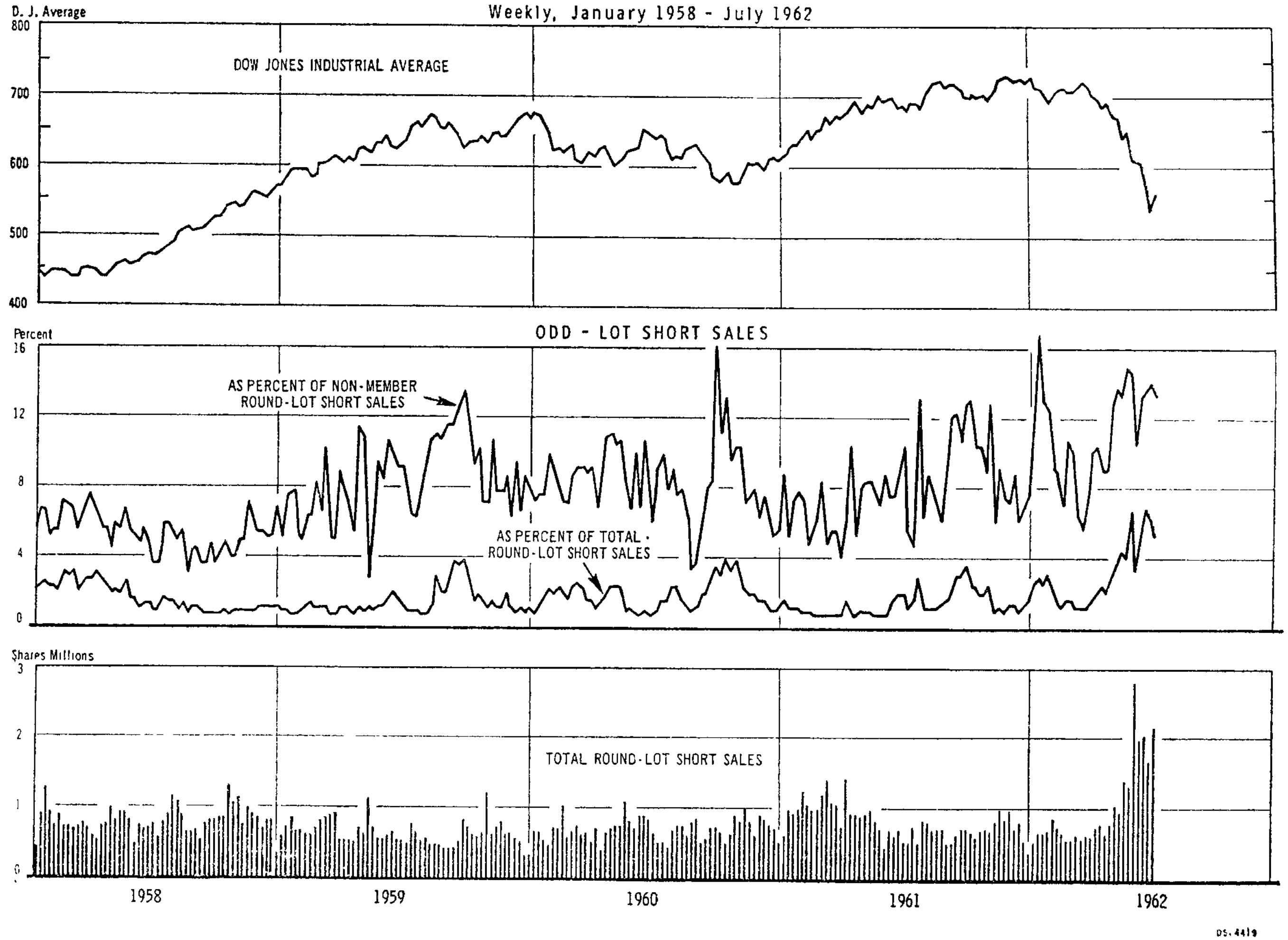
Chart VI-n

ODD-LOT CUSTOMERS' SHORT SALES ON N.Y.S.E.

as Percent of Total Round-Lot Short Sales and as Percent of Non-Member Round-Lot Short Sales

Weekly, January 1958 - July 1962



fore, compares odd-lot short sales to both total round-lot short sales and to short sales by nonmembers alone. Short sales in odd lots are not large on an aggregate basis in either comparison. However, odd-lot short selling, which during periods of rising prices often amounts to no more than 1 percent of total round-lot short selling, rises to 4 percent during pronounced dips in the market and rose to more than 6 percent during the decline in May–June 1962. As compared with nonmembers' round-lot short selling, odd-lot short sales varied from less than 4 percent to more than 16 percent, the same proportionate range.

The ratio of odd-lot short selling to total odd-lot sales increased (in the 4½-year period shown) from a minimum level of less than 1 percent (during well established upward trends in stock prices) to above 2 percent during declines and, on the May 1962 precipitous fall, to over 6 percent (chart VI–o).

3. THE STOCKS IN WHICH SHORT SELLING OCCURS

As mentioned, reports issued each month by the New York Stock Exchange provide aggregate figures in shares of the short interest in stocks, the number of issues in which any short interest was reported by member firms, and a list of the individual stocks in which the short interest amounted to 5,000 shares or more or changed from the previous month by 2,000 shares or more. This section presents an analysis of these reports in an effort to determine the extent to which short selling is concentrated in particular issues and the characteristics of such issues.

a. Number of stocks in which a short interest is reported

Generally about 60 to 65 percent of the stocks listed on the New York Stock Exchange [533] have a reported short interest. The ratio has varied in recent years from a low of 55 percent in October 1956 to a high of about 70 percent in April 1961. The number of stocks in which there was a short position, and the ratio of such issues to the total number listed, are shown in charts VI–p and VI–q, respectively.

Chart VI–p indicates a rather wide variation in the number of issues with a short position. To adjust for the increase in the number of stocks listed during the period, the figures are expressed as a percent of the total listed issues for the corresponding month (chart VI–q).

In contrast with some of the preceding charts in which short selling was shown to reach a peak at or near the lowest point of a decline, charts VI–p and VI–q indicate that short selling tends to spread to a greater number of issues after the lowest point and when the market has progressed well onto a new upward trend. In fact, during the three instances shown in the charts, the peaks occurred from 6 to 8 months after the new upward trend started.

b. The concentration of stocks in which short sales occur

Generally, the NYSE's monthly report of stocks in which there is a short position of 5,000 shares or more, or a change of 2,000 shares or more from the preceding month, consists of less than 200 issues, ranging from 126 in July 1956 to 188 in May 1962; in November 1962

[533] The number of listed stocks has exceeded 1,500 since 1952, rising from 1,522 that year to 1,558 in November 1962.

Chart VI-o

SHORT SALES BY ODD-LOT CUSTOMERS ON N.Y.S.E. as Percent of Total Odd-Lot Sales

Weekly, January 1958 - July 1962

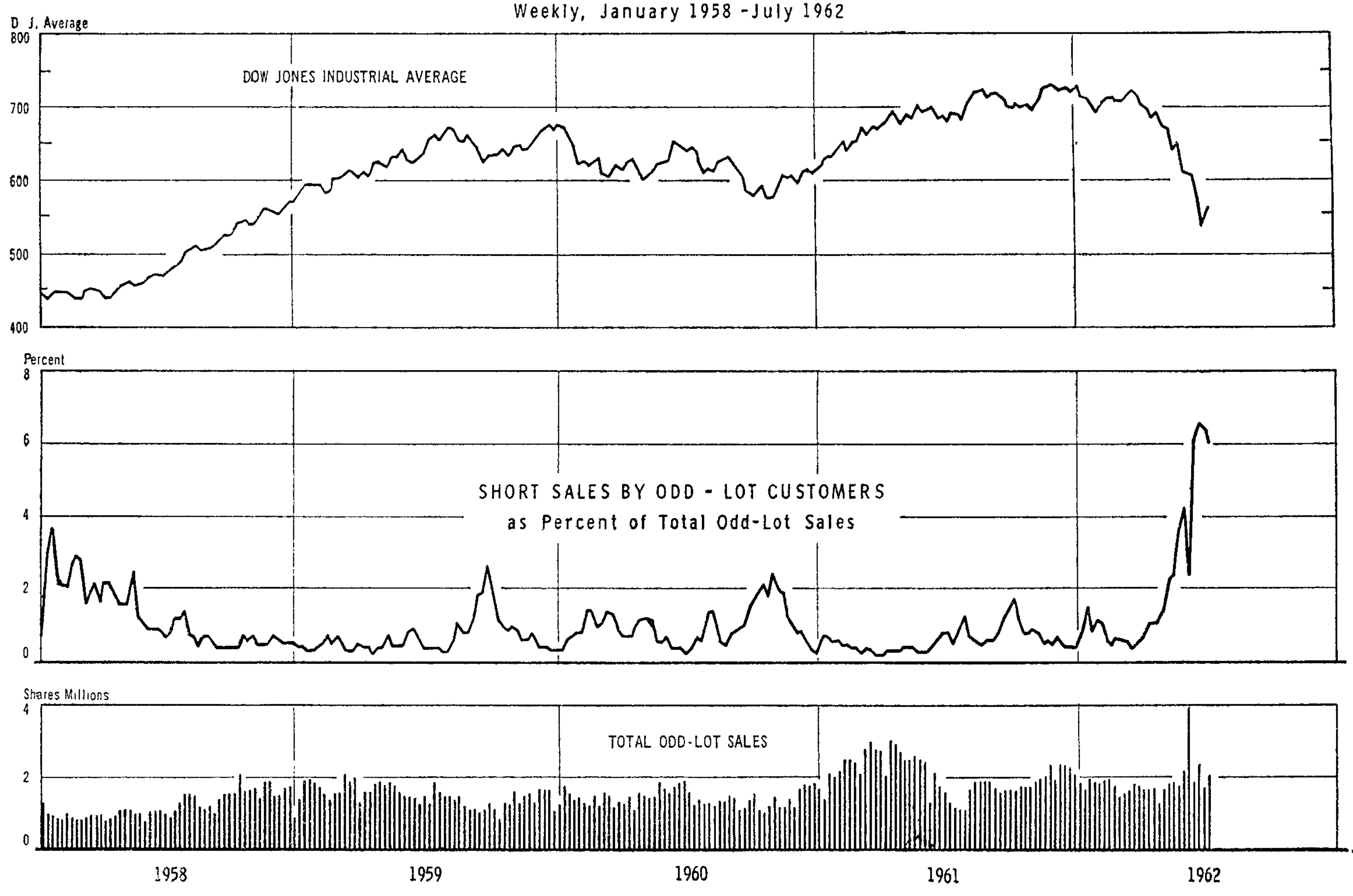
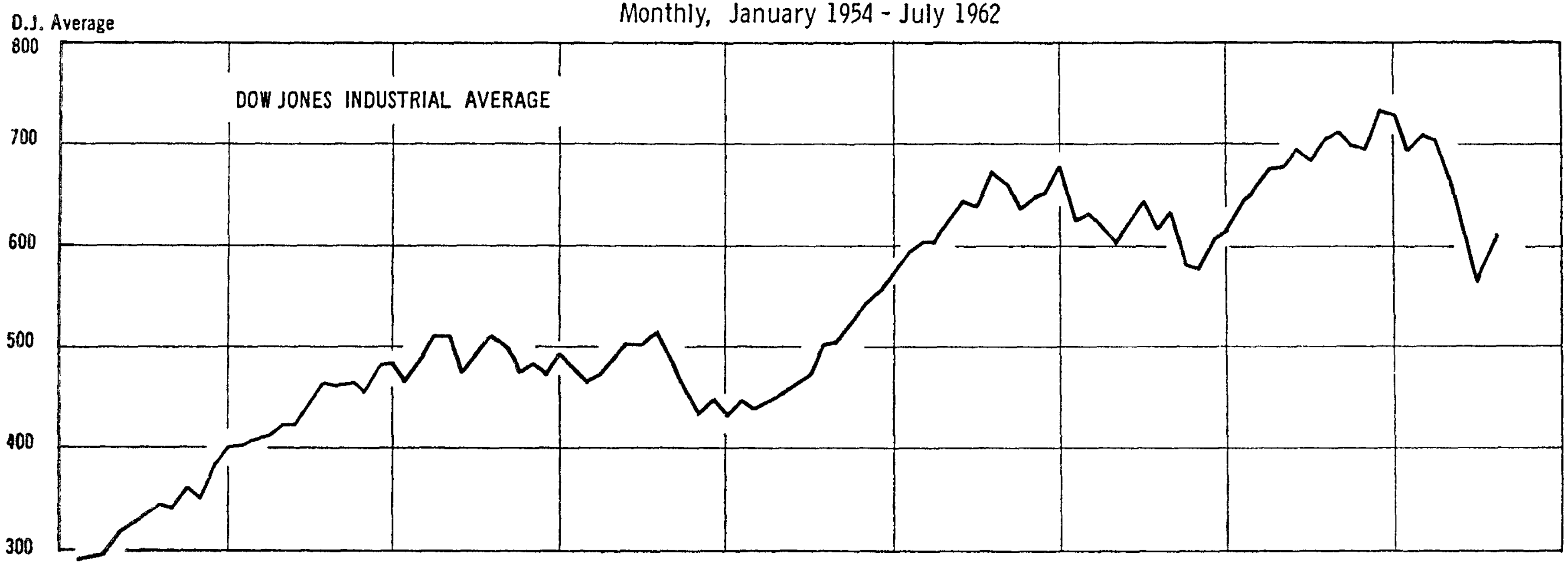


Chart VI - p

NUMBER OF ISSUES WITH A SHORT POSITION ON N.Y.S.E.

