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REVIEWS

## THE WALL STREET SPECIALIST: KING OF THE JUNGLE

Donald Shelby Chisum*

THE WALL STREET JUNGLE. By Richard Ney. New York: Grove Press, Inc., 1970. Pp. 348. $7.50.

The tone of *The Wall Street Jungle* is set in its preface: "[T]here is more sheer larceny per square foot on the floor of the New York Stock Exchange than any place else in the world."[1] The indicted principals are the specialists on the floor of the Exchange.[2] Accessories include the whole Exchange establishment, insiders of the corporations whose stocks are listed on the Exchange, the Securities and Exchange Commission (SEC), the Federal Reserve Board, and members of Congress, all of whom are accused of acquiescing or even sharing in the specialists' plunder. A close examination of Mr. Ney's bill of particulars reveals, however, that he exposes little about the persistent problem of the specialist and his function in the securities exchange auction market that has not already been debated in professional circles.[3] In fact, as a piece of scholarship, the *Jungle* is a jungle itself, suffering from a lack of coherent organization. It contains glaring gaps in analysis, non sequiturs, and unsupported hyperbolic assertions. Much of the text either paraphrases or directly quotes a 114 page section of a single government document—the SEC's 1963 *Report of the Special Study of Securities Markets*.[4]

Mr. Ney's best-selling work is important nevertheless because he has

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1. R. NEY, THE WALL STREET JUNGLE 8 (1970) [hereinafter cited as JUNGLE].

2. Ney directs his attack at both the New York and American Exchanges (since the specialist system functions similarly on both) but concentrates on the former since quantitatively it is the more significant.

3. *See generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION CASES AND MATERIALS, 700-27 (2d ed. 1968); 2 L. LOSS, SECURITIES REGULATION, 1201-08 (2d ed. 1961, Supp. 1969). S. ROBBINS, THE SECURITIES MARKETS: OPERATIONS AND ISSUES, 191-201 (1966).

4. SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong. 1st Sess., pt II, at 57-171 (1963) [hereinafter cited as SPECIAL STUDY].

successfully popularized a technical problem in the operation of the exchange markets for corporate securities. It now behooves the technicians and professionals to separate the wheat from the chaff in the *Jungle*'s harvest of accusations against the specialist system to the satisfaction of the investing public.

## I. SPECIALISTS AND THE AUCTION MARKET

To understand and evaluate Mr. Ney's accusations, a brief, simplified description of the exchange market and the specialist's functions in it will be helpful.[5] Stocks are traded on the floor of the New York Stock Exchange in a "continuous auction system." Member firms doing business with the investing public relay buy and sell orders from their customers to their commission brokers on the floor who execute the orders as agents. The floor contains a number of "posts," each of which is the locus for trading of a number of stocks. A broker with an order for a given stock goes to the proper post and joins the "crowd" (*i.e.*, participates in the auction). Buy and sell orders are matched in a typical auction fashion—with each broker seeking the best possible price for his principal.

Specialists, unlike commission brokers and other members,[6] do not move about the floor, but are stationed at a given post where the stocks in which they "specialize" are traded. The specialist performs two distinct functions. As a *broker*, he acts as sub-agent for commission brokers in the execution of "limit" and "stop" orders.[7] Since these orders, unlike "market" orders,[8] can normally be executed only at a

5. *See generally* SPECIAL STUDY 40-45.
6. Other members operating on the floor are *"two dollar" brokers* (independent brokers who execute orders given to them by commission brokers as sub-agents, receiving as compensation part of the commission charged to the public customer), *odd-lot dealers* (dealers who buy and sell "odd lots"—orders for less than the "round lot" standard trading unit of 100 shares—and adjust their positions as principals by the purchase or sale of round lots), and *registered floor traders* (members who buy and sell securities as principals for their own accounts).
7. A *limit order* is an instruction to buy at a given price or lower or to sell at a given price or higher. A *stop order* is an instruction to sell at market when the price declines to a specified level or to buy at market when it increases to a specified level. SPECIAL STUDY 72. Both are included in the generic statutory term "limited price order" in section 11 of the Securities Exchange Act of 1934, 15 U.S.C. § 78K(b) (1964).
8. A *market order* is an instruction to the agent to execute the order "at the most advantageous price as promptly as reasonably practicable." SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 26 (1936), *quoted in* 2 L. LOSS, *supra* note 3, at 1202.

future time when the market price changes to a given level, roving commission brokers usually entrust such orders to the specialist whose constant presence at the post assures prompt execution at the proper time. The specialist records all his limit and stop orders in his notorious "book."[9] As a *dealer*, the specialist buys and sells his specialty securities for his own account.

