all of which were not confirmed out to customers at the public offering price of $5\frac{1}{2}$ until almost 3 weeks after the offering date. At the same time the firm trading account was selling Seaboard stock at prices as high as $15\frac{1}{2}$.[110]

(e) *Nondelivery of certificates.*—Normally stock certificates are delivered by the issuer to the underwriter at the closing, when the underwriter remits the proceeds of the offering to the issuer. The closing usually occurs 5 to 10 days after the offering although in a "best efforts" underwriting the underwriter may not receive stock certificates until several weeks or more after commencement of the offering. Customers receive their certificates shortly after the closing although there may be a slight delay if instructions are not given to the transfer agent prior to the closing to break down the certificates into proper denominations. These apparently unimportant details concerning delivery of certificates became, in recent years, a means of restricting the supply of stock in the after-market. By failing to deliver certificates for weeks or even months, some broker-dealers effectively prevented customers from selling.[111]

One underwriter stated that certain houses deliberately delayed delivery of certificates because many customers "think they could not sell it until they have possession of it." [112] Another underwriter testified that the failure to deliver certificates was "one of the abuses of the industry." Some underwriters took the position that such delay was caused by breakdowns in the offices of transfer agents or in their own back offices, but others indicated that there was no excuse for delay since arrangements could be made with the transfer agent prior to the closing.

Although physical control of the certificate is not always necessary to sell a security, many broker-dealers were reluctant to sell for a customer unless he had a certificate, particularly if the buying broker-dealer insisted on regular 4-day delivery. As a practical matter, the ability of public purchasers to sell was often limited until they received certificates. For example, a customer of one small firm which under wrote new issues complained that:

> I requested delivery in my name many times but did not get delivery. After a concerted effort, stock was finally delivered about 4 months late and *in a street name* after I made threats. Prior to this I was always told it was "in registration." I had wanted to sell several times at a profit through another broker but stock was not delivered until after it was below my purchase price or very close to it. [Emphasis in original.]

This firm did not deliver stock certificates to customers until weeks or, in some cases months, after the effective date. In the Mallory Randall offering, which became effective on May 22, 1961, the prospectus stated that stock certificates would be delivered to purchasers in the original distribution on or about May 29, 1961. Nevertheless, many customers of Pistell, Crow, Inc., the managing underwriter, did not receive their certificates until August 1961.

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110 Johnson, Lane, Space indicated to the study that the delay in notifying customers resulted from a reduction in the size of its selling group allotment which made it necessary for its salesmen to contact each customer who had given an indication of interest and "explain the situation and make sure that token allotments would be acceptable to the customers."

111 The problem of nondelivery of certificates in connection with a new issue should be distinguished from "fails to deliver" by broker-dealers in trading transactions, discussed in pt. E of ch. III.

112 In some cases involving marginal underwriters, the transfer agent was controlled by the underwriter.

The files of the Commission contain numerous complaints from purchasers of new issues who were unable to obtain delivery of their certificates. Approximately 20 percent of the public complaints received by NASD district No. 12 (New York) during the period between July 1, 1960, and June 29, 1962, related to this problem. One customer complained to the NASD that when he attempted to sell an allotment of a new issue purchased through a small underwriting firm and requested delivery of his certificate, he was told by a salesman that the firm did not wish its customers to sell immediately after the offering and that if the shares were sold, the salesman would be "in trouble." Another complaint was made by a registered representative of another such firm to the NASD concerning his firm's policies with respect to delivery of certificates. The registered representative stated that the proprietor of the firm told his salesmen not to let their customers sell three issues underwritten by the firm and that certificates of stock in these issues were not to be released to customers.[113]

Failure to deliver certificates may be related to the capital position of the underwriter. The marginal undercapitalized underwriter making a "best efforts" offering may, instead of remitting the proceeds of the offering to the issuer, use the proceeds for working capital in the course of his own business. By delaying remittance of the proceeds to the issuer, the underwriter cannot make delivery of certificates to customers who may wish to sell.[114]

Under the circumstances described above, trading markets immediately after a distribution reflect a distorted picture of supply and demand. Trading firms can to some extent assess available demand on the basis of prior indications of interest, limited price orders to purchase in the after-market, and responses of customers to solicitation; but potential selling pressure remains to a large extent unknown.[115] Moreover, if the underwriter who has control over the delivery of certificates is the sole or primary market-maker for the issue, failure to deliver certificates can serve as a crude device to rig the trading market for the issue.