Monthly, January 1954 - July 1962



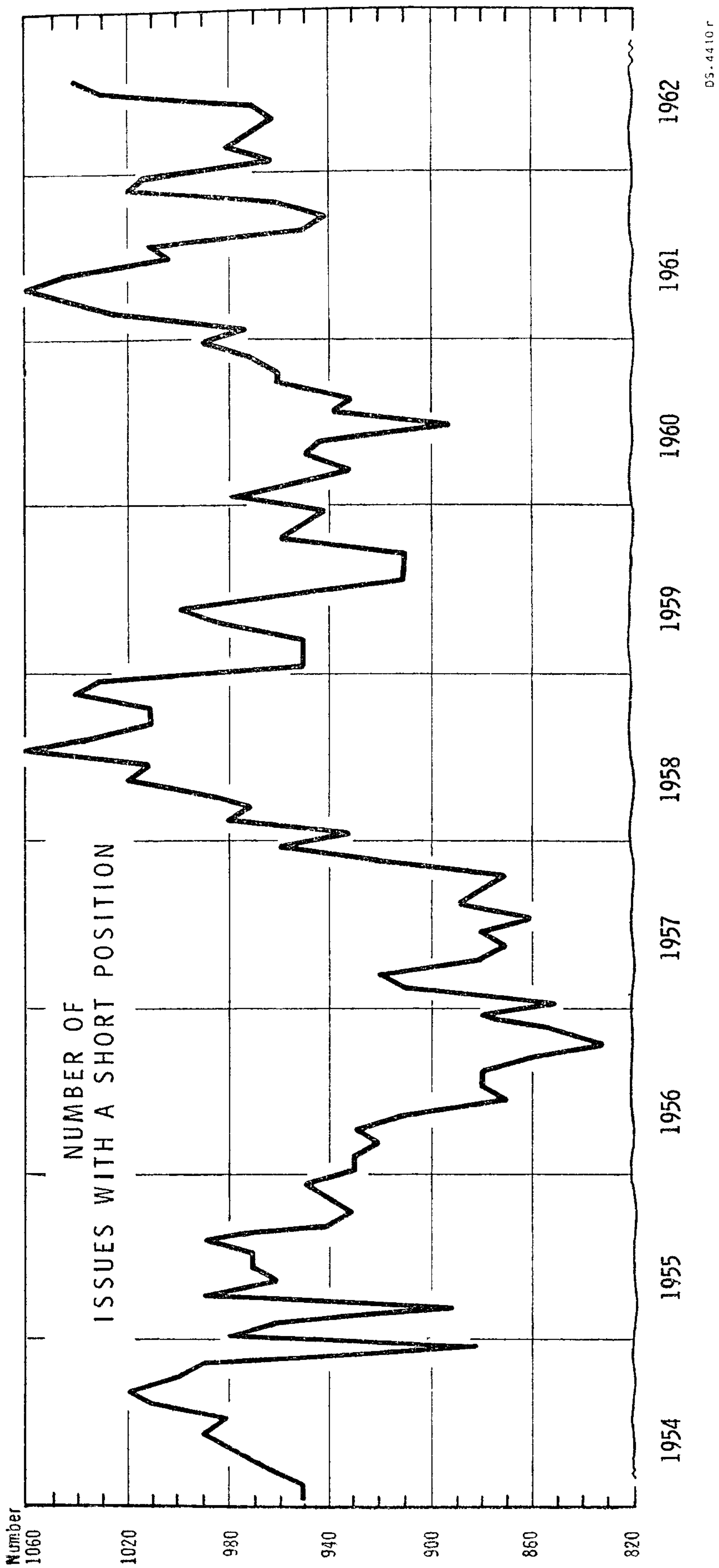
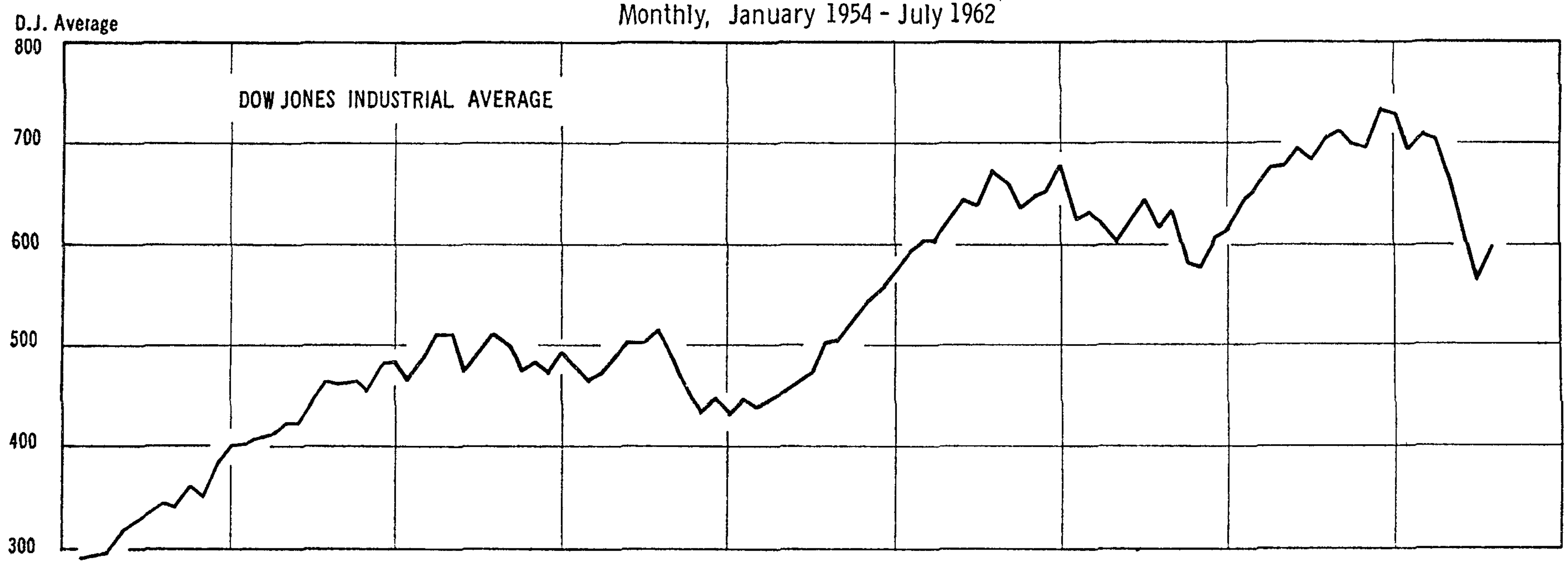
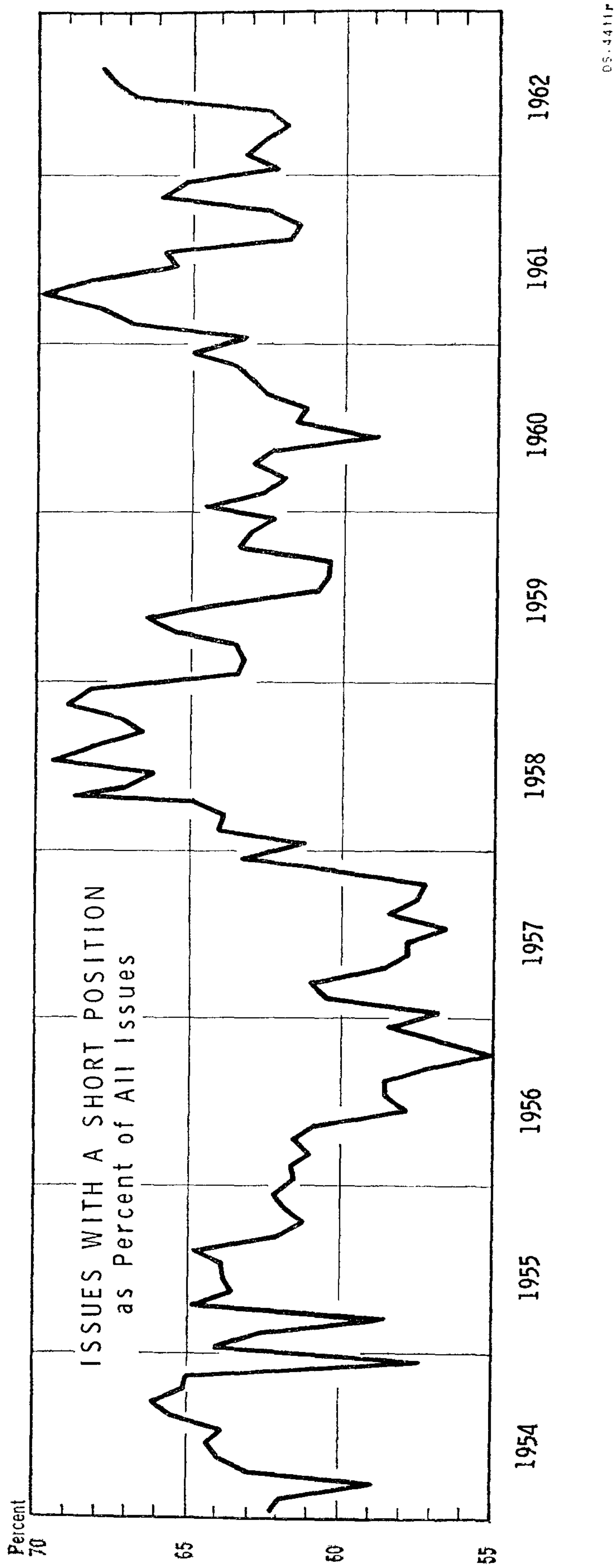

NUMBER OF
ISSUES WITH A SHORT POSITION
Number
1060
1020
980
940
900
860
820
1954
1955
1956
1957
1958
1959
1960
1961
1962
DS-4410 r

Chart VI - q

ISSUES WITH A SHORT POSITION ON N.Y.S.E. as Percent of All Issues

Monthly, January 1954 - July 1962




ISSUES WITH A SHORT POSITION
as Percent of All Issues
Percent
70
65
60
55
1954
1955
1956
1957
1958
1959
1960
1961
1962
OS-4411r

it went as high as 291. The relatively small number suggests a high degree of concentration, which is further indicated by the number of stocks in which there was a sizable short interest rather than merely a change of 2,000 or more shares: this averaged 185 in the monthly reports in May, June, and July 1962, or 18.1 percent of the average of 1,015 issues in which there was some short interest for these months. The distribution of the 185 stocks according to the size of the short interest is shown in table VI–p.

The average short interest in these 185 issues represented 81.5 percent of the average number of shares short in all issues (4,346,000) for these months. An average of 82 issues, or approximately 45 percent, were concentrated in the lowest class where the short interest ranged from 5,000 to 10,000 shares. These 82 issues represented only 18 percent of the total number of shares that were short in the 185 issues. Conversely, the 32 issues having a short interest of 30,000 shares or more accounted for almost half of the total short interest in the 185 stocks.

TABLE VI–p.—*Short interest in NYSE stocks (average of May, June, and July, 1962)*

Class (thousands of shares)	Number of issues			Number of shares		
	3-month average	Cumulated		3-month average	Cumulated	
		3-month average	Percent of total		3-month average	Percent of total
5 to 9	82.33	82.33	44.7	643,000	643,000	18.2
10 to 19	50.00	132.33	71.8	705,000	1,348,000	38.1
20 to 29	20.00	152.33	82.6	487,000	1,835,000	51.8
30 to 39	15.67	168.00	91.1	530,000	2,365,000	66.8
40 to 49	5.00	173.00	93.9	223,000	2,588,000	73.1
50 to 59	4.67	177.67	96.4	250,000	2,838,000	80.1
60 to 69	2.33	180.00	97.7	152,000	2,990,000	84.4
70 to 79	.33	180.33	97.8	24,000	3,014,000	85.1
80 to 89	.67	181.00	98.2	58,000	3,072,000	86.7
90 to 99	.00	181.00	98.2	0	3,072,000	86.7
100 and over	3.33	184.33	100.0	470,000	3,542,000	100.0
Total	184.33			3,542,000		

c. *Classification of stocks by industries*

To note any predilection of short sellers for stocks of certain industries, the short interest reports for the period of January 1961 through June 1962 were examined to ascertain which stocks appeared consistently throughout the period. In each of the 18 monthly reports, 54 stocks appeared; these were classified by industry as shown in table VI–q. Since most industries are represented by one or more of the 54 stocks, the table leaves some doubt as to concentration of short selling in any particular category. However, the greatest number of issues are in the broad classification of manufacturers of durable goods and of these, stocks of companies manufacturing radio, television, and communication equipment appear to have been more subject to short selling than any other single group. This is hardly surprising since the eight electronic stocks in this group had been, prior to the decline, among the most active on the NYSE.[534]

[534] The eight stocks are Ampex, Avco, General Telephone & Electronics, International Telephone & Telegraph, Motorola, Texas Instruments, Varian Associates, and Zenith Radio.

TABLE VI–q.—*54 stocks consistently in NYSE short interest reports classified by industry (January 1961–June 1962)*

	Number of stocks
Manufacturing:	
Durable goods:	
Iron and steel	2
Nonferrous metal	2
Nonelectrical industrial machinery	1
Office machines	2
Service industry machines	2
Electrical machinery	2
Radio, television, and communication equipment	8
Motor vehicle parts and accessories	4
Aircraft and missiles	4
Scientific instruments	3
Toys, amusement and sporting goods	3
Manufacturing—Con.	
Nondurable goods:	
Food and beverage	1
Tobacco products	1
Paper and allied products	2
Industrial chemical	1
Drugs	1
Other chemical	1
Petroleum refining	1
Rubber products	3
Paving and roofing materials	1
Transportation: Railroad	2
Utility: Telecommunication	2
Trade, Finance, and Service:	
Retail trade	3
Other finance and service	1
Contract construction	1

NOTE.—Industry groups are based upon U.S. Bureau of the Budget, Office of Statistical Standards, "Standard Industrial Classification Manual."

Table VI–r identifies the 54 stocks by name. The list scarcely needs any additional data to indicate that the most popular stocks for short selling purposes are the so-called "market leaders" or current "trading favorites." [535] Among the leaders are such stocks as American Telephone & Telegraph, Bethlehem Steel, Chrysler, General Electric, and U.S. Steel, while some of the trading favorites are American Motors, Avco, Bell & Howell, Brunswick, Litton Industries, Polaroid, Texas Instruments, and Varian Associates.

TABLE VI–r.—*54 stocks consistently in NYSE short interest reports (January 1961–June 1962)*

Aluminum Company of America	Litton Industries
American Machine & Foundry	Lockheed Aircraft
American Motors Corp.	Lorillard (P.)
American Photocopy Equipment	McCrory Corp.
American Telephone & Telegraph	Minnesota Mining & Manufacturing
Ampex Corp.	Monsanto Chemical
Automatic Canteen	Motorola, Inc.
Avco Corp.	New York, New Haven & Hartford RR.
Bell & Howell Co.	Norfolk & Western Railroad
Bethlehem Steel	Northrop Corp.
Brunswick Corp.	Polaroid
Certainteed Products	Republic Aviation
Chock Full O'Nuts	Revlon, Inc.
Chrysler Corp.	Rexall Drug & Chemical Co.
Ford Motor Corp.	Reynolds Metals
General Dynamics	St. Regis Paper Co.
General Electric	Texaco, Inc.
General Motors	Texas Instruments
General Telephone and Electronics	Underwood Corp.
General Tire & Rubber	U.S. Industries
Goodrich (B. F.)	United States Steel
Goodyear Tire & Rubber	Universal Match Corp.
Great Western Financial	Universal Oil Products
Hewlitt Packard Co.	Varian Associates
International Telephone & Telegraph	Vendo Corp.
Korvette (E. J.)	Western Union Telegraph
Lionel Corp.	Zenith Radio

[535] The volume of trading for the 54 stocks during 2 months of the period (December 1961 and June 1962) accounted for 15.5 and 22.6 percent, respectively, of total trading on the NYSE in those 2 months indicating they were among the most actively traded.

4. EFFECT OF SHORT SELLING ON PRICES

An analysis was made of the data provided by the monthly short interest reports to ascertain, if possible, the relationship between short selling, short covering, and stock prices during different types of market movements. As indicated below, the analysis was not productive. For 9 different groups of 30 securities each, data including the following were examined: the short interest, price range, and volume of trading during the period studied, and the industry classification of the issue. The groups included stocks with the largest short interest as of a market low, stocks with the largest decrease in short interest during a period of market advance, and others with the largest increase during a decline; stocks with the largest percentage price rise in a year of rising prices, and those with the largest percentage price change in a period of decline. The changes in short position of each of the 270 stocks were then compared with the stock's price changes in the period for which it was studied.

It was not possible from the data available for these tests to find any relationships, nor did the study of individual price movements provide any corroborative evidence. For example, the rise in the market after the 1960 lows amounted to some 177 points in the Dow-Jones Industrial Average. It might have been assumed, therefore, that the 30 stocks with the largest short interest would not only advance during the subsequent general rise because of short covering, but would perhaps advance even more vigorously than the average. However, the 30 stocks not only failed to advance at a more rapid rate than the general market, but 20 of the group actually declined in price.

The several tests indicate the difficulty of employing the monthly short interest figures to attempt to gage the influence of short selling or covering on the price movements of stock.

5. A CLOSER LOOK AT SHORT SELLING

Accordingly, it is important to examine short selling with respect to the individual stocks where such selling is large, and, as much as possible, to pinpoint this selling to specific instances of time. For this purpose, reference was made primarily to data concerning eight selected stocks obtained from the Special Study's analysis of the May 1962 market break. These data include detailed information on short selling for the 3 days of the market break period, May 28, 29, and 31, and summary statistics for 14 selected days prior and 2 days subsequent to the market break.[536]

This discussion is divided into three parts. The first provides some highlights on short selling in the eight stocks during the selected 14 days prior to the market break, the second presents an overall view of the market break period, while the third furnishes a detailed analysis of short selling in the eight stocks during May 28, 29, and 31.

a. The period prior to the market break

Most of the eight stocks suffered a generally falling trend during the period covered by the 14 selected days and all of them experienced

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[536] See ch. XIII for a fuller analysis of trading on these days. Short sales by nonmembers were estimated on the basis of reports by 25 leading NYSE member firms accounting for the highest volume of commission business in 1961.

declines during the latter part of the period. Short selling rose to unusual heights, as indicated in table VI–s, which shows the days on which estimated short selling was 8 percent or more of total sales for each of the stocks. On various days short selling actually constituted over 25 percent of total sales of two of the stocks. As a point of comparison, it may be noted again that from January 1954 through July 1962, short selling in relation to total trading in all stocks varied from 3 percent to over 8 percent.

TABLE VI–s.—*Days on which short sales amounted to 8 percent or more of total sales in 8 selected stocks*[1] *(14 selected days, 1961–62)*

[Short sales as percent of total sales]

Trade date	AT&T	Avco	Brunswick	General Motors	IBM	Korvette	Standard Oil (N.J.)	U.S. Steel
Nov. 3, 1961			13.2			48.6		
Nov. 6, 1961			8.4			41.0		
Nov. 15, 1961			8.8		17.3			
Nov. 16, 1961						14.8		
Nov. 17, 1961	8.2					36.6		
Jan. 29, 1962			10.4			22.9		
Jan. 30, 1962	8.1					54.7		13.6
Mar. 15, 1962		8.5	9.5	29.1		13.2		
Mar. 16, 1962	13.5							
Apr. 27, 1962						22.4		11.7
Apr. 30, 1962	12.3			18.9		24.0		17.2
May 1, 1962				10.6		17.0	9.4	
May 11, 1962	11.6	28.2	9.6		13.0	30.8		
May 14, 1962		35.0			9.1	8.1		24.9

1 Short sales by members were reported for each of the 8 stocks. Short sales by nonmembers were estimated on the basis of reports by 25 leading NYSE member firms accounting for the highest volume of commission business in 1961.

