

**OFFICIAL REPORT OF PROCEEDINGS**  
**BEFORE THE**  
**SECURITIES AND EXCHANGE COMMISSION**

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Docket No. \_\_\_\_\_

In the matter of DISCUSSION OF NASD MARK-UP POLICY

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Place Washington, D.C.

Date December 20, 1962

Pages 1 thru 129

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DISCUSSION OF NASD

MARK-UP POLICY

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Room 286,  
Securities and Exchange Commission  
Building,  
425 2nd Street, N. W.,  
Washington, D. C.  
Thursday, December 20, 1962

Met, pursuant to notice, at 10:00 o'clock a.m.

APPEARANCES:

EUGENE H. ROTBERG (presiding), SEC

RICHARD MEYER, SEC

SHELDON RAPPAPORT, SEC

MARTIN MOSKOWITZ, SEC

STANLEY SPORKIN, SEC

JOSEPH A. KEENAN, SEC

7 EDWARD H. LADD

3 MERRILL COHEN

1- GLENN ANDERSON

5 LLOYD DERRICKSON

2- DONALD BURNS

4 FRANK CUNNINGHAM

6 ROBERT HAACK

8 AVERY ROCKEFELLER, JR.

9 MARC A. WHITE

P R O C E E D I N G S

1  
2 Mr. Rotberg (presiding): This meeting today was  
3 convened to discuss primarily the NASD mark-up policy.

4 I want to take this opportunity to thank you gentlemen  
5 for coming here. I realize that it might have come at an incon-  
6 venient time for you, and you can be well assured that the Com-  
7 mission and the Special Study appreciate your courtesy and cooper-  
8 ation in discussing what is a most complex and difficult subject.

9 I hope that we can get a pretty good exchange of ideas  
10 as to what the mark-up policy is and the way that you think that  
11 it has been and should be properly interpreted.

12 I suppose that the best way to begin, perhaps, is for  
13 Mr. Rockefeller, either himself or by designating another person,  
14 to briefly explain what the purpose of the mark-up policy is.

15 Mr. Rockefeller: I might start by saying that the  
16 mark-up policy -- interpretation of the mark-up policy in our  
17 manual today is roughly four pages long. This replaces one that  
18 was roughly 17 pages long.

19 This mark-up policy has been in the process of evolution  
20 for many, many years.

21 Glenn Anderson here -- I may be passing a fast ball to  
22 him -- had a great deal to do with the rewriting and condensing  
23 of the current mark-up policy, and I think that he would prob-  
24 ably give us more of a background than any other individual in  
25 the country on the mark-up policy, as it has evolved this way.

1           Mr. Anderson: Well, I do not know exactly where to  
2 start. Of course, the beginning of the mark-up policy came from  
3 the action of the SEC, I believe, in proposing a disclosure rule.  
4 And at that time in discussions with the NASD the need was recog-  
5 nized for some policy which would enable the members of the  
6 Association to have a guide as to what sort of profits they should  
7 figure on in the operation of their business so far as mark-ups  
8 were concerned.

9           From that developed the original letter issued by the  
10 Board of Governors in 1943 on an outline of a policy -- not a  
11 rule or a specific figure.

12           There has been, in addition to this, from time to time,  
13 as a result of decisions made by the SEC and cases which have  
14 come before the NASD -- that resulted in this 17-page document  
15 we are talking about in the manual, with completely unrelated --  
16 I mean one page jumped from one thing to another matter that was  
17 unrelated. About three years ago this attempt was made to try  
18 to take all of this and put it into a concisely stated interpreta-  
19 tion of what the NASD policy is with respect to mark-ups.

20           Now, this is a brief statement of how it came about  
21 and how it gets to this point.

22           Mr. Rotberg: I notice that in 1959, in the minutes of  
23 the Board of Governors, Mr. Anderson, you made a comment, and I  
24 will quote it, just to open up the discussion, so that we can  
25 properly evaluate, perhaps, the policy.

1           You said:

2           "There is little doubt that members have admitted to  
3 guilt or been found guilty of excessive mark-ups, when, in fact,  
4 there has been no violation, simply because they did not under-  
5 stand the factors which should be considered and were thus unable  
6 to furnish information to support their actions."

7           Could you expound on that, and just tell us in your own  
8 words what the problem was?

9           Mr. Anderson: Well, this, of course, was in a report  
10 to the Board on the need for clarifying our policy.

11           As you know, from about 1955, I guess, to 1959, there  
12 was a tremendous increase in the size of our membership in the  
13 Association.

14           Now, as to the people who had been in the business,  
15 back to the days of the beginning of the policy, and had read  
16 the decisions and the interpretations, generally, I think they  
17 were familiar with the considerations involved in the five per  
18 cent policy.

19           But, with the large increase in membership, it became  
20 evident from many of the cases which came before the Board that  
21 the new people coming into the business really, not only did not  
22 understand the five per cent policy, but they did not understand  
23 any other policy that we had.

24           Frequently, unless there was an attempt made by the  
25 District Committee or the Board on review to dig behind what was

1 in the record, it was rather obvious that many firms, not under-  
 2 standing the policy, would simply acknowledge or admit that they  
 3 had violated, and they would appeal the case in the hope that the  
 4 Board would reduce the penalty.

5 It was in this way that we discovered, in digging into  
 6 some of these cases, that there were factors involved which, if  
 7 the respondent had known or understood the policy and brought  
 8 these factors out himself, probably would have resulted in no  
 9 objection being taken.

10 Mr. Rotberg: Do you think that at this time, which is  
 11 1959, there was any problem in connection with the District Com-  
 12 mittees uniformly interpreting the five per cent mark-up policy?

13 Mr. Anderson: Well, I think there has always been some  
 14 problem, because of the different conditions which exist around  
 15 the country, and the Committees, themselves, look at things as  
 16 they are accustomed to seeing them in their own District, and  
 17 relating them to their own business.

18 So you have always had some differences of view as to  
 19 what the policy means or how various things should be related  
 20 and what weight should be given to various factors in considering  
 21 the fairness of the mark-up.

22 But I do not believe that there was any basic differ-  
 23 ence in the over-all policy in the thinking of the District  
 24 Committees. It related more to the mechanics of how you relate  
 25 these things and how much weight should be given to one factor

1 versus another.

2 Mr. Rotberg: In this connection, in this same report  
3 you set forth a hypothetical transaction in which there is a  
4 dealer who is making a two-way market, and he is not only putting  
5 his quotations in the sheets two ways, but he is actually buying  
6 and selling both ways with other dealers. He is, under the  
7 hypothetical, however, an integrated house. He is also selling  
8 some of his accumulated inventory, or, perhaps, sales in a short  
9 position, to customers.

10 The hypothetical that you put indicated that his con-  
11 temporaneous cost was at a given price because he was buying on  
12 the bid side, and that he was selling at about a four or five  
13 per cent mark-up over the independent offer.

14 You wrote at that time, in connection with that trans-  
15 action, which caused the mark-up from the contemporaneous cost,  
16 which is his purchases on the inside bid, to his sale price to  
17 customers, which was in excess of five per cent, overall -- you  
18 wrote as follows:

19 "A District Committee, in looking over the Examiner's  
20 report, could be expected to question the profit of that dealer."

21 Now, is there any statement that you can make as to  
22 whether the mark-up policy means that you should or should not  
23 use the independent offer where there is a contemporaneous cost?

24 Mr. Anderson: Well --

25 Mr. Rockefeller: May I interrupt a second, Glenn?

1 I don't know whether we should pause here to go back  
2 into the mechanics of an Examiner's report in what he takes off  
3 the firm's books and the information required on Schedule A,  
4 and then at the same time discuss further how that information  
5 is treated by a District Business Committee, before we get into  
6 answering this question, because we are kind of jumping from the  
7 actual situation to the end result here, without going through the  
8 steps in the middle.

9 Mr. Rotberg: Fine.

10 Perhaps someone could explain what the Schedule A  
11 would entail?

12 Mr. Rockefeller: Don, do you want to run through the  
13 Examiner's procedure in what he takes off the firm's books, the  
14 information required on Schedule A, and how that is treated,  
15 before it gets to the District Committee?

16 Mr. Burns: Certainly.

17 The reference to Schedule A is a form which is used  
18 by the Examiners as part of their examination relating specifically  
19 to mark-ups or the practice of mark-ups taken by the member being  
20 examined.

21 The form provides for 30 entries, as I recall it, which  
22 will indicate the customer to whom the securities were sold, usually  
23 by initial, an identification and description of the securities  
24 sold, the number of shares, the unit price, the total price. That  
25 would be on the left-hand side of the form.

1           On the opposite side the form provides for information  
2 relating to the acquisition of those securities.

3           Where there is a practice of no inventory position and  
4 it is obvious that a specific transaction relates to a specific  
5 purchase from another dealer, the appropriate entry is made on  
6 the form on the right-hand side to indicate the dealer from whom  
7 the security was purchased, the date, the unit price, and the  
8 total cost to the member.

9           Further to the right on the form are columns for the  
10 computation -- first of all, for the listing of the independent  
11 market, which would be the representative offer as shown from the  
12 sheets.

13           Mr. Rotberg: Offer or bid and offer?

14           Mr. Burns: Bid and offer.

15           Beyond that, there are two columns for the computation  
16 of the mark-up, using two bases: One, the cost, where available,  
17 the simultaneous cost, as we refer to it; and the mark-up,  
18 based on the representative offering.

19           Those forms are made part of his examination report  
20 and referred to the District Committee for review.

21           There are a number of cases where it is so obvious that  
22 there is no inventory position taken, either long or short, that  
23 the sales for the customer always result from approximately  
24 simultaneous purchase for the dealer, and the mark-ups, computed  
25 on that cost, are well below the five per cent policy.

1 Up until several years ago the Examiner would make  
2 his computation based solely on that cost, and that is what the  
3 District Committee would have before it.

4 Mr. Rotberg: Is that only in the situation where he  
5 had no inventory?

6 Mr. Burns: That is right, and where it was very  
7 obvious that the mark-up seemed quite well within reason. This  
8 was, of course, a decision for the Examiner to make. But the  
9 District Committee, of course, would always realize that the  
10 mark-ups all ran 2.5 or 3 per cent, and there was no problem.

11 You got into an area, of course, where the mark-ups  
12 would range close to 5 -- 5, or a little above. At that point,  
13 the question arose as to what the independent market might have  
14 been. I am taking the same situation, where there was no in-  
15 ventory.

16 The Board felt, in reviewing cases coming before it,  
17 that further information was necessary before they could reach  
18 a proper conclusion as to the propriety of the mark-ups. And  
19 instructions were issued to the District Secretaries to have  
20 their Examiners in all cases, not only give the simultaneous  
21 cost, but also the representative market at that time, and make  
22 the appropriate computations.

23 Mr. Rotberg: From the inside offer, or the inside bid?

24 Mr. Burns: From the offer, from the representative  
25 offering in the pink sheets. And that is the practice which is

1 now followed.

2 Mr. Rockefeller: You are insinuating he makes two  
3 computations.

4 Mr. Burns: He makes two computations, right.

5 Mr. Rotberg: Do I understand, then, on a so-called  
6 riskless transaction, starting in 1959, you began to consider the  
7 independent inside offer in computing the mark-up?

8 Mr. Burns: As well as the simultaneous cost, that is  
9 right.

10 Mr. Rockefeller: This had been done, I think, in  
11 some Districts well before 1959. I think -- the instructions  
12 to all Examiners came in 1959.

13 Mr. Anderson: In going back to the question, this  
14 was the reason for bringing this up:

15 The Board found, and a number of the members of the  
16 Board felt very strongly, that they needed this information, and  
17 the Examiners in most cases at that time were not giving the  
18 representative market -- they were giving the contemporaneous  
19 cost. And the purpose of this statement here, this example, in  
20 the report is to point out the need for having all of this in-  
21 formation so that the Board or any member of a District Committee  
22 can see the entire picture and not just contemporaneous cost.

23 Mr. Rotberg: Just to clarify this point, though, on  
24 the riskless transaction, as Mr. Burns has explained it, what  
25 would be the relevance of the existence of an independent offer?

1 Assuming that it was a riskless transaction with a firm trading  
2 from flat position, in which it did not make a market?

3 Mr. White: Well, I think, to continue with Mr. Ander-  
4 son's answer, from the way that the complaint was drawn, the  
5 decision written, and the evidence that supported the decision,  
6 you could not make an initial determination at the Board level  
7 of whether it was a riskless transaction or not.

8 Mr. Rotberg: Do I take it, then --

9 Mr. Rockefeller: This was an attempt to get all in-  
10 formation out in written form before --

11 Mr. Rotberg: Well, could you explain, on the same  
12 point, exactly how the knowledge or information of the existence  
13 of an inside offer assisted in determining whether the transaction  
14 was riskless?

15 Mr. Anderson: Well, this has nothing to do with whether  
16 it was riskless or not. But, by the same token, the mere fact  
17 that you have a purchase and a sale of 100 shares, both on the  
18 same day, does not necessarily conclude that it is a riskless  
19 transaction. So you needed the whole picture and to get the  
20 facts behind it in order to make that determination.

21 Now, once you determine that it was not a so-called  
22 riskless transaction, then you had to go to the representative  
23 market in order to determine the fairness of the mark-up.

24 Mr. Rotberg: Well, going back once again to the risk-  
25 less transaction situation, if you determined that it was risk-

1 less, that the firm had no inventory to that day, that it had not  
2 been making a market, that it had not been inserting any quotations  
3 in the sheets, that it was an unsolicited or a solicited order  
4 of a customer, and that it was a one-day transaction, I take it  
5 that in that situation you would apply the contemporaneous cost  
6 theory?

7 Mr. Anderson: Not necessarily.

8 Mr. Rotberg: Explain that, please.

9 Mr. Anderson: You would go behind it to find out what  
10 were the circumstances -- if it looked as though it was justified  
11 to go into it this far -- what were the circumstances surrounding  
12 the transaction.

13 And, to cite an example, suppose a dealer has a customer  
14 who wants to buy 300 shares of stock, and he goes out and decides  
15 it is not an active stock, to try to find where he might get the  
16 stock, and spends quite a bit of time searching out a source of  
17 supply. After several days of negotiations, he is able to acquire  
18 a block of 300 shares against this customer's order.

19 Now, on his books he would not have been making a  
20 market for this stock; he would have no inventory in it; it would  
21 be a same-day purchase and a same-day sale.

22 While it would be a riskless transaction, the fairness  
23 of the mark-up would have to take into consideration these pre-  
24 liminary negotiations and what took place.

25 Mr. Rotberg: Well, assuming that he was able to purchase

1 the stock at a given price, would you then permit a mark-up in  
2 excess of 5 per cent?

3 Mr. Anderson: Depending on all of the factors that  
4 were involved, as you weighed them.

5 Mr. Rotberg: Even though the contemporaneous cost  
6 should have been identical to the independent offer?

7 Mr. Anderson: Well, I do not know that --

8 Mr. Rockefeller: I do not know that follows.

9 Mr. Rotberg: In other words, I think what we are  
10 agreeing, then, is even on the admittedly riskless transaction,  
11 there might be some leeway past five per cent in evaluating a  
12 mark-up.

13 Mr. Anderson: Very definitely.

14 Mr. Rotberg: But that really goes to the point of the  
15 flexibility of the five per cent rule, rather than the question  
16 of the base upon which you compute it.

17 Mr. Anderson: Right.

18 Mr. Rockefeller: This falls under the general consider-  
19 ations, December 5th, page G-3 of our manual:

20 "The determination of the fairness of mark-ups must be  
21 based upon the consideration of all the relevant factors of which  
22 a percentage of mark-up is only one."

23 Mr. Rotberg: Well, now --

24 Mr. White: Could I answer one point that you made  
25 there?

1           One of the reasons -- even if you had what looked like  
2 a riskless transaction on the face of a complaint and decision,  
3 and the Board decided to require both computations in both the  
4 market and the contemporaneous cost, the posture of the case can  
5 change a great deal between the District decision and an appeal  
6 to the Board, where there is a hearing with additional evidence  
7 put in and additional arguments made.

8           And then the Board was faced with the position of  
9 resolving those questions or problems without the background in-  
10 formation.

11           We decided it was easier to get the background informa-  
12 tion in the first instance and not later on.

13           Mr. Sporkin: May I ask this?

14           Is it not important to have the mark-up, even on the  
15 so-called riskless transactions, in order for the Board to deter-  
16 mine whether the possibility of interpositioning exists, or  
17 getting the best market?

18           Mr. Anderson: I was going to carry this further.

19           There is another illustration in this same thing here.

20 If in a riskless transaction you did not take off the market, then  
21 you have the situation we very frequently run into in actual cases,  
22 where a small firm which has no contact with markets and simply  
23 goes to the nearest dealer to get whatever stock he wants to buy --  
24 he may have a market that is 4 to 4 1/4 in New York -- a fairly  
25 active market of 4 to 4 1/8.

1 He may well buy that stock and it may go through two  
2 sources before it gets to him, so he pays  $4 \frac{1}{4}$  for it, and he  
3 may sell it for  $4 \frac{3}{8}$  or  $4 \frac{1}{2}$ .

4 And if you looked only at his cost and his profit, you  
5 would have part of the picture.

6 Now, it may be that the public is being hurt by his  
7 inability to acquire securities competitively. And there is  
8 another need for knowing what the outside market is.

9 Mr. Rotberg: In that situation, where you have an  
10 interposition broker-dealer who acts for another broker-dealer,  
11 is the mark-up on a so-called riskless transaction computed  
12 from the cost of the customer's broker-dealer or is it computed  
13 from the cost which is paid by his interposition broker-dealer?

14 Mr. Anderson: Well, I think in the example that I just  
15 gave, a member of a District Committee or a Board would look at  
16 the representative market and try to determine what he should pay  
17 for the stock, what was a reasonable price to pay for the stock,  
18 and whether or not the price that he paid represented a prevailing  
19 market.

20 Mr. Rotberg: Let me clarify this.

21 Let us assume that the independent market is  $5, 5 \frac{1}{4}$ .  
22 Let us assume that a dealer in a small city could buy the stock  
23 at  $5 \frac{1}{4}$  directly from a market maker, and then mark it up. But,  
24 because he does not have the facilities, or for other reasons,  
25 he uses another broker-dealer to buy the stock for him, and that

1 other broker-dealer also buys the stock for  $5 \frac{1}{4}$  and then  
2 charges an eighth, either on a principal basis or an eighth  
3 commission, which results in a net cost to the customer's broker  
4 of  $5 \frac{3}{8}$ .

5 When you compute the customer's broker's mark-up, do  
6 you compute it over the  $5 \frac{1}{4}$  or do you compute it over  $5 \frac{3}{8}$ ?

7 Mr. Anderson: Well, on this schedule Mr. Burns spoke  
8 of, you would probably have both figures in there. You would  
9 have the mark-up, in many cases, on his cost, which is  $5 \frac{3}{8}$ .  
10 You would also have the mark-up shown as a mark-up on the repre-  
11 sentative offering side of the wholesale market.

12 Mr. Rotberg: Well, which is the NASD official policy?

13 Mr. Anderson: I do not think either is. This is a  
14 matter that a businessman has got to look at the situation and  
15 try to determine which should be the basis for using this particu-  
16 lar case.

17 Mr. Rotberg: It might vary in case to case?

18 Mr. Derrickson: Your question is what cost. It would  
19 be the customer's broker's cost solely. You will not use some  
20 other broker's cost. That is a separate transaction.

21 Mr. Rotberg: In other words, you would use it based  
22 on the  $5 \frac{3}{8}$ , not the  $5 \frac{1}{4}$ ?

23 Mr. Derrickson. That is right.

24 Mr. Anderson. In one column -- and then you would  
25 also show the representative market in the other column.

1           Mr. Rockefeller: There is another thing to toss in  
2 here. We have been talking about one isolated transaction,  
3 as though we were going to hang this poor little fellow on this  
4 one.

