

COMMENTS  
OF  
Certain Wholesale Dealers  
ON  
Chapter VII  
OF THE  
Report of Special Study  
of Securities Markets

*Presented by*

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In a comprehensive manner, Chapter VII of the Special Study of Securities Markets (the "Study") deals with the many sectors of the over-the-counter market. The Report recognizes the diffuse and heterogeneous nature of this important market, and concludes with certain recommendations which are "essential in some sectors" but "unnecessary or inapplicable in others".

The specific conclusions and recommendations of the Study are acknowledged not to have been presented to any private person or group for comments. In his transmittal letter, Chairman Cary recognizes the need to subject many of them to further evaluation. Because the conclusions and recommendations of this Study so vitally affect the business of the wholesale dealers, we are taking this means of presenting our comments in the hope that they will be evaluated and carefully considered by the Securities and Exchange Commission before it acts to implement the conclusions and recommendations proposed by the Study.

As the Senate Committee on Banking and Currency has said, the over-the-counter market "has become an important institution for the channeling of investor capital into the nation's business enterprises" (S. Rep. 379, 88th Cong.,

1st Sess. at p. 11). Its growth during the past twenty years is a testimonial to the function it has performed. We are not unmindful of the paramount responsibility of the SEC to protect the interests of the public investor. We believe that this protection can—and must—be provided without impeding the orderly functioning of a market which has contributed so much to the growth of American business and thus to the growth of America. The over-the-counter market is the market in which new corporate securities are introduced and seasoned. It is also through the over-the-counter market that large blocks of securities of essentially privately-owned companies can be efficiently transferred from large shareholders to smaller investors, thereby enlarging and diversifying the base of American capital investment. No one could effect a distribution of an unlisted security in the absence of a post-distribution trading market—and this is a major function of the over-the-counter market.

It is the wholesale dealer who is at the fulcrum of this important market. Without the wholesale dealer, there would be no over-the-counter market, for he is the only one who provides the marketability which results from the wholesale dealer's willingness to put his capital at risk by taking a position in a designated security. That is why he is so often referred to as the "market maker". That is why it is so essential to preserve the wholesale dealer's role in this market.

In so very many ways, the Study demonstrates that its authors made a very careful analysis of certain aspects of the over-the-counter market. It contains many wholesome proposals for reforms which will be afforded wide acceptance in the industry. We fear, however, that the authors of the Study had a tendency to become over-

impressed with statistical tabulations and underimpressed with the "stuff" which is at the heart of the over-the-counter market. For example, we feel that the Study failed to place proper stress upon the risk which the "market maker" takes; failed adequately to appreciate that the exactitude which is possible when trading is confined to a specialist enjoying a monopoly is not to be expected where trading is decentralized and competitive as it is in the over-the-counter market; and failed to comprehend the extent of the merchandising aspects involved at the retail level in the marketing of over-the-counter securities.

The "market maker" is one who has his capital at risk, who must constantly exercise a judgment as to market trends without knowing what "demand" for the stock exists or what "supply" of the stock is available elsewhere or at other price levels and who in the midst of these uncertainties must be ever ready to suffer the consequences of an error in judgment. Each dealer is constantly in price competition with all other dealers who elect to make a market in that same security. A specialist on a regulated exchange is not in competition with anyone and is the central depository of all indicated buy and sell orders.

The regulated exchange is essentially a monopoly market, with the specialist enjoying the monopoly; the over-the-counter market is a competitive market, with all transactions resulting from a "negotiation" between a buyer and a seller, generally after the buyer has canvassed several potential sellers of the very same security. In this situation, it is unreasonable to expect the kind of regularity and certainty that can be found in the case of a regulated market where the specialist sits in a position

of a monopolist and remains the only source through which purchases and sales may be channeled. He is also the only source which need be canvassed to obtain volume and price range data whereas to collect trading data on over-the-counter trading, information would have to be collected from a number of different dealers, many of whom are even in different cities.

The merchandising aspect involved in over-the-counter trading can perhaps best be illustrated by pointing out that listed securities are generally the securities of better known companies and the availability of their stocks is reported each day in the newspapers in the New York Stock Exchange and other stock exchange listings. The great bulk of over-the-counter stocks is that of the lesser known companies, frequently ones which are little known outside of their immediate geographic areas. The sale of a security for such a company frequently requires that the retailer or his salesman first acquaint himself with the company and its financial position; that he next come to a conclusion concerning the prospects of the company; and, finally, that he "sell" that company to his customer. It is only through such sales effort that the stocks of many companies can be brought to market and the flow of capital for those corporations can be obtained. This "merchandising" is a costly aspect of a broker-dealer's business. A broker-dealer can afford to engage in it only if he is to be fairly compensated. If he is not to receive fair compensation for this service, he would forego this business and this would, in turn, impair the liquidity of the market.

If these central considerations can be accepted, the effective worth of the comments to follow will be apparent. They are made on behalf of eleven wholesale dealers who

currently insert in the "sheets" two-way quotations for over 3,800 securities for themselves and over 1,000 additional securities for their correspondents. Collectively, these wholesale dealers represent a tremendous number of years of experience in the securities business and it is this extensive experience which has been heavily relied upon in the formulation of these comments.

### Part A—INTRODUCTION

While the Study candidly recognizes the enormity of the over-the-counter market, we learn from this Part A that Chapter VII is based upon a study of over-the-counter trading in a single trading day—January 18, 1962—and of only 200 stocks. We question the adequacy of this sampling. The staff itself recognizes that the over-the-counter market is by far the largest single market in terms of number of stocks traded. These stocks range from the highest grade bank and insurance companies through some of the most prominent nationwide industrial companies down to the more recently issued stocks of small or newly-organized companies, possibly with only regional acceptance and often in the process of transferring from family ownership to public ownership.

