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THE THIRD MARKET — CHALLENGE TO THE NEW YORK STOCK EXCHANGE

by Anthony D. Schlesinger

The 1963 *Special Study of the Securities Markets* by the Securities and Exchange Commission[1] devoted considerable attention to a segment of the over-the-counter market which deals in listed securities. The SEC labeled this mysterious phenomenon the "Third Market."[2] This Comment explores the Third Market in terms of what it is, who is in it, what function is served by its existence, and the significance of its impact on the securities industry.[3] In order to simplify an already complex plot, only the main characters are presented, *i.e.*, the New York Stock Exchange (NYSE or Exchange), the Securities and Exchange Commission (SEC or Commission), and the Third Market. References to the American Stock Exchange and the regional exchanges[4] are omitted even though each contributes to the overall picture.

I. Origin and Nature of the Third Market

In simplified terms the Third Market consists of the broker-dealers, nonmembers of either large stock exchange, who actively engage as principals in buying and selling listed securities over the counter on a continuous basis and who themselves make the markets in such listed securities.[5] The Third Market has grown and thrived as a result of two deficiencies in the nation's most important auction market for securities, the NYSE: (a) inherent short-run inadequacies of an auction market, and (b) the built-in NYSE commission structure.[6]

The essential function of the NYSE is "to furnish exchange rooms for the convenient transaction of their business by its membership."[7]

[1] SEC, *Report of the Special Study of the Securities Markets,* H. R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [Hereinafter cited as *Special Study*].

[2] *Special Study* pt. 2, specifically at 870-911; generally throughout ch. V-VIII.

[3] The Third Market has attracted an increased share of the trading in NYSE listed securities. In 1941, it accounted for about $84 million or 1.7% of the NYSE trading. In 1965, it accounted for $2.5 billion or 3.4% of the NYSE trading—*Special Study* pt. 2, at 873-74; SEC *Statistical Bulletin,* March, 1966, at 10.

[4] There are twelve regional exchanges: Boston Stock Exchange, Chicago Board of Trade (inactive since 1961), Cincinnati Stock Exchange, Detroit Stock Exchange, Midwest Stock Exchange, National Stock Exchange, Philadelphia-Baltimore-Washington Stock Exchange, Pittsburgh Stock Exchange, Salt Lake City Stock Exchange, San Francisco Mining Exchange, and Spokane Stock Exchange. Source, 31 SEC Ann. Rep. 40 (1965).

[5] *Special Study* pt. 2, at 872

[6] NYSE Const. art. XV, §§ 1-12 as found in 2 CCH NYSE Guide ¶¶ 1701-12. (All NYSE Constitution and Rule Citations are found in 2 CCH NYSE Guide. Hereinafter reference only to paragraph).

[7] NYSE Const. art. 1, § 2, ¶ 1002.

The members, acting for their customers or for themselves, participate in a continuous auction in the market place provided by the Exchange. Transactions are completed through the two-way auction process in which all who represent interested buyers compete for the securities offered by those representing interested sellers (likewise competing with each other to make a sale). Since the system endeavors to gather together in one market all components of supply and demand, instability is inherent, especially during sudden fluctuations of either supply or demand. A buyer and seller often may prefer a direct confrontation where they can negotiate an entire transaction apart from the uncertainties of an exchange market.[8]

Unlike the inherent inadequacies of an auction market, the commission rate structure is artificially created and preserved by the Exchange itself. The Exchange Constitution fixes a uniform commission rate for every round lot transaction executed by a member for or with a nonmember.[9] These rates must be "net and free from any rebate, return, discount or allowance made in any way . . . direct or indirect."[10] The institutional customer who purchases or sells 2000 shares pays twenty times the commission which would be paid on the purchase of one hundred shares. It is the unbending commission rate level and structure of the NYSE that pervades almost every regulatory problem and structural strain of the securities trading market.[11] For the moment, it is sufficient to conclude that the existence of a rigid commission policy has prompted nonmember broker-dealers and institutional investors to look elsewhere for trading in Exchange-listed securities. This gap has been plugged by the Third Market.

As indicated previously, the Third Market is a negotiated (as opposed to auction) market. Customers trade directly with the broker-dealer who acts as the principal buyer or seller. The price is a net price (no commission), and the broker-dealer profits from his spread on trading. Business is strictly "cash and carry" in the sense that the broker-dealer furnishes no services to his customer;[12] there is no advice giving or hand holding by the broker-dealer.