In accordance with the general pattern, the predominant amount of short selling on the 14 days was done by the members. In some instances, this selling came from the specialists; one important specialist testified that he tried during this period to end each day with a short position in three of his stocks.[537] In other instances, the short selling came from floor traders and members off the floor, probably prompted by speculative motives. For example, the large amount of short selling of U.S. Steel on April 27 and 30 may be ascribed, at least in part, to the price controversy between the Government and the steel companies that occurred during this period and to the announcement on April 27 of a Federal grand jury indictment against several companies, including U.S. Steel, on charges of price fixing.

The consistently large amount of short selling in Korvette both from members and from the public very likely was inspired by speculative motivations. During this entire period the stock was in the public eye and its sharp price changes probably influenced the substantial short selling activity that occurred. Such short sales, carried into the period of the market break itself, undoubtedly contributed to the severe weakness of the stock that developed around the spring of 1962.

Avco presents an interesting case of an entirely different kind. Over half of the unusually high volume of short selling on May 11 and 14 represented hedged transactions against the company's convertible bonds by two firms which do a great deal of arbitraging.

537 See pt. D.6.e(4) of this chapter.

Thus, during the period preceding the market break, short selling was created by varying motivations. All three of the stocks just mentioned were very much in the public eye during this period and therefore the burden of absorbing a large volume of short selling on certain critical days may have contributed more to the general weakness of the period than is implied even by the amount of short selling in the particular stocks.

b. An overall view of the market break period

Before presenting the data in regard to the eight stocks during the market break period, it may be helpful to show the extent of short selling in general on those three days. These data are summarized in table VI–t. The table shows that short sales increased from 368,000 shares (or 3.7 percent of total sales) on May 28, to 774,000 shares (5 percent) on May 29, and to 1,417,000 shares (12.9 percent) on May 31.

TABLE VI–t.—*Summary of markets and short selling by members and nonmembers (May 28, 29, and 31, 1962)*

	May 28	May 29	May 31
MARKET			
Dow-Jones Industrial Average (close)	577	604	613
Net change from preceding day	−35	+27	+9
Total round-lot sales [1] (thousand shares)	9,820	15,452	10,997
SHORT SELLING			
A. SHARES SOLD SHORT (THOUSANDS)			
All short sales	368	774	1,417
Members	214	611	1,202
Specialists	185	530	1,033
Floor traders	10	15	63
Members off floor	19	66	106
Nonmembers	154	163	215
B. AS A PERCENT OF TOTAL SALES			
All short sales	3.7	5.0	12.9
Members	2.1	3.9	10.9
Nonmembers	1.6	1.1	2.0
C. AS A PERCENT OF ALL SHORT SALES			
All short sales	100.0	100.0	100.0
Members	58.2	79.0	84.8
Specialists	50.3	68.5	72.9
Floor traders	2.7	1.9	4.4
Members off floor	5.2	8.6	7.5
Nonmembers	41.8	21.0	15.2
D. AS A PERCENT OF THEIR OWN TOTAL SALES			
Members (excluding odd-lot dealers)	11.3	15.2	35.6
Specialists	12.8	15.9	40.2
Floor traders	5.8	7.2	31.8
Members off floor	7.0	13.8	17.2
Nonmembers	2.0	1.5	2.8

[1] The volume of sales shown here represents total volume as contrasted with reported volume used in other tables in this section. Reported volume is obtained from the ticker tape and is generally 3 to 5 percent less than total volume.

Members accounted for 58.2 percent of all short selling on the first day, 79 percent on the second, and 84.8 percent on the third day. The major part of such selling was by specialists, who increased their proportion from 50.3 percent on the day of decline to 68.5 percent and 72.9 percent respectively on the following 2 days of rapid recovery in the market. Floor traders accounted for about 2 to 3 percent on each of the first 2 days but increased their proportion on May 31 to 4.4 percent. Members off the floor, whose ratio of short sales to total sales rose from 5.2 percent to 8.6 percent, accounted for less than their usual average. On the second day of recovery, May 31, about a third of all selling by members on the floor, i.e., specialists and floor traders, was for short accounts.

Nonmembers increased the volume of their short selling from 154,000 shares on May 28 to 215,000 shares on May 31. However, because of the much greater rise in short selling by members during these days, the nonmembers effected their greatest proportion of total short sales on May 28. On that day they did 41.8 percent of total short selling, compared with 15.2 percent on May 31. On the other hand, the nonmembers' short selling relative to their own total sales rose from 2 percent on May 28 to 2.8 percent on May 31.

c. Short selling in the eight stocks during the break (May 28)

Tables VI–82 through VI–89 (which appear at the end of the chapter) contain comparative data on total selling and short selling by class of seller for each of the eight stocks on each of the 3 days during the market break period. Table VI–v summarizes this information for all eight stocks. The relatively large amount of short selling in these stocks on May 28 is indicated by the fact that they accounted for 15.5 percent of total short selling, whereas their total volume of trading represented less than 10 percent of all trading. Also, on that day of drastic decline, short sales in the eight stocks amounted to about 6 percent of total sales in these stocks; the ratio increased substantially on the following 2 days of rapid price recovery. By the third day, short sales in the eight stocks exceeded those on the 28th by some 171,000 shares, and about 65 percent of this increase was by members, principally specialists.

It is clear that in these stocks the market had to absorb a large amount of short selling, which reached unusually high proportions in the cases of U.S. Steel and Korvette on the day of sharp decline, as shown in table VI–u below:

TABLE VI–u.—*Short sales in 8 stocks on May 28*

Stock	Total short sales		Net price change per share
	Shares (arrayed in descending order)	Percent of total sales	
United States Steel Corp	14,600	16.6	−1⅞
E. J. Korvette, Inc	10,600	16.7	−2⅞
American Telephone & Telegraph Co	10,500	3.7	−11
Avco Corp	7,200	8.8	−2⅞
Standard Oil Co. (N.J.)	4,200	2.8	−5
General Motors Corp	3,800	3.8	−1⅝
Brunswick Corp	3,300	3.2	−4⅝
International Business Machines Corp	2,800	4.9	−37½
Total (8 stocks)	57,000	6.2	

TABLE VI–v.—*Trading data for 8 selected stocks combined (May 28, 29, and 31, 1962)*

	May 28		May 29		May 31	
	Shares (in thousands)	Percent of total	Shares (in thousands)	Percent of total	Shares (in thousands)	Percent of total
	A. 8 stocks in relation to entire market					
Total reported volume in all stocks	9,350	100.0	14,750	100.0	10,710	100.0
Reported volume in 8 stocks	924	9.9	1,349	9.1	1,203	11.2
Total short sales in all stocks	368	100.0	774	100.0	1,417	100.0
Short sales in 8 stocks [1]	57	15.5	120	15.5	229	16.2
	B. Short selling relative to total trading in 8 stocks					
Total reported volume in 8 stocks	924	100.0	1,349	100.0	1,203	100.0
Short sales in 8 stocks [1]	57	6.2	120	8.9	229	19.0
	C. Short sales in 8 stocks by type of seller					
Total	57	100.0	120	100.0	229	100.0
Members	23	40.3	64	53.3	135	58.9
Specialists	13	22.8	35	29.2	83	36.4
Floor traders	4	7.0	5	4.2	21	9.3
Members off floor	6	10.5	24	20.1	30	13.3
Nonmembers [1]	34	59.7	56	46.7	94	41.0

[1] Short sales by nonmembers were estimated on the basis of reports by 25 leading New York Stock Exchange member firms accounting for the highest volume of commission business in 1961.

NOTE.—Figures do not necessarily add to totals due to rounding.

Moreover, in spite of the Commission rule limiting short selling to up-ticks,[538] and without evasion of that rule, in six of the eight stocks most or much of the short selling occurred at times when these stocks were under the greatest pressure.

United States Steel Corp.

This stock is the only one of the eight studied that had substantial short selling by the stock's specialists on May 28. Of a total of 14,600 shares that were sold short, the two competing specialist units in this stock accounted for 12,700, or 87 percent. The remaining 1,900 shares were accounted for by nonmembers.

Each specialist unit had an opening position on May 28 of 1,100 shares long. During the first 2 hours the stock traded in a range from its opening price of 52 down to 51½. At 11:42 a.m., both units together sold 4,500 shares at 51¾, of which 3,300 shares were short sales, apparently made to supply part of an accumulation of buy orders.

As a result, by 1:00 p.m. one specialist unit was short 1,500 shares and the other was short 400 shares; the stock had not gone below 51¼. At the end of the next 2 hours, however, it had declined to 50⅜. During that period the specialists did not use their short position to absorb selling pressure, which is the usual reason offered by specialists for their building up a short position. Instead, the two units purchased 5,300 shares and sold 5,600, each unit accounting for about one-half of the purchases and sales. Of the 5,600 shares sold, 4,500 were

[538] "Up-ticks" include both "plus ticks" and "zero-plus ticks."

short sales, which were made in small lots just as were their covering purchases.

By 3 p. m., one unit was short 1,600 shares and the other, 600 shares. They did no more trading until the closing 7 minutes, when they began covering, the first unit purchasing 2,500 shares (and selling 300 shares in this time) and the second purchasing 800 shares. The purchases were at 50¼ and 50⅜, made just after the stock traded at the day's low of 50⅛. The specialist units ended the day with a combined long position of 800 shares, 1,400 shares less than they had at the opening. The stock proved to be one of the least affected by the avalanche of selling on May 28, but when the stock started its decline after 2 p.m., the specialists did not use their short position to absorb the selling pressure.

E. J. Korvette, Inc.

Korvette appears to offer a relatively clear-cut example of stock in which short selling may have been a factor in the decline on May 28. All but 100 shares were sold by nonmembers and most of this was concentrated in late trading when the stock suffered its worst decline. The stock opened at 40⅜, unchanged from the previous day's close; rallied to 41⅜ toward noon; remained at or above the opening until after 1:00 p.m. and then fell on increasing volume to a low of 34 between 3:00 p.m. and 3:25 p.m. It closed at 37½ on a sharp recovery of 3½ points in the final few minutes of trading. Based on the substantial sample of nonmembers' transactions, most of their short selling occurred at prices which placed such selling during the rapid decline from around 40 to 34.

American Telephone & Telegraph Co.

Nonmembers were the principal short sellers of AT&T. While this selling took place steadily during the day as the market declined from about 109 to almost 100, a large part of it occurred as the market neared its low in the latter part of the day.

Augmenting this short selling, floor traders sold 3,000 shares. About one-third of this was done between 1 and 2 p.m., during the initial decline of the stock, and most of the rest was concentrated during the final half hour of trading. On balance, floor traders increased their long position slightly during the day.

Members off the floor (though ending the day with a net purchase balance) sold 1,500 shares short, most of it as the market began its downward slide.

Avco Corp.

All the short selling in Avco was done by members off the floor. Although they made fairly substantial net purchases for the day, they sold 3,100 shares short, the bulk of it toward the end of the first hour and prior to the inception of the decline.

Standard Oil Co. (N.J.)

Short selling was modest relative to total sales in Standard Oil but most of it occurred during the weakest part of the decline near the close.

General Motors Corp.

Short selling represented 3.8 percent of total selling in the stock, most of it by nonmembers. About one-third of this selling occurred during the final half hour of trading, near the lowest price of the day.

Brunswick Corp.

Short selling represented 3.2 percent of total selling in the stock, and all of it was by nonmembers. Most of this selling occurred soon after the opening, near the high of the day.

International Business Machines Corp.

Nonmembers and floor traders accounted for about equal amounts of all the short selling in IBM. The nonmembers' selling was distributed throughout the day. On the other hand, floor traders concentrated more than a third of their short sales between 1 and 2 p.m., when the market was falling rapidly. In addition, they were heavy sellers on balance during the day.

6. AN EVALUATION OF THE SHORT SELLING RULES

The preceding analysis highlights two important facts: First, the volume of short selling tends to expand during declining phases of the market and thereby, contrary to the classic argument, augments already existing downward movements. Second, the current rules have been unable to prevent even the concentration of short selling in times of critical market decline, or the concentration of substantial short selling in individual stocks, frequently at moments of great selling pressure in those stocks. Not only did the current rules fail to eliminate the aggravating influence of short sales during the market break of May 1962, but as the table below indicates, a much larger amount of short selling might have been effected than actually took place.

TABLE VI-w.—*Maximum opportunities to sell short in 8 stocks*

	May 28	May 29	May 31
Maximum opportunities to sell short:			
Number of up-ticks	1,517	2,497	1,461
Total shares sold on up-ticks	316,500	739,900	898,300
Short sales (shares)	57,000	120,300	228,500
Short sales as percent of total sales on up-ticks	18.0	16.3	25.4

Despite the weak condition of the market on May 28, there were over 1,500 up-ticks on which short sales could have been effected in the eight stocks selected for study. During the market break particularly, the supply of stock which short selling introduces adds further selling pressure to an already unbalanced market. One specialist commented as follows:

Q. During the break in May did you feel any pressure from short selling at all?

A. There was a great deal of short selling; there can't be too much pressure because we can only sell on plus ticks.

Q. Did you——

A. They certainly lengthen the time that it took a stock to go up, probably.

Q. In other words, when you had an up-tick——

A. There had to be substantially more buyers to move the stock up because of the heaviness of the sell orders—the short orders, excuse me.

Q. So that when there was an up-tick, there would be the short selling——
A. Right.
Q. That would take place?
A. Right. Not in every stock, just certain ones.

Another specialist testified along substantially the same lines:

Q. What were the circumstances in General Foods on the morning of May 28?
A. On May 28 there were in the marketplace, not only in General Foods but in many other stocks, many orders to sell short. * * * We had a downtrend of the market with news and you might say at that time that bids were being satisfied for over a period of time in the marketplace on top of which were these orders to sell short.
Q. You are talking about May 28?
A. Yes.

* * * * * * *

But on May 28 there were bids and, of course, the specialists have had to temper his [sic] markets with his bids on the way down. It was a most difficult job because no matter what he did he had short orders coming in right on top of him.
Q. The short selling rule would prevent——
A. Artificial depressing of the stock but nevertheless they came down with the market.

An important reason for the continued downward pressure that short selling may exert even during severely shrinking markets is the weakness of the tool designed to prevent this pressure. The tool takes the form of the tick test which establishes a "trade-to-trade" basis for determining the permissibility of short selling, but that does not serve to prevent short selling in a declining market.[539]

Ample illustrations have been brought to light of the fact that plus or zero-plus ticks may be commonplace during sharply declining markets. Thus, when measured against the preceding different price, short selling may appear to have no important influence on the movement of the market; measured against a basic trend, however, which could have been in motion for some time, short selling may exert a heavily deleterious effect on the movement of the market.

7. SHORT SELLING EXEMPTIONS

Since 1939 the only change made with respect to the short selling rules has been the adoption of certain exemptions. Of these, the most important probably are two arbitrage rules; the first refers to arbitrage transactions between equivalent securities and the second to international arbitrage. Another exemption was provided for so-called equalizing transactions, i.e., those effected on an exchange for the purpose of equalizing the price of a security traded on that exchange with the current price on another exchange where the security has its principal market.

All of the exempt transactions are exempt only from paragraph (a) of rule 10a–1, that is the provisions which determine when a short sale may be made, and not from paragraph (b), which requires all sales to be marked either "long" or "short." The Commission did not specifically prescribe special markings for exempt short sales. However, after meetings with the staff of the Commission, the Exchange was advised that marking such orders "short exempt" would satisfy the marking requirements of rule 10a–1. In the statistics that are regularly compiled and published, these "short-exempt" transactions

[539] For the correspondence between ticks and price trends, see pt. D.6.e(2) of this chapter.

are not counted as short sales but are included with regular sales. Accordingly, the only record available on the volume of "short exempts" is located in the accounts kept by the individual member firms.

To throw some light on the extent of such sales, a limited survey was made of certain member firms by the Special Study. Although the survey was not broad enough to yield useful data on the volume of such transactions, since it focused upon firms known or believed to be engaged in arbitrage, some information was gained in regard to their practices.

The investigation covered arbitrage transactions at nine member firms, in American Telephone & Telegraph Co., Avco Corp., and Brunswick Corp., principally for the 2 days, May 28 and 29, 1962, but in some cases for other periods:

a. International arbitrage

As one firm pointed out, the amount of international arbitrage is now much less significant than in the past and this very specialized operation is kept alive only among a few firms. Perhaps for this reason, the investigation found so few transactions effected during the periods covered that only a small amount of data was produced.

In regard to short selling by the foreign participants in arbitrage accounts, the same firm stated that in executing trades for their foreign customers, their Amsterdam office is instructed to inquire and make note if a sale is "long" or "short." The firm indicated, however, that while this is the rule, it has been left largely to the client (usually large and reputable) to designate the trade. Another firm's comment adds still further doubt concerning the degree of compliance with the short selling rule and the efficacy of available records or other means of which compliance can be checked. The firm was quoted as saying:

> Short exempt sales must be reported to the NYSE *only* if they originate on the Floor.

