data as to his present and prior employment, disciplinary matters, and eligibility under statutory disqualifications, together with a certificate as to his good character and, for applicants without adequate prior experience, as to his successful completion of any required examination. Copies of the basic registration form would be made available to affected regulatory and self-regulatory agencies. Subsequent changes in employment and disciplinary actions should be required to be reported and recorded in the individual file. Duly licensed persons would be, for regulatory purposes, eligible for employment by any firm.

5. Under such a system of licensing and registering individuals, disciplinary actions could, in appropriate cases, relate to individuals without necessarily involving current or future employers, as is now the case. The present system, under which the Commission may proceed only against a broker-dealer firm, often operates inefficiently or unfairly in that the Commission must move against an employee's firm or not at all. The Commission's powers in this respect should therefore be made more flexible even apart from the recommendation in paragraph 4, so that it will have the power to bring administrative proceedings directly against individuals involved in violations of the securities laws.

6. Apart from statutory disqualifications and requirements for filing of basic data by firms and individuals, standards for entry into the securities business should encompass (a) competence, in the sense of knowledge and experience; (b) character and integrity; and (c) financial capacity and responsibility—the first two applying essentially to individuals and the third essentially to firms. In all three areas there have been significant accomplishments but there are serious gaps and deficiencies that need to be remedied promptly, as set forth in the following paragraphs.

7. The basic regulatory control in respect of competence is the examination. Present examinations and examination programs can and should be considerably improved, refined, and coordinated. The standard examination should cover a core of basic subjects for salesmen, supervisors, and principals, with appropriate supplemental questions for supervisors and principals, and with such further supplementation as any particular agency may desire for its own purposes. For certain recognized specialties, special supplementary questions should be provided; individuals whose activity (and license to act) is to be limited to any such specialty may be permitted to qualify through appropriately limited examinations. To achieve maximum results with minimum burdens, a National Board of Securities Examiners should be established by and for the various regulatory and self-regulatory agencies, to administer existing programs, and foster improved programs. Through the same or a similar agency, the various existing training programs should be coordinated, extended, and improved.

8. Quite apart from knowledge as tested through examination procedures, appropriate experience in the securities business should be a requirement for individuals in certain crucial roles. The individuals for whom there should be an experience requirement include at least one principal in each registered firm and, if other than such principal, the individual designated as being in

charge of regulatory and self-regulatory matters, the supervisor of selling activities, the supervisor or manager of each branch office, and the supervisor of research activities. Appropriate periods and types of prior experience are left for future definition.

9. The matter of part-time salesmen has been the subject of considerable difference of opinion among members of the financial community and regulatory agencies. There appears to be no reason to exclude part-time salesmen as such, but they should be subject to exactly the same qualification requirements as full-time salesmen.

10. Of all the types of qualifications needed for the securities business, perhaps the most important, but also the most difficult to assure by formal regulation, is that of character and integrity. As rapidly as possible a system involving local "character and fitness" committees, as in the legal profession, should be established. More immediately, the responsibility for maintaining a proper level of character and integrity of all personnel must reside in the individual firm, but with effective enforcement of this responsibility by the self-regulatory agencies. In addition, regulatory and ethical standards should receive greater emphasis in training and examination programs of the self-regulatory agencies. If the latter are to fulfill the role for which they are thought to be uniquely suited, they must also, of course, exert leadership in defining and elevating ethical standards for their members, above and beyond legal requirements.

11. A minimum net capital requirement is of high importance as one of the several different approaches to assuring a broker-dealer community of principals and firms reasonably qualified in terms of responsibility and commitment. The requirement need not and should not be a uniform one for all firms but should be appropriately scaled to reflect the type and size of business engaged in. Subject to exceptions and refinements to be worked out in the future (such as special provision for small proprietorships engaged only in sale of open-end investment company shares), and subject to an appropriate "grandfather" clause or adjustment period, every broker-dealer should be required to have at the commencement of business, and maintain at all times thereafter, net capital of at least $5,000, plus, say, $2,500 for each branch office and, say, $500 for each salesman employed at any time.

12. Since the underwriting of public offerings involves special obligations and responsibilities, any firm engaging or proposing to engage in underwriting securities offered to the public pursuant to the Federal securities laws, whether on a "firm commitment" or "best efforts" or any other basis, should be required to have and maintain minimum net capital of $50,000 plus, say, 2 percent of the aggregate amount of underwriting commitments or undertakings in the most recent 12-month period (but not less than the amount required under par. 11).

and needs. Where there is total reliance on the salesman's recommendations, as in discretionary accounts, or partial reliance, there is an even greater obligation for the salesman to be guided by the best interests of his customer. Human nature being what it is, however, considerations other than the welfare of the customer may divert his attention from these obligations. Principally, these considerations are the salesman's compensation and the merchandise which his firm may provide for him to sell.

Compensating salesmen on a commission basis is an almost universal practice. Many are paid a draw against commissions, but the direct stimulus of the commission to the production of business still remains. Many firms increase this awareness by paying the salesman a larger percentage of all commissions in a month in which his total commission business exceeds a certain figure. While some firms have insulated salesmen somewhat from direct dependence upon the amount of commissions they earn, the prevailing trend has definitely been the other way.

In addition to volume, the salesman's compensation for a given transaction varies according to other factors. One important such factor is the NYSE minimum commission rate schedule, which, with its prohibition against splitting commissions with nonmembers, diminishes or eliminates commissions for salesmen of nonmember firms from transactions executed on that exchange. Commissions from customers' purchases of over-the-counter stocks are frequently higher for all salesmen—including those of most NYSE member firms—than commissions from sales of listed stocks. The directness of the impact of compensation is demonstrated by the effectiveness of extra compensation paid to salesmen in distributions of blocks of securities. Under this stimulus, there is usually little problem in disposing in a few hours of a block which might normally take days to sell. The potential influence of such factors as these on the economic incentives of salesmen is clear.

The extensive variety of securities sold to the public makes specialization inevitable, and it is desirable to the extent that it affords to the investor the benefit of expert valuation by a dealer of his merchandise. One risk that specialization involves for the public, however, is exemplified by the type of firm which obscures its specialization at the same time as holding itself out as willing and able to give impartial advice on investments of all kinds. Within this category are the firms specializing in speculation, whose salesmen concentrate on selling low-price stocks of high-risk companies without knowledge of or concern for the financial curcumstances or needs of their customers, and sometimes without even a superficial knowledge of the securities they offer. An even more menacing specialty is the boiler room, which characteristically sells obscure or worthless stocks to unknown and unseen members of the public through long-distance telephone campaigns and by means of glowing and thoroughly misleading descriptions and forecasts, and other devices.

High-pressure selling, particularly during the recent bull market, has not been confined to the boiler rooms and other marginal firms, but has been found to exist even in the branch offices of some large, well-known NYSE brokerage firms. During the study, complaints were received from the public concerning objectionable selling by salesmen for large member firms. Limitations on the time and man-power available to the study precluded investigation of every complaint, but the limited number that were investigated confirmed the existence of unethical and improper selling practices among salesmen of larger firms and, combined with the study's other findings, confirmed that they were not mere isolated instances. Examples were disclosed in public hearings. One involved overtrading customer accounts and check-kiting in a branch office atmosphere of indifference to rules. It also involved neglect of the problem by home office supervisory personnel. A second showed the highly communicable nature of speculative fever, with salesmen of a number of leading NYSE member firms vigorously soliciting sales of a stock which at best might be described as marginal, some of them using high-pressure telephone calls, repeating a totally misleading picture of the company's position and prospects based on grossly inadequate information, and ignoring the suitability of the investment for their customers. The third case involved a total breakdown in supervision resulting in the aggressive sale of stock of a highly risky new issue to public customers on the basis of unwarranted predictions of earnings and suggestions of the firm's interest in the company, with salesmen taking sizable positions and subsequently selling their own holdings at the same time they were recommending purchases or discouraging sales by customers.

Broker-dealers are charged with the responsibility of supervising the activities of their employees by the Federal securities laws and the rules of the NASD and the exchanges. The larger firms, where problems of supervision are most acute simply because of their size, have established elaborate systems of internal supervisory controls. In firms with numerous branch offices a complex organizational structure may exist, but all firms and authorities emphasize that the key to proper supervision is the branch manager. In almost all large firms the branch manager is required to review all transactions on a daily basis, and in many he must approve large or unusual orders, new customer accounts, and transactions of new and inexperienced salesmen. Despite the heavy burden of administrative duties and supervisory responsibilities carried by branch managers, few firms have chosen to relieve them of the burdens of servicing their own customer accounts, and most continue to compensate them for such business on a commission basis.

Centralized, or home office, controls form a second keystone of internal supervision. Principally these consist of senior supervisory personnel (an executive committee of partners, regional and national managers, or some similar organization), an internal audit system, and electronic data processing equipment (EDP) upon which almost all large firms rely and without which they would be unable to conduct their businesses. EDP, which can make possible daily home office review of all branch office transactions and can promptly disclose unusual activity of any kind in any branch, is indeed a valuable tool of supervision, but no machine alone can supervise men. As indicated by the cases developed in the public hearings, unfortunate situations in branch offices can go undetected despite the use of EDP. Its proper use as a supervisory tool requires training, skill, intelligence, and vigilance on the part of those who use it.

The types of selling practices which the industry generally seeks to exclude but which occur with sufficient frequency to warrant special vigilance on the part of supervisors and supervisory systems include overtrading of customer accounts, misrepresentations and high-pressure sales tactics, and recommendations of securities unsuited to the customer's financial resources and investment objectives. Of the three, overtrading generally receives most attention in internal supervision systems. Procedures to detect overtrading are included at almost every level in most large firms from branch manager to home office review, and EDP may be used to detect obvious abuses in this area. The evidence of overtrading found by the study even in firms which use these procedures, however, suggests either inadequate review of the information developed or inadequacy of the existing procedures themselves in light of the volume of transactions involved. Effective control of salesmen's oral representations is obviously difficult, but firms could place greater emphasis on regular branch manager conversations with customers, thorough investigation of customer accounts, and continuing training in ethical selling methods. Most firms appear to place little emphasis in their supervisory processes on the important NASD requirement of suitability of recommendations. In recent months a significant segment of the brokerage community has shown a growing awareness of the importance of adequate supervision, evidenced both by public pronouncements and internal revisions of firm policies.

The Commission, the NASD, and the NYSE—the three principal regulatory bodies exercising control over the selling practices of securities firms and their salesmen—each has a set of rules covering the major problems which exist in this area. However, the adequacy of the substantive rules which delineate legal and ethical standards of selling in the industry are not always matched either by the techniques available to detect violations or the enforcement action applied after detection.

The Federal securities statutes and rules protect investors, both by prohibiting specific improper selling practices and by requiring disclosure of material facts in securities transactions. In addition, the antifraud sections of the securities laws prohibit fraudulent schemes and devices peculiar to the sale of securities, and the Commission relies primarily on these sections in its enforcement actions directed against illegal selling activities. A substantial portion of the Commission's enforcement activity has been directed at firms of the boiler-room type, although proceedings against large and well established firms have been instituted when the facts warranted such action.

The emphasis of the Commission's enforcement program on the more serious frauds and the boiler rooms has several reasons. Under the statutory scheme of the Exchange Act, contemplating both Federal regulation and industry self-regulation, a natural division of labor allocates to the Commission control over clearly illegal selling practices—typified by the boiler room or the confidence man's tactics—while improprieties in the nature of unethical practices are left to the industry bodies. The pattern of legal sanctions also contributes to this emphasis, since the Commission can institute administrative proceedings only to revoke a broker-dealer's registration or to suspend or teminate membership in the NASD, but it cannot apply intermediate sanctions or proceed directly against a salesman. For isolated instances of illegal selling in a large, essentially well-run firm, the Commission's sanctions may often be too severe to justify their use.

Despite techniques which aid the Commission in identifying boiler rooms, such as its broker-dealer inspection program, its improved inspection procedures, and its use of NASD records and complaints from the public, the unscrupulous brokers and salesmen who compose the boiler-room blemish on the community are able in many cases to induce large numbers of public customers to invest in worthless securities before effective action can be taken. The recommendation in chapter II to raise qualification standards will help to reduce the incidence of boiler-room selling.

The NASD rules governing selling practices are sufficiently broad and inclusive to cover the major abuses found to exist in this area, as enumerated above. Unlike the Commission, the association can impose a wide range of sanctions which encompass censure and fine as well as the most drastic actions of suspension and expulsion, but although it can apply sanctions to the salesman directly, it cannot proceed directly against a salesman without involving the firm.

The methods used by the NASD to detect violations of rules among its members and their employees are not well geared to uncover selling practice abuses. The association does not, because of its relative anonymity, receive a significant number of public complaints; its examination program emphasizes financial and bookkeeping matters rather than selling methods, it makes almost no examination of the branch office—the seat of a substantial proportion of the selling abuses among the larger firms; and it has no procedure by which it can evaluate the efficacy of its members' supervision systems.

These limitations on the association's detection system do not appear to have handicapped it in its identification of boiler rooms. However, to facilitate the disposition of actions against such firms, proceedings are frequently based on violations of rules other than those relating to selling practices, especially by violations of the net capital rule. This practice unfortunately tends to allow unscrupulous salesmen to go to work in other firms, since they have not been named as causes in the proceedings. The benefit derived from simpler proceedings may therefore be overshadowed by the fact that their salesmen continue in circulation.

In its decision, the NASD demonstrates its ability to deal with boiler rooms either through findings based on violations of the financial and bookkeeping rules or on occasion through opinions relating to selling abuses which seem to set high ethical standards for its members, particularly in the area of suitability. For improper selling practices occurring in firms other than boiler rooms, the NASD procedures are less effective and its results less impressive.