We think that the selection of 200 stocks—however conscientious the selection—is too small a sample, and that the experience of a single trading day is too limited to supply a foundation on which to base important general conclusions. The date selected—January 18, 1962—is a date during which speculative fever was at its height. Any trading period, when speculative fever runs high, naturally gives rise to atypical situations. In order to obtain a representative sampling of over-the-counter trading, it would probably be necessary to select a minimum of

500 stocks and to examine the trading experience on one day in each of the 12 months. Only in this way, in our opinion, could the Commission have before it a representative sampling of over-the-counter trading. Moreover, the over-the-counter market is a far less active market since May 28, 1962, and many of the problems which stemmed from the abnormal trading have disappeared.

Accordingly, because the sampling was a fairly limited one and because it was taken at a time when speculative fever was at its height, we think the Commission ought to be particularly careful in evaluating the recommendations contained in the Study, recognizing that those more drastic ones might not be warranted if the market operations had been appraised on the basis of a wider trading base and upon post-May 28, 1962 conditions.

#### **Part B—THE OVER-THE-COUNTER MARKETS— AN OVERVIEW**

In this Part, the Study endeavors to present a general perspective of the over-the-counter market, its participants, its product and its functioning. Though we deal later in a more specific way with most of the matters which are treated generally in this Part B, there is one matter that deserves to be treated here.

The Study comments upon the high concentration of over-the-counter business within a few large firms. It should also recognize, however, that this concentration—particularly insofar as it applies to the wholesalers—is the result of business channeled to them by the numerous small brokers around the country so that while there may be concentration at the “market-making” level, there is widespread activity at the broker-customer level. More-





Memorandum from

MILTON P. KROLL

Burns } 1 Gov at large  
Harris } to repr. Trading  
Inceps } part of industry

Creation of Trading  
Committee - should all  
tr. matters -  
Meeting see - Nov 13 -

over, it is essential to understand that the concentration at the wholesale level results from the fact that the risks of market-making are so great in the over-the-counter business that only a few firms are ready to put their capital at such risk. The market is frequently mercurial and price changes are swift. Only the experienced and the alert are likely to survive. Even an experienced trader on a "good day" will have a large number of unprofitable trades and there is a cost connected with every execution whether it be at a loss or a profit. Stock exchange commissions are fixed and from time to time raised to offset the increased cost of doing business. The operating costs of the wholesale dealer have also increased but intense competition has kept his gross profit margins at the same low levels.

It is no wonder then that there are only about 25 market makers which account for approximately 50% of the trading by all wholesalers with other dealers. If the recommendations of the Study were to be implemented, it would, we believe, further reduce this number. Already the stock exchange "wire houses" are taking over large percentages of the over-the-counter business, including the wholesale business. If the trend continues, the large integrated houses will be the dominant factors in the over-the-counter industry and the wholesale dealer, on the one hand, and the small broker, on the other hand, will be left to play only minor roles, if they survive at all.

### Part C—WHOLESALE MARKETS

Part C is of primary concern to us, for it deals with our business, i.e., the wholesale markets.

After opening with a recognition of the two important and related functions performed by the wholesale dealer, the Study states that the "spread" between the whole-

saler's bid and asked price represents his "profit". This is not so. The "spread" represents only the difference between what a dealer is prepared to pay for a stock and the price at which he is prepared to sell it at a given moment. But his "bid" may be, and frequently is, far from his cost and his "asked" may be, and frequently is, far removed from the price at which he acquired the particular stock he is now ready to sell. In other words, a dealer's bid and asked have no relationship to the "cost" of the position he has acquired in a stock. His bid and asked must conform to the current market conditions (i.e., supply and demand) without regard to what he may earlier have paid for stock which he acquired or without regard to the price at which he sold stock some time before. As earlier noted, even a successful trader is one who effects a large percentage of his transactions at a loss, meaning a sale of a stock at a price lower than the price at which he paid for it, or a purchase of a stock at a price higher than the one at which he previously sold. It is, therefore, unfortunate to fix the climate of the wholesaler's business in terms of the "spread" representing his profit. The wholesale dealer's business is a highly competitive business of very substantial risk and of small margins.

The question of supervision of the traders by the wholesale dealer is a very important one. For the most part, a trader is a mature man of extensive experience and sometimes the senior traders are partners or firm officers. When traders are "on the firing line", handling a large number of securities and a tremendous number of inquiries, it is understandable that the trader must be allowed a measure of discretion. The example given in the Study of the dealer who gives his trader complete and unrestrained authority in the conduct of all his trad-

ing activities is certainly not typical of the industry. Of the firms which are parties to this report, none permits its non-partner traders to have unrestricted discretion. All of them exercise supervision over such traders and their activities. For example, among our firms the uniform and accepted practice is to require the initiation or termination of market-making activities for a particular stock to be approved by a responsible partner or officer and require that any transaction of an unusual nature be reported before execution. As an industry, we do not believe we are remiss in exercising our obligation of supervision over the traders' activities.

We believe that the Study makes a very constructive suggestion in proposing that all listings in the "pink sheets" which are made on behalf of a correspondent be separately designated. We think this is a wise and wholesome reform. We would support its introduction; we think all established and reliable companies would do so.

We regret, however, that the Study questions the efficacy of the correspondent system because of what it seems to regard as its "break-down" during the hectic period of trading experienced on May 28, 1962. We believe that the correspondent system is a very useful one, and we do not believe that the system broke down at all. We find it difficult to believe that trading houses generally advised their correspondents that markets could not be regarded as firm because they were "alarmed". The stubborn fact is that there was a major mechanical breakdown. The volume of trading which suddenly deluged the houses was more than the mechanical systems (telephones, telex lines, etc.) could possibly handle. The difficulty of obtaining current prices was not confined to the over-the-counter market; it also applied to stocks traded on the exchanges. Surely there is no occasion to stigmatize an established

system of doing business merely because of the very unusual and atypical situation which arose on May 28, 1962.