5           If in the 50 transactions taken off this was only one,  
6 or maybe five or six, you would probably overlook it, unless it  
7 was a mark-up of 50 per cent or something. But it is the pattern  
8 we look for, rather than the various isolated transactions down  
9 the line.

10          Mr. Rotberg: Well, suppose the broker whom we are  
11 talking about has a pattern of always using an interpositioning  
12 broker-dealer, and it always costs him an eighth more, and it is  
13 not an isolated transaction.

14          Is it generally agreed that the mark-up is properly  
15 on the basis of  $5 \frac{3}{8}$ , not  $5 \frac{1}{4}$ ?

16          Mr. Derrickson: I would say yes. I would like to --

17          Mr. White: We had some specific cases on that inter-  
18 positioning, where there was a pattern, and I think we would have  
19 to check what we have done specifically.

20          Mr. Derrickson. We have had cases on it, yes.

21          Mr. Rotberg: That is the reason I raised the question,  
22 because the Boston cases, as I read them, where there was a  
23 pattern of using an interposition broker-dealer, hold that you do  
24 not use the cost of the customer's broker, but you use the cost  
25 of his servicing agent.

1           Now, is there a difference of opinion, or are there  
2 two sides to this?

3           Mr. White: I do not think any of those cases ever  
4 went to the Board. But I think that is a fair statement of it.

5           Mr. Burns: I think that is the way they do it up there.

6           Mr. Derrickson: There are isolated cases, I think --  
7 I think the cases you are referring to are cases wherein the  
8 person really should have been working for the broker from whom  
9 he was obtaining the stock, but he just had an office someplace  
10 else, and he really was not operating as a broker-dealer. I  
11 think you have to consider all the facts.

12           Mr. Rotberg: Well --

13           Mr. Meyer: You would say that those Boston cases  
14 are atypical?

15           Mr. Derrickson: I would say so.

16           Mr. Meyer: That the general rule would be to apply  
17 the broker's cost, even where he has used interpositioning?

18           Mr. Derrickson: I would say so. That is my opinion.

19           Mr. Rockefeller: Of course, you still have both fig-  
20 ures before you: your cost figure and your market figure.

21           Mr. Rotberg: Well, Mr. Anderson made a point that,  
22 although the public might get hurt by going to an inefficient  
23 broker-dealer, by having to pay an eighth more, that broker to  
24 whom he goes just may not have the wherewithal and the communica-  
25 tion facilities to check markets.

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Can anybody comment on that?

Mr. Anderson: Well, we have a statement in our policy here. Let us see if I can find it.

Mr. White: Seven, I think it is.

Mr. Cohen: While he is looking, may I ask a question? When were these Boston cases heard?

Mr. White: I think in the 1940's.

Mr. Sporkin: No, we have had them in 1959, 1960 and 1961.

Mr. Moskowitz: Up to Mr. Doyle's departure, that was the general practice of the District: to look for a pattern whereby an out-of-town broker-dealer would use one interpositioning broker consistently.

In those cases they would use the interposition broker's cost.

Mr. Meyer: In fact, there are only three cases resulting out of formal complaints in Boston, but I think the Boston District Committee's files show a number of letters requesting that the practice be stopped of broker-dealers engaging in it.

Mr. Anderson: Well, getting back to this statement in our policy, No. 7:

"The Board is aware of the differences in the services and facilities which are needed by, and provided for, customers of members. If not excessive, the cost of providing such services and facilities, particularly when they are of a continuing

1 nature, may properly be considered in determining the fairness of  
2 a member's mark-up."

3 Now, in the practice which you were discussing, if it  
4 appeared to a Board member or a member of a District Committee  
5 that, because of his lack of facilities and so forth, the public  
6 would be hurt if they had to pay this additional cost when they  
7 could buy these same securities normally without having to pay it  
8 elsewhere, then I think they would consider that you have to  
9 look at the representative market as opposed to his costs in  
10 determining the fairness of his mark-up.

11 Now, it is the same thing -- we get into so many of  
12 these cases where a firm handles practically all of **its** business  
13 in \$100 transactions, and, obviously, if the man is going to  
14 stay in business, he has to take a profit that seems to most of  
15 us to be unconscionable.

16 Now, the question is raised: Should the public have  
17 to pay a price that includes a mark-up of such size just for this  
18 man to make a profit, when his business is all -- all consists  
19 of these small transactions?

20 I think this is implicit in this statement here --  
21 that these are things you would have to consider.

22 Mr. Rotberg: Well, from the broker's point of view,  
23 here is a fellow who is sitting in his office. He is a perfectly  
24 honest, reputable citizen. And he wants to abide by the mark-up  
25 policy. But he just does not have the facilities to go directly

1 in to Troster Singer, Singer Beam, and he uses a New York City  
2 wire to check markets and it costs him money.

3 Do you think that he knows today whether he is supposed  
4 to mark up over his cost or his servicing interpositioning  
5 broker's cost?

6 Mr. Anderson: Well, I think I would have to say that  
7 many of those who have come into business in the past few years  
8 probably do not. But I think this is not because they could not  
9 find out. I think it is because they just do not care enough to  
10 really find out what they are supposed to be doing.

11 Mr. Meyer: What would the answer be?

12 Mr. Anderson: I do not think there is any clear-cut  
13 answer to it, except in relation to, upon weighing the thing, how  
14 much he is having to pay for this.

15 Mr. Meyer: Well, suppose I am a broker up in Boston,  
16 and I have a wire into a New York firm, and I have a customer  
17 who comes to me, wants to buy an over-the-counter stock, and  
18 the market is being made by two or three New York wholesale houses,  
19 of which my wire correspondent is not one.

20 Now, my practice there in that case is to go to my  
21 wire correspondent and I say to him on a \$10 stock, "Shop around;  
22 get me the best market and take an eighth for yourself."

23 I imagine a lot of firms do that.

24 Then I want to know what I can sell to my customer for.  
25 And let us say my operation entails considerable expense, and I

1 want to get pretty close to the 5 per cent mark-up.

2 Can I include that eighth?

3 Mr. Anderson: Well, I think I can answer it this way,  
4 based on my experience.

5 If you do have a correspondent working for you this  
6 way, and you are doing most of your business with him, you will  
7 find that in practice you are not paying the topside of the  
8 market plus an eighth for everything you are buying. If he is  
9 doing a good job for you, he is probably getting stock to you  
10 at almost a competitive basis with what you might get it if  
11 you got on the teletype and went directly into New York to buy  
12 it.

13 Mr. Meyer: You say the topside of the market plus an  
14 eighth. But do I understand, then, that when we say the repre-  
15 sentative market we are talking about the high offer?

16 Mr. Anderson: No.

17 Mr. Rockefeller: To go back, for this particular ques-  
18 tion you ask, I think, in practice, this situation described  
19 happens very infrequently.

20 Using a New York correspondent -- the trade will be  
21 done in -- the individual, originating broker will be given up  
22 and the New York correspondent will handle this as a service.

23 Now, if you are in Portland, Maine, and then went into  
24 a Boston house, who then went to New York, this case might  
25 happen between the Boston house and the Maine house for the

1 additional cost of handling that transaction.

2 Mr. Rotberg: Perhaps we ought to circumscribe, then,  
3 the situation we are talking about.

4 Mr. White: May I suggest something?

5 Most of these gentlemen have been on the National  
6 Business Conduct Committee. We review around 200 and some cases  
7 a year now. We probably reviewed the Boston interposition cases.

8 If you are going to pursue that, it might be that we  
9 pinpoint the specifics and have somebody read the decision, be-  
10 cause in this area it is much easier to talk about a specific  
11 case than a hypothetical situation.

12 Mr. Rotberg. I just want to clarify what the situation  
13 we are talking about is.

14 I will not belabor the point any further.

15 We are talking about a situation where it is a small,  
16 out-of-town broker-dealer, and his only wire, or his only com-  
17 munication facilities are, probably, to a New York stock exchange  
18 firm, and one which is not a big market maker.

19 In that case, is it the practice to give up, where the  
20 New York stock exchange firm is checking markets with Troster  
21 Singer, Hanseatic, and Singer Beam?

22 Mr. Rockefeller: The general practice, at least in  
23 the firms I am aware of -- and there are others here who can  
24 speak to this -- is to give up the out-of-town broker's name.  
25

1 Mr. Rotberg: Even where you are not making a market  
2 yourself?

3 Mr. Rockefeller: Yes.

4 Particularly when we are not making a market ourself.

5 Mr. Cunningham: I concur in that.

6 Mr. Rockefeller: Frank is in the same position I am,  
7 and Marc and Bob Haack here are in the other position of being  
8 out of town, coming into New York.

9 Mr. Ladd: I would say that, generally, it comes  
10 through the stock exchange firm for the correspondent up in  
11 Portland, Maine; if they come in to us, we will make them the  
12 market, and they will give up the name of the dealer out of town.

13 One other factor:

14 Where they might not have a wire, where there may be 3  
15 or 4 markets -- we will say 2 dealers are making 5 to a quarter,  
16 and 2 dealers 5 to an eighth, three-eighths, and this  
17 interpositioning dealer, his responsibility would be to buy at  
18 the best he could, so that he -- maybe at 5 1/4 -- he might even  
19 buy it from the place that is making 5 1/4 at 5 1/8.

20 Mr. Cunningham: If this small dealer had to come in  
21 to New York himself and the market is 5 to a quarter, there is a  
22 good possibility he could not buy it any cheaper than 5 1/4.  
23 But, by using the efforts of the second broker-dealer in  
24 there, who knows more about the market and has done a diligent  
25 job of checking, he is able to get it at 5 1/8 and sell it to  
this third party at 5 1/4.

1 Mr. Rotberg: So that the net cost is the same as if  
2 he had gone himself to check the markets?

3 Mr. Cunningham: Right.

4 Mr. Anderson. I was going to say that we are an out-  
5 of-town dealer. We have a wire to a New York office. And some  
6 of the small dealers there, they have a long-distance line into  
7 our office, and we do business with them.

8 They are looking for 100 shares of some stock as traded  
9 in New York.

10 We check, and if we find that the market is a close  
11 market, we simply give up. We say Troster Singer is selling  
12 you 100 shares at so much. Or we may find that, as opposed to  
13 being able to buy 100 shares at  $5 \frac{1}{4}$ , this is a block of 500  
14 shares that will not split that we can get at  $5 \frac{1}{8}$ .

15 We may say we will give you a -- report a sale Troster  
16 Singer to you at  $5 \frac{1}{4}$ , or we will take this block of stock and  
17 give you 100 shares out of it and we will take the other 400.

18 Mr. Meyer: On these give-ups, am I correct in under-  
19 standing that the New York Stock Exchange requires that the member  
20 firm charge the over-the-counter dealer a give-up charge?

21 Mr. Rockefeller: No, never.

22 Mr. Meyer: That is not required?

23 Mr. Rockefeller. That is not required.

24 Mr. Meyer: Is there, in fact, a give-up charge?

25 Mr. Rockefeller. No. Not with us.

1 Mr. Meyer: Not usually?

2 Mr. Rockefeller: I never heard of a give-up charge.

3 Mr. Rotberg: Off the record.

4 (Discussion off the record.)

5 Mr. Rotberg: Back on the record.

6 Mr. Haack: Mr. Chairman, I am from up in Milwaukee.

7 We are on both ends of this give-up matter.

8 No. 1, I think that interpositioning is not the factor  
9 in the business today that it was sometime ago for a couple of  
10 reasons. First of all, communications have so vastly improved  
11 that no matter where you are in this country, you can always,  
12 without spending a nickel, check somebody's market.

13 Now, a small dealer up in, say, the sticks in Wisconsin,  
14 if he has a large-sized order, 500 or 1000 shares, his own  
15 competitive position and his profit motive will try to make him  
16 seek out the most reasonable price.

17 Conversely, if he has a small order, say for 50 shares,  
18 and he might come in to us in Milwaukee and ask whether or not we  
19 will buy the stock for him in New York, we, in turn, will use  
20 our facilities, and, because we cannot profitably run through a  
21 ticket on 50 shares of stock to make an eighth of a point, we  
22 will just say, "You bought it from so-and-so; we will give up the  
23 name."

24 So I think, because of improvements in communications,  
25 competitive positions, and costs, interpositioning is not the

1 factor that it was.

2 Mr. Rotberg: That is an interesting point.

3 May I ask, to whom do you have your wire in New York?

4 Mr. Haack: We go to Clark Dodge & Company.

5 Mr. Rotberg: Now, there are some firms in Milwaukee  
6 which go to Troster Singer or Singer Beam or Hanseatic?

7 Mr. Haack: Well, a number of the firms in New York,  
8 for example, have direct communications with branch officers or  
9 correspondents in Chicago, and they, in turn, have three or four  
10 telephones which are available to dealers in Milwaukee. So,  
11 again, by spending no money, you can check markets.

12 Mr. Cohen: May I comment on your question?

13 Now, I am speaking for Minneapolis.

14 Troster Singer had, and I believe still have, a wire  
15 to a Minneapolis house. We have a wire to Doyle O'Connor.  
16 We give up Doyle O'Connor's markets. Doyle O'Connor pay us five  
17 cents a share on every trade. Whoever has the wire to Troster  
18 Singer, I am sure, has a similar market, which means that for  
19 the cost of a local call, the Minneapolis dealer can check at  
20 least two representative markets and buy at the price quoted by  
21 the wholesale dealer.

22 Mr. Rotberg: I think that was the only point I was  
23 going to make: That there are usually a number of wires going  
24 to the large market makers in New York from a number of the  
25 financial centers in the country.

1           Mr. Meyer: Has the situation always been thus, or has  
2 there been an improvement in communications over the years?

3           Mr. Haack: I would say it is much improved.

4           Mr. Meyer: In approximately what period did the im-  
5 provement occur?

6           Mr. Rockefeller: It improves almost annually. Not so  
7 many years ago we did not have the ultrasonic machines which we  
8 have today, which were missing three years ago, and they are  
9 fairly prevalent in offices around the country today.

10          Mr. Haack: I think it has grown, too, as a result  
11 of more firms joining the New York Stock Exchange. For example,  
12 Mr. Cohen's firm, O. T. Dominick Wire, now can check through the  
13 Dominick facilities markets in any one of the cities in which they  
14 have a correspondent, which is probably 15 or 20.

15          Mr. Cohen: The arrangements to which I referred, the  
16 Troster wire, the Doyle wire, are a function of greater activity.  
17 You start with a fixed cost, the cost of your wire. If the  
18 volume over that wire justifies that cost, it is profitable.  
19 If the volume does not, it is unprofitable.

20          As activity has increased, the number of that type of  
21 wires extending into the country has increased along with it,  
22 because the activity has made it profitable.

23          Mr. Rotberg: Off the record.

24                 (Discussion off the record.)

25          Mr. Rotberg: Back on the record.

1 Mr. Sporkin: May I just ask Mr. Anderson:

2 On this theoretical basis here, are we not talking  
3 about, when we are trying to measure the spread, whether it is  
4 excessive or not, are we not, by the terms of your policy,  
5 checking to determine the spread between the market and the cost --  
6 the retail customer pays for the stock -- is that correct? The  
7 price paid by the retail customer is then compared with the market  
8 price of that security?

9 Mr. Anderson: This is one of the things that I think  
10 you want to see, if you look at any transaction, yes.

11 Mr. Sporkin: And in determining the market, we will  
12 use two standards:

13 One is we look to what the cost is, because that might  
14 be reflective of the market; and, secondly, you look to see what  
15 the quotes are in the sheets, is that correct?

16 Mr. Anderson: Right.

17 Mr. Sporkin: But the whole test is market?

18 Mr. Anderson: What?

19 Mr. Sporkin: The concept is you are making the compari-  
20 son between cost and market, cost being the price paid by the  
21 retail customer?

22 Mr. Anderson. No.

23 I think you determine both, and then, based upon the  
24 circumstances, you decide which one is the one that should be  
25 applied.

1. Mr. Sporkin: I see that.

2. But I am using price paid by retail customer in compari-  
3. son with what I call a market, which is a broad concept. That  
4. market, to determine what that market is, you look to the cost  
5. paid by the broker-dealer, if it is a simultaneous or a concurrent  
6. cost.

7. You also look to what is quoted in the sheets for that  
8. stock, is that correct?

9. Mr. Anderson: That is right.

10. Mr. Sporkin: And you find out which one of those two is  
11. the most reflective of the actual market?

12. Mr. Anderson: You either decide which one you are going  
13. to consider as the market, for purposes of mark-up, and then apply  
14. that to the customer's cost.

15. Mr. Sporkin: Now, when we look at the interpositioning  
16. problem, then we in that case say that -- or do we say that the  
17. market there, that the quotes in the sheets are most representative  
18. of the market, because the costs paid by this person are the  
19. costs, assuming that he has paid the mark-ups of two interposi-  
20. tioning brokers, so that that would not be reflective of a market.  
21. Am I correct?

22. Mr. Anderson: Well, I do not know if I am clear now.

23. Mr. Moskowitz: Off the record.

24. (Discussion off the record.)

25. Mr. Rotberg: Back on the record.

1           We have now discussed some facets of the riskless  
2 transaction, and certain aspects of the question of interposi-  
3 tioning.

4           I now want to direct your attention to the question of  
5 what standards are used in order to determine whether or not the  
6 contemporaneous costs should be used or the independent offer.

7           I want to concentrate on the situation where a broker  
8 is making a two-sided market, and where he has an inventory,  
9 sometimes long, sometimes short.

10           Could any of you gentlemen just set forth some of the  
11 standards which cut one way and which cut the other way?

12           Mr. Cohen: I will try to answer this way.

13           I might add, this is my first attempt to formulate  
14 orally my understanding of the policy. I apply it, but, usually,  
15 as a result of internal reasoning rather than as a result of  
16 some clearly expressed attitude.

17           But I think I would try to define it this way.

18           As I look at a transaction involving both a retail sale  
19 and a position, I think of it, in effect, as reflecting two func-  
20 tions.

21           One is the retail function. For this, I think the  
22 dealer is entitled to a profit equivalent to the profit he would  
23 derive if he were not in position, and adequately related within  
24 the reference of the 5 per cent policy.

25           That any profit that he earns as a result of being in

1 position, and at risk, is a separate profit, to which he is  
2 entitled by virtue of his willingness to assume the risk.

3 Therefore, I would, in this case, base his mark-up, the  
4 fairness of his retail mark-up, on the relationship of that market  
5 to the price at which he could have bought the stock, if he were  
6 not in position.

7 Mr. Rotberg: So that the mark-up under that theory  
8 would be based on the independent offer?

9 Mr. Cohen: May I stop a minute? I have expressed my  
10 opinion.

11 Now, others here might wish to comment.

12 Mr. Cunningham: I think that is a very good statement.  
13 Where you are making a two-sided market in an active stock, say  
14 yesterday morning, when the market looked very sick, you might  
15 have accumulated 500 shares on the bid side of the market at 20.  
16 You might have bought more stock at 20. In the afternoon, the  
17 market turned up. You bought stock at 20 1/8, 20 1/4, because  
18 the market continued to improve.

19 Now, I think, I believe that later in the afternoon,  
20 because that stock you bought at 20 in the morning was a risk  
21 transaction, that when the market became 20 1/4, 20 3/4, in the  
22 afternoon, your purchase at 20 should not be related to your  
23 purchases at 20 1/4, and your offering should be from 20 3/4.

24 Mr. Rotberg: Mr. Cunningham, that really is not  
25 the exact question we are focusing on, I think, for this reason.

1 You are posing the problem where there has been a shift or a  
2 change in the market, and it is difficult to identify a con-  
3 temporaneous cost.

4 Let us take the simpler situation first, where you are  
5 buying at 20, because the market is 20, 21, and your bids are  
6 being hit by incoming callers, and you are constantly buying at  
7 20, and the market does not change.

8 As I understand it, it is Mr. Cohen's position that the  
9 mark-up should be something over 21 -- 21 plus whatever the mark-  
10 up policy would dictate.