The comment may be ambiguous but it does emphasize the need for more complete records on short exempt sales in international arbitrage as well as on other sales based on the technical exemptions under the rule.

b. Arbitrage based on convertible issues

The majority of firms visited appeared to be conducting arbitrage in convertible issues properly under the rule, by conversion of the security to cover share positions acquired through short exempt sales.

However, in the case of at least one firm there appears to be some question of full compliance. For example, during the period from May 8 through June 29, 1962, the firm sold at least 23,350 shares of American Telephone & Telegraph Co. "short exempt" without converting bonds, apparently covering their short position in the stock by purchases of the stock instead. A similar situation appeared in the firm's arbitrage account in the securities of Avco Corp.

These investigations raise a question of possible apathy toward, or misuse of, the exemption provisions of the rule.

8. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Short selling not only is used by exchange members and members of the public for speculative purposes, but is used also by arbitragers, specialists, and odd-lot dealers to facilitate market operations, and is used generally for hedging and tax purposes. The practice was the subject of much difference of opinion during the congressional scrutiny which led to passage of the Securities Exchange Act of 1934, and at least after each major downward plunge of market prices, its utility and impact have been vigorously debated.

The Exchange Act made short selling subject to the full regulatory power of the Commission. The current rules governing the practice incorporate limited changes from the original. Short selling is allowed only at a price above the last different one; also, short sales must be marked "short" on the order slips. Various exemptions have been made from the price requirements, the most important of which are for arbitrage transactions. Exempt short sales are required by the Exchange, with the concurrence of the Commission, to be marked "short-exempt." The Special Study's investigations suggest that there is some laxness in the observation of the Commission's short-exempt rules, and that the records by which compliance may be checked are not adequate.

The only data regularly compiled and published concerning short sales are daily aggregate figures for all stocks on the New York and American Stock Exchanges, and monthly figures on the short positions in certain stocks of the NYSE and in all securities on the Amex. Analysis of such data permits only broad conclusions about short selling practices. In recent years, such selling has varied from a low of about 3 percent to a high of over 8 percent of total NYSE share volume, dropping to the lower percentages as stock prices reach a peak and advancing to the higher as prices approach their bottom levels. This tendency for the ratio of short sales to increase as a market decline progresses, which is attributable principally to increased short selling by nonmembers, calls into question the classic argument that short selling (because of later covering purchases) has a stabilizing influence during market declines.

Ordinarily, nonmembers' round-lot short selling in the aggregate is small compared with their total round-lot sales, especially toward the end of a sustained rise, when the ratio tends to fall below 1 percent. During market declines the ratio has risen to around 2 to 5 percent, while in the critical break of May 1962, the ratio rose to more than 4 percent and to almost 7 percent during the further decline in June. The odd-lot short sales are quite small compared with round-lot short sales during advancing markets, but rise, relatively, as the market dips downward; during the May–June decline, the ratio increased to more than 6 percent.

Specialists do the greatest amount of short selling, partly because their obligation to maintain fair and orderly markets frequently leads them to make short sales. In recent years, their short selling ordinarily has represented 40 to 70 percent of total short sales. As a percentage of their own total sales, specialists' short selling is predominantly between 15 and 20 percent, and has a tendency to decrease on market advances and to increase in market declines. Off-floor members' short sales represent 10 to 25 percent of total short selling, and range predominantly from 8 to about 25 percent of their own total sales. More markedly than specialists, they tend to decrease their short activity on advances and to increase it on declines. Floor traders' short selling accounts for only 2 to 10 percent of total short selling.

However, as a portion of their own total sales, floor traders' short sales range predominantly from 5 to 15 percent, and—at least relative to other members' short sales—appear more volatile in their rising in weak markets and falling in strong ones.

The number of stocks with relatively large short positions tends to rise as the market declines and to fall as the market advances. In general, however, the large short positions tend to be concentrated in no more than 100 stocks including both the so-called "market leaders" and the "trading favorites." This strong concentration of short selling in a relatively small number of stocks suggests that the aggregate data used above, although useful to portray broad patterns, tend to obscure the true signficance of short selling. It is well established that the price action of these stocks has a wide-ranging effect on stocks in general. Because of the concentration of short selling in such stocks, therefore, the practice has a more telling influence on the market than is indicated by the aggregate statistics. Accordingly, it is important to examine short selling with respect to individual stocks and to pinpoint this selling, as much as possible, to specific instances of time. For that purpose, reference was made primarily to short selling in eight selected stocks during 14 selected days prior to, and during the 3 days of, the market-break period in the last week of May 1962.

Most of the eight stocks experienced a declining trend during the period of the 14 selected days prior to the market break, and all of them showed a decline during the latter part of the period. Yet short selling in a number of instances rose to over 8 percent of total reported sales, and in two stocks to over 30 percent. Contributing to this large volume of short selling were varied factors, such as in the case of U.S. Steel, the dispute with the Government about steel prices, in a stock such as Korvette, a general speculative interest, and in the case of Avco, the specialized transactions of a few members.

Of the total short selling in the eight stocks during the May 28–31 market-break period, over 75 percent occurred in four of them, AT&T, Avco, Korvette, and U.S. Steel, with the bulk of such selling taking place on the second and third days. Nevertheless, on the day of actual break, May 28, over 10,000 shares were sold short in each of three stocks and some short selling occurred in each of the remaining five. In the cases of both U.S. Steel and Korvette, short sales constituted over 16 percent of total sales. A detailed analysis of each of the eight stocks on May 28 reveals that much of the short selling came during spells of decline. Certain of this extra supply of stock when the market already was under heavy selling pressure undoubtedly contributed to the downward movement. In addition, an awareness of this augmented supply may well have tended to cause professionals on the floor of the Exchange, including the specialists, to diminish and withdraw their buying.

This emerging picture of a substantial volume of short selling in prominent stocks during intervals of price weakness indicates the inadequacy of current rules to cope with the harmful effect of short selling which they were devised to prevent. The presence of extra selling burdens during a market which is generally weak may be a contributory factor during a period of market break. An important aspect of the inadequacy of the current rules is their reliance upon a "tick test," which goes on a "trade-to-trade" basis making short selling permissible at prices above the last preceding different price. There is need for a rule of broader perspective, focusing not upon the "trade-to-trade" situation but upon the underlying trend, so as to be an effective limitation on short selling in a security when its market is under extraordinary selling pressure. Before enactment of such a rule, its effects should be thoroughly explored to insure that it meets its intended purpose without limiting the use of short selling in other market conditions. There is need also for the Commission's rules to provide for rapid action to prohibit short selling in a particular security or in general, in emergency situations.

As has been indicated, the primary objectives of the current rules are to prevent the use of short selling either to effectuate a "bear raid" or to accelerate a declining trend. While the Special Study has not uncovered any evidence of the use of short sales to spearhead a "bear raid," it has concluded that short sales may contribute importantly to accelerating the trend of a falling market. The present up-tick limitation, complemented by one or some combination of changes such as those suggested, would preserve those features of short selling that are in the public interest.

The Special Study concludes and recommends:

1. The two series of data on short selling presently compiled by the New York and American Stock Exchanges are inadequate for regulation. The series are neither compatible nor are they useful in indicating the degree of short selling in individual issues, the effect of such selling on the price stability of a security, or whether the provisions of the Commission's rules are being observed. Accordingly, the exchanges should initiate systems of reporting that will provide more frequent information on the volume of short sales in particular stocks classified as between the public and the principal classes of members. Monthly data on the short interest should show corresponding information in the selected individual stocks. In addition, consideration should be given the feasibility of indicating exempt short sales and furnishing information on the other types of short sales such as "against the box," arbitrage, and hedging. The Commission also should consider the extent to which short sales data should be reported by other exchanges. The Commission should designate the information to be furnished to it on a regular basis, and should also determine the extent and type of short selling data to be made available to the public.

2. It is difficult to determine the extent to which short sales are being made on "minus" or "zero-minus" ticks in the guise of exempted arbitrage transactions, but there is some indication that advantage is being taken of this exemption. The stock exchanges should examine current procedures for marking transactions as "short-exempts" and institute checks to insure that this marking is accurate, and thereafter the Commission should review and evaluate the procedures adopted.

3. Present rules appear inadequate to relieve the added pressure that short selling may create during a severe decline in the general market or a declining price trend in a particular security. Despite the rules, a relatively large volume of short selling occurred in particular stocks, including "market leaders" and "trading favorites," during the period of decline preceding the market break of May 28, 1962, and at critical junctures on that day, and many additional opportunities existed when short sell-

ing could have occurred. Accordingly, the present up-tick limitation should be supplemented by a rule or rules designed to cope more effectively with the potentially depressing effects of short selling during price declines. While the Special Study is not prepared to suggest the exact form of such rule or rules of general application, among the possibilities to be considered would be: the prohibition of short selling in a particular stock whenever its last sale price was below the prior day's low; or alternatively, whenever the last sale price was a predetermined dollar amount or percentage below a base price (e.g., the prior day's close or low or the same day's opening) as specified in the rule; or instead, given the circumstances of such a decline, a limitation of short sales in any particular stock to a predetermined proportion of the amount of stock available at the prevailing market. As a further precaution for times of general market distress, the Commission's rules should provide for temporary banning of short selling, in all stocks or in a particular stock, upon an appropriate finding by the Commission of need for such action.

I. Commission Rates

1. INTRODUCTION

The subject of stock exchange commission rates is of importance entirely apart from the dollar amounts involved,[540] since the structure of commission rates—the relative amounts charged for transactions of various types by persons in various categories—has far-reaching impacts on market patterns and practices. Both the level and structure of commission rates are established by rules of the various exchanges and are encompassed in the Commission's statutory authority with respect to "the fixing of reasonable rates of commission" (sec. 19(b)(9) of the Exchange Act).

The broad field of security commission rates on the exchanges is the subject of this part of chapter VI. It comprises the principles involved in the determination of such rates, the methods and means employed in reviewing them, and their impact on the securities markets. Although principles and methods are discussed, it should be emphasized at the outset that the Special Study has not felt called upon or equipped to study or comment on the level of any particular commission rate or rate schedules, whether in effect now or at any time in the past. Thus, neither the analysis of past experience nor the recommendations advanced here are in any sense to be construed as implying comment on the "reasonableness" of the level of rates. The concern of the study has not been with specific rates but rather with principles and methods, and, in the case of the rate structure, with various practices resulting from it.

a. Scope and methods of study

This section introduces the subject with a statement of the commission rate schedules and of the Commission's power to review them. Sections 2 and 3 concentrate on rate structure, while section 4 considers methods and questions involved in determination of the level of rates and the procedural aspects of rate review.

The information for this part has been drawn from a variety of sources. Chief among these have been, of course, the published con-

[540] In 1961, commissions aggregating more than $900 million were paid by members of the public to effect transactions on the various stock exchanges.

stitutions, rules, regulations, and other policy statements and interpretations of the various exchanges bearing on commission schedules and related practices. Nonpublished materials in the files of the New York Stock Exchange (NYSE) dealing with commissions were also important in obtaining a picture of the NYSE's position on various commission schedule matters. In addition, the Special Study took testimony from individuals responsible for the interpretation and enforcement of NYSE commission schedules and rules.

Several of the regional exchanges supplied the Special Study with data relating to the commission rate structure, and responses of their members to the Special Study's questionnaire EX–4 provided the basis for some of the discussion in section 2.a. This material was supplemented by conferences and interviews held with various persons, including officials of several of the exchanges, officers of mutual funds and other institutions, and various broker-dealers. Finally, the files of the Commission bearing on commission rates were carefully reviewed.

Before summarizing the commission rate schedules of the exchanges, it will be helpful to define two basic terms to be used throughout this part. One is the "commission" paid brokers for effecting securities transactions on exchanges; i.e., the subject of this part. In exchange transactions for the account of others, the broker usually does not act as principal but as an agent, and receives payment for his services in the form of a commission as distinguished from a "markup" or differential earned by a dealer when he buys or sells for his own account as a principal in the over-the-counter market.

The second term is the "transaction" completed by the broker and for which he receives a commission. It basically includes two parts: The first, referred to as the "execution," consists of using the facilities of the exchange to locate a seller (or buyer) and consummating the trade. The second referred to as the "clearance" of the transaction, covers arrangements for the actual exchange of the stock certificates and the payment for such certificates. These functions of executing and clearing a security transaction also involve the bookkeeping entries necessary to record the transaction.

b. The commission rate schedules

(1) *The NYSE*

The avowed objectives of organizing the NYSE in 1792 were the setting of minimum commission rates and the establishment of a preference for members of the Exchange in their dealing with other members, and were stated as follows:

> We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter percent Commission on the Specie value, and that we will give a preference to each other in our Negotiations. In Testimony whereof we have set our hands this 17th day of May, at New York, 1792.[541]

Since commissions are the lifeblood of the brokerage business today even as in 1792, it is not surprising to find that the various exchanges treat the subject of commission rates with considerable formality. Thus, the main commission rate schedule and the basic rules governing it are set forth in the NYSE's constitution, the progenitor of the others. Article XV provides, in essence, that:

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[541] Eames, "The New York Stock Exchange," p. 14 (1894).

(a) Commissions must be charged on each transaction executed by members on behalf of others in securities admitted to dealings upon the Exchange;

(b) The commissions charged may not be less than the rates set forth in article XV of the constitution; i.e., the commissions set forth are mandatory minimum commission rates;

(c) The commissions charged "shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect"; and

(d) Nonmembers of the Exchange shall pay higher rates of commission than members.

The constitution then sets forth details of rates and regulations covering both member and nonmember transactions in each type of securities dealt in on the Exchange—stocks, rights, warrants, and bonds—all of which are divided into classes and subclasses. For purposes of simplicity, this part will be primarily concerned with the commission schedule applicable to round-lot transactions in regularly traded stocks selling at $1 and above.

The inclusion of the principal commission schedules in the body of the NYSE constitution means, as a practical matter, that the commission schedule can be changed only by amendment of the constitution. Article XIX of that document provides a detailed procedure for such amendment. In brief, this consists of approval by the board of governors and then submission to members. A majority of outstanding memberships must participate in the vote, and a majority of the ballots must favor a change before it can become effective.

(a) *Nonmember commission rates.*—Three basically different methods have been used to compute nonmember commission rates for stock transactions in the 170-year history of the Exchange. From 1792 to 1919 the base was a flat rate on par value; from 1919 to 1947 it was a sliding scale per share charge on share value; from 1947 to the present it has been a sliding scale on money involved per round lot. The present commission schedule for nonmembers on the NYSE is quite simple in form. It may be summarized as follows:

Money involved per round lot:	*Commission*
Under $100	As mutually agreed.
$100 to under $400	2 percent plus $3.
$400 to under $2,400	1 percent plus $7.
$2,400 to under $5,000	½ percent plus $19.
$5,000 and over	1/10 percent plus $39.

NOTE.—Minimum: $6, when amount involved is $100 or more; maximum: $75.

Several points, to be discussed in greater detail below, should be noted:

1. These are minimum rates and apply uniformly to all nonmembers of the NYSE. Coupled with the antirebate provisions of the constitution referred to above, they obviously preclude direct price or rate competition.

2. These rates cover the basic brokerage function and include ancillary services as well, but there is no specification as to the types or extent of such services to be included, nor is there any prohibition against making additional charges for such services. Thus, within limits, competition in respect of services is quite permissible.

3. Commission rates are computed on the amount of money involved in each round-lot transaction (100 shares). There is no discount for size or volume of transaction; the commission for a 1,000-share transaction is 10 times the amount for one of 100 shares.

4. The declining percent base of the round-lot rate decreases the rate, computed as a percent of round-lot dollar amount, as the dollar value of the round-lot increases.

5. The rate on odd lots (transactions of less than round-lot size) is $2.00 less than the round-lot commission.[542]

[542] See sec. 2.e, below, and pt. E of this chapter for a discussion of the odd-lot differential which, in effect, is an additional charge paid by odd-lot customers.

In certain of the above respects, however, as is also discussed below, the apparent rigidity of the schedule is considerably relaxed in actual practice.

(b) *Member commission rates.*—The member commission schedule differs from the nonmember schedule in two material respects: First, these rates are markedly lower than those set forth in the nonmember schedule. Second, members of the NYSE do not deal with one another on the basis of a single all-inclusive commission rate, but separate member or "internal" minimum commission rates are set forth for: (1) executing and clearing; (2) executing only, and (3) clearing only.