The specialist's broker function is clear enough, and its value to exchange trading has never been questioned. His dealer function is more complicated, however, and its combination with the broker function has long been a source of controversy. The specialist participates in the auction market for his specialty stocks primarily to "make a market," that is, to smooth out temporary, very short-run imbalances in the supply and demand for the stock. A simple example will illustrate this function. Assume at time T, a broker comes to the post with a market order to sell 100 shares of X stock. The specialist's book on X contains limit orders to buy 200 shares at 20 and limit orders to sell 200 at 24. The last sale price was 22. If at time T, there is no broker in the "crowd" with a market order to buy, and the specialist does not participate as dealer, the transaction will be executed with the limit order to buy on the book at its bid (20). At T + 1, a market order to buy 100 shares arrives. If there is no market order to sell in the "crowd," the transaction will be executed with the limit order to sell on the book at its offer (24). At T + 2, a market sell order would be executed at 20; at T + 3, a buy at 24. This discontinuity in successive transaction prices (20, 24, 20, 24,) is considered undesirable because it enhances the uncertainty of the investing public as to the price at which a given stock can be bought or sold at any given time. Discontinuity lessens the relevance of recent transaction prices as indicia of a given stock's value.

In the above example, the specialist, participating as a dealer, could and probably would "narrow the spread" between the bid and offer

9. Traditionally, the specialist's book is a 4 by 11 inch looseleaf binder with a page for each dollar level. SPECIAL STUDY 72. The binder is being replaced by a computerized system that will flash the specialists' orders onto a screen at the push of a button. *Throwing Out the Book?*, BARRON'S July 6, 1970, at 3. Since the contents of the book is valuable trading information—indicating the existing supply and demand for stocks—the 1934 Act forbids disclosure of it by the specialist except under specified circumstances. Securities Exchange Act § 11, 15 U.S.C. § 78K(b). Ney claims illegal disclosure is a regular occurrence. JUNGLE 33.

quotations as set by the public orders. He would quote, for example, 21⅞ bid, 22⅛ offer. The series of transactions would be at 21⅞, 22⅛, 21⅞, and 22⅛. The specialist would participate in the transactions at a ¼ point profit, his compensation for adding continuity to the market. That continuity is his establishing a reasonable relation between the price of successive transactions. Over the series, his inventory of X shares would remain unchanged. Here the specialist is able to exercise discretion by setting the exact transaction prices. His quotation could as easily have been 21⅝–21⅞ or 22⅛–22⅜. It is to the specialist's economic advantage not to narrow the spread too much, since his compensation increases as the spread becomes greater.[10]

Beyond this very short-run function, the specialist is expected by Exchange policy to participate as a dealer to add "depth" and "continuity" to price movements.[11] If the orders to sell (buy) a stock consistently exceed those to buy (sell) at a given price, it is obvious that the price must go down (up). The specialist cannot, should not, and does not "stabilize" prices by indefinitely buying or selling against the trend of orders to maintain a set price. However, he *is* supposed to deal against the trend ("lean against the wind")—building an inventory as the stock's price goes down, reducing it as the price goes up. The effect is (1) a cushioning of intermediate price swings beyond or away from long-run equilibrium levels that otherwise, it is thought, would be too sharp, and (2) an added continuity in the price movement, *i.e.*, each transaction's price is only a small increment below (above) the previous one.