(f) *"Free riding and withholding."*—i. *Free riding practices.*— Perhaps the most widespread and troublesome factor in restricting the supply of stock of a new issue is the practice generally known as "free riding and withholding." This study reveals that it was common for underwriters or selling group members to withhold amounts of stock in the accounts of (1) partners, officers, or employees of the firm; (2) relatives of such persons; or (3) persons affiliated with other broker-dealers with whom they may have had reciprocal arrangements

[113] The courts and the Commission have consistently held that a broker-dealer impliedly represents that he will deal fairly with the public and that this implied representation of fair dealing includes an implied representation that a transaction with a customer will be consummated promptly unless there is a clear understanding to the contrary. If a dealer does not intend to consummate a transaction promptly and fails to disclose this intention to his customer, he omits to state to the customer a material fact necessary to make the representation of prompt consummation not misleading. See Securities Exchange Act release No. 6778 (Apr. 16, 1962).

[114] See, e.g., *D. Earl Hensley Co., Inc.*, Securities Exchange Act release No. 6611 (Aug. 4, 1961); *Smith, Holly Co., Inc.*, Securities Exchange Act release No. 6642 (Oct. 2, 1961). The Commission has recently adopted a rule under the Exchange Act to deal with this situation. Rule 15c2–4 makes it a fraudulent, deceptive, or manipulative act or practice for a broker-dealer in a "best efforts" underwriting to fail to remit promptly the proceeds of an offering to the issuer or selling shareholder or, if the offering is on an "all or none" or other contingent basis, to fail to place the proceeds in escrow or in a trust account until the appropriate contingency has occurred, at which time the proceeds are to be promptly transmitted to the persons entitled thereto.

[115] See sec. 3.b(1), above.

or obligations. In many instances, the withheld shares were later offered to the public at premium prices.[116]

Each of the issues studied revealed some degree of "free riding" by underwriters or selling group members. For example, Hill, Thompson & Co., co-underwriter of the public offering of 108,000 units of Cove Vitamin, allotted 10,150 units to 27 relatives of principals in the firm, out of a total allocation to the firm of 54,000 units.

"Free riding" was inevitable in firms where most of the customers were relatives of the firm's principals. Sidney Lyon, a partner of Ross, Lyon, testified that the bulk of the firm's accounts were those of relatives and that these accounts were the largest in the house. When the firm received an allotment of 4,000 shares of Cove Vitamin as a selling group member, 1,000 shares went to relatives.

Although some firms had strict policies against free riding by their employees, these policies were useless if they were not enforced. In some large firms, registered representatives opened fictitious accounts in which they had an interest for the purpose of receiving allotments of "hot issues." Some firms sensed that stricter controls over free riding were necessary. One underwriter testified that the firm would not honor indications of interest received through branch offices, because salesmen and branch managers would place stock in accounts in which they had an interest. The same underwriter stated that on the basis of his experience, the placing of "hot issues" in fictitious accounts by registered representatives was "done often."

In some instances, free riding was employed not only as a means of giving persons connected with the underwriter or other participants in the distribution a preferred position in the offering, but also to control and manipulate the market for the security. In several cases coming before the Commission, many of them involving regulation A issues, the underwriter was found to have withheld a substantial portion of the issue by placing shares in fictitious and other accounts which it controlled and then generating public demand for the issue. Customers were told by salesmen that the issue was oversubscribed, fictitious quotations were placed in the sheets at premium prices to create the appearance of an active and broad trading market, and optimistic publicity was disseminated concerning the issuer. The public was then induced to buy the issue in the market at premium prices, the "market" being one created by and under the control of persons actively engaged in the distribution.[117]

Similar patterns of activity were found in some of the 22 issues studied. In the 110,000-share Rocket Jet offering, Thomas Jay, Winston & Co., Inc. (Jay, Winston), the managing underwriter, allotted 15,000 shares to Shearson, Hammill & Co. (Shearson, Hammill) as a selling group member. The manner in which Shearson, Hammill's allocation came about is significant. Jack Temkin, Rocket Jet's accountant and a customer of Jerome Goldberg, a registered representative in Shearson, Hammill's Beverly Hills, Calif., branch office, inter-

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[116] It should be pointed out that the Special Study relied almost completely upon questionnaires submitted by the broker-dealer participants to determine the extent of free riding. Except in a few issues no attempt was made to determine whether the persons named as having received allotments were affiliated in any way with participants in the distribution.

