Michigan Law Review

Volume 62 | Issue 4

1964

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Recommended Citation
Philip A. Loomis Jr. & Eugene H. Rotberg, *Over-the-Counter Market Quotations*, 62 MICH. L. REV. 589 (1964).
Available at: https://repository.law.umich.edu/mlr/vol62/iss4/4

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OVER-THE-COUNTER MARKET QUOTATIONS†

*Philip A. Loomis, Jr.** and *Eugene H. Rotberg***

CHAPTER VII of the *Report of Special Study of Securities Markets of the Securities and Exchange Commission*[1] focused attention upon the little understood and often perplexing problems presented by the quotations for over-the-counter stocks which appear regularly in the newspapers—the so-called retail quotations system. The *Report* was quite critical of the existing retail quotations system, concluding that it was inconsistent with the general philosophy of full disclosure elsewhere applied in the administration of the federal securities laws and, in fact, operated "to conceal what elsewhere in the securities business is considered essential to be disclosed."[2] While there does not appear to be unanimity in the securities industry with respect to the efficacy of the sytem, it is vigorously defended by its supporters as important, if not essential, to the business survival of smaller over-the-counter dealers and to the liquidity of the markets in many securities. It seems clear, therefore, that the problem warrants the attention which it will undoubtedly receive, both from the National Association of Securities Dealers (NASD) and from the Securities and Exchange Commission.

The retail quotations system reflects to some degree the underlying mechanics of the over-the-counter market, which are in many respects quite different from those of an exchange market; consequently, some general background concerning such mechanics appears appropriate.

INTER-DEALER MARKETS

In the over-the-counter market there is no central location where all public or professional buyers and sellers communicate their interest in the purchase or sale of securities. Markets are

† This article carries a date of authorship of November 4, 1963. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its members or employees. Therefore, the views expressed here are the authors' own and do not necessarily reflect the views of the Commission or its staff.

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1 H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as *Special Study*].

2 *Special Study* pt. 2, at 674.

made by and between broker-dealers who communicate quotations representing the prices at which they wish to deal for their own account in particular securities. These broker-dealers, commonly referred to as market makers, quote "bid" and "asked" prices and hope to profit from the difference between the "bid," the price at which they are willing to purchase a security, and the "asked," the price at which they are willing to sell the security. The market maker essentially performs a passive role in trading for his own account in response to incoming inquiries of buyers and sellers. To the extent that he purchases or sells on balance in transactions with other broker-dealers (who may be acting for themselves or for public customers), he adds depth to the market and performs a function somewhat similar to that of a specialist on a national securities exchange. Each market maker quoting prices in a particular security also, in a sense, functions as a minature exchange providing a situs for the collection of buy and sell orders. The analogy, however, cannot be drawn too far, for on an exchange the orders of buyers and sellers can be, and often are, executed on the floor of the exchange without professional intervention. By contrast, in the over-the-counter market, although the market maker provides a situs for collection of orders and their execution, the orders funnelled to him do not cross. Instead, the market maker is compensated by trading for his own account and profiting by the difference between the price paid by buyers and that received by sellers—the spread or so-called jobbers turn.[8] There are sometimes as many as thirty market makers, or as few as one, simultaneously quoting a market to those who are interested in a particular security. The number of competing market makers usually depends on the volume of transactions and the related possibility of profit from a high turnover of purchases and sales. Each of the competitors, through variations in his quotations, attempts to attract buying and/or selling interest.

Competing market makers do not transmit their quotations or the prices of execution of particular transactions into a central location. Instead, they advertise their markets through a facile and inexpensive voice and printed telegraph wire network which links them to other broker-dealers and perhaps to institutional clients throughout the country. Open-end telephones and private

[8] It should be recognized, of course, that the maintenance of a spread does not assure profit since the depreciation in market value of an accumulated inventory may and often does seriously impair the financial benefits derived from the spread. Also a dealer may not be able to buy at his bid and sell at his asked.

teletype wires, which permit almost instant communication, feed out from the offices of major market makers in financial centers to blanket the country and advise the financial community of the quotations in securities traded over-the-counter. The greater the number of communication links controlled or used by a particular market maker, the greater the chance that he will be a dominant factor in the market in terms of the volume of business done, compared to competitors quoting the same security.