Even member firms of the New York Stock Exchange are by no means immune to the problems of objectionable selling practices. In general the rules of the Exchange, which are superimposed on its members in addition to NASD and Federal rules, are adequate to cover the types of practices which have been disclosed in the course of the study. Its methods of detection of violations of these rules, however, have left much to be desired. Its stock-watching program, valuable as a tool in detecting manipulations, has little application to the types of selling practices which are the subject of this chapter. Its examination program, which, like the Commission and NASD inspection programs, primarily focuses on the books and records of member firms, is valuable too for detecting bookkeeping violations and signs of financial instability, but is equally impotent to detect improper selling. Finally, it has treated complaints from public customers, which are often a fruitful source of information on improper conduct of salesmen, in a manner which at best contributes little to the effective enforcement of its rules.

The Exchange has for some time been concerned about the limitations of the sources which it has had, and since 1955 has made sporadic efforts to determine other methods by which it could obtain knowledge of improper selling by salesmen of member firms. However, progress by the Exchange has been slow. Only after two customer interview programs in 1961 had convinced the staff that random sampling interviews were less effective than case investigation did the Exchange establish a unit of supervision and control for selling practices. Only after the study's public hearings disclosed extensive evidence of improprieties among salesmen of member firms did it expand the unit beyond its previous one full-time employee and one part time. The limited number of disciplinary proceedings concerned with the types of objectionable practices here discussed also suggests either the inadequacy of the Exchange's detection program or its reluctance to acknowledge that such practices are a matter of concern.

The Special Study concludes and recommends:

1. The supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures including, but not necessarily limited to: the designation of one home office senior executive responsible for internal supervision and regulatory and self-regulatory matters generally; increasing the branch manager's supervisory role while deemphasizing his selling activities in branches having large numbers of salesmen; and in large firms with many branches, the tightening of home office control procedures, with more extensive use of electronic data processing equipment programed to expose overtrading, undue concentration in speculative securities, and other potential abuses.

2. The self-regulatory agencies should establish clear standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms. While the recent publication of the New York Stock Exchange's guide to supervision and management of registered representatives and customer accounts represents a significant step in this direction, the implementation of the standards there set forth will call for strengthening of surveillance. The NASD control procedures in respect of selling practices are also in need of substantial strengthening. More regular and frequent examinations of branch offices are called for, and examinations should include interviewing salesmen, and in appropriate cases customers, when accounts shows heavy trading or concentration in speculative issues.

3. The Commission should adopt rules to facilitate and reinforce controls by firms, the self-regulatory bodies, and the Commission over selling practices. Such rules should, for example, require: that every retail transaction be designated "solicited" or

"unsolicited" in the permanent records of a broker-dealer; that all customer complaints be kept in a single file and available for inspection and examination by the Commission, the NASD, and the exchanges; and that customer account cards or similar records include such information as investment goals, occupation, and type of service desired.

4. Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of "suitability" of particular securities for particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement. The NYSE, which has less clearly recognized suitability as a standard of conduct, should make greater efforts to define its content and undertake necessary surveillance and enforcement. This area would seem to be a particularly appropriate one to be dealt with through statements of policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. Such statements of policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.

5. The importance of disclosure for the protection of investors has long been recognized in securities regulation, and it is of particular value in connection with selling practices. The present mandatory, officially filed disclosures by issuers (reports and proxy statements), extended and improved as recommended in chapter IX, should have wider and more prominent use in selling activities, and the obligations of broker-dealers in this regard should be appropriately defined by the self-regulatory agencies and the Commission. These obligations might include such matters as: actually consulting available officially filed data prior to recommending or selling specific securities; furnishing copies to customers in appropriate cases; and advising customers whether officially filed information is available with respect to any security recommended for purchase.

6. The almost universal industry practice of compensating salesmen in proportion to the volume of business produced may be assumed to be inherent in the nature of the business, but certain of its particular aspects may tend to introduce undue pressures or biases into the selling process. This would appear to be another appropriate area for continuing attention of the self-regulatory agencies, with the view to evolving rules and standards, in line with the best existing practices, that might eliminate or reduce the more extreme forms of pressure or bias in selling. Among possible measures in this direction that should be considered by broker-dealer firms and the self-regulatory agencies would be: making monthly compensation less specifically dependent on each month's production; eliminating a step-up of commission rates for transactions in a given month on reaching a stated

volume for the month; discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential; and requiring disclosure of extra compensation in respect of particular types of transactions.

7. The sanctions now available to the Commission in respect of selling practice and similar violations—revocation of a firm's registration with the Commission, or expulsion from or suspension (for up to 12 months) of membership in an exchange or national securities association—are sometimes unsuitable to the needs of particular cases, especially where the disciplinary action relates to only one or few salesmen or only one of many branch offices of a firm. The Commission should have more flexible powers to deal with the latter type of situation, so that it may invoke measures appropriate for dealing with particular kinds and degrees of misconduct rather than being limited to the choice between no sanction or an excessive or inappropriate one.

Part C. Research and Investment Advice

Recent years have seen a vast increase in the amount of published material directed by the financial community to the investing public and devoted to describing, advising, recommending and in some cases urging the purchase of particular securities. The greater part of this material is prepared by broker-dealer firms and sent without charge to their customers and to potential customers whose names may come from mailing lists or responses to advertisements. A smaller but still significant portion is prepared by firms not engaged in selling securities but registered with the Commission as investment advisers who, for a subscription fee, provide information and recommendations on specific securities through periodical publications, sometimes supplementing the recommendations in the periodical with some personal investment advice to the subscriber.

Published advisory materials have been produced by both sources in large and increasing volume. As might be expected, they have had an influence on investors and the security markets. When responsibly prepared, these materials play a useful part in the flow of reliable information about securities which is so important to sound investment decisions. When irresponsibly or recklessly prepared, or when too casually based on unfounded statements of unreliable company managements, they can start a chain reaction which may end in disaster for many investors. Such a chain reaction and its effect on the public was illustrated in the eager recommendations of the stock of Dunn Engineering Co. by publications of broker-dealers and subscription publishers alike shortly before the company's bankruptcy.

The preparation and dissemination of printed advisory matter has become an ordinary part of conducting a successful retail securities business today and plays an important part in sales promotion. The most common forms taken by broker-dealer published material are the market letter, sent daily or weekly, the research report, devoted to recommending a specific company or group of companies and sent regularly or occasionally, a monthly report and special securities reports, often in finished magazine form. Some of this material contains detailed and extensive evaluations of the merits, risks, and prospects of the securities considered. Far more of it does not purport to make any detailed analysis to support the recommendations. It generally classifies the securities in terms of investment goals, but omits any consideration of adverse data or uncertainties. Overwhelmingly the recommendations are to purchase; recommendations to sell securities are few, and for the most part deliberately avoided, even with respect to securities previously recommended whose prospects may have changed. The core of the recommendation is generally a projection, which often is in the form of an estimate of future earnings but which sometimes involves an outright prediction of a future market price well in excess of the present market. Ordinarily little information is given concerning the extent or method of research and about the person responsible for the recommendation. Moreover, usually there is no indication of any interest in or intentions as to the securities recommended on the part of the distributing broker-dealer firm, since few disclosures of these facts go further than an unrevealing boilerplate hedge clause.

While the material produced by subscription publishers is not principally designed as sales promotion material, and reflects on its face a greater diversity in research approaches than the material of broker-dealers, it is nevertheless similar in many respects. As in broker-dealer material, recommendations to buy securities are overwhelmingly predominant, although recommendations to sell are not as scarce. Also, like broker-dealer material, subscription publications are almost uniformly silent on the subject of their publishers' positions and intentions with respect to recommended stocks.

Common to printed material of broker-dealers and subscription publishers alike is the suggestion, express or implied, that their recommendations are the product of research. The study's survey of the research practices followed by firms in each category revealed wide variations in the practices followed and the adequacy of research staffs to perform the functions they were called on to perform, as well as a frequently broad gap between the practices followed and the standards professed. At the upper end of the scale, firms in each group followed practices which were meticulous, painstaking, and time consuming. At the other extreme were investment adviser firms with limited staffs and what can at best be described as a casual approach to research, and broker-dealer firms with obviously overburdened research departments. In the research departments of broker-dealer firms, which publish regular market letters and other selling material, answer a steady stream of questions from salesmen and their customers, review portfolios for customers and potential customers, and often prepare special reports for institutional customers, the study also found wide variations in the standards applicable to differing research functions. As a general policy, the highest quality research efforts are directed to institutions and substantial customers, and the most casual efforts are generally directed to review of portfolios submitted in response to newspaper advertisements.

Reliance on outside sources for research services also occurs in both broker-dealer and investment adviser firms. Some firms circulate material prepared by the research departments of larger correspondent firms or independent research organizations, with or without disclosure of the source. On the other hand, the occasional circula-

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tion by broker-dealers under their own names of material prepared by public relations counsel of the company whose stock is recommended, or by advertising firms or others, represents an abdication of responsibility.

Both broker-dealers and investment advisers almost inevitably find themselves on some occasions in situations where the nature of the advice they give to the public may be affected by consideration of their own interests. The most common situations involve the broker-dealer's failure to disclose its position or its market-making activities in a stock it recommends. Whatever the motives, which may be good or bad, the legal and ethical responsibilities in such situations are not clearly defined. A wide variety of views exists even on the propriety of using market letters to recommend a security in which the firm has a position which it has decided to liquidate. Diversity of opinion similarly exists concerning the propriety of making recommendations available in advance of publication to certain favored classes of customers. The study found evidence of some practices, however, which go to the basic question of good faith: in both broker-dealer and investment adviser firms the study found cases of proprietors and employees "scalping," or buying securities which they were about to recommend, in anticipation of the market impact of the recommendation, and selling immediately thereafter.

The investing public gets only modest protection from existing Government and industry controls over the form and content of investment advice and the manner in which it is produced and disseminated. Printed investment advice of broker-dealers, which is essentially sales-promotion material, is subject to Federal control through the application of the Federal antifraud statutes, and both the NYSE and the NASD have promulgated broad general standards applicable to it. However, the Commission has concentrated its efforts on the selling literature of boiler-room-type broker-dealers, and makes no concerted effort generally to police the mass of sales-promotion material of all broker-dealers subject to its jurisdiction. While the NYSE has established "guideposts" for the preparation of sales material, a number of firms appear to pay little attention to them, and although the Exchange has recently devoted more effort to a program of reviewing this material, its activities still fall considerably short of vigorous self-regulation. Similarly the general standards articulated by the NASD suffer from largely ineffective enforcement.

The self-regulatory agencies have been slow to accept their responsibilities in this area. Only at the urging of the Commission did the exchanges and the NASD establish even the modest controls now afforded by their programs for review of selling literature. The New York Stock Exchange still encourages its members to advertise their research and advisory activities without concerning itself with their ability to perform the services which they purport to perform. The Exchange's inquiries into trading against market letters came only after the disclosure of such activity by the study. In areas of other ethical questions—disclosure in advisory material, other than by meaningless hedge clauses, of positions, trading intentions, and market-making activities; preferential treatment of different categories of clients; responsibility for following recommendations—the self-regulatory agencies have not provided leadership.

Unfortunately, the registered investment advisers operate largely in an area which lacks any guiding self-regulatory organization. The emergence of such an organization, which could formulate standards and educate its industry to a higher ethical plane, is highly desirable. Absent such an organization it will remain for the Government to take further steps for the protection of investors in respect of the problems which have come to light.

The responsible dissemination of sound investment advice, even as a method of sales promotion, is clearly beneficial to the investment community at large. It can be assisted by governmental measures which may clarify some cloudy areas of legal responsibility, and encourage the dissemination of reliable information, officially and unofficially, by issuers. Irresponsible dissemination of advice, however, has been responsible for injury to the public investor and to the reputation of the entire investment community. It behooves the responsible leaders of that community, and particularly its self-regutory institutions, both to clarify the ethical responsibilities of its members and to promote the establishment of reasonable standards which the dissemination of investment advice may be expected to meet.

The Special Study concludes and recommends:

1. Investment advice furnished by broker-dealers, though an integral part of their business of merchandising securities, is incidental to that business and, for the small investor particularly, their facilities for providing advice are quite varied in quantity and quality. This being the case, a minimum protection for such investors is that firms should not be permitted to represent that they perform research or advisory services which they are not reasonably equipped to perform. The New York Stock Exchange, instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard, and the NASD should provide similarly for its membership.

2. Specific practices with respect to investment advice, whether expressed in market letters, advertisements or otherwise, should receive more positive and effective attention from the self-regulatory agencies. Such agencies obviously cannot assume responsibility for the staffing of their member firms or the quality or validity of specific recommendations, but they should assume responsibility for eliminating irresponsible or deceptive practices by their members firms. This area also lends itself to establishment of standards through Statements of Policy, covering such matters as (a) required disclosures in printed material of sources of information, research techniques used, and/or other bases of recommendation, rather than general disclaimers as to sources and reliability of data in market letters; (b) required disclosures in written advice of existing positions, intended dispositions, and market-making activities, rather than general "hedge" clauses as to possible present conflicting positions or transactions; (c) required indication of the name of the person responsible for the preparation of market letters, and dating of such material; (d) in printed investment advice which purports to analyze issuers, required references to most recently filed official disclosures by

issuers, and representations that such filed information has been examined, with specific identification of issuers for which no officially filed information is available; (e) prohibition of specific practices in connection with written or oral recommendations, such as predicting specific future price levels of particular securities, claiming "inside" information by reason of a directorship, and trading against recommendations or other self-dealing; and (f) required disclaimers in connection with salesmen's written or oral recommendations not emanating from a firm's research department or otherwise sponsored by the firm.

3. The market letter surveillance program of the New York Stock Exchange should be strengthened and redirected toward achieving greater responsibility and restraint in the use and contents of such letters. More effective market letter surveillance should also be undertaken by the NASD and the other exchanges, or a coordinated program of self-regulatory agencies should be evolved.