The Study deals at length with the question of the initiation and termination of wholesale trading, and it concludes that the "decision to make a market or to discontinue making a market is not subject to any recognized standards or regulatory restraints . . . other than the broad prohibitions against fraud and manipulation in the securities laws". There are indeed no fixed standards to govern the initiation and termination of trading, and, in our judgment, there cannot be and there should not be.

The essential ingredient that determines whether an active market for a security exists is the public's interest in that security. If there is an active trading interest, the search for entrepreneurial profits is a sufficient incentive to insure that there will be dealers to trade the security; if there is not adequate public interest, then obviously there will be little inducement to make a market and the dealer will "go out of the sheets". The Study, however, errs in suggesting that the absence of a quotation in the pink sheets indicates the absence of a market. This is far from the fact. One of the essential aspects of the over-the-counter market is that it is always possible to sell a security of any company which is not insolvent. Any broker who has a customer that wants to sell a stock can always go to the "National Stock Summary", find out who most recently had an interest in the stock, and then negotiate with that dealer—or any other for that matter—for the sale of that stock. Wholesale dealers are constantly buying and selling stocks that are not listed in the pink sheets. The absence of a listing in the pink sheets means only that there is not an active market for that stock, but it does not mean that there is no market for the stock.

It is not at all surprising that in the winter of 1962 there were no pink sheet listings for a number of stocks which "went public" in 1961. Many of these were stocks of companies which had short lives and either became operationally inactive or financially insolvent. The fault here is not with the wholesale dealer for not making a market; the fault, if it lies any place, is with those who initially sold the stock to the public. Most of those issues proved to be stocks with very little investment value to commend them. Too often the prospects of these companies did not materialize and the public lost its interest in their stocks. Wherever the blame may properly lie, it should not be thrust upon the shoulders of the wholesale dealer. The wholesale dealers had poorer experiences trying to maintain a market in those stocks—however short the duration of the period of trading—than they had in most other stocks.

On the issue of responsibility for continued trading, we state firmly that a wholesale dealer cannot accept the burden of continuing to trade a stock once he begins to trade it. As we indicated earlier, it is the public's interest that determines the activity in the stock and so long as there is activity, a dealer will trade it. A dealer ceases to trade a stock when the public interest wanes, and the trading activity disappears. There is a practical limit to the number of stocks one company can effectively trade, and obviously good business dictates that its efforts be confined to the more actively traded stocks. It must be remembered that the wholesale dealer had nothing to do with bringing the stock to the market in the first place. If there is to be a continuing obligation to maintain a trading market in a stock, the obligation should be upon the underwriter that brought it to the market. Again,

however, it needs to be restated that the mere fact that a company's stock is not listed in the pink sheets does not mean that the market has disappeared; it means only that there is not sufficient activity in the stock to warrant a quotation listing in the pink sheets.

There are many reasons for terminating trading in a stock. A dealer may find that its trader simply is ineffective in handling this particular stock; it may find that the trader is not getting the primary inquiries; it may find that he has had a continuing unprofitable experience with this stock; it may find that the essential trading for this stock is in a different geographic region; or it may find that the stock is getting into "poor hands" and the firm simply does not want to dignify it with a quotation in the sheets.

Whatever the reasons, we do not think that there ought to be any "regulatory restraints" to govern the initiation and termination of trading. We think this should be left just where it is now—with the individual decision of the wholesale dealer. We doubt that any set of standards which would be prescribed within a regulatory framework would bring about any better results than are experienced under the present system.

The Study's concern with the validity of quotations is surely deserving of support. We must recognize, of course, that the over-the-counter market, like the stock exchange markets, never "stands still"; prices are constantly fluctuating. Nevertheless, we endorse the Study's view that primary market makers should make firm markets. We do. We believe that an examination of the practices of the major market makers will persuasively demonstrate that their quoted prices are valid prices when given. We deplore the practice of "backing away" from quotations.



The practice of "backing away" is a bad practice. We do not believe it to be widespread. But, in any event, we stand ready to join with the SEC and the NASD in formulating any program which is designed to prevent "backing away" by those few dealers who may have engaged in the practice.

We are pleased that the Study discloses the intensely competitive nature of the wholesale over-the-counter business. It is indeed a competitive business. To understand, however, why the "spreads" are smaller in the case of stocks in which more dealers are making two-way quotes, one must realize that where a large number of dealers are "in the sheets", it simply indicates greater activity in the stock with increased competition between the dealers. Where there is this greater activity in the stock (meaning a greater demand and a greater supply of the stock), there is less risk to a trader who holds a position and, therefore, he can afford to trade the stock on a smaller spread basis. There is nothing sinister about this. It is simply the stubborn fact of evaluating the risks and recognizing the results of competition. What it does do is again demonstrate our central theme: That the over-the-counter business is an intensely competitive business; that it is a business of risk and where the risk is minimized, the margins can be smaller; where the risks are greater, the margins must necessarily be greater. So where the public is heavily interested in a stock and there is active trading, a trader, of course, can afford to trade on a closer spread because he can more easily get in and out of the stock. Where a stock is traded infrequently, he obviously needs a wider spread between his bid and asked, because the opportunities to liquidate his position are correspondingly lessened.

After acknowledging the intensely competitive nature of the industry, the Study deals with certain non-competitive practices, such as "hand-holding". "Hand-holding" is a practice which fortunately is indulged in sparingly and it is a practice which all the established firms frown upon. Traders are constantly instructed not to indulge in this practice, and traders found indulging in the practice are invariably disciplined. We doubt the practice exists to any significant extent but we agree that it should not exist at all.