The information transmitted on the communication network is not public. The system is bilateral and basically inter-dealer; *i.e.*, communication is generally private between the parties, both of whom usually are professionals, one a market maker—the other a broker-dealer acting for a member of the public or on his own behalf.[4] Because the system is bilateral and private rather than public and open, a broker-dealer wishing to execute a public customer's order with a market maker must check a number of lines of communication with competing market makers in order to obtain the best market. In an exchange market such checking is unnecessary, since the market on the floor of the exchange is, by definition, the best market made both on the bid and offer side by the various professional and public participants. Their bids and offers, in effect, are aggregated and the best of these hold the floor of the exchange as "the market."

In addition to teletype and voice communication, broker-dealers in the over-the-counter market submit their quotations at a particular point in the day to the National Quotation Bureau, a private organization which disseminates the quotations on the following morning for the use of the financial community. The National Quotation Bureau "sheets" generally are not publicly available. They identify the security, the name of each market maker inserting a quotation, his telephone number and his bid and asked quotation. This information is available for approximately 8,000 securities on a daily basis. The quotations are supposed to represent the precise quotation at which an inserting dealer was willing and able to execute transactions at the time of the submission of its quotation. Although these quotations are "stale" when disseminated, they provide a rough guide to the approximate market price of the security on the preceding day.[5]

[4] Large institutional or sophisticated customers may have access to the market place and trade directly with the market maker at his quoted prices rather than executing the order with or through other broker-dealers.

[5] For a detailed discussion of the mechanics involved in the receipt and dissemination

It should be emphasized that the quotations of market makers are disseminated upon inquiry from others. They are not continuously reported, even privately, but rather are continuously *available* to the broker-dealer community if requested. In active stocks, because of the steady flow of requests for markets, quotations may emanate from the market makers on a more or less continual basis to all inquirers; any specific inquirer for a quotation, however, must recheck the market if it does not execute immediately, because industry custom and practice considers a quotation good only during the period of actual communication.

Market makers communicate with each other in order to determine whether their markets are consistent with those of their competitors. This may be of primary importance if a market maker wishes to follow the market made by others, and does not wish to be non-competitive on either the bid or asked side of the market. It is necessary to check the markets of competitors since the flow of information concerning demand and supply may be concentrated in certain firms whose quotations will reflect that information.[6]

Although market makers generally expect to receive incoming calls and hope to profit by the spread between their bid and asked, sometimes the incoming callers will negotiate with market makers. They may be able to purchase securities at slightly less than the offer and/or perhaps sell securities at slightly higher than the quoted bid. Normally, a market maker who wishes to accumulate securities will raise his bid and/or negotiate more readily in order to attract orders to himself and away from competing market makers.[7] Conversely, if he wishes to sell securities, he often will lower his offer below that of competing market makers and thereby hope to attract inquiries from other broker-dealers who wish to purchase securities for themselves or for public customers. By shifting the bid and offer, broker-dealers, therefore, attempt to increase, decrease, or stabilize their inventories through encourage-

of inter-dealer quotations, and the role of the National Quotation Bureau, see *Special Study* pt. 2, at 595-609.

6 While competition tends to keep the various over-the-counter "markets" in line with each other (assuming a lack of diversity in the evaluation of the market and the needs of the various market makers), it is entirely possible for variations to occur in the prices at which simultaneous transactions in particular securities are executed by different market makers simply because of the limitations of the communication network.

7 On occasion, however, the lines of communication made available by a particular firm to the financial community may be sufficiently hardened by both custom and business relationships that the quotation of better markets under certain circumstances may not be effective to attract the orders of broker-dealers accustomed to doing business elsewhere.

ing or discouraging the orders of broker-dealers who are seeking the best market. Quotations, of course, are not merely the passive indicators of demand and supply. Quotations also represent the evaluation by the market maker of the potential or lack of it for the security (and the related advisability of decreasing, maintaining, or increasing an inventory position) and, of course, represent the market maker's own financial resources and his reasons for making a market.

The quotations, therefore, which are disseminated by voice and printed wire, or through the facilities of the National Quotation Bureau, are the market; they reflect the incoming buy and sell orders on the market and the professional's evaluation of those orders and his own needs.

Certain salient differences between the over-the-counter market and the exchange market relevant to the quotations problem become immediately apparent. Of these, the most significant is the fact that no information is available to the public or even to the dealer community concerning the range of prices at which transactions occur, the average prices, or other data which would require compilation or extraction from the total universe of all executed transactions. Nor are there any reports of the volume of transactions in any security, either in the aggregate or by a particular dealer during any given period. In the exchange market, of course, such information is reported from second to second over the ticker tape; the opening, high, low and closing prices, and the volumes are published in the newspapers every day. Another obvious and related difference is simply that, in the over-the-counter market, unlike the exchange market, there is no central focus comparable to the specialist's post on the exchange floor at which substantially all transactions in a particular security occur. Under such circumstances, the over-the-counter investor relies upon a quotation, not upon a report of an actual transaction in the market place for the price of an over-the-counter security.