The specialist, as broker and dealer, also exercises important control over the price at which his specialty stocks "open." The Exchange is a "continuous auction market" only during a limited number of hours during the business days each week. However, brokers accumulate orders to buy and sell at all hours. At the beginning of a trading session, brokers give all their orders to the specialist who then deter-

10. SPECIAL STUDY 86-88.

11. Rules 103 and 104 of the Board of Governors of the New York Stock Exchange, *quoted in* R. JENNINGS & H. MARSH, *supra* note 3, at 721-22; *see* Wolfson & Russo, *The Stock Exchange Specialist: An Economic and Legal Analysis*, 1970 DUKE L.J. 707, 714-17, 727-29.

mines the opening price at which all orders are executed.[12] For example, if the specialist is given orders to sell 1,000 shares of Y stock and to buy 800 shares of Y stock and the previous closing price was 22, the price will normally be lowered at the open. If the specialist has a limit order to buy 200 shares at 20 on his book (and none higher), the price would drop to 20 *unless* (as is likely) the specialist himself steps in to buy for his own account. If he does participate, he could set the opening price at anywhere from 20⅛ on up. He could even set the price *above* 22 despite the preponderance of sell orders if he buys for his own account or uses available orders on his book. Normally, however, the latter course of action would violate the rules of the Exchange.[13] In any case, it is again obvious that the specialist enjoys a great deal of discretion in setting the opening price which, in turn, is of great influence on successive transaction prices.

## II. REGULATION OF SPECIALIST ACTIVITY

Criticism of the power and position of specialists has been leveled at nearly every aspect of their activity but has centered around (1) the inherent conflict of interests to which the specialist is subject, (2) the power over price movements in his speciality stocks that he possesses and the valuable knowledge as to the available supply and demand for those stocks that he gets from his book—both of which can be used for his personal trading profit as a dealer, and (3) the extent to which specialists through their dealings for their own accounts actually contribute to the depth and continuity of the market. The response to these criticisms has always been to isolate abuses and practices easily subject to abuse, to set standards of conduct for specialists, and to implement more and better means of surveillance to detect non-

12. SPECIAL STUDY 137-42.

13. Participation at openings or reopenings. A specialist should avoid participating as a dealer in opening or reopening a stock in such a manner as to upset the public balance of supply and demand as reflected by market and limited price orders, unless the condition of the general market or the specialists' position in light of the reasonably anticipated needs of the market makes it advisable to do so. He may, however, buy and sell stock as a dealer to minimize the disparity between supply and demand at an opening or reopening.

Note to Rule 104 of the Board of Governors of the New York Stock Exchange, *quoted in* R. JENNINGS & H. MARSH, *supra* note 3, at 724.

compliance with the standards. Radical suggestions for reform, such as the segregation of the specialist broker function and the dealer market-making function or the abolition of the market-making function, have consistently been rebuffed.[14]

The activities of specialists acting as dealers are regulated by section 11(b) of the Securities Exchange Act of 1934,[15] SEC Rule 11b-1,[16] and Rules 103 and 104 of the Rules of the Board of Governors of the New York Stock Exchange.[17] Cumulatively, these require specialists to participate as dealers for their own accounts in order to assist in the maintenance of a "fair and orderly" market and prohibit them from dealing except for that purpose. The rules generally condemn such specific specialist dealer abuses as "cleaning up the book," "cleaning up the market," and "reaching across the market."[18] The Exchange scrutinizes specialists' dealings to detect non-compliance with the standards —that is, to determine whether the specialists' dealer transactions are "stabilizing" (against the price trend) or "destabilizing" (with the price trend).[19] The 1963 *Special Study* found Exchange surveillance

14. In 1934, Congress directed the SEC to report on the "feasibility and advisability of the complete segregation of the functions of dealer and broker," which would include specialists. Act of June 6, 1934, ch. 404, § 11(e), 48 Stat. 891. The SEC's report, published in 1936, concluded that segregation was not advisable. *See* note 8, *supra*. The Special Study concluded that there was no need for "any broad and drastic change in the system" as it now exists. SPECIAL STUDY 167.

15. Securities Exchange Act § 11(b), 15 U.S.C. § 78K(b) (1964).

16. 17 C.F.R. § 240. 11b-1 (1970). Prior to 1965 there was no formal SEC rule relating to specialist regulation. SEC policy was expressed in an administrative interpretation of Section 11(b) known as the Saperstein Interpretation. *See* S. ROBBINS, *supra* note 3, at 195; Wolfson & Russo, *supra* note 11, at 717-21.

