How the New York Stock Exchange Really Works

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Richard Ney on the Role of the Specialist

by Michael Templain

> "The story is told that after he had been deported to Italy, Lucky Luciano granted an interview in which he described a visit to the floor of the New York Stock Exchange. When the operations of floor specialists had been explained to him, he said, 'A terrible thing happened. I realized I'd joined the wrong mob'" (1Ney, 8).

It was with these words that Richard Ney began his first of three books on the nature of the New York Stock Exchange. Ney wrote over 20 years ago, a time when a 750 Dow was high and today's volumes were beyond imagining. Some of his material is dated, and must be read in the light in which it was written. But the main premise of his books is still true: that the specialist exists not to ensure the free and orderly trade of stock in a particular company, but to fatten upon the innocence and ignorance of the small investor.

The New York Stock Exchange is not an auction market (2Ney, 86), though many investors still hold onto that image. It is a rigged market. Volume is an effect of price. Prices are controlled absolutely by the specialists, the 'market makers' in individual stocks. It was this discovery that led Mr. Ney to eventually give us small investors a priceless gift: enlightenment.

> "Studying the transactions in each stock, I became immediately conscious that, on too many occasion to be a coincidence, a stock would advance from its morning low and then, often during the afternoon, would show an up-tick of a half-point or more on a large block of anywhere from 1,500 to 5,000 or more shares. This transaction seemed to herald a transformation in what was taking place, for immediately thereafter the stock would begin to drop like Newton's apple. Before I could find out what caused this, another question presented itself: What caused the same thing to happen at the low point in that stock's decline? For it was also apparent that a block of stock of the same size often appeared on a down-tick of a half-point or more, after which the stock quickly rallied. Together these two facts seemed to give a stock's pattern continuity. At the end of several days of investigation, I discovered that these transactions at the top and bottom of a stock's price pattern were for the specialist's own account. ... Clod that I was, I had at last recognized that, although the study of human nature may not be fashionable among economists, it is never out of season" (2Ney, 9).

The specialist is part of a system. First, he is part of that rare fraternity of men who are all specialists in an exchange. It is a small private club, to whose membership one can only be born. The specialists of the Dow 30 exhibit the spirit of 'all for one, and one for all'. If one of the 30 is having problems, the other 29 wait for him, before they move onto their next agreed upon campaign (2Ney, 172). The rest of the specialists take their lead from watching the Dow 30.

But the system is more extensive and more powerful than just the specialists. The specialists are the heart of the exchange. The exchange, in turn, has practical control of the major corporations, banks, insurance companies, and brokerage houses in this country. These, in turn, influence news reporting and the regulatory agencies.

ADVANTAGES OF BEING A SPECIALIST

The specialist has many advantages, many tools to use to pry dollars from unsuspecting investors and mutual funds. Chief among these advantages is his book. In his book he can see at a glance all the buy and sell orders from the public and the funds. His book tells him of potentially massive sales above and below his current price. This gives him a great advantage when he is trading on his own investment and omnibus accounts.

Because of his book, the specialist sees shifts in trends long before anyone else. This gives him a great advantage. The specialist will buy heavily at the bottom of a slide (at wholesale) then advance prices and sell, at heavy volume, at the peak of the rally (retail). He will then sell short and take prices down. The turning points of a rally will be marked by heavly volume in the Dow 30 (3Ney, 85-89).

When he desires he can even make large block trades without entering them into his book. In this way the public is never made aware of those trades. Should the specialist want to supply a buy or sell order from his own accounts, rather than from public orders on book, he can and will do so (1Ney, 156). Ney cites specific examples when his customers orders were ignored while the specialist completed orders for his own accounts.

When serving as the market maker, the broker's broker, the specialist trades from his Trading Account, which is to be used to service the needs of the market. However, he also has Investment Accounts (plural). His Segregated Investment Accounts put him directly into competition with every other investor in his stock. The reason for he has segregated investment accounts is that they enable him to convert regular income into long-term capital gains (1Ney, 113).