RETAIL QUOTATIONS

The principal source of retail quotations is the daily newspapers throughout the country. Some newspapers publish quotations daily for securities traded primarily in a local area; others publish quotations for securities traded in wider geographical or regional areas; others, such as major New York daily newspapers, publish the quotations for securities traded on a national

basis.[8] There are also lists on a regional or national basis published weekly by newspapers throughout the country.

The decisions concerning which securities are suitable for public dissemination of quotations are controlled by the NASD which has assumed responsibility for the administration and publication of quotations through public news media. The NASD imposes various minimum requirements in terms of the number and value of shares outstanding, the market price for the security, the number of shareholders, the extent of dealer interest, etc., which are required of securities traded in the over-the-counter market for dissemination in national, regional, and daily or weekly lists. Generally the requirements are more stringent with respect to the national list securities quoted on a daily basis than are the requirements for regional and/or weekly lists.[9]

Bid and asked quotations are submitted by broker-dealers who are designated by the NASD to provide quotations for specified stocks. The designated broker-dealer sometimes has a substantial interest in the security and always knows that the quotation will be used for public dissemination. The designated broker-dealer, however, need not necessarily be "making a market" or have any interest in the security, nor must he necessarily have transactions with the public or anyone else in the security. Basically, an attempt is made to equalize the burden of submitting quotations and to accede to preferences of dealers who may have an interest in wide publication of the quotation of a particular security. The designated broker-dealer assesses the market for the security at two points in time during the day as the market is made by those professional market makers who are responding to the demand for and the supply of the security. The quotation submitted to the NASD may be his own quotation, a representative quotation, or the best market for the security.[10] The bid, the price a professional market maker is willing to buy and the offer, the price

8 There are approximately 1,000 securities quoted in newspapers which are traded on a local basis and which are not quoted in regional or national lists. There are approximately 600 securities traded on regional lists (Pacific, Eastern, Midwest, Southwest) and 800 securities on the national list. The *Wall Street Journal* currently combines the regional and national lists on a single list without separate identification into national or regional categories.

9 *Special Study* pt. 2, at 630-34.

10 The Study found the quotations supplied by the designated dealers were often not the best market obtainable, *i.e.*, did not represent the highest bid and/or lowest offer and in a significant number of instances were not as good as the median bids and offers being quoted by the various competing market makers who were advertising their markets for the security. *Id.* at 636-37.

at which it is willing to sell, are transmitted to the newspapers by or under the supervision of the NASD after receipt from the designated broker-dealer.[11] Prior to the submission of the quotation to the newspapers, however, the NASD adjusts the offer side of the market upward for actual publication. The adjustment of the quotation prior to publication does not result from any inadequacies in the mechanics of the market; rather, it represents a decision by the NASD to increase the offer by a fixed amount ranging from approximately 2 percent to 5 percent, depending on the price level of the security. Securities traded in the market up to 25 dollars are increased by adding about 5 percent to the offer, *e.g.*, a security quoted in the market place at 20 bid-21 offered is adjusted to 20 bid-22 offered for publication; those selling between 25 and 70 dollars are increased by 3.6 to 5 percent; 70 and 100 dollars, from 2.5 to 3.6 percent; those selling between 100 and 135 dollars, from 2 to 2.5 percent; those over 135 dollars, by approximately 2 percent.[12] The adjustment, therefore, has the effect of increasing the spread between the bid and offer.[13]

The upward adjustment, in effect, permits a broker-dealer who executes a public order on a principal basis to charge a service fee which might vary considerably from the fee charged by others. For example, if the market for a security were 60 bid-60 1/2 offer (a relatively narrow dealer market usually reflecting competition and activity) the newspaper report after adjustment would be 60 bid-63 1/8 offer. A broker-dealer ordinarily would purchase the security for a public customer at the time of compilation for 60 1/2 from a market maker. He might then charge a disclosed New York Stock Exchange commission (45 dollars for a round lot transaction) for the service performed as agent for the customer. Alternatively, the broker-dealer could execute the

[11] The quotation supplied the NASD by the designated dealer does not represent a range of transaction prices over a period of time, nor does the difference between the bid and offer supplied by the designated dealer represent the high and low of actual quotations during a period of time by all market makers or any particular market maker. Rather, it is a bid and offer of an unidentified dealer, as it was being made at a fixed but also unidentified point in time. This situation, however inadequate it may appear, compared to the flow of information concerning prices on an exchange, may be accounted for by the mechanics of the market which does not now provide facilities for a continuous reporting of transactions or quotations.

