleum, a specialist long-term account at Gilligan, Will purchased a total of 85,000 shares in 1959 and early 1960 from the company and from individuals close to the company. All 85,000 shares were sold on the Exchange from February 29, 1960 through December 13, 1960. In addition, a large stockholder sold 87,000 shares of Occidental Petroleum on the Exchange through Gilligan, Will from August 12, 1959 through December 14, 1959.

Various distributions also took place in El-Tronics on the Exchange through Gilligan, Will. These included 30,000 shares sold in 1956 and 1957 by a specialist long-term account and various agency accounts, and 161,428 shares sold in 1958 and 1959 by corporate insiders or agency accounts.

New Idria is an example of a situation in which the specialist helped to facilitate an over-the-counter distribution and also distributed his own shares on the Exchange. The firm of Gilligan, Will had obtained 10,000 shares of New Idria stock for services rendered by Gilligan in arranging for a merger with Beaver Petroleum. The New Idria shares issued to the Beaver Petroleum stockholders were distributed over the counter at prices geared to the Exchange price. During the course of the over-the-counter distribution in July and August 1956, Gilligan admitted that he received telephone calls on the floor of the Exchange directly from David Schindler who was part of the Beaver Petroleum group. Schindler, a selling stockholder, instructed Gilligan to place orders to purchase 97,600 shares of New Idria stock and at no time did he instruct Gilligan to sell any stock. The shares were not placed in Schindler's name although the money for the purchase price came from him. At the time this buying was taking place, the stock almost invariably closed the day's trading on an "uptick." The 10,000 shares which Gilligan, Will had purchased at a cost of two cents per share were sold on the Exchange on September 26 and 27, 1956 at 1⅞.

8. Gilligan and the Exchange Government

The Exchange cannot claim to have been unaware of the nature of the Gilligan, Will operation, since on numerous occasions, facts came to light which, if investigated, would have disclosed the manner in which Gilligan was conducting his activities. For example, prior to the listing of Guild Films, Gilligan filed a letter with the Exchange stating that he and George De Martini had purchased $500,000 worth of stock to add to the company's working capital in anticipation of listing. At the same time, an Exchange form was filed which disclosed that Gilligan, Will held more than 10% of Guild Films' outstanding common stock.

The Exchange was also aware of Gilligan, Will's participation in private placements of newly issued shares in stocks in which it specialized, because when these shares were approved for listing the firm was required to disclose its participation. Furthermore, in accordance with its rules, the Exchange was advised of many of Gilligan, Will's block purchases off the Exchange from issuers and individuals. However, at no time during the period when the Exchange required specialists to obtain permission to make such block purchases did Gilligan, Will ever obtain such permission.[47]

On one occasion, in July 1959, Gilligan appeared before the Committee on Floor Transactions on charges that he had violated Rule 174 of the Exchange, which restricts specialists' transactions in securities in which they are registered to those which are reasonably necessary to maintain a fair and orderly market. The charges arose from a letter by the Division of Trading and Exchanges advising the Exchange that on July 10, 1959 Gilligan and Louis Alter, a floor trader closely associated with him, had purchased 56,000 shares of

[46] The attitude of the firm of Gilligan, Will towards investment letters is vividly illustrated by a card appearing in the customer files of the firm under the letter "I" which reads as follows: "Investment Letters—In Cabinet Underneath Counter Desk Where Willie [Will(?)] Works—Stencils For Letters on Lower Shelf."

[47] An amendment to Rule 187, adopted May 18, 1961, eliminated the exception to the rule against block purchases that provided such purchases were permissible if individually authorized by Exchange authorities.

Guild Films stock, representing approximately 50% of the volume for the day. On that day the price of the stock rose from 2¼ to 2⅞—up about 25%. Gilligan appeared before the Committee and testified that his purpose in making these large purchases was to cover a short position which he held in Guild Films. He also told the Committee that he had had inside information that a merger of Guild Films with another company was contemplated. Despite the fact that Gilligan's explanation could hardly be regarded as an adequate answer to the charges, the Committee unanimously decided that he had not violated Rule 174. It is significant that of the eight members of the Committee who were present, five were specialists and one was an ex-specialist.