Concerning the pink sheets issued by the National Quotation Bureau, Inc., we believe that given the decentralized nature of the over-the-counter market, these pink sheets serve an exceedingly useful function and those who publish these sheets do a very conscientious job in accurately presenting the current state of the market. It is not material to us whether or not the sheets are made more widely available; this is a matter on which the retail broker or the integrated dealer may have a better-informed view. Similarly, we endorse the proposal that stern disciplinary action should be taken against any brokers or dealers who insert fictitious quotes or otherwise use the sheets to create false impressions of either trading activity or price ranges. Here again, the misuse of the sheets by certain unscrupulous dealers should not be deemed reflective of the entire industry nor should it cause the Commission to destroy a useful medium for the dissemination of important information concerning over-the-counter stocks.

We also endorse the Study's suggestion that the pink sheets would be more useful if dealers in inserting quotations therein were to indicate by appropriate notation any quotation which is good for less than the conventional trading unit. Further, we certainly would agree that the

use of symbols to designate other matters affecting the stock, such as dividend payments, extra dividends, etc., would be useful. Indeed, the very symbols used by the national securities exchanges might properly be adopted for use in the pink sheets.

### Part D—RETAIL MARKETS

Our comments on this Part of this Study are made with some hesitation. As wholesale dealers, it is perhaps not fitting that we comment upon that part of this Study which deals with the business of others, i.e., the retail dealers. Nevertheless, because our activity and our business are dependent in a good measure on the wholesomeness of the retail markets, we feel that certain general comments upon some of the items discussed in this part of the Study are not out of order.

What concerns us most is the failure of the Study to recognize the retail dealers' costs of doing over-the-counter business. The Study is critical of retail dealers' current "mark-ups". Yet, it would saddle the retail dealer with the additional cost of checking virtually every bid and asked quote before concluding a transaction in an over-the-counter security for a customer. The truth is that if a retail dealer were to check all the market makers in an active security, the price might very easily change while he went through this laborious process of checking the market in an effort to get the "best execution". The basic fact is that after a period of experience, a dealer knows pretty well from whom he is likely to get the "best execution" at any particular time or at least over a period of time. There is just not enough certainty in the over-the-counter market to assure each customer the very lowest

purchase price and the very highest sale price on every transaction. The market is too diffuse and decentralized to yield any such certainty.

A retail dealer who has been troubling a primary market maker all week for quotes and who finally is in a position to place an order for 100 shares for a customer can hardly be expected to ignore the dealer who had serviced him all week with quotes because the stock he is now able to "buy" or "sell" may be available at some other dealer with whom he has never had prior experience nor who has ever before given him any service. Surely a retail dealer's obligation to his customer does not require him to ignore the kind of established trade practices which are the warp and the woof of the fabric of American business.

The Study talks of "riskless" transactions, ignoring completely the cost that the dealer might have had in initially researching the merits of the security involved in that transaction and in educating his customer about it in an endeavor to persuade him to buy it. The transaction itself may be "riskless" as a transaction, but there may have been a good deal of cost involved on the broker's part prior to the time when he received his customer's order to effect the transaction. The securities business is not as simple as the Study would have one believe. Perhaps the solution to the problem of unreasonable mark-ups will be found in a formula which will require a broker-dealer to handle an unsolicited transaction on an agency basis but permit him to handle as a principal any buy or sell order which was prompted as a result of his recommendation.

Obviously, it is not of direct concern to a trading firm whether a retail dealer discloses to his customer the

“wholesale market” for a security. We cannot, however, resist saying that it is indeed an unusual situation where a retailer must disclose to his customer the wholesale price of the wares which he sells. As long as the customer is satisfied with the service he receives and is protected against unreasonable mark-ups, why is it necessary that he know his dealer’s precise gross mark-up? What may appear to a customer as an unusually high mark-up—particularly when compared with a stock exchange commission—may nevertheless be only fair compensation for the retail dealer’s service. It is a mistake to assume that “best execution” necessarily means the lowest price. There is more involved in the purchase and sale of a security than the price. It might be the service that is being rendered or the value of the recommendation to buy or sell the security.

The Study overemphasizes, we feel, the importance of fractional price variances to a public investor. The truth of the matter is that small price variations are generally not of prime concern to public investors. They may be of major concern to dealers who are trading frequently and in large volumes and perhaps even to institutions (which generally are quite able to fend for themselves), but very few investors invest in a stock for a fractional movement either up or down. They are more concerned with dealing with a reliable broker who will cater to their needs, who will periodically review their portfolio, and who will make worthwhile recommendations, than they are with the dealer who will “shop” the market to try to save them a fraction on a particular purchase but who, in the process, may by “overshopping” cause him to lose a fraction.

It is true that occasionally a customer pays 20 for a stock from a dealer and another customer pays 20¼ from another. Naturally, where merchandise is obtainable at more than one trading post, small price differentials are to be expected. Even in the case of listed stocks being traded on more than one exchange, the same stock may sell on one exchange at some variance from the price on another. Competition insures that in the cases of both listed and over-the-counter stocks, these differentials will always be small.

We think the Study placed the emphasis on the wrong point, and we are concerned that if the emphasis of the Study is accepted by the Commission, it will inflict adverse consequences upon small broker-dealers. The undeniable fact is that many of these small firms—and we mean the reliable ones!—are either going out of business or are being forced to merge into larger organizations because the heavy cost of doing business is no longer covered by the small margins they realize on securities transactions. The result of what the Study strives to achieve in this part of the report would be to force more small brokers out of business or force them to join with the larger stock exchange houses which, because of their large volume, can afford to do business at lower rates. As these small brokers go out of business, the ability of small industrial companies—with only regional reputations—to raise capital will be correspondingly curtailed.