In addition, he also trades on Omnibus accounts, taking orders from a friendly bank on behalf of friends, family, and himself (1Ney, 58). Although he is not allowed to be both long and short in his Trading account, he can take the opposite stance in his Investment or Omnibus accounts (3Ney, 130).

A Specialist will often not have any shares in his trading or omnibus accounts. If public demand for shares suddenly increases, the Specialist is more than happy to supply those shares to the public by short selling. This, of course, forces the Specialist to take the price down soon thereafter, so that he may cover his short sales at the lower price. Or, the Specialist may sell from his Investment Accounts, establishing a middle or long term high (1Ney, 61), and then take the price down. Whichever strategy he employs, a large public demand for stock ultimately drives the price of that stock down, not up.

Distribution of large amounts of stock can be done from the specialist's trading account, usually as short sales. The trading account can then be covered by transferring stock from the long-term investment accounts into the trading account (1Ney, 64).

The existence of the specialist's Investment and Omnibus Accounts is ultimately detrimental to the public. "In a stock with only a small capitalization or floating supply, the segregation of large blocks into long-term investment accounts for the specialist further decreases the supply of the stock available to the public" (1Ney, 61)

The specialist has absolute control over price. He can match the buys with the sells in any way he sees fit. He can raise the price of the stock 3 points in three trades, and open the next day down 5.

The seeming unpredictability of stock prices is due to the fact that prices exist at the whim of the specialist. A stock is only worth what the specialist is willing to pay for it at the moment. The fluctuations you see are, in fact, the evidence of how the specialist is working out his inventory problems to meet his short-term, intermediate-term, and long-term goals (2Ney, 172). The specialist will sometimes 'leap frog' his prices up or down, creating a gap. This is done to keep a group of investors from buying or selling at a particular price. 'Leap Frogs' show specialist intent.

Ney offers specific examples where specialists opened stocks considerably lower:
August 8, 1967 Chicago and Northwestern Railroad opened down 39 points.
October 21, 1968 one of the preferred stocks of TRW opened down 28 points.
February 4, 1970 Memorex opened down 29 1/2 points (1Ney, 15)

> "With $8,000, you can buy $10,000 worth of stock, but with $8,000 in stock, any Stock Exchange member can buy $160,000 worth of stock for his own segregated investment account" (1Ney, 112).

Because most investors have margin accounts, and the margin account agreement allows their brokers to lend their shares, specialists have an unlimited number of shares to borrow and sell short (1Ney, 68).

Margin agreements also allow the broker to use their customer's shares as collateral without the customer's knowledge or permission. This practice is fraught with dangers. In November, 1963, the Ira Haupt brokerage firm (NYSE), which dealt in both stocks and commodities was caught unwittingly in a scheme by one of its commodities customers to leverage nonexistent salad oil. The failure wiped out the partners of the firm and left it owing some $37 million in debts. "To compound Haupt's and the New York Stock Exchange's problems, it was impossible to return the stock to customers because the stock (held by the brokerage firm for its customers) had been pledged to banks by Haupt" (1Ney, 122).

Margin accounts usually allow the broker to borrow any cash in the account to use for his own purposes at no interest, even to lend back to the customer for margin purchases, at interest (1Ney, 119).

At the bottom of a cycle of a stock, having panicked customers into selling, the brokers and specialist borrow the customers' money to make their own long-term purchases; using their advantageous margin to acquire large amounts of stock. At the top of the cycle the process is reversed. Customers are paid back their money by the brokers and the specialist selling their shares to customers at a profit. The insiders even have extra cash to loan customers for margin purchases (1Ney, 136).

Another powerful tool for the specialist is the short sale. Though the specialist is responsible for 85 percent of the short selling done in a stock, the Exchanges are loathe to print any timely data on specialist short sales (2Ney, 94)(3Ney, 234). The specialist uses the short sale to control both downward and upward movements of stock (3Ney, 88).

