THE FLOOR DEPARTMENT

MEMORANDUM

July 9, 1971

A meeting of the Special Committee on Specialists' Performance was held this day, Mr. S. Peck presiding as Chairman. Also present were Messrs. Fraiman, Gallagher, Phelan, Schloss, Stone, and Stott.

Present of the Staff: R. Howland, J. W. O'Reilly, W. Freund, J. O'Donohue, N. Miller and A. Kotler

Mr. Peck requested that N. Miller explain more thoroughly the use of the index numbers in measuring specialist performance.

Mr. Miller initially referred to that part of a letter sent to all specialists concerning the distribution of the continuity and spread ratings of all stocks on the Exchange and their own specialty stocks. In utilizing somewhat similar type ratings for continuity and spread and combining these ratings in statistical manner, an index number can be obtained for each specialist's overall performance.

As an example, Mr. Miller reviewed how price continuity is analyzed in such a system. The main factors affecting price continuity are price; volume on a dollar value basis; average size of transaction; and volatility.

Mr. Stott asked whether this involved any qualitative measures. It was explained that these were solely quantitative measures.

Mr. Phelan asked about the length of the time period used in gathering the data for the formula rating and was informed that it was for one month periods. However, they could be used for longer periods and were, in fact, used for three month periods.

Mr. Fraiman asked whether the market statistics characterizing a stock would change when such stocks moved from one specialist to another.

Mr. Miller stated that is exactly what could happen. By applying the continuity formula, we would obtain what the normal continuity rating should be; then by comparing it to the actual continuity we would obtain a continuity rating that would reflect the difference in continuity of each of the different specialists.

Mr. Schloss asked whether the index considered the overall performance of a specialist and whether it was consistent in its ratings.

Mr. Miller said the index considered all the specialists stocks as to continuity and that there was a tendency for units to be consistent in their performance rating from one period to the next.

Mr. Phelan raised a question about the factors which are used in the formula and indicated there were many other factors not used. In addition he asked whether the factors were weighted.

Mr. O'Reilly pointed out that the factors used in the rating of continuity were not taken at random but were determined after statistical analysis of many factors such as shares outstanding, TTV, etc. Only those factors affecting continuity were used. Dollar volume and price account for approximately 5/6 of the weight in the formula whereas volatility accounts for a relatively small amount.

Mr. Stott asked whether news items or the presence of large institutional market orders not yet executed (percentage orders) were considered in the formula and was informed they were not considered directly. However, if such events affected any of the four statistical factors related to continuity, such as volatility, they would be reflected in the rating.

Mr. Miller continued on the continuity rating by explaining that if three stocks, similar as to market characteristics, had a formula rating of expected computed continuity of 5 while the actual continuity showed 5, 6 and 4 respectively, then when compared to the norm of 5, one stock would show a rating equal to the norm, another better than the norm, and the third worse than the norm (0 rating, minus rating, plus rating).

Mr. Fraiman felt that the factor of volatility is affected by the specialist through price continuity.

Mr. Miller agreed that this is possible, but felt that volatility was one possible statistical element to differentiate between an issue like Control Data and some less volatile stock.

Mr. Schloss raised the point about specialists participation and its relation to the market, stating that in stocks with a heavy book, participation (TTV) was usually small.

Mr. Miller indicated that there was no relationship between %TTV and continuity and therefore it is not considered in the formula. However, he mentioned his recent discussion with the Floor Department concerning the possible development of the specialists' book as a factor. This would involve obtaining data from specialists as to the number of shares on the book within, say 10% of the last sale of the day. This would then be related to average daily volume in the stock as a simple statistical measure to characterize the nature of the book. Such a measure would then be tested to see if it had a meaningful relationship with continuity or other market measurements.

Mr. Stott felt that reproducing a book also means reproducing the crowd.

Mr. O'Reilly indicated that while we could not measure a crowd, hopefully we could get some meaningful information from the book.

Mr. Stone mentioned that in one of his stocks the book is so heavy they have to force themselves to deal in order to show a %TTV. This formula doesn't reflect anything about specialist dealings.

Mr. Miller mentioned that %TTV was not used because statistical analysis showed it was not related to price continuity.

Mr. Fraiman stated that volatility is synonymous with continuity and should be eliminated as a factor from the formula.

Mr. Miller stated that, by considering volatility, it permits a little more leeway toward the specialist in judging continuity in a volatile issue.

Mr. Schloss felt that specialist participation in block size transactions was an important factor to be considered; that we should measure to what degree a specialist participates in blocks.

Mr. Phelan asked whether we are having a problem with price continuity and if not why is it necessary to establish a standard for it?

Mr. Peck stated there is no continuity problem but that it is important to create incentives for specialists who do less effective jobs to improve their markets.

Mr. Phelan said we should take the formula rating and correlate it with performance so that it would show who are considered to be the good and bad units.

Mr. Miller indicated this in effect was done by translating the continuity rating for the unit's stocks into an index number.

Mr. Stone stated that 95% of the price variations in 1970 took place at one-quarter of a point or less and that our competition could not say this. However, is the basis of the effort in the continuity area as a result of the 5% of price variations greater than one-quarter?

It was generally agreed that this was one of the reasons but not the only one.

Mr. Fraiman felt that it would be necessary and worthwhile to look at and evaluate each factor; that is, %TTV, stabilization, continuity etc. and that some measure of service be considered.

Mr. Peck agreed that all factors should be considered and that service was a factor that was strongly considered at the first meeting.

Mr. Stott stressed the importance of having the ability to reproduce the specialists book.

Mr. O'Reilly indicated that this would be feasible only at such time as the Floor becomes more fully automated.

Mr. Stott pointed out that the upstairs people many times create problems because by withholding large orders from getting to the Floor, the composition of the book is not truly reflecting what is available or what is being sought. This will make analysis of the book that much more difficult. He cited one of his stocks in which the size on the book at the current quote was 7 x 15. However, he indicated that two different firms had orders upstairs amounting in the hundreds of thousands to buy at the current bid and to sell at the offer.

Mr. Schloss pointed out that there is a great variance of performance among specialists. Some shows a willingness to deal in size and deal in great depth especially in high volume issues whereas others will operate differently. Some will provide super service yet not run as good a market.

Mr. Phelan suggested the possibility of categorizing specialists according to the manner in which such specialists desired to conduct business. For example, some do not desire high volume volatile issues.

Mr. Schloss suggested we could consider the switching of stocks to better fit the type of business a specialist wishes to conduct i.e. institutional type for block dealers.

Mr. Peck stated that we are now getting into the area of starting to determine standards before we have decided on the type of measures we need.

At this point the meeting was adjourned with the next meeting date to be determined.

Arnold Kotler