The entire pattern of activities conducted by Gilligan, Will was so clearly contrary to the functions of a specialist as set forth in the statute and the rules of the Exchange that the Exchange might have been expected to act promptly in putting a halt to them. It would appear, however, that Gilligan was immune from disciplinary action by the Exchange. He testified that he has not been the subject of a disciplinary action of the Exchange for at least twenty years.

Gilligan was an Exchange governor from 1939–40. He did not stand for re-election because "it is a terrific headache. Only the people who want glory take it." His relationship with the individuals who governed the Exchange for the past several years is of interest, however. McCormick purchased shares in several securities which were then, or later, traded at Gilligan's post. A number of these purchases were made on the recommendation of Edward L. Elliott, a close associate of Gilligan's, at whose firm McCormick maintained his account.[48] Mooney acquired $5,000 principal amount of Crowell-Collier debentures as a favor from Gilligan.[49] Dyer's specialist account is financed by Gilligan, Will (the latter firm participates in 10% of the profits) and Bocklet's specialist account clears through Gilligan, Will.[50]

A transaction which occurred between Gilligan and Reilly in 1959 is worthy of note. In January 1959, Gilligan placed in Reilly's account 4,700 shares of Guild Films stock. Reilly was then chairman of the Committee on Floor Transactions. This was part of a block of 63,000 shares of unregistered stock which Gilligan had acquired over the counter indirectly from a company controlled by Alexander L. Guterma. According to Reilly, he knew nothing about the transaction until after it had been consummated. Upon learning of the purchase, Reilly immediately sold the stock at a profit of approximately $2,300. Reilly was called upon six months later to participate in a disciplinary proceeding in his capacity as chairman of the Committee on Floor Transactions, before which Gilligan was called to explain his trading in Guild Films stock.[51]

The testimony of a former chairman of the Committee on Business Conduct, John Brick, a partner in Paine, Webber, Jackson & Curtis, is especially pertinent at this point:

> My own personal feeling was that somewhere along the road, Gilligan & Will had an interest in too many situations relating to the Exchange; that is, the individual members, not the management of the Exchange. That, in having that interest, say, in having financed seats, which I thought they had been doing, financing books, which they possibly were doing, or at least, I thought they were doing, they were quite powerful over there. Having learned the nature of the man later, which I did not know when I had this feeling over there, I decided in my own mind that he would be the fellow to use whatever power he had.

Apparently the only specific disciplinary action taken against Gilligan within the last twenty years was the five day suspension from the NASD which the Commission imposed on Gilligan, Will for violation of the Securities Act in the *Crowell-Collier* matter.[52] This penalty was hardly a deterrent to future violations of the kind and extent described herein, particularly since the specialist is not dependent upon NASD membership for his livelihood. Gilligan testified that the Commission's penalty had no effect whatsoever on him financially.

C. Other Problem Areas

Apart from the matters discussed above as being particularly exemplified in the case of Gilligan, Will, other problem areas involving specialist activities relevant to the organization, management and regulation of members of the Exchange, were disclosed in the investigation.

1. Public Customers

The traditional view of the specialist is that he acts as a broker's broker and has no direct dealings with the public. A leading writer on the subject

[48] See Sections I D(4) and II A *supra*.
[49] See Section I D(5) *supra*.
[50] See Section III B(1) *supra*.
[51] Discussed *supra* in this sub-section.
[52] Described in Sec III B(7) *supra*

of the stock market has stated: "The customers of a specialist are other members of the exchange; he transacts no business with the general public." [53] The specialist certainly does not require public customers to properly perform his functions on the floor of the Exchange. In neither his capacity as broker nor as dealer is it necessary for him to be in direct contact with a member of the public.

It has been seen above that Gilligan, Will maintained an active clientele of "public" customers consisting of a preferred list of friends, relatives, business associates, and corporate insiders.[54] These accounts traded actively and, upon occasion, in co-ordination with the specialist in the securities in which he specialized. The orders to buy or sell were generally given to one of the office partners of Gilligan, Will and then transmitted from the office to the floor of the Exchange. The specialist always knew when he was executing a Gilligan, Will order since the name of the firm appeared on the order. Some customers were able to place their orders directly with Gilligan on the floor.