In order to execute a trade on the NYSE without the assistance of another member, a member firm must have a direct wire to a partner on the floor acting as a floor broker. In order to clear a trade executed on the Exchange without the assistance of another member firm, a member must have a "back office" operation within a reasonable distance of the Exchange to facilitate delivery and receipt of tickets and securities, although clearing by mail is now permitted under specified circumstances. Member firms without execution and clearance facilities must channel their Exchange orders through New York member firms possessing them. For this service the "customer" firm must pay the other member the "execution and clearance commission." This rate is prescribed by the Exchange on a per share basis (rather than on a money-involved basis) and varies, with reference to the nonmember rate, from a low of about 17 percent for a $150 stock to a high of about 36 percent for a $10 stock, depending on the price of the security involved.

The "execution and clearance commission" actually consists of two separate commissions. The first, the "execution commission" or "floor brokerage," is simply the commission paid to the specialist or floor broker who executes the order. Based on a charge per share as set forth in the constitution, it varies from about 8 to 21 percent of the nonmember commission in accordance with the price of the security involved. For most transactions, floor brokerage constitutes exactly 50 percent of the prescribed minimum execution and clearance commission. The remaining half, i.e., the "clearance commission," is derived by simply subtracting floor brokerage from the execution and clearance commission.

These member rates apply to member agency transactions, i.e., transactions effected on behalf of customers. When the transaction involved is for the member's own account, procedures and commissions are the same as described above with the exceptions that (1) the clearing commission, graduated on the basis of the price of the security, is substantially lower than on agency transactions and (2) the basic rate applies if purchase and sale of the security are effected on the same day—otherwise a rate 50 percent higher applies. When adjustment is made for this time factor, the member clearing commission ranges from about 4 to 12 percent of the total nonmember commission.

These commissions are set forth in table VI–x, where each is expressed both in dollar terms and as a percentage of the nonmember commission.

TABLE VI-x.—*New York Stock Exchange commission charges to members and nonmembers (per 100 shares)*

Price of stock	Nonmember commission	Execution and clearance commission		Floor brokerage		Clearing commission on agency transactions [1]		Clearing charges on member principal transactions [2]	
		Amount	As percent of nonmember commission	Amount	As percent of nonmember commission	Amount	As percent of nonmember commission	Amount	As percent of nonmember commission
$1.00	$6.00	$2.00	33.3	$1.25	20.8	$0.75	12.5	$0.56	9.3
$2.00	7.00	2.25	32.1	1.40	20.0	.85	12.1	.56	8.0
$5.00	12.00	3.50	29.2	2.10	17.5	1.40	11.7	.75	6.3
$10.00	17.00	6.20	36.5	3.10	18.2	3.10	18.2	2.06	12.1
$20.00	27.00	7.30	27.0	3.65	13.5	3.65	13.5	2.06	7.6
$40.00	39.00	7.70	19.7	3.85	9.9	3.85	9.9	2.06	5.3
$50.00	44.00	7.70	17.5	3.85	8.8	3.85	8.8	2.25	5.1
$100.00	49.00	8.70	17.8	4.35	8.9	4.35	8.9	2.25	4.6
$150.00	54.00	9.00	16.7	4.50	8.3	4.50	8.3	2.25	4.2
$200.00	59.00	10.00	16.9	5.00	8.5	5.00	8.5	2.25	3.8

1 Execution and clearance commission minus floor brokerage.
2 Reflects charges for purchases and sales not on same day.

Source: New York Stock Exchange constitution, art. XV: sec. 2(a), nonmember commission; sec. 2(b), execution and clearance commission; sec. 2(c), floor brokerage; and sec. 4, clearing charges on member principal transactions.

(2) *The American and regional exchanges*

Until 1958, the nonmember commission rate schedule of the American Stock Exchange (Amex) was the same as the NYSE schedule for stocks over $10 in price but slightly less for lower priced stocks. Since 1958, the rates have been identical, and the rules governing commissions have also been similar in scope and effect. When the NYSE changed its nonmember rates in 1959, the Amex promptly followed suit.

The Amex "internal" or member rates are somewhat different, as can be seen in table VI–y, but only one variation is of particular note here: the Amex provides special rates for a separate class of members known as "associate members," established in 1921. Under a revision of the schedule adopted in 1963, an associate membership costs approximately 5 percent of a regular membership (or, recently, approximately $2,500), plus annual fees which are the same as for regular members. It saves its holder about 70 percent of the commissions paid by nonmembers if he clears transactions, and about 60 percent if he does not clear. This type of membership can be utilized only by dealers actively engaged in the business of buying and selling securities. It is discussed further in section 2.a(4).

TABLE VI–y.—*Comparison of NYSE and Amex commission rates on stocks selling at $1 and above (per 100 shares)*

NEW YORK STOCK EXCHANGE

Nonmember rates	Floor brokerage		Member clearance (agency transactions)	
	Stock price	Amount	Stock price	Amount
2 percent on 1st $400 plus 1 percent on next $2,000 plus ½ percent on next $2,600 plus 1/10 percent on all over $5,000 plus $3.00: Minimum $6.00; maximum $75.00.	$1 to under $2	$1.25	$1 to under $2	$0.75
	$2 to under $5	1.40	$2 to under $5	.85
	$5 to under $10	2.10	$5 to under $10	1.40
	$10 to under $20	3.10	$10 to under $20	3.10
	$20 to under $40	3.65	$20 to under $40	3.65
	$40 to under $100	3.85	$40 to under $100	3.85
	$100 to under $150	4.35	$100 to under $150	4.35
	$150 to under $200	4.50	$150 to under $200	4.50
	$200 and over	5.00	$200 and over	5.00

AMERICAN STOCK EXCHANGE

Nonmember rates	Floor brokerage				Member clearance (agency transactions)		
	Stock price	Regular member	Associate member	Speculator	Stock price	Regular member	Associate member
Same as NYSE	$1 to under $2	$1.75	$2.40	$0.70	$1 to under $2	$2.75	$3.45
	$2 to under $5	2.05	2.80	.80	$2 to under $5	3.20	4.00
	$5 to under $10	3.30	4.85	1.35	$5 to under $10	4.90	6.30
	$10 to under $20	4.00	6.35	1.70	$10 to under $20	6.05	8.20
	$20 to under $40	5.10	8.05	2.00	$20 to under $40	7.75	10.75
	$40 to under $100	5.65	8.90	2.20	$40 to under $100	8.60	11.80
	$100 and over	6.50	21.35	2.60	$100 and over	9.75	24.85

The nonmember commission rates on the six largest regional stock exchanges registered with the Commission are identical to those of the NYSE, with the single important exception that three of these exchanges grant discounts to certain classes of nonmembers.[543] On the

[543] Broker-dealers qualifying for a special rate as compared with the general public would be "members" under the definition in sec. 3(a)(3) of the Exchange Act. The exchange thus assumes some responsibility for regulating their conduct, but not necessarily of the same kind or degree as in the case of regular members or member firms.

Pacific Coast Stock Exchange this discount may be extended, if approved in each case by the Exchange, to "members of a national securities exchange, or a national securities association * * * or (those) engaged in the banking business in the United States * * *." The Detroit Stock Exchange discount is available to all "members of the National Association of Securities Dealers, Inc., and/or members of another exchange outside of Michigan where the rules of such other exchange provide for reciprocal arrangements * * *." On the Cincinnati Stock Exchange, the discount is limited to (1) members of other exchanges which permit a reciprocal division of commissions and (2) members of the NASD who lack Cincinnati representation and who charge the Cincinnati nonmember rates.

As has the Amex, the regional exchanges have followed the lead of the NYSE in setting their nonmember commission schedules. As chapter VIII.E makes clear, the great bulk of the trading volume of the regional exchanges consists of stocks traded on both the NYSE and the regional exchanges ("dual trading") and is transacted largely by members of the regional exchanges who are also members of the primary exchanges ("dual members"). These conditions constitute fairly irresistible reasons, apart from others, for the regional exchanges' having almost automatically adopted the same nonmember commission schedules as the NYSE. Because of this fact, little separate attention is given here to the commission rate schedules of the regional exchanges.

c. The statutory and business background for commission rate regulation

Section 19(b) of the Exchange Act vests in the Commission certain authority and corresponding responsibility with respect to commission rates. The pertinent language is:

> The Commission is * * * authorized if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealings in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as * * * (9) the fixing of reasonable rates of commission, interest, listings, and other charges * * * and (13) similar matters.

For the purposes of setting the backdrop for the discussion which follows, attention is particularly directed to the following:

(1) The sole statutory standard for commission rates is that they be "reasonable," a term defined only through the criterion of "protection of investors or to insure fair dealings in securities traded in upon such exchange or to insure fair administration of such exchange." The legislative history affords no additional clues. The original drafts of the bills referred to "uniform" rates of commission, but the language was changed to the present wording, without formal explanation, shortly before enactment of the statute.[544]

(2) The Commission's power in respect of commission rates is to be exercised in the same manner as in the case of certain other exchange rules. After an exchange promulgates a rule concerning commission rates, the Commission is empowered, after formal request for

[544] See "Hearings on Stock Exchange Practices Before the Senate Committee on Banking and Currency," 73d Cong., 2d sess., p. 7705 (1934).

a change and, if necessary, public hearing, to compel amendment or adoption of a different rule. The Commission has no authority to suspend a rule prior to completion of an administrative proceeding, nor does it have power to compel retroactive adjustments. Again, the legislative history does not reveal any special concern with the treatment of rules relating to commission rates as distinguished from other exchange rules.[545]

(3) The nature of the securities commission business differs sharply from that of the typical public utility commonly associated with fixing and regulation of rates. Thus no single firm has a franchise conferring upon it special monopoly rights—commission rates are set uniformly for all member firms. Moreover, no substantial capital investment in fixed plant equipment is normally required, and volume characteristics of the securities business are markedly different from those of the typical public utility.

(4) Finally, the commission rate is designed to provide compensation not only for a service performed in all cases—execution and clearance of agency transactions—but also for such ancillary services of various kinds as are performed by the different member firms competing with one another.

These points are further elaborated below.

2. STRUCTURAL ASPECTS OF THE PUBLIC RATE SCHEDULE

This section singles out certain aspects of the structure of the public or nonmember commission rate schedule because of their distinctive repercussions not only upon public customers but also on professionals in the securities business who are not members of the NYSE, on the regional exchanges and their members, and on both mutual funds and their shareholders. The next section examines structural aspects of the members' rate schedules. While these structural aspects involve issues of basic importance, many of which have been the subject of numerous studies and differences of view within the Exchange community, they have only in limited respects received the formal attention of the Commission.

a. Nonmember professionals pay the same rate as other customers

Under the public commission schedule of the NYSE, a nonmember broker must pay a member the same commission that his customer would pay if he were to place the order directly with a member. Yet the nonmember incurs, in addition to the commission cost, overhead and other expenses incident to securing and transacting the business. Since competition normally prevents the nonmember from charging his customer any more than the rate charged by a member, his gross income from the transaction generally equals the commission he pays to the member, notwithstanding his other costs. Yet unless he accepts such NYSE business placed with him by his customer, he runs the danger of losing both customer and business altogether.

Such business is important to the NYSE. Its studies conducted between 1952 and 1960 show orders from nonmember brokers to the NYSE for public individuals, institutions, and others accounting for 11 to 24.3 percent of total share volume effected for the account of

[545] A provision of the original bill (sec. 18(c) of S. 2693, 73d Cong., 2d sess.) empowered the Commission to fix rates directly, just as it was authorized to deal directly in most of the other areas now covered by sec. 19(b). When the present machinery of sec. 19(b) was substituted, no attention appears to have been given, at least on the record, to its impact on the review of commission rates.

institutions and intermediaries, which during this period represented about 20 percent of the Exchange's total volume.[546] Such transactions at full commission rates are obviously profitable to the NYSE member, and there is incentive for him to make it attractive for the nonmember professional to forward it to him. But the constitution of the Exchange provides that commissions paid to the member shall be—

> * * * net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect.[547]

Member and nonmember must then devise some other means of both reimbursing the nonmember and attracting the business to the member. Attempts to bypass this NYSE antirebate provision have been the single most important cause of the development of what are generally referred to as "reciprocal business arrangements" and "special" services among member and nonmember firms.

(1) *Reciprocal business arrangements*

The member desiring to reciprocate for commission business given him by a nonmember professional can do so by returning commission business to the nonmember. There are several methods, only the most important of which can be mentioned here: he may place business on a regional exchange with a nonmember who is a member of that exchange even though (a) the member is also a member of the regional exchange (dual member) and could have placed the business there directly or (b) the security is traded on the NYSE as well as the regional exchange (dual listing) so that the dual member could have effected the transaction directly on the NYSE. He may place orders for unlisted securities with the nonmember to be transacted over the counter, even though the member firm may have a trading department capable of effecting the transaction directly. This reciprocal commission business is generally placed under arrangements involving "reciprocal ratios" of 2 to 1, 3 to 1 or similar ratios; that is, the NYSE member will direct $1 in commissions to the nonmember for each $1.50, $2, or $3 of commissions received.[548] The ratio always favors the NYSE member.[549]

A variation of the basic type of reciprocal commission arrangement is cited in the testimony taken by the Special Study of a partner in a member firm of both the NYSE and the Philadelphia-Baltimore-Washington Exchange and himself an active specialist on the latter exchange. Many of the firms which are members of the regional exchange but not of the NYSE give this firm orders to execute on the NYSE. When asked what his firm gives, by way of reciprocity, to such regional members, the partner answered:

> A. We eventually will give that man clearance[550] to the extent, we will say, of roughly 50 percent. It would not be in excess of that. That will net him about 40 percent, after he pays floor brokerage and clearance charges.
>
> Q. What kind of clearance business will you give him? Where will it come from?
>
> A. If Laird, Bissell & Meeds [an NYSE member firm] will sell us 500 General Motors, instead of giving up our name on the transaction we will give up the name of a local member to whom we wish to give clearance business.

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[546] NYSE, "Ninth Public Transaction Study," p. 11 (1959); "Tenth Public Transaction Study, Pt. II," p. 10 (1960).

[547] NYSE constitution, art. XV, sec. 1.

[548] See pt. E of ch. VIII.

[549] Apparently as a result of reciprocal arrangements of all kinds, one nonmember firm advised the study that despite the antirebate provisions of the NYSE constitution the firm ultimately receives in return the equivalent of approximately 40 percent of the commission on NYSE business forwarded to member firms.

[550] The term "clearance" here seemingly refers to both execution and clearance of a transaction.

If a bank, for instance, gave us 500 Pennsylvania Railroad to sell, we would give up the name of some local broker on that transaction. He would act as clearance agent on that. Therefore, it would come both from firm trading and from customer business.

Q. What is the ratio here?

A. I do not know, possibly 60 to 40; 60 percent firm and 40 percent customer, in our case. In other cases it might all be the customers.

Upon first impression, one might regard a practice such as this as typical of reciprocity in many industries in which a firm reciprocates for orders from a customer by placing business with him for goods or services it cannot provide itself. Thus, securities commission firms commonly receive brokerage business on a reciprocal basis from commercial banks in which they maintain sizable accounts.[551] There is a fundamental difference in reciprocal commission arrangements between brokers, however, because the NYSE member is generally able to handle directly, and at least as effectively, the business he places with his reciprocal partner.

The extent of these reciprocal commission arrangements is revealed in the returns to the Special Study's questionnaire EX-4. Of 447 members of the four largest regional exchanges not members of the NYSE (i.e., "sole members"), 298 reported participation in such arrangements in ratios ranging up to 3 to 1, but with 2 to 1 most popular. Of the 285 members reporting on the income received from such arrangements, 41 attributed to them at least 40 percent of their income, and 175, or 61 percent, attributed a minimum of 20 percent of their income to this source. (Tables VI-z to VI-bb.)

TABLE VI-z.—*Number of sole regional exchange members having reciprocal arrangements*

Exchange	All members	Members with reciprocal arrangements	Members with no reciprocal arrangements
Total	447	298	149
Boston	29	6	23
Midwest	233	149	84
Pacific Coast	78	59	19
Philadelphia-Baltimore	107	84	23

TABLE VI-aa.—*Nature of reciprocal arrangements of sole regional exchange members*

[Number of members]

Reciprocity ratio (regional members to NYSE members)	Exchange				
	All members	BSE	MSE	PCSE	PBSE
Total	[1] 280	5	137	57	81
1 to 1	7		3	2	2
1½ to 1	2				2
2 to 1	203	3	85	50	65
2½ to 1	36	2	28	2	4
3 to 1	32		21	3	8

[1] Excludes 18 members who have reciprocal arrangements but did not furnish complete information

[551] See ch. VIII.C.4.c.

