

THE FLOOR DEPARTMENT

MEMORANDUM

January 6, 1971

Present from the SEC: Nicholas Wolfson, Thomas Russo, Kenneth Rosenblum, Helen Steiner, Robert Bretz, Herbert Mayer, Jim Mann and, on occasions, Irving Pollack.

Present of the Exchange: J. W. O'Reilly and James Swartz.

The meeting started at 10:00 a.m. Except for a break for lunch, it was completed shortly after 5:30 p.m. Primarily this concerned the performance of specialists and financial surveillance over specialists.

In the past the SEC Staff has not agreed on many occasions with the judgment shown with respect to disposing of cases in the Investigating Division but they were not generally critical of the surveillance exercised by The Floor Department. This time, covering a review of the May 1970 visit, the SEC was critical of the surveillance.

The SEC was of the opinion that in the week April 27 – May 1, not nearly enough had been done with respect to seeing that the specialists were performing their functions. They mentioned that the aggregate data indicated specialists were net sellers while the market was declining. This contributed to the lack of stabilization in the market.

The SEC said they recognized that on balance figures do not mean positively that specialists did not perform but that the indications were there and that The Floor Department should have looked further into the facts. They said they looked at 88 stocks and 31 of them indicated some failure on the part of specialists to perform adequately. Of these, they said that 14 deserved further attention from the Exchange and nine should at least be sent to the Advisory Committee.

The whole morning and part of the afternoon was given over to reviewing these fourteen stocks. I was requested to render a written opinion concerning each of these stocks and to tell what action the Exchange had taken. I was also asked to report to them on the number of Form 81 reports requested by The Floor Department from specialists in the fourteen stocks which were independent of the requests made by the SEC. Mr. Wolfson mentioned that the report on their inspection visit had been sent to the Commission prior to discussing it with me.

Mr. Pollack mentioned the interest on the "hill" in the securities business, the complaints congressmen had received and the need for focusing on the financial area.

Reference was made by Mr. Wolfson to the SEC Commission Release #743 spelling out an agreement between the Exchange and the SEC that it would be notified whenever a specialist received a margin call and was not able to perform. Initially, the

SEC stated that this agreement had been violated. This was based on changes in the financial arrangements of specialists. Subsequently, they agreed that it had not been violated but that they want to expand the agreement so that they would be notified any time there was a change in financial arrangements. I mentioned that if a man had a 50% arrangement and it was changed to 40%, they would want to be notified whereas another could have a 10% arrangement and they would not want to be notified. Thus they were requesting data which possibly had nothing to do with possible liquidity problems. They then changed this to request that they be notified whenever the financing arrangement was changed to go below 25%. I told him we would think about it.

Initially, the SEC was critical of the fact that we were checking specialist capital every two weeks since they felt that something could happen in the time interval between. In the past we had checked based upon changes in the market. Therefore, they requested that we check at least semi-weekly. This I refused to do. They were also critical of the fact that we gather capital information by telephone. In conclusion, they asked me not to change the two week time without notifying them.

The SEC were also critical of the fact that specialists filed Form SPC dealing with specialist borrowings and equity much later than the ten days required by the Rule and that this interfered with our capital check. I mentioned that SPC had nothing to do with a capital check; that it was filed for the purpose of gathering borrowing information for submission to the Federal Reserve Board; but that we used it to see what margin the specialist was on at that particular moment in time. Further there was no ten day requirement in the Rule. It was a Staff "flagging" device for determining lateness. I mentioned we would improve on that area.

The Floor Department has arrangements with a number of banks--with the permission of the specialist creditor--that the banks will notify us when they, in effect, issue margin calls to specialists. In other cases the clearing specialist firm that deals directly with a bank has informed us in writing that they will notify us immediately when they receive a margin call from the bank. The SEC requests that we receive such information directly from the banks.

The SEC felt there is no real check on the financial status of specialists. They had reviewed the accountant reports and the information was not in there. I mentioned the accountant report was primarily to check on specialists handling of orders and that all specialist firms submitted answers to questionnaires to The Department of Member Firms. The opinion of the SEC was that specialist firms should file financial statements based upon an outside audit by certified public accountants.

The Sec stated that they had been unable to reconcile the differences between the Exchange's Income and Expense Report and The Floor Department report from specialists showing profit and losses by stock. We were requested to change the recording requirements so that it would be possible to reconcile these reports. Further, they requested the Exchange obtain profit and loss statements by stocks from the specialists on a monthly basis. In an aside, they noted that there were some firms that

made very hefty profits indicating that possibly they were not doing a good job during the bear market.

In an earlier inspection visit the SEC Staff noted there were a number of complaints with respect to stop orders. It was stated that the SEC has received numerous complaints from customers concerning the execution of such orders when there is a wide gap between the stop price and the execution price. They requested me to write to them and tell them what the Exchange would do with respect to changing the rule so that our rule corresponds with the American Exchange where stop orders can be entered only as limited price orders at the stop price.

They said there was a large file on up tick purchases by specialists. They cited instances of what they considered to be lack of adequate action by the Exchange and asked for my comments after I had time to review them. In a number of them we had sent cautionary letters to the specialists and the SEC felt they should be Advisory Committee cases.

Without being specific, they expressed their concern over the specialist contacts with company officials. They mentioned that they thought it was an area about which the Exchange should be more concerned. They also felt that more care should be given to reviewing Form SPA wherein specialist public customers orders were shown. They said they noted instances where there were a number of orders in the same stock indicating possible recommendations by specialists of specialty stocks.

Other subjects discussed were specialist investment accounts, "not hled" orders, percentage orders, rulings with respect to specialist trading off-Floor, hedge fund accounts.

In the course of the meeting they recommended strongly that the Exchange use chart computer graphs which would show what stocks should be reviewed after specialist dealings, etc. were added. They had not considered the economics of the situation nor the fact that we do not have the specialist dealings in the computer but have to obtain it directly from the specialists. They recommended that we keep records by specialists units of possible violations and a Rule file, which would list all possible violations of the Rule.

J. W. O'Reilly