Gilligan, Will is not alone in maintaining accounts of public customers. Various specialists testified that they handled the accounts of friends and relatives, which included the officials of companies in which they specialized. One stated that he had between 400 and 500 public customers who occasionally traded in the securities in which he specialized and that these public customers included corporate officials of companies in whose stock he specialized. The specialist in Colonial Sand & Stone Co., Inc., Victor Grande, testified that the controlling stockholders of that company traded in the stock through him and that he is on close personal terms with those individuals. A partner in a firm which specializes on both the American and the New York Stock Exchanges testified that he handles orders for public customers, which orders come to the floor through his clearing agent.

The individuals and firms mentioned above do not maintain a sales organization for the solicitation of retail orders. On the other hand, certain member firms having one or more partners specializing on the Exchange do also maintain an organization for the solicitation of public business. The customers of such firms may trade in stocks listed on the Exchange, including securities traded at the post in which one of the firm's partners is registered as specialist.

The potential abuses of a system wherein specialists are permitted to handle orders on behalf of "public" customers of their firms are clear. The danger exists that such customers will receive preferential treatment in the execution of their orders. The danger also exists, as amply demonstrated in the cases of the Res and Gilligan, Will, that these public customer accounts may be used by the specialist to assist him in making large scale distributions through the Exchange mechanism.[55] Four of the specialists questioned on the subject of public customers stated that they maintained no such accounts, and one of them testified that he saw no need for the maintenance of such accounts.

Under a new Exchange rule, a specialist is prohibited from effecting any business transaction with a company or officers or directors of a company in whose stock he is registered as a specialist.[56] This rule has been interpreted by the Exchange to bar a specialist from acting as broker on behalf of a company, its officers or directors (apparently excluding principal stockholders) in the handling of orders on either the American or New York Stock Exchanges. The specialist is now required to report to the Committee on Floor Transactions all accounts introduced by him to member firms, and he must state whether he has a beneficial interest in such accounts.[57] There is no rule, however, with respect to a specialist's executing orders for friends, relatives, business associates, and customers of his firm in the stocks in which he specializes.

2. Long-Term Investment Accounts

A practice which has become prevalent among the Exchange's specialists is that of segregating securities in which they specialize in so-called "long-term investment accounts." The primary motive behind the creation of these accounts is to turn profits which would otherwise be taxed as ordinary income into long-term capital gains. Section 1236 of the Internal Revenue Code is the key provision. It provides that a gain by a

[53] Leffler, *The Stock Market* (New York, 1957), p. 216

[54] Section III B(6), *supra*. Another very important example of this practice is discussed in the brief of the Division of Trading and Exchanges in the matter of *Re, Re & Sagarese* dated April 28, 1961, pp 79–80

[55] Section III B(7), *supra*. Brief of the Division of Trading and Exchanges in the matter of *Re, Re & Sagarese* dated April 28 1961, pp 79–80

[56] Rule 190(a), effective May 18, 1961.

[57] Rule 190(b), effective May 18, 1961.

dealer in securities from the sale of a security shall not be considered as a capital gain unless: (a) the security was identified within thirty days of the acquisition as a security held for investment; and (b) "the security was not, at any time after the expiration of such thirtieth day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business."

Such long-term investment accounts have been referred to in several places in the above discussion of Gilligan, Will.[58] In addition, Reilly testified that approximately half of the specialists currently registered on the Exchange maintained long-term accounts in one or more securities during the past five years. He also submitted a list showing those joint specialist accounts which held segregated or long-term accounts as of October 23, 1961 (Appendix V). Seventeen joint accounts appeared on the list.

The securities in these long-term or segregated accounts were purchased either over-the-counter or on the Exchange. Over-the-counter purchases by specialists are now prohibited by Rule 187 of the Exchange. However, purchases made on the Exchange for the purpose of segregation into long-term investment accounts raise problems which go to the heart of the specialist system. The specialist is permitted to trade for his own account only when such trades affirmatively contribute to the maintenance of a fair and orderly market. Despite this directive, four specialists and an exspecialist testified that they decided in advance to accumulate a long-term position in a particular security and then made purchases of that security on the Exchange with the intention of segregating into a long-term account. Where the specialist goes into the market with the intention of segregating the securities purchased and not with the purpose of creating a fair and orderly market, the trading is clearly contrary to the statutory and regulatory standards. Beyond this, the specialist with a long-term position now has a stake in seeing that the security rises in price—he has become an "investor" as well as a dealer. The accumulation and segregation of large blocks of stock in long-term accounts also tends to decrease the floating supply, and in a low capitalization stock this may well have the effect of raising the market price.