The incompleteness of many replies precluded any precise quantitative summary of the full extent of free riding.

[117] See sec. 3.b(1), above.

ested Goldberg in the Rocket Jet issue. Goldberg persuaded the partner in charge of Shearson, Hammill's investment banking department to participate in the offering, but the firm would agree to take only as many shares as Goldberg thought he could sell and stipulated that none of the shares should be sold in the East. Of the 15,000 shares which Goldberg said he could sell, he allotted 2,000 to six accounts over which Temkin had discretionary authority, 4,810 to accounts of partners and clients of Temkin and members of their families, and 1,600 to accounts owned beneficially by Temkin (one of which was in a fictitious name). In addition, Goldberg allotted 1,000 shares to his own mother-in-law (over whose account he had discretionary authority), 700 to his minor unmarried daughter (under a fictitious name), and 200 to J. & J. Investments, an account jointly owned by Goldberg's wife and Temkin.

After allocations had been made to selected dealers, Jay, Winston had 30,700 shares for its own customers. Of these, 3,350 went to friends of the family that controlled the issuer, 4,750 to accounts in which the president of Jay, Winston or his relatives had a beneficial, interest, 2,400 to Temkin or his relatives (in fictitious names), 750 to relatives of Goldberg, and 800 to J. & J. Investments.

On the first day of trading, Rocket Jet stock was quoted in the sheets at a high bid of 10, low offer of 10½, a substantial premium over the offering price of 5. On that day customers of Jay, Winston bought 3,740 shares and sold 3,740 shares. All of these transactions were executed at 9 and were crossed within the Jay, Winston office, each sell order being matched with a buy order. On the following day customers of the firm bought 2,565 shares and sold 2,565. All of these transactions were consummated a price of 9, except for 465 shares which were purchased for a relative of a partner of the firm, at a price of 7½, from 15 of the original distributees. This pattern of trading within the firm continued, at a lower volume, for several more days. Since none of these crossed transactions went through any firm that was making a market in the stock, they could not affect the quotes in the sheets.

Many of the customers who bought Rocket Jet shares at premium prices in the immediate after-market had given Jay, Winston limited orders to purchase stock at prices up to 9, after they were unable to obtain allotments at the original offering price. Others were solicited by salesmen of the firm, who told them that the price would rise and that they would make a quick profit. Still others were discretionary accounts maintained by the firm. The president of the firm has testified that he did not know that his salesmen were soliciting customers in the after-market. He stated:

> * * * if I heard or knew they were soliciting, I would have discouraged them—not discouraged, put a stop to them soliciting.

Goldberg told the Special Study that in allocating new issues it was his policy to tell each of his customers to hold "for investment." Nevertheless, on May 23, 1961, the first day of trading, he sold 500 shares out of the discretionary account of his mother-in-law. He testified as follows concerning this sale:

> Question. I notice that very few of your customers sold the security within the first 40 days, even though it sold [at] a hundred percent premium. Is there any reason which you could give me for that?

Answer. To repeat, I had looked at the company very closely, personally; I felt that it was a good investment and there were just—nobody indicated a desire to sell.

Quesion. However, your mother-in-law sold a thousand shares through you. Why would she—she sold 500 on the effective date at $9 a share. Why did that take place when very few of your other customers sold out?

Answer. Because in my opinion the stock had gone to too high a premium.

Question. And yet you didn't encourage your other customers to sell?

Answer. Well, if my recollection is right, there was no chance to tell them. The stock did drop immediately thereafter. And, as a matter of fact, some of them were told and refused to sell. They just wanted to hold on for a while. Those that I could call and discuss it with were told.

Free riding also was found in the 166,666-share Associated Testing offering at $3 per share. The participation of George, O'Neill & Co., Inc. (George, O'Neill), the managing underwriter, was 105,000 shares. The firm withheld at least 32,050 shares, or almost one-third of its total participation, placing the shares in accounts controlled by the firm or its principals. These shares were subsequently sold to the firm's customers at twice the offering price.