11 Mr. Cohen: I do not think -- I am sorry to interrupt  
12 you -- perhaps I should let you finish.

13 Mr. Rotberg: I was just wondering if Mr. Cunningham --  
14 first, did I state your position correctly?

15 Mr. Cohen: Not completely, because you are giving me  
16 a specific -- I was speaking to a general attitude. You are  
17 giving me a specific situation in numbers. Fairness of markets  
18 and representative markets, in my judgment, cannot be determined  
19 solely by saying the market was 20 to 21.

20 I think what I said was that reflection should be  
21 given to the fact that the man is at risk.

22 Now, if a market is 20, 21, I would not invariably  
23 assume that the fair retail mark-up should be based on 21.  
24 A 20, 21 market, a point spread in stock something at 20, could  
25 very well close. I might consider, in determining what is a

1 fair mark-up, what I would consider a fair trading spread at  
2 a given time, giving effect to the fact that a 20, 21 quote on a  
3 bid might close 20 to 3/4, might close 20 to 1/2.

4 I may be getting too involved, but I do not like to be  
5 quite as rigid as the question suggests.

6 Mr. Rotberg: That is complicating it by changing the  
7 problem, by introducing a shift in the market.

8 Mr. Cohen: No, sir, I beg your pardon. A quoted market  
9 is not -- how shall I put it -- is not necessarily -- does not  
10 necessarily represent the prices at which stock is going to trade  
11 when an actual bid or offer comes into the market.

12 Mr. Anderson: Would it not simplify this, instead of  
13 using -- he speaks of making an active market, or an active market  
14 of 20 to 21 -- if we used a quote of 20 to 20 1/2 to start with,  
15 would this not make it easier to discuss this?

16 Mr. Rotberg: The only reason I do not want to use the  
17 quote of 20 to 1/2 is because in that situation, either where you  
18 use the mark-up on the basis of contemporaneous cost, which is  
19 20, or the independent offer, which is 20 1/2, if you sell at  
20 21, you are still within the 5 per cent.

21 So let us perhaps drop the stock to a cheaper price --  
22 let us say to 5, 5 1/2.

23 Mr. Cohen: Let us hold it at that price, and let us  
24 talk about a spread which will take it over 5 per cent. Let us  
25 say the market is 20 to 1/2, and the retail was at 21 1/2. I

1 would be inclined to accept what was apparently a 5 per cent  
2 mark-up as reasonable, assuming that it was the type of stock  
3 which, in my judgment -- put it this way -- I would take 20 1/2  
4 as a reasonable basis for figuring the retail spread.

5 Mr. Rotberg: Fine.

6 Is there any disagreement, or any qualifications that  
7 any of you gentlemen would like to make?

8 Mr. Rotberg: The only qualification I might toss in is  
9 that if this were the spread, this would probably not be a very  
10 actively traded stock, which is one of the assumptions you built  
11 in earlier.

12 Mr. Rotberg: Well, I want to give a hypothetical of  
13 20 to 20 1/2. I know there are some active stock traded at 20  
14 to 20 1/2, and there are inactive ones, and there are stocks with  
15 15 dealers in the sheets at 20 to 20 1/2, and there are some with  
16 three dealers in the sheets.

17 Now, I think Mr. Cohen's position is that the retail  
18 price should be computed something over the 20 1/2, and the policy  
19 should be based on the 20 1/2.

20 Now, is there general agreement that in that case you  
21 should use the independent offer?

22 Mr. Anderson: I agree.

23 Mr. Rotberg: All right. Apparently there is general  
24 agreement on that.

25 Now, if that is the case, then does it come down to the

1 fact that where you have an inventory, and where you are making  
2 a market, the mark-up policy uses the independent offer and not  
3 the contemporaneous cost? Is that correct?

4           Everybody seems to be nodding their heads.

5           Mr. Anderson: Yes.

6           Mr. Rotberg: The answer is yes. All right.

7           Now, am I correct, to restate Mr. Cohen's position --  
8 and apparently the position of the people here -- that the reason  
9 for this is because a broker-dealer is entitled to a profit  
10 for his risk, which involves trading profit, for adding the  
11 depth of liquidity to the market, and is also entitled to be  
12 compensated for the expense of selling securities retail?  
13 Apparently everyone agrees to that.

14           Now, let us assume that, in making a market, that the  
15 firm buys 400 or 500 shares and sells 400 or 500 shares and  
16 never accumulates a significant position. And so they never risk  
17 a substantial amount of shares or dollars.

18           Would your answer still be the same with respect to  
19 whether you used the contemporaneous cost or the independent  
20 offer?

21           Mr. Anderson: Generally speaking, I would say yes.

22           Mr. Rotberg: So the contemporaneous cost is only used,  
23 in effect, in riskless transactions. Is that what it comes down  
24 to?

25           Mr. Anderson: That is what it boils down to, yes.

1 Mr. Rotberg: All right.

2 Now, could you explain, then --

3 Mr. Anderson. May I just add one thing?

4 Contemporaneous cost is the only figure that is used  
5 in a riskless transaction, but it does not necessarily follow  
6 that the same-day cost is always the basis used in a riskless  
7 transaction.

8 You would have to say that, to go back to the question --

9 Mr. Rotberg: In other words, if it is an inventory  
10 situation, it is not contemporaneous cost -- it is independent  
11 offer. And if it is a non-inventory situation, it still may not  
12 be contemporaneous cost.

13 Mr. White: Right.

14 Mr. Meyer: Let me ask you how you would treat this  
15 situation.

16 The particular firm in question is not making a market  
17 in the security, although other brokers are making a market, and  
18 are quoting it at 20 to 1/2. The firm in question decides it  
19 wants to retail the stock. In order to increase its profit,  
20 rather than purchase on the offer side of the market, it decides  
21 it will put a bid in the sheets at 20 1/8 and accumulate stock  
22 on the bid.

23 Now, I am going to give you two different situations.

24 First, it accumulates the stock at 20 1/8, and, as the  
25 100 shares come in, each time its bid is hit, it notifies the

1 retail department, and the retail department solicits a customer  
2 and is able to sell to that customer within a relatively short  
3 period of time, and does sell at 21 1/2.

4 Secondly, take the situation where, instead of immed-  
5 lately soliciting the retail customer, they accumulate a position  
6 over a period of days and then retail it, also at 21 1/2.

7 How would those transactions be treated?

8 Mr. Rockefeller: To throw the third case in, Glenn,  
9 do you want to give an example of what we were talking about the  
10 other day?

11 Mr. Rotberg: I think these two are going to be complex  
12 enough.

13 Mr. Cunningham: Are both of these examples here risk  
14 transactions?

15 Mr. Rotberg: You have heard the situation.

16 Mr. Anderson: First, I would like to say this. I think  
17 the illustration you give is very unlikely to happen, or cannot  
18 happen, first. I do not think the dealer who is not in a market  
19 for a security can go in the sheets this way and have much success  
20 in buying stock on this basis. I think we are dealing with what  
21 is a theoretical situation and not a practical situation.

22 Mr. Meyer: Well, would you think that it would be more  
23 apt to happen if he put a nominal ask price in the sheets?  
24 Would the other broker-dealers have any way of knowing whether  
25 he was really making a market?

1           Mr. Anderson: Well, I think some of the men from  
2 New York might better answer this, but, from my experience with  
3 the sheets, just about ever since they have been published, a  
4 firm going into the sheets for a specific purpose like this does  
5 not accomplish very much.

6           The firms who are recognized as the markets for that  
7 security are generally the ones who get the calls.

8           Mr. Meyer: Even if they have a higher bid?

9           Mr. Anderson: Well, it will correct itself very  
10 quickly, if this situation develops.

11          Mr. Rotberg: Is it your position that a firm cannot  
12 pick up securities on a bid by entering its name in the pink  
13 sheets if it is a reputable, large firm?

14          Mr. Anderson: I do not think they will get a lot of  
15 stock this way, from a practical standpoint.

16          Mr. Cohen: I would like to expand on that, because you  
17 seem amazed at something which I think most of us would take as  
18 more or less a matter of course.

19          The securities business is a competitive business like  
20 any other. When you lay a two-sided market, you are trying to  
21 buy stock at your bid; you are trying to sell it at your ask.  
22 If your markets are the same as everyone else's, you are com-  
23 peting with everybody else bidding 20, everybody else offering  
24 stock at 20 1/2.

25          The tendency of most traders, when they check markets,

1 is to check people with whom they have continuing relationships,  
2 who have been identified in a given market for a long period of  
3 time.

4 They tend to be regarded as the most dependable source  
5 of bids and offerings.

6 Also, in the case of a stock which is at all active,  
7 some of those houses are in New York and more readily accessible  
8 than a house in Minneapolis.

9 So, as Glenn says, if we were to decide to take, call it,  
10 a flash position in a stock, and we were to go in the sheets in  
11 competition with, first, Boston, Blight, Troster Singer, any of  
12 the known trading houses, it is highly unlikely that we would  
13 get any significant part of the volume in that stock at any time.

14 Mr. Meyer: All right. The point is not worth arguing.  
15 We can change the situation and make it a little more subtle.

16 Let us assume that you know this, and so you have a  
17 wire to Troster Singer, who has been making a market in this stock  
18 right along, and you say to Troster, "Troster, I want to retail  
19 some of this to my customer. I do not want to pay your ask  
20 price. We have been doing business a long time. You can con-  
21 tinue bidding and offering the stock as you see fit. But you  
22 can bid for me as my agent  $1/8$  higher than your street bid. And  
23 whatever you pick up on that  $1/8$ , I will give you half of it  
24 or a sixteenth as a commission. You do it as my agent."

25 Now, I take it that situation does happen.

1           So we will use that situation: rather than an appear-  
2           ance by the firm itself, they will use a wholesaler to do it.  
3           And I think -- have we gotten over that hump, then -- that this  
4           can be done, and you can accumulate stock in this fashion.

5           Mr. Cohen: It is possible, in my judgment, for a house  
6           which is willing to take a position, at times to buy stock between  
7           the bid and the ask. So a situation can arise where a house  
8           could accumulate stock for a position at a price below the cur-  
9           rent ask side of the market.

10           This would be my feeling.

11           Mr. Rotberg: Now, the question is: When he sells it  
12           at 21 1/2 to a customer, is it okay?

13           Mr. Anderson: That was not the question he asked, as  
14           I understood it. I thought he was asking how we considered that,  
15           as to whether we considered that a riskless or a risk transaction.

16           Mr. Meyer: No. I just want to know how the mark-up  
17           policy will apply to a sale to a public customer at 21 1/2, first,  
18           in the situation where the sales are made shortly after each pur-  
19           chase of 100 shares and, secondly, where a block is accumulated  
20           and then the stock is retailed at 21 1/2.

21           Mr. Anderson: Well, I will start it off by saying  
22           in these two instances, if he bought the stock on this basis and  
23           if he had no order at the time he bought it from his retail ac-  
24           counts, whether he got an order 2 hours later or whether he  
25           waited for the rest of the day, into the next day, and accumulated.

1 500 shares, as far as I am concerned, he is at risk.

2 Therefore, you would use representative market in  
3 determining the amount of the mark-up.

4 Mr. Rotberg: To clarify -- "representative market,"  
5 you mean inside offer?

6 Mr. Anderson: Right.

7 Mr. Meyer: And his sale, therefore, at 21 1/2 would  
8 be within the 5 per cent margin?

9 Mr. Anderson: Well, this brings in another area, which  
10 goes beyond just the matter of the mark-up. This goes into all  
11 the other considerations.

12 Mr. Meyer: I did not say policy -- I said the margin  
13 of 5 per cent -- for that purpose.

14 Mr. Rotberg: Is there any other comment that any of  
15 you gentlemen would like to make on those two hypotheticals?

16 Mr. Cohen: I would, if nobody else would.

17 I would like to simply expand on our reasoning.

18 I sense a feeling -- and perhaps I sense what does not  
19 exist -- but I think I sense a feeling that, because the retail  
20 department has been successful in moving the stocks that came  
21 in, that the man really was not at risk.

22 Our approach would be that he was at risk if he did not  
23 have orders, because our experience has been over a long period  
24 of time that what the retail department did yesterday or two  
25 hours ago is not an infallible guide to what it is going to do in

1 the next two hours or in the next three days.

2 Mr. Rotberg: Now, I am sure that all of you are  
3 familiar with the many Commission decisions on this question.  
4 Has the NASD censured any broker-dealers who acquired securities  
5 on their bid, maintained an inventory, and then sold stock out  
6 at a mark-up over the independent offer?

7 Mr. White: That would require a pretty thorough  
8 knowledge of all our cases.

9 Mr. Rotberg: Well, Marc, you have heard the expression  
10 of opinions by these gentlemen. I wish you would express your  
11 opinion, as objectively as you can, whether or not this expression  
12 is consistent with the cases that you have seen brought before  
13 the Commission or the NASD in the last five years.

14 Mr. White: Well, I can give you my opinion, and these  
15 gentlemen all have had some experience during the period of time.  
16 Mr. Anderson came on the Board when I started out as Counsel.

17 I think that five years ago there was a tendency at  
18 the District level to bottom these cases on contemporaneous cost.  
19 I think shortly -- in, say, 1959, we began requesting the  
20 additional information to make this determination. We also began  
21 to give more careful review of the existing 5 per cent policy,  
22 the 17 pages Mr. Anderson is talking about.

23 It was in connection with reviewing all these cases  
24 that we decided to require all this information about the market  
25 and costs from the Districts so that the Board could make a

1 determination.

2           Now, I would be inclined to think that, with the empha-  
3 sis on contemporaneous cost in the early days of five years ago,  
4 that, probably, members have been censured where we did not review  
5 it or there was not an appeal to the Board.

6           We are generally familiar with the decisions of the  
7 Commission, and, after reading Mr. Gilleran's testimony, I notice  
8 that someone from the Commission Study Group said that the  
9 Commission had not altered or reversed us in the 5 per cent policy  
10 area.

11           Actually, they did that fairly dramatically before my  
12 time in the Herrick Waddel Case.

13           In the five years I am talking about, 1958 and on,  
14 we have had around 950 disciplinary actions, which is about the  
15 same number as we had in the first 19 years of the Association.  
16 In that time the only cases that have gone to the Commission  
17 involving the 5 per cent policy, which did not have other various  
18 violations or other elements in them, to my knowledge, are  
19 the Samuel D. Franklin Case, which went all the way to the Supreme  
20 Court, and the Thill Case, which is pending before the Commission  
21 now.

22           We had one case, Maryland Securities, which had maybe  
23 a couple of other causes in the complaint, where the penalty was  
24 a monetary one.

25           The Franklin case was a monetary penalty. And all the

1 cases that involved a significant penalty of suspension or expul-  
2 sion that came here had other elements in them -- referring  
3 to Maryland Securities, for example. Borne & Company, where the  
4 Commission reversed us on one transaction, where the member had  
5 actually acquired a block of stock and we used contemporaneous  
6 costs and the Commission said we should have used representative  
7 market.

8 Mr. Rotberg: Let me read a statement and perhaps you  
9 can express an opinion whether you gentlemen would agree or  
10 disagree.

11 "The applicant is not aided by pointing to the fact  
12 that the published bid and ask quotations in low-priced securities  
13 sometimes have spreads in amounts as great as those involved in  
14 mark-ups charged by the applicant. It does not appear from the  
15 record whether the particular securities dealt in by the appli-  
16 cant were the subject of such widely spread quotations when  
17 his transactions were effected."

18 Now, this is the quote I want to direct your attention  
19 to.

20 "But even assuming they were, in our opinion it is  
21 clear that, while public quotations have been used as an indi-  
22 cation of prevailing market prices in the absence of evidence  
23 to the contrary, the difference between a bid quotation, which  
24 represents the lowest price at which a dealer considers he may  
25 be able to induce other dealers to negotiate with him respecting

1 his purchase, and the asked, which generally represents the high  
2 price at which a dealer considers he can induce negotiations  
3 for the sale, cannot properly be treated as a measure of what  
4 is a fair or reasonable mark-up over contemporaneous cost."

5 Now, Mr. Anderson, would you agree with that statement?

6 Mr. Anderson: When you refer to the "quotations," are  
7 you speaking here of dealer or published quotations?

8 Mr. Rotberg: Dealer quotations.

9 Mr. Rockefeller: There was something there, too, about  
10 low-priced securities. Is that a low-priced dealer, or the whole  
11 gamut?

12 Mr. Rotberg: Well, is there any difference in your  
13 policy with respect to high-priced or low-priced stocks? I do  
14 not know. It just says low-priced stocks.

15 Mr. White: Is that an excerpt from a Commission de-  
16 cision?

17 Mr. Rotberg: Yes.

18 Mr. Derrickson: Is that an excerpt from the Samuel  
19 D. Franklin Case involving Penny stocks?

20 I think it is.

21 I think it is important here to have some expression  
22 as to what the representative market is, and what it means to  
23 these gentlemen who are in the business and know what it means.  
24 You have not gotten into that.

25 Mr. Rotberg: I want to clarify this question, though:

1           Whether or not a dealer such as Franklin can come in  
2 and say, "Look, I am making a market, I am making a two-sided  
3 market. The spread happens to be 40 per cent. I am going to  
4 mark up over the inside offer."

5           Now, as I understand Mr. Cohen and Mr. Anderson, their  
6 position is that that is correct; that is okay.

7           Mr. Rockefeller: Wait a minute.

8           Mr. Derrickson: No, they did not say that.

9           Mr. White: That is without qualification. I have not  
10 read the original Franklin Case in some time. But in that case  
11 he advanced these arguments, which the Board considered and did  
12 not accept.

13           I would venture to think that on its computation in  
14 the Franklin Case his mark-ups were excessive.

15           Mr. Rotberg: I do not think we should hypothesize in  
16 that regard.

17           I want to clarify this. Suppose that on the independent  
18 offer, they were not excessive. Do I understand the position of  
19 the current Board to be that he could mark up over the independent  
20 offer if he was maintaining an inventory?

21           Mr. Rockefeller: You are talking here of only one  
22 factor.

23           Mr. Rotberg: This is the factor.

24           Mr. Rockefeller: I do not think you can isolate any  
25 one particular factor in any of these determinations and discuss

1 that one factor alone, without taking into consideration all  
2 the other relevant factors, as we state in the interpretation.

3 We try and look at all these factors at the same time.

4 Mr. Rotberg: What factors will be used which will  
5 negate the use of an independent offer from inventory?

6 Mr. Rockefeller: You mention here he was dealing in  
7 Penny securities, or this came up, and the spread was 40 per  
8 cent. He was probably then the only market in this Penny  
9 security. Therefore, I kind of wonder whether that is a market.  
10 When you have a sole dealer, whether this cannot get beyond the  
11 idea of a market into a concept of fraud.

12 Mr. White: For example, in the Franklin Case, the  
13 penalty was \$1000 at the District level. He appealed, with no  
14 great quarrel except that he could not make a profit in that  
15 segment of the industry, based on his views of our interpretation  
16 of the 5 per cent policy.

17 The major determination there was that it was unfair  
18 to customers for him to make his additional profit, conducting  
19 his business that way. That is about what that case stands for.  
20 And I think that it is not any lack of desire on the part of  
21 these gentlemen to answer a question flatly. It is the great  
22 difficulty in this area of taking a whole look at the members --  
23 the factual situation presented to them at the time.

24 When we get a case in this area where this mark-up --  
25 the mark-ups are not excessive by anybody's determination, where

1 they are close, the case represents one of the most difficult  
2 we have to determine at the Board level. And I do not think you  
3 can take a case and not get all the facts on the table before  
4 we discuss the possible answer.

5 Mr. Rotberg: Before we get all of the facts on the  
6 table, I am trying to get an expression of an opinion as to  
7 whether or not, where there is an inventory and where there is a  
8 broker making a two-sided market with other dealers, whether or  
9 not he can be assured that when he sells his stock at a mark-up  
10 based upon the independent offer, assuming there is an independent  
11 offer, he is within the law.