[12] *Special Study* pt. 2, at 634-35.

[13] The fact that the spread is widened for publication does not affect the market or jobbers turn of the dealers making markets. They continue to quote prices and execute transactions at or about the preadjusted quotations, hoping to buy at their bid and sell at their offer.

transaction in the principal form[14] by purchasing the security *for its own account* at 60 1/2 and immediately reselling it to the customer at a higher net price in a so-called "riskless" transaction. Under such circumstances the dealer need not disclose the differential between its market cost and cost to customer. Since the newspaper quotation has been adjusted upwards, in such situations the dealer often charges the published offer price, which on a 100-share transaction would represent a 262 dollar service fee, or approximately six times the New York Stock Exchange commission for the same transaction.[15] The investor cannot determine that he was charged a 262-dollar service fee, because the confirmation rules under the Exchange Act[16] do not require disclosure of such information on principal transactions (even though functionally they may be indistinguishable from an agency transaction), and because the retail quotation system allows for the reporting of a quotation as if it were the underlying market quotation for the security. Some customers apparently are gratified to learn upon receipt of the confirmation that they have purchased the security at a net price, without payment of a commission!

Newspapers usually report in a masthead preceding over-the-counter quotations that the prices quoted are only a guide to the range within which the securities could have been sold. While such explanatory legend may be considered accurate if the word "guide" is emphasized and given a liberal meaning, it is suggested

14 While theoretically the capacity of principal or agent is a matter for negotiation and/or the relationship between the parties, as a practical and customary business matter, the broker-dealer firm usually makes a unilateral decision as to capacity and typically does not base that decision on an evaluation of common-law doctrines of principal and agent. In this connection the Special Study reported the following colloquy:

Q. Would you explain those circumstances in which a salesman would decide . . . to be principal and in which he would decide to be agent?
A. How he would make that decision?
Q. Yes. Is there a firm policy on this?
A. No; there is no firm policy on it.
Q. Well, is there a firm standard operating procedure?
A. It is dictated somewhat by the salesman. In other words, he acts as principal.
Q. Would he make more money out of it?
A. In most cases, as a principal; yes.

Special Study pt. 2, at 615.

15 The *Report* found approximately 25% of all retail sales to the public in a randomly selected group of 78 securities which were quoted in the *Wall Street Journal*, which traded on January 18, 1962, were sold at the retail offer or higher. The average markup for riskless principal transactions was approximately 4% over cost. The Study also noted that for a sample of 200 securities traded on January 18, 1962, the average price paid by customers on agency transactions was lower in 87% of the securities than the average net price paid by customers in purchases on a principal basis in riskless transactions.

16 Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. § 78 (1958 & Supp. IV, 1963) [hereinafter cited as Exchange Act].

that the use of the expresssion "range" may be misleading in the absence of disclosure that the range represents not market movement, or high-low, but rather the fact that different executing broker-dealers charge a range of prices for the service of execution, and that the offer side of the market represents, for the average priced security, the maximum which could be charged under the NASD's markup policy.[17]

This adjustment in the asked quotation prior to publication is the crux of the controversy over the retail quotations system. It is attacked and defended vigorously both on the level of principle and upon the grounds of practical conduct and business needs. The avowed purpose of the adjustment is to assist retail dealers in selling securities as principal,[18] and particularly to facilitate so-called "riskless" transactions—that is, transactions by which a dealer, after receiving a customer's buy order, purchases the security from a market maker at the inside asked price and immediately resells it to the customer at an undisclosed markup over that asked price. The *Report* thought it improper to adjust prices included in an allegedly objective and accurate quotations system, simply to facilitate selling by enabling dealers to refrain from disclosing the service fee that they were charging.

The usual defense of the system based on principle is to the effect that this adjustment approximates the actual retail market, since many dealers normally charge such a markup over the wholesale price, and that, since other merchants are not required to disclose wholesale prices and markups, securities dealers should not be required to do so. The difficulty with this argument is the fact that a cardinal principle of security regulation, particularly at the federal level, is to require disclosure of material facts. Actual markets and service costs appear to be material facts. In addition, it is the practice, not only in the exchange market for securities, but in most other public markets which are characterized by rapidly changing prices, to disclose the actual professional market price or quotation. This is true, for example, of the commodities markets and of the money markets. Furthermore, quite apart from the fact that selling securities is not analogous (in the

17 This is not to say that a more accurate masthead could cure the problem. The Commission noted in 1942 in connection with a basically similar system: "In fact, we have grave doubts if any statement in the masthead or elsewhere can cure the basically misleading character of these quotations. After careful consideration of the method of their compilation, we are at a loss to say what they represent affirmatively. . . ." Sherman Gleason & Co., 15 S.E.C. 639, 653 (1944).