A further problem arises when the specialist who maintains such long-term accounts is required to sell stock to maintain a fair and orderly market and he has no stock in his specialist trading account. It is Reilly's opinion that the specialist never really "owns" the stock in which he specializes since he must always hold such stock in readiness for delivery according to the needs of the market. Both Reilly and Mooney have stated that they consider all stock in long-term accounts available for the needs of the market and that the specialist must make delivery of such shares before selling short. Of course, if the six month period of the tax statute is almost over, the specialist may well be tempted to keep his stock in the long-term account and neglect the needs of the market.

Specialists do not agree among themselves as to whether they would deliver stock out of their long-term accounts in order to maintain a fair and orderly market or whether they would sell short and keep the stock in these accounts. Four specialists testified that they would sell short before delivering shares out of their long-term investment accounts, and this includes a partner of a firm which also specializes on the New York Stock Exchange. It is interesting to note that two participants in the same joint book (James and Louis Herman) had differing opinions as to whether they would make delivery out of their long-term accounts to meet the exigencies of the market. This diversity of opinion indicates that the specialists were not made aware of Reilly's and Mooney's opinion that they must make delivery out of their long-term accounts.

An opinion expressed by Reilly before the Committee on Floor Transactions on January 28, 1960 is pertinent in this connection. In opposing a proposal by James F. Rafferty & Co., Inc., an incorporated specialist firm, to set up a partnership for the purpose of maintaining long-term accounts, Reilly stated that the obligations of a specialist transcend any desire as an individual to take advantage of the capital gains tax and that specialists must conform to the requirements of Rule 174, i.e., that a specialist shall trade as dealer only when reasonably necessary to maintain a fair and orderly market.[59] The Committee apparently acquiesced in Reilly's statement since Rafferty was not permitted to set up the partnership requested.

[58] Section III B, *supra*

[59] As to this rule, see Section III A (1) and (3), *supra*

However, Reilly's statements before the Committee had little, if any, discernible effect beyond the immediate occasion, since three members of the Committee at that time still maintain such accounts, and, as stated above, Reilly's data show that seventeen joint specialist books currently have long-term accounts.[60] In addition, after Reilly's ruling, Rafferty's co-stockholders maintained personal investment accounts which dealt substantially in the securities in which Rafferty specialized. These activities are considered in the next subsection.

3. Financing Arrangements

Rule 170(b) of the Exchange, which became effective on June 15, 1961, requires every registered specialist and every joint account acting as a specialist to maintain a cash or liquid asset position in the amount of $10,000 or in an amount, sufficient to assume a position of four units of each security in which the specialist or joint account is registered, whichever amount is greater. The Exchange does not require the specialist personally to have this cash or liquid asset position since he is permitted to rely upon a line of credit.

As described in Section B(1) above, it is not unusual for one specialist to be financed by another and in fact, Gilligan, Will acts as banker for numerous specialist accounts on the Exchange.[61] These financing arrangements are open to the criticism that if all the accounts being financed require substantial credit at the same time because of market pressures, which may also affect the financing firm, the latter may be unable to supply the necessary funds. The amount of financing available to a specialist obviously affects his ability to maintain a fair and orderly market. Gilligan's testimony to the effect that his financed accounts must check with him on certain purchases and that he might require them to sell stock to lighten their positions is illustrative of the problems presented.[62]

Another type of financing arrangement encountered in the investigation is that of James F. Rafferty & Co., Inc., the sole "incorporated specialist" on the Exchange. This corporation was formed in January 1960 with a group of five persons furnishing virtually all of the working capital by stock purchases and through loans in return for 60% of the equity. Only one of them received voting stock (the other four hold non-voting stock) and as an allied member is subject to Exchange discipline. None of the individuals had had any prior experience in the securities business, and none has ever worked on the floor.[63]

After James F. Rafferty & Co., Inc. was formed, Rafferty's co-stockholders effected a large number of transactions and held very substantial positions (in brokerage accounts of their own, their wives, investment clubs in which they had substantial beneficial interests, family trusts and foundations, and corporations which they controlled) in stocks in which Rafferty was specialist. The most dramatic example occurred in the stock of Cubic Corporation. Since January 1960 they have purchased more than 10,000 shares of that company's stock over the Exchange at a total cost of over $600,000 and sold over 7,500 shares for about $450,000. At one point (in September 1960) they held approximately 25,000 shares of Cubic stock with a market value of approximately $1,500,000.[64]