17. *Quoted in* R. JENNINGS & H. MARSH, *supra* note 3, at 721-22.

18. "Cleaning up the book" is the purchase by the specialist of all the stock offered on the book at the last preceding price or the supplying of all the stock bid for on the book at the last sale price. SPECIAL STUDY 81. "Cleaning up the market" is the purchase of all the stock offered in the market or the supplying of all the stock bid for in the market. *Id.* at 93. "Reaching across the market" is the initiation of a transaction by the specialist by buying at the offer or selling stock at the bid (whether the orders are on the book or in the crowd) rather than waiting for someone to trade. *Id.* at 109. All are considered abuses because they are not necessary to maintain price continuity and may create or accentuate price movements. The Exchange has always maintained that a specialist has a greater right to "reach across the market" to liquidate a position than to establish a position. This is based on an avowed need for "business survival"—even though such liquidation is in competition with public customers' orders and may accentuate a price drop. *Id.* at 121-23.

19. The Exchange has traditionally used the "tick test" to measure whether specialist dealer transactions are stabilizing or destabilizing. A transaction is considered "stabilizing" if it is a purchase on a minus or zero minus tick (at a price below the previous different transaction price) or if it is a sale on a plus or zero plus tick (at a price above the previous different transaction price). The tick test has been criticized as an inadequate guide in judging whether the sum of a specialist's dealings are stabilizing or destabilizing.

to be inadequate,[20] but the Exchange claims to have increased the quality and quantity of its surveillance in response to that study and the urging of the SEC.[21]

The activities of specialists acting as brokers are regulated by Exchange auction rules designed to ameliorate the conflict of interests involved—conflicts that arise because the specialist frequently deals as principal with those for whom he is acting as agent or as broker-agent for opposing principals in a transaction. A specialist cannot, for example, compete directly with his principals.[22] He cannot purchase for his own account at a given price if he has a bid at that price on his books nor sell at a given price if he has an offer at that price. But the very act of market-making causes the specialist to compete indirectly with the persons for whom he holds orders as a broker. For example, in the above X stock hypothetical, the specialist outbid (at 21⅞) his own principal who had a bid on the book at 20. As the gap between the specialists' bid and that of his principal narrows, the fiduciary problem obviously becomes acute. When a specialist deals with his book for his own account, the transaction is subject to the "crossing" procedure (a broker in the "crowd" may upset the cross by outbidding or under-offering the specialist) and to the right of the principal's commission broker to repudiate the transaction. The *Special Study* concluded that

As the *Special Study* points out, "[t]he tick test does no more than direct the specialist to buy low and sell high, a course he is led to more simply by his profit incentive." SPECIAL STUDY 103. There will typically be some upticks in every general price decline and some downticks in every rise. S. ROBBINS, *supra* note 3, at 197-99. The *Special Study* found no totally satisfactory measurement of price trends against which to judge a specialist's performance.

20. SPECIAL STUDY 170-71. The Exchange has been specifically criticized for directing its surveillance primarily to instances of underparticipation (failing to deal in an inactive stock so as to maintain a narrow bid and offer quotation), thereby ignoring the problem of overparticipation (dealing in stocks in which trading is so active that there are few temporary disparities in supply and demand).

21. SEC Securities Exchange Act Release, No. 7432, Sept. 24, 1964. Both the New York and American Stock Exchanges agreed to implement new performance tests, to make greater use of computer technology in surveillance, and to require specialists to keep records on commission income and dealer profits and losses by each specialty stock and make such records available to the Exchange on request.

There are indications that the Exchanges are in fact strengthening their specialist surveillance programs. The New York Stock Exchange, for example, recently announced that it had censured and fined two specialists $25,000 each. The violation was buying a large block of stock as dealers on the floor without filling a broker's order for part of the block. But in typical fashion, the Exchange sought to preserve public confidence in the specialists system by stressing that the violations were "technical" and did not reflect on the "specialists ability to make a market in their specialty stocks." *See* Wall Street Journal, March 8, 1971, at 5, col. 3.