12 Mr. Rockefeller: Based on that one fact alone?

13 Mr. Rotberg: That is correct.

14 Mr. Rockefeller: I want to go back again to all the  
15 other factors that must play a part in our eventual determination.

16 Mr. Meyer: Well, then, based on that fact alone, he  
17 can say that nobody can tell him that he is outside the rule simply  
18 on the basis of that fact alone. Is that correct?

19 Mr. White: You may make that prima facie statement.

20 Mr. Rotberg: Do you agree with that comment, Mr.  
21 Anderson and Mr. Cohen, of Mr. Rockefeller?

22 Mr. Anderson: I would agree.

23 Now, you refer to this independent market. If you will  
24 define "independent market" as a market which one of these  
25 gentlemen or a group of these gentlemen will accept as an

1 independent market, when they have looked into the situation,  
2 then he is entitled, if he is in position to use the offering  
3 side of the market, to base his mark-up on that.

4 Now, to go a step further -- and I think it relates to  
5 this particular Franklin Case -- this frequently becomes an  
6 academic question that the Board in the hearing does not feel  
7 the need to go into because of the fact that there are a large  
8 number of transactions where, even giving the benefit of the  
9 offering side, the mark-up may be 25 per cent.

10 So why spend a lot of time discussing the question of  
11 representative market if his mark-up on that basis appears to  
12 the group to be excessive?

13 Mr. Rotberg: If it is excessive in both instances,  
14 then we would not be here discussing this difficult problem.  
15 We are discussing the problem where it is over 5 per cent, where  
16 he uses contemporaneous cost; but it is within the 5 per cent,  
17 where he uses the independent offer.

18 Now, perhaps we could go back, then, once again, and  
19 perhaps Mr. Rockefeller could tell us what are the specific  
20 circumstances which would cause you to use the contemporaneous  
21 cost rather than independent offer in a situation where a firm  
22 is making a market and has an inventory.

23 Mr. Rockefeller: Well, I think you have to know the  
24 general level, dollar level, of the securities. Is it a Penny  
25 stock, or is it a stock that is generally traded in the higher

1 ranges?

2 Mr. Rotberg: Which way would that cut?

3 Mr. Rockefeller: Well, I think if it is a Penny stock,  
4 it is awfully hard to deal in Penny stocks with a 5 per cent  
5 mark-up. I think we are all agreed on that.

6 Mr. Rotberg: Which way would it cut? Would he have to  
7 use independent offer or contemporaneous cost?

8 Mr. Rockefeller: Could I get through my whole pattern  
9 first?

10 I would like to know the volume of transactions; is  
11 this an isolated transaction, or are there thousands of them, or  
12 is the Schedule A only involved in this one security; is this a  
13 general pattern; are all his transactions this way, or are there  
14 other transactions spaced in there with different types of mark-  
15 ups.

16 Going back to the Thill Case where everything came out  
17 almost exactly the same percentage mark-up --

18 Mr. Rotberg: Over what -- independent offer or con-  
19 temporaneous cost?

20 Mr. Derrickson: Costs, mostly.

21 Mr. Rotberg: Why did you use contemporaneous cost?

22 Mr. Rockefeller: In that particular case?

23 Mr. Rotberg: Yes.

24 Mr. Rockefeller: I think there was -- he was pretty  
25 much the sole market there.

1 Mr. Rotberg: Was he making an independent market?

2 Mr. Derrickson: They were almost all riskless, or at  
3 least within a day or two. They seemed to be. And that is what  
4 he said, is my recollection.

5 Mr. Meyer: You say --

6 Mr. Rotberg: But Mr. Anderson and Mr. Cohen say if  
7 it is an hour, he is at risk.

8 Mr. Derrickson: That is true, I think. Do you not  
9 think so?

10 Mr. Rotberg: If he is at risk, why would he use the  
11 contemporaneous cost?

12 Mr. Derrickson: I think the best way to answer that  
13 would be to get out the schedule and see, and I think you will  
14 find there are good reasons for what was done.

15 Mr. Rotberg: Is the reason because you do not like  
16 the broker-dealer --

17 Mr. Derrickson: Maybe all these men were not on the  
18 Board when it was decided.

19 Mr. White: Let us see if we can pinpoint some of the  
20 problems.

21 Mr. Rotberg: Before that, I would like to get Mr.  
22 Rockefeller's views.

23 Mr. Rockefeller: I cannot say in my own mind this one  
24 makes me lean this way and this one that way.

25 Mr. Rotberg: You say low-priced stock versus high-priced.

1 Which way does it go? If it is low-priced, do you use contempor-  
2 aneous cost or independent offer?

3 Mr. Rockefeller: If he is the sole market? A Penny  
4 stock with a 40 per cent spread, that has a bearing in my thought.

5 Mr. Rotberg: Which way?

6 Mr. Rockefeller: On the cost.

7 Mr. Rotberg: You would use contemporaneous cost?

8 Mr. Rockefeller: If he is the sole market.

9 Mr. Rotberg: Suppose there are five other dealers in  
10 the sheets, and the stock is selling 75 cents bid, \$1 asked.

11 Mr. Rockefeller: I would like then to see the other  
12 factors. Is this a pattern?

13 Mr. Rotberg: Yes. Every transaction he marks up  
14 over \$1. The bid is 75 cents; the offer is \$1; and he sells out  
15 to customers at \$1.10, or \$1.05.

16 Mr. Cunningham: How many people are in the sheets?

17 Mr. Rotberg: Five.

18 Mr. Ladd: What is he buying at?

19 Mr. Rotberg: Seventy-five cents.

20 I would like to get an answer to this.

21 Mr. Rockefeller: I think your question is unreason-  
22 able, because I do not think the spread would be that wide with  
23 five brokers in the sheets.

24 Mr. Rotberg: You think that spread is narrow with the  
25 increasing number of broker-dealers in the sheets?

1           Mr. Rockefeller: Absolutely.

2           Mr. Rotberg: In dollar stocks?

3           Mr. Rockefeller: I think so, yes -- actively traded  
4 dollar stocks.

5           Mr. Rotberg: Well, now, let me again put this hypo-  
6 theoretical.

7           He buys at 75 cents; he is offering at a dollar to  
8 other dealers. May he sell to customers at \$1.05? There are  
9 five dealers in the sheets.

10          Mr. Cohen: May I speak to that and just express my  
11 own opinion.

12          First, though, I want to get back to your statement of  
13 my attitude, which suggested that I felt that the independent  
14 market should always be used when a man was at risk.

15          I think I qualified that statement when I first made  
16 it, when you spoke of a market of 20 to 21 on a \$20 stock, and  
17 I indicated that this, to me, was a market which I might be in-  
18 clined to discount.

19          Then we got to a 20 1/2 market, which seemed to me a  
20 valid one, and all my remarks from that point on were premised  
21 on a spread which seemed valid and reasonably related to the  
22 stock.

23          Now, you are bringing up a situation in which the spread  
24 seems unreasonably related to the value; it is 33 1/3 per cent.

25          Mr. Rotberg: That is right.

1           Mr. Cohen: In that case, I certainly would not  
2 personally regard the asked side of a market with such a wide  
3 spread as a fair basis for determining mark-up, if that answers  
4 your question.

5           Mr. Rotberg: I think it does.

6           Now, the question is whether we can get an agreement  
7 on that point: That on the lower-priced securities, where the  
8 spreads are typically quite wide, and they average about 25 per  
9 cent under a dollar, that there you do not use the independent  
10 offer, but you use contemporaneous cost, because you think that  
11 the spread is unreasonable.

12           Can we get an agreement on that? Or is there still  
13 disagreement?

14           Mr. Cohen: Could we take this in two steps? Could  
15 we see if there is an agreement that we do not use the asked  
16 side of the quoted market?

17           Mr. Anderson. I will agree to that.

18           Mr. Rotberg: Now, where in the NASD policy, the mark-  
19 up policy, do you find a distinction between stocks under a dollar  
20 and higher-priced stocks, in applying the standard?

21           Mr. Cohen: In the statement that all relevant factors  
22 are to be considered, and the spread is a relevant factor.

23           Mr. Rotberg: All right.

24           Now, do you think, just as an objective matter, that  
25 the people in the securities business understand this difference?

          Mr. Rockefeller: We could bounce right back and say

1 define "people in the security business". We have 4800 members,  
2 and about 3800 of them are probably very, very small operations.  
3 Many of them are involved solely in mutual funds. I would say --  
4 I think the majority of this type of member does not understand.  
5 Of the other thousand, I would think the ones active in the over-  
6 the-counter market would understand.

7 Mr. Rotberg: Of course, those other thousand are not  
8 dealing in penny stocks.

9 Mr. Anderson: They deal in some penny stocks.

10 Mr. Rotberg: Well, let us take, then, the case where  
11 an enormous bulk of over-the-counter business takes place between  
12 \$3 and \$7 a share, where **you can get markets** 3, 3 1/2, or 4, 4 1/4,  
13 and where, if you use the contemporaneous cost, you are over the  
14 5 per cent, but if you mark it up over the independent offer,  
15 you will be okay.

16 What do you do in those cases?

17 Mr. Rockefeller: Shall we ask what the other relevant  
18 factors are here?

19 Mr. Anderson: I think you have got to take a schedule  
20 that is before you of a dealer's transactions, and you are going  
21 to look at all of the things. You are going to look at the  
22 pattern.

23 I am perfectly willing to admit in my own case, if I  
24 have considered such matters, if I see a market of 5 to 5 3/4  
25 and his cost was 5 1/8, I may in my own reasoning, in trying to

1 resolve whether this is a fair mark-up or not, conclude that  
2 5 3/4 is not a fair basis for computing this. But neither is  
3 5 1/8 a fair basis for computing it.

4 Perhaps a more realistic market would be 5 to 5 3/8, or  
5 5 to 5 1/2.

6 Then, if you come up with a mark-up of 5 per cent or 6  
7 per cent on that transaction, or even 7, look at all the other  
8 transactions, and if a great majority of them are well within what  
9 is intended under the 5 per cent policy, then you would ignore  
10 that.

11 Mr. Rotberg: The reason I raise this question of the  
12 intermediate-price stock between \$3 and \$7 a share is because  
13 I would like you just to put yourself in the position of the firms  
14 who deal only in penny stocks or dollar stocks.

15 They would answer to me, perhaps, just as Mr. Cohen  
16 has:

17 That they are entitled to a profit for their risk and  
18 a profit for their retailing, and that the profit for their risk  
19 will be 33 per cent because the stocks are inactively traded, they  
20 are highly speculative, and they want a greater spread.

21 Under those circumstances, can you appreciate that  
22 there might be some inconsistency between the reasons why you  
23 apply the mark-up policy one way at \$20 and a different way at \$1?  
24 Don't your arguments apply to the \$1 stock, or the penny stocks,  
25 just as much as they do to the \$20 stocks?

1           Mr. Anderson: I do not think there is any inconsistency  
2 because I think the man who is reviewing the thing is looking  
3 at a determination as to what is a representative market. And  
4 he may not, in his consideration, accept these figures as being  
5 the representative market.

6           For example, in some of the penny stocks where there  
7 will be five dealers in the sheet at 75 cents bid, \$1 asked,  
8 another firm -- and we have seen this happen in specific cases --  
9 which does not make a market in the stock, but which has bought,  
10 in the course of a week, hundreds of shares of this same stock  
11 at 75 cents from the same firm which is listed in the sheets as  
12 making a market of 75 to \$1.

13           Now, it does not stand to reason that this firm making  
14 a market of 75 to \$1, if he is paying 75, is going to sell stock  
15 at 75 cents to the same man, day in and day out.

16           Mr. Rotberg: You are saying this is a fictitious quo-  
17 tation on the offering side?

18           Mr. Anderson: It certainly raises the question as to  
19 whether it is a valid market or not.

20           Mr. Rotberg: Do you make the determination as to  
21 whether there is a fictitious quotation on the offer side in  
22 the higher-priced stocks, too?

23           Mr. Anderson: If there is enough difference.

24           Mr. Meyer: How would you determine whether it is fic-  
25 titious? Would that simply be based on the fact that there is a  
large spread?

1           Mr. Anderson: No, you would not conclude on that.  
2 One thing I just mentioned would be one indication -- then this  
3 would be merely a matter of opinion. I do not think you would  
4 necessarily conclude that it is a fictitious market. But this  
5 would be a factor, I think you would have to consider in the  
6 over-all picture.

7           Mr. Meyer: But if the market were not fictitious, you  
8 would still be inclined to use the contemporaneous cost, where  
9 you had that type of spread in a penny stock?

10          Mr. Anderson: Well, not one that normally there are  
11 that many dealers in the sheets, because normally in an active  
12 stock in the penny range you would not have a spread of 33 1/2  
13 per cent between the bid and asked, so far as actual trading is  
14 concerned.

15          Mr. Meyer: Would your opinion be different if, instead  
16 of 75 cents to \$1, it were 7/8 to \$1?

17          Mr. Anderson: Yes, I think mine would.

18          Mr. Meyer: In that case you would be inclined to use  
19 the dollar?

20          Mr. Anderson: I would be a lot more inclined to use  
21 the dollar as a representative offering price.

22          Mr. Rotberg: Doesn't this discussion really reflect  
23 an opinion that you do not like the markets in penny stocks and  
24 that you are more reluctant to accept the independent offers  
25 as true offers?

1           Mr. Cohen: I would comment on that -- although I would  
2 paraphrase it.

3           I do not think it is a question of any emotional atti-  
4 tude, as to whether we like or dislike them. I think that I  
5 would feel that a 25 per cent spread in a stock with any degree  
6 of activity probably reflected an extreme quotation which could  
7 be closed by anyone who wished to buy or sell, on one side or the  
8 other.

9           And so I would agree with you that I would be skeptical  
10 as to the validity of the quotation.

11          Mr. Meyer: So that there might be some duty on the  
12 part of a broker selling to a customer, even if he is not a  
13 market maker, where the market is  $3/4$  to \$1, to go in and bid  
14 at, say,  $7/8$ ?

15          Mr. Cohen: I suspect very strongly, without being  
16 able to prove it, that a dealer who had an order for a stock  
17 quoted 75 cents to a \$1 would make a heroic effort to buy it  
18 cheaper than \$1.

19          Mr. Rotberg: Let us take about a five-minute break.

20          (Whereupon, a short recess was taken, after which the  
21 hearing was continued.)

22          Mr. Rotberg: On the record.

23          Mr. Meyer: Before we broke, I think it was mr. Cohen  
24 who stated that in the hypothetical situation where the market  
25 was 75 cents to \$1 in a low-priced stock, that he would tend to

1 view that market with some distrust, and would regard the firm  
2 selling to a customer as having the duty to try and pick it up,  
3 if it were not a wholesale firm, at less than \$1, something like  
4  $7/8$ ; in which case, if he were successful in picking it up  
5 at  $7/8$ , what would then happen.

6 I assume that that would be the new market, is that  
7 right?

8 Mr. Cohen: Well, what we are talking about now, if  
9 I follow the question correctly, is something a little different  
10 than what we had been discussing. And I think we are using it  
11 simply to illustrate my opinion that these markets were not  
12 valid.

13 But the situation we are discussing now is a riskless  
14 trade, of course. The dealers had gotten an order, as you  
15 put it, to buy stock at \$1, but who was not in position and had  
16 to go out and fill the order. He would fill it at the best  
17 price.

18 The price at which he bought it would be the price  
19 from which he could mark it up, because in this case he clearly  
20 had a riskless trade.

21 But we started with the premise he has not ordered.

22 Mr. Meyer: Is that important?

23 Mr. Cohen: Unless I am confused, it is vital, because  
24 we are not now talking about the man in position. We are talk-  
25 ing about a hypothetical dealer who has no order, who has no

1 position, but who has an order which he goes out to fill. Those  
2 facts, to me, make it clearly a riskless trade.

3 Mr. Meyer: In that case, his cost is used. It would  
4 be a better estimate than the market.

5 Now, if he decided, rather than having an order to  
6 fill, if he simply decided he was going to try and retail the  
7 stock and went out and accumulated some stock at 7/8, then he  
8 could use the dollar to mark up from?

9 Mr. Cohen: If I may qualify my answer, I would like  
10 to do so, with this comment.

11 During the time that I have been on the Business Conduct  
12 Committee, both at the District and at the National level, as yet,  
13 I have not had occasion to decide one case solely on the basis of  
14 contemporaneous cost.

15 As nearly as I can recall, every mark-up case that has  
16 come before us, mark-up policy case, has involved mark-ups from  
17 the representative market so gross that there was a clear viola-  
18 tion without having to go into those mark-ups which involved  
19 contemporaneous cost.

20 Now, this may not be true over a long period of time.  
21 I am speaking now to my experience.

22 So what I am telling you is what I think I would do if  
23 confronted with this problem -- not what I have done when the  
24 problem existed or what the Board has done during my tenure.

25 Pat and Ted have been on the Board during my two-year

1 tenure, and Marc has, of course, observed our actions. And I  
2 wonder if that statement is factually accurate.

3 Mr. White: I think in the time you have been on the  
4 Board we have not had one case which turned on contemporaneous  
5 cost alone.

6 Mr. Rotberg: Now, what about, when you say "has not  
7 turned on contemporaneous cost," you mean that there are other  
8 matters involved, or has not turned on whether you use contemporaneous  
9 cost or independent offer?

10 Mr. Cohen: The latter.

11 I mean that the mark-ups applying independent market  
12 have been so excessive in relation to the five per cent policy  
13 that we have not had to go to contemporaneous cost.

14 Mr. White: I would like to reserve judgment. The  
15 Thill Case might be -- oh, you were not there.

16 Mr. Cohen: I was on the Thill.

17 Mr. Rotberg: What about the Naphthalin Case?

18 Mr. White: In that case Mr. Cohen excused himself  
19 from consideration of the case and excused himself from the room.

20 Mr. Rotberg: In that case, am I correct that the mark-  
21 up, when computed on the independent offer, was within five per  
22 cent, but, when computed with contemporaneous cost, was outside of  
23 five per cent?

24 Mr. Derrickson: There was a large question there if  
25 there was any independent offer.

1           Mr. Rotberg: That gets us back to the question, then,  
2 as to how do you determine what is an independent offer. Could  
3 someone comment on that?

4           Mr. Anderson: I do not think there is any clear-cut  
5 way. I think this is a matter of -- as I said to someone --  
6 using your best effort to check everything you can check; when  
7 this question becomes important and has a bearing on the decision,  
8 then to look at everything that you can find that might throw  
9 some light on what should be used as the independent market,  
10 and then make a decision on that basis.

11           Mr. Rotberg: What are some of the factors which would  
12 indicate the existence of an independent offer or the lack of an  
13 independent offer?

14           Mr. Rockefeller: May I say something first?

15           In many of these cases, when you are looking back at  
16 some of them, the offer in the sheets is not always a very good  
17 market, as you can understand. They come out once a day. The  
18 prices go into the sheets -- usually, the previous day -- or  
19 they go in 2:00 o'clock today for tomorrow's publication.

20           Mr. Cunningham: The deadline is 1:30.

21           Mr. Rockefeller: And those sheets are distributed  
22 around New York tomorrow. They may get into outlying areas 1 to  
23 3 days late. So that market really is not a very good one to  
24 tie your hat to sometimes. It is very difficult to know many  
25 months later what the exact market in the street was at a partic-

1 ular time.

2 Mr. Rotberg: Am I mistaken that you use the -- that  
3 is the exact market you use in connection with inventory cases --  
4 this market that you think is not too good?

5 Mr. Rockefeller: I do not think you always do, no.

6 Mr. Rotberg: Wait a minute.

7 You say that you use the independent offer in the in-  
8 ventory cases, and, yet, now you say that is a pretty bad  
9 market to look at.