The Third Market caters primarily to the institutional investors[13] such as insurance companies, banks, and pension trusts. These insti-

[8] See notes 19-21, *infra*, and accompanying text.

[9] NYSE Const. art. XV, §§ 1, 2, ¶¶ 1701-02.

[10] NYSE Const. art. XV, § 1, ¶ 1701.

[11] *Much To Be Done*, address by Manuel F. Cohen, Chairman SEC, to 54th Annual Convention Investment Bankers Association, as reprinted in Investment Dealers Digest, Dec. 20, 1965, p. 44. In this issue see Johnson, *Application of Antitrust Laws to the Securities Industry*, 20 Sw. L.J. 536 (1956).

[12] Weeden, *The Third Market*, in DUKE CONFERENCE ON SECURITIES REGULATION 173 (Mundheim ed. 1964).

[13] Weeden, *supra* note 12, at 172; *Special Study* pt. 2, at 880-81.

tutions trade mainly as principals and maintain their own holdings, although some institutions, notably banks, invest the assets of others in a fiduciary capacity.

The primary supplier of the institutional investor, the "market maker" is a nonmember broker-dealer who trades over-the-counter for his own account in NYSE listed securities.[14] The Third Market is dominated by about six such market makers[15] who altogether trade in about 270-300 listed stocks. One firm may make a market for anywhere from fifteen to 150 stocks depending on its capital and the needs of its customers.[16]

The catalysts of the Third Market, characterized by the *Special Study* as "professional intermediaries," are also nonmember broker-dealers. A professional intermediary may act purely as a broker by arranging a transaction between two customers, or he may represent one customer transacting with a market maker.

The most important advantage of trading in the Third Market is the price. This is especially true for the nonmember broker-dealer whose customer wants to trade in listed securities. If he trades with an Exchange member, the imposition of the full NYSE commission to the transaction leaves the intermediary with little or no room to extract a commission for his own services and still compete with a member broker-dealer. Thus, many nonmembers are forced to trade at no profit merely to please a good over-the-counter customer. The Third Market offers a competitive advantage. The nonmember may be able to effect a transaction with a market maker near enough to the Exchange price so that he can charge his customer a commission equivalent to the full NYSE commission. Through the mechanism of the Third Market he can satisfy the wishes of his customers and still turn some profit.

Although price advantage on odd lots and small round lot transactions is significant to the nonmember broker-dealer, the big competitive price advantage of the Third Market is in block transactions. The institution that wishes to trade a large block of stock must pay an Exchange member a full commission and often a double commission[17] to complete the transaction. For example, the commission for purchase or sale of one hundred shares at thirty-eight dollars per share is thirty-eight dollars.[18] If 2,000 shares are traded, the commission

[14] In 1961, market makers participated in an estimated 97% of all Third Market transfers. *Special Study* pt. 2, at 885 n.152.

[15] American Securities Corp., Blyth & Co., Inc., A. W. Benkert & Co.

[16] *Special Study* pt. 2, tables VIII-45-46, at 1063.

[17] See text accompanying notes 26-28 *infra*.

[18] Based on rates, NYSE Const. art. XV, § 2, ¶ 1702.

multiplies accordingly, and therefore a NYSE member must charge his customer a total price of at least $76,760 and in many special block transactions where the commission is doubled the price jumps to $77,520. A market maker can quote a net price of as much at 38⅜ (total $76,750) and the institution is still able to save up to $770 on the transaction. Since the institution rarely wants anything in the way of services from its broker-dealer (for which, part of the NYSE commission is ostensibly allocated) the entire saving is pocketed.

The Third Market also offers to the block customer mechanical advantages inherent in an over-the-counter market aside from price. The customer is able to retain control of his order throughout the transaction. Negotiation of price is directly with the market maker. There is often an opportunity to shop the market if more than one market maker is trading in the stock. Finally, there is always the alternative of going to the NYSE if, in fact, its market appears more responsive.

An important consideration to the institutional trader is the "depth" of the market. Used in this context, the term refers to "the quantity of buying or selling interest in a stock at particular price levels."[19] A current quotation of a listed stock merely indicates the price at which a customer may purchase or sell one hundred shares. Where block sales are contemplated, however, it is difficult, if not impossible, to determine the extent to which buying interest will be maintained at the quoted price. In order to complete the sale, the last round lot may have to be sold at a price much lower than the first. The extent to which a block offering would drive down the price of a given stock must also be considered in terms of the net price that will be realized after the final lot is traded—which may be substantially lower or higher than the first round lot price would have indicated. A market "specialist" may give a modest "cleanup" offer for the entire block or he may be unable or unwilling to participate at all in the sale. In short, no matter how sophisticated the trader may be in gauging the depth of a given market, the trading of any block through the auction market is cloaked in uncertainty.[20] By contrast, the market maker will quote a fixed, net price for all or part of an order. If his inventory in the stock is low he may even assume a short position. In the Third Market the element of depth uncertainty is removed.