4. Reckless dissemination of written investment advice by broker-dealers, whether or not for a separate fee, or by registered investment advisers, should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability in favor of customers reasonably relying thereon to their detriment. Without limiting the general principle, written investment advice which purports to analyze issuers but fails to consider most recently filed official disclosures of issuers should be one of the factors to be considered in determining whether such advice is recklessly disseminated.

5. As recommended in chapter II, registered investment advisers other than broker-dealers, should be organized into an official self-regulatory association or associations, which should then adopt and enforce substantive rules corresponding to those recommended above in respect of advisory activities by broker-dealers. Alternatively, the Commission should extend and strengthen its own direct regulation of advisers to accomplish the purposes indicated.

Part D. Protection of Customers' Funds and Securities

Many broker-dealers perform banking and custodial functions in the course of which they have custody of, and use, customers' assets of enormous value. The degree of dominion and control over customers' cash and securities may vary considerably depending upon the type of account which the customer has with the broker-dealer and with the amount, if any, owed by the customer to the broker-dealer. While many firms give regular notice to customers as to the status of their accounts, it would appear that there are many others which do not do so.

Customers' free credit balances are among the foregoing assets and may form a substantial part of the working capital of many broker-dealers. They are rarely segregated from broker-dealers' own funds. On the basis of prior loss experience, there does not appear to be a need to require complete segregation at this time. It would seem, however, that broker-dealers may reasonably be required to maintain an adequate liquid reserve against free credit balances, much as banks are required to maintain such a reserve against deposits. Furthermore, broker-dealers should be required to inform customers at regular intervals as to the status of their accounts.

Customers' margin and fully paid securities likewise are held in large volume by broker-dealers. Under the rules of the Commission, some States, and certain exchanges, broker-dealers are restricted both in the use which may be made of those securities and in the manner in which they may be held. The rules presently existing are salutary to the extent of their coverage; the rules of the Commission and of some of the self-regulatory organizations should be extended, however, so that they provide the fuller protection now existing under the rules of certain exchanges with respect to segregation and hypothecation and lending of customers' securities.

The net capital ratio rules of the Commission and certain exchanges have been a valuable protection for investors in preventing insolvency of broker-dealers. The current rigid "haircut" provisions of these rules, however, do not distinguish among broker-dealers performing different functions in the securities markets (except that exchange specialists and other members having no public business are not subject to such provisions), nor do they take account of changing circumstances in the markets. One result is that broker-dealers, including those making primary markets, may not be adequately restricted in accumulating inventories of over-the-counter securities during periods of price rises, but may be compelled to reduce inventories rapidly during periods of falling prices, contrary to market needs.

Section 60(e) of the Bankruptcy Act is a notable advance in the administration of broker-dealer bankruptcies. Nevertheless there are within it certain ambiguities which should be resolved; furthermore, it is believed that customers whose securities or free credit balances are appropriately segregated should be entitled to greater protection than they are now accorded by section 60(e).

The Special Study concludes and recommends:

1. The net capital rules of the Commission and the self-regulatory agencies should be amended to require broker-dealers to maintain a reserve of, say, 15 percent of the aggregate amount of free credit balances in the form of cash or short-term U.S. Government securities; or in the alternative, if a lesser reserve is maintained, to charge the difference to net capital. In addition, broker-dealers holding free credit balances should be required to give customers at least quarterly notice of the amounts of such balances. Such notice should include information to the effect that their free credit balances may be withdrawn at any time; that while held by the firm they are not segregated and may be lent to other customers or otherwise used in the business of the firm; that interest is not paid on such balances (or the circumstances in which interest is paid); and that financial statements of the broker-dealer firm are available for inspection.

2. The Commission should be empowered to adopt rules requiring that excess margin and fully paid securities be segregated and marked in a manner which clearly identifies the interest of each individual customer.

3. The Commission should be empowered to adopt rules requiring that there be a "reasonable relationship" between the

amount of each customer's securities that can be hypothecated or lent by the broker-dealer and the amount of indebtedness of such customer; and also requiring that broker-dealers obtain the specific, prior written consent of a customer before borrowing or lending his excess margin or fully paid securities.

4. Consideration should be given to the feasibility of providing greater flexibility in the so-called "haircut" provisions of the net capital ratio rules and in their administration, in order to take account of different functions, market circumstances, and needs. Additionally or alternatively, consideration should be given to exempting specified quantities (perhaps 500 shares) of securities in the inventory of a "primary market maker" as defined in chapter VII.

5. Section 60(e) of the Bankruptcy Act should be amended to provide (a) that customers' securities that have been appropriately segregated within 4 days after receipt so that their ownership can be ascertained, whether or not specifically identified (e.g., the bulk segregation system), and customers' free credit balances if similarly segregated, will be considered to be "identified specifically" within the meaning of section 60(e)(4) notwithstanding that such segregation may have occurred less than 4 months prior to bankruptcy or during insolvency; (b) that the term "stockbroker" clearly include "dealers" as well as "brokers"; and (c) that the term "customers" includes persons depositing cash for the purchase of securities. In addition, the Bankruptcy Act should be amended to empower the Commission to petition that an insolvent broker-dealer be adjudicated a bankrupt, so as to assure equitable treatment of claimants under section 60(e).

PART E. DELIVERY OF SECURITIES

The importance of encouraging prompt delivery of securities is clear. Late delivery to customers may render it difficult for them to sell when they so desire and may cause a loss of public confidence in the industry. Excessive "fails to deliver" may result in actual danger to the financial position of broker-dealers. Furthermore, the rise in fails to deliver in periods of heightened market activity suggests the danger that present securities handling, clearing, and delivery methods would prove inadequate to meet any sustained increase in volume. A "fails" situation such as that which arose in the spring of 1961 should not again be allowed to occur.

The volume of fails to deliver at any given time may well be reduced by revision of the present rules of the self-regulatory organizations or their affiliated clearing organizations to encourage prompt delivery. It is apparent, however, that these organizations should give increased attention to basic changes in present methods of handling, clearing, and delivery of securities and also to centralization of bookkeeping systems, in order to prepare for the expected increase in volume. A number of ideas have been advanced in this area for many years; their implementation is desirable.

The establishment of over-the-counter clearing facilities and the New York Stock Exchange pilot project for handling securities are promising developments. The Midwest Stock Exchange's centralized bookkeeping service, while not performing custodial functions, gives promising indication that centralized handling systems may be able to perform these functions.

The Special Study concludes and recommends:

1. The NASD should reconsider the adoption of rules under the Uniform Practice Code permitting marking to the market on a greater range of contracts than is now permitted. The experience of the Pacific Coast Stock Exchange with respect to mandatory marking to the market appears to have been highly satisfactory and the self-regulatory organizations should consider the desirability of the adoption by them or their affiliated clearinghouses of rules requiring marking to the market for all clearinghouse transactions.

2. A requirement for mandatory buy-ins might be of material assistance in reducing the volume of fails to deliver. It is recognized, however, that the adoption of such a system might raise certain problems such as the unavailability of securities which could be bought in at a fair price. The self-regulatory organizations and the Commission should give further study to the feasibility and utility of such a requirement for various types of markets or categories of securities.

3. The NASD should promptly reconsider the adoption of appropriate rules which would permit the NASD Board of Governors to establish hours of trading for all members or for specified classes.

4. The industry, with the cooperation of the Commission, should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing, and delivery systems, with the goal of evolving institutions and procedures which would permit the reduction of physical transfers of securities and centralization of functions now performed by broker-dealer back offices insofar as possible.

Part F. The Broker-Dealer as Corporate Director

For purposes of the present discussion, there is no occasion to question the merits of broker-dealer representation on boards of directors of publicly held companies. Undoubtedly the managements of many corporations who seek individuals in the securities business as directors value their judgment and experience, as investment bankers and otherwise. Many broker-dealers assert that the need for this kind of judgment and experience is especially great in the case of corporations which have recently made a first public offering and whose managements are inexperienced in financial matters and in fulfilling obligations to public stockholders. From the broker-dealer's point of view, representation on a corporate board can aid it in discharging what it considers its responsibilities as underwriter and at the same time may be of tangible or intangible value to the firm in other ways.

The problems here considered arise from broker-dealer representation on company boards in conjunction with other relationships and activities of the broker-dealer that may involve other obligations or interests, and therefore potential conflicts of obligation or interest. For example, if the broker-dealer represented on the board has been a managing underwriter in the flotation of a company's securities, obligations to customers in the original allotment and to fellow underwriters and their customers may be important. If the same broker-dealer is now making a market, or recommending or selling the securities to retail customers, or has investment advisory clients, additional motivations and obligations may arise and the potentiality for conflict with the director's obligation to his corporation and its stockholders inevitably widens.

The nub of the difficulty is the use of inside information. It is well established that a director is a fiduciary who may not use inside information for his private benefit, and enforcement of such fiduciary obligation of directors (and officers and controlling stockholders) of listed companies is the central purpose of section 16 of the Exchange Act. The most obvious misuse of inside information for the director's own benefit would be in transactions for the broker-dealer's own account as principal, a subject which is further considered in chapter IX.

The most subtle questions of conflict arise where transactions of customers are involved. Where a broker-dealer has inside information through a directorship, there may be a violation of obligation to the corporation and its stockholders if the information is used, and, at least in some circumstances, there may be violation of obligations to customers if it is not used, especially if the customers have been led to rely on the protection flowing from his close affiliation with the corporation. But the problem is even more complex than this, because the use of inside information for the benefit of customers may amount to fraudulent activity in respect of members of the public on the other side of customers' transactions.

Broker-dealer firms have a great variety of views and practices in this area. Some firms take the position that inside corporate information is available for their benefit and that of their customers; others attempt to maintain a wall of insulation between the individual when serving as director and the same individual in relation to his firm, its trading department and its retail customers. In the former instance, apparently no obligation to the corporation or its stockholders is recognized, or else an obligation to customers is considered dominant. In the latter, the emphasis is on obligations as director notwithstanding any obligations to the public customer. Just how sharply and consistently these theoretical distinctions are maintained in practice is not easy to determine. Other firms avoid or prefer to avoid directorships entirely, because of the conflicts problem or for other reasons.

The regulatory and self-regulatory treatment of this subject is of rather recent origin. The New York Stock Exchange recently issued two educational circulars to its members, pointing out the many pitfalls in this area. The Commission's staff, while making no general pronouncement on the subject, has advised individual broker-dealers that the duty to disclose material information to customers may be overriding in some circumstances, so that many broker-dealers may prefer not to place themselves in a position where there is a conflict between this duty and any obligation as director of a corporation not to disclose the information. In the 1961 case of *Cady, Roberts*, the Commission held that the antifraud provisions of the securities laws had been violated where inside information as to reduction in a company's regular dividend became the basis for transactions of a partner of a broker-dealer firm for his wife's account and discretionary accounts of customers, in the absence of disclosure of the inside information to persons on the other side of the transactions. The rather distinct problems that may arise from directorships in connection with over-the-counter making of markets and retailing seem not to have received attention from the NASD, the agency with primary self-regulatory responsibility for over-the-counter markets.

The Special Study did not conduct any investigation, as such, of the effect of directorships on broker-dealer trading and retailing activities, although views and descriptions of practices were sought in interviews with several firms. It is clear from even this limited survey that broker-dealer directorships are far from being an unmixed blessing to those involved or those affected. In some circumstances the positive aspects may be so far outweighed by negative ones as to preclude the directorships; but even where this is not the case, vigilant concern for niceties of conduct is obviously called for.

Actually, the problem of directorships is part of a broader one. A striking phenomenon of the securities industry is the extent to which any one participant may engage in a variety of businesses or perform a variety of functions. A single firm with customers of many kinds and sizes, may, and often does, combine some or all of the functions of underwriter, commission house in listed securities, retailer of unlisted securties, wholesale market maker for unlisted securities, custodian of funds and securities, investment adviser to discretionary accounts, to others on a fee basis, and to one or more investment companies, and financial adviser to one or more corporations. Its principals may invest or trade for their own accounts in securities also dealt in for others. In addition, as more particularly discussed above, principals and employees of the firm may serve on boards of directors of issuers of securities which the firm has underwritten, in which it makes a wholesale market, which it recommends to its retail customers, or all three.

Since each of these functions involves its own set of obligations to particular persons or groups of persons and since the self-interest of the broker-dealer may be involved in one or more, there are multifarious possibilities of conflict of obligation or interest in matters large and small. The multitude and variety of possibilities of conflict in the securities business make it difficult, if not dangerous, to generalize as to the problems presented or possible remedies. Total elimination of all such possibilities is obviously quite out of the question; theoretically, it would involve complete segregation of functions—a remedy often invoked or suggested where conflicts are considered. But segregation as a specific remedy for all the multifarious possibilities for conflicts in the complex securities business could not be a simple segregation in any traditional sense but would have to involve fragmentation of the business to a point where (as facetiously pointed out in a recent magazine article) each investor would have his own broker who would not be permitted to act for any other customer or for himself.

In some limited sectors, combinations of functions involving clearly conflicting roles may be excluded as a matter of business policy or public policy because the conflicts are deemed so fundamental and pervasive as to require separation; in most sectors, multiple roles are not excluded as a matter of policy, but here the conduct of broker-dealers performing them may require increased regulatory and self-regulatory vigilance. Some kinds of conduct (as in *Cady, Roberts*, for example) are so gross that they already have been, or may in the future need to become, the subject of specific decisions or regulations. For others, more capable of being handled in terms of ethics than of law, the self-regulatory agencies would seem to have an ideal milieu for performing their role of elevating and guiding conduct of their members above and beyond strictly legal requirements. The exchanges and the NASD should be charged with continuing responsibility for keeping abreast of changing forms and methods of doing business, identifying areas of frequent difficulty, and setting forth guides to the conduct of broker-dealers serving as directors and performing other roles containing potentialities of conflict.