Likewise, in the 165,000-share Custom Components offering, at least 32,905 shares went to accounts of participants in the distribution and their officers, partners, and employees, or in which such persons had a beneficial interest; other broker-dealers and their officers, partners, and employees; and individuals closely associated with participants who, in certain instances, received allocations in nominee names. Of 58,500 shares retained by the managing underwriter for distribution, at least 15,455 shares were placed in such accounts, 5,000 shares going to officers, employees, and designees of May & Gannon, which began making a market in the stock on the effective date of the offering. Wm. Stix, Wasserman & Co., Inc., which was underwriter of 20,000 shares, allotted 5,100 shares to the principal of the firm, his son, daughter, and a trust which he controlled; 1,650 to employees of the firm; and 4,400 shares to employees of other broker-dealers. These allocations were not disclosed in the prospectus.[118]

ii. *Controls.*—Free riding has been a problem of major concern to the Commission during every period of recent history in which speculative new issues have proliferated. In April 1946, during a period of public demand for new offerings, the Commission issued a release which noted that free-riding practices "are a major factor in driving the price of [new stock issues] above the public offering price."[119] In its release the Commission proposed a rule under section 15(c)(2) of the Exchange Act which would have made it a fraudulent practice for any broker-dealer participating in a distribution to offer any undistributed part of an offering at a price above the prospectus price unless a bona fide offer had been made, for a reasonable time, to distribute the shares at no more than the prospectus price. Under this rule, a bona fide offer would not include a sale or offer to a partner, officer, director, or employee of the broker-dealer firm or any account with which any such person had a control relationship or in which he had a beneficial interest. Shares taken for investment were exempted from the proposed rule if the allocation was disclosed in the prospectus.

[118] For a discussion of related aspects of the Custom Components offering, see subsec. 3.b(1), above.

[119] Securities Exchange Act release No. 3807.

The proposed rule met a barrage of criticism from the industry, much of it based upon the argument that it would have the effect of depriving persons connected with underwriters and selling group members of the opportunity to invest in new issues of securities. According to this reasoning, such persons were members of the public and should not be treated as second-class citizens. In addition, the NASD claimed that, as a self-regulatory organization, it and not the Commission should undertake the regulation of free-riding practices.

The market decline of September 1946 deprived the problem of its urgency and the proposed rule was never promulgated. In 1950, the NASD adopted an interpretation of article III, section 1, of its "Rules of Fair Practice,"[120] which declared that it would be violation of the rule for any member, directly or indirectly, to withhold portions of any public offering in its account or to sell any such portion to persons connected with it, members of their immediate families, or accounts in which such member or such persons had a beneficial interest. Securities taken for investment were exempted from the interpretation if the allotment was in accordance with the purchaser's normal investment practice. In May 1959 the NASD amended the free-riding interpretation to include the additional requirement that any stock taken by insiders not be disproportionate in amount to allotments made to the public.

Increasing interest in new issues in 1959 renewed the Commission's concern with the free-riding problem. In October 1959 the Commission released a preliminary report by the Director of its Division of Trading and Exchanges which discussed the results of an inquiry into the circumstances surrounding the distribution of a number of "hot issues" which had sold at a substantial premium immediately after the effective date.[121] This report took note of the practice of allocating portions of public offerings to insiders of the participants, other broker-dealers with whom they might have reciprocal arrangements, insiders of such other broker-dealers, and trading firms which made a market in the stock. The report pointed out the various provisions of the Securities Act and the rules thereunder which may be violated by these practices, and it stated that the Commission's inquiry into free riding would be continued. In April 1960 the NASD's free-riding interpretation was further amended by the addition of a requirement that aggregate sales made by participants in public offerings to insiders be insubstantial.

Despite the tightening of the free-riding interpretation and attempts by the NASD to enforce it, free-riding practices seem to have continued without abatement. In 1959 the executive director of the NASD reported to the membership: "Free riding continues as perhaps the most important new disciplinary development before us—and certainly one of the most difficult." Between April 1960 and August 1961, the NASD district No. 12 (New York) analyzed 1,589 replies to questionnaires sent to member firms participating in 122 new issues offered between August 1958 and January 1961 which had gone to a premium. Of the replies, 379 (or 25 percent of the total) resulted in complaints being brought or letters of caution being sent

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120 This is the basic rule providing that "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

121 See Securities Exchange Act release No. 6097 (Oct. 29, 1959).

with regard to free-riding practices. Complaints were filed against 45 percent of the members queried.

