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Memorandum for the Commissioners

From: David Saperstein

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MEMORANDUM PRELIMINARY TO HEARINGS ON
SPECIALISTS

I. The Activities of the Specialist, in General

As of the first day of July, 1933, there were approximately 372 specialists on the New York Stock Exchange and 377 specialists on all other exchanges throughout the country, making a total of 749 specialists. It is estimated that at least twenty exchanges have no registered specialists.

Specialists commonly act as sub-brokers executing orders for the account of other brokers in particular stocks, and also act as principals dealing in securities for their own account. Every stock listed on the New York Stock Exchange has a specialist; some stocks have more than one specialist; and some specialists have more than one stock.

Specialists are not restricted by the rules of the Exchange as to the kind of orders they may execute. Hence, they fill market orders, limited orders and stop orders. A market order to buy is an order to buy at whatever price the security is immediately obtainable; a market order to sell is an order to sell at the price immediately obtainable. A limited order to buy is an order which fixes the maximum price at which the customer will buy; a limited order to sell is an order which fixes the minimum price at which the customer will sell. The effect of a limited order is to vest the specialist with authority to buy at a lower price than the maximum or to sell at a higher price than the minimum fixed by the customer. A buy stop order is an order to buy at the market after the stock shall have sold at or through a fixed price above the current price. A sell stop order, which, like a buy stop order, is generally a protective order to limit loss, is an order to sell at the market after the stock shall have sold at or through a fixed price below the current price.

The majority of specialists also act as dealers, and trade extensively for their own account. It is in connection with their activities as traders for their own account that most of the problems concerning specialists arise.

For a general discussion of the activities of the specialist see excerpts from "The Work of the Stock Exchange", by J. Edward Meeker, in Schedule 1 annexed hereto.

For a discussion of the percentage of trades in particular securities which clear through specialists, and the percentage of trades of specialists for their own account, see excerpts from Chapter 1 of the report of the Senate Subcommittee in Schedule 2 annexed hereto.

II. Problems

1. SHALL THE SPECIALIST BE PERMITTED TO TRADE FOR HIS OWN ACCOUNT?

(a) Affirmative arguments -

(1) The specialist maintains a closer, more orderly, and more liquid market for the securities in which he specializes.

Note:- For the comments of various individuals in support of this argument, see excerpts from the discussion before the Senate Committee on Banking and Currency, contained in Schedule 3 annexed hereto.

(2) The compensation derived from activities as a broker specialist exclusively is not sufficient to warrant the specialist in incurring the risks attendant thereon.

Note:- For the comments of various individuals in support of this argument, see excerpts from the discussion before the Senate Committee on Banking and Currency, contained in Schedule 4 annexed hereto.

(b) Negative arguments -

(1) The specialist's trading in the active stocks which would have a continuous market without his personal trading bears a larger proportion to the total transactions in such stocks than in the less active stocks where his trading is needed.

(2) The specialist's trading in many cases does not stabilize the market because he is following the trend of the market.

(3) Since a substantial percentage of all trading in a particular security clears through the specialist (See Schedule 2 annexed), the "book" reflects the condition and tendency of the market and invests the specialist with superior bargaining power over those who trade with him.

(4) The specialist by virtue of his relationship to the market is in a position whereby his influence may be converted into a price factor of major importance and may even become the price determinant.

(5) The specialist's trading encourages speculation by the public and the more active the specialist's trading, the greater the public interest (See Sprague's testimony in Schedule 3 annexed). The specialist's trading is prompted by the fact that the profits on his trading are greater than those derived as commissions. Moreover, when his own trading stimulates public activity, his commissions are increased.

(6) Although the specialist's trading may create a narrower market in the particular transaction, excessive trading by the specialist creates the impression of an active market which induces outsiders to trade and accelerates the rise or decline in the price of the stock. The general price level of the security may have been substantially lifted or lowered as a result of the specialist's trading. Thus, while the customer may profit by a fraction of a point in the particular transaction, the specialist's trading may have altered the price level considerably to the customer's disadvantage.

(7) There is no obligation on the specialist to maintain a close and orderly market. In many cases, he trades only when he sees an opportunity to make a profit.