The dangers in permitting co-stockholders and partners of a specialist to purchase, sell and hold blocks of securities in which he is registered, without the restrictions applicable to the individual specialist, are apparent. The most important are those which are involved in the old "pool" op-

[60] From January to October 1960, Rafferty, the person to whom Reilly's remarks were directed, acquired and maintained in his specialist trading account very large positions in several of the securities in which he was the specialist. On November 7, 1960, the Committee on Floor Transactions, after learning the extent of these positions, expressed the opinion that these "would appear to be investment positions rather than specialist trading positions and that in the future he [Rafferty], should guide himself accordingly under the Saperstein opinion that a specialist should make only such transactions as may be reasonably necessary to maintain a fair and orderly market and continuity of price." It is not clear why the Exchange's regulatory action in the Rafferty situation appears to have been more vigorous than in other generally comparable situations

[61] Section III B(1), *supra*

[62] *Ibid.*

[63] It is clear from the testimony that these men financed Rafferty not only because they hoped to make money from the specialist business but also because they hoped that through Rafferty's efforts in locating good companies, as future candidates for listing, they would themselves receive opportunities for investment. Exchange approval of this corporate setup took place in March 1960. However, Reilly's testimony indicates that he has never agreed with that decision.

[64] This represented about 30% of the floating supply of Cubic stock at that time. Cubic was one of the stocks in which they acquired a substantial position on Rafferty's recommendation prior to the formation of James F. Rafferty & Co., Inc. These individuals have stated that the purpose of their purchases was generally that of investment; and with few exceptions, the securities purchased in these accounts were held for more than six months.

erations.[65] But even assuming the absence of deliberate concerted action of that kind, important problems remain. For one thing, the specialist, in accounting to his business associates for his operations on the floor of the Exchange, is faced with the difficult task of avoiding disclosure of the state of his book. Further, it is problematical whether the specialist, in such circumstances, can avoid the temptation to give preferential treatment to his co-stockholders in the execution of their orders. In addition to the close relationship which frequently exists among stockholders of a securities firm, there is in this case the added fact that "outside" stockholders have supplied virtually all of the capital for the conduct of the specialist's business.

Rafferty's associates contend that they were advised by counsel that Reilly's views before the Committee on Floor Transactions with respect to long-term accounts did not apply to them as individuals if their transactions were entered into (as they stated was the case) without consultation with, or prior notice to, Rafferty. As their counsel has pointed out, the prohibitions of Rule 174 of the Exchange do not by their terms apply to co-stockholders of the specialist.

In closely related areas, the Exchange has recognized the desirability of preventing conflicts of interest similar to those noted above and the necessity of extending regulations to partners and co-shareholders of a specialist; thus Rule 175 (relating to transactions in unlisted puts, calls, and other rights relating to listed securities, joint accounts for the purchase of listed securities, and other matters) by its terms includes partners and co-stockholders of a specialist within its limitations.[66]

[65] See *Stock Exchange Practices*, pp. 47–50 (73d Cong., 2d Sess., Senate Report 1455).

[66] Rule 175 provides:

"No specialist, member firm of which he is a partner or partner thereof, or member corporation in which he is a holder of stock or any stockholder therein shall, directly or indirectly:

"(a) Acquire, hold or grant any interest in any put, call, straddle, option or selling agreement in any security in which such specialist is registered, or in any right or warrant to acquire such security when such right or warrant is not admitted to trading on the Exchange

"(b) Acquire or hold any interest or participation in any joint-account for buying or selling on the Exchange any security in which such specialist is registered, except a joint-account with a partner of such specialist or a regular member or regular member firm or regular member corporation of the Exchange, which joint-account has been reported to the Exchange pursuant to Rule 360 and not disapproved.

"(c) Acquire or hold any security which is convertible into any security in which such specialist is registered when such convertible security is not admitted to trading on the Exchange.

"(d) Acquire or hold any interest or participation in any finder's fee payable in cash, stock, or otherwise, which finder's fee is paid or to be paid by any person in connection with a transaction effected or to be effected by or with the issuer, or in any security of the issuer, of the stock in which such specialist is registered."