TABLE VI-bb.—*Proportion of total exchange income received from reciprocal business by sole regional exchange members*

[Number of members]

Ratio of income from reciprocal business to total exchange income (percent)	Exchange				
	All members	BSE	MSE	PCSE	PBSE
Total	[1] 285	6	139	59	81
0.1 to 10.0	52	2	19	18	13
10.1 to 20.0	58	1	28	13	16
20.1 to 30.0	88	1	45	14	28
30.1 to 40.0	46		26	11	9
40.1 to 50.0	18	1	12		5
50.1 to 60.0	14		5	2	7
60.1 to 70.0	5		2		3
70.1 to 80.0	2	1	1		
80.1 to 90.0					
90.1 to 100.0	2		1	1	

[1] Excludes 13 members who engage in reciprocal business but did not furnish complete information.

Return by an NYSE member of cash to his reciprocal correspondent for commission business would violate the antirebate rule cited above, but the return of a cash equivalent in the form of profitable security commission business which might have been transacted directly by the NYSE member is permissible. The distinction is obviously a fine one and it has produced a fertile field for administrative interpretation. The Exchange's published constitution and rules have never officially recognized a need to regulate reciprocal commission arrangements. Its rule 369 outlaws 10 specific commission practices either outright or under specified conditions, but does not mention reciprocal arrangements with nonmember professionals. An NYSE interstaff memorandum illustrates that the problem is present and is a perplexing and demand one:

> In general, the Exchange does not object as a matter of policy to the existence of reciprocal arrangements, per se, even when they are based upon a ratio, such as 2 for 1, 1 for 3, etc., provided any business directed to the nonmember is bona fide business, and does not involve so-called "generated" business or "allocated" trades, and further provided any ratio is not guaranteed and no deficiency in the amount of business given by the member to the nonmember is paid or made up in cash. If a member firm has a well-organized and well-staffed department for handling, as an example, over-the-counter business, the Exchange probably would object to that firm's directing all of its over-the-counter business to a nonmember under a reciprocal arrangement.

Testimony to the Special Study by NYSE staff officials Frank Coyle and Walter Coleman served to point up the problems of interpretation. Coyle and Coleman confirmed that the first sentence in the quoted paragraph still represents the policy of the Exchange. They noted that an "allocated" trade "would be a transaction which is a bona fide trade but, as an example, might have been executed by me as a broker and I would give bookkeeping credit to someone else for having executed when in fact they would not." An example of "generated business" was given by Coleman as "* * * a transaction which I originate as principal, not as customer. I might as a broker give you an order for which I had no particular need." Coyle defined the term as "an order created solely for the purpose of paying you a commission for executing it in a stable security where the risk is not high and where I would reverse the transaction again giving you another commission." The witnesses were asked "* * * does it matter if the ratio is a firm one or not?" and the testimony proceeded as follows:

A. [By Coyle] To my way of thinking it makes no difference at all what the ratio is. If the reciprocity is merely on a business basis that I give you business because I think you can execute it, and I hope you give me business for the same reason, and we will try to keep even with each other, and so long as I have sufficient on your exchange to match what you give me on my exchange, and the rates I pay for that are proper, I see no objection to it whatever.

Q. The paragraph goes on to say that if a member firm has a well-organized and well-staffed department for handling, say for example, over-the-counter business, the Exchange probably would object to that firm directing all of its over-the-counter business to a nonmember under a reciprocal arrangement. Is that the present policy of the Exchange?

A. Well, I have got to add a little explanation with it, yes, with this explanation. By agreeing to give all your business in over-the-counter securities to one broker, you may not be servicing your customers properly because he may not properly cover the waterfront. An unlisted market is not the same as a listed market where there is a central point and policies, and records of the transaction. We think it is the duty of the broker to do the best for his customer and by promising to give all the business to one person willy-nilly might violate that.

* * * * * * *

Q. The policy refers to a "well-organized and well-staffed department." How many member firms of your Exchange meet this test, percentagewise?

A. Again you are reading from a memorandum, an interstaff memorandum, which was not written with the idea that it was going to be a legal matter for all time and it is one member of the staff telling another member of the staff in general terms broad policy. I think I would have to get a definition from you as to what you mean by a well-organized and completely staffed department to answer your question as to how many firms have them.

The complexity of the problem becomes apparent. Reciprocity arrangements representing "generated" or "allocated" business violate the antirebate rule; reciprocal business based on the member's "hope" that he can secure return business is legitimate. The arrangements referred to above actually fall somewhere between the extremes. The member normally directs business to his reciprocal correspondent with something more than "hope" that his correspondent will reciprocate. Members' reports of such agreements filed with the Midwest Exchange under its commission rules indicate the firmness of the understanding on which they are founded. This general recognition of the existence of reciprocal ratios elevates the basis of these arrangements from the level of "hope" to that of reasonable expectation based on informal agreement, often crystallized by years of business relationship and always subject to the sanction of cancellation if the correspondent fails to maintain the agreed ratio.

The NYSE's task of policing the antirebate rule in this field extends beyond its own floor. Because its members often discharge their reciprocal obligations by placing business with reciprocal correspondents for transaction on the regional exchanges, the question is presented concerning the Exchange's power to prohibit a member from engaging in a practice permissible under the rules of a regional exchange but constituting a rebate under its own rules.

A prime example of this conflict is the problem discussed at a Toronto meeting of top officers of the NYSE and the presidents of some of the regional exchanges in October 1952. At issue was the question of the amount of the commission to be paid by a dual member to a regional-only member on reciprocal business. At that time most of the regional exchanges either provided that the member "execution and clearance" commissions might be "mutually agreed" between members of the particular exchange, or else prescribed minimum rates of 25 percent of the nonmember rates. Dual members, however, were voluntarily paying more than 25 percent for the execution and clearance of business which they directed to regional members in return for NYSE orders received from such members. In many cases they paid the full nonmember rate.

Although such practices were permissible under the rules of the regional exchanges, the NYSE opposed them, arguing that, as a member of the regional exchange, the NYSE dual member was entitled to execution and clearance at the regional member rate of 25 percent, and any payment in excess of that figure constituted a rebate of commissions received on NYSE business placed with him by the regional member. The regional exchanges initially emphasized their exclusive jurisdiction in setting their own internal rates. The Toronto meeting resulted in a compromise arrangement under which most of the regional exchanges either increased their minimum execution and clearance commission to 50 percent of the nonmember rate, or continued to allow each member to set his own execution and clearance rate, with an understanding in both cases that no dual member would be charged more than 50 percent of the nonmember rate if he did any NYSE business with the regional member. This compromise was described in an NYSE memorandum as " * * * an informal but nonetheless binding commitment to us * * * " that the regional exchanges would not permit dual members engaged in reciprocal business with regional members to pay "anything in excess of 50 percent of the full nonmember rate."

At first the Boston (BSE), Pittsburgh, and Cincinnati exchanges refused to accept this arrangement, but by 1954 only Boston remained as a holdout. The BSE's position caused the NYSE considerable embarrassment, as interoffice memorandums and correspondence reveal. The matter was apparently formally closed in May 1962, when Boston apparently finally accepted the 50-percent arrangement.

Coyle was asked to explain the basis for the acceptance of the 50-percent rate as a dividing line between permissible commissions and rebates.

Q. Did your department inquire into whether the 50 percent represented a reasonable compensation for [execution and clearance]?

A. Yes.

Q. What was the conclusion?

A. The conclusion was that we were leaning over a little bit to accept that as the reasonable cost of doing such business.

Q. Well, was this 50 percent a negotiated figure between your Exchange and regional exchanges?

A. I don't know.

Q. Well, under what circumstances did you make such a study or give consideration as to whether 50 percent was a reasonable arrangement?

A. Well we related it to the known arrangements on our own Exchange where out-of-town member firms, correspondents of New York firms, had such work done for them and a great deal more, including the transportation of business from out-of-town to New York on a costly private wire, and that they were doing that for, as I said, from 27 to 40 percent.

Q. But here the local member on the regional Exchange is receiving 50 percent without providing any of the services which were in fact being borne by the New York member?

A. That's right.

Q. So that the 50 percent then would represent more of a difference between 40 and 50 percent than would appear on the surface?

A. That's right.

* * * * * * *

Q. Was it your judgment that this did or did not involve a rebate, this 50-percent figure?

A. I wouldn't say it involved a rebate. I think it showed the development of a loophole by which the donors of New York Stock Exchange business could find an avenue of return income within and with the help of rules of other exchanges of which they were members.

Q. Was it your judgment that they have successfully found such a loophole?

A. I don't think I have an opinion.

Q. Well, you do agree that the 50-percent figure [when considered], with the other services [provided by the dual member for the nonmember firm], is far in excess of the [execution and clearance] figures that prevail on your own floor.

A. Obviously.

The drive to circumvent the strict terms of the NYSE nonmember commission rate schedule may be illustrated by another practice known as a reverse transaction. In this situation the NYSE member seeks to reward the nonmember for business received not by returning commission business but by effecting the nonmember's transaction at a cost less than the commission rate. One form of this practice is set forth in an Exchange memorandum outlining a so-called arbitrage operation which involved the NYSE and the Midwest Stock Exchange.

Mr. Thomas Kohler, a specialist on the Midwest Stock Exchange, who also acts as floor broker for Scherck, Richter & Co., sits right next to the teletype machine of [the NYSE member firm of] Vilas & Hickey on the Midwest floor. Other specialists who want to buy stock on the NYSE to offset their specialists positions go to Mr. Kohler if he is available, and merely say "buy 100 Steel" or something comparable, and it is tacitly understood that Mr. Kohler will give that order to the Vilas & Hickey telephone operator, who transmits it to New York. Vilas & Hickey buys for its own account on the NYSE 100 shares of Steel, or whatever the order calls for, and wires back, via the teletype wire to the Midwest floor, instruction to sell the same stock to the Midwest specialist who placed the original buy order. In the case of low or medium priced stocks, this is done at an automatic markup of ⅛ point over the actual cost on the NYSE. In the case of some high-priced stocks, the markup is ¼ point.

In a few cases, when the Midwest specialist introduces his buy order through Kohler, or in Kohler's absence, directly with the teletype operator of Vilas & Hickey, a price is specified. In most cases, however, no price is specified and it is tacitly understood that Vilas & Hickey will buy for its own account at the market in New York and sell on the Midwest at a markup of ⅛ or ¼ point.

It is very fast wire, and according to Mr. Hosty there is a steady stream of orders going over the wire all day long. Further, according to Mr. Hosty, practically everyone on the Midwest Exchange knows that the purpose of the arrangement is not to conduct an arbitrage, but, rather, to enable specialists and floor traders or floor brokers on the Midwest Exchange to get New York executions for less than the nonmember commission.

The NYSE required the member firms involved to discontinue the practice and subsequently denied a request by the Midwest Stock Exchange to allow the practice. Its occurrence demonstrates, however, the motivations created by a commission schedule which treats essential business transactions of nonmember professionals in the security commission business the same as ordinary transactions of the public generally.

(2) *Special services arrangements*

Subject to the vaguely adumbrated exceptions discussed above, the NYSE member may thus reward a nonmember professional for securities business by reciprocating commission business on an agreed ratio without violating the antirebate rule. He may also accomplish the same objective, within certain limitations, by furnishing his correspondent with special services: installation and maintenance of wire services,[552] clearance of non-Exchange transactions,[553] office space,[554] special research, and promotional materials and displays.[555]

Once more the interpretation is a delicate one. Section 2.c, below, describes how the nonmember commission rate covers many services incident to the brokerage business in addition to the execution and clearance of a transaction. Most of these services for public customers are generally not required by a professional in the securities business. But because the nonmember professional receives no discount under the existing nonmember schedule, the NYSE member can correct this apparent inequity and, at the same time, tangibly acknowledge his appreciation for securities business directed to him by furnishing the nonmember with special services he does need.

Consistent application of the antirebate rule would seem to require an interpretation prohibiting special services costing more than services rendered to other customers generally. Once again the distinction poses some fine administrative questions. They may be illustrated by the practice of maintaining private wires between the offices of a member and nonmember in order to service the nonmember's business transacted with the member. The practice is generally permissible, but where the nonmember also uses the wires for communication with his own branch offices or with another nonmember, the rules require him to contribute toward the cost "in proportion to his use thereof with a minimum of 10 percent." This refinement aside, a member may incur unlimited expense in maintaining such wires as long as they are used to service the nonmember's business with the member. It would, however, be a rare coincidence if the cost of such wires turned out to approximate the cost of value of normal services to investors generally included in the commission rate.

Another special service of NYSE members to nonmember professional customers is the clearance without charge of nonexchange transactions. Although the NYSE does not purport to prescribe commissions for such transactions, the Exchange has interpreted the "no rebate" provision to prevent members from reciprocating for security commission business on the NYSE by clearing regional exchange or over-the-counter transactions free of charge. The problem again proved vexing, however, when the Exchange's interpretation of the antirebate rule collided with a regional exchange's application of its own commission rules. An NYSE departmental memorandum of March 1954 noted that dual NYSE-Boston members with clearing facilities in Boston were clearing BSE transactions for BSE members free of charge in return for NYSE business received from such BSE members. It added that "Mr. Besse, president of the Boston Stock Exchange, has told us that this has been standard practice for the past 30 years." No action was taken on the matter until 1960, when Coyle, in a memorandum to NYSE President Funston, noted in part:

> In the Philadelphia, Chicago, and West Coast Exchanges our members make charges for handling any clearance business for specialists on those exchanges.

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[552] NYSE rule 359; NYSE Guide, par. No. 2359.10.
[553] NYSE Guide, par. No. 2381.18.
[554] NYSE rule 344; NYSE Guide, par. No. 2344.11.
[555] NYSE Guide, par. No. 2440A. See ch. XI.

The charges are not uniform in all the regional exchanges, but they are based on a per-share item charge. In Boston, however, for many years a few member firms have not charged anything at all for clearing transactions—primarily odd lots—for certain Boston specialists.

We propose to tell each of the member firms in Boston presently doing such clearance on a "love" [free] basis that the Exchange expects that some charge be made—a per-share charge that will at least cover out-of-pocket expenses. This is entirely consistent with our decisions over the years not to permit any firm to rebate commissions on listed business effectively by doing other business for nothing. Each of the member firms involved receive listed NYSE business on which full nonmember commissions are charged.

The Exchange then advised some of the firms involved in the practice that "* * * we believe that the free clearing of such transactions is contrary to the spirit of our 'commission law' " and that the Exchange "expects" member firms to charge a per-share rate "that will at least cover out-of-pocket expenses for handling such business." The Boston exchange complied with this request, but after discussion with the NYSE, it was agreed that the charge be fixed at 25 cents per item rather than on a per-share basis.

When asked whether his department made any study to determine whether the 25-cent-per-item charge was compensatory, Coyle stated simply, "No, we did not." This 25-cent rate applied to the clearance of each odd-lot order would appear to be far lower than the NYSE clearance charge on agency transactions of 75 cents to $5 per 100 shares, depending on the price of the stock.[556] The resolution of this rebate problem appears to have followed the same pattern as the 50-percent compromise discussed above: a nominal charge converted a prohibited rebate into a permissible arrangement.

(3) *Some consequences of the arrangements*

When the various reciprocal business arrangements and special services have been described, it may be proper to ask whether the inflexibility of the present schedule which gives rise to them constitutes a real problem after all. Do not these arrangements and services informally achieve salutary results? In answering this question, consideration must be given to collateral consequences in terms of difficulties of administration, possible conflicts of interest, distortion of costs, and impact on regional exchanges.

The administrative involvements alone might be considered a sufficient answer to the question.[557] A complex system of arrangements designed to circumvent the strict prohibitions of an antirebate provision would not seem to be a desirable answer to a pricing problem in any industry, even apart from the fact that the Commission is called upon to grant its blessing to such practices, at least tacitly, by approving the commission schedule which begets them.

The possible conflicts of interest arise from the fact that the member's desire to provide reciprocal business to the nonmember professional is likely to exert some influence upon the member to place orders with his reciprocal correspondent in order to fulfill his com-

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556 See table VI-x, p. 298, above.

557 As early as 1940, a special committee of the NYSE referred to reciprocal business and special service arrangements as a "highly controversial subject":

"No split of commissions with non-members is recommended at this time. But it is recommended that the highly controversial subject of reciprocal business, payment for facilities such as wires, office facilities and the like, all of which have a definite bearing upon commission splits between members, be studied later by a committee appointed as a subcommittee of the Committee on Member Firms."

No record of any such study could be found in the Commission's files.

mitments according to an agreed ratio, rather than transacting all his business in the best available market. Even the member who steadfastly resists this pressure would surely be less vulnerable to criticism or question in the absence of such possible conflicts of interest.

These arrangements also tend to complicate measurements and analysis of the costs of conducting a security commission business.[558] The NYSE Income and Expense Report for member firms provides for deduction from income of security commissions paid to others; yet this is an expense that, in the absence of a reciprocal arrangement, the member might often be able to reduce or eliminate by handling the transaction directly. The report also contemplates deduction of amounts paid for wire services, statistical and advisory services, and similar items, although these expenses cover services that may differ radically in scope from those normally performed for public customers.