18 NASD, *Review of NASD Markup Policy*, NASD Manual G-51 (1961).

scheme of government regulation) to selling automobiles or washing machines, there is a fundamental and functional economic reason for treating transactions in securities differently from transactions in consumer goods. The public purchaser of consumer goods at the retail level can easily check markets, and then purchase from the lowest seller. Since the underlying "wholesale" market for such goods does not change during the period of "shopping," it is not material to the buyer that he does not know the wholesale market price—the price paid by the merchant. In the securities markets, however, the underlying market price established by the professsionals is constantly changing, thereby making it almost impossible to shop around and compare net prices charged because in a principal transaction, the portion of the net price attributable to the market change and the portion attributable to the service fee are indistinguishable.

There is another answer to the argument based upon the analogy to retail merchants. While merchandising is, of course, an essential ingredient of the securities industry, that is not the entire story. To an important extent, the securities industry is a personal service business; indeed its representatives frequently characterize it as a "professsion."[19] The regulatory pattern and ethical standards of the industry recognize and essentially are built upon this personal service concept and the obligations which flow therefrom.[20] Thus viewed, a securities firm is, and usually represents itself to be, engaged not merely in selling commodities to customers, but rather in furnishing services to clients. These services essentially comprise locating and making available to the client investments which will be desirable for him, and furnishing various ancillary services. The substantial extent to which members of the industry act as agents for customers, rather than selling as principal to them, is another recognition of the service aspect of the business. But both the industry and the Commission recognize that the fundamental relationships do not necessarily depend upon the form of a particular transaction. Whatever may be the practice of merchants in disclosing wholesale prices, it is, of course, universal practice in service industries to disclose to customers the price being charged for the service.

The practical arguments for the existence of the present system are somewhat more formidable. Defenders of the existing

19 *Special Study* pt. 1, at 240-42.
20 *Id.* at 237-40.

quotation system maintain that the over-the-counter dealer is confronted with a dilemma. For competitive reasons, they say, he cannot charge a *disclosed* selling commission or service charge in excess of the New York Stock Exchange commission schedule because, if he did, customers would buy listed securities instead of over-the-counter securities or would take their business elsewhere —probably to a totally commission-oriented firm. This, it is contended, would be most detrimental to the health of the market, for many firms cannot limit themselves to the New York Stock Exchange commission schedule and survive because the cost of selling and doing business in the over-the-counter market is higher than is the cost in the exchange market. This latter is asserted to be true for two principal reasons. First, since investors are not as familiar with over-the-counter securities as they are with listed securities, and the material facts with respect to over-the-counter securities are often much harder to come by, research costs and selling costs are considerably higher. Second, costs of execution are somewhat higher since a dealer must communicate with one or more market makers, check their prices, report to the customer, and execute the order instead of merely sending it to the exchange floor. It is consequently asserted that the higher undisclosed markup in the over-the-counter market is necessary to the business survival of many dealers. Their absence, it is argued, would materially diminish the liquidity of the market.

Probably the validity of these contentions cannot be established on the basis of either statistics or history, since over-the-counter dealers have never been required to operate under a system of disclosure of inside prices and of markups. However, quite apart from the validity of the assertions concerning the higher cost of over-the-counter transactions, it is clear that disclosure of service fees has not inhibited selling in exchange securities, or in mutual funds or underwritten offerings where customary fees consistently exceed the typical over-the-counter principal markup.

Further, some facts are available which seem to cast doubt upon the empirical foundations for the arguments made for preservation of the current system. The Study reported that a substantial number of shares sold to the public in the over-the-counter market involved executions on a disclosed agency basis. The *Report* noted in this connection:

"In terms of number of shares, 61 percent of the pur-

chases and 75 percent of the sales by the public on January 18, 1962, were made through broker-dealers as agent. By dollar volume, broker-dealers acted as agent in slightly less than one-half of the purchases and 62 percent of the sales by the public."[21]

Analysis was also made of the type of firms which executed transactions as principal and agent in order to determine whether the smaller, perhaps less efficient firms predominately sold securities as principal or agent. The *Report* found:

"From the reports received of trading in the January 18, 1962, sample of 200 stocks, it was observed that certain firms consistently traded as principal in stocks in which they made markets but acted as agent in all others. In all stocks on January 18, 1962, 740 broker-dealers, or 40 percent of the 1,839 who had purchases or sales for public customers (individuals and institutions), effected all of their transactions with the public on an agency basis. On the other hand, 290 broker-dealers, or 16 percent, effected all of their transactions with the public on a principal basis. About two-thirds of the broker-dealers in the former group were small firms which had less than $10,000 of transactions for the public during the day.