The private investor or mutual fund can only sell short on an up- tick. The up-tick rules serves only to trap the public into selling short at the bottom, as the specialist drives the price down without a single up-tick for the public's use (1Ney, 72). But the specialist need not even create an up-tick to sell short. The SEC has been careful not to publicize its rule 10a-1(d), in which sub-paragraphs (1) through (9) exempt the specialist from the up-tick rule (2Ney, 97)(3Ney, 126, 215).

The Securities Exchange Act of 1934 prohibits pegging, the act of artificially holding a stock's price at a certain level for the advantage of the person or persons doing the pegging. However, SEC rule X-9A6 (1940) allows pegging by specialists in order to 'maintain an orderly market' while a large-block distribution of shares is taking place (2Ney, 117).

THE CORPORATION, THE SPECIALIST, AND THE EXCHANGE

The specialists and brokers hold shares "in street name" for investors, and therefore can vote the proxies for those shares. Officers in a corporation must report to the SEC any trading they do in the shares of their own company. Yet the Specialist reports his profits in trading the shares in that same corporation to no one (1Ney, 54-55).

The specialist, one of his partners, a friendly broker, their lawyers, or their bankers, often sit on the company's board of directors, which makes the specialist privy to information before the average trader. Where an officer of a corporation is held strictly accountable to the SEC for his use of 'inside information', the specialist and fellow brokers are accountable to no one (1Ney, 54-55).

> "It is an ideal situation. When you control a corporation's proxies, everyone is sympathetic to your point of view and your choice of directors. This is the other reason why nearly every major corporation listed with the Exchange (NYSE, M.T.) has a broker or a broker's banker on its board. It gives the exchange a pipeline to that corporation" (1Ney, 90).

Large brokerage houses, large banks, and the New York Stock exchange use dummy corporations as fronts to hold large portions of stocks in corporations. A list from any large corporation of its largest stockholders will be a roll of these very dummy corporations, who show up on list after list of major stock holders in America's largest corporations (2Ney, 19-23).

The intertwining of interests runs even deeper when the relations of Wall Steet's top Law firms are examined. For example, in 1974 the New York Stock Exchange's legal counsel also represented Chase Manhattan Bank. Both entities, through their dummy corporations, were large stockholders in scores of major U.S. corporations (2Ney, 26).

THE EXCHANGE, THE SEC, THE FEDERAL RESERVE, AND THE WHITE HOUSE

> "The bankers' man, Senator Carter Glass, who steered the Federal Reserve Act through Congress in 1913, had maintained that the Federal Reserve banks would be merely 'lenders of money.' The only collateral they were to accept was notes that could be paid when, in the course of business, goods and services had been manufactured and distributed. However, almost from the day of its inception, the Federal Reserve System set about making loans on common stocks" (1Ney, 103).

Who sits on the Federal Reserve Board? ... Chief officers of banks and corporations, all of whose companies are controlled by the Exchange (1Ney, 103-105).

Billions, perhaps trillions of dollars worth of stocks are now held by banks as collateral for loans.

This too works to the advantage of the specialists. For, to protect their interests, banks will issue stop orders to sell the stock before it falls below a certain price. The specialist holds those stop orders in his book and therefore knows exactly where a large number of shares can be had, and at what price they can be purchased. One quick sweep down those ranges of prices will deliver to the specialist the inventory he desires for short and mid-term purposes (1Ney, 101).

On June 30, 1934 President Roosevelt appointed Joseph Kennedy to be the first Chairman of the SEC. Only 4 months before, Kennedy, along with Mason Day, Harry Sinclair, Elisha Walker, and others were found to be responsible for operating ‘pools’ that were actively manipulating stock. When these, “poolsters withdrew and the boom collapsed the administration denounced the men who operated them” (1Ney, 215). But what’s a little denouncement between friends?

The stock markets had been headed downhill since December of 1968. On May 26, 1969 a party was held at the Nixon White House. In attendance were John Mitchell, Maurice Stans, Peter Flannigan, thirty five guests from Wall Street, fourteen industrialists, seven bankers, five heads of mutual and pension funds, and two heads of insurance companies. The next day a bull rally began on Wall Street. May 27th saw the Dow Jones 30 average rise by 5 per cent in one day (2Ney, 71).