It is morally desirable and it is legally essential to protect the interest of investors. It is equally desirable and just as essential to provide a medium for American business to obtain a source of much-needed capital. To stultify and close off that source of capital would vitally affect our economy and stifle the ability of many small

but efficiently-operated companies to obtain a broader investment base for their operations. The Commission should be concerned about this growing trend of concentration of business in fewer and fewer companies, and, therefore, it should be reluctant to go along with the Study's recommendation in this particular matter.

The Study statistically concludes that in most cases the average cost of an individual customer's purchase from dealers acting as principals is higher than the cost of purchase on an agency basis. We point out, however, that the Study itself recognizes that the reverse is true in the case of sales. Accordingly, we suggest that on a full turn-around—that is a buy and sell—the customer comes out just about the same whether the dealer acts as principal or handles the transaction on an agency basis. And a small investor frequently does better on an over-the-counter purchase, for he avoids the odd-lot premium which applies to the purchase of listed securities. We will not challenge the suggestion that institutions with their large purchase and sale orders probably average out better per share than the small buyer, but, here again, it is simply a matter of economics. There are certain basic costs of handling any transaction, whether it is for a limited number of shares or a large number of shares. Obviously, when those basic costs can be spread over a large purchase, the cost per share drops and that is why institutions frequently do better in a transaction than an individual purchasing a limited number of shares.

#### **Part E—THE POSSIBILITIES OF AUTOMATION**

Most of the primary market makers are not unfamiliar with the new advances in electronically-operated business machines. We make wide use of newer communication

techniques and most of us have either automated or are in the process of automating our bookkeeping activities. To suggest, however, as does the Study, that bids and offers could be selected, orders executed and transactions cleared all through the use of automation is to indulge in fantasy. It may well be that the Univac Division of Sperry-Rand Corporation (whose self-interest is not to be denied!) can think in terms of a centrally-located computer which would be omniscient, but we can envisage only a board of flashing multi-colored lights and a galaxy of confusion.

We have earlier emphasized a dealer's vulnerability to market fluctuations. What a dealer offers to buy or sell depends upon his "feel" for the market. If he is deprived of the opportunity of talking with those many brokers who have buy and sell orders to execute, he is deprived of the very source material he needs in order to make a judgment of the market trend. With the broker "programming in" his buy or sell orders directly into the computer instead of to a "market maker", there will be no dealers willing to put their capital at risk to inventory stocks if the persons with whom they deal and the terms of the transactions are taken from them and transferred to a "mechanized specialist". With the wholesale dealer out of the picture and the "mechanized specialist" unable to acquire a long or short position, the price variations will be swift and wide and the market chaotic. With such disorder a characteristic of the market, it is not likely long to survive.

Here again, we find the Study indulging in the basic error of believing that over-the-counter trading can be cast into the mold of an exchange market with the features of a single trading post. We are satisfied that it cannot. The "limitations" that have historically characterized



both the operation and the regulation of the over-the-counter markets will be sooner removed by finding means of preventing untrained, inexperienced and unscrupulous dealers from entering the business; it will not be achieved by eliminating from the market the very people whose skill and judgment have made the market, and the purposes which it has served, possible.

We find it difficult to take seriously the proposals made in this Part E of the Study. What we do know, however, is that the proposed "automation" is wholly impracticable, and that it would not work. Its only appeal is that of novelty. We are fearful that if this proposed computer were to be activated, the first message it would "read out" would be the formal obituary of the over-the-counter market.

We urge the Commission most earnestly to eliminate completely from its consideration the suggestions made in Part E of the Study.

## Part F—SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Before considering the specific conclusions and recommendations, we think a general comment is in order. We are aware that in an industry as dynamic as ours, the inheritance of the past does not always supply a guide for an enduring future. We know that changes in business practices must conform to the needs of the community. Certain disclosures by the Study indicate the need for certain changes and these we warmly endorse. Most of these, however, can and will be effected by and within the industry. What the Study seems to dismiss, but what the Commission will not want to overlook, is the

industry's own ability and willingness to effect necessary changes.

Perhaps, as is suggested by the Study, there is a "necessity for a greater recognition of responsibility on the part of the NASD". It may well be that the NASD could better operate the quotations system. It may even be that the NASD would be in a position to compile more useful industry statistics. It may be that the NASD should promulgate more definitive rules or standards of trading conduct. With none of this do we quarrel. We say only that if the NASD is to be given wider authority, then steps should be taken to insure that the NASD affords adequate recognition to all segments of the industry so that its enlarged authority is used in a way which gives weight to the problems and concerns of all phases of the industry and not just those of the integrated dealers and the underwriters.

Of course, what must be kept in mind is that if the NASD is to undertake more functions, it will require a larger budget. If these added expenditures are to be met by an assessment against the industry, it means only that the charges for handling securities transactions by the assessed industry will have to be increased, and the ultimate cost will be upon the public investor.

We turn now to the specific "Conclusions and Recommendations" of the Study, as they appear in Section 6 of Part F. We are certain that the Commission will not fail to note the Study's acknowledgment that its conclusions and recommendations are put forth with recognition that the measures recommended "are not necessarily equally applicable to all securities, broker-dealers or markets, so that the appropriate scope and limitation of particular

measures may require a more exact definition in the process of implementation”.

**Conclusion and Recommendation No. 1:** In the over-the-counter markets, there is a dichotomy between inter-dealer (wholesale) and public (retail) markets in many important respects, but there is a close and continuous relationship between wholesale and retail markets for any particular security. Inter-dealer and public quotation systems are vital to the operation of these markets and, whether handled by private enterprise or by a self-regulatory agency, they are vested with a public interest and should be brought under appropriate supervisory control of the Commission. At the same time, the operator of any such system would be vested with authority and responsibility to regulate the use of its system by broker-dealers through appropriate rules and procedures consistent with the rules of the NASD and the Commission.