22. SPECIAL STUDY 143-44.

the crossing procedure was inadequate since the specialist can wait to cross when no one is in the "crowd" and brokers, as an accommodation to the specialist, rarely repudiate the transaction or upset crosses.[23]

Mr. Ney believes that the regulatory standards are systematically circumvented or violated by specialists who deliberately manipulate prices up to sell long or short and down to buy or cover their short positions.[24] Whether he is right or wrong is open to doubt. Clearly the examples he cites do not prove his general thesis. What *is* disturbing is that specialists clearly possess the power to set price trends or create price swings at least to some extent.[25] It is difficult even in theory to distinguish when this power is properly exercised and when it is improperly exercised. For example, selling on upturns and buying on downturns are exactly the kinds of stabilizing "leaning against the wind" that specialists are supposed to undertake. Yet timed correctly, such activity can be extremely profitable over the long-run for the specialist. The critical question is whether the specialists cause or accentuate the upturns and downturns, and that question appears too difficult to resolve from afar. Mr. Ney says that they do; Exchange propaganda, fortified generally by the findings of the *Special Study*,[26] assures you that they do not or cannot. The Exchange's position requires a certain faith in the integrity and sense of fiduciary responsibility of specialists and those who regulate specialists; Ney appeals to the "absurdity of rules that trust to the value judgments of human nature."[27]

23. *Id.* at 146.
24. Such deliberate manipulation would be a federal crime. *See* United States v. Re, 336 F.2d 306 (2d Cir. 1964).
25. The extent of the specialists' power is a matter of dispute among economists. *See* Wolfson & Russo, *supra* note 11, at 714-17. To the extent that investor demand, and hence the equilibrium price for a stock, depends on fundamental factors (such as past earnings) their power must be considered small. But if demand is influenced substantially by technical factors (past movements of the stock's price), their power is greater since they can use their own discretion over small incremental price changes to create a stock price chart pattern that will evoke appropriate responses from technical speculators. Ney is himself a chartist—mainly because he thinks specialists deliberately manipulate prices in a pattern designed to hoodwink other chartists less sophisticated than himself. JUNGLE 257-59.
26. The *Special Study* found "no widespread abuses or patterns of illegality" on the New York Exchange. A prior SEC report on the American Stock Exchange found more evidence of abuse. SEC, REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE, 23-39 (1962). The American Exchange, however, has since been substantially reformed. *See* 2 L. Loss *supra* note 3, at 3145-49.
27. JUNGLE 33.

While Ney fails to prove his case that specialists engage in deliberate manipulation, there is more substantial evidence that specialists may profit as dealers on the basis of undisclosed material inside information.[28] Ney places great weight on the P. Lorillard-Schenley Industries merger affair in 1967.[29] Schenley was trading in the 60's when a false rumor circulated that the merger had fallen through. A rash of sell orders came in. Trading was suspended for most of March 14 but one specialist did open the stock for one trade at the close—down 11⅞ points—in which he purchased 80,000 shares. The next day the falsity was revealed and Schenley bounced up 11¼ points on buy orders. There was no direct evidence that the specialist had any inside information, but it has been persuasively argued that the specialist should have continued the suspension until the rumor was cleared up—rather than trading himself.[30]

Ney does emphasize certain clear defects in the regulation of specialists. One is the specialists' use of "segregated investment accounts."[31] All profits realized by a securities dealer such as a specialist in his trading account are taxed as ordinary income regardless of the actual holding period. However, under section 1236 of the Internal Revenue Code of 1954, a dealer can obtain capital gains treatment by (1) identifying a given security as one held for investment and (2) not holding it primarily for sale to customers in the ordinary course of his business. Some specialists attempt to take advantage of section 1236 by segregating some holdings of their specialty stocks into a segregated investment account. Whether such segregation is really effective for its avowed tax purpose is apparently unresolved.[32] The *Special Study* identified this practice as an abuse[33] but the SEC was unsuccessful in eliminating it.[34] The practice clearly is an abuse for at least three reasons: First, it gives the specialist a motive for using his unique position of knowledge and subtle power of control over the price of his specialty stocks to benefit his investment account rather than to maintain a "fair and

28. Exchange policy forbids specialists from acquiring such "inside" information. SPECIAL STUDY 157.
29. JUNGLE 39-45.
30. Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U.L. REV. 695 (1967).
31. JUNGLE 57-66.
32. *See* Rev. Rul. 160, 1964-1 CUM. BULL. 306, 309.
33. SPECIAL STUDY 133-35.
34. JUNGLE 65; Wolfson & Russo, *supra* note 11, at 733.

orderly" market. Second, it withdraws a portion of his capital and his inventory from possible use in maintaining such a market. Finally, it also seems to constitute an unfair use of the specialist's special exemption from the Federal Reserve Board's margin rules.[35] The purpose of the exemption is solely to allow specialists greater access to capital in order to increase their ability to participate as dealers in the maintenance of orderly markets.