The Special Study concludes and recommends:

1. The many facets of the securities business, including the typical combinations of broker and dealer functions, underwriting functions, quasi-banking functions, and advisory relationships with issuers of securities and with customers, involve potential conflicts of interest and obligation of many kinds and degrees. This would appear to be the kind of area in which the self-regulatory agencies, with support from governmental agencies where violations of legal duties are involved, can be instrumental in defining and effectuating higher ethical standards. With all credit to the limited efforts they had made, the self-regulatory agencies have left many important subjects virtually untouched; for example, although the NYSE has recently advised its members concerning conduct in connection with the holding of directorships, the NASD, which has special responsibilities in respect of over-the-counter markets, apparently has never addressed itself to the conflicts involved in the role of the broker-dealer who is a corporate director while engaging in interdealer and retail transactions in the corporation's securities. The self-regulatory agencies, no less than the Commission, should institute more positive, continuing programs for the study of important problems of conflict of interest in the securities business, with a view to speaking out on particular questions in the form of cautionary messages, policy statements, codes of ethics, or rules of fair practice, as circumstances may require.

CHAPTER IV

PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

[Part A (Introduction) presents statistical data concerning distributions of corporate securities during the postwar period, with particular emphasis on equity issues during the years 1959–61.]

PART B. NEW ISSUES

The new-issue market, which gathered force in 1959, reached its peak in 1961, and subsided with the market decline of early 1962, can now be seen in perspective. The intensive and extensive examination made by the Special Study reveals a picture—which perhaps will not be surprising to the financial community or to investors—of a general climate of speculation which may rank with excesses of previous eras.

More than any single activity or incident, it is this climate of speculative fervor which provides a key to the new-issue phenomenon. Its causes need not be dwelt on here. It is sufficient to note that its roots are presumably deep in human nature, and its manifestations include a willingness by more and more of the public to purchase securities at prices less and less in line with experience and reasonably foreseeable earnings.

The "hot" issues which thrived in this climate, being the plainest evidence of the riches attainable through the purchase of stocks without regard to earnings or other fundamentals, also helped to nourish it. This kind of interaction between cause and effect appears throughout any analysis of the new-issue market. The interaction may make it more difficult to identify underlying causes of particular problems and excesses in individual cases, but it may also assist in the search for practical solutions: the vicious circle of cause and effect can perhaps be broken by relatively limited remedies applied at strategic places.

With public expectation of continuously rising stock prices, hundreds of nonpublic companies and their major stockholders found unprecedented opportunities in recent years to make public offerings of their stock that would not have been possible in a different climate. The number of companies making their first public offerings climbed steadily during the period from 1953 to 1961, reaching an historic high in the years 1959 to 1961 when the bull market attained its peak. The new-issue phenomenon provided many small companies with the opportunity to raise funds for legitimate corporate purposes. It also provided an opportunity, however, to sell stock in companies that in a different climate would not have been deemed ready or appropriate for public financing.

The underwriter played an important role in the new-issue phenomenon not only by originating and distributing stock in companies going public but also, in many cases, by encouraging the speculative climate. Most of the older firms exercised careful investment banking judgment in determining which companies were suitable for public ownership, and in so doing still provided many small companies with access to the capital markets. Other firms, under pressure from customers and salesmen hungry for new issues, lowered their standards of quality and size of issuers whose securities they would underwrite. Broker-dealers whose principals had little experience or knowledge of the underwriting business and whose capital commitment was minimal were hastily organized in order to participate in the new-issue boom. Professional finders, either self-employed or employed by broker-dealer firms, occupied themselves in bringing issuers and underwriters together.

It is against this background of excitement and expectation of profit that the details of the offering of new issues must be seen. In the pricing of new issues, underwriters could not help but be influenced by the knowledge that the prices of many issues would subsequently rise in the immediate after-market to prices hardly justified by traditional standards of value. A high offering price might not be justified by these standards, yet a low offering price, which might seem to be called for by a sober regard for fundamentals, merely assured an initial premium that whetted the public's appetite for the next issue. For the careful underwriter, these conflicting considerations posed a difficult dilemma in the pricing of a new issue. Others set low offering prices in the expectation of withholding substantial portions of the issue in accounts of insiders to be sold out to the public at premium prices.

Some underwriters found opportunities with the strong public demand for new issues to obtain very high amounts of compensation from small speculative companies. Thus, the weakest companies financially had to carry the heaviest burden and the investor in these companies paid the highest cost to assume the greatest risk. Since many of these offerings were made by newer underwriters on a "best efforts" or agency basis, there was very little or no risk for the underwriters.

It also became increasingly common for underwriters of new issues to receive a substantial portion of their compensation in stock, options, or warrants of issuers. Instead of serving as a substitute for cash compensation, equity compensation tended to appear in those offerings with the highest rates of cash compensation. The practice of taking unreasonable amounts of noncash compensation, particularly among the smaller and more aggressive underwriters, not only diluted the equity in the company of the public purchasers of the stock in the public offering, but it also gave the underwriter holding the stock, options or warrants a special kind of interest in the after-market for the issue.

In general, some investment banking houses carefully investigated issuers whose offerings they brought to the public market and registration statements reflected the meticulous standards of these underwriters and the lawyers and accountants involved in preparing them. Other underwriters, anxious to merchandise stock in public demand, were lax in performing their responsibilities to investigate issuers whose securities they intended to offer to the public. Under these circumstances carelessly prepared registration statements, if they were not corrected by the Commission's staff, might contain serious misrepresentations about the issuer and its affairs.

If the general background outlined above as a *sine qua non* of the new-issue boom, the premium prices of particular stocks were the results of the mechanics of the market and in many cases of the techniques and activities employed by particular broker-dealers. In a typical "hot issue," over-the-counter trading began simultaneously with effectiveness of the registration statement or clearance of the Regulation A filing. Stocks were being quoted at premium prices in the after-market before all customers knew of their allotments, before the closing at which the managing underwriter remitted the proceeds of the offering to the issuer, and before customers received their stock certificates. Thus, the trading markets for new issues tended to reflect a distorted picture of demand and supply. While potential buying interest in an issue was often communicated to trading firms prior to the offering date, potential selling interest in the after-market was more difficult to assess and was seldom adequately reflected.

It was of prime significance that a limited number of shares of new issues were available for trading in the immediate after-market. Many new issues involve a relatively small number of shares. Moreover, most distributors of new issues had a policy of confining their allotments to customers who would not immediately resell in the open market. They implemented this policy by such measures as: (*a*) allotting only to customers with a record of not reselling prior new issues; (*b*) allotting to discretionary accounts or to a relatively small number of customers who customarily relied on the advice of the distributor; (*c*) advising customers of a "requirement," "necessity," or "expectation" that they would not immediately resell, or that immediate resale would reduce their chances of being allotted future issues; (*d*) penalizing salesmen whose customers sold their allotments in the immediate after-market; or (*e*) simply refusing to execute sell orders of customers in the immediate postdistribution period. Although a policy of selling new issues to "investors" rather than to "speculators" may be based on excellent motives, such as assuring a successful distribution and discharging responsibilities to the issuer or to codistributors, the effect of the policy was to reduce the shares available for immediate trading in the after-market.

Supply was also reduced by delays in notifying customers that shares had been allotted to them and in sending them their stock certificates. Whereas trading markets may commence immediately upon effectiveness, customers normally did not receive notice of their allotments for 24 to 48 hours and sometimes for several days or weeks. Delay in notifying customers of their allotments gave added importance to the initial premium since the decisions of customers whether to accept allotments could be made on the basis of prices quoted in the after-market, rather than on information provided in the prospectus. Some underwriters did not deliver stock certificates for weeks or even months after the effective date, thus discouraging customers from selling. Thus, in the critical hours and days immediately following effectiveness the potential supply (including potential selling by owners who might have sold had they known of their ownership) might be artifically limited; and for a considerable period thereafter selling was hampered by the difficulty of making delivery.

In short, the opening quotations and the opening "market" were based on trading of but a fraction of the outstanding shares, and on information that could not be said to reflect accurately the potential supply at the premium or any other price.

Supply of the stock of many "first" offerings also was restricted by the practice of "free-riding and withholding." Despite NASD and Commission prohibitions against the practice, participants in distributions would place portions of new issues in the accounts of insiders of the firm and their families. In some offerings, substantial amounts of stock were thus "shelved," while demand was being stimulated by trading activities, publicity, and solicitation of customers. Withheld shares were then sold to customers at premium prices in what amounted to a redistribution of the shares offered.

Buying interest, unlike selling interest, was likely to be reflected in the trading markets at the very outset. Buying interest was frequently communicated to the trading markets *prior* to the effective date, by both distributors and nondistributors of the security. Trading firms based their opening quotations on orders placed with them prior to effectiveness. Moreover, solicitation of after-market purchases was common and might be actively engaged in by one or more of the major distributors. While it was often difficult to determine whether solicitation of purchases in the after-market occurred prior to or immediately following the effective date, the study indicates that significant public buying on the first day of trading was usually by customers of one or two or several participants, thus suggesting the presence of active solicitation or recommendation by such participants at least as early as the notice of effectiveness. To add to the after-market excitement, some managing underwriters arranged for solicitation of customers at premium prices through nonparticipating firms. Demand for new issues was further stimulated in some cases by market letters, advisory recommendations, articles in the financial press, and other planned publicity, usually optimistic in tone.

The disclosure provisions of the Securities Act assume a particular importance to the purchaser of a new issue in the after-market, especially in periods of intense demand. The study of new issues indicates that many persons who received original allotments of new issues were sophisticated investors aware of and able to assume the risks of investing in a speculative issue. On the other hand, persons who bought in the after-market often were less sophisticated and more susceptible to the allure of publicity and rumor about "hot issues." These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never received a prospectus as required during the first 40 days of the offering.

In extreme cases it appears that the original distributees, whether "insiders" or favored customers of the underwriters and selling group members, and the trading firms which made markets in the stock served merely as conduits through which the shares were funneled to the "real" distributees of the new issues—the customers who purchased at premium prices, often pursuant to direct solicitation and influenced by favorable publicity and market letters, rather than the prospectus.

A separate inquiry undertaken by the Special Study showed a high degree of failure among small companies which went public during the past decade. Under the philosophy of the Securities Act it is not the role of the Federal Government, of course, to pass on the merits of securities or decide which companies should receive the investor's dollar. The role of the Government is to insure disclosure of information and fairness of the markets in which securities are distributed and traded. Certain specific improvements in disclosures and market practices, with particular regard to new issues, are suggested by the study's data.

Determination of the suitability of issues for public financing has traditionally been part of the role of the underwriter, a role demanding particular skill, experience and sense of responsibility. Many of the broker-dealers who undertook the role of underwriter under the stimulus of the new-issue boom not only were lacking in these qualities but were substantially judgment-proof with respect to their statutory liability under the Securities Act to those purchasing issues underwritten by them. These underwriters usually sold stock on a "best efforts" basis and in some cases were organized to merchandise only one or two issues. The recommendation in chapter II of this report, that all underwriters have a minimum capital commitment, should help to eliminate the paradox that underwriters who fail to make even the most rudimentary investigations of an issuer can be immune from the basic sanctions contemplated by the Congress in enacting the civil liability provisions of the Securities Act.

During the years 1959–61, the "truth in securities" philosophy of the Federal securities laws became irrevelant for many investors. An accurate prospectus is of little value to a purchaser who does not care about a company's asset value, operating history or prospects but who buys only in the expectation of an immediate premium for its stock. Neither the disclosure philosophy nor the registration requirements of the Securities Act and the procedural machinery which has grown up around them is in any way invalidated by the results of this study. What these findings do demonstrate, however, is that particular problems exist in the distribution and trading of new issues, and that certain requirements, not applicable to distributions of securities by seasoned issuers but designed to reach some of the specific excesses revealed in the new-issue phenomenon of 1959–61, should be instituted and enforced.

The Special Study concludes and recommends:

1. The Commission's administration of the registration provisions and related exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable. Nevertheless, there are limited respects in which provisions of that statute and the administration thereof or of related provisions of the Exchange Act should be modified in order to adapt them more closely to experienced needs. The troublesome and sometimes dangerous phenomenon of "hot" issues is primarily associated with "first" issues, i.e., first public offerings of securities of a particular issuer. Accordingly, such "first" issues, whether fully registered or exempt under regulation A, should receive particular attention, with a view to preventing certain practices that appear to have contributed unnecessarily to "hotness," while not interfering with normal and legitimate practices in connection

with underwriting of "first" or any other issues or the flow of venture capital into new business.

2. Appropriate rules should be adopted by the NASD and/or the Commission, applicable to "first" issues of common stock generally, designed to eliminate or temper certain factors which, either independently or in interaction with each other, appear to have produced artificially high but ephemeral premiums in many instances. Among the types of rules that would appear appropriate for consideration and adoption would be rules (a) requiring that, with respect to allotments resulting from solicitations or indications of interest prior to the effective date, notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible, any delay of more than (say) 24 hours after the effective date to be deemed prima facie unreasonable; (b) requiring that, again with respect to allotments resulting from solicitations or indications of interest prior to the effective date, certificates of stock be delivered or made available for delivery to purchasers as promptly as reasonably possible, any delay of more than (say) 2 weeks after the effective date or more than (say) 1 week after the underwriting closing to be deemed prima facie unreasonable; (c) prohibiting all broker-dealers from initiating a trading market for a limited period of (say) 72 hours after the effective date, except for stabilizing activities in conformance with rule 10b-7 and such other exceptions as may be provided by rule or in specific circumstances; (d) clarifying or defining restrictions on soliciting, holding, or transmitting, prior to the effective date, indications of interest or orders to purchase in the open market after the effective date; and (e) prohibiting all participants in the public offering, until the distribution is completed or for a period of (say) 40 days after the effective date, whichever is later, from soliciting or recommending purchases of the stock (including placing stock in discretionary accounts) at a price in excess of (say) 120 percent of the public offering price.