From the standpoint of workaday operations, it is not material to us whether the inter-dealer quotation sheets are handled by private enterprise or by a self-regulatory agency so long as they continue to serve the function of acquainting dealers and others who have a legitimate right to know about the securities for which an active market exists and the price ranges within which they may be acquired or sold. As we have stated earlier, we think the job has been done and is being done quite well, and we find it difficult to understand why any change in ownership is needed, particularly in light of the Study's own conclusion that the job is being done conscientiously. We agree that the public must be protected against fraudulent and manipulatory practices, but we think the Commission already has that power and we feel that an intelligent exercise of that power gives to the investors in over-the-counter securities the protection that is needed.

**Conclusion and Recommendation No. 2:** Broker-dealers, although entirely free to change their inter-dealer quotations in the course of trading as at present, should be positively obligated to buy or sell 100 shares (or other indicated "size") of a quoted stock at their prevailing quotations, unless clearly designated as not firm, and should be required to keep a timed record of changes in quotations. All quotations entered in an inter-dealer quotation system should be firm, unless otherwise designated, when supplied. The NASD should establish appropriate programs for surveillance and enforcement of these obligations. The NASD and/or the Commission should have the power and responsibility to deny or temporarily suspend any broker-dealer's right to enter quotations in an inter-dealer quotation system with respect to a particular security or all securities, for willful abuse of a quotation system (e.g., by entering other than bona fide quotations) or willful violation of any special rules applicable to inter-dealer quotations.

We endorse the recommendation that a quotation should be good for an established unit of trading (usually 100 shares) unless otherwise specifically stated, but we cannot agree that primary market makers and others should be required to keep a time record of changes in quotations. The changes are so frequent and a trader trades so many different stocks (unlike a specialist who perhaps trades just a few) that it is simply a physical impossibility to keep accurate time records of price changes. The vesting of more forceful disciplinary power in the NASD over misuse of the quotation sheets by irresponsible and undesirable dealers is certainly a constructive suggestion and it has our endorsement.

**Conclusion and Recommendation No. 3:** Other rules applicable to inter-dealer quotation systems and/or to broker-dealers using such systems should require: (a) that quotations entered by one broker-dealer on behalf of another be so designated by appropriate symbols, with clear differentiation between correspondent arrangements and other arrangements involving this practice, and with clear indication where two or more quotations in different names represent a single quotation; (b) that "OTC-listed" securities (see Chapter IX) be differentiated from all other securities by appropriate symbols, and that securities eligible for extension of credit (see Chapter X) be designated by separate symbols; and (c) that, consistent with the recommendation in paragraph 9, persons other than broker-dealers be eligible to become subscribers to inter-dealer quotation systems, and that broker-dealers be required to make available to their regular public customers, upon request, any quotation system to which they may be subscribers. In addition, upon establishment of a system for identification of "primary market makers" as recommended in paragraph 4, consideration should be given to a further rule providing that primary market makers for a particular security should have the exclusive right (subject to possible defined exceptions) to enter two-way quotations in any inter-dealer quotation system; whereas any other broker-dealer, although free to enter one-way or *OW* or *BW* quotations, should be permitted to enter two-way quotations only as correspondent for an identified primary market maker.

We agree that quotations entered by one broker-dealer on behalf of another should be properly designated. We are prepared to accept any system of symbol identification that will convey more information to the people who use

the quotation sheets. Further, we have no objection to broker-dealers making available to their regular public customers whatever information on quotations is available to them. We can readily agree with the proposal which would limit two-way quotations to the primary market makers; yet, we feel compelled to add that such a limitation would be disadvantageous to the smaller dealers and might even be violative of the anti-trust laws.

**Conclusion and Recommendation No. 4:** Because of the large numbers and varieties of securities and participants involved in the over-the-counter markets, the quality and depth of the market for any particular security and the reasonable expectations of investors in such security are intimately related to the number and identity of dealers making an inter-dealer market. As a foundation for various immediate or longer-term improvements in the operation and regulation of over-the-counter markets, a system for official identification of the "primary market makers" in each security (tentatively defined for this purpose as "any broker-dealer who, with respect to a particular security, holds himself out, by entering two-way quotations in any inter-dealer quotation system or otherwise, as being willing to buy from and sell to other broker-dealers for his own account on a continuous basis") should be established by the Commission or the NASD as promptly as necessary mechanical arrangements can be worked out. Such a system would contemplate that each primary market maker in a particular security would file, prior to or promptly after becoming such, a data card showing the name of the security and the dealer's relation to the issue or issuers (as underwriter, director, optionee, etc.); that a primary market maker ceasing to act as such, either permanently or temporarily, would give notice to that effect; and that the Commission or

the NASD would maintain, for public inspection or circulation, an official "primary market list" of those dealers who are primary market makers for each security at any given time.

This is entirely acceptable to us so long as it is clear that a primary market maker has an unrestricted right to determine when it will initiate trading and when it will terminate trading. The mere "giving notice" of such a decision to the NASD is surely something which can be arranged if it is believed to serve any significant purpose.