The Federal Reserve Board has finally moved to restrict the exemption from the margin rules for specialists to preclude its use for segregated investment accounts.[36] However, the SEC's failure to get tough with the Exchange on this issue has only added fuel to the flame of critics such as Mr. Ney.

## III. PROPOSALS FOR REFORM

As might be expected, Ney advocates the complete elimination of the specialist's function as a dealer and market-maker, retaining specialists only as brokers to execute limit and stop orders.[37] Indeed he would go further and completely segregate broker and dealer functions on the exchange.[38] Members of the Exchange would act solely as brokers, and be prohibited from trading or investing in stocks listed on the Exchange.[39] Realistically, neither suggestion is likely to be adopted. The Exchange has a long and successful record of convincing Congress and the SEC that specialists, with their unique powers, are necessary to provide a "fair and orderly" market, and no major abuses in member trading generally have yet been exposed.

35. Regulation T of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 220.4(g).

36. *See BNA* SEC. REG. & L. REP., Jan. 27, 1971, at F-1.

37. JUNGLE 243-44. The SEC has statutory authority under section 11 of the Securities Exchange Act of 1934 to accomplish such segregation by a regulation. 15 U.S.C. § 78K(b) (1964). Stock exchanges in other countries function in a variety of ways. The Paris Bourse seems to approximate Ney's model of an all-broker exchange with no specialists or dealer members. 2 L. Loss, *supra* note 3, at 1221.

38. JUNGLE 245. Such segregation would require an Act of Congress. Section 11 only empowers the SEC to preclude floor trading and to prevent "excessive" off-floor trading by members.

39. The *Special Study* found that "[t]rading by NYSE members on the exchange but from off the floor accounts for approximately 5 percent of total exchange purchases and sales. . . ." SPECIAL STUDY 246. It concluded that little is really known about such trading other than that it is done for a variety of purposes—personal investment, arbitrage, block-positioning, etc. In executing such trades, the member enjoys commission rates lower than those paid by the public.

As a second-best solution Ney proposes that specialists make full disclosure of their dealer trading and profits in their specialty stocks.[40] With that I wholly concur. As Ney points out, the officers, directors and major shareholders of publicly-held corporations must regularly disclose their holdings of their corporation's stock and any changes therein.[41] Specialists are not corporate insiders,[42] but they do in effect and by representation operate as fiduciaries for the investors and potential investors in the corporation's stock. As fiduciaries, they can have no legitimate claim to financial privacy. Reporting of trading profits and the summarized result of the various Exchange surveillance tests of specialist performance would at least inform the investment community of the cost of maintaining a "fair and orderly" market.

On a broader plain, the fundamental question today on the status of the major exchanges is not whether they should operate with or without specialists but whether they can or should continue to exist at all in their present form—that is, as auction markets taking place at a single physical location in New York. An exchange market for a given stock is a natural monopoly.[43] Hence the need for a *centralized* market for a given stock is clear. However, with the advent of modern communications, especially the computer, it is becoming increasingly clear that centralization no longer means spatial concentration. In this respect, the experience with the NASDAQ[44] system, a computer-based, nationwide quotation network for over-the-counter stocks, could have a major impact. As it is now constructed, NASDAQ merely "computerizes" the existing over-the-counter market in which dealers make markets in given stocks and brokers execute buy or sell orders for their

40. JUNGLE 245-46. The *Special Study* suggested full public disclosure, but again the SEC was unable or unwilling to obtain the acquiescence of the Exchange. SPECIAL STUDY 170. At present, specialists are under a duty of disclosure only to the regulatory authorities of the Exchange themselves.