"On January 18, 1962, individuals purchased over-the-counter stocks from or through a total of 1,398 broker-dealers. Of these firms, 517 always acted as agent for the customer and 407 dealt exclusively on a principal basis; these 924 firms that dealt exclusively on one basis or the other tended to be firms with small public business so that 1 or 2 transactions may have represented their total volume of individuals' purchases that day. Apart from this, however, there was no readily apparent distinction between firms with smaller or larger volume as to the handling of public business on a principal or agency basis. A distribution of broker-dealer firms by size of individual customers' purchases and by proportion of such purchases made on an agency basis indicates that there is no tendency for firms with small volume to act more frequently on a principal basis than firms with larger volumes."[22]

Finally, the *Report* noted that in the higher priced stocks (which presumably are better known and require less selling effort

21 *Id.* pt. 2, at 612.
22 *Id.* at 613.

and research), the proportion of principal transactions with the public was higher than those of lower price, and that riskless transactions with individual purchasers accounted for less than twenty percent of their purchase transactions.[23]

In an analysis not published in the *Report*, but derived from data submitted to it, it was determined that in a sample of 200 securities,[24] 364 firms executed principal riskless transactions. Forty-four percent of these firms were members of the New York Stock Exchange. Of the fifty-six percent of the broker-dealers who were not members of that exchange, it appeared that those broker-dealers whose adjusted net capital was between 100,000 dollars and 500,000 dollars were predominant in number and also most important in terms of number of "riskless" purchases and sales effected. In contrast, small firms (*i.e.*, those with net capital of 10,000 dollars or less) accounted for only about fifteen percent of all nonmember broker-dealers who effected "riskless" trades, and for less than ten percent of the number of such trades. A further breakdown of the nonmember broker-dealers by location of their main offices indicated that all but eighteen firms were located in cities of more than 100,000 population.

While the data above does not relate to the overall costs of firms who execute transactions on a principal basis, it does not support the argument that the principal form of transaction is generally used by the small, non-metropolitan firm, which executes transactions in low-priced stocks and which requires an undisclosed higher markup to remain in business. Clearly, some firms fall into that category and indeed some would be threatened by any substantial change in the existing system. On balance, however, from the data accumulated to date, it appears that the problem of the small firm may be somewhat overstated, or perhaps misdirected, in placing the burden for assuming their economic survival on the continuation of the present system, rather than on more fundamental remedies which might render them more efficient and financially stable.

Quite apart from the economic consequence of requiring disclosure of the market, it has not been established that customers could not be persuaded to pay a higher commission or service charge if they were educated to the fact that the service may be

[23] *Id.* at 612-14.

[24] For a detailed discussion of the methods of selection of the security sample, the time periods studied, and the universe of reporting broker-dealers, see *id.* at 543-46.

worth the price, which in many instances might be the fact. It appears to be assumed by many in the financial industry that disclosure is inconsistent with merchandising securities. The fact that over-the-counter securities are less popular and less well-known than listed securities may increase the likelihood that securities which are, in fact, undervalued may be found in the over-the-counter market by the diligent dealer who, by discovering such a security for an investor, will have performed a service justifying a fee materially in excess of the ordinary stock exchange commission. The public might be educated to that fact, rather than kept in the dark for fear it would not understand. The *Report* concluded in this connection:

> "A standard justification for the present system is to the effect that the public would misunderstand any other system, but it may not be assumed that the over-the-counter markets can function only by withholding what in other contexts is deemed essential information. The NASD and other industry organizations can and should undertake further efforts to educate the public as to the mechanisms of the over-the-counter markets, in this and other respects. While a change from the present quotation system may create special need for educational efforts, it is believed that little explanation will be needed for a system which does not hold itself out to be something more than or different from what it is in fact."[25]