10 Mr. Rockefeller: That is what Glenn is getting to by  
11 saying it is not very clear-cut, what we can use, in many of  
12 those cases.

13 Mr. White: Is not what you mean, Pat, is that you  
14 could have six dealers in the sheets with various bid and asked,  
15 and that the respondent in one of our cases might be relying on  
16 his mark-up over the highest offer, and we might take a look at  
17 all six and determine that the more representative offer was  
18 something else?

19 Is that correct?

20 Mr. Rockefeller: A much narrower market than the one  
21 laid down by any particular individual.

22 Mr. Sporkin: Mr. Rockefeller, how does a broker, who is  
23 determining how much he is going to make up a transaction, know  
24 what he can do; what are the standards that are going to be used?

25 It is all well and good to say, looking many months

1 later in reviewing this as a disciplinary matter, to go back  
2 and look at these various standards. But how does the broker  
3 who wants to determine what is the proper thing to do?

4 Mr. White: It seems to me he is in the same position  
5 that everybody in this room was in at one stage of the game.  
6 We saw the difficulties of attempting to write an interpretation,  
7 and then people opposed it because they thought it was a rule,  
8 and then we tacked on explanatory letters and statements over a  
9 period of years, and rewrote this in umpteen drafts, the four  
10 pages that now appear in the manual.

11 And he looks to the language of the manual and uses  
12 his best judgment, based on his experience.

13 Mr. Rotberg: Marc, a few moments ago you said that up  
14 to 1959 there was a general policy to use contemporaneous cost  
15 as a basis for computing the mark-up, even in inventory situa-  
16 tions. But, since that time, there has been a -- more of a shift  
17 to the use of the independent offer in the inventory situation, is  
18 that right?

19 Mr. White: I do not believe I said that exactly that  
20 way.

21 My impression of what happened up to 1959, I gained  
22 from what I began to see in cases being decided in 1958, when  
23 I came with the Association.

24 I think that the stress was put, in cases there, on  
25 contemporaneous cost.

1            Now, it may well be, if I had gone back to the deliber-  
 2            ations of the District Committee to determine whether they  
 3            would file a complaint, or whether they would pursue it to deci-  
 4            sion, if I had the benefit of that, I might have seen that they  
 5            took all these things into consideration.

6            What we saw at the Board level was what appeared to be  
 7            an overemphasis on contemporaneous cost as a basis for computing  
 8            mark-ups, and in cases that we began to review and hear on appeal,  
 9            we found there was another whole argument to be considered before  
 10           we made a determination.

11           Mr. Rotberg: Which had not been considered up until  
 12           1959, as far as you know?

13           Mr. White: I will not say it had not been considered,  
 14           because I have just explained how it could have been at the  
 15           District level before a complaint was filed.

16           Mr. Rotberg: I mean the level which you were at.

17           Mr. White: It appeared to me there was not a suffi-  
 18           cient enough emphasis, in view of the thinking of the Board that  
 19           I became acquainted with, there was not sufficient emphasis put  
 20           on the independent offer.

21           Mr. Rotberg: And this, I suppose, ties into Mr. Ander-  
 22           son's comment that in 1959 many brokers were admitting to viola-  
 23           tions when they were not probably guilty, is that correct?

24           Mr. Anderson: Right.

25           Mr. Rotberg: Well, what I want to try to get at here

110/50

1 is:

2 Was this fact, that you were now reconsidering the  
3 matters or considering the matters from independent offer, ever  
4 communicated to the broker-dealers?

5 Mr. White: Well, I can answer that by saying that what  
6 was known to the membership, and the basis on which they oper-  
7 ated, was our policy in the book.

8 The four pages that appear there now, which we filed  
9 here, were filed here with the covering letter that was not  
10 intended as a change of substance.

11 Now, how acquainted each member was in a given area  
12 with the intricate thinking, and I think it is, as exhibited  
13 here, of Committee men determining these cases, I just cannot  
14 say from my own experience.

15 Mr. Rotberg: Well, was the new facet, or the new  
16 stress on independent offer, which began to evolve around 1959  
17 or 1960, communicated to the Commission?

18 Mr. White: Well --

19 Mr. Derrickson: Could I say something?

20 Before getting further into that -- I think that there  
21 arose a problem, and I think Don could speak to this, too -- in  
22 many cases where dealers did not have any contemporaneous cost,  
23 so it had to be related to the market, so-called market, as in  
24 the sheets or any other evidence he might have.

25 Mr. Rotberg: We are talking, really, almost exclusively

1 about the integrated firm who has a contemporaneous cost and who  
2 is making a market, and who is selling retail.

3 Mr. Derrickson: If you are talking that way, then you  
4 should not be talking about a lot of the cases we have, because  
5 they were not that type of firm, and we do not have cases like  
6 that.

7 Mr. White: If I can answer your question, the last  
8 question, I think that the Commission, at least on the staff  
9 level, Division of Trading and Exchange, was thoroughly aware of  
10 our general thinking and the rationale behind this policy,  
11 because, as Mr. Anderson will attest, we went over every single  
12 paragraph of this policy that is now in the book, and the  
13 reasons for it, and why this change was not a change of substance,  
14 and how we viewed this.

15 Mr. Anderson was then Chairman of the National Business  
16 Conduct Committee, became Chairman of the Board the following  
17 year, and that represented the then Board thinking.

18 Mr. Rotberg: Let me read to you a critical page of the  
19 mark-up policy.

20 "In the absence of other bona fide evidence of the  
21 prevailing market, a member's own contemporaneous cost is the  
22 best indication of the prevailing market price of a security."

23 Now, does that not mean that even if there is an  
24 inventory, that where there is a "contemporaneous cost, it is  
25 the best indication of the prevailing market price"?

1 Does it mean that or does it not?

2 Mr. Anderson: Would you say that again?

3 Mr. Rotberg: "In the absence of other bona fide evi-  
4 dence of the prevailing market, a member's own contemporaneous  
5 cost is the best indication of the prevailing market price of a  
6 security."

7 Now, does that sentence apply to risk inventory situa-  
8 tions?

9 Mr. Anderson: If there were no evidence of a market  
10 outside, then you would have to go to the same-day cost as the  
11 best evidence of the prevailing market.

12 Mr. Rotberg: So that you read the sentence as follows:

13 In the absence of an independent market, a member's  
14 own contemporaneous cost is the best indication of the prevailing  
15 market price?

16 Mr. Anderson: Well, I am not sure I read it that way,  
17 because I think that implies that if the dealer is the only one  
18 who makes a market, then that could not be --

19 Mr. Rotberg: Aside from that situation --

20 Mr. White: Could I interrupt right there?

21 I think you posed that same question to Mr. Gilleran  
22 and he answered in the affirmative.

23 Mr. Anderson discussed that last night, and his answer  
24 then was in the absence of other evidence to the contrary --  
25 would perhaps be a better statement -- which still does not get

1 to the point you are raising.

2 Mr. Rotberg: Well, am I correct that the expression,  
3 "in the absence of other bona fide evidence of the prevailing  
4 market," or the expression, "in the absence of evidence to the  
5 contrary," you mean the existence of an independent offer? Is  
6 that what it means?

7 Mr. Anderson: Not necessarily, because it could apply  
8 if this very dealer is the only one who makes a market.

9 Mr. Rotberg: Aside from that situation.

10 Mr. Anderson: Aside from that, I think this is what  
11 it means, yes.

12 Mr. Rotberg: It was not contemplated that that sen-  
13 tence would refer only to distress sales where a dealer was  
14 able to purchase at a low price, and that was the evidence to the  
15 contrary. Is that not what that sentence meant to imply?

16 Mr. White: Well, let me see if I can go back a bit.

17 I think that sentence was a rewrite of a standard boiler-  
18 plate sentence that the Commission had in various decisions,  
19 and what had happened -- and, of course, these decisions are  
20 not representative of mark-up problems across the board with all  
21 types of firms and all types of securities -- what had happened  
22 was that the Commission, in disposing of cases over a period of  
23 time, from the Hughes Case on, I think, said in the absence  
24 of countervailing evidence, we look to the contemporaneous cost.

25 Mr. Rotberg: That is correct.

1           Mr. White: And I think we listed that language with-  
2 out any idea to foreclose anyone from consideration of the  
3 independent offer.

4           Is that a fair statement?

5           Mr. Anderson: That is right.

6           Mr. Rotberg: Did not the expression in the Hughes  
7 Case and the cases immediately after that, "in the absence of  
8 evidence to the contrary," mean in the absence of your proof that  
9 you were able to buy a huge block at a distress price, then you  
10 could use -- then you must use the contemporaneous cost? Is that  
11 not what that referred to?

12           Mr. Anderson: That is not the way I understood it.

13           Mr. White: No -- and, actually, the phrase has been  
14 used again in subsequent cases where that was not even in issue.

15           Mr. Rotberg: All right.

16           Now, if that is the case, if the expression "in the  
17 absence of other bona fide evidence of the prevailing market" means  
18 in the absence of an independent market, would the NASD object  
19 to rewriting this rule to state:

20           "In the absence of an independent offer, you use your  
21 contemporaneous cost. If you have an inventory, you do not  
22 use your contemporaneous cost, but you use that independent offer."

23           Is there any objection to that, since this apparently is  
24 your view?

25           Mr. Rockefeller: That is a policy question that kind

1 of precludes some of the other relevant factors that may come  
2 in here.

3 Mr. Anderson: Well, this would be only the matter of  
4 determining the mark-up, and the other factors would still be  
5 considered.

6 The only problem it gives me is that when you use the  
7 word "independent," I think you rule out the dealers on market.  
8 And there are instances in which a dealer makes both a wholesale  
9 and a retail market, but he may be the only one. And, certainly,  
10 if I found a case where a dealer was making a market of 5 to  
11 5 1/4 on the inside, and 5 to 5 1/2 elsewhere, and this was the  
12 only market, and I found sales to dealers at 5 1/4, I would  
13 consider that independent.

14 Mr. Rotberg: So that you now reach the conclusion that  
15 in the inventory case, even if he is the only dealer, you will  
16 still use the independent offer?

17 Mr. Anderson: If there is evidence that this is  
18 actually a market.

19 Mr. Rotberg: Yes.

20 Dealers are buying from him at 5 1/4, and he is  
21 selling to customers at 5 1/2.

22 Mr. Anderson: I would think so.

23 Mr. Rotberg: Well, then, what is left of the mark-up  
24 policy, except for the pure riskless transaction? Maybe it only  
25 applies to that. I want to get that on the record -- if that is

1 all it means to cover, that is all it means to cover.

2 Mr. Cohen: I do not think that that would lead us quite  
3 to where you put it.

4 I would revert to what I said initially:

5 That I think that there are two factors to a position  
6 trade -- the risk involved in the position and the profit  
7 applicable to merchandising.

8 A riskless trade is the easiest, because we have only  
9 one factor.

10 A position trade, in which there is an active market,  
11 is very easy -- relatively. The less active the market, the  
12 more restricted the market, the more difficult it becomes to  
13 apportion fairly a part of the profit for risk. And when you  
14 get down to a case where there is no other market, it becomes  
15 extremely difficult.

16 This, however, does not, I think, eliminate the five  
17 per cent policy, except in the case of riskless trades.

18 In the case of a trade at risk, where there is an active  
19 market, it is easy to apply --

20 Mr. Rotberg: In that case it would be the independent  
21 offer.

22 Mr. Cohen: Assuming that it appears to be a valid one.  
23 In the case of an inactive market there is more judgment, again,  
24 as to whether the ask side of the independent market is the valid  
25 base.

1           In the case where the dealer is the only market -- and  
2 I am now hypothesizing as to how I would decide if that came  
3 before us, because I have never had one -- I would attempt --  
4 and I am speaking only for myself -- to determine, if the  
5 circumstances appear relevant, how much of a spread the man  
6 might be entitled to for the fact that he is in position, and  
7 then apply the five per cent policy to what seemed to me a fair  
8 ask price after making that determination.

9           Now, this gets to a matter of business judgment. But  
10 I do not know how we can apply this, except by using our business  
11 judgment. And I feel that those of us who have been in the  
12 business as long as we have, have developed some degree of  
13 judgment in these matters. But I do not think that the appli-  
14 cation of a policy such as the one that I am outlining makes  
15 the five per cent policy applicable only to riskless trades.

16           Mr. Rotberg: I should have corrected that. I meant  
17 that the contemporaneous cost theory is only applicable to risk-  
18 less trades.

19           Mr. Cohen: Yes.

20           I want to emphasize I am expressing a personal opinion  
21 here -- not acting as spokesman for the group.

22           Mr. Rotberg: I assume your opinion is completely  
23 **accepted by everyone** in the room, as you have expressed it.

24           Mr. Meyer: Let me --

25           Mr. Ladd: I think there might be some argument at

1 times. When you look at the whole picture, and you take in  
2 all the facts, my own inclination would be to take it from his  
3 cost, unless there was some justification. I have been in a  
4 professional type of business, so I do not have quite the same  
5 problems that these retail dealers have.

6 Mr. Rotberg: I think that you are making the critical  
7 point, which is really going to distinguish between the two  
8 opposing -- two perhaps divergent points of view. What is it  
9 about being in the retail business which makes one want to  
10 use independent offer, while being in the strictly wholesale  
11 business tends to cause you to be in favor of the use of  
12 contemporaneous cost?

13 Mr. Cohen: Well, I will tell you, being in the retail  
14 business, what makes me at least want to use independent market --  
15 and Ted can speak for the attitude of those in the wholesale  
16 business -- I cannot -- and that is the awareness that when we  
17 take a retail position, that we stand to lose money. This aware-  
18 ness, when we take a position in the hopes of retailing a stock --  
19 this awareness is sharpened by the fact that frequently we do,  
20 and in the last six months we have in a great many cases. We  
21 think, therefore, that if a person who does not take this risk  
22 is entitled to a certain retail market, that those of us who do ac-  
23 cept the risk are entitled to some compensation for that risk,  
24 because those that are profitable must, to a degree, be used  
25 to offset those that are unprofitable, and to look only at the

1 profitable ones is, perhaps, an unfair computation of our total  
2 risk-taking profits.

3 Now, Ted can speak to the other side.

4 Mr. Ladd: I would not disagree in the case when you  
5 are taking a risk and have an inventory, and where you are sub-  
6 ject to the changes in the market. You may buy a stock at 21,  
7 and when the market is  $20 \frac{3}{4}$ ,  $21 \frac{1}{4}$ , with the idea that you  
8 might retail at  $21 \frac{1}{2}$ , but before you have retailed, the market  
9 might be  $20 \frac{1}{2}$ , 21, so you have taken a risk. Then you are  
10 entitled to that compensation.

11 But I am saying if a dealer comes in to me, a retail  
12 dealer, and I am making a market, 21 to a half, and he buys  
13 my stock at  $1 \frac{1}{2}$  and goes out and sells it, then I think that  
14 is a riskless transaction.

15 Mr. Meyer: You said before -- and correct me if I am  
16 misinterpreting -- that there are two elements which may exist  
17 in any transaction: the wholesale and the retail.

18 The retail side of the transaction -- what would that  
19 include?

20 Mr. Cohen: That would include the distribution of the  
21 stock to a retail customer.

22 Mr. Meyer: Now, do you include in retail the taking  
23 of a position?

24 Mr. Cohen: As we keep our own books now -- are you  
25 asking how I personally regard it?

1           Mr. Meyer: Yes.

2           You see, I may be a little vague here, but I get the  
3 feeling that somehow the five per cent policy is not quite the  
4 five per cent for the retailer who takes a position in the stock.

5           Mr. Cohen. I think the total profit can work out to  
6 more than five.

7           But let me try to answer you from my point of view.

8           I think it is fairly consistent now with the point of  
9 view I have just expressed.

10          We are retailing certain stocks. These stocks --  
11 we will take a given stock -- quoted at 21 to a half. At any  
12 given moment we can buy stock and mark it up, let us say five,  
13 for easy calculations, without any risk. Everything being  
14 equal, then, this is the most effective way to conduct such an  
15 operation -- if we simply wish to make five -- to then  
16 make five per cent and stay within a merchandising operation.

17          Why should we subject ourselves to risk under those  
18 circumstances? The only reason we will subject ourselves to  
19 risk is to be able to buy it below the ask side at a lower price.  
20 Then we have a spread from which we can either sell it to  
21 another dealer or a spread which will permit us, as we see it,  
22 to retail it at a five per cent mark-up for the representative  
23 market, and we have been paid for taking the risk involved.

24          Do you follow me?

25          Mr. Meyer: Are you saying that if you take a position

1 acting strictly in a retail capacity, that you are entitled to  
2 mark up more than five per cent?

3 Mr. Cohen: Under these circumstances:

4 If, by taking that position, we have bought it at a  
5 lower price than we could have bought it at that moment without  
6 a position. If the market is 21 to a half, and we buy it 1 1/2,  
7 we are entitled to no greater profit if we are in position than  
8 if we had waited until we had the order. But if the market  
9 is 1 to a half, and we are willing to buy it at 21 1/8 or 1/4,  
10 in the hopes of later getting an order, then we think we have  
11 earned the difference between 21 1/8 or 1/4 and 21 1/2 by a  
12 willingness to assume the risks that go with holding the stock  
13 until we have been able to sell it.

14 Mr. Ladd: I did not differ with you on that.

15 Mr. Cohen: The fact that we are in position entitled  
16 us to nothing.

17 Mr. Rotberg: Now, in a situation where, prior to  
18 the issuance of a market letter, you decide to go into the  
19 sheets and buy on the bid and accumulate the security, prior to  
20 the issuance of the market letter, so that you can buy it slowly  
21 and at the bid side and then sell it to your customer at a  
22 flat price -- in that situation, do you mark up over the existing  
23 independent offer?

24 Mr. Cohen: At the time we retail it?

25 Mr. Rotberg: Yes.

1 Mr. Ladd: You have taken a risk.

2 Mr. Cohen: Yes.

3 Mr. Rotberg: You have taken a risk?

4 Mr. Cohen. Yes.

5 Mr. Rotberg: Now, in that situation, you would be  
6 able to acquire the stock at the bid, is that correct?

7 Mr. Cohen: If we are running a position, we may get  
8 it at the bid, yes.

9 Mr. Rotberg: That is right.

10 Well, I thought that earlier this morning someone had  
11 said that a dealer who wanted to retail stock, wanted to get the  
12 greatest profit available, could not expect to go into the  
13 sheets and pick up stock at the bid because nobody knew him,  
14 and they deal with their own tried-and-true market makers.  
15 Apparently that is not so with many firms who issue market  
16 letters.

17 Mr. Cohen: Well, this is an intricate business, and  
18 I suppose everything we say has to be carefully qualified.  
19 If we are an active factor in a market in a continuing position,  
20 we expect to buy our stock around the bid side.

21 Mr. Rotberg: I am saying you are not in the market,  
22 and you decide to go in.

23 Mr. Cohen: Into a new market, where we have not had  
24 a position?

25 Mr. Rotberg: That is right.

1           Mr. Cohen: As we discussed earlier, the probabilities  
2 of our buying stock at the bid side in competition with those  
3 people who are actively identified with it are remote. The  
4 possibility of our buying it in between the bid and the asked, if  
5 we take our time and show a continuing interest, exist, and we  
6 will buy some, in all probability, if the market does not move.

7           Mr. Rotberg: As you are buying the stock, if you spin  
8 it out to your retail customers, you think that you are still at  
9 risk?

10          Mr. Cohen: You say as we buy it, we spin it out. This  
11 suggests that this is concurrent. If we buy the stock before we  
12 have an order for it, in our judgment, we are at risk. Anytime  
13 we are long or short of stock, without an offsetting order, in  
14 our judgment, we are at risk, because before we buy or sell that  
15 stock, the market can move. Our experience is that it has moved  
16 in many cases.

17           We may derive a greater profit; we may derive a loss.

18           But the only riskless position, in my judgment, is  
19 one which you are neither long nor short. You cannot avoid  
20 risk with a position. They are inseparable. Position means  
21 risk.