Until the introduction of the "disproportionate" and "insubstantial" tests, it was possible for participants in public offerings to allot large portions of new issues to insiders and defend the practice on the ground that the stock was taken for investment. If this were done frequently enough, it could also be claimed that this was a "normal investment practice." Underwriters and selling group members were thus able to justify insiders' purchase of all or substantially all of an allocation. It does not appear that the 1959 and 1960 amendments have significantly altered the practices of many broker-dealer firms.

Apparently a major reason for the ineffectiveness of the free-riding interpretation is the inadequacy of penalties imposed by the NASD for disclosed violations. In most cases, member firms found to have violated the interpretation are censured, or at the most are fined relatively small amounts. For example, of the 74 free-riding complaints which were disposed of in 1961, 6 were dismissed, 36 resulted in censures, and 29 resulted in fines of less than $500.[122] No member of the NASD has ever been expelled and only two have been suspended from the organization for free-riding violations. Firms that have been merely censured or fined by the NASD for free riding repeated the offense. For example, officers of May & Gannon were each fined $500 by the NASD in November 1960 for violating the free-riding policy. Six months later in connection with the Customs Components offering these same individuals engaged in the very same conduct.[123] Since free riders in many cases realize profits which far surpass the amount of the fines, it is not surprising that the NASD's lenient enforcement has not been an adequate deterrent.[124] Few firms have requested a hearing to contest disciplinary proceedings brought against them for free riding, and in only one case has there been an appeal from the NASD to the Commission.[125]

(3) *Factors increasing demand*

Limitations on the floating supply of stock of a new issue made the price of the security in the aftermarket susceptible to even slight changes in public demand. When demand was stimulated by active solicitation and the use of publicity techniques, the price could be expected to rise dramatically.

Strong public demand for new issues, combined with general speculative fever, created the necessary climate for the "hot issue" market of the years 1959 to 1961. It is important to emphasize that the practices of broker-dealers which stimulated demand—some of which might be usual and acceptable outside the "hot issue" context and others which would be questionable in any event—did not of themselves cause the "hot issue" phenomenon. Without public expectation of a rising market and public appetite for quick profits in such a market, the 1959–61 surge of "hot issues" could not have existed.

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[122] Under the NASD rules of fair practice. the board of governors may not impose a fine in excess of $1,000 for any violation of the rules.

[123] See sec. 3.b(1), above.

[124] In 1960, the NASD fined one of its members $1,000 for free-riding violations in which the member made a profit of $63,000. The member also was suspended for 10 days.

[125] *First California Company*, Securities Exchange Act release No. 6586 (July 6, 1961). Free-riding practices may give rise to violations of the registration and antifraud provisions of the Securities Act and the antifraud and antimanipulative provisions of the Exchange Act, and the rules thereunder. See Securities Exchange Act release No. 6097 (Oct. 29, 1959).

(a) *Solicitation.*—In many of the new issues studied, broker-dealers, including those participating in the original distribution, stimulated aftermarket demand by active solicitation. The following examples, derived from the study of 22 new issues, illustrates the effects of such solicitation.

On February 20, 1961, 200,000 shares of Shore-Calnevar common stock were publicly offered at 9, underwritten by H. Hentz & Co. and Federman, Stonehill & Co.[126] The stock was immediately quoted in the after-market at a slight premium, with bids at 9¼ and offers at 10¼. About 2 or 3 days after the effective date, when the stock was selling at only a slight premium, Philip Shore, the president of Shore-Calnevar, visited the southern California offices of several broker-dealers, among them Hentz and Mitchum, Jones & Templeton. He informed salesmen at these offices that a prospective acquisition of a vending company would greatly increase Shore-Calnevar's earnings. Other representations were apparently made concerning the growth potential and possible earnings of Shore-Calnevar. According to customers of Hentz and Mitchum, Jones & Templeton, salesmen of these firms told them that they had "inside" information that Shore-Calnevar stock was underpriced, that the security would rise to 30 in the near future, and that the automobile accessory division alone would have earnings of between $1.50 and $2.50 per share.[127] Meanwhile, during March and April 1961, the company carried on an active publicity campaign. On April 18, 1961, Shore-Calnevar was quoted in the sheets at a high bid of 22½ and a low offer of 22¾.