3. Acceleration by the Commission of the effective date of a registration statement or permitting clearance of a regulation A filing, with respect to any "first" issue of common stock, should normally be conditioned on delivery of a prospectus or offering circular in substantially final form to each person to whom any participant in the distribution expects to make original allotments at least (say) 48 hours before any sales are made.

4. The 40-day period during which all dealers are required to deliver prospectuses should be extended to 90 days in the case of "first" issues of common stock, except as may be otherwise permitted by rule or in specific circumstances. The same provisions should apply to offering circulars under regulation A exemptions. (It is recommended below that the 40-day requirement be eliminated in connection with offerings of securities of issuers subject to the continuous reporting requirements of sections 13, 14, and 16 of the Exchange Act.)

5. The NASD should strengthen its enforcement of the prohibitions against "free-riding and withholding" by requiring, in the case of any "first" issue of common stock for which a price in excess of (say) 120 percent of the public offering price is reached

within (say) 40 days after the effective date, a report of the managing underwriter showing all stock allotted to any participant in the distribution (other than stock resold at or below the public offering price) or its principals or members of their immediate families or to any broker-dealer other than a participant, and the disposition thereof, if any. In general, since those violating the "free-riding and withholding" prohibitions may be in a position to realize profits greatly surpassing the fines customarily imposed by the NASD, substantially severer penalties should be imposed in flagrant cases so as to provide an adequate deterrent.

6. The NASD has a taken a forward step in providing for the review of underwriting arrangements in connection with offerings of unseasoned companies. To provide guidance to its membership, the NASD should periodically publish summaries of specific rulings relating to the amounts of compensation and types of compensation arrangements that have been considered unacceptable in given circumstances.

7. Underwriters receiving options, warrants, or "cheap stock" in connection with any public offering should be required to report to the Commission and the NASD: (a) upon exercise of options or warrants, the date and price; (b) upon transfer of options or warrants, the date, consideration, and identity of transferee; and (c) upon disposition of underlying securities without a posteffective amendment, the date, consideration, identity of distributee, or class of distributees, and the exemption relied on. The general subject of transfer of such options, warrants, or "cheap stock" to registered representatives, traders, or others not directly involved in the underwriting of an offering should receive greater attention of the NASD, with a view to adoption of rules or a statement of policy defining circumstances in which such transfer is deemed consistent or inconsistent with high standards of commercial honor and just and equitable principles of trade.

8. In light of widespread misunderstandings or uncertainties among broker-dealers, as discussed in this and other portions of the report, the Commission should take appropriate steps to clarify the application of rule 10b–6 (a) during a period when stock is being held "for investment" by a broker-dealer, (b) in connection with various forms of "shelf" registration, (c) in connection with a planned reduction of inventory or "workout," and (d) in connection with unregistered distributions generally.

Part C. Unregistered Distributions

Unregistered distributions can be quite sizable individually, and in the aggregate they are a very significant phenomenon in the securities markets. They are of growing importance because of the increasing participation of institutional investors in the markets. From the point of view of public customers, they are often indistinguishable from registered distributions in respect of disclosure needs. Yet they occur, for the most part, without even the minimum disclosure protections that would seem practical and with a speed that does not permit careful consideration of the merits of the security being distributed.

If a distribution emanates from the issuer or a controlling stockholder, it is the theory of the Securities Act that the issuer, selling stockholder (if any) and underwriter can and should supply comprehensive data about the issuer and the distribution itself. But if the distribution is from any other source, even though the factual distinctions may be narrow ones and the needs of investors may be no different, no disclosures are usually required even as to the distribution itself (except in the case of certain but not all exchange-approved distributions). Granting that the basic distinctions in kinds and amounts of disclosure must be maintained for practical reasons, there is no reason why certain basic data with respect to the distribution itself cannot be provided just as readily in the case of an unregistered distribution as in the case of a registered one. The needs for protection of investors are no less great in the former case than in the latter.

The disclosure requirements applicable to exchange distribution and special offering plans under rules of the New York Stock Exchange and other exchanges, as described above in section 2, provide a useful pattern in considering the minimum disclosures that are needed and practical to obtain. These requirements should be extended to all unregistered distributions in defined categories so that, in addition to notifying the Commission, there will be disclosed to prospective purchasers prior to completion of the transaction the total amount involved in the distribution, whether it is for the broker-dealer's account or on behalf of other persons (with or without identifying the persons); the underwriting arrangements and/or discounts and commissions involved; and whether stabilizing transactions may be effected. Some of this information should also be supplied to the prospective purchaser at the time of solicitation in view of the importance of disclosure at this point in the making of an investment decision. Consideration should be given, also, to the feasibility of requiring a minimum interval between announcement and actual commencement of an unregistered distribution.

In view of the importance of rule 10b-6, the basic antimanipulative rule in respect of distributions and the uncertainty concerning its application to unregistered distributions, it would appear that appropriate measures should be taken by the Commission to clarify its applicability.

The Special Study concludes and recommends:

1. Any broker-dealer managing an unregistered distribution should be required to file with the Commission a brief notification as to the total amount of securities involved in the distribution; whether the distribution represents inventory or investment stock of the broker-dealer and/or is on behalf of one or more other persons (with or without identification of such other persons); the offering price and underwriting arrangements and/or discounts or commissions involved; and whether stabilizing transactions may be effected. Consideration should be given, also, to the feasibility of requiring, with respect to all or specified categories of unregistered distributions, an interval of time, say 48 hours, between the filing of the notification and the commencement of the distribution (in which case only the method of determining price and spread rather than actual amounts would be set forth).

For purposes of this recommendation and the following one, the term "unregistered distribution" should be defined to include the sale by any broker-dealer, as principal (including any planned reduction of inventory or "workout") or as agent, of any block of securities of such size as to require an underwriting or selling group and/or receipt or payment of compensation exceeding normal compensation for routine (nonblock) transactions in similar securities, unless the block is sold to fewer than 25 purchasers and/or at an aggregate price of (say) $300,000 or less.

2. Any broker-dealer participating in an unregistered distribution as principal or as agent should be required to advise each customer in his confirmation of the substance of the matters to be set forth in the notification, and at the time of solicitation as to appropriate portions thereof.

3. Reference is made to the recommendations in part B of this chapter as to clarification of the application of rule 10b–6 in respect of unregistered distributions and otherwise.

PART D. THE INTRASTATE EXEMPTION

The intrastate exemption reflects a congressional decision to relieve from the registration process local offerings which can be regulated locally and which ordinarily are not of substantial national concern. The exemption serves its intended purpose well, when availed of, as it ordinarily is, for small offerings by small businessmen in their home communities. Even in such offerings, investors are entitled to Federal protection against fraudulent practices.

The exemption may, however, be available for public offerings of substantial magnitude, and it is in this area that troublesome problems arise. Reflecting its purpose, the conditions and limitations of the exemption are not well adapted to substantial public offerings, and the likelihood of inadvertent violation of the Securities Act of 1933 in the course of a substantial public offering is high, even where reasonable precautions appear to have been taken. Such violations may expose issuers and underwriters to substantial liabilities, as well as creating possible regulatory difficulties for registered broker-dealers.

While reliable information is not available as to the extent to which the intrastate exemption is availed of for public offerings, the records of the Commission, financial manuals and other sources indicate that sizable public offerings in reliance upon the intrastate exemption are not infrequent. While undoubtedly many of these offerings are entirely legitimate, there is a significant potential for fraud in such relatively unsupervised distributions, and it appears that fraudulent promoters have exploited this potential. The absence of prompt notice to the Commission of such public offerings greatly complicates its efforts to protect the public against fraud. A requirement that notice be given would also provide useful information as to the significance of this type of financing, and provide a basis for determining whether legislation establishing further controls of such offerings is needed.

The Special Study concludes and recommends:

1. Issuers or controlling persons of issuers (in cases of secondary offerings) who propose to make substantial public offerings in

reliance upon the exemption from registration provided by section 3(a)(11) of the Securities Act should be required to file with the Commission an advance notice of such offerings. Such notification, on a prescribed form, would include information with respect to the principal business or businesses of the issuer and their location, the amount, purpose and place of offering of the securities and identification of the person on whose behalf the offering is made, a description of the manner in which the offer or sale is to be accomplished, and disclosure of any recent or proposed offerings by the issuer other than that set forth in the notification. Filing of such notification would not be a condition to the availability of the exemption, but any failure to file would be subject to the usual penalties for violation of the Commission's regulations.

Part E. Real Estate Securities

The recent spectacular expansion of public participation in real estate securities has created new problems and intensified existing ones. The principal problems relate to the speculative nature of some of the real estate securities being offered the public, the extent of compensation and other direct and indirect benefits reserved to the promoters of such securities, and the manner in which such securities are sold to the public.

Further study is necessary to determine whether the Commission's power to compel disclosure is adequate to deal with the problems presented by speculative offerings, promoters' benefits, insider transactions and cash flow distributions. The complexity of the problems as well as the specialized use of familiar terms and the high degree of risk of some of the offerings, all make disclosure especially important both in the original offering to prospective purchasers and, on a continuing basis, to the owners of the securities.

At least as much as in other parts of the securities industry, selling practices need improvement. The absence of an effective self-regulatory securities association with jurisdiction over the industry and the lack of adequate qualifications, training and supervision of many of the salesmen engaged in the business are matters of concern.

A special problem relating to real estate securities involves the extensive reliance by their offerors on the intrastate exemption from Federal registration. For further discussion of this subject, see part D above.

The Special Study concludes and recommends:

1. The Commission should propose to the Congress that section 15A of the Exchange Act be amended to provide that all distributors of and dealers in real estate securities in interstate commerce shall be required to be members of a registered securities association having such rules relating to the business in real estate securities carried on by its members as shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors. Also, all individuals engaged in selling or distributing real estate securities should be subject to the registration requirements recommended generally in chapter II for persons engaged in selling or distributing securities.

2. The Commission should further study the problems of speculative offerings, promoters' benefits, insider transactions, distri-

butions, and the information furnished to security holders, and the adequacy of its power to deal with such problems.

PART F. INTEGRATION WITH PREVIOUS FILINGS

The continuous reporting requirements of sections 13, 14, and 16 of the Exchange Act operate, or can and should be made to operate, to provide a reservoir of reliable, reasonably current, publicly available data about an issuer. Certain of the study's recommendations in chapter IX are aimed at assuring the sufficiency, reliability, and the widest possible dissemination of such data and recommendations in chapter III seek to insure its use by broker-dealers and investment advisers. As a general principle filed information, if prepared and reviewed with appropriate care, ought to have as much validity and utility in connection with sales and purchases amounting to a "distribution" as it has in connection with sales and purchases in the trading markets, subject to appropriate supplementation to cover recent developments and the distribution itself. In tandem with accomplishing other recommendations to strengthen Exchange Act reporting requirements and procedures, it should be possible to achieve closer integration of these with Securities Act registration requirements and procedures, with the aim of improving the total disclosure result and at the same time expediting and simplifying the Securities Act registration process in appropriate cases.

The Special Study concludes and recommends:

On the assumption of and in harmony with the carrying out of recommendations in chapter IX for extending and strengthening Exchange Act reporting requirements and wider dissemination and use of filed reports, the Commission, in consultation with industry representatives, should seek to develop a program for closer integration of disclosure requirements of the Securities Act and the Exchange Act, a possible outline of which is as follows:

1. A registered public offering of securities of any issuer (with exceptions as may be provided under rules of the Commission) already subject to the continuous reporting requirements of sections 13, 14, and 16 of the Exchange Act, by reason of having a class of stock registered on a national securities exchange or a class of "OTC listed" stock (see ch. IX), should be permitted under a special "short-form" registration statement and prospectus. Such short-form registration statement or prospectus should be required to contain data concerning price and spread; underwriting arrangements; if a primary offering, the proposed use of proceeds, or if a secondary, the reasons for selling; capitalization; summary of earnings; recent developments in business and other material occurrences not previously reported; financial statements; and a specific reference to previously filed material fulfilling other requirements of the appropriate registration form, with a representation and consent that such material shall be deemed part of the present registration statement and prospectus for all purposes of sections 11 and 12 of the Securities Act.

2. To the extent, if any, that present reporting requirements (forms 8–K, 9–K, and 10–K) or proxy soliciting requirements may

be inadequate to assure an adequate reservoir of reliable information on a current basis, these inadequacies should be appropriately corrected entirely apart from the present recommendations. Also, to the extent practicable, examining procedures now followed in connection with prospectuses and proxy statements should be made applicable to annual and other reports.

3. The waiting period between filing and effective date should be kept to a minimum for short-form filings. The 40-day period during which all dealers are required to deliver prospectuses should be eliminated in the case of short-form filings, without limiting the obligation of any dealer in respect of securities constituting some or all of an unsold allotment to or subscription by such dealer as a participant in the distribution.

CHAPTER V

TRADING MARKETS—INTRODUCTION

[Part A (Basic Components of Trading Markets) contains general introductory material for chapters VI, VII, and VIII, and includes discussions of the nature of participants in trading markets, of the two general types of trading markets in the United States, and of "multiple trading" in securities on various markets.

[Part B (Basic Concepts and Standards Relevant to Trading Markets) sets forth the statutory and nonstatutory criteria for evaluating trading markets and discusses the possibility that there may be some degree of conflict among them. Part B also considers the concept of "depth" in trading markets.

[Part C (Practices in Foreign Securities Markets) discusses, for purposes of comparison, certain characteristics of foreign securities markets, with emphasis on the London Stock Exchange.]

CHAPTER VI

EXCHANGE MARKETS

[Part A (Introduction) discusses the legislative background of the Commission's authority to regulate exchange markets. The chapter focuses primarily on the NYSE and includes a discussion of the diversity of securities traded on the Exchange and of its member firms.

[Part B (Operations of Exchange Markets) discusses the mechanics of market operations and the characteristics of members executing transactions on the floor.

[Part C (Members' Transactions) is a general discussion of exchange members' trading for their own accounts and serves as an introduction to the succeeding parts dealing with specialists, odd-lot dealers, floor traders, and members' off-floor trading.]