Another advantage of the Third Market to the block trader, related to depth, is the speed of completion of the full transaction. If the

[19] *Special Study* pt. 2, at 898.
[20] *Ibid.*

Exchange market is shallow and slow to absorb a block sale, the institutional trader may be forced to spread his sale over a day or several days.[21] By contrast, the same transaction might be consumated on the telephone with a market maker in a matter of minutes.

II. THE NEW YORK STOCK EXCHANGE AND THE THIRD MARKET

Predictably, the NYSE is opposed to the Third Market. Its chief objection is couched curiously enough in the familiar term "depth." Since the Exchange is carefuly trying to preserve liquidity and marketability in the primary auction market, its rules prohibit off-floor trading by members in listed stocks.[22] The Exchange reasons that the primary auction market has heretofore provided investors with an all but certain market for trading—even on the worst of trading days.[23] But given the increased holdings by institutional investors (the turnover rate for institutions is lower than for individuals),[24] the supply has thinned somewhat. This fact, coupled with a substantial diversion of trading from the primary auction market, indicates potential impairment to Exchange depth. Exchange president Funston expressed his concern to the *Special Study*.

> We believe the erosion of the public market is not in the public interest. It tends to undermine the purpose and usefulness of publicising transactions in the primary market and may impair the liquidity which all investors rightly expect when investing in securities listed on this exchange. . . . [P]roblems arise when transactions in listed securities are executed on the over-the-counter market. Here, too, there is no assurance of obtaining the best price available in the primary market at the time the order was executed. . . .
>
> These diversions may bring about insufficient supply and demand on the primary market necessary to appropriately reflect the public's evaluation of the prices of these securities. This might result in the Exchange becoming merely a quotation board furnishing prices for the bulk of transactions in listed securities being made off the Exchange floor.
>
> Consequently we would urge a careful examination of alternative means for preventing the erosion of the primary market.[25]

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[21] In 1961, for example, median periods for a single block sale or purchase on the Exchange ranged as high as sixteen to twenty trading days (and over fifty calendar days). The corresponding median period for an over-the-counter sale or purchase was only one or two days. The number of transactions needed to carry out a block sale or purchase on the Exchange ranged from twelve to fifty-two. The over-the-counter maximum was three transactions. *Special Study* pt. 2, tables VIII-30-32, at 1050-52.

[22] NYSE Rule 394, ¶ 2394.

[23] NYSE, THE STOCK MARKET UNDER STRESS (1963).

[24] NYSE, INSTITUTIONAL SHAREOWNERSHIP 41, table 19 (1964). All NYSE volume turnover (1963) estimated at 21%. Institutions (other than mutual funds) ranged from 2.5% to 14.8.%.

[25] *Special Study*, pt. 2, at 955-56.

A. *Internal Changes By The New York Stock Exchange*

Through concern for investors' access to a primary auction market —and perhaps also through a less altruistic concern for the value of Exchange membership—the NYSE has made certain internal changes to counteract diversions to the Third Market.

1. *Trading Procedures* The NYSE has made efforts to minimize or, in some cases, avoid the basic problems inherent in the structure of the continuous auction market. These efforts are largely directed toward improvement in effecting block purchases and sales.

Recognizing that the auction market, even aided by the specialist, is not always capable of supporting block purchases or sales within a reasonably short period of time, the Exchange has adopted some special procedures for handling block trades apart from the auction market. The following four procedures involve stock distribution: *The Secondary Distribution*[26]—a member or syndicate of members publicly offers the block away from the floor at a fixed price. The seller pays at least two (often three to six) full commissions and the buyer pays net. *The Exchange Distribution*[27]—the seller's broker accumulates the necessary buy orders and then crosses the stock on the floor at or above the market price at the moment. Again the seller pays both commissions and the buyer pays net price. *Special Offering*[28]—a member announces an offer at a fixed price (at last sale or current) which is left open for a time so that any member can accept all or part of it. Again the seller pays two commissions and the buyer pays net. *Specialist Block Purchase*[29]—the seller's broker negotiates the sale directly with the specialist in the offered stock. The price is negotiated but must be under market. The seller, again, pays full commission. Three acquisition special procedures—the Exchange Acquisition, the Special Bid, and the Specialist Block Purchase—are merely the converse of the last three distribution special procedures.