Between the effective date of February 20, 1961, and March 30, 1961, customers of Hentz's Beverly Hills office purchased approximately 38,295 shares of Shore-Calnevar stock at prices ranging from 10½ to 15⅞, and customers of Mitchum, Jones & Templeton purchased approximately 9,275 shares at prices ranging from 13⅝ to 21. On November 2, 1962, Shore-Calnevar stock was quoted in the sheets at ⅞ bid and 1⅜ asked.

Another example of active solicitation by an underwriter in the immediate after-market was that of Bristol Dynamics. On March 20, 1961, 100,000 shares of its common stock were offered to the public at 7. The underwriter, William, David & Motti, Inc., sold 89,500 shares of the offering to its own customers. On the first day of trading, Bristol Dynamics stock sold at about 16—more than twice its offering price. The issue continued to sell at a premium, reaching a high of about 22 in the middle of April 1961. On November 2, 1962, the stock was quoted at 3 bid and 3½ asked. About 5 days after the original offering date, salesmen of William, David & Motti, Inc., commenced solicitation of customers. Customers were told that if they did not buy Bristol Dynamics at the premium price they could not get an allot-

[126] Hentz, in negotiations with the president of the issuer, priced the issue at nine times earnings. According to Hentz, the president of the company, on the other hand, had wanted the issue priced at 10 to 12 times earnings.

[127] In response to an inquiry in questionnaires sent to purchasers in the after-market as to the reason given by salesmen for making the purchase, customers of Mitchum, Jones & Templeton gave the following responses:

"Broker had 'inside' information that earnings picture was very good."

"Good long-term prospects for company * * * will earn $1 per share."

"My broker had also been told that the company's president was currently * * * a large buyer of its stock in the open market.

"Broker's thinking and basis for recommendation as a speculative growth issue was based to a great extent on conversation with Philip Shore and his attorney."

"Broker led me to believe that he was in active contact with president of the company—he always had the latest inside info as to what was about to happen."

ment of other new issues brought out by the firm, and that because of a thin floating supply and great demand the price would rise to 40.[128]

As noted above, some underwriters selected co-underwriters and selling group members with the understanding that these firms would generate retail activity in the after-market. In other instances, firms that had no nominal connection with the initial distribution would be used to merchandise the issue in the after-market at premium prices, as exemplified by the Custom Components offering described above.[129] In situations such as these, a substantial redistribution of shares held by persons receiving original allotments was made to a new group of customers purchasing at premium prices.[130]

One firm, when asked to explain solicitation at premium prices by its salesmen after itself having established the offering price as managing underwriter a few weeks or days before, stated:

> Then the market itself has spoken, as it were, on the value, and we have to recognize what the market has said.

Another firm's explanation was that the stock was now "seasoned"—1 month after the offering. Questions remain, however, as to the degree of underpricing of the offering to assure a substantial premium, and the degree to which active solicitation itself enhances the premium in the after-market.

Practices and standards apparently vary somewhat among different firms. For example, Kidder, Peabody stated to the study that, although this firm opposed any prohibition upon solicitation of customers at premium prices, it would not expect, "in the absence of developments in general market conditions or developments affecting the issuer or the industry in which it operates," that Kidder, Peabody salesmen would recommend purchases at prices "materially in excess" of the initial price.

(b) *Market letters and publicity.*—Demand in the immediate after-market was stimulated not only by oral solicitation but in some cases by market letters, advisory recommendations, articles in the financial press, and other planned publicity.[131]

In the case of Quality Importers, 260,000 shares were offered to the public on July 31, 1961, at $5 per share, with Sutro Bros. as managing underwriter. On October 19, 1961, the stock was selling over the counter at 10¾. On the following day Sutro Bros. issued a market letter which gave a generally favorable view of the company's financial condition and prospects. By the next day the stock had climbed

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[128] In addition, customers who had bought Bristol Dynamics stock at about 20 were told not to sell because the price would go higher and their selling might depress the market. One such customer wrote to the Special Study, "if you sold out right after the issue came out and did not support it then you could not get any new issues." Customers probably could not have sold their shares even if they had wanted to because certificates were not delivered to them until 5 to 10 weeks after the effective date. See subsec. 3.b(2)(c) and 3.b(2)(e), above.

[129] See subsec. 3.b(1), above.