22          Mr. Rotberg: On the question, again, of what is the  
23 independent offer, we were trying to get back to this question  
24 of how you would evaluate, in any price stock, whether there is  
25 an independent offer. Could some of you comment on some of the

1 measurements?

2 Mr. Haack: Mr. Chairman, I was going to speak to that  
3 a minute ago. I had been on the Business Conduct Committee now  
4 for the past year and come to grips quite frequently in mark-up  
5 cases. I do not want to sound ethereal, but I think there are  
6 several abstractions that I have looked to and I suspect others  
7 have.

8 No. 1 is the security in question. If I see the  
9 Bankers Trust, First National City Bank, Dun & Bradstreet,  
10 large, reputable companies, that is a factor in my judgment.  
11 I know I can trust the market. I look to the people who are  
12 making the market, if you please. Are the firms reputable; are  
13 they knowledgeable; what is the background of their interest;  
14 do they have a traditional underwriting relationship, and so  
15 forth and so on; or are these firms part of a group which are  
16 known in the trade as to operate on the fringe and go hand-in-  
17 hand and work in concert with each other and what not?

18 These are all factors that I have tried to utilize to  
19 determine what I think is one of the pivotal things: the validity  
20 of this market.

21 Mr. Rotberg: Now, when you say the "validity of that  
22 independent offer," what is it that you are really looking for  
23 about that independent offer? What is it you are trying to find?

24 Mr. Haack: Well, I want to see if it is real, if it  
25 is valid.

1           Now, if you tell me the market is 1 to 1/4 in a stock  
2 and I see you buying it, as Mr. Anderson said, at 1 day in and  
3 day out, I think you are either an awful good trader or the  
4 market is not valid.

5           Mr. Meyer: Let me come back to that situation before,  
6 Mr. Cohen, when we were talking about a situation before where a  
7 stock might be quoted at 3/4 to 1, with a number of dealers in the  
8 sheets, and I think the opinion was expressed that that might not  
9 be a realistic quotation, and someone who was executing for a  
10 customer might have an obligation to try and pick up stock at 7/8.

11           Let us say that a firm did try to pick up stock at 7/8,  
12 and went around the street trying to get stock at 7/8.

13           If he did, if he bought at 7/8 on a customer's order,  
14 then that would be the basis, I take it, from which you would  
15 compute his mark-up.

16           Mr. Cohen: I would apply the riskless trade --

17           Mr. Meyer: To the 7/8?

18           Mr. Cohen: To the 7/8.

19           Mr. Meyer: Now, if he did not have a customer's order  
20 and he took the 7/8 into inventory, what would you compute the  
21 mark-up on?

22           Mr. Cohen: And subsequently resold the stock?

23           Mr. Meyer: Resold the stock.

24           And let us say he resold it for \$1.05.

25           Mr. Cohen: I would have to try to decide in my own

1 mind whether an eighth spread in a position in a stock selling  
2 at that was a fair compensation to him for the risk he had assumed  
3 in being in position there.

4 One of the things that would influence me would be the  
5 asked side of the market.

6 I would also have to decide, going back to our dis-  
7 cussion of a few minutes ago, whether in buying it at  $7/8$  he  
8 had really bought it at a price which gave him compensation for  
9 risk or whether he had simply bought it at a price -- bought it  
10 for inventory to have a greater mark-up.

11 Let me revert to what I said to you in response to a  
12 different question.

13 You cited the case of a stock quoted 21 to  $1/2$ , and  
14 you asked me whether, if we bought the stock at  $21\ 1/2$ , we felt  
15 we were entitled to a compensation for risk, in addition to our  
16 normal mark-up.

17 And I said to you if the market were 21 to  $1/2$ , and we  
18 bought it at  $21\ 1/2$ , that all we would be entitled to would  
19 be the mark-up over  $21\ 1/2$  as a representative mark-up.

20 Mr. Meyer: Regardless of the fact that you take it  
21 into position?

22 Mr. Cohen: Yes, because we did not take it into posi-  
23 tion, it seems to me, without a business reason. We take it  
24 into position to achieve, not, as I see it, to evade our five  
25 per cent policy, but for an economic reason: that by buying it

1 at the lower price, you achieve an opportunity for a greater  
2 profit by the assumption of risk. You have accomplished something  
3 by taking the position. You bought it at a lower price than you  
4 could if you avoided the risk.

5 Mr. Meyer: On the other hand, if you pick it up at  
6 21 1/8, if you do it on a customer's order, you are only entitled  
7 to a mark-up over 21 1/8?

8 Mr. Cohen: If I do it on a customer's order, yes.

9 Mr. Meyer: But if you take it into position, you are  
10 entitled to a mark-up on 21 1/2, is that your position?

11 Mr. Cohen: Yes.

12 But let me explain that because I think, again, you  
13 have suggested an unreal situation. The probabilities of buying  
14 stock at 21 1/8 to fill an order are remote. The order comes  
15 in at a given time and must be filled at that time, and you go  
16 to the people that own the stock and you buy at the best price  
17 you can.

18 To buy it at a price close to the bid, you go in there  
19 and compete with the other buyers, and at some moment in time may-  
20 be you will get some. But to suggest you can fill customers'  
21 orders at the asked side of the market or close to it would not  
22 be realistic -- at the bid side of the market, I am sorry --  
23 because you have this time element.

24 Mr. Rotberg: Unless you had intended to engage in a  
25 particular selling effort through a market letter, and you could

1 slowly accumulate the stock and expect to sell it upon the issuance  
2 of a market letter. I am sure that has happened fairly often.

3 Mr. Cohen: I think so. But the point --

4 Mr. Rotberg: Do you think you are at risk in that  
5 situation, too?

6 Mr. Cohen: We do not issue market letters. Let us  
7 put it that way -- in terms of what I consider a market letter.  
8 But there are securities of which we think favorably. There are  
9 times when we will accumulate them and subsequently sell them.  
10 And we will attempt to accumulate a substantial amount of stock  
11 before we sell them. And we hope, when we release our sales  
12 material, that we will sell them.

13 However, we think we are at risk during the period of  
14 accumulation. We think we are at risk during the period of  
15 accumulation because on occasion this well-laid plan has gone  
16 awry, and before we could start our sales effort, the stock has  
17 gone down, or after we started it, we have found that we  
18 accumulated 5000 shares and could sell 2000, and before we  
19 could distribute the balance, the market went down, and we took  
20 a loss. So we very definitely think we are at risk.

21 We do not think one can accurately predict the retail  
22 performance of any sales organization at a future date. There  
23 are some things which may affect it.

24 Mr. Rotberg: This raises a related question about the  
25 use of the independent offer.

1           You have three or four market makers making a market  
2 in the security, and the company under question is also making  
3 a market. The market is 20 to 20 1/2.

4           How do the District Committees go about evaluating  
5 whether the independent offer of 20 1/2 is for more than 100  
6 shares?

7           Mr. Cohen: Three months later?

8           Mr. Rotberg: Yes.

9           Mr. Ladd: May I ask Mr. White a question off the  
10 record?

11           (Discussion off the record.)

12           Mr. Rotberg: Back on the record.

13           Mr. Ladd: There have been instances where it was very  
14 difficult to judge what was the true market from the quoted  
15 market, particularly when such market was a period of three or  
16 four months behind.

17           And in one specific instance I am sure that we went to  
18 certain dealers who were maintaining a primary market to see at  
19 what prices those transactions were taking place, so that we  
20 could determine what was the true market compared to the quoted  
21 market in the sheets.

22           Mr. Rotberg: But the dealer who was under scrutiny,  
23 all he could base his mark-up on, assuming he was acting in  
24 all honesty, is what he saw in the pink sheets. Is that correct?

25           Mr. Rockefeller: No.

1 He has available to him the wire system, so he could  
2 check markets at several different places.

3 Mr. Rotberg: Is it such a problem with the pink sheets  
4 that in critical cases, where the existence of an independent  
5 market must be determined, that you just cannot rely on the  
6 pink sheets, but you have to go into the transactions, and that  
7 is why you do it?

8 Mr. White: In some cases we have, in order to deter-  
9 mine the accuracy of the pink sheets which he might be relying  
10 on.

11 Mr. Rotberg: Why do you do that?

12 Mr. White: Because, for example, we will have a case in  
13 a given area, and we will have -- at the Board level, I am talking  
14 about -- have a Governor sitting on a hearing who is familiar  
15 with perhaps the stock, the people who were in the sheets, per-  
16 haps has even traded in the stock himself. And he will have a  
17 question about what is in the pink sheets.

18 I have seen this happen.

19 And he will go back and determine from various other  
20 dealers in the city what the market actually was at that period.  
21 Sometimes it checks out with the pink sheets; sometimes it does  
22 not.

23 Mr. Rotberg: Don't the pink sheets consistently  
24 reflect the market on the **offer** side.

25 Mr. White: In a general way, I think they do, but in

1 some specific cases we have pinned it down closer than that.

2 Mr. Anderson: And from a practical standpoint, they  
3 can only reflect the market as of one time during the day?

4 Mr. Cunningham: They offer a guide to the market. And,  
5 also, Mr. Rotberg, some of these traders, when they are preparing  
6 the little slips picked up by Lou Walker's organization, make  
7 them up at 9:30; the conscientious ones make them up at 12:00;  
8 and if there is a change between 12:00 and 1:30, they call up  
9 the national quotation.

10 Mr. Sporkin: Isn't that reason not, then, to use the  
11 pink sheet prices?

12 Mr. Rockefeller: Well, the pink sheet prices still  
13 give you a pretty good guide. And if you are worrying about  
14 a mark-up of 25 to 40 per cent, whether it is 20 to 1/2 or 20  
15 to 3/4 is not going to make an awful lot of difference.

16 Mr. Ladd: Am I correct in this:

17 In the study of the markets we may look at the pink  
18 sheets over a period of a few days to see whether that market  
19 did change? It may be there was a consistent market over that  
20 period?

21 Mr. Sporkin: Let me ask this -- pursue it a little  
22 bit this way.

23 If you are advising a new person coming into the  
24 business how he could be absolutely safe and not violate the  
25 mark-up policy, then would you not advise him that he should base

1 his mark-ups on his contemporaneous cost?

2 Mr. Anderson: I would not advise him that.

3 Mr. Sporkin: You would not?

4 Mr. Anderson: No, I would not advise him that. If  
5 they are riskless transactions, yes, but not otherwise.

6 Mr. Sporkin: How would you advise him otherwise?

7 Mr. Anderson: I would tell him to do the same thing all  
8 the rest of us have had to do, and that is read the policy and  
9 try to get the principle involved and use his own good business  
10 judgment as to whether or not he has complied with that policy.

11 Mr. Rotberg: Do you think it is clear? Do  
12 we all agree that it is clear or not so clear, or difficult,  
13 or that the new ones do or do not understand it?

14 Mr. Anderson: I think any policy of this type is bound  
15 to be involved, and it takes a certain amount of study and  
16 discussion to understand. It would be impossible to write such  
17 a policy without having this. But I would like to throw  
18 some light on this.

19 You were asking how you determine the validity of a  
20 market and so forth, and I can refer to a specific case --  
21 I cannot recall the name of it -- it was a case in Florida, and  
22 it involved one of these situations, and these prices I am using  
23 are relative.

24 The pink sheet showed a market of 1 to 1 1/4.

25 Mr. White: In this case you are talking about, you

1 discovered this, and it was not a defense raised by the respondent?

2 Mr. Anderson: That is right.

3 And Mr. Brook, who was on the Board at the time, and I  
4 were holding a hearing, and this got down to a point of it was  
5 very important as to whether or not -- the mark-up was so close  
6 in violation that it was important to know whether the market was  
7 1 to 1/4, 1 to 1 1/8.

8 So we asked the man what he did when you bought the  
9 securities, and he said, "Well, when I am dealing in the stock,  
10 I usually get on the teletype and go to a New York firm and I  
11 may check a local stock exchange firm and get them to give me a  
12 market, so I have two things."

13 I asked, "Do you make any record of that?"

14 He said, "I usually on the teletype message note what  
15 the local stock exchange gave me as a quote."

16 I said, "Could you supply it for me?"

17 We recessed the hearing, and he went to his office and  
18 that afternoon brought back all of these things.

19 Now, it turned out each time he would call on this  
20 particular day to New York or the local stock exchange firm he  
21 was getting a quote of 1 to 1 1/8, and he was buying stock at  
22 1 1/8, so in this case we used that as a basis of a valid market,  
23 as opposed to the pink sheets, which were showing 1 to 1 1/4.

24 Mr. Sporkin: Would you then say, in order to be safe,  
25 he has to get three bids or seek out three quotations in order

1 to base his -- determine what his spread is going to be?

2 Mr. Anderson: I do not think he should approach it  
3 from the standpoint of being safe. I think he should approach  
4 it from the standpoint of his own obligation as a man in the  
5 securities business, to use prudence in seeking out the amount  
6 at which he buys the stock.

7 Mr. Sporkin: So that should be a guide: that he has  
8 a duty to search out the market before he effects a transaction.  
9 So that would be something you would like to see if this policy  
10 were revised, that that should be placed in there?

11 Mr. Anderson: Well, this could make it more compli-  
12 cated. I think this is basic to anybody dealing with the  
13 securities business, dealing with the public, that this is a  
14 basic obligation. I do not think it has to be put in a rule or  
15 interpretation.

16 Mr. Cohen: I would say this is one of the relevant  
17 circumstances that we would take into consideration and that if  
18 you enumerated this particular one, you might be under an obli-  
19 gation to enumerate about 20 more. So I think that the inclusive  
20 phrase which provides room for judgment is the best definition  
21 that we can achieve in some of these areas.

22 Mr. Rotberg: Either Mr. Cohen or Mr. Anderson, at  
23 the very beginning of this hearing, commented about the Commission-  
24 proposed rule in the 1940's which would have required a disclosure  
25 of a broker-dealer's cost, even if he had an inventory, and his

1 margin of profit, whether it was a prior agency transaction, and  
2 that it was an outgrowth of that proposed rule that the NASD's  
3 mark-up policy was formulated upon.

4 Didn't that rule contemplate that there would have been  
5 a disclosure to the public, in the confirmation, of the dealer's  
6 cost?

7 Mr. Anderson: Well, I am not sure I can recall from  
8 memory that detail, but I think, if I am not mistaken, that it  
9 simply provided that you had either disclosed your cost, or had  
10 to disclose what the outside market or prevailing market was at  
11 that time -- some information which would give the public a basis  
12 of judging how much profit you made in the transaction.

13 Mr. Rotberg: That is right.

14 But was it not the disclosure of the cost, if you had  
15 one, and if you did not have a cost, the best independent market?

16 Mr. Anderson: I do not recall.

17 Mr. Rotberg: Well, if it were that -- and I do not know  
18 if any of you recall that -- would this not indicate to you that  
19 the Commission was interested in computing the profit from con-  
20 temporaneous cost, and not the existence of an independent market?

21 Mr. Rockefeller: In an inventory situation?

22 Mr. Rotberg: Yes.

23 Mr. Anderson: My recollection is that this rule, dis-  
24 closure rule proposed, related primarily to riskless transactions.  
25 But I am not sure of this.

1 Mr. White: I would have to look it up.

2 Mr. Rotberg: If it did relate to riskless transactions,  
3 then, of course, the current interpretation, as you have enunciated  
4 it and as Mr. Cohen has enunciated it, would be completely con-  
5 sistent with the original rule.

6 If, on the other hand, the rule was designed to cover  
7 inventory situations, as well as non-inventory situations, then  
8 the use of the independent offer is somewhat inconsistent with the  
9 original rule.

10 Could we agree on that?

11 Mr. White: Well, I have one comment to make. I recall  
12 a case in the early days of the Commission -- the early days of  
13 the NASD and the Commission, where they either in dicta, or  
14 in the actual holding, said that if it were disclosed, it would  
15 have been all right.

16 Actually, the Board's determination was that even if  
17 disclosed, the mark-up was unfair. And the Commission turned the  
18 case on the idea that he had disclosed some of the specifics of  
19 the transaction.

20 So I would be inclined to think that disclosure was  
21 not tied into it.

22 We in this present interpretation say disclosure is a  
23 factor, but it does not prevent us from finding that the mark-up  
24 is unfair.

25 Mr. Rotberg: The question, Marc, is whether or not the

1 disclosure is disclosure of your contemporaneous cost or dis-  
2 closure of your independent market.

3 Mr. White: As I said earlier, I just do not know.  
4 I am inclined to think it did not have the relation that you  
5 were pointing out.

6 Mr. Rotberg: Now, are any of you familiar with any  
7 Commission decision or any NASD decision which considered the  
8 defense, "We marked up over an independent offer," and which  
9 rejected that defense and said, "You have got to use contempor-  
10 aneous cost on an inventory situation"?

11 Has this been the typical Commission decision? Are  
12 you familiar with those?

13 Mr. White: I would think that argument is made in Com-  
14 mission decisions. The Board has decided that they did not have  
15 an inventory and were not in a risk position.

16 Mr. Rotberg: I am saying when the Commission has  
17 considered this defense, independent offer -- if I use the  
18 independent offer, I am within the 5 per cent mark-up policy,  
19 and where the dealer in question has had an inventory, am I  
20 not correct that the Commission has rejected that defense and  
21 said, "You will use your contemporaneous cost"?

22 Mr. Derrickson: I do not think we have.

23 Mr. White: I will tell you in one case that they  
24 reversed us -- Borne & Company, in 1960 -- and they found that  
25 Borne & Company had purchased a block of Texas Toy Company

1 stock and put it in inventory, and we based our determination  
2 of the mark-up and held it unfair, based on contemporaneous cost.  
3 The Commission reversed us and said that, in view of the inventory  
4 purchase of this stock in a block and its being in inventory, we  
5 should have used the representative market.

6 Mr. Rotberg: Why did you use contemporaneous cost in  
7 that case?

8 Mr. White: Well, in the light of the Commission  
9 decision, I think we should not have. But I cannot go back and  
10 reconstruct why we did. I must say that was one block of stock.  
11 There were a lot of other transactions in the same stock that did  
12 not come out of this block, and there are also other five per  
13 cent violations in that case.

14 Mr. Rotberg: Off the record for a second.

15 (Discussion off the record.)

16 (Whereupon, at 1:00 o'clock p.m., a recess was taken  
17 until 2:00 o'clock p.m., of the same day.)

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## AFTERNOON SESSION

2:00 p.m.

1  
2 Mr. Rotberg (presiding). On the record.

3 Mr. Meyer: I hate to keep coming back to the same  
4 factual example, but it troubles me, and I want to see if we can  
5 clear something up.

6 Where you have a bid and an offer and a broker has an  
7 order and he goes out to fill that order and he is able to do  
8 so at less than the offer and fills the order on a riskless  
9 basis, I take it that it is agreed that the mark-up is computed  
10 from the price at which he purchases the stock, the contemporaneous  
11 cost price, is that right?

12 Mr. Anderson: Unless there were unusual circumstances  
13 surrounding his purchase of the stock.

14 Mr. Meyer: What would the theory be for using that,  
15 rather than the higher offer price in that situation? Would that  
16 be that the offer price, in fact, was not a real independent  
17 market because he could purchase at less than the offer price?

18 Mr. Anderson: I think it would be the fact that it  
19 was a riskless transaction.

20 Mr. Meyer: I am trying to fit this into the language  
21 of the mark-up policy.

22 The risk factor is, of course, in the policy. But that  
23 is used as determining -- that goes towards the five per cent,  
24 as I read it.

25 In other words, in determining what is adequate compen-

1 sation, we determine whether or not the broker is taking a risk.  
2 So in some cases four per cent might not be justified, and in some  
3 cases six per cent might be justified. And the question of taking  
4 a risk would go to that.

5 But, as far as determining what is the prevailing  
6 market, I do not see anything in the policy itself that tells you  
7 that the fact whether a particular broker-dealer who is retailing  
8 the stock is taking it into inventory or not is relevant at all.