On April 17, 1971, President Nixon, who along with Attorney General Mitchell had been a Wall Street lawyer (Maurice Stans was a broker), appeared for photographs with friends from the New York Stock Exchange. Nixon recommended the public to invest in the market. By April 28th the market was in a steep decline. Nixon circulated, “to 1,300 editors, editorial writers, broadcast news directors, and Washington bureau chiefs a list of the stocks of ten corporations that had advanced during the past year” (2Ney, 32).

There is a revolving door between the exchange and Washington. SEC Chairmen ‘retire’ to go to work for the Exchanges or major brokerage houses at many times their government salaries (2Ney, 50-63). SEC Chairman Hamer Budge was found by Senator Proxmire’s investigation to be making frequent trips to Minneapolis to confer with officials of IDS. IDS was under investigation at the time by the SEC. After leaving the SEC, Budge took the position of Chairman of the Board with IDS (2Ney, 56).

NEWS AND FINANCIAL REPORTING

It is highly unlikely that we will see news reports critical of U.S. stock exchanges, or of the specialist system. There is a simple reason for this. All news organizations are corporations and do but reflect their management’s views. Corporations that own media have specialists influencing the choice of management. Newspapers, magazines, and television are but extensions of the corporate world.

When Richard Ney’s first book, The Wall Street Jungle, came out it was on the New York Times best seller list for 11 months. Yet the New York Times would not review it. The Wall Street Journal refused to take an ad from a New York bookstore that featured The Wall Street Jungle (2Ney, 30).

All three of the major networks were wary of having Ney appear. NBC banned only two people from appearing on the Tonight show with Johnny Carson: Ralph Nader and Richard Ney. Not only do large banks, brokerage firms, and corporations advertise on television, they also are the largest stock holders (2Ney, 33- 34).

SPECIALIST STRATEGY

The specialist should be thought of as a merchant with some rather unique inventory problems and opportunities. His goal, always, is to buy at wholesale prices and to sell at retail. This applies to his actions in the course of trading day as well as a year of trading.
At the bottom of a slide the specialist will buy heavily for his trading, investment, and omnibus accounts. His goal then becomes to raise the price of his stock with his wholesale inventory intact. In practice, though, he may have to sell shares to meet public demand. This will cause him, then, to lower the price to re-accumulate his inventory before he can proceed to higher levels.

A rally begins while the price of the average stock is still falling. "Major rallies begin and end with the unexpected," (3Ney, 184).

To stimulate public demand for his stock, near the high the specialist will raise the angle of the rising prices dramatically for the stock. True to one of Ney's axioms that prices beget volume, the public will rush into the market place at the rally high. The specialist can now sell his accumulated inventory to fill the increased demand. Heavy Dow 30 volume at the high is evidence of heavy short sales by the specialists (3Ney, 113).

When the specialist has sold all his inventory, and has sold short, he will then begin a downward slide of prices so necessary to his plans. Slides are a mirror of rallies. Near the bottom, the specialist will increase the angle of price decline, alarming investors, scaring them into selling their shares to the specialist who needs them to cover his short sales, and to build a new inventory at wholesale. The media will remain bullish, or cautiously optimistic throughout a slide, until the last two weeks, when they will turn suddenly bearish (3Ney, 158).

TIPS FROM RICHARD NEY:
Specialists in the most active stocks will require more time than their fellow specialists to move stocks up or down, or to cover at the top of a rally or the bottom of a slide (2Ney, 84-85).
Specialists may use a rally as a 'stalking horse' for a later rally. Price is used like a geiger counter to locate volume (3Ney, 149).

During the typical bear market, or slide, the specialists will usually bring prices up on Fridays, to keep investors hopes alive (2Ney, 92).

Leaders of the rally in the Dow 30 will often act as 'screens' for the price declines of the other 24 or 25 Dow stocks.

Each stock exhibits its own distinct pattern or rhythm of price behavior (2Ney, 189).