When a member desires to use a special procedure to effect a block purchase or sale, prior approval of the Exchange must be sought. The Exchange usually acts within minutes on the request.[30] Several

[26] NYSE Rule 393, ¶ 2393. Not to be confused with a secondary distribution pursuant to the Securities Act of 1933.

[27] NYSE Rule 392, ¶ 2392. Of interest is an ad in *Wall Street Journal*, Nov. 12, 1964, p. 18.

[28] NYSE Rule 391, ¶ 2391.

[29] NYSE Rule 107, ¶ 2107.

[30] NYSE, INSTITUTIONAL SHAREOWNERSHIP 40 (1964). Chart includes summary of all special procedures with special important features of each.

factors are considered by the Exchange, all involving the ability of the auction market to support or absorb the block within a reasonable period of time.[31]

The extent to which the special methods have remedied the problem is questionable.[32] Meanwhile, the Third Market continues to thrive. The obvious conclusion is that the special methods do not solve completely the inadequacies of the present NYSE structure.

2. *Commissions* The Exchange has yet to budge on its commission rates. Normally the Exchange justifies its commission rates in terms of services rendered to customers over and above the execution and clearance of orders. But the institution has little need for such services as research, investment advice, and "street" accounts.[33] The investment decisions of institutions are made by professionals within the organization, using for the most part their own research facilities. In most cases, the member broker-dealer is needed solely to complete the execution and transfer.

In order to compensate the institutional or block investor, Exchange members offer them so-called "special" services. These include private wire installations to the member's office, special elaborate research, or management services to mutual funds.[34] One member firm has a ten-man "institutional desk" to keep in touch with institutions and to service their orders.[35]

Another practice that softens the rigid commission structure is the "give up" or directed split of commissions.[36] An important customer can direct a member to give up part of his commission on a transaction to another member. The customer still pays the full commission but, in doing so, he is able to reciprocate for services rendered by another member. The "give-up" is used most by mutual funds that

[31] See, *e.g.*, NYSE Rule 392, ¶ 2392. Use of special methods is approved after consideration of the factors listed. In the case of specialist's transactions, the further consideration is the specialist's position in the stock. NYSE Rule 107, ¶ 2107.10.

[32] In 1961, special trading procedures accounted for under 2% of the total Exchange volume. None of the special acquisition methods were used. In 1963, only secondary distribution (15.8 million shares) and Exchange distributions (sixty-eight transactions for 2.7 million shares) were utilized. In the fourth quarter of 1965, there were thirty-one secondary distributions (4.6 million shares) and fourteen Exchange distributions (.67 million shares). *Special Study* pt. 2, at 845; NYSE, INSTITUTIONAL SHAREOWNERSHIP 39 (1964); SEC *Statistical Bulletin*, Feb. 1966, at 11.

[33] ROBERTS, THE STOCK MARKET 42. A "street" account is where the member keeps the certificates for the customer. He also relays all corporate mailings, proxies, dividends, etc. to the customer.

[34] *Special Study* pt. 2, at 313.

[35] Wall Street Journal, Jan. 25, 1965, p. 1, col. 8.

[36] *Special Study* pt. 2, at 316-318.

want to compensate members for selling the mutual fund shares to the public or for performing other services for which they might not otherwise be compensated.

B. *Primary Auction Market Or The Total Market*

Exchange developments as described above have made questionable contributions toward resolving the conflict between the Third Market and the NYSE. If anything, continued growth of the Third Market has brought the ultimate issue to light. What is called for is an assessment of the role of the NYSE in light of the recent growth of institutions and the public interest. It must be determined whether public interest is better served by increased competition between securities markets or by arbitrary preservation of the primary auction market. The institutions with the potential to resolve this conflict are the NYSE, the courts, and the SEC.

1. *The NYSE* The NYSE has been called both a private club and a public institution (although seldom by the same source). The former is appropriate to the extent that Exchange members are anxious to preserve the value of their membership,[37] but it is cynical indeed to attribute the NYSE point of view entirely to member self-interest. Such an approach would render the statutory scheme of self-regulation a travesty.

The Securities Exchange Act of 1934[38] created the SEC and em-

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[37] Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROB. 663, 667-74, 690 (1964).