9 Do I make myself clear?

10 Mr. Cohen: Not to me.

11 Mr. Rotberg: Well, Mr. Meyer poses the case where the  
12 independent offer is 21, but that a dealer who is executing on  
13 a riskless basis is able to get it at 20 7/8, and we are  
14 apparently all agreed that the mark-up will be computed not  
15 on the basis of over 21, but it will be computed on the basis of  
16 20 7/8.

17 And that is his contemporaneous cost.

18 And the fact that he saved an eighth should be for the  
19 benefit of the customer, and not for the broker-dealer. Is that  
20 correct?

21 Mr. White: Did somebody say yes to that?

22 Mr. Ladd: Under normal conditions.

23 Mr. Anderson: Under normal conditions, yes. But  
24 there could be exceptions to that.

25 Mr. Cohen: I would go back of that a little further

1 to your previous remark: That the fact that he bought it at  
2 20 7/8 made contemporaneous cost the guide rather than the  
3 independent offer.

4 I think -- and perhaps we have not been able to convey  
5 this as clearly as possible -- I think we do not feel that  
6 quoted markets are exact prices from which no one deviates. There  
7 is flexibility in markets. There is negotiation in the purchase  
8 and sale of stock. And if the market is quoted at 20 1/2 to 1,  
9 and the man buys at 20 7/8, we think this is probably the repre-  
10 sentative market.

11 Mr. Meyer: Fine.

12 In other words, the fact that he was able to buy at  
13 20 7/8 indicates that the 20 7/8 was the real independent offer.

14 Now, if he did not purchase on a riskless basis but took  
15 it into inventory, I think it was said before that the mark-up  
16 would be from the 21.

17 Now, what is there in that type of purchase that would  
18 lead you to conclude that in that situation the 21 was an inde-  
19 pendent offer?

20 Mr. Anderson: May I make a distinction -- I believe  
21 when you cut it down to this point and say 20 7/8 against a 21  
22 market, I do not believe that is exactly what was said. I do not  
23 think this would change the conclusion of that group that that  
24 is the prevailing market. But against the 20-21 market, if he  
25 bought it, say, at 20 3/8 for inventory, this might indicate that

1 there is a difference here between his acquisition price and the  
2 prevailing market.

3 Mr. Rotberg: Well, suppose he did buy it at  $20 \frac{3}{8}$ ,  
4 and put it into his position.

5 Why would you use the 21 as the basis for computing  
6 the mark-up, when the facts are he was able to buy it at  $20 \frac{3}{8}$ ?

7 Mr. Anderson: I do not believe it has been said that  
8 you use the 21. You started off with this figure in the  
9 beginning, and Mr. Cohen said he had trouble with this particular  
10 illustration, and he changed it to 20, to  $20 \frac{1}{2}$ , and said he  
11 would use the  $20 \frac{1}{2}$ . But I would say, if you are going to use  
12 the illustration of 20 to 21, and the transaction takes place at  
13  $20 \frac{3}{8}$ , you might just as well conclude that  $20 \frac{7}{8}$  was the  
14 actual market, even though the trade did not take place there,  
15 as you would if somebody else had bought it to fill an order.

16 Mr. Meyer: We have a few figures floating around.  
17 Let us see if we can stick to one example. Let us take the  $20 \frac{7}{8}$ .

18 Mr. Rockefeller: May I ask a question here now?

19 Before we get to this, can you give us the quoted market  
20 first? Is your market now 20, 21?

21 Mr. Meyer: The quoted market is 20, 21.

22 Mr. Rockefeller: How many dealers are making the market?

23 Mr. Meyer: Five dealers.

24 Mr. Rockefeller: Is this stock being actively traded?

25 Mr. Meyer: Whatever you like -- reasonably active, let

1 us say.

2 Mr. Rockefeller: I think if we have a reasonably active  
3 trading, one point spread at 20, the spread is too wide.

4 Mr. Meyer: It does not matter. Use any figures you  
5 want. Let us make it 20 1/2.

6 Mr. Rockefeller: All right, 20 to a half.

7 Mr. Meyer: All right, 20 to a half.

8 In one situation we have the broker going out and  
9 purchasing on a riskless basis and being able to get the stock  
10 at 20 3/8. And I think we are all agreed that where it is risk-  
11 less --

12 Mr. Cohen: 20 7/8?

13 Mr. Meyer: 20 3/8.

14 Mr. Cohen: What do you mean, on a riskless basis?  
15 On a 20 to a half market?

16 Mr. Meyer: The quoted market is 20 to a half. He has  
17 a customer's order and he buys it at 20 3/8. And I think every-  
18 one is in agreement that he can mark up from the 20 3/8 and not  
19 from the 20 1/2.

20 Now, is there similar agreement, given the same facts,  
21 where he purchases at the same price, 20 3/8, but instead of  
22 being on a riskless basis, puts it into inventory, is there  
23 agreement as to what the price -- assuming there is no change in  
24 the market -- as to what the price should be from which he can  
25 mark up?

1           Mr. Cunningham: I think you are making a false assumption  
2           tion there. Assuming that he is going to accumulate a thousand  
3           or two thousand shares of stock at 20 3/8, and that that market  
4           is going to stay 20 to a half --

5           Mr. Meyer: No -- 100 shares, it can be.

6           Mr. Rotberg: He buys it at 20 3/8, and he puts it  
7           into his inventory, and he holds it there for a week, or two  
8           days. He holds it at risk for two hours. At what price can he  
9           sell the security?

10          Mr. Rockefeller: And the outside quote by the five  
11          other broker-dealers is still 20 to a half?

12          Mr. Rotberg: Yes.

13          Mr. Derrickson: You mean on that day, that hour, or  
14          yesterday's sheets, or what?

15          Mr. Rockefeller: After the purchase of 20 3/8, check-  
16          ing with the five other dealers, the other five dealers come  
17          back with the market 20 to a half. I think then -- since he is  
18          at risk -- he can mark up from 20 1/2.

19          Mr. Ladd: Provided that there is no question -- that,  
20          in effect, it is a simultaneous transaction, although not billed  
21          at the same time or timed at the same time. And that is where  
22          we have to use our business judgment.

23          Mr. Meyer: This is where the difficulty comes in,  
24          because where it is a riskless transaction, you work it into  
25          the language of the five per cent rule by saying that the cost

1 price that he pays is a better indication of the market than the  
2 stated offer.

3 But you do not do that where he has it in inventory,  
4 or where he has an inventory position, a running inventory, or  
5 what not.

6 And it is hard -- I can see what you are doing from a  
7 practical point of view, and it looks as though it makes sense,  
8 because in the one case the man is taking a risk; in the other  
9 case he is not. But what I am concerned about is how you justify  
10 it theoretically within the language of the five per cent rule.

11 Mr. Rotberg: Is the problem clear?

12 Mr. Anderson: I think the problem is clear. I think  
13 it gives me a little bit of a problem, because we are bringing  
14 it down to such a fine point. And if I could use an illustration  
15 that would at least, maybe, broaden this out a little bit to make  
16 a distinction -- we have got a market to 20 and a half, and one  
17 man has an order for stock which he feels by doing into the  
18 market and buying it at  $20 \frac{3}{8}$ , and we have said that this would  
19 be the basis of his mark-up,  $20 \frac{3}{8}$ .

20 Another firm thinks that it would like to sell the  
21 stock and wants to go in the market to get some stock for in-  
22 ventory for distribution. They may call a firm who makes an active  
23 market in the stock and say, "We would like to have 500 or 1000  
24 shares, if some cheap stock comes in," and, thereby, is able to  
25 buy 1000 shares at  $20 \frac{1}{8}$ .

1           Now, here I can make a clear distinction that as between  
2 the 20 1/8 cost and the market still 20 to a half, that they  
3 would be entitled to use the 20 1/2 as their basis for a mark-up.

4           I have a little problem of making any distinction on  
5 the 20 3/8 figures on a 100-share lot, on that close figure. I  
6 would be a little bit inclined, I think, not to make any distinc-  
7 tion as to whether at that point he bought it for inventory or  
8 bought it against an order.

9           In reality, if you draw it that fine, the 12.5 cents,  
10 which is less than three-quarters of one per cent, is not  
11 going to make or break the decision.

12           Mr. Rockefeller: The other problem here is that you  
13 have five people making a market exactly at the same time. In  
14 one particular instance, in the case where the outside dealer  
15 comes in and buys from one of them at 20 3/8, that fellow's  
16 market at that one particular time is 20 to three-eighths, whereas  
17 the other four markets are still 20 to a half. This does not  
18 happen in the stock exchange, where you only have one transaction  
19 at a time.

20           But here it is conceivable you could have three  
21 transactions taking place at the same minute -- one at three-  
22 eighths, one at a half, and one at five-eighths -- either in  
23 the same city or across the country.

24           And this is where I think you are having your problem  
25 in trying to draw this down to as fine a line as possible.

1           Mr. Sporkin: Is it not conceivable that this broker-  
2 dealer could have purchased these shares from a member of the  
3 public he knows, one of his clients wants to sell, and would it  
4 not be conceivable he would have paid him \$20 for the stock? And  
5 if he has an order for it, where is he permitted to mark it up,  
6 over what price?

7           Mr. Rockefeller: Is he buying it against an order or  
8 is he buying it in inventory?

9           Mr. Sporkin: Let us assume Mr. Meyer gives me an order  
10 to buy one share of stock. The market is at 20 1/2. I go out  
11 and I know one of my customers --

12           Mr. Rockefeller: The market is 20 to a half.

13           Mr. Sporkin: Twenty to a half. I have a customer  
14 who I know owns the stock. I go out and buy it from him. So  
15 I take it I would pay him \$20, is that correct?

16           Mr. Rockefeller: You might and you might not.

17           Mr. Cunningham: One share of stock?

18           Mr. Sporkin: All right.

19           Whatever it is -- 100 shares. Let us assume it is 100  
20 shares. I would pay him 20 cents, is that correct? I would pay  
21 him the inside bid?

22           Mr. Rockefeller: I can tell you what would happen to  
23 our firm if we had the situation. We would split the difference  
24 and charge a commission, probably. I think a lot of firms would  
25 do this.

1           Mr. Sporkin: Then you are getting to the question of  
2 whether it should be a principal transaction and riskless situa-  
3 tion, anyway. But let us put that aside.

4           Now, it is proper that he could buy this at \$20 from a  
5 member of the public. And the question Mr. Meyer is posing and  
6 the question I am posing now is: What can he mark that up over?  
7 Would he mark it over the \$20 here, over the 20 1/2, or what?

8           Mr. Rockefeller: Does he have an order?

9           Mr. Sporkin: He has an order. This is to avoid this  
10 changing of the markets, because he goes now out to a member of  
11 the public.

12           Mr. Anderson: I think one thing ought to be said here.  
13 As a matter of fact, I do not believe mark-ups have been computed  
14 in the NASD on the basis of any market except dealer markets.

15           Mr. Sporkin: In other words, if he goes out and buys  
16 from a member of the public, you exclude that?

17           Mr. Burns: You relate your base to the professional  
18 market.

19           Mr. Anderson: Now, your responsibility to the dealer  
20 is not to buy the stock from a customer and take a mark-down in  
21 successive --

22           Mr. Sporkin: That is if you are selling him something  
23 else. But, as I understand it -- I want to be perfectly clear  
24 on this -- when you are purchasing from a member of the public,  
25 that this transaction is excluded in the 50 transactions that  
are taken off by --

1           Mr. Anderson: The transaction is not excluded, but  
2 the basis for the mark-up, the \$20 figure, has no bearing, so  
3 far as the basis of the mark-up is concerned.

4           Mr. Sporkin: So, therefore, you would use 20 1/2?

5           Mr. Anderson: Right.

6           Mr. Sporkin: And if he brought it from a broker, he  
7 would have to use his contemporaneous cost. So it is to his  
8 benefit that he should solicit this sale from a member of the  
9 public, is that correct?

10           Mr. Anderson: That is true. You are cutting out simply  
11 the so-called broker profit -- the wholesale profit end. You  
12 are not penalizing a member of the public. If he were going to  
13 liquidate the stock, he would not get any more than \$20 for it.

14           Mr. Meyer: Coming back to the situation where you  
15 have the inventory situation as against the riskless situation,  
16 the reason, probably, why it is troublesome to someone like me  
17 is that it looks like, and it is, apparently, the situation  
18 that the dealer who takes the position gets a higher return than  
19 the riskless dealer, which seems perfectly justifiable from the  
20 point of view that he is taking the inventory risk.

21           But I take it the purpose of the mark-up policy is not  
22 only to assure that brokers do not make inordinate profits, but  
23 also to see that customers are not overcharged.

24           Now, I wondered whether anyone would care to give us  
25 what they view are the benefits of having a dealer who is not

1 making a primary market take a position in a security from the  
2 customer's point of view -- benefits to the customer that  
3 would accrue from that situation.

4 Mr. Haack: I think the retailing of the securities is  
5 made simpler.

6 Now, in our shop, for example, we have got about 50  
7 salesmen scattered over the State of Wisconsin. If we are oper-  
8 ating in a stock which has a thin market, and they are on the  
9 road or out of constant touch and stopping in towns that do not  
10 have good communications, and so forth and so on, we, if we  
11 are in position, can give them a measure of protection, so far  
12 as the availability of stock is concerned.

13 And if you understand the way a retail salesman works  
14 and the way he thinks, it is a great advantage to him to know  
15 that if he gets the order, the stock is there. And that is one  
16 of the reasons that we maintain positions in things we are  
17 retailing: to provide the certainty that within normal fluctua-  
18 tion, stock will be available for the salesman after he has gotten  
19 the order.

20 Mr. Rotberg: Do you not ever sell stock to customers  
21 in a short position?

22 Mr. Haack: We do not.

23 Mr. Meyer: Would that make any difference to the  
24 customer, though?

25 Mr. Haack: Yes, I think it does. One of the most

1 frustrating experiences any of us can have is to get an order  
2 and then find out that we have missed the market, or that the  
3 market is thin, or that the price has changed, and we have lost  
4 the order on that basis.

5 Mr. Rotberg: Could you not miss the market, even though  
6 you have an inventory?

7 Mr. Haack: I do not think you are as apt to. I am  
8 sure that any firm represented in this room has on occasion sold  
9 stock at a price which is advantageous to a customer, as compared  
10 to the present market, simply because the salesman did make a  
11 representation, let us say, the day before.

12 Mr. Rotberg: It is not clear to me, though, the situa-  
13 tion that you are describing. You say that if you do not have  
14 an inventory -- let us say the stock is selling in the \$20  
15 range -- you might have to go out and buy that stock  
16 after you get the order, and by the time you get around to  
17 buying it a day or two later, it might have been up to \$22 a  
18 share. And you compare this to the situation where you do have  
19 an inventory and the stock is \$20 a share.

20 Is it not just as likely that the stock is going to  
21 move up to \$22 a share away from you?

22 Mr. Haack: Yes.

23 Mr. Rotberg: So that it does not really -- the fact  
24 that you have an inventory does not tend to cause the price not  
25 to move away, does it?

1 Mr. Haack: Oh, no. But it does insure a supply at a  
2 price, which is not always the case.

3 Mr. Rotberg: Well, the fact that you have an inventory  
4 does not assure the supply at a price, any more than if you had  
5 to go out and buy the stock in the open market. You also have to  
6 buy it at a price. I mean it is not clear to me how the existence  
7 of the inventory makes the salesman feel more secure.

8 Mr. Rockefeller: Well, if --

9 Mr. Haack: Let us say that we have a salesman who is  
10 working in the Western part of the state, and he will call in  
11 and say, "What is Wisconsin Power & Light," and it might be  
12 25 to 3/4. We will say to him -- he will say, "How can I retail  
13 it?"

14 We tell him he can retail it at 26 1/4.

15 All right. He may not have any further contact with us  
16 for the rest of that day. He might call in at 1:00 or 2:00 o'clock  
17 and give us 2 or 3 orders in that stock. He knows, and we are  
18 bound to respect the order, that he has gotten, at that price.  
19 Now, if the market has gone down, of course, the customer gets  
20 the advantage. By the same token, if the market goes up, we  
21 assume that.

22 So that is what I mean when I say that the salesman  
23 can work with the full assurance that if the market goes down,  
24 he will get a lower price; and, if the market goes up, the  
25 price to his customer will not rise.

1           Mr. Meyer: But this assurance really comes from the  
2 fact that you are willing to absorb an adverse effect of a change  
3 in the market.

4           Now, you will not necessarily have to be operating  
5 from a position in order to assume that obligation.

6           Mr. Haack: I would not want to guarantee him a price  
7 of 26 1/4 without a position, because if the market goes up,  
8 then I am committed and have no stock.

9           Mr. Cunningham: And you might find, if there are five  
10 or six people making a market earlier in the day, they might  
11 have been willing to sell 200, 300, 400 shares, but if there was  
12 an improvement in the price, traders have a way of pulling away,  
13 and their offering might be limited to 100 shares.

14           Mr. Rotberg: Is there any other reason, aside from  
15 this, that you can give?

16           Mr. Anderson: I might throw a little bit of light  
17 on this.

18           In our own situation we encourage our men not to put  
19 us in a position, particularly in inactive issues.

20           For example, an active issue like Transcontinental Gas,  
21 where your wholesale market has, maybe, a quarter of a point  
22 spread, we cannot do anything to help our salesmen or the  
23 customers by trying to save it in the wholesale market.

24           But in an active situation that is quoted, say, 19 to  
25 20, if we would normally shoot for about a 3 per cent mark-up,

1 if we had to go on the market and buy it -- this means if we go  
2 in and can do no better than 20, then we have to sell the stock  
3 at 20 1/2 or 20 5/8 to get a normal mark-up.

4 In order to avoid this, in order to be in a better posi-  
5 tion to compete with somebody who would get such an order on a  
6 riskless basis and also in order to increase our profit, we will  
7 buy a block of stock, if it comes into the market, say, at  
8 19 1/4, 19 3/8, which will put us in a position to retail the  
9 stock, not at 20 1/2, but maybe at 20 1/4, which will give us  
10 a better competitive price in the market, and it still gives us  
11 more profit than we would get if we did not do this.

12 So, actually, we are splitting the difference, in effect,  
13 with the public.

14 Mr. Rotberg: So the customer is getting a benefit.

15 That reminds me of a question that I would like you,  
16 perhaps, to estimate on.

17 Would you think that your sales to customers as principal  
18 from inventory are on the average more expensive or less expen-  
19 sive than an execution on an agency basis by a dealer with no  
20 inventory in the same security?

21 Mr. Anderson: You mean to the customer?

22 Mr. Rotberg: That is right.

23 Mr. Cunningham: Non-solicited order or solicited?

24 Mr. Rotberg: I assume there would not be any difference  
25 in the agency commission, whether it was solicited or unsolicited.

1           Mr. Cunningham. No. But there might be a difference  
2 in the cost to the firm as far as research was concerned.

3           Mr. Rotberg: No, no.

4           My question is: You have two customers. One customer  
5 goes to Firm A and buys a stock on a principal basis from a firm  
6 which has the stock in inventory and is charged a net price. A  
7 second customer buys the same stock, only instead of buying the  
8 stock from the firm with inventory, he goes to a firm who is not  
9 a market maker and has no inventory, and says, "Act as my agent  
10 and buy the stock, in fact, from that firm over there, who has  
11 the inventory, and charge me the normal stock exchange commission."

12           In your experience, would you say that the price --  
13 which customer do you think, on the average, gets the better  
14 deal?

15           I raise this question because, Mr. Anderson, of your  
16 hypothetical --

17           Mr. Anderson: I think I would answer it by saying that,  
18 generally speaking, buying the stock through, say, a commission  
19 house on a commission basis would probably, in the majority of  
20 the cases, acquire the stock at a cheaper over-all cost. And I  
21 will give you an illustration of this which brings it very close  
22 to home.