PART D. SPECIALISTS

The specialist stands at the hub of the market mechanism of the NYSE and other major American exchanges. Since the inception of the specialist system about 100 years ago, the role of the specialist has increased greatly in importance. Starting essentially as a broker who had the function of storing limited price orders incapable of immediate execution, the specialist has also become a dealer who participates in a substantial percentage of exchange transactions for the purpose of maintaining a "fair and orderly market" in the securities in which he is registered.

The Special Study's examination of the NYSE specialist system has disclosed no widespread abuses or patterns of illegality. Nevertheless, serious problems have been found concerning the system itself and its surveillance and regulation by the Exchange. Certain fundamentals disclosed by the Special Study are at the core of these problems. The first is that in the last 25 years the specialist's dealer function has become as important as, if not more important than, the brokerage function—on both a quantitative and qualitative basis. The second is that the conflicts of interest inherent in any simultaneous combination of dealer and broker functions have been intensified, on the one hand, by this expansion of the dealer function and, on the other hand, by extentions of the brokerage function beyond that of handling market and limit orders for other brokers. The third is that there are wide variations in financial and other capacities, and in performance, among the 110 different NYSE specialist units, resulting in considerable divergency in the nature and quality of markets for individual securities even apart from inherent differences in their market characteristics, and indicating that the regulatory framework permits too wide a tolerance from acceptable norms.

A. THE SPECIALIST AS DEALER

The specialist's participation in the market as dealer has increased steadily through the years. Today, specialists are purchasers or sellers in approximately 30 percent of all exchange transactions. In 1960, approximately one-third of all specialists derived a greater part of their income from dealer profits than from brokerage commissions.

The basic dealer function, the maintenance of reasonable price continuity, is a useful one in several ways. A market which moves in small fractions probably tends to discourage undue speculative activity. Transactions in a particular stock on a particular day are likely to involve only a small number of shareholders, some of whom may have peculiarly urgent needs to liquidate their positions, and a responsible dealer system can prevent sudden changes in prices caused not by changes in intrinsic worth or general market conditions but by vagaries of supply and demand at a particular moment. The specialist serves as nexus between buying and selling orders, which arrive haphazardly rather than simultaneously in a continuous auction market.

A considerable portion of specialists' dealer profits are derived from the "jobber's turn"—the profit realized by purchasing from members of the public at the quoted bid and selling to them at the quoted offer. Since the potentialities for profit are greatest in the more active stocks, specialists' dealer activities tend to be concentrated in these stocks. Furthermore, the risks of acquiring an inventory are smallest in active stocks, which have the greatest volume of market orders and usually the thickest "books"—the unexecuted orders on both sides of the market entrusted to the specialist for execution—with which the specialist can trade in order to dispose of a long or short position. Responsible professional participation is needed most, however, in the least active stocks, where risks are greater and profit potentials are more limited. The Exchange has a policy of assigning certain types of stocks to well capitalized specialist units with a high rate of dealer participation, but there is no attempt to give each unit a "balanced portfolio" so that a more or less assured dealer profit and brokerage income in stable issues can be available for volatile stocks and inactive issues. Thus there is no systematic method of allocating total capital resources of the specialist system to less profitable as well as more profitable issues.

Closely allied with the problems of assuring adequate participation in inactive issues is the great difference between the concepts under which so-called "dealer specialists" (well-capitalized units with a high rate of dealer participation) and "broker specialists" (units which emphasize their brokerage function) seem to operate. The increasing importance of the specialist's dealer function for the entire market is making this gulf so wide as to threaten the image of the Exchange as a marketplace whose specialist system assures strength in all markets. The extent of dealer participation on the part of different specialists depends in considerable degree on the adequacy of their capital, and thus an adequate capital provision is a basic prerequisite for a strong specialist system. This is true not only in respect of extraordinary demands on the system in the handling of large blocks, as discussed below, but also in respect of more routine market situations, as illustrated by those specialist units which endeavor to end each day with as small a long or short position as possible ("daylight trading"), in order to avoid risk and capital commitment. The capital requirements of specialists, designed to assure that specialists have sufficient funds to maintain fair and orderly markets, have not been increased by the NYSE for many years although they were established at a time when market conditions were vastly different from those existing at present. In terms of units of stock (but not necessarily dollars) they are lower than Amex requirements as recently increased.

Just as underparticipation by some specialists in some situations raises one set of questions, so also are there important questions of overparticipation by specialists. The latter questions had earlier recognition and emphasis in regulatory terms; under the Exchange Act, a specialist's dealer transactions are to be restricted "so far as practicable to those reasonably necessary to maintain a fair and orderly mrket," and this standard was early defined (in the Commission's so-called Saperstein Interpretation of 1937) as relating to price continuity and minimizing the effects of temporary disparities between supply and demand. Despite the restrictive tenor of the statute and its official interpretation, the NYSE, particularly in recent years, has emphasized high dealer participation as a general standard for specialists.

The restrictive purpose of the Saperstein Interpretation should receive new emphasis in the form of a Commission rule, while at the same time the affirmative obligation of specialists to make fair and orderly markets should also be set forth in such a Commission rule. Exchange rules should then give further content to both aspects, by expressing as specifically as practicable the requirements and standards deemed applicable to typical problems of overparticipation and underparticipation as they have arisen in respect of various market situations and among different specialist units. In particular, there should be greater emphasis on what might be termed "continuity with depth," i.e., with reasonable volume at each price level, rather than mere price continuity without regard to volume. The total aim of Commission and Exchange rules should be to focus more closely on experienced problems of each type, overparticipation and underparticipation, rather than blanketing all problems of specialist participation under a general emphasis either on minimum participation or high participation.

As specialists' dealer participation has increased, there has been a growing tendency by the Exchange to express the utility of the specialist dealer function in terms of "stabilizing" prices (as distinguished from providing transaction-to-transaction continuity). To measure specialists' stabilization performance, the Exchange uses the "tick test," under which, in general, a purchase below or a sale above the price of the last different transaction in the stock is deemed to be stabilizing. The results of the Special Study show that, under the tick test or other tests of stabilization, the stabilizing effect of specialist trading varies considerably among specialist units and in differing circumstances, so that aggregated data obscure wide disparities.

During the May 1962 market break, specialists as a group did not have a significant stabilizing effect on the market, though as a group they had been reducing their inventories since the end of 1961, and there were wide differences in performance among specialists. The data collected concerning the market break demonstrate that the tick test is an inadequate measure of stabilization, since it fails to take account of specialists' trading in relation to the overall trend of the market. The Exchange should not only develop more effective methods of testing specialists' performance, but should apply its regulatory authority to bring deficient specialists up to an acceptable level. It should be emphasized, however, that ordinarily the capacity of specialists to provide price stability is a distinctly limited one. No system of dealer trading can be expected to stabilize—in the sense of preventing price changes—in a market subjected to heavy public buying or selling.

Although the Saperstein Interpretation emphasized that each dealer transaction must meet a test of affirmative market necessity, some specialists have claimed that they have the right to liquidate their inventory if it becomes financially necessary to do so, regardless of the market effect of such liquidation. Connected with this is the view that a clearing firm financing a specialist has the right to instruct the specialist to liquidate his position without prior notice to the Exchange. During the May 1962 market break, a few specialists were in financial difficulties. It is not clear whether the Exchange was aware of the financial condition of these specialist units, but in any event no corrective action was taken. It is imperative that the Exchange keep itself informed of specialists' financial condition on a current basis, and that stocks registered with specialists who find themselves financially unable to perform their dealer function adequately be promptly reallocated, in order to assure the public the continuous benefits of specialists' performance.

The Saperstein Interpretation is ambiguous as to whether the policy against a specialist's "cleaning up the book" applies to liquidating a position. This ambiguity should be resolved by making the policy applicable to liquidations, and relevant standards and procedures in respect of acquiring or liquidating a position against the book should be more specifically defined.

Increasing institutional participation in the market has changed and may still be changing the kind and degree of demands on the specialist system, because the tendency of institutional investors to deal in large blocks tends to increase temporary disparities between supply and demand. Specialists vary considerably in their willingness and ability to buy or sell susbtantial blocks at prices close to the last sale price. To preserve the Exchange's place as a centralized market, mechanisms for orderly trading of blocks in all listed issues within the auction market should be reexamined and strengthened where possible and, to meet this specific need as well as the general need mentioned above, specialists' capital requirements must be reevaluated.

The dealer activities of some specialists are influenced by tax considerations rather than the needs of the market, especially where specialists segregate holdings of securities in which they are registered into long-term investment accounts. These accounts raise several types of questions. First, their existence is generally inconsistent with the Saperstein Interpretation, because neither the acquisition of stock for investment nor the withholding of stock for investment reasons comports with the criteria for specialists' dealings as principal. Second, they make the specialist an investor and give him a motive to support the market instead of merely performing his function of providing continuity and depth to the market. Third, specialists frequently establish these accounts by taking advantage of their exemption from Federal margin regulations, a purpose contrary to the purpose of the exemption.

Although providing market continuity and "instant" liquidity in a continuous auction market requires heavy professional participation, and the Exchange has encouraged such participation, Exchange literature has spoken of the specialist as merely a "balance wheel" between public supply and demand, a professional who buys when others want to sell and sells when others want to buy. What has not been made clear is that in many significant ways the specialist is in a position to, and does actually, "administer" the market and affirmatively influence price levels and trends—that the specialist, except in the most active stocks, may often be the market rather than a mechanism for linking buyers and sellers together.

It is in openings that dealer activities of specialists have made the clearest intrusion on the concept of a free market. The opening price of an issue is probably the single most important price of the day. Here above all, the principle of a free and open market, with prices set by public supply and demand, should govern. Except to maintain price continuity, the specialist should not interfere in openings, either by this participation as dealer or his judgment as broker. The present system of centralizing orders in the hands of the specialist, however, seems a fairer and more efficient system than the old system, where brokers individually bid and offered.

The virtual disappearance of competing specialists makes it particularly important that there be uniform standards as well as close supervision in respect of various types of situations where the specialist's ability to set prices unilaterally is particularly high. The Exchange has recognized that it has an affirmative duty to improve specialist dealer standards in this as well as in other areas. Yet the diversity among the various specialist units is so great as to indicate that existing standards are too flexible.

B. THE SPECIALIST AS BROKER—CONFLICTS OF INTEREST

The combined functions of the specialist, acting as he does for the orders entrusted to him and for his own account as principal, involve an inherent conflict of interest. Furthermore, he acts for customers on both sides of the market, and he also has a responsibility to act on behalf of the market as a whole. In view of the benefits which responsible dealer activities can confer on the market, this conflict is tolerable, but only under a regulatory system which contains effective controls.

The general argument in favor of continuing to permit the combined functions is that specialist brokerage income, which is substantial, provides a continuous source of capital and incentive in the performance of market-making activities. Although the force of this argument is somewhat weakened by the fact that dealer activities also generally provide a continuous profit, it nevertheless remains a strong one.

An even stronger argument is that expectations of investors, credit arrangements which depend on liquidity, and the very organization of the exchanges, to one extent or another revolve around the technical market functions of the specialist. These considerations alone would require that any such drastic change as segregation of functions should be based on a clear preponderance of the evidence. Such preponderance does not exist, although it is clear that the specialist can and does compete with his own customers and that many fine distinctions are involved in differentiating proper from improper conduct. For example, when a specialist outbids or underoffers customers who have employed limit orders, which indicate a price beyond which they are unwilling to go, he may be merely performing his dealer function of providing continuity between transactions or in some circumstances he may be competing unfairly.

The specialist's exclusive knowledge of the orders on the book and the known source of supply and demand available to him through the book give him a definite trading advantage over other market participants. This can be justified only by the benefits which the specialist confers on the market, and only if high standards of conduct in dealer and broker activities are defined and enforced.

Certain practices of specialists which exacerbate the inherent conflict of their dual role should be terminated. Specialists and their firms should not be allowed to have their own retail customers (as opposed to customers of other brokers whose orders are given to the specialist for execution). Transactions for a specialist's own customers do not affirmatively assist his market-making activities and are fraught with possibilities of abuse.

The practice of "stopping stock" against orders on the specialist's book, i.e., using an order on the book to guarantee a price to another investor, involves too great a compromise of the specialist's fiduciary obligation for personal profit without any strong offsetting gain to his market-making function. A number of transactions made pursuant to "stops" are deliberately omitted from the tape, apparently without valid justification.

There is confusion as to the precise kinds of orders that specialists are permitted to accept and their responsibilities with respect to each. Although NYSE specialists have been prohibited by the Exchange since 1952 from accepting "not-held" orders—orders allowing discretion as to time or price of execution—many specialists continued to accept them until the fall of 1961. The acceptance of "not-held" orders by specialists involves a compromise of fiduciary obligations (and in some cases market-making activities) which far outweighs any possible benefits.

C. SURVEILLANCE AND ENFORCEMENT

Although present NYSE surveillance procedures are in the hands of a capable and sophisticated administration, there is need for greater attention to specific problem areas and there is need for a more thorough examination procedure generally. In one particular, the surveillance process should be more sensitive to conflict of interest problems. Ideally there should be a regular method by which the sequence of transactions, the specialist's book, and his own transactions in any stock could be quickly and conveniently reproduced.

Modern data processing equipment would very likely permit this to be done, but the NYSE has shown little inclination to move in this direction; indeed, it has not yet arranged for orders to be clocked at the specialist post, a procedure that has been in effect on the Amex for some years. Also, it is difficult to see how standards of performance and risk-taking can be set without taking into account profitability as well as unprofitability, yet until the NYSE obtained data on specialists' income as a result of the study's Questionnaire EX-1, the floor department had no information whatsoever with respect to trading or brokerage income of any specialist unit or in the aggregate.