[38] Securities Exchange Act, 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-hh (1964). [Hereinafter referred to as Securities Exchange Act with section number.] Pertinent sections and parts thereof as follows:

> Section 6(b): No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered inconsistent with just and equitable principles of trade.
>
> Section 6(d): If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national exchange.
>
> Section 19(b): The Commission is further 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 changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to

powered it to register national securities exchanges and to regulate and oversee their affairs.[39] The act is unique in that it contemplates self-regulation by these exchanges through their own rules and regulations,[40] which must only meet the standard: "just and adequate to insure fair dealing and to protect investors."[41] It is clear from the position of its president that the NYSE conceives the primary auction market (without the dilution from the Third Market) to be the mechanism that can best insure fair dealing and the protection of the investor.[42] Most Exchange rules are geared to preserve this mechanism, and, to this end, many of them are distinctly anticompetitive in their effects. Indeed, absent the Securities Exchange Act, they would constitute *per se* violations of the antitrust laws.[43] The disadvantage of anticompetitive aspects within the structure of the NYSE is usually outweighed by the efficient operation of the Exchange market; however, now that increased competition among securities markets is urged, the NYSE conception of "public interest" as embodied in its structure and rules, is seriously challenged.

The NYSE membership apparently stands squarely behind its president in favor of the preservation of the present market conditions. If changes are to be made, it is unlikely that they will be initiated by the NYSE.

2. *The Courts*[44] Some individuals have taken it upon themselves to resolve this conflict in the courts. In *Silver v. NYSE*, the Supreme Court held that the Securities Exchange Act did not exempt the NYSE from the antitrust laws.[45] Stating that antitrust laws must

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> 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 affect such changes) in respect of such matters as . . . (5) the manner, method, and place of soliciting business; . . . (9) the fixing of reasonable rates of commission, interest, listing, and other charges; . . . and (13) similar matters.

[39] Securities Exchange Act § 4 established the SEC; sections 6(b) and 6(d) (see note 38 *supra*) provide the standards of registration in terms of the exchange rules and regulations required; section 19(b) empowers the SEC to scrutinize the exchange rules and regulations after they are registered.

[40] Securities Exchange Act § 6(b).

[41] Securities Exchange Act § 6(d).

[42] See text accompanying note 25 *supra*.

[43] Silver v. NYSE, 373 U.S. 341 (1963). The antitrust laws are Sherman Antitrust Act, 26 Stat. 209 (1890), as amended, 15 U.S.C. §§ 1-7 (1964); Clayton Antitrust Act, 38 Stat. 730 (1914), as amended, 15 U.S.C. §§ 12-27 (1964). For a complete analysis in this Symposium see Johnson, *Application of Antitrust Laws to the Securities Industry*, 20 Sw. L.J. 536, 557-73 (1966).

[44] See also in this Symposium Johnson, *Application of Antitrust Laws to the Securities Industry*, 20 Sw. L.J. 536 (1966); Nerenberg, *Applicability of the Antitrust Laws to the Securities Field*, 16 W. RES. L. REV. 131 (1964); Comment, *Antitrust and the Stock Exchange: Minimum Commission or Free Competition?*, 18 STAN. L. REV. 213 (1965).

[45] 373 U.S. 341 (1963).

normally prevail when in direct conflict with the act, the Court admitted, however, that most rules of the NYSE, coupled with Commission power to effect changes therein,[46] are proper incidents of the duty of self-regulation.[47] In *Kaplan v. Lehman Bros.*[48] federal District Judge Hoffman expanded this latter expression that Exchange rules are not illegal *per se*. Refusing to grant relief, the judge noted that commission rates must be tested in terms of reasonableness, a task which he deferred to the administrative expertise of the SEC.[49] Similar suits, now pending,[50] will decide the effect of *Kaplan* on the main thrust of *Silver*. Hopefully, courts will recognize the infinite complexities of coordinating securities regulations and antitrust policies[51] and will follow the example of Judge Hoffman.