41. Securities Exchange Act § 16(a), 15 U.S.C. § 78p(a) (1964).

42. The *Special Study* was critical of the relationships maintained between specialists and insiders of companies in whose stock they specialize. SPECIAL STUDY 157-60. Exchange policy now prohibits specialists from serving as commission brokers for such insiders.

43. *See* Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675, 703-04 (1970).

44. NASDAQ is the acronym for National Association of Securities Dealers Automated Quotation system. NASD is a self-regulatory association of broker-dealers who deal mainly in over-the-counter (OTC) stocks (*i.e.*, those not listed on any securities exchanges). The NASD is registered under Section 15A of the Securities Exchange Act of 1934. 15 U.S.C. § 78(o)(3) (1964). Firms which are members of the major exchanges usually are also members of the NASD since they handle OTC as well as listed stocks for their customers.

customers at the dealer's offer or bid quotation.[45] At present, the NASDAQ system does not include stocks listed on the stock exchanges.[46] However, the system or one like it can easily be expanded to include all stocks and be restructured to allow direct communication of bids and offers and even the direct execution of trades between brokers or indeed between investors themselves.[47] If such a system is implemented and proves to be more efficient than floor auction exchanges, such exchanges will no longer continue to exist in their present form.[48]

45. NASDAQ is programmed to operate on three "levels". Level I is informational. It can retrieve current median bid and offered quotations by market-makers for any stock in the system. An investor's broker can thus supply up-to-the-minute price information similar to what is available for listed stocks. Level II allows the broker to retrieve an actual current quote from any market-maker. Level III is the one into which market-makers enter their quotations. No actual executions are effected through the NASDAQ system. The broker must communicate directly with the market-maker by telephone or otherwise. *See* BNA SEC. REG. & L. REP., Feb. 10, 1971, at A-12-A-13.

46. There is no legal restriction on the inclusion of listed stocks in the system. Broker-dealers who are not members of the exchange on which a stock is listed can and sometimes do make a market or effect executions in such a stock (the so-called "third market"). Up to the present, the "third market" has been generally confined to large block transactions in which OTC broker-dealers could profitably undercut the minimum commissions charged on the Exchanges. This competitive advantage has been lessened by the SEC's moves to abolish minimum commissions on large blocks. *See* Wall Street Journal, April 2, 1971, at 30, col. 1. But with a system such as NASDAQ, third market competition could run deeper with OTC market-makers, for example, offering better quotations than the specialists on the exchanges.

The decision to exclude listed stocks from NASDAQ was actually an eleventh hour affair. An OTC broker-dealer, Shumate & Company, Inc. of Dallas, has brought an antitrust suit, charging the exclusion was dictated by stock exchange member firms that dominate the Board of Governors of the NASD. *See* BNA SEC. REG. & L. REP., Dec. 23, 1970, at E-1-E-4. The decision to exclude listed securities may be altered. *See* Wall Street Journal, Jan. 21, 1971, at 3, col. 2. Indeed, under the pressure of the Shumate antitrust suit and from members of Congress, the NASD decided to include 36 exchange-listed securities on NASDAQ on an experimental basis. *See* BNA SEC. REG. & L. REP., March 17, 1971, at A-2; Wall Street Journal, March 15, 1971, at 5, col. 1.

47. For example, the INSTINET system (Institutional Networks Corporation) is programmed for direct execution of transactions among large institutional investors. *See* SEC Securities Exchange Act Release No. 8661, August 4, 1969. As the Release notes, computer systems present regulatory problems and may constitute stock exchanges or broker-dealers within the meaning of the Securities Exchange Act. The Release proposes for adoption a rule that requires SEC approval of any "automated trading information system." NASDAQ would be exempted since the NASD assumes regulatory responsibility for the operation of the system.

48. The Exchanges are, of course, being pressured to move to computerization themselves. The New York Stock Exchange has implemented the BAS (Block Automation System) that allows communication of interest in large blocks by member firms and institutional investors. Direct communications between investors is not allowed, however, and executions are subject to normal exchange rules (that is, normally they must cross on the floor). *See* SEC Release, *supra* note 47.

The regional stock exchanges are considering an "electronic linkup" which would eliminate the floor auction. *See* Wall Street Journal, March 19, 1971, at 5, col. 1.