23           We have a situation in which we were a primary market.  
24 We were making a market of 48 to 48 3/4 in a preferred stock.  
25 We were retailing that stock at 49 1/4. So our outside market

1 was 48 to 49 1/4.

2 One of our men made a trip to a city 50 miles away  
3 and spent sometime with a customer and got an order for 200 shares  
4 of stock, or, rather, offered 200 shares of stock at 49 1/4.  
5 The man picked up the telephone and called a commission house.  
6 The commission house called us for a wholesale market. We  
7 offered them 200 shares at 48 3/4. And they sold our stock to  
8 our customer at 49.

9 Now, this disturbed the salesman, of course. But it  
10 did not disturb me, because had the situation been reversed and  
11 they had gone after the order, we could have done the same way  
12 to them, because we had no expense involved in soliciting the  
13 order.

14 So that we simply did not take the time to try and do  
15 any more business with the account, it is not worth doing, if  
16 you have to compete on that basis.

17 Mr. Rotberg: Now, do any of you gentlemen have a  
18 policy in any of your firms of executing all riskless transactions  
19 which are unsolicited on an agency basis?

20 Mr. Ladd: Unless we maintain a market in the stock.

21 Mr. Rotberg: Pardon me?

22 Mr. Ladd: Unless we are maintaining a market in the  
23 stock, we act as agent.

24 Mr. Rotberg: I -- Dominick & Dominick, First Boston  
25 does, Kidder Peabody does, and Robert Baird, and Dayne.

1 Now, suppose it is a solicited order. Is the answer  
2 the same?

3 Mr. Cohen: You have to define "solicited order" for

Mr. Rotberg: All right, I will define it.

The salesman first raises the question of the purchase  
7 of the security to the customer.

8 Mr. Cohen: Recommends the security to the customer?

9 Mr. Rotberg: That is right.

10 Mr. Cohen: In that case we act as principal. We are  
11 speaking of an over-the-counter stock now.

12 Mr. Rotberg: Yes. No inventory.

13 Mr. Cohen: No inventory. We act as principal.

14 Mr. Ladd: Unless we have an inventory and are main-  
15 taining a market, we act as agent.

16 Mr. Ladd: Agent.

17 Mr. Rockefeller: So do we.

18 Mr. Cunningham: Agent.

19 Mr. Rotberg: So that you do not distinguish between  
20 solicited or unsolicited in the sense I just describe it. You  
21 act as agent on that type of transaction.

22 Mr. Haack: Our criteria is risk or no.

23 Mr. Ladd: I think we should add that we are not in the  
24 business of distributing to individuals that these gentlemen are.  
25 First Boston is in a little different position.

1           Mr. Rockefeller: The firms that do this on an agency  
2 basis are not typical of the majority of our membership.

3           Mr. Rotberg: Off the record.

4           (Discussion off the record.)

5           Mr. Rotberg: Back on the record.

6           Mr. Meyer: I have a specific question about the mark-  
7 up policy.

8           I am looking at the manual, page G-5, No. C-5, down at  
9 the bottom. That talks about transactions where a customer sells  
10 his securities in order to pay for different securities which he  
11 is purchasing from the firm, and it says that any mark-up, mark-  
12 down, rather, or commission charged on the sale by the customer  
13 shall be included in considering whether mark-up on a sale to  
14 the customer is reasonable or not.

15           Mr. Cohen: Mr. Chairman, if I am not interrupting the  
16 proceedings, if I revert a minute to the previous question,  
17 because in the rush to the floor I did not get a chance to  
18 comment, and I would like to make one comment.

19           Mr. Meyer's question was, as I heard it stated, that  
20 the dealer who takes a position is enabled to realize, under  
21 our policies, a larger total profit than the dealer who executes  
22 a riskless trade, and asks what benefits accrue to the customer  
23 from the dealer taking a position.

24           I do not have anything to add to the recital of the  
25 benefits that might accrue to the customer. But I would like  
to be sure that it is understood that it is my position, and

1 I think the position of the Association, that even though the  
2 dealer who takes a position realizes, under our rules, a higher  
3 total profit than the dealer who engages in a riskless trade,  
4 that this additional profit is not, in our judgment, at the  
5 expense of the customer.

6 Mr. Rotberg: I think that is clear, and I think you  
7 made that point also this morning -- that the customer, in either  
8 case, pays the same price.

9 Mr. Cohen: This is the point I wanted to be sure --  
10 that it is sure the additional profit is not realized at the  
11 customer's expense.

12 Mr. Meyer: In the situation I gave you, where both  
13 purchases took place at  $20 \frac{3}{8}$ , that is not 100 per cent true.

14 Mr. Cohen: Then your implication was that we were  
15 realizing a greater profit at the customer's expense?

16 Mr. Meyer: Yes.

17 Because in the one case you would allow him to mark  
18 up from  $20 \frac{1}{2}$ , and in the other you would only allow him to  
19 mark up from  $20 \frac{3}{8}$ , even though both purchased at  $20 \frac{3}{8}$ .

20 Mr. Cohen: I think there is a fallacy in this example,  
21 and that fallacy is the assumption that a dealer would purchase  
22 stock for position at a price equivalent to the price at which he  
23 could buy it without position.

24 Our judgment is that when a dealer buys for position,  
25 he does so because he is able to obtain a better price than the

1 contemporaneous offering, and that the example you cite, while  
2 arithmetically correct, would not be a practical operation.

3 Mr. Meyer: That would supply the theoretical justifi-  
4 cation?

5 Mr. Rotberg: Yes.

6 And it would also indicate that there is no sense check-  
7 ing for best markets, because the contemporaneous offers are  
8 all the same; you could never get it cheaper. I do not think  
9 that is the case. You probably can get it cheaper, if you shop  
10 around.

11 Mr. Cohen: In many cases.

12 Mr. Rotberg: So that you can buy stock at a price lower  
13 than the inside offer.

14 But since you raise the question, I think it is an  
15 important one, about the cost to the customer not being greater  
16 in the normal case, whether you are riskless or whether you are  
17 in position -- the customer will have to pay a given price all  
18 the time, and, therefore, the customer is not put at any dis-  
19 advantage.

20 Would you consider that comment from the point of view  
21 as to what happens on a riskless transaction when you act  
22 as principal compared to when you act as agent; is the customer  
23 at a disadvantage there?

24 Mr. Cohen: A customer who buys a security from us in  
25 a transaction in which we are acting as principal pays a higher

1 price than he would pay in relation to the existing market when  
2 in a situation in which we act as agent.

3 Now, having stated the facts, would you care to have  
4 me rationalize them or explain them?

5 Mr. Rotberg: Well, I just wanted to bring out that,  
6 depending on the formality of the transaction, it may make a  
7 difference to the customer, and I can appreciate the general  
8 argument and discussion which involves your higher cost when  
9 you act as principal, and the fact that when you act as prin-  
10 cipal, you do so, perhaps, after having done research and gone  
11 through certain expenses.

12 I did not really mean to open up the subject, except  
13 to point out that, although there is no difference correctly  
14 between the cost paid by a customer, whether you are at position  
15 or have no position, there is a difference whether it is prin-  
16 cipal or agent.

17 And I am aware that this latter opens up a whole area.

18 Mr. Cohen: You are right. I would just like to add one  
19 thing to that statement. The cost is different and the service  
20 performed is different.

21 Mr. Rotberg: In some firms I am sure it is.

22 Now, I think Mr. Meyer had a question specifically  
23 related to the mark-up which is one of the last ones which we  
24 will get to. It dealt with the sale of a customer's security  
25 and a mark-down which will be considered in computing the base

1 cost of the mark-up when he purchases the security at the same  
2 time.

3 Mr. Meyer: This is in reference to C-5 under the mark-  
4 up policy, which says that any commissions or mark-downs on  
5 the sale by the customer shall be included in the mark-up when  
6 the customer purchases for purposes of determining whether the  
7 mark-up is reasonable or not within the five per cent policy.

8 I think I am stating it correctly.

9 From what I heard this morning describing how these  
10 mark-up examinations are made, I could not determine quite how  
11 you can tell what these costs are and when they exist.

12 Would anyone care to comment on that?

13 Mr. Burns: That can be easily determined by a review  
14 of the books -- I mean, normally, easily.

15 Mr. Meyer: Is that information taken as a matter of  
16 course on this Schedule A, or whatever it is?

17 Mr. Burns: Not on the Schedule A. They are only  
18 principal sale of two customers.

19 Now, if it is observed that there are transactions  
20 such as you have just referred to, where there are liquidation  
21 for the same customer to whom sales are made --

22 Mr. Meyer: How would that be observed?

23 Mr. Burns: From the records, from the customer's  
24 records, and from the blotters.

25 Mr. Meyer: So they look at both sides of the blotter,  
then.

1 Mr. Burns: That is right.

2 And if they are so observed, then a Schedule B is  
3 prepared, having the same type of information in reverse.

4 Mr. Rotberg: In computing the mark-down, do you use  
5 the price paid to the customer or the inside bid?

6 Mr. Burns: The money at risk by the dealer. That is  
7 the money he pays to the customer -- what did he make on the money  
8 he put out.

9 Mr. Rotberg: You do not look at the inside bid?

10 Mr. Burns: You said how do I compute it, or what is  
11 the basis.

12 Mr. Rotberg: I am taking the reverse of the mark-up  
13 policy. Do you compute the inside bid or do you compute the  
14 payment to the customer, in --

15 Mr. Burns: The basis is the price paid to the customer.

16 Mr. Rotberg: He marks up on the new sale, based upon  
17 the amount of money that he paid to the customer. Is that correct?

18 Mr. Burns: Assume 20 to 20 1/2 market. Assume that he  
19 pays the customer 19 3/4. And he is able to sell at 20.

20 Mr. Rotberg: Assuming he pays the customer 19 3/4.  
21 When he sells the customer a security, what do you compute the  
22 mark-up over -- 19 3/4?

23 Mr. Burns; Let us remain with the purchase for the  
24 customer at 19 3/4, and he can sell, and does sell, in the open  
25 market at 20. There is a mark-down or mark-up, whatever you want

1 to call it, of a quarter of a point.

2 So you would use the 19 3/4 as a base, compare the  
3 difference between 19 3/4 and 20. That is one side of the  
4 transaction. You then go to the sale to the customer, and follow  
5 the procedures we have talked about so far. You combine those  
6 two. And if they exceed the five per cent area, the interpreta-  
7 tion says that this is one matter to be considered.

8 Mr. Rotberg: As a result, most brokers or dealers  
9 would be forced to have extremely limited mark-down charges.

10 Mr. Burns: Let me say this provision was to get to  
11 the extreme case to a dealer who would say, "I will take five  
12 per cent going in and five per cent going out."

13 Mr. Rotberg: I see.

14 Well, if he takes anything when the stock is being  
15 sold on the mark-down, that cuts into his total five per cent,  
16 does it not?

17 Mr. Burns. That is right.

18 Mr. Rotberg: Suppose he charges a commission. Is  
19 the amount of the commission counted against the five per cent?

20 Mr. Anderson: It is counted.

21 I think one thing ought to be said here, in connection  
22 with this particular section. I mentioned a minute ago that we  
23 took this thing out from 17 pages to 4 pages, but it turned out  
24 to be one sentence less than we thought it was going to be,  
25 because, somehow or other, in the transcribing of this or other-

1 wise, one sentence was left out, off of that particular paragraph,  
2 that did not get printed and in the interpretation.

3 Mr. Rotberg: Was it an important sentence?

4 Mr. Anderson: To my memory, it was a sentence which said  
5 in effect, that, however, the Committee should take into consider-  
6 ation the fact that there are the additional expenses of handling  
7 an additional transaction.

8 In other words, you do have two transactions provided  
9 for -- that some allowance should be made for that in figuring  
10 the fairness of the mark-up.

11 Mr. Sporkin: Mr. Anderson, you said it was considered.  
12 But, as I understand Schedule A and Schedule B, you do not  
13 take off agency transactions, is that correct? They are only  
14 principal transactions required on these schedules.

15 Mr. Burns: That is largely true.

16 Mr. Anderson: And I think on Schedule B, where  
17 there is a proceeds transaction, even though it was a commission,  
18 I think that would be shown.

19 Mr. Burns: Let me also add that the liquidation on  
20 an agency basis is customarily done without commission.

21 Mr. Rotberg: It is?

22 Mr. Burns: That is generally speaking.

23 Mr. Meyer: Assuming that is so, I wonder -- and, in  
24 any event, it seems fairly evident from what we have heard  
25 that either mark-downs or commissions on sales by customers are  
considerably less than mark-ups on sales to customers -- I wonder

1 if anyone would care to give us his views as to why this is so.

2 Mr. Burns: I have my own opinion. I think this is a  
3 merchandising business, and the profit comes in on the sale of  
4 your merchandise to the customer. All you are doing in liquidating  
5 other securities is, for the purpose of obtaining proceeds, for  
6 the sale of a customer.

7 Mr. Anderson: I would give the same view.

8 As a matter of fact, most firms that I know of in the  
9 retail business, whereas they will pay a commission to a salesman  
10 on a retail sale, give no consideration at all on a liquidation,  
11 and take just enough to handle the transaction, or nothing at  
12 all. And do not shoot for any profit. And this is not uniforml  
13 so.

14 Mr. Cohen: I would diverge a little from Don's inter-  
15 pretation. This sounds to me -- and I do not think Don means it  
16 this way -- as though no thought was given to the appropriateness  
17 of the liquidation of a given item, and that the salesman was  
18 in a constant search for securities he could liquidate in order  
19 to free up funds for the sale of other securities.

20 Mr. Burns: I made no such inference.

21 Mr. Cohen: I think it is generally realized that the  
22 liquidation of a given security by a customer does provide funds  
23 for reinvestment, and that, therefore, as a practical matter,  
24 the dealer is willing to do this on a shorter margin because  
25 he receives some compensation on the other side.

1           But in our case -- and I am not speaking of proceeds  
2 trades now, but of straight liquidations -- whether or not they  
3 are recommended by us, we do charge a commission going out. We  
4 handle no transactions for nothing, as a general rule.

5           Mr. Rotberg: You do not mark down, then. You do not  
6 sell on a principal basis?

7           Mr. Cohen: The only securities which we repurchase  
8 on a principal basis are those in which we have a position. If  
9 we are handling the sale by a customer of a security in which we  
10 do not have a position, we handle it as an agent.

11           Mr. Rotberg: Why is it that you handle the sale out  
12 of a customer as an agent on a riskless transaction, but the  
13 sale to a customer as a principal on a riskless transaction, if  
14 both of them involve the same amount of care and recommendation?

15           Mr. Cohen: By and large, they require less sales  
16 effort. This may sound surprising to you, but factually it is  
17 the case.

18           Mr. Rotberg: But they do not involve less care so far  
19 as the recommendation goes?

20           Mr. Cohen: So far as the decision is concerned. But  
21 if I may inject the economics of the security business for a  
22 moment, your greatest element of cost, your single element, is  
23 your sales cost, the commissions that you pay to your salesmen,  
24 and, therefore, the amount of time and effort a salesman devotes  
25 to a given transaction is a considerable element in the compensa-

1 tion you expect to get from the customer.

2           Mr. Rotberg: Would not the salesman devote just as  
3 much time in evaluating whether a customer should purchase as  
4 whether a customer should sell?

5           Mr. Cohen: Well, let me give you a practical example.  
6 When a salesman goes out to sell something, he has no list of  
7 people who may be reasonably certain to buy it, so he is out  
8 prospecting for those people.

9           When a salesman has a selling recommendation, he has  
10 a list of customers of his who own that security, who, presumably,  
11 respect his judgment, and those salesmen, when we make a sales  
12 recommendation, will come much faster than the merchandising of  
13 an issue on the other side.

14           There are other factors, but I think this would be one  
15 that would be considered.

16           Mr. Rotberg: I think we have just about exhausted  
17 this aspect of the mark-up policy -- witness the fact that we  
18 are now going into other areas, which I do not think we should  
19 really expand on.

20           Mr. Haack: I would like to point out one peculiarity  
21 of this section that Mr. Meyer made reference to, if you are not  
22 aware of it already.

23           Mr. Meyer, for example, could go to J. M. Dayne and  
24 sell 100 shares of stock to J. M. Dayne at 19 3/4 if the market  
25 were, in fact, 20 to a half, and he could take his \$19.75

1 and go over to Dominick and buy 100 shares of stock, and Dominick  
2 could mark it up 4 per cent, and the total -- each of the dealers  
3 would be in a defensible position.

4           However, by reason of the proceeds factor, he cannot  
5 accomplish the same transaction in the same shop, because if he  
6 does, it is contrary to the rule.

7           Mr. Rotberg: I just wanted to get one thing clear.

8           In the situation where the market was 20 to a half, the  
9 reason that he received 19 3/4 rather than 20, or 20 minus a  
10 small commission, was because he was not reinvesting the proceeds,  
11 is that correct?

12           Mr. Haack: You do not know that.

13           Mr. Rotberg: Well, why did he not get the inside bid,  
14 20? Was it because it was a mark-down from Dayne & Company,  
15 because he was not reinvesting the proceeds?

16           Mr. Cohen: Would you like to have me try to answer  
17 that? The inside bid is a professional bid which is rarely made  
18 available to the individual customer. This is the wholesale  
19 quoted market.

20           Mr. Rotberg: Is not the wholesale bid in the newspapers  
21 as the retail bid?

22           Mr. Cohen: In some areas they follow that policy, but  
23 it is usually because they feel the bid side will close a little  
24 bit.

25           Mr. Rotberg: I always believed that the publication of

1 a bid was the retail price of the bid.

2 Mr. Cunningham: In the national list it is.

3 Mr. Cohen: If a stock is quoted in the national list  
4 20 to a half, we would not pay the customer 20 net for the stock,  
5 any more than we would -- nor would we encourage him to think he  
6 could get 20 net -- any more than if we quoted steel 55 to a half  
7 on the board, we would let him think that 55 is the price available  
8 to him.

9 Mr. Rotberg: You will pay him, though, a little more  
10 if he is reinvesting the proceeds, is that correct?

11 Mr. Cohen: This would depend on the total spread in  
12 the transaction. As long as we are comfortably within the five  
13 per cent limits, we ordinarily contemplate on the going  
14 outside the equivalent of a stock exchange commission, or if  
15 it is a very inactive stock, maybe a commission and a half. And  
16 this would be generally applicable whether it is a one-way  
17 liquidation or a trade.

18 Mr. Rotberg: I see.

19 But you take care that on the reinvestment, that the  
20 total spread is within the five per cent. That is the test?

21 Mr. Cohen: The rule is there.

22 Mr. Meyer: I have also heard the theory, on these --  
23 on paying closer to the inside bid on the liquidation as com-  
24 pared to the sale, this theory -- and I do not know just how  
25 valid it is, but I would like your comments on it -- that

1 customers are generally more conscious of what they are getting  
2 on a liquidation than they are of what they are paying when they  
3 purchase; they know what they have paid for the stock, and they  
4 want to get as much for it as they possibly can when they sell,  
5 whereas, when they are purchasing, it is the beginning of the  
6 transaction, and they may have high hopes and may not be too sharp  
7 in looking for the extra eighths and quarters.

8 Do you think there is anything to that theory at all?

9 Mr. Anderson: It would not be, so far as my experience  
10 is concerned.

11 Mr. Rotberg: I now note we are far afield from mark-  
12 ups. Perhaps this is the time to adjourn this discussion.

13 I want to take this opportunity to express our apprecia-  
14 tion for the time and the effort that you have spent in coming  
15 here, great distances.

16 I am sure that the record will be useful to all those  
17 who review it. And I think it does set forth, not only your  
18 positions, but the problems involved in interpreting the  
19 positions, both by yourselves, by District Committees, and by  
20 the brokerage industry.

21 So let me again thank you for your cooperation.

22 (Whereupon, at 3:00 o'clock p.m., the Conference  
23 adjourned.)  
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25