3. *The Securities and Exchange Commission* The Chairman of the SEC, Manuel F. Cohen, has urged that it is the role of the SEC, with judicial and congressional oversight, to set the course of the securities markets within the framework of the Securities Exchange Act.[52] The act imposes a duty on the NYSE to make vigorous, concerted efforts to maintain a "fair and orderly" market. In fact, the 1943 case of *Baird v. Franklin* held that failure by the Exchange to enforce properly its rules adopted under section 6(b) of the act could subject the Exchange to civil liability.[53]

In *Colonial Realty Corp. v. Bache & Co.*,[54] decided recently by the Second Circuit, the plaintiff, a nonmember, alleged that the failure by a member of the NYSE to abide by the rules of the Exchange gave rise to a private cause of action against the member. The Second Circuit refused relief but did not reject the plaintiff's proposition altogether. Instead it suggested that he must show by a heavy burden of persuasion that the violation of the particular rule raises a federal claim inferred through the act.[55] The court's analysis, granting the possibility

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[46] Securities Exchange Act § 19(b). See note 38 *supra*.
[47] 373 U.S. 341, 356 (1963).
[48] Kaplan v. Lehman Bros., CCH FED. SEC. L. REP. ¶ 91, 631 (N.D. Ill. 1966).
[49] *Ibid.*
[50] Thill Sec. Corp. v. NYSE, Civil No. 63-C-264, E. D. Wisc., Oct. 1962. See also New York Times, March 25, 1965, p. 1, col. 3.
[51] See Silver v. NYSE, 373 U.S. 341, 357 (1963).
[52] Letter from Manuel F. Cohen to Sen. A. Willis Robertson, July 30, 1965; reprinted in 3 CCH NYSE Guide ¶ 5273.
[53] Baird v. Franklin, 141 F.2d 238 (1943), *cert. denied*, 328 U.S. 737 (1944). The court agreed that the Exchange had violated its duty under Securities Exchange Act § 6(b) and could thus be liable to petitioners. But the majority held that damages had not been traced to petitioner. 141 F.2d 238, 239. (dissenting opinion at 240).
[54] 358 F.2d 178 (2d Cir. 1966).
[55] *Id.* at 182.

for a nonmember to sue a member for violation of an Exchange rule, implies the elevation of NYSE rules to the stature of SEC rules—federal regulatory rules. Such implication lends further persuasion to the view that scrutiny of those rules should be left to the SEC.

Section 19(b) provides the mechanism through which the SEC can insure that the rules and regulations of the Exchange are consistent with public interest.[56] Since the enactment of the Securities Exchange Act in 1934, the SEC has had only one occasion to use the full measure of its authority and rewrite an Exchange rule.[57] In 1941 the SEC ordered revision of a constitutional provision of the Exchange which prohibited members from dealing in dually-traded stocks (traded on both the NYSE and one or more regional exchanges) on regional exchanges for their own accounts.[58] Balancing the interests of the NYSE in the protection of its commission rates against the need for protection of competition (through regional exchanges), the SEC looked to the latter as more compelling. The SEC framed its decision in antitrust terms:

> . . . enforcement of the Rule would violate one of the basic purposes of regulation under the Act, a purpose which is closely related to the public policy regarding unreasonable restraints and the maintenance of fair competition as declared by congress in the Sherman Act, the Clayton Act and the Federal Trade Commission Act.[59]

Although the Commission was not confronted with a situation in which the primary auction market was challenged by a different mechanism entirely (as is the case with the Third Market), the propriety of the present challenge must likewise be tested in terms of consistency with long-range public interest.

The SEC, in its *Special Study*, came to the cautious but not unequivocal conclusion that the structure of the NYSE is indeed not adequately responsive to the public interest. The study carefully hedged its conclusion in two respects, both valid. First, it recognized the delicate balance that exists in the securities market. Therefore, secondly, it called for more study and close observation of the fundamental market patterns and changes.[60]

It seems logical that if the theory upon which the Exchange operates is defective, the proper means to correct that theory is not through court "pot shots" at particular rules but through SEC deter-

[56] See note 38 *supra*.
[57] Rules of the NYSE, 10 SEC 270 (1941).
[58] Former NYSE Const. art. XVI, § 8 (present art. XIV, § 8, ¶ 1080).
[59] 10 S.E.C. 270, 287 (1941).
[60] *Special Study* pt. 2, at 961.

mination that in the public interest market competition should be emphasized more, on balance, than the primary auction market.*