Proponents of the existing system also urge that aggressive merchandising is necessary to preserve liquidity in the over-the-counter market, particularly as to lower priced and more obscure issues. There is very little spontaneous buying of these securities—while there is considerable spontaneous purchasing of over-the-counter issues of institutional grade and for many New York Stock Exchange issues. Consequently, it is maintained that unless dealers have an incentive to sell these securities at retail—and do so—there will be few, if any, buyers available when holders wish to sell. Retail selling is asserted to be necessary to the maintenance of wholesale markets, since market makers will not buy securities unless they are in a position to sell them, and the retail dealers are their only outlet. This is particularly true since the average dealer making a market is not an investor who acquires securities for appreciation, but rather looks for his profit in the existence of a spread be-

[25] *Id.* at 667.

tween the inside bid and asked price and in his ability to dispose promptly of positions taken and thereby avoid the risks of market depreciation.

While there is undoubtedly considerable validity to these contentions, it would seem that they cannot be pressed too far. If a situation develops in which the rewards of merchandising obscure or low-priced stocks exceed those obtainable from selling more seasoned securities, dealers may develop an incentive to push a questionable class of merchandise upon investors. In other words, there comes a point when liquidity for particular issues may not be worth its cost in terms of intensive merchandising of speculative securities to unwary investors. That point clearly is reached in the "boiler room" situation. Presumably, the main reason boiler rooms sell bad rather than good stocks is the simple fact that they can get bad stocks at very low cost and mark them up excessively, thus covering the high costs that attend a boiler room operation. Of course, the type of merchandise that boiler rooms sell is rarely included in the retail quotations system; nevertheless the excesses of boiler rooms vividly illustrate the consequences of high rewards for the aggressive merchandising of otherwise illiquid securities. Even apart from the boiler room situation, several thousands of securities are now quoted in the over-the-counter market in which there is but one market maker who in turn creates, through a merchandising campaign, sufficient liquidity to enable him to assume and dispose of positions. In such a non-competitive market, the danger from not disclosing the true market to customers, particularly in terms of the spread maintained by such dealer, may, and often does, result in investments being made with little awareness of potential risks.

A practical objection to the existing system, which has been advanced from time to time within the securities industry, is that, by artificially widening the published spread between the bid and the asked price, the existing retail quotation system creates an unjustified impresssion in the mind of knowledgeable investors that over-the-counter markets are characterized by wide spreads and are, therefore, presumably inactive and illiquid; in fact, however, there exists for many of the better known over-the-counter issues, and particularly those quoted in the national lists of the retail quotations system, a close, liquid, and active market. In bank securities, for example, which typically are higher priced than most over-the-counter stocks, the market may be quite narrow because of the quality of the security, institutional interest,

and significant dealer participation. However, the published quotations may show spreads quite inappropriate as a reflection of the market, thereby misleading even government bodies (for example, as to the appropriate tax base), the companies themselves and the public as to the depth of the market or the prices at which a customer could purchase the security.[26]

The response of the NASD to one of the practical objections to the existing system—the possibility of excessive markups—has been an endeavor to regulate the amount of the markup through its so-called five percent policy.[27] Under this policy it is deemed a violation of ethical principles for a dealer to sell a security at a price not reasonably related to the current market price, or to charge a commission which is not reasonable. In part as a result of the statutory inhibition upon the existence of any fixed discounts or commissions by the NASD,[28] and in part for practical reasons, this policy—notwithstanding its name—is quite flexible. In general, a dealer is required to determine the wholesale market, and then to add to that a markup which is reasonable under all of the circumstances. A figure not in excess of five percent is commonly accepted, but it is recognized that in certain situations, particularly involving low-priced securities, a higher markup may be justified.[29] As the *Report* pointed out, the administration and enforcement of this policy has proved to be a difficult task,

26 The *New York Times* has recently revised its masthead for over-the-counter securities. It now states: "Ranges, supplied by the National Association of Securities Dealers, reflect prices at which securities could have been sold (bid) or bought (asked). The asked quotations are adjusted upward by the N.A.S.D.; it is sometimes possible to obtain lower prices on actual purchases."

The *Report* found, in support of the *Times* conclusion concerning lower prices that: "In 82 percent of the stocks in the sample traded on January 18, 1962, in which comparisons could be made, the average cost to individual customers of purchases from dealers acting as principal was higher than the cost of purchases on an agency basis. Moreover, agency transactions usually result in a lower cost of execution to a customer than a principal purchase on a net basis, whether the firm sells to the customer out of its inventory or purchases the stock and then sells it to the customer in a riskless transaction. In 80 percent of the securities studied, when an individual public customer purchased shares from a dealer with an inventory which existed prior to the order, the customer paid more on the average than when he purchased through a broker on an agency basis (including commissions). Similarly, the net price to individual customers in principal purchases from firms which had no positions were also more costly than purchases on an agency basis. Of the stocks in the sample in which both of these types of executions occurred on January 18, 1962, the average price of purchases on a principal basis was higher in 87 percent of the stocks." *Special Study* pt. 2, at 625.