Paragraphs (c) and (d) were added on July 6, 1961.

It is interesting to note that one of Rafferty's co-stockholders held calls in two stocks in which Rafferty was specialist in direct violation of this rule.

4. Disclosure of the Specialist Book in Secondary Distributions[67]

Rule 393.15(a) of the New York Stock Exchange provides in part:

> When a Secondary Distribution becomes effective after the close of the market, the distributor, for at least one-half hour after it becomes effective, shall make and keep available to the members of the Exchange, through the specialist in the security, a sufficient quantity of the security being distributed to fill all bids represented on the Floor at the close of the market at or above the offering price.

This rule has been informally adopted by the American Stock Exchange and made applicable to secondary distributions by member firms of stocks listed on the Exchange.

It is apparent that the rule envisages some disclosure of bids on the specialist's book. However, there appears to be no practical objection to the rule if the disclosure occurs after the close of the market and the sole purpose is to make a *bona fide* offer to the members of the public whose buy orders at or above the offering price are on the book.

The rule itself does not specify how or when the underwriter secures the information necessary to set aside the amount of stock he must keep available for the book. Reilly, McCormick and Lee (director, Department of Admissions and Outside Supervision) testified that the proper procedure is for the underwriter to obtain the necessary information from an Exchange official *after* the close of trading on the date of the offering. Lee testified that at no time is a representative of the underwriter entitled to go directly to the specialist and obtain the bids on his book. He also testified that there is no reason for the underwriter to know the price specified in each bid above the offering price since his only obligation is to fill such bids at the offering price. However, it appears that the Exchange government has failed to provide a clear written statement as to what its

[67] For the purposes of this section, "secondary distribution" means an offering of a block of a listed security off the floor at a price not exceeding the last sale price of the security on the floor at the time of offering. The offerings discussed herein were registered under the Securities Act of 1933.

officials recognize as proper procedure and that in practice there have been significant departures from such approved procedure.

Wickliffe Shreve, senior partner of Hayden, Stone & Co., has testified that it was his practice, with regard to secondaries on both the American and New York Stock Exchanges, to inquire of the specialist directly, a day or more prior to the date of the offering, as to the aggregate bids on the book between the market price and the estimated offering price. He asserted that it is necessary for Hayden, Stone to have this information (which it did, in fact, obtain) prior to the offering so that it will have some idea as to how much stock must be allocated to the book and how much will be available for allocation among the members of the underwriting group.

Several registered secondary offerings in which Hayden, Stone was the principal underwriter have been examined, including Barnes Engineering Co., Cubic Corporation, Majestic Specialties, Inc., and Electronic Assistance Corporation [68] In the first three cases, the specialists denied having been asked by Hayden, Stone for the bids at or above the offering price prior to the close, and further denied that they had ever furnished such information to an underwriter.[69]

With respect to the Electronic Assistance secondary in May 1961, the following is an excerpt from the minutes of the Committee on Floor Transactions meeting of May 8, 1961:

> Mr. Reilly informed the Committee that Hayden, Stone & Company were coming out with a Secondary Offering for a block of stock starting tomorrow night; that the partners of said firm contacted Mr. Robert J. Smith, Specialist in said stock, namely, Electronic Assistance Corporation, and gave him prior information as to the price. Mr. Reilly stated that this appeared to be in violation of the Federal Law in giving prior information to the Specialist long before the SEC had approved the price. Mr. Reilly also stated that during that period of time a partner of Hayden, Stone & Company indicated he wanted to know how much stock was on the book down to the offering price; that Mr. Smith admitted that he gave the information to the partner on the particular day and that the partner today wanted the book from Mr. Smith and that Mr. Bohner, floor partner for Hayden, Stone & Company, when discussing the matter with Mr. Smith, stated that he could not understand Mr Smith's reluctance since the Specialists in two former cases, namely Cubic Corporation and Majestic Specialties, gave the book on those operations ahead of time.