III. The Aftermath

A. *The Third Market*

Although the SEC undoubtedly intends to regulate the Third Market, it cannot regulate in a vacuum and "the inherent differences between the off-board market and exchange markets preclude their being placed in the same mold."[61] Indeed, the market makers, themselves, want to be regulated. As one leading market maker put it: "We would like to see a fence built around this market—high enough to keep out people who do not qualify to get over it. We want the third market to have dignity and a substance."[62] But it is predictable that the future regulations will involve more than merely building a fence around the market. NYSE President Funston, who criticized the SEC for failing to act immediately, has called for a comprehensive plan of regulation equivalent to that under which the Exchange now operates.[63] He has suggested a scheme that would include: periodic reports to the SEC and the public; trading regulations closely akin to those on the NYSE; detailed records of every transaction; joint surveillance by the NASD and the SEC; and prompt notification to the SEC by market makers before the start (or cessation) of trading in a stock, with the reasons therefor.[64] Funston has also urged that the Third Market be regulated to minimize the potential for abuse and manipulation that could infect even his own NYSE.[65]

The SEC has not stood still since the report of the *Special Study*. The study expressed concern about the dearth of available information on the Third Market. It called for the institution of reporting requirements aimed at identification of the participants, particularly the market makers, and at the reporting of all significant over-the-counter trading of listed securities.[66] In December, 1964, the SEC

* Editor's note: Mr. Johnson in his article in the Symposium evidently prefers "pot shots." For comparison, see Johnson, note 45 *supra*, at 557-73.

[61] *Id.* at 908-09; Wall Street Journal, Oct. 15, 1964, p. 4, col. 3.

[62] Weeden, *The Third Market*, in Duke Conference on Securities Regulation 167 (Mundheim ed. 1964).

[63] Wall Street Journal, Oct. 15, 1964, p. 4, col. 3.

[64] *Ibid.*

[65] See United States v. Dardi, 330 F.2d 316 (2d Cir. 1964). In this case defendants used the Third Market for a "boiler room" operation to sell 500,000 shares of unregistered stock in a NYSE listed company. Through fraudulent pegging devices, defendants were able to dump their stock on the market without deflating the NYSE price. Funston told the SEC that Third Market regulation should minimize the threat of abuse of the trading markets that instances like this can represent. Wall Street Journal, Oct. 15, 1964, p. 4, col. 3.

[66] *Special Study* pt. 2, at 190-911.

adopted rule 17a-9[67] to implement the suggestions of the study. The rule requires filing of three forms by broker-dealers trading in the Third Market, which will enable the SEC to determine how multiple the markets actually are in given stocks, the extent to which the market makers look to the exchange for their own inventory, and the extent to which the Third Market is used to effect block transactions between two public customers. These new reporting requirements cannot be termed regulation of this market. The purpose of the requirements is to "enable the Commission to evaluate the need for more detailed reporting and further regulation of this market."[68]

Another step in the groundwork is the announced intention of the Commisison to conduct periodic transaction studies.[69] These studies, coupled with the information received through the reports, should bring the Third Market into better focus. But it will probably be another year or so before any further developments take place.

B. *The New York Stock Exchange*

As NYSE's Funston keeps the heat on the SEC, it is, in turn, studying the Exchange and subjecting it to scrutiny, the results of which could be far reaching. Specifically, the Commission has been studying Exchange rule 394 which prohibits off-floor trading by members.[70] This rule, as much as any, preserves the mechanism of the primary auction market that, due to the competitive pricing often available in the Third Market, might otherwise be thinned. It appears that, if the Commission's attitude has not changed since the *Special Study*, off-floor trading restrictions would be inimical to intermarket competition. Recently a nonmember broker-dealer has claimed that rule 394 prevents member broker-dealers from obtaining the best price for their customers and has requested that the SEC hold public hearings on the rule.[71]

Indeed the fact that the Commission has been investigating rule 394 for over a year is testimony not to bureaucracy but to the complexities underlying any revision of the rule. For example, assume the SEC ordered the rule dropped completely. The effect on the primary auction market would certainly be profound. Given the present commission structure and the existence of the Third Market, it is foreseeable that members would often turn from the Exchange to

[67] 17 C.F.R. § 240. 17a-9 (1964) adopted SEC Securities Exchange Act Release No. 7474, Dec. 1, 1964.

[68] SEC Securities Exchange Act Release No. 7474, Dec. 1, 1964.

[69] 31 SEC *Ann. Rep.* 18 (1965).

[70] 2 CCH NYSE Guide ¶ 2394; Address by Manuel F. Cohen, cited note 11 *supra;* Wall Street Journal, March 17, 1966, p. 4, col. 1; April 26, 1965, p. 6, col. 3.