**Conclusion and Recommendation No. 5:** The Commission and the NASD should make it part of their continuous agendas to seek further possibilities for strengthening the mechanisms of inter-dealer markets and the protection of investors in relation thereto, particularly in light of the possibilities of automation referred to below. Among other subjects for possible coverage in future rules, interpretations or Statements of Policy, to be applied either generally or in respect of specified categories of securities or of broker-dealers, would be: rights and obligations of primary market makers in maintaining competitive, fair and orderly markets; the grant of "cheap stock," warrants or options to primary market makers (see chapter IV. B); standards of supervision and methods of compensation of traders; intra-firm responsibility for and supervision of the insertion of quotations in an inter-dealer quotation system; provisions for the handling of limit orders; and possible special requirements or exemptions for primary market makers in broker-dealer capital rules, including a possible exemption from "haircut" provisions in respect of limited amounts of inventory of securities traded by a primary market maker (see chapter III. D).

In this recommendation, the Study simply lists a number of items which need further exploration. Chairman Cary's letter of transmittal indicates a desire to discuss these further with the NASD. We think all of these are proper avenues for exploration, and we would like to join with any group with which these items are discussed. If this is to be done with the NASD, it is imperative that the wholesale dealers be afforded adequate representation in the councils of the NASD. Since these subjects are so vitally connected with the operation of the wholesale over-the-counter market, we trust that any discussions which take place will include representatives from our segment of the industry.

**Conclusion and Recommendation No. 6:** While a public investor must ultimately rely upon the competence and probity of his broker-dealer for a good execution, under present rules and standards in over-the-counter markets the price paid or realized by an investor on the purchase or sale of a security may depend, to an excessive degree, on the diligence of the broker-dealer and the capacity in which he acts and/or on the identity of the investor. The NASD and/or the Commission should adopt rules and standards requiring all broker-dealers executing retail transactions, whether or not they are primary market makers in the particular security and whether the transaction is on a principal or agency basis, (a) to make reasonable effort, in light of all circumstances including the kind and size of order, to ascertain the best inter-dealer quotations (and to show in their permanent records the number of markets checked), and (b) to provide an execution as favorable as may reasonably be obtained in light of the kind and amount of securities involved and other pertinent circumstances.



This matter primarily concerns the brokers or integrated dealers. It is of only little concern to us except that we think it important for the Commission to know that as a practical matter no broker can check all the markets, particularly in an actively traded security. If a broker tried to do so, the cost would be prohibitive and in any event by the time all the primary markets were checked, the price would likely have changed. Some trust must be placed in the astuteness and integrity of the broker. A broker who does not serve his customer well is not likely to have a customer very long.

**Conclusion and Recommendation No. 7:** Under present rules and standards in over-the-counter markets the disclosure of facts on which the investor may judge the price and quality of an execution depends in part on whether the broker-dealer acts as agent or principal. So-called "riskless" transactions, i.e., those in which a broker-dealer who neither is a primary market maker nor has a bona fide inventory position elects to execute a customer's purchase order by buying from another broker-dealer and reselling to the customer (or the reverse in the case of a customer's sale order) on a "net" basis without disclosure of markup or commission, are inherently susceptible to abuse and (subject to possible defined exceptions) should not be permitted to take that form; that is, a broker-dealer who neither is a primary market maker nor has a bona fide inventory position should be required (subject to defined exceptions) to execute customers' orders on an agency basis.

Again, this recommendation concerns primarily the broker-dealer who engages only in retail-type transactions. We have indicated earlier our concern for the smaller brokers if they are required to handle over-the-counter

transactions on stock exchange commissions. We do not think it is possible for most of the small brokers to survive on that basis. Perhaps a solution is to confine unsolicited orders to an agency arrangement but permit the broker freedom of handling solicited orders on a principal basis.

**Conclusion and Recommendation No. 8:** The NASD's markup policy is in need of substantial clarification and strengthening in respect of other than "riskless" transactions. In particular, an integrated broker-dealer's obligation and standards of retail pricing in relation to its contemporaneous cost or its current inter-dealer quotations, especially in the case of securities for which there is no independent market, should be defined, by the Commission and/or the NASD, more clearly and positively than has been done in the interpretations or administration of the present markup policy.

Again, this is of no direct concern to us, but we are inclined to believe that neither the broker nor the integrated dealer would object to this recommendation, for most of them, we believe, would be pleased to have better guidelines.

**Conclusion and Recommendation No. 9:** As a further basic improvement in retail over-the-counter markets the present retail quotation system of the NASD should be supplanted by a system designed to show generally (with appropriate exceptions to deal with exceptional categories of securities or situations, if any) the best prevailing inter-dealer bid and asked quotations that can be reasonably ascertained and the number of primary market makers for each security. Any other quotation system designed for public dissemination, including electronic systems, should be required to conform to the same provisions. By appropriate explana-

tory legends and by NASD-sponsored educational efforts the investing public can and should be advised that published quotations in such form are inter-dealer quotations rather than retail quotations and hence are subject to markups, markdowns or commissions in retail transactions.

**Conclusion and Recommendation No. 10:** The NASD should re-examine and strengthen, in a manner consistent with the above, its methods of handling "local" quotations, the functioning of its local quotations committees, and its procedures for coordinating and supervising the work of such committees.

**Conclusion and Recommendation No. 11:** The NASD should also give consideration to ways and means of improving its retail quotation system in other respects, including, but not necessarily limited to, supplying indications of dividends, ex-dividends, insolvency or reorganization proceedings, etc., in the manner of stock exchange quotations.

Apart from the fact that we are not concerned with who operates the quotation sheets, these recommendations seem to us to embody objectives which are deserving of further exploration.

**Conclusion and Recommendation No. 12:** To the extent that space limitations prevent inclusion in any newspaper or similar quotation system of more than a fraction (presently about one-sixth) of all securities quoted in inter-dealer systems, the privilege of being included in the NASD's "national" or "regional" list should be limited to the "OTC-listed" category (see chapter IX), and within that category the selection should be based on appropriate rules of the NASD or other operator of the particular quotation system.