THINGS OF WHICH TO BE AWARE
How can you spot the nadir of each high and low? Ney says to look at volume very closely. In particular look at the volume of the individual Dow 30 Industrial stocks (2Ney, 171). Get to know these specialists' habits. Follow what they do. Patterns of behavior will emerge.
Ney emphasized that a sense of timing was critical for survival in the market (2Ney, 149).

Ney was convinced that detecting Specialist short selling was a key. Specialist short selling at the peak of a rally should be detectable through increased volume.

Richard Ney used charts extensively. Ney was quick to point out that what is really being measured in his charts is not the behavior of the masses in the marketplace, but the techniques of the specialist in an individual stock as he maneuvers to solve short-term, intermediate-term, and long-term inventory problems (1NEY, 259).

Ney points to the gaps in prices that develop when a specialist is trying to ‘catch up’ with the market. These gaps, be they up or down, signal specialist intent (2Ney, 172).

> “Investors assume that what happens in the economy or to the corporation in terms of earnings or sales determines the trend of stock prices. … The most misleading element in this type of analysis is that it ignores the basic needs and motivations of the specialist system” (2Ney, 150).

We, as consumers react to certain critical numbers. Specialists know this. Specialists use the 10′s (10, 20, 30, etc.) and 5′s (5, 15, 25, etc.) in their strategies. They will use these numbers to elicit heavier buying or selling from the public. Often too, though, they will avoid critical numbers to avoid buying or selling stock when they do not wish to do so (2Ney, 155-156 & 163).

NEY’S SMALL INVESTOR TRADING RECOMMENDATIONS (1Ney, 297-301)
1. Do not buy the acknowledged leader in a field. Buy the number 2 or 3 company. These companies are more likely to be subject to bull raids by the specialists (1Ney, 298).
2. “Nothing puzzles me more than an investor’s willingness to pay more than fifty dollars a share for stocks. Buy low priced stocks. It’s percentages you’re after and you’ll get them in these stocks in a bull market” (1Ney, 298).
3. Invest only in stocks listed on the NYSE.
4. Do not buy secondary offerings from your broker.
5. Buy only stocks whose prices have fallen at least 35 to 50 percent.
6. “The rule, ‘Cut your losses and let your profits ride,’ was invented by a broker” (1Ney, 298).
7. The average investor need not worry about tax brackets, so do not hesitate to sell at a profit. “A short-term gain is better than a long-term loss” (1Ney, 299).
8. Own your stock. Do not use margin.
9. Do not sell short.
10. Do not allow your stock to be borrowed (via a margin account; M.T.)
11. Credit balances should be immediately transferred to your bank.
12. Do not leave your stock with your broker in street name.
13. Invest only in growth oriented, not income, stocks.
14. 4 to 5 stocks in a portfolio is plenty.
15. Make arrangements with your bank to receive your stock.
16. If there has been a major advance from the summer lows, look for the public to begin selling 6 months hence.
17. Big block sales at the end of a run-up (usually marked by heavy volume) marks the imminent decline in price.
18. Look for bull raids in May, up from the April 15th tax low.
19. Never enter stop or limit orders.
20. If you are interested in a stock, learn its specialist’s habits.
21. Stocks that are ideal for bull raids are those that decline as close as possible to an angle of 45 degrees.

Works Cited:
1Ney, Richard. THE WALL STREET JUNGLE, fifth printing. New York: Grove Press, Inc., 1970.
2Ney, Richard. THE WALL STREET GANG, third printing. New York: Praeger Publishers, Inc., 1974.
3Ney, Richard. MAKING IT IN THE MARKET. New York: McGraw-Hill, 1975

[The source for this essay is here. I posted my version of the entire essay because I edited out comments that the author Michael Templain made that I disagreed with, i.e., I felt he didn't grasp fully what Ney had written. You can read the original essay for yourself in order to make up your own mind. If you decide to read the books, read them in chronological order. They are impossible to find in a library, and are very expensive to buy used.]

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