27 NASD, *Review of NASD Markup Policy*, NASD Manual G-1 to G-6 (1961).

28 See Exchange Act § 15A(b)(7).

29 But see LOSS, SECURITIES REGULATION 1496 (2d ed. 1961): "In every case to go to the SEC so far the claim has been made that a higher mark-up is justified in selling low-priced stocks, and in every case the Commission has recognized the principle but rejected the claim on the facts."

both because of the amount of surveillance required in order to provide effective enforcement and because of uncertainties which make it difficult for a dealer to determine either the amount of the markup which is permissible in a particular case, or the price which represents the "prevailing market" at a particular time.[80] Unfortunately, the latter difficulty is particularly great in the case of low-priced or illiquid securities with wide spreads, where the market is both thin and erratic and where it may be almost impossible to determine what is the "prevailing market" at a given time. In view of these and other difficulties, the *Report* concluded that, although the NASD markup policy sets important outer limits of conduct and undoubtedly precludes gross over-reaching,[81] it is not a sufficiently precise instrument to furnish a suitable substitute for more adequate disclosure of the underlying markets.

From time to time, various alternatives to either publishing the inside or actual market price or continuing the present system have been suggested. One that has been advanced is simply to publish the inside bid price, which is generally agreed to be a proper practice, and not to publish any offer at all (in view of the contention that to publish the inside offer would damage the liquidity of the market and to publish the adjusted offer would be misleading). This device would also eliminate the confusion in the minds of some investors between the bid and asked price and the stock exchange high and low. On the other hand, it is asserted that investors who saw a bid price in the newspaper would assume that this was the price at which they could expect to *purchase* the security, or at least the price to which selling commissions or other charges would be added in determining the price they would pay. In many over-the-counter securities the spread between the inside bid and asked price is quite large, often amounting to twenty percent or more. The customer who saw a security quoted in a newspaper at a bid price of four dollars and was charged five dollars for it might assume that the dealer was charging a markup of one dollar, whereas in fact most of the difference would represent the spread in the wholesale markets and the dealer might actually be obtaining a markup of only a few cents.

Another possible approach is to seek a gradual transition which

80 For a discussion of the controversy and uncertainties involved in determining the appropriate base from which to compute mark-up, see *Special Study* pt. 2, at 643-53.

81 *Id.* at 668.

perhaps could be halted at whatever point practical experience indicated the change was doing more harm than good. While it may well be true that many securities in the over-the-counter market depend for liquidity upon aggressive merchandising, this is not true of all securities. Many of the securities traded in the over-the-counter market, for example those of the large banks and insurance companies, are the subject of wide institutional, investor, and broker-dealer interest and are characterized by close, active, and liquid markets. It can hardly be said that the markets for these securities depend wholly upon the merchandising activities of particular retail dealers. On the other hand, it is precisely as to these securities that the objections to the existing system seem most cogent, insofar as the wide spreads in the newspapers convey to prospective investors the false impression that the market is poor or inactive, thus discouraging investment in these securities. It is submitted, therefore, that the unadjusted inter-dealer quotations for these securities might be published perhaps on an experimental basis. The results could then be evaluated and a determination reached upon the basis of experience, rather than upon theory or conjecture, as to whether or not injury to the markets or to any segment of the broker-dealer community would result. Upon the basis of this experience, decisions could be made as to whether or not the principle should be applied to all over-the-counter securities, or at least as to how far and fast it would be safe to go in extending the principle of market disclosure to other categories of over-the-counter securities.

These are not easy questions, and no easy answer presents itself. It would appear, however, that the existing system requires substantial improvement. Not only is it now inconsistent with the full disclosure principle, but it provides a cloak for excessive selling charges, and therefore an incentive to undue selling pressures. Moreover, it is unlikely that the existing system will long survive unchanged even if it is not modified by regulatory action. Rapid technological advances in data collection may make it feasible to collect and rapidly disseminate information concerning actual transactions of market makers with other dealers. Indeed, this is probably technically feasible at the present time and, if not presently feasible economically, it is likely to become so. Once this occurs, the publication in newspapers of quotations at variance with those otherwise obtaining in the market place could hardly continue.