We think a limitation of the NASD "national" lists to the more actively traded securities is desirable, but we believe using the same standard for "regional" lists is undesirable. At this writing, of course, it is too early to know whether the Study's recommendation for what it calls "OTC-listed" category of securities will become law. Therefore, we say only that whatever patterns are determined for listing eligibility, they should be tailored to the recognition that the regional lists serve a different purpose than the national lists, and the standards ought to be promulgated in light of the purposes that those lists are designed to serve. Otherwise, small companies with only regional interests will be severely prejudiced in their financing programs.

**Conclusion and Recommendation No. 13:** The NASD and/or the Commission should re-examine present requirements with a view to improving disclosures, at the time of soliciting a retail purchase or in confirmations, of essential information relevant to particular types of retail transactions. Among other possibilities that should receive early consideration in this connection would be rules of the following kinds: (a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20 percent or more in prevailing inter-dealer bids and offers, should be required to disclose such fact or facts at the time of solicitation. (b) The confirmation of a customer's purchase or sale involving 100 shares or less (or, in the case of securities priced at \$5 per share or less, involving, say, \$1500 or less), if handled on a principal basis, should be required to show the best inter-dealer quotation on the opposite side of the customer's transaction (i.e.,

the inter-dealer bid in the case of a customer's sale or the inter-dealer offer in the case of a customer's purchase) reasonably ascertainable at time of execution. (c) The confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between inter-dealer bids and offers by showing a representative bid quotation.

Again, this conclusion and recommendation primarily concerns brokers soliciting or executing an order at the retail level. They, rather than we, should, therefore, comment directly on this proposal. What we do fear, however, is that if a broker is required to disclose the wholesale price, it may seriously interfere with his ability to do business in over-the-counter securities. The immediate loss is not only to the broker-dealer, the ultimate loss is to the companies who depend upon the over-the-counter market for a source of capital; and the greater loss is to the stifled growth of the economy.

**Conclusion and Recommendation No. 14:** With an already strong communications network, there is on the horizon the likelihood of a computer system that would assemble all inter-dealer quotations and instantaneously determine and communicate best quotations for particular securities at any time. If such a system were established, the further possibility of using it in connection with executions and to compile actual price and volume data for over-the-counter transactions would exist. Any such automated system would clearly be affected with a public interest and should be under regulatory supervision. The NASD is the natural source of leadership and initiative in dealing with matters of automation in respect of over-the-counter markets. It should actively carry forward the very limited

with auction markets. In implementing the recommendations in this chapter for over-the-counter markets generally, appropriate exceptions and/or special requirements should be provided for over-the-counter transactions in exchange-listed securities. Other recommendations on this subject appear in chapter VIII. D.

This conclusion and recommendation concerns what is still a relatively new phase of the over-the-counter market. It is difficult to anticipate what, if any, problems may arise. If any purpose is served by reporting periodically the volume of trading in listed securities by over-the-counter market makers, we are certain that some arrangement could be made for it without thwarting an activity still in its infancy.

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There are other problems not dealt with in Chapter VII of the Study which are of vital concern to our segment of the industry. We take this opportunity to express our hope that the Commission, in formulating new ground rules for the various aspects of securities trading, will come to grips with them.

One of the important problems we constantly face is whether or not the stock being tendered to us is in fact lawfully tradeable stock. We, as traders, have no way of knowing whether the stock, when originally issued, was registered stock or whether it was issued under one of the statutory exemptions to the registration requirement. While it might not solve all problems, it would certainly help considerably if the Commission were to adopt a regulation requiring all stock issued under one of the exemptions to be stamped with an appropriate legend on the certificate. In that way, when a certificate is received

with a legend indicating that it was initially non-registered stock, we can immediately either refuse the tender or take steps to assure ourselves that the resale of the stock is perfectly in order even though it was unregistered at the time of original issue.

We recognize, of course, that even registered stock may sometimes not be resold because it is part of a "distribution". In this connection, whenever we have reason to believe that a sale may be part of a "distribution", obviously we immediately take appropriate steps and refuse to handle the transaction. On the other hand, most of the time, it is simply impossible for a single market maker to know whether its particular purchase is part of a "distribution" because a controlling person deciding to unload stock could easily so diversify his sales among so many different brokers that it would simply be impossible for any one dealer to tell that a distribution was under way. We think, therefore, the obligation of determining whether stock offered for sale is part of a "distribution" should be the obligation only of the broker or dealer who has the contact with the owner who is selling the stock. It is unfair to place this burden upon dealers who have no direct contact with the seller.

In this same connection, we think it is vitally important for the Commission to formulate and announce the kinds of situations in which investment letter stock can be sold without registration. It is a matter of common knowledge that the guide lines for determining whether or not investment intent has been satisfied are vague and undefined. There is possibly more confusion in this phase of the law than in any other. We are frequently being asked to trade securities which were originally issued under investment letters where it is represented that the investment

intent has been satisfied. We think a great service would be performed for the entire industry if the SEC would issue the guide lines by which people could determine with greater certainty whether or not the investment intent had been satisfied. We earnestly, eagerly and seriously urge this course of action upon the Commission.

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The Study speaks with force. It proposes changes which touch the very nerve center of our business. We cannot afford to be complacent; we have taken the liberty of presenting our comments and expressing our concern with candor. We know that ours is a complicated industry. We know that for many problems there is no litmus to supply a ready answer. We believe that in assessing the needs of the public, the Commission will want to appraise the effect of the Study's recommendations upon the orderly functioning of the over-the-counter market and the purpose which it serves. That is why we have endeavored, in formulating our comments on the Study, to draw upon our extensive experience. It is our hope that the lessons of experience will help the Commission sift the novel from the necessary.

We are prepared to meet with the Commission for discussions concerning these comments whenever it suits the purposes of the Commission.

Respectfully submitted,

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