Note: For confirmation of this argument, see testimony of Harry H. Moore, member of the New York Stock Exchange, testifying at the request of the specialists before the Senate Committee on Banking and Currency, set forth in Schedule 5 annexed hereto.

(8) The trading operations of the specialist are of a sporadic character and may frequently cause fluctuations and wide swings which would otherwise not result.

(9) In those stocks where the specialist does maintain a continuous market, it is the speculative "in and out" rather than the investor who benefits. The speculator's interests require a continuous market, the investor's, a stable one.

(10) The fact that the specialist acting as a broker incurs some risk for which he may not be adequately compensated is not an argument in favor of permitting him to trade for his own account. Every floor broker assumes the risk of the solvency of the other party to a transaction or of error in the execution of an order.

2. SHALL THE SPECIALIST CONTINUE TO KEEP CONFIDENTIAL THE INFORMATION CONTAINED IN HIS "BOOK"?*

(a) Affirmative arguments -

(1) The "book" gives the specialist no advantage over the public since it contains only a small portion of the orders in a particular security.

(2) Divulging the contents of the "book" would give manipulators and "sharp" traders an advantage over the public.

(3) The information contained in the "book" may be misleading to inexperienced investors or speculators.

(4) The relationship between broker and customer is confidential and the customer might object to having his order disclosed.

(b) Negative arguments -

(1) The "book" has been conceded by specialists to give them an advantage over the public. The percentage of trades which clear through specialists is sufficient to give them an accurate picture of the trend of the market (See Schedule 2).

(2) Since the specialist has exclusive knowledge of

*See Section 11 (b)(3) of the Act.

bids below the market and offers above, as well as of stop orders above and below the market, he is in a superior position to trade for his own account, and to influence the price level.

III. Tentative Suggestions as a Basis for Discussion.

The Commission is empowered under Section 11 (b)(2) to permit a specialist to act as a dealer as well as a broker, or to limit him to acting as a dealer. If he is permitted to act as a dealer, the following suggestions are offered for the purpose of restricting his dealings to those reasonably necessary to permit him to maintain a fair and orderly market.

(1) If the specialist is long of stock or has no position, he cannot buy stock from his "book" at a price which would make a new high for the day. At the opening, he cannot buy stock from his "book" at a price higher than the closing price of the previous day. If the specialist is short of stock, he can buy stock from his "book" for the purpose of covering his position, even at a price which will make a new high for the day.

The advantages of this rule are that:

(a) It restricts him from "marking up" stock to new highs by trading with his "book" when he has a long position, but does not penalize him if he desires to cover a short position. When a stock makes a new high, the public's trading and not the specialist's will be the cause.

(b) It will decrease the number of "strings" appearing on the tape as a result of trading by the specialists. Such "strings" encourage the public to purchase on bulges.

(c) It does not prohibit him from trading with other than those on his "book" and leaves him free to trade between the bid and ask prices on his "book."

Note: It is assumed that the present rules of the New York Stock Exchange giving precedence to the orders of his customers over his own will continue in effect.

(2) The specialist cannot fill bids on his "book" by selling the stock short. Subject to such rules as the Commission may promulgate with regard to short selling, the specialist may sell short to fill bids other than those on his "book."

This rule, by restricting the specialist to selling short only to fill bids other than those in his "book", should prevent him from accentuating minor reactions. The public with stock for sale will receive better prices since the bids on the "book" will be available to them rather than to the specialist who would go short of stock.

(3) The specialist cannot sell long stock to his "book" at a price which would make a new low for the day. At the opening, he cannot sell long stock to his "book" at a price below the last sale of the preceding day.

This rule would make it impossible for the specialist to establish a new low price by trading with his "book." While the specialist is placed at some disadvantage as compared with the general public, this disadvantage is merely compensatory of the advantage which he derives by virtue of his exclusive knowledge of the "book." It also prevents him from accentuating the rapidity of a decline and discourages him from taking very large positions.

Note: The adoption of the foregoing rules, since they minimize the advantage to be derived by the specialist from the exclusive knowledge of his "book" commensurately minimize the importance of the question whether the "book" should be disclosed.

(4) The specialist should be required to preserve his "book" and other records of his transactions for a period of at least two years and the "book" and other records of his transactions should be kept in such form as to be available to inspection by officials of the Exchange or representatives of the Commission during such period.