A further consequence of these practices concerns the regional exchanges, which are discussed in chapter VIII.E. It has been seen that the regionals have served as an instrument for the transaction of reciprocal commission business. The arrangements have obviously created trading volume for the regionals but has made them dependent to that extent upon the maintenance by the NYSE of a unitary commission structure.

(4) *Possible courses*

A possible solution to these problems would be extension of some form of preferential treatment in the NYSE commission rate structure to nonmember professionals. This would presumably grant such nonmembers the equivalent of present rewards without the existing maze of reciprocal commission and special service arrangements.

As indicated in section 1, the Amex and three of the regional exchanges provide special treatment for the nonmember professional. As of March 1962 the Amex had 415 associates members—there is no limit on the number in this class [559]—compared with 499 regular members. They are subject to exchange discipline (although their partners are not),[560] but they do not vote on matters affecting the exchange and do not share in its liabilities.[561] Since all but 41 of the Amex's associates member firms also have full seats on the NYSE, this class of membership does not appear to have served primarily to provide access for professionals not able to afford a full seat. The Amex has recently amended its constitution to increase the number of its full memberships, apparently with the purpose of encouraging some of its associates to become full members, and at the same time making associate membership more attractive for others.[562]

In 1955, a Special Review Committee on Rules and Procedures of the NYSE investigated the status of the nonmember professional and reached the following conclusions:

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[558] The subject of measurement and analysis of cost is more broadly discussed in sec. 4, below.

[559] Amex Constitution, art. IV, sec. 1(c).

[560] The Amex has recently indicated that the subject of disciplinary controls over partners of associate members will be studied with a view to extending such controls to this group. See note 543, p. 299.

[561] Amex Constitution, art. IV, sec. 1(c); art. IV, sec. 4; art. XIII.

[562] As a result of these amendments to art. IV, sec. 1; art. VI, sec. 2; art. VII, sec. 1; and art. II, sec. 2, approximately 60 associate members elected to purchase regular memberships by the end of May 1963. All of these amendments will be wholly effective by the end of July 1963.

Existing provisions for membership in the Exchange are adequate to the needs of the security industry and the Exchange should not create associate memberships.

The committee arrived at these conclusions because it felt that the payment of any reasonable portion of the minimum commission to a nonmember would not represent an adequate inducement for the nonmember to exert effort to produce additional listed business; that any lowering of the standards or basic principles of present Exchange membership would detract from the value of the marketplace. In the opinion of the committee nonmembers who wish to participate in the Exchange business should join the Exchange membership either as partnerships or corporations and contribute directly to the marketplace.[563]

This position was endorsed by the Special Committee on Member Firms Costs and Revenues in 1958. The supplementary report of this committee stated:

The committee found no reason to recommend splitting commissions with nonmembers. Qualified individuals or firms willing to participate in Exchange commission business should join the membership, submit to Exchange regulations and contribute directly to the Exchange marketplace.

Although the first of the quoted reports was made public by the Exchange, it appears that the Commission's review of rate changes on various occasions, as discussed in section 4, did not involve consideration of this aspect of the rate structure. It is clear that the problem warrants further study with active Commission participation. The general objective would be to consider the feasibility and advisability of formulating a special rate or limited membership so that the return received by a nonmember broker-dealer for placing NYSE business would be broadly equivalent to his return under the present system of reciprocal business and special service arrangements. Depending on the details, a probable result of such a change might be a loss in volume of trading on the regional exchanges—an effect requiring candid appreciation and analysis. Thus, one of the questions meriting further study is whether and how the needed flexibility may be introduced into the NYSE commission structure without causing irreparable harm to the regional exchanges.

b. Rates are based solely on dollar value of round lot

A second major structural characteristic of the NYSE public commission schedule which has given rise to a host of special problems is the charging of the same commission rate, based on the value of the round lot, for each transaction regardless of size. The commission on an order for 5,000 shares is exactly 50 times that on an order for 100 shares.[564]

This aspect of the commission rate structure can be evaluated in terms of either the size of a particular order or the volume of a customer's transactions over a period of time. While the problem has been chiefly approached on the former basis as one of a "block discount," the same general considerations apply in either case. In either case the question comes down to whether a commission rate favoring the volume buyer or seller might be justified by savings to the member in brokerage, sales, back office, promotion, research, or other expenses.[565]

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[563] "Report of the Special Review Committee on Rules and Procedures of the New York Stock Exchange," p. 8 (November 1955).

[564] It may be noted in passing that the commission on a sale is the same as on a purchase. This is in contrast to the common (but not universal) practice in the over-the-counter markets, of charging a higher markup and paying a higher salesman's commission on customers' purchases than on customers' sales. See chs. III, p. 259 (pt. 1), and VII.D.3.

[565] See ch. VIII.C on institutional market participation and block transactions.

The questions here presented cannot always be sharply differentiated from those relating to the nonmember broker discussed above. The commission business underlying the reciprocal arrangements discussed above is often likely to be large-volume business and, for that reason, attractive to member brokers. In each case, too, the member realizes savings because the present nonmember commission rate covers payment not only for the basic brokerage function, which is common to all these transactions, but also for sales expense and ancillary services (discussed below in sec. 2.c) which often are of no utility to either the professional or the volume or block customer. But the member's ability to reciprocate for commission business on the Exchange by giving other commission business to a broker-dealer, and his inability to do so to a nonprofessional, have created different arrangements to effect the reciprocity objective. Although these arrangements overlap at points, the differences between them have warranted separate treatment of each.

It should also be noted that, while the portion of the following discussion concerned with special services applies to all large-volume or large-block customers, the portion devoted to "give-ups" relates almost entirely to a single category of such customers, viz, open-end investment companies or mutual funds. Chapter XI.C treats, from the perspective of mutual funds, a phenomenon treated here as a consequence of the public commission structure generally.

(1) *Special services and preferences*

The use of special services as a reward or inducement for the commission business of the block or volume investor is basically the same as that discussed in the preceding subsection for the nonmember professional. In each case the member reciprocates for profitable security commission business by furnishing special services, i.e., services varying in content, scope, and depth from those provided the average public customer. The different needs of each class of customer may dictate performance of different services, but there is no clear line of demarcation; many of these special services are useful to both professionals and nonprofessionals in the security commission business.

An excellent description of these services appears in a letter from a member firm to the Exchange objecting to a specific interpretation—described below—of the antirebate rule:

> * * * In our opinion, no one knows the full extent and the variety of special services currently furnished by member firms of our Exchange without payment other than the receipt of commission business. That they are indeed numerous and varied is not open to doubt. Merely to mention one well-known example: Member firms are permitted to confer on large customers (nonmember firms or institutional investors, such as banks or mutual funds) the special service of installing in the customer premises direct wires involving substantial extra monthly costs, but paid for entirely by the member firms out of the commission business thus received from the customer. To mention another example: the furnishing by member firms of extensive—and in some instances, elaborate—analytical and statistical services, involving expenditures by member firms of large sums recouped only through the receipt of commission business. Indeed some firms furnish, in exchange for commission business, elaborate special studies prepared by their "special industrial field staff," and captioned "This Report Is for Your Own Confidential Use and Is Not To Be Shown to Anyone Outside Your Organization." Such studies would entail engineering, accounting, and analytical fees of very substantial sums of money for the customer who employed directly the professional talent needed to prepare the desired study. Yet it is furnished by the member firm without charge as an auxiliary service in connection with the receipt of commission business.

Still other member firms offer a variety of other special and costly services to institutional investors such as mutual funds, in exchange for commission business. In this category are the management services having a value based on prevailing rates of approximately $250,000 per annum, which are furnished by our well-known member firm, * * *, to a mutual fund * * * solely in consideration of the receipt of the fund's commission business. A number of other member firms perform without any charge or "load" (which ordinarily range between 4 to 8 percent of dollar amount of sales) the services and responsibilities of serving as national distributor of certain funds in order to receive from these funds their brokerage business and management fees. * * *

Still other member firms perform for mutual funds as an auxiliary service, solely in consideration of receipt of commission business, the special and costly task of pricing their entire portfolios and computing asset values several times each day.

The foregoing are among the more easily identifiable of the services rendered by member firms for commission business. However, it is widely known in informed circles that there are many other types of extant arrangements. These include the tie-in arrangements between members firms and nonmember firms (over-the-counter dealers, members of other exchanges) based upon a reciprocation of commission business in agreed ratios. It is believed there are other, more subtle relationships and arrangements, which channel the flow of commission business to member firms and constitutes an identifiable quid pro quo for such business.

As implied in this letter, the Exchange finds these services unobjectionable although their obvious purpose is to reciprocate for commission business. The basis for its action are various exceptions from the general prohibition against rebates. For example, rule 369 enumerates under the heading of "Prohibited Arrangements, etc.," a number of the special services or preferences employed to reciprocate commission business which have been prohibited either outright or made the subject of limited exceptions: advance of money on "unusual" terms or for "special and unusual" rates of interest, assumption of stamp taxes, assumption of bank charges for handling securities, assumption of office expenses of nonmembers, furnishing of statistical and investment advisory services, assumption of a customer's loss on a transaction, arrangements to provide nonmembers with office space, payment of gratuities to employees of members or nonmembers, and the cost of transmitting orders for another member or nonmember.

The nature of the administrative problem, in its simplest form, is illustrated by the outright prohibition against arrangements whereby "special and unusual rates of interest are given or money advanced upon unusual terms for the purpose of obtaining or retaining business." Despite the rule, members have paid large-volume customers the proceeds of a sale of stock prior to the settlement date or have delayed past the settlement date the collection of sums due on the purchase of stock, thus giving such customers the benefit of interest on the funds involved. A review of NYSE auditors' reports for 2 months of 1961 revealed instances of this practice by a number of member firms in a number of cities. One such report stated:

[A member of the firm involved] stated that inasmuch as all other member firms in the Houston area are also making prepayments without charging interest, his corporation must do the same for competitive reasons. He also stated that, even though some of the members may be using New York funds, the distinction between local and New York funds is meaningless because the banks give the customers immediate credit, whether the check is drawn on New York or local banks, if the check is drawn by a well-known brokerage firm.

A report on another member firm, also of Houston, noted:

[A member of the firm] stated that approximately 4 or 5 months ago, all of the members of the New York Stock Exchange in the Houston area had a meeting relative to prepayments to determine if the practice of making prepayments could be discountinued entirely by all members. However, one member firm stated that they would not discontinue making prepayments and therefore [the firm being audited], as well as other members, felt that they could not discontinue prepayments entirely because of the unfair competition by this one firm.

The upshot of these reports appears to have been the adoption, on October 18, 1962, of an interpretation of the NYSE's rule governing books and records, under which a member firm is required to maintain at its main office "a report containing information regarding any prepayment to a customer of the proceeds of sales of listed securities" and its review by a principal of the firm.[566]

The prohibition against furnishing office space to nonmembers also appears to be simple to enforce. Rule 369 prohibits the assumption by any member of—

* * * any expense pertaining to the office of a nonmember except the cost of maintaining a private means of communication with the nonmember provided that such cost is not in contravention to the provisions of [the policy governing wire connections, discussed above]; [and] * * *.

An arrangement involving the furnishing of office space to members, member organizations, and nonmembers which is in contravention to the provisions of rule 344—and allied material—Office Space Arrangements.

Rule 344 of the Exchange provides that:

Each office of a member * * * shall be under the control of the member * * * establishing it; shall be used solely for said business and, except as permitted by the Exchange, shall not be occupied jointly with any other member or nonmember.

Together these rules constitute the NYSE's policy against underwriting by its members of the office expenses of nonmember customers. Interpretative difficulties arise because of the ambiguity of the term "office expenses," which is not defined, and the exceptions to the basic rule. By way of exception, for instance, the supplementary material under rule 344 provides that a member may provide free office space to a nonmember customer if the nonmember "* * * does not conduct a business with the public from such space." This exclusion allows the generally recognized practice of providing free desk or office space to customers with active accounts. The supplementary material also permits members to "* * * sublease space to nonmembers at rentals reasonably comparable to the going rate for like space," a standard sufficiently flexible to present nice questions of judgment, including judgments as to rental values.

The fine distinctions required in the application of these relatively simple prohibitions prepare the way for consideration of a troublesome and controversial one, the furnishing of "statistical and advisory" services by an Exchange member to a professional nonmember (who is defined for this purpose as a "broker-dealer in securities or commodities, insurance company, investment adviser, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity"). An NYSE interdepartmental memo sketches the background of the problem:

In the early 1930's many of our small firms found themselves at an acute disadvantage with larger member firms which can afford to hire high-priced statisticians, researchmen, and analysts, which were beyond the financial abilities of our smaller member organizations.

[566] NYSE Guide, par. No. 2440K.10.

Several of the small firms, in an effort to offset this competitive disadvantage, sought and obtained the acquiescence of the appropriate committees of the Exchange to purchase specific services, reports, and analytical studies from outside research, statistical, and analytical organizations and to make these reports, etc., available to their customers.

By the 1940's, staff became concerned about the extent and possible abuses of this practice. It conducted a survey and found many abuses by both small and large firms which sought to attract business by gratuitously offering to customers many services, among which were some which were completely unrelated either to the securities business or to the relationship between the firm and its customers.

At the recommendation of the staff, the advisory committee and the board of governors amended related rules and policies to preclude members buying at their own expense and furnishing to nonmembers any statistical material, etc.

The major expression of NYSE policy in this area appears in the supplementary material under rule 440, which states, in essence, that a member may furnish "statistical and investment advisory services" to a "professional nonmember," provided that the statistical and investment services are:

(A) Prepared by the member or member organization; or

(B) Prepared by others and reissued by the member or member organization in his or its own name with the consent of the original issuer or publisher, provided the reissuing member or member organization is not required to pay for such consent.

These services may be rendered either free of cost or on a fee basis, and if the latter, the "fee may be adjusted in accordance with commission business received from the * * * nonmember." This principle is more precisely stated in the supplementary materials as follows:

Different fees may be charged to different customers for the same or equivalent statistical service.

Exempt from all limitations imposed by these supplementary materials is—

* * * the occasional information supplied by a member or member organization to another member or member organization or to a nonmember customer, upon request, such as individual corporation analyses, specific excerpts from recognized standard statistical services, etc.

Operating under these rules with specific Exchange approval, several member firms developed an extensive business of supplying nonmember mutual fund dealers with promotional and selling aids in return for security commission business placed with them by the funds. But the growth of this practice apparently accentuated the need of drawing a line between permissible statistical and investment advisory services and prohibited rebates. The most valid objective basis for defining a rebate in such a situation would appear to be the relationship between the cost of the questioned service and the cost of services performed for other customers (in this instance the public as a whole). But since this standard has not been applied to other special services, the Exchange's solution was to limit permissible "statistical and investment advisory services" to those—

* * * intended to aid professional or nonprofessional clients of member firms in investment decisions concerning securities or commodities.[567]

This interpretation was adopted in 1962 during the course of the Special Study's investigation into the amount and type of materials

[567] NYSE Guide, par. No. 2440A.10.

being furnished by members to mutual fund dealers in return for security commission business.[568] It led to the letter of objection from a member firm which was the source of the quotation at the beginning of this subsection. Still another firm viewed the interpretation as discriminating against the smaller firms; it wrote the NYSE as follows:

> We do not suppose your staff means to suggest that the so-called statistical or advisory publications issued by member firms, or the advisory services offered, are not "promotional." We assume everyone recognizes that these services are intended to produce commission business for these firms, directly or indirectly. We wonder whether your staff really knows the amounts of money which some of the larger member firms expend each year in offering these special services? We think that when they discover the actual figures they will find them quite staggering in many instances. These member firms are thereby enabled to attract business away from smaller firms which cannot or do not dare undertake promotional expenditures on such a scale. Yet, your staff's recommendation does not propose to limit or curtail in the slightest degree such "promotional" expenditures, no matter how elaborate or expensive, so long as they are classified as "statistical or advisory."
>
> Smaller member firms such as ours are clearly at a severe disadvantage in competing for business against these huge promotional expenditures of large firms ladled out freely as "statistical and advisory publications and services." Since we cannot match these large financial outlays we endeavor to cope with this competition by offering services for which we have particular qualifications—services which involve the expenditure of our specialized knowledge and talent, as contrasted with the expenditures of large amounts of cash. If we correctly understand your staff's proposal, we are now to be deprived of our ability to compete fairly for business by rendering to our customers services utilizing our particular knowledge and skill. At the same time, those large firms willing and able to invest unlimited cash expenditures for promotional services under the "statistical and advisory" labels are to be left with a broad and open road. We believe the staff's proposal discriminates most unfairly against the smaller firms supplying services based on specialized knowledge and talent, and in favor of the large firms which are free to spend unlimited amounts of moneys in elaborate promotional services labeled "statistical and advisory."