Whether the obligations of specialists are defined very broadly in terms of "fair and orderly markets" or are defined somewhat more specifically in relation to particular types of problems, it is clear that a large measure of judgment and discretion is involved in their application and that the administrators of the regulatory system—primarily the exchanges themselves—must exercise vigilance and discrimination in evaluating performance in particular situations. A mechanical application of any or all of the tests used in surveillance (or even new tests) to come to an aggregate figure for all specialists does not discharge the duty of surveillance which ultimately is the protection of individual investors in specific transactions.

The Special Study concludes and recommends:

1. The specialist system now in operation on the NYSE and Amex is different in significant respects from the system which existed when present regulatory policies were established, and is different also from the image of the specialist system as frequently projected. In its present form, it appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be serving its purposes satisfactorily. There is a need, not for any broad and drastic change in the system, but for a number of important, specific improvements in specialist practices and in regulatory concepts and methods, as set forth in the following paragraphs. For the most part, these can and should be accomplished through changes in the rules and procedures of the respective exchanges, except that, since the Commission is not presently empowered to enforce rules of the Exchange (see ch. XII), it would be desirable to define certain basic dealer responsibilities of specialists (pars. 2 and 3 below) in rules of the Commission under section 11(b) of the Exchange Act. The limited volume of transactions on the regional exchanges and the dependence of these exchanges on the dual trading system may make it impracticable to place such responsibilities on regional exchange specialists and for the present they should be excepted from any such rules under section 11(b). Further studies are needed in the structure of regional exchange specialist systems, and questions of responsibilities and privileges of these specialists should be held in abeyance pending such studies.[1]

[1] For this reason most of the following paragraphs are applicable only to the NYSE and/or Amex although specific items may also be applicable to one or more regional exchanges insofar as they use a specialist system in respect of primary listings.

2. Section 11(b) of the Exchange Act states a policy of restricting specialists' dealings "so far as practicable to those reasonably necessary to maintain a fair and orderly market." The so-called Saperstein Interpretation promulgated in 1937, among other things, limits specialists' dealer transactions to those reasonably necessary to maintain price continuity and minimize temporary disparity between supply and demand. The NYSE's policy and practice of indiscriminately encouraging specialists to increase their participation as dealers is incompatible with the restrictive tenor of these provisons. Although the changed market context since 1937 has seemingly changed the level at which the standard of "reasonably necessary" in the foregoing provisions must be applied, it is still an appropriate and desirable standard which needs restatement, in place of the NYSE's present emphasis. The relevant portion of the Saperstein Interpretation should be embodied in a rule under section 11(b).

3. While specialists should be restricted in their dealer participation to what is reasonably necessary to maintain a fair and orderly market, an affirmative obligation on their part to participate to the extent reasonably necessary to maintain a fair and orderly market should be more clearly recognized and enforced. The rules of the NYSE now merely state that such participation is "commonly desirable," and, in practice, the Exchange has not held individual specialists to high standards of performance, with the result that considerable unevenness in the quality of markets in individual securities has been tolerated. A rule should be adopted under section 11(b) to state the obligation positively.

4. The NYSE should increase its specialist capital requirements in recognition of current market needs and specialist obligations. Instead of the present requirement of capital sufficient to carry 400 shares of each stock in which a specialist is registered, the nature of the market in most securities would seem to require that specialists have the capital ability to carry at least 1,200 shares, and preferably a higher amount such as 2,000 shares, of each issue; the exact figure or figures may be left for future definition by the exchange and the Commission jointly.

5. The NYSE and Amex should adopt rules relating to specialists' participation in openings and their trading as dealers, as follows:

(a) With respect to openings, such rules should be designed to prohibit specialists from participating in openings in such manner as to upset the public balance of supply and demand; i.e., from using their position as dealer, or a broker or all participating parties, to change prices. The policy of such rules would be that opening prices should move, from the previous close, in the direction dictated by public supply and demand and not against it.

(b) With respect to trading after the opening, such rules should limit the ability of specialists to "reach" across the market; i.e., buying at the offer or selling at the bid, whether such transactions are to establish or to liquidate a position. Provisions should be made for exemptions from such rules with approval of floor officials and for systematic review by the respective floor departments.

(c) With respect to the general obligation of specialists to participate to the extent reasonably necessary to maintain a fair and orderly market, such rules should give emphasis to the concept of continuity with reasonable depth; i.e., participating in reasonable volume at each price level, and should also make clear that the obligation to participate requires that all quotations be reasonable ones in view of market conditions and not merely nominal ones.

6. The NYSE and Amex should adopt rules requiring that each specialist unit maintain a single trading account. All securities in which a specialist is registered which are owned by such specialist or his unit should be maintained in such account and not segregated for tax or other purposes. No recommendation is made with respect to specialist inventory practices for tax purposes. Nevertheless, in view of the testimony of some specialists that they occasionally trade to adjust inventories kept on a LIFO basis, it should be made clear that trading so motivated is not permissible.

7. The NYSE and Amex should adopt rules governing the brokerage function of specialists and should clarify various related floor procedures, as follows:

(a) The respective exchanges should adopt rules affirmatively defining market and limited price orders and variations thereof, and defining specialists' (and floor brokers') responsibilities with respect to each type of order.

(b) The existing ban against specialists' accepting "not-held" orders should continue. If necessary, consideration should be given to increasing floor brokerage rates to compensate floor brokers adequately for their efforts in handling discretionary orders.

(c) Specialists on the NYSE and Amex should be prohibited from granting "stops" (either by allocating customers' orders or as principal) at any price at which a specialist holds an unexecuted customer's order capable of execution at such price.

(d) The present policy of the NYSE which permits executions resulting from stops to be omitted from the tape should be changed by a rule requiring that every transaction taking place on the floor be reported on the tape. The policy requiring the selling broker to report transactions should be strictly enforced.

(e) A specialist represents conflicting interests, his own and that of customers, whenever he purchases from or sells to his "book;" i.e., from or to a customer whose brokerage order he holds. Policies should be formulated to prevent specialists from dealing with or for customers at unfair prices in relation to the general market conditions or the specialists' own transactions including but not limited to situations where a specialist sells to his customer at the limit price when he knows of a large offering or buys from his customer at the limit price when he knows of a large buy order. Whenever a specialist deals with the book a floor member representing the firm which forwarded the order should initial the specialist's memorandum of each such transaction. In its routine surveillance the Exchange should systematically review transactions covered by such memoranda in light of subsequent transactions by the specialist.

(f) To keep within as narrow limits as possible the conflicts of interest inherent in a specialist's combination of functions, NYSE and Amex specialists and their firms should be prohibited from servicing the accounts of public customers, or receiving commissions on such accounts "introduced" by them at other firms.

8. No information is now publicly available with respect to specialist dealer activity in individual stocks. The NYSE and Amex should report to the Commission on a weekly basis each specialist's purchases and sales as principal in each issue traded. Such reports should be made public so as to give interested investors an indication of the degree of activity, exclusive of specialist participation, in particular issues. On the other hand, in its public statements on specialist activities the NYSE has tended to exaggerate the degree of stabilizing that specialists accomplish or could be expected to accomplish. The Exchange's "tick test," whatever its other uses, is not by itself significant as an evaluation of "stabilizing" of the market by specialists and should not be so represented.

9. The NYSE and Amex should undertake studies, in conjunction with the Commission, as to methods or plans by which the capacity of specialists to acquire larger blocks of stock within the framework of the auction market could be otherwise strengthened. Among other possibilities, consideration should be given to (a) the establishment of an exchange-administered capital fund from which specialists could borrow under appropriate limits and safeguards; (b) the establishment of a capital fund, through contributions from the brokerage income of all specialists, that would be administered by specialists' representatives and/or the Exchange itself and would be available for taking positions beyond the financial capacity of an individual specialist; or (c) establishment of a system of limited self-insurance by specialists as a group. Reference is made to recommendation 4 above with respect to increasing the specialist capital requirement and the recommendation in part F of this chapter concerning the possibility of creating a category of "auxiliary specialists."

10. The NYSE and Amex should be required to report to the Commission any indication that a registered specialist unit is in violation of its specialist capital rule or has received a margin call. These exchanges should adopt rules providing in substance that any member firm which clears for or finances specialists may not terminate clearing arrangements or call for additional margin without adequate prior notice to the Exchange. Where a specialist in financial difficulties cannot promptly secure additional capital sufficient to bring his account above the required margin maintenance, his stocks should be reassigned temporarily or permanently to units with capital adequate to handle them.

11. The NYSE has pioneered in the development of surveillance techniques regarding specialists' performance and has devoted considerable energy to this area. Nevertheless, its present techniques are not sufficiently refined to deal adequately with certain important aspects of the specialist's role and obligations. Among needed improvements on this Exchange as well as the Amex are the following, which should be developed promptly by the exchanges in conjunction with the Commission:

(a) For many routine surveillance purposes it would be invaluable, but it has not heretofore been practical, to have a means of preserving or reconstructing a specialist's book for a given period; modern automation techniques may well remove the practical difficulties and should be promptly explored.

(b) Surveillance of overparticipation as well as underparticipation should be strengthened; as a basic check, regular reporting to the respective exchange of income of specialists, segregated between brokerage income and dealer income, should be required.

(c) In general, surveillance should be directed toward assuring that each specialist is performing his obligation to maintain a fair and orderly market in each security, with appropriate procedures and sanctions for enforcement and with the ultimate purpose of allocating and reallocating securities where required to assure high standards of performance with respect to all securities.

(d) In addition to present tests to evaluate performance, tests for evaluating specialist purchases, sales, and positions in relation to price movements should be evolved, with the object of determining the market effects of specialist dealer activities.

PART E. ODD-LOT DEALERS

About 10 percent of the share volume on the New York Stock Exchange, and a much higher percentage of the transactions, is represented by odd lots—trades in fewer shares than the minimum round-lot unit (in most stocks, 100 shares). The two member firms of Carlisle & Jacquelin and DeCoppet & Doremus for many years have jointly dominated the handling of odd lots on the NYSE, doing about 99 percent of the business. An odd-lot customer deals with these firms only indirectly, through his commission firm. The odd-lot order is executed with the odd-lot firm at a price determined by the price of the next round-lot sale in the security, plus the "odd-lot differential" of a quarter or an eighth of a point (or, for the seller of the odd lot, minus such an amount). The execution of odd-lot orders, which is purely mechanical and in fact is often done by a clerk, is carried out by about 100 floor brokers who work exclusively for one or the other of the two odd-lot firms. The seats held by these brokers, together with those held by the odd-lot firms' partners, account for about 10 percent of the NYSE membership; in contrast, the two largest commission firms have about 1.5 percent of the membership.

The Exchange has allowed the odd-lot differential to be established by the odd-lot firms themselves rather than by Exchange rule, apparently on the theory that a price differential as distinguished from a fee or commission is a matter for negotiation between the odd-lot firms and other member firms. Price competition has not existed between the two major firms for decades, and limited price competition from other member firms was effectively discouraged by a uniform price policy adopted by the Exchange in 1938. Certain of the regional stock exchanges, which theoretically might be a competitive factor with respect to dually traded stocks, have acceded to pressure for uniformity exercised by the New York odd-lot firms and the dual members.

There has indeed been some competition between the two New York firms in the rendering of services such as providing current market information, liberally adjusting transactions to correct errors, and making interest-free loans by means of borrowing large amounts of stock. All of these services, however, are provided by the odd-lot firms to other member firms, particularly the commission houses who provide their odd-lot business, and are only indirectly and partially for the benefit of public odd-lot customers who bear the cost.

The commission firms could hardly have been expected to champion the interests of public customers with respect to the amount of the differential. Indeed, where there has been occasion for them to be heard, their principal concern has been to avoid the embarrassment of having to choose between better prices for their customers and better services for themselves. Hence it does not seem realistic for the Exchange to go on the theory that the differential for odd lots is purely a matter for negotiation between trading firms, since this ignores the reality that the differential is established unilaterally and is borne solely by the odd-lot investor. Likewise, it does not seem realistic to rely on competition in rendering services to the commission firms, since this ignores both the deterrent effects upon actual and potential competition and the passing of the whole cost burden to the public odd-lot customers, who are only the partial beneficiaries of the services.

A duopoly dominating a large and important public business would seem a classic case for rate regulation, and the Exchange has clear statutory authority to regulate, yet it has failed to exercise its jurisdiction and thereby disavowed responsibility. Nor has the Commission ever formally exercised its authority under sections 11(b) and 19(b) of the Exchange Act with respect to the differential or other aspects of odd-lot dealer activities.

As to the other aspects of odd-lot operations, though the Exchange formerly had a standing committee with jurisdiction over odd lots and though it acknowledges that it has full power to regulate odd-lot trading, it has chosen not to exercise that power in the last 25 years. The Commission's suggestion in 1950 that the Exchange consider adopting special rules and regulations did not produce any results. If the handling of odd-lot transactions is essentially mechanical, the handling of offsetting round-lot transactions involves possibilities of special advantage that would seem to call for surveillance if not affirmative regulation. This has received congressional recognition in section 11(b), where it is provided that exchanges may permit (subject to the Commission's residual power of veto or amendment) an odd-lot dealer to buy and sell for his own account, with this explicit limitation: "so far as may be reasonably necessary to carry on such odd-lot transactions * * *." At a minimum, the transactions should be systematically reported, as floor traders' transactions are now reported, and the Exchange should itself supervise the handling of odd-lot brokers' "triggering" round-lot transactions.

The matter of automation is of a different character but is not less a matter of public concern. In 1956 the Exchange employed the firm of Ebasco Services, Inc., to make a study of possibilities for automation on the Exchange. The Special Study has reviewed the history of their proposals concerning the handling of odd lots and of the odd-lot firms' attitudes and actions in regard to them. It is clear that the two firms regarded the possibility of automation as a grave threat to their duopoly, and it is difficult to escape the conclusion that they succeeded in warding off a consideration of the merits by emphasizing the potential impact on seat values for all members and otherwise beclouding the real issues of economy and efficiency. More particularly, they almost immediately succeeded in establishing the principle that the full complement of associate brokers, with their approximately 100 stock exchange seats, was sacrosanct; and once this principle was accepted, the potential for substantial savings vanished and automation was doomed. Automation, whether of factories, railroads or securities markets, always presents difficult problems and conflicting interests—often including the public interest—but it is unusual to have the problems and conflicts resolved with the factor of cost-savings eliminated at the outset.