[71] Wall Street Journal, March 17, 1966, p. 4, col. 1.

do their trading in order to avoid the commission and compete with the Third Market. One writer stated it rather melodramatically:

> The central market place might lose its depth, perhaps to the point where it would no longer be the central market place. If that happened, what would be the purpose of having an Exchange at all? If there no longer were a liquid market where the investor could readily and conveniently sell his shares, the investor wouldn't be the only loser. The whole capital-raising process would be impeded, with unknowing repercussions on the national economy.[72]

It is unlikely that the above greatly overstates the position of the NYSE. Rule 394 will doubtless get close scrutiny in the days to come. Before a change is effected, the SEC will surely want to understand better the Third Market so that it can forsee the effects of a change and, more important, take the necessary regulatory steps to protect the public interest.

While the *Special Study* did not deal specifically with rule 394, it did devote considerable attention to the commission rate problem.[73] After acknowledging the SEC's authority and responsibility for review of commission rates pursuant to section 19-b, the study underscored familiar objections to the existing rate structure—namely that nonmember professionals get no special rates or rebates and that volume discounts are not available for block transactions.[74]

In 1955 and 1958 the Exchange had considered proposals for splitting commissions with nonmember professionals, but each time the idea was rejected. The feeling of the Exchange was that nonmembers who wanteed to participate in Exchange business and enjoy the commissions "should join the membership, submit to Exchange regulations and contribute directly to the Exchange marketplace."[75] Implicit in this point of view is the philosophy of the primary auction market (or maybe the protection of the "private club"). Predictably, the SEC in its study was not sympathetic to the Exchange's position. The study concluded that the Exchange should join with the SEC to explore possibilities of creating a more favorable rate situation for nonmember professionals, being mindful of the public interest particularly with regard to competition, market depth, and reciprocity.[76] The volume discount problem was resolved with a similar SEC recommendation—study by the SEC in conjunction with those affected

[72] ROBERTS, THE STOCK MARKET 49-50.

[73] *Special Study* pt. 2, at 294-351. The problem is consistently referred to in part 2.

[74] *Special Study* pt. 2, at 350. See notes 8, 9, and accompanying text.

[75] *Special Study* pt. 2, at 311 quoting from a supplementary report of NYSE, *Special Committee on Member Firm Costs and Revenues* in 1958.

[76] *Id.* at 350.

by the problem.[77] The Exchange membership is once again reportedly considering new commission rates including volume discounts.[78] It remains to be seen whether it will enact the discounts on its own or whether the SEC will impose changes. One thing appears fairly certain—some changes will be made. But the *Special Study* repeatedly cautioned that any changes to afford preferential Exchange treatment to nonmembers or volume discounts to block traders should be effected only after careful consideration of the impact of such changes on multiple trading.[79]

It is conceivable that a NYSE house cleaning could cure the deficiences upon which the Third Market has thrived. If this were the case, the Third Market could eventually dissipate as a result of the same competitive forces through which it grew. This development appeared doubtful to the study but the possibility was eloquently alluded to:

> Only a withering of the needs which have given rise to the third market can justify the "elimination" of that market. . . . In the competition of markets for trading of securities, it is surely not too much either to retain and capture the largest possible trading volume or to believe that, absent unreasonable discriminations and within the necessary bounds of investor safeguards and the public interest, the best markets will be those whose performance in that interest sanctions their claim to existence.[80]

IV. Conclusion

The structure of the NYSE embodies the philosophy of the primary auction market. The NYSE, in implementing that philosophy, apparently has not adequately responded to the needs of the institutional investor. This unbending shortsightedness is haunting the Exchange today. The concept of primary auction market is apparently being replaced by the philosophy of multiple trading—the "total market."

The SEC has displayed that it is becoming increasingly aware of the existence of the Third Market, and it may be surmised that it is carefully laying the groundwork for needed regulation. Fortunately, the SEC is moving very cautiously in dealing with the problems of the primary auction market which have given rise to the

[77] *Ibid.*

[78] Wall Street Journal, Dec. 29, 1964, p. 3, col. 2; Jan. 25, 1965, p. 1, col. 8.

[79] *Special Study* pt. 2, at 951. The study was referring specifically to the potential impact on regional exchanges. But the Third Market will also be affected by any Exchange commission adjustments. Indeed the commission structure seems to be the main factor that separates the two.

[80] *Special Study* pt. 2, at 909.

development of the Third Market. To date, the courts and Congress have stayed properly on the sidelines. As it ponders the fate of the primary auction market, the SEC should pay heed to Exchange president Funston's warning that the public needs a market place, not merely a quotation board for keeping score.[81]

[81] See note 25 *supra*.