This internal dispute in the NYSE underscores both the pressure to perform special services in order to attract security commission business and the uncertain workings of the no-rebate principle.

(2) *The give-up or directed split*

The practices resulting from the structural characteristics of the NYSE public rate schedule have, up to this point, shared one quality in common: in each case a customer placing commission business with an NYSE member has paid the entire commission to the member, who has retained it in its entirety, and the customer has then received reciprocity in the form of other commission business or special services. The practices described did not involve a split of commissions.

The NYSE commission rules (and those of other exchanges) do permit, however, a split of the commission dollar among members under certain circumstances, with the result that the foundation of a network of arrangements more complex than the reciprocal commission arrangements discussed above has been laid. Give-ups are all derived from the customer's ability to direct the member executing a transaction (hereinafter referred to as the primary broker) to "give up" a part (excluding floor brokerage and clearance, which must be retained by the firm which actually performs the services) of the customer's

[568] See ch. XI.C.2.a(2).

commission payment, in cash, to another member (but only to another member).[569] The amount so paid out may range as high as 60 percent of the nonmember commission. This form of give-up, which is referred to here as the "reciprocal" give-up to distinguish it from other forms of give-ups, appears to be utilized largely by mutual funds, and is further discussed in chapter XI.C.

The simplest form of reciprocal give-up is a transaction in which a mutual fund placing an order with an NYSE member directs him as the primary broker to give up a specified percent of his commission to another member of the Exchange. The basis for the direction is generally the mutual fund's desire to reciprocate for services performed by the beneficiary, such as the sale of mutual fund shares and such special services as the provision of research, statistics, wire facilities, and quotations.

A variation of the reciprocal give-up arrangement occurs when the mutual fund directs the member serving as primary broker, A, to give up to another member, B, who renders services for a nonmember, C, the beneficiary of the give-up. The distinction between cash and services is significant because the Exchange permits a member to give up cash only to another member but permits a member to render services to nonmembers.[570] The primary broker serves as a conduit between the customer (the mutual fund) and various members performing services to nonmembers, permitting greater flexibility in apportioning give-up benefits.

The reciprocal give-up also utilizes the regional exchanges as channels for the distribution of cash to beneficiaries who are disabled from receiving it under the NYSE rules. In the typical case, the fund places portfolio business with a dual member; i.e., a member of both the NYSE and the regional exchange, who transacts it on the regional exchange and gives up a portion of the commission to a regional-only member or, in the case of the three exchanges affording special treatment to specified groups of nonmembers, even to nonmembers. Multiple trading of stocks listed on the NYSE (discussed in chapter VIII.E) thus combines with multiple membership on the exchanges to permit the distribution of cash, through the device of the reciprocal give-up, to broker-dealers selling mutual funds throughout the country.[571]

As pointed out in chapter XI, the reciprocal give-up is part of an arrangement understood by the mutual fund and the beneficiary although not reduced to writing. In this respect it closely resembles the reciprocal commission arrangements described in the preceding subsection. This practice also brings sharply into question the validity of the distinction between a permissible split in commission with a direction to pay over a substantial portion to satisfy the customer's purposes, and an impermissible rebate in which a portion of the commission is returned directly to the customer.

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[569] The customer's ability to direct a split of commission among members may be contrasted with the inability of the customer directly to obtain a discount or rebate on his own behalf. Thus, the customer may direct an exchange member to make a cash payment to a second member which reduces the first member's commission income while compensating the second member for reasons which may not be connected to exchange business. This would seem to undercut one of the principles underlying a nonrebate policy.

[570] It is these services which were somewhat curtailed by the Exchange ruling in 1962 on statistical and advisory materials discussed on pp. 314–316, above.

[571] The over-the-counter equivalent of the reciprocal give-up is described in ch. XI.C.

(3) *Some consequences of the practices*

The reciprocal give-up and the special services for volume and block customers both stem from the fact that the NYSE commission rate structure does not formally recognize such customers as deserving treatment different from the average round-lot customer. What the rate schedule fails to do, the industry accomplishes informally, unevenly, and largely covertly,[572] by means of these arrangements. The consequences parallel those resulting from the failure of the schedule to recognize nonmember professionals as a separate class. Three consequences are quite similar: the troublesome problem of administration in the case of special services; the distortion of cost data; and the channeling of business to the regional exchanges.

The reciprocal give-up aggravates the problem of compiling cost data for rate-setting or review purposes. Where one NYSE member gives up to another such member who renders services for the customer, the give-up represents a deduction from income to one and an increase in income to the other. The give-up affects the profitability of each firm, and raises questions as to the reasonableness of any deduction by the reciprocal beneficiary for services performed for the fund which are not directly attributable to the security commission business. Where the regional exchanges or the over-the-counter markets are used to accomplish a split in commissions with nonmembers of the NYSE, there is a deduction from income for the NYSE member without an equivalent increase in income to any other NYSE member.[573] It thus has the tendency, for the membership as a whole, or reducing income and profit figures pertainent to the determination of reasonable rates.

The reciprocal give-up also produces a conflict of interest, but one unlike that mentioned in connection with brokers' reciprocity ratios. Here the conflict exists between the interest of fund shareholders in lower commission charges and the interest of mutual fund advisers and underwriters in stimulating the sale of additional shares through directing a split in commission charges. A discussion of these effects is found in chapter XI.C.

Finally, the commission rate schedule's lack of recognition of block or volume transactions produces another effect of a different kind from those described above or in the previous subsection. It is generally considered to be responsible in significant degree for the diversion in recent years of trading in NYSE stocks to the over-the-counter market in listed securities, a development which is discussed in chapter VIII.D. The expansion of this market tends to indicate that the informal arrangements by individual member firms to attract block and volume business have not been uniformly successful, and the Exchange has become increasingly aware of the impact of competition from this source.[574]

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[572] It is, however, customary to make a general reference to reciprocal practices in mutual fund prospectuses.

[573] It is to be noted that the reciprocal give-ups here discussed do not necessarily involve the primary broker's—or any other member's—receiving anything by way of reciprocity.

[574] In a letter to the Special Study the president of the NYSE noted that the exchange believes that "over the past few years our listed issues and shares are being traded in increasing numbers on the Nation's regional exchanges and the over-the-counter market. We believe this erosion of the primary market is not in the public interest. It tends to undermine the purpose and usefulness of publicizing transactions in the primary market and may impair the liquidity which all investors rightly expect when investing in securities listed on this exchange."

(4) *Possible courses*

The NYSE has sought to meet this competition by the establishment of special techniques and methods of handling block transactions; these are discussed in chapter VIII.C. Of greater interest here is the exchange's consideration of revision of its commission rate structure to provide special recognition of block transactions on a regular basis. The high point of its study in this field was reached in connection with the proposal in 1953 [575] for increased commission rates.

At that time, a special nine-man committee which had investigated rate structure and commissions for close to a year recommended two fundamental reforms: a reduction in the percentage spread of commission rates between high- and low-priced stocks (discussed in sec. 2.d, below) and a "graduated" rate of 1 percent on the first $2,700 of each transaction, regardless of number of round lots, and 0.5 percent above that, provided that the business was transacted in 1 day. This charge was to be superimposed on a base charge of $4 for each round-lot and $2 for each odd-lot transaction. The committee explained the declining rate on volume orders as one that—

> * * * conforms to the price structure of most other industries, recognizes the reduced cost factor in volume orders, and should improve the position of member firms in competing with others in the securities industry.

Two members of the committee dissented. They objected that the proposed commission for block transactions effected in 1 day would be less than the rates in force at that time, and saw no reason for a decrease because "presently the markets for such transactions in the stocks referred to are primarily upon the exchange." They also contended that the proposed schedule would encourage grouping of orders for transaction through a nonmember at a lower commission rate, would put a premium on placing orders in 1 day, and would reduce members' income from out-of-town correspondents.

The majority then issued, in rebuttal, an elaborate statement defending its position. It analyzed costs of operation to show that only brokerage cost was related to the round lot while sales and processing costs were geared to the size of the transaction. In systematically answering each of the minority's arguments, the statement compared the majority's proposed changes with rates based on a 12½ percent "across the board" increase to show that its proposed increase would be twice as much for a single round-lot transaction in a $40 stock, but would be some 15 percent less for a 1,000-share transaction in the same stock.

The majority's recommendations were met with intense and widespread opposition. Since its proposal incorporated changes other than the graduated rate for block transactions in 1 day, it is difficult to assess the amount of opposition to this attribute alone, but the latter clearly accounted for much of the protest. Some member firms which habitually executed large orders demurred, fearing loss of income. Others based their resistance on the possibility that nonmembers would "bunch" orders against them. Still others interpreted the "1 day" requirement as creating a conflict of interest between good brokerage and desire for higher commission income because of the reduction in commission resulting from execution of large orders in 1 day.

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[575] See sec. 4, below.

The regional exchanges also objected strenuously to the new schedule. They feared the incentive it created for transaction of a large-block order on a single exchange, thereby reducing volume on the regionals by inhibiting the split of such business. The result of these protests by both the members and the regional exchanges was a substantial modification of the majority's proposal. The board of governors submitted to the membership a substitute plan providing for a rate based on the dollar value of the round lot, with a discount of 20 percent on each round lot *after* the first 1,000 shares executed on a given day or pursuant to a single order. This alternate plan was defeated by a membership vote of 573 to 532 on August 6, 1953. On October 29, 1953, the membership approved, by a vote of 639 to 530, a schedule similar to the one now in effect, making no provision whatever for a block discount or "graduated" rate on multiple round-lot orders.

In 1958, an NYSE special committee revived the question of a block discount. After taking cognizance of the majority report of the 1953 committee, it then "* * * noted, too, the problems set forth in the Minority Committee Report in 1953, which might be encountered in the administration of a minimum commission schedule containing a volume discount," and therefore "* * * determined to recommend that no change be made in the present basis of computing commissions." [576]

The Special Study has found that many institutional investors today consider the reform of the NYSE's public commission schedule in this area as a major desideratum for the securities markets generally. Following are some typical answers of institutional investors to the item in questionnaire IN-4 requesting suggestions for changes in the practices, procedures, or structures of the securities markets:

> We favor a volume discount on large purchases and sales of listed stocks, both to save money for our shareholders and to encourage a broader market in listed issues. The current trend toward off-board purchases and sales of listed issues by institutions necessarily reduces both the breadth and depth of the primary auction markets. The fact that New York Stock Exchange firms and members of other exchanges are willing and are permitted to "give up" 50 to 70 percent of commissions paid by mutual funds under present commission schedules, substantiates this viewpoint.
>
> * * * * * * *
>
> As a matter of self-interest, as well as the interest of the general public, it would be helpful to an institution such as this company if some consideration, in terms of reduced commissions or discounts, were given to large block transactions on the major exchanges. It costs little, if any, more to execute single trades of 5,000 or 10,000 shares than it does for 1,000 or 100 shares. As an investor interested generally in effectuating transactions in this size, it is believed that some consideration should be given to the larger trades.
>
> * * * * * * *
>
> The only suggestion that we have with respect to practices and procedures of the various securities markets is to have a reduction in the commission charged on large blocks of stocks. By "large" we would mean those in which the principal amount of the transaction would be $25,000, or more.
>
> * * * * * * *
>
> A transaction in a large block of stock should involve a smaller commission rate per 100 shares than a transaction for 100 shares, particularly as the broker-dealer often has less responsibility for the investment results in the large block than in the 100-share block.
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> * * * * * * *

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[576] As mentioned in sec. 4.a, below, pursuant to an understanding with the Commission announced in 1959, the Exchange recently undertook a further study of the volume or block discount.

simplify and make cheaper transactions in large blocks of stock on the New York Stock Exchange.

c. Services covered by the commission rate

As already pointed out, a security transaction on the Exchange involves two basic components: (*a*) Execution of the order on the floor; and (*b*) clearance of the order, i.e., completion of arrangements for the transfer of the stock certificate and payment for it. Exchange members generally perform, however, a variety of other services for customers in connection with the brokerage business. Certain of these services may precede the transaction, such as rendering investment research or advice, obtaining quotations, or providing a "customers' room" where customers may watch the tape. Some services may follow the transaction, such as the safekeeping of a customer's securities. Other services may be only remotely connected with the transaction, such as the collection and delivery of dividends, rights, and warrants on securities which the customer has left in street name with the broker. For purposes of simplicity, all these regular services are referred to here as "ancillary services."

Since the public schedule of minimum commission rates precludes direct price competition, these ancillary services constitute the most significant area of competition among members of the Exchange. And to the extent that such competition tends to improve the scope, depth, and quality of those services which are useful to the public, this would appear to be a desirable characteristic of the rate schedule. It has other effects, however, which may require further evaluation.

One is the condition described in the previous subsection. Members' competition for the business of block and volume investors, coupled with the frequent nonutility of normal ancillary services to such customers, has led to the substitution of special services, which may involve substantially more cost than the usual ancillary services.

But for a customer lacking the leverage to negotiate such an arrangement, inclusion of the cost of ancillary services in the commission rate may have another effect. Such a customer may well be paying for services he does not want. Nor does he enjoy the usual remedy of taking his business to another member who neither performs the unwanted services nor charges for them. Regardless of where the customer goes to trade in securities listed on the Exchange—unless perchance in the over-the-counter market for listed securities—he must pay the same minimum rates.[577] This characteristic of the rate structure may also tend to promote the expansion of ancillary services as a means of maintaining business and attracting new customers. Chapter III.C describes, for example, the development of research and investment advisory services of varying quality, as a competitive measure.[578] This development is beneficial for those who use the ancillary services, but to those who do not, it represents an increase in cost without any corresponding increase in value.

The problem of special charges for some types of services has perplexed the Exchange membership for many years. The 1938 rate in-

[577] The pricing practices in the over-the-counter market for listed securities are discussed in ch. VIII, pt. D.

[578] The question here discussed is, of course, closely related to those considered in the preceding subsections. In the case of the nonmember broker-dealer, it is he rather than the member who is likely to provide the ancillary services included in the minimum commission received by the member. In the case of the block or volume customer, the lack of need or desire for usual ancillary services is most likely to be present.

crease included a charge on inactive accounts that was rescinded shortly after its adoption.[579] In the same way, a schedule of fees adopted in 1940 to apply to dividends, rights, transcripts of statements, etc., was rescinded 26 days after its effective date. A split in the 1958 special committee points up a basic difference in the attitude of its members. The majority pressed a recommendation for both higher commission rates and special service charges:

> The performance of services requested by certain customers, apart from the complete components of the ordinary commission transaction, is a normal function of a good brokerage business. However, these additional services do result in increased costs and, in the opinion of the Committee, should be paid for by the person requesting them. The establishment of mandatory service charges at reasonable rates will not endanger the competitive position of member firms with respect to other types of financial institutions.
>
> * * * * * * *
>
> The Committee feels * * * that certain mandatory service charges should be imposed which will permit the commission increase to be lower than otherwise would be necessary.

A single member of the committee dissented, arguing that—

> * * * adoption of mandatory minimum service charges would narrow the area of competition among member firms * * *. It would be a big step toward making ours a noncompetitive, price-fixed business, a paradoxical step when one considers the free and open auction securities market we jealously guard and the type of economic system we all espouse.
>
> * * * * * * *
>
> The proposed service charges and the proposed higher commission rates, if adopted, will result in driving more of our customers and potential customers into the eager arms of our over-the-counter competitors.[580]

Whether because of the minority report or for other reasons, the board of governors withheld from its membership the majority's proposals on service charges and announced "that the subject should receive further study."

The NYSE's present Income and Expense Report does not attempt to determine the cost of ancillary services (or, for that matter, of special services), as distinguished from the basic brokerage function. Despite the Exchange committee's finding in 1958, the Exchange's Special Cost Study reported in 1961 that the identifiable cost relating to "certain traditional services to customers; namely, security custodianship, proxy service, transfers, dividend claiming, etc., * * *" appears to be minimal for the test firms and "does not seem disproportionate to that of other sales and services industries."

More detailed data on the costs of these and other ancillary services might prove them nominal, as the Special Cost Study indicates with respect to those enumerated, thereby reinforcing the present practice of absorbing the costs in the basic nonmember commission rate. A showing of relatively high expenditures for these services, on the other hand, might raise the question whether customers not using them ought to be required to subsidize those who do, and might suggest the possibility that the basic commission rate should cover solely the execution and clearance of security transactions, with all other services being

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[579] Rate changes since passage of the Exchange Act are discussed in sec. 4.a, below.

[580] The dissenting member also objected that service charges would diminish the value of rights and similar offerings, penalize the small investor, cause a loss of revenue to firms already imposing service charges, create difficulties in policing the schedules, render it impossible for margin accounts to effect their own exchanges of securities (i.e., they are "captive" to the mandatory charges), and create additional bookkeeping problems and clerical work.