That the odd-lot firms themselves would resist any plan for modernization which would reduce their profits, eliminate many associate brokers, and make it easier for competition to develop is not surprising. It is regrettable, however, that the Exchange was so ready to accept their contentions and that the commission firms did not feel called upon to voice the interests of public odd-lot customers, whose business both the Exchange and the firms actively solicit. Finally, it is to be noted that the Commission apparently was not advised of the Ebasco proposals at any point, and there was no governmental representation of the public interest in any stage of the deliberations.

This history has significance reaching beyond the specific subject of odd-lot automation. In an age in which electronic means of communication and data processing are being constantly improved and expanded, there are certain to be many valuable new techniques for the securities markets, if not in the next year or two then in the next decade or two—"certain," that is, if the possibilities are not stifled in private discussions among those with vested interests to protect. Securities markets are not inherently more immune from featherbedding than any other business.

If the securities markets are to be truly public institutions, as they have been under the law for 30 years, the public interest in questions of automation must have a voice. The Commission should equip itself to keep abreast of electronic and computer developments in the securities industry. Otherwise, these may be neglected or suppressed for want of any consideration of the public interest.

The Special Study concludes and recommends:

1. Although existing problems in the handling of odd-lot business on the New York Stock Exchange and its regulation by the Exchange and the Commission can be pointed out with considerable specificity, it has not been feasible nor would it have been appropriate for the Special Study to undertake the detailed studies required to arrive at specific answers, as distinguished from pointing out the kinds of studies still needed in order to make appropriate and effective improvements. Especially because the problems revealed affect the small investor, it is important not only that they be recognized, but that the Exchange and the Commission move with dispatch toward their resolution. In the absence of prompt and effective action by the Exchange, the Commission itself should directly undertake the needed measures.

2. The New York Stock Exchange should recognize and meet its responsibility to regulate odd-lot differentials. As a first step to that end, it should immediately undertake, with such participation of the Commission as may be found appropriate, a cost study of the odd-lot business. In such study, costs should be appropriately allocated so that odd-lot customers will not be charged for services rendered to others, including the odd-lot firms' cost of stock borrowing and of information services that benefit commission firms or their round-lot customers. As in the case of commission rates on round-lot transactions (see ch. VI.I (pt. 2)) the Commission should undertake a more affirmative role of oversight in connection with the determination of relevant costs and the fixing of differentials.

3. The Exchange should promptly adopt (i) appropriate rules governing the handling of odd-lot transactions and offsetting round-lot transactions (including but not necessarily limited to the problem of "triggering" round-lot transactions by odd-lot dealers, and the relationships between odd-lot dealers and specialists), and (ii) systematic reporting requirements and surveillance procedures concerning such offsetting transactions.

4. The Exchange should be directed to advise the Commission in writing at an early date (and from time to time thereafter so long as the Commission considers the question open) as to the feasibility of automating the execution of odd-lot orders and as to the possible effects of automation on floor operations, costs, and odd-lot differentials. In connection with its current plans for automation of certain functions and facilities, the Exchange should promptly advise the Commission in writing whether all or any part of the information services now rendered by the odd-lot firms to the Exchange and its members can and should be eliminated, modified, or replaced in any manner. The Commission should make such further studies of its own or in conjunction with the Exchange, and take such further measures, as may be indicated in light of the Exchange's advices on each of the above matters.

5. Inasmuch as the Special Study's consideration of the odd-lot business was essentially limited to the NYSE, the Commission should, in conjunction with the American Stock Exchange and the regional exchanges, undertake studies of the methods and costs of handling odd lots on those exchanges.

6. Reference is made to the recommendation in part I of this chapter with respect to disclosure of the odd-lot differential in customers' confirmations of odd-lot transactions. Reference is made, also, to the recommendation in chapter VIII.B with respect to possible reduction of the round-lot unit.

PART F. FLOOR TRADERS

Of all classes of exchange members on the floor, the floor trader stands alone in having no fiduciary status, no duty to execute transactions, and no market responsibilities or obligations in relation to the operation of the market as a public institution. He is, in short, the only type of member granted access to the floor without being required or expected to participate in the handling of securities transactions. The floor trader's presence on the floor is simply a matter of his desire to trade for his own account. That any individual who purchases a seat thereby becomes entitled to do his personal trading on the floor of an exchange without having any special function or undertaking any obligation in relation to the operations of the market raises, in itself, a fundamental question of public policy as to the extent to which a public market may be permitted to maintain this vestigial "private club" aspect, even apart from very serious questions as to the net impact of floor trading on the orderly functioning of the market.

The privilege of access to the floor provides trading advantages of a substantial nature; the commission cost of trading on the floor is appreciably lower than for off-floor trading, trading activity may be observed minutes before it appears on the tape, and bids or offers may be entered or withdrawn in a matter of seconds. In addition, presence on the floor carries with it the benefit of what has been termed a "feel of the market"—a heightened sense of market tenor and trend. In part this "feel of the market" is attributable to the constant exchange of observations among floor members, either with respect to general market conditions or, more specifically, to such factors as the volume and type of orders or cancellations coming to the floor. More subtle factors also add significantly to the floor member's awareness; familiarity with the trading techniques of specialists or floor brokers, for instance, in many cases combined with knowledge that a large block of stock is being accumulated or distributed, is a factor that facilitates the trading activities of the floor trader.

Section 11 of the Exchange Act vests the Commission with broad powers to regulate or prevent principal transactions by exchange members on the floor of an exchange. It is clear that one of the major legislative concerns underlying this broad grant of power was that benefits derived by the public from member trading on exchange floors were not in balance with the advantages derived by the preferred groups.[2] Viewed in this light the broad scope of the section is thoroughly consistent with one of the dominant themes running through the series of statutes administered by the Commission—denial of special advantage in the public interest and for the protection of investors. The equality of access to full and accurate corporate in-

[2] Early drafts of sec. 11 would have turned exchanges into pure auction markets, banning all except brokers from access to the floor. See "Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce," 73d Cong., 2d sess., pp. 116–117 (1934).

formation sought to be guaranteed by these statutes is complemented by the specific provisions of the Exchange Act which seek to provide open and honest markets in which investment decisions may be acted upon. In its administration of the statutes the Commission has shown that the guiding concepts are dynamic and not static. If anything, there has been an increasing emphasis on fairness and equality. A recent case, for example, has made it clear for the first time that a broker in possession of important nonpublic corporate information is under severe limitations as to the use of his knowledge in the marketplace.[3] In a disciplinary proceeding within the last few months the NYSE found it contrary to acceptable business practice for a broker to trade on similar information. Although the content and quality of floor information and the "lead time" of a trader on an exchange floor may be different from the information and advantages noted in these cases, the principle remains the same. Only some strong, demonstrable, countervailing public benefit can justify the special advantages enjoyed by the floor trader. Absent such a balancing consideration, floor trading is an anomaly—a special advantage in a public market which can be enjoyed by purchasing access to the floor of an exchange.

The anomaly becomes more disturbing in light of the fact that floor traders tend to have a destabilizing influence on prices. On at least 15 separate occasions since 1934, studies conducted by the Commission and the Division of Trading and Exchanges, confirmed by studies made by the Special Study, have shown that floor traders are generally buyers in rising markets and sellers in declining markets, with respect to both the market as a whole and to individual stocks. Their trading, as a result, is inimical to the orderly functioning of the market, tending to accentuate rather than to stabilize price movements.

Apart from its effect on price stability, floor trading has been defended on the grounds that added market liquidity and continuity are its beneficial byproducts. There is no doubt that floor trading, as does any kind of trading, adds liquidity to the market. The same may be said, however, of transactions effected in error, pool operations, wash sales, or other transactions generally acknowledged to be undesirable elements of a sound market. That is to say, added liquidity standing alone cannot justify trading that in other respects is deleterious. In addition, floor trading is heavily concentrated in the active stocks where added liquidity is needed least. Finally, to the extent that floor traders improve liquidity; they may, on occasion, fulfill a specialist's function but they remain totally free of the specialist's responsibilities.

Much the same considerations deprive the continuity defense of floor trading of much of its weight. Because floor traders concentrate their trading in the active stocks, the continuity they add is limited for the most part to the stocks that suffer least from lack of continuity. Such continuity, moreover, is obtained at the expense of permitting a type of floor activity that has an adverse impact on price stability. Again, in adding continuity they perform a specialist function without incurring specialist obligations. In at least one respect, the con-

[3] *In the Matter of Cady, Roberts & Company*, Securities Exchange Act Release No. 6668 (Nov. 8, 1961). This case held a broker-dealer in violation of secs. 17(a) of the Securities Act and 10(b) of the Securities Exchange Act, for selling stock for his own and customer discretionary accounts, upon learning—one-half to three-quarters of an hour before the public—that the issuer had cut its dividends. (See ch. III.F. (pt. 1).)

tinuity defense of floor trading is definitely less persuasive than the liquidity defense; whereas floor trading may never be said to detract from liquidity, there are occasions on which floor trader participation in the market has a negative impact on price continuity. Due to the tendency of floor traders to trade with price trends, their participation in auction proceedings often adds to the imbalance of buyers and sellers and thereby encourages more rapid and sizable price changes.

Floor trader contributions to market liquidity and continuity, in short, are not of sufficient magnitude or importance to warrant retention of this vestigial "private club" aspect of the exchanges. If the exchanges feel problems of market liquidity or continuity exist, solutions should be sought which provide greater assurance of these qualities in those stocks and during those periods when they are most needed, rather than fortuitously or when and where least needed. Improving specialist capital requirements, for instance, or assigning floor traders responsibilities as "auxiliary specialists," would constitute more direct approaches to these problems, and the latter approach would enjoy the further merit of tempering special market advantages with definite market obligations.

Attempts to retain or expand the benefits of floor trading and at the same time curtail its undesirable characteristics have been nominally successful at best. In 1945 the Commission proposed the abolition of floor trading, but withheld action in light of repeated assurances that the exchanges would develop effective self-regulation of this activity. Despite the great variety and complexity of exchange rules experimented with to date, however, floor traders still retain their significant private trading advantages in a public market, continue to concentrate their activities in the more active stocks, and continue to accentuate price movements.

Self-regulation in this particular area has not only been generally ineffective, but in a most important respect it has been misdirected. The exchanges' regulation of other categories of members on the floor is generally to assure adherence to obligations designed to benefit the market. In the case of the floor trader, on the other hand, the exchanges have established elaborate rules and complicated enforcement mechanisms, the sole purpose of which is to restrict activities that are primarily of private benefit. The public interest cannot ignore this administrative burden required to police private investing practices on the floor.

The Special Study concludes and recommends:

1. Floor trading in its present form is a vestige of the former "private club" character of stock exchanges and should not be permitted to continue on the NYSE or Amex. The Special Study therefore recommends that, except as permitted under any program adopted pursuant to the following paragraph, (a) floor trading on the part of members and member firms of the NYSE and Amex whose income from floor trading in each of the years 1961 and 1962 amounted to less than 25 percent of their total gross income from all activities in the securities business (including floor trading) should be prohibited by a Commission rule under section 11(a) on and after January 2, 1964; and (b) floor trading on the part of members and member firms whose income from floor trading in either of the years 1961 or 1962 exceeded 25 per-

cent of their total gross income from all activities in the securities business (including floor trading) should be prohibited by such rule on and after January 2, 1965. There should be excepted from these prohibitions, however, (i) transactions by specialists or odd-lot dealers in stocks in which they are registered, if reasonably necessary in terms of the functions served by such members; and (ii) transactions effected to offset transactions made in error.

2. It has been noted, in chapter VI.D (pt. 2), that the financial capacity of some specialists or of the specialist system generally is in need of strengthening, and it is possible that some present floor traders could perform a highly useful function as "auxiliary specialists." The NYSE and Amex should undertake studies, in conjunction with the Commission, as to the feasibility and desirability of a program under which present floor traders or other members of such exchanges might register with the exchanges as "auxiliary specialists," with permission to trade on the floor in any security on condition that (a) the auxiliary specialist meets special capital requirements equivalent to those applicable to a specialist registered in (say) 10 average-priced stocks; (b) all transactions of such auxiliary specialist on the floor are either undertaken at the unsolicited request of a specialist and in accordance with rules similar to those governing specialists, or are effected for the purpose of reversing in whole or in part a transaction so undertaken. If such studies indicate the feasibility and desirability of such a program, it should be put into effect promptly with appropriate procedures for surveillance by the respective exchanges.

3. Since floor trading on regional exchanges in dually listed stocks does not appear to influence price movements or involve special advantages, a different approach or approaches to floor trading on regional exchanges may be warranted and should be the subject of separate consideration by the Commission. Among other things, consideration should be given to whether floor trading in solely listed stocks on regional exchanges is or is not comparable to floor trading on the NYSE and Amex.

PART G. MEMBERS' OFF-FLOOR TRADING

Trading by NYSE members on the Exchange but from off the floor accounts for approximately 5 percent of total Exchange purchases and sales, but on occasion accounts for more than 50 percent of all purchases or sales in a given stock over a given day or week. Generally such trading is characterized by a tendency to favor stocks and stock days of high volume; and by a rather consistent pattern showing significantly more sales than purchases. The sources of the shares sold on the Exchange in excess of those purchased are generally considered to be stock splits or dividends or arbitrage purchases in other markets, but data have not been obtained to confirm these assumptions. Similarly, the extent to which member off-floor trading represents investment, speculation, arbitrage activity or other functions has never been ascertained. Until such data are available, no conclusions as to the significance of such trading may be reached.