There is some conflict in the testimony with regard to the identity of the persons associated with Hayden, Stone who contacted Smith, but it is clear that Hayden, Stone was the firm seeking knowledge of the book prior to the offering. Smith's testimony in general corroborated the account set forth in the minutes, except that he denied that he had given the book to Hayden, Stone prior to the offering. He conceded, however, that he may have given the partner of Hayden, Stone an indication in general terms as to the state of the book.[70]

On the following day, after the close, Vernon Lee prepared the following memorandum:

> MAY 9, 1961.
>
> MEMORANDUM
>
> In connection with a secondary distribution of Electronic Assistance Corporation, Mr. McCormick called and said that Hayden, Stone & Co. apparently has approached specialists before the commencement of secondary distributions in order to determine the possible requirements of the specialist for stock to fill orders at or above the offering price.
>
> Mr. McCormick said that the firm had been told it should not approach the specialist since he is not permitted to disclose this information regarding his book to them any more than to any other member.
>
> When I went to the specialist after the close to obtain the usual basic information preparatory to the approval of the secondary in Electronic Assistance Corporation, I asked Mr. Smith for information regarding the number of shares he would need to fill orders at or above a price

[68] James Rafferty was the specialist in Barnes and Cubic; Vincent Leonard, Rafferty's associate in a joint book, was the specialist in Majestic; and Gerald Sexton and Robert Smith were specialists in Electronic Assistance.

[69] Leonard testified that in the case of Majestic Specialties, he furnished the necessary information on request after the close directly to Hayden, Stone, and that he has never been asked by an Exchange official for such information in connection with a secondary offering. Cf. Section III B(4), *supra* with regard to the Cubic offering.

[70] Other aspects of Smith's testimony with regard to the Electronic Assistance secondary are worthy of note. Smith testified that approximately one week before the secondary became effective he received a telephone call on the floor of the Exchange from Shreve, who during the conversation explained to him Hayden, Stone's method of pricing the secondary. According to Smith, Shreve explained that the price of $37 a share was to be used as a base and that, on the offering date, for every point in the closing price of the stock over 37, the secondary would be priced up half a dollar. At the time of the conversation Electronic Assistance was selling at 46. Smith also testified that during this conversation Shreve stated that the price of the stock was too high, that Hayden, Stone would not be able to sell the secondary at anywhere near that price, and that in fact he (Shreve) thought this would be true of any price over 41. Smith stated that Shreve then asked him what his position was in Electronic Assistance and when Smith informed him he was long approximately 2,500 shares, Shreve replied, "You know your business better than I do but if I were you I would get out of the position because I think the stock is too high." Shreve denied that he ever had a conversation with Smith along those lines He admitted, however, that he made a similar advance disclosure to the specialist as to Hayden, Stone's pricing formula in connection with the Cubic secondary in September 1960. See Section III B(4), *supra*.

four points below the closing price. The firm in this case proposed to offer the stock at a price approximately four dollars under the closing price. I passed on to the firm the amount of stock which would be needed, after getting counsel's approval. The firm then asked the amount of stock which would be needed to fill orders on the specialist's book at or above a price two points below the closing sale. After talking to counsel, I gave the firm this additional information.

* * * * *

Henceforth, member firms contemplating secondary distributions are not supposed to go to the specialist for information regarding orders on his book.

It is to be noted that at the time of Lee's initial inquiry of Smith the offering price of the secondary had not been finally fixed, and that Hayden, Stone, with Lee's assistance, apparently sought to use the information from the book to adjust the offering price of the secondary.[71]

Disclosure by a specialist to an underwriter of orders on the book prior to the fixing of the offering price would seem to be in direct violation of Section 11(b) of the Exchange Act. Moreover, the possibility of abuse in connection with the disclosure of non-public information on the specialist book in secondary offerings as revealed by the instant investigation is substantial. For example, the underwriter, issuer, or selling stockholder may adjust the offering price or the time of offering because of the receipt of such non-public information in order to benefit themselves. While Reilly and other Exchange officials have indicated that they concur in these views, it is evident that the principles have not been made sufficiently clear to the Exchange staff and member underwriting houses.

[71] The offering was finally made at a 4½ point discount with approximately 5,000 shares being supplied to fill bids on the book.

D. Conclusion

Specialists are at the heart of the problems of organization, management and disciplinary procedures of the Exchange. Their dominance of the administration of the Exchange, their overriding concern for expansion of business through new listings, the misuse of their fundamental role in the operation of a fair and orderly auction market, and the breakdown of regulatory and disciplinary controls over them—all are part of a complex pattern of interlocking causes and effects. It is for this reason that any program of reform must concentrate heavily on the dominant role of the specialist.