[130] For a substantial redistribution by the managing underwriter in the after-market, see the description of the activity of Blyth & Co. in connection with the Grosset & Dunlap offering in ch. VII.

[131] For an example of a case coming before the Commission in which misleading market literature was used by a broker-dealer firm in the after-market, see *Heft, Kahn & Infante, Inc.*, Securities Exchange Act release No. 7020 (Feb. 11, 1963). For a discussion of corporate publicity generally, see pt. C of ch. IX. While the impact of such publicity might have been tempered if "accompanied or preceded by a prospectus," purchasers in the after-market frequently did not receive copies of the prospectus or offering circular even during the first 40 days after the commencement of the offering. See subsec. 3.c, below.

to 12, and within a week it was at 14½.[132] It is interesting to note that Sutro Bros. published the market letter upon the request of representatives of the company, who wrote it after first rejecting a draft prepared by Sutro Bros.

In the Universal Electronics offering, a strong written recommendation by an investment advisory service apparently increased the price of the stock in the after-market and made possible a distribution of securities to the public. On January 25, 1961, Underhill Securities Corp. as managing underwriter offered 75,000 shares of this security at a price of $4 per share, pursuant to regulation A, but was able to distribute only about 24,050 shares to selling-group members and 6,850 shares to its own customers. On March 14, 1961, the company filed an amendment to the offering circular, naming Richard Bruce & Co., Inc. (Bruce) as co-underwriter. Bruce immediately "distributed" the remainder of the 75,000 shares, 9,800 shares going to its own public customers and the balance of 37,800 shares to a number of broker-dealers. At the close of business on March 23, 1961, customer accounts at A. T. Brod & Co. held 16,200 shares and at Irvin Weis & Co. 22,450 (18,000 of which were in accounts of friends and relatives of a registered representative of the firm, who had discretionary authority over some of them). Bruce went short 3,500 shares, which it "overallotted" because "some people may not like the offering circular when they read it," but the firm covered its short position on March 23 and purchased an additional 1,400 shares on that day and the next. Customers of Bruce still held approximately 9,100 shares.

This was the situation on March 24, 1961: The price of Universal Electronics common stock was 4⅛, scarcely more than the offering price. The majority of the offering was in the hands of a few broker-dealer firms, including participants in the offering, or in accounts controlled by these firms. Until that time, trading activity in the stock had been insignificant. For example, on March 17 trading firms bought 800 shares and sold 700, principally filling the orders of retail houses executing customers' orders.

On March 24, 1961, the Dynamics Letter, a weekly investment advisory letter,[133] mailed to its subscribers an issue containing the following comment on Universal Electronics stock:

> There are only 75,000 shares of this stock in public hands; and since the issue came out a month ago at $4 it has attracted barely enough informed buyers to carry it to around $6 or $7. Based upon the rate of growth this company *must* enjoy, you'll be able to add at least a pair of zeros to today's prices within as brief a time as a year or two. [Emphasis in original.]

On March 27, Bruce went into the sheets for the first time. The price had now moved to about 8 bid, 9 offered. A representative of Bruce told the study that he had not known of the Dynamics Letter recommendation at the time but he saw a number of calls coming in through the wire system which led him to believe that the stock "should be played from the long side." [134] The principal distribution

[132] On Oct. 19, 1961, 3 employees of Sutro Bros. purchased shares of Quality Importers stock, one of the purchases being in the amount of 1,000 shares. The 1,000 share block was sold on Oct. 20, 1961, at between 11⅜ and 11½, the original purchase price being 10⅛. The salesman making the purchase was questioned by Sutro Bros. and claimed that he bought the stock because of a "tip" given to him by one of his customers.

[133] Dynamics Letter had a circulation of approximately 1,500. Many of its subscribers were registered representatives of member firms. For a further discussion of this publication, see pt. C of ch. III.

[134] A representative of Bruce stated that although he knew the owners of the Dynamics Letter, he did not talk to them about Universal Electronics.

of Universal Electronics stock to retail customers occurred during the week beginning March 27 when the public, stimulated by the item in the Dynamics Letter, began to place orders through large wire houses.[135] During the period from March 16 through March 30, 1961, both firm and customer accounts at Bruce, A. T. Brod & Co., and Irving Weis & Co. distributed at least 36,465 shares to the public at prices ranging from 4⅛ to 18¾, at a gross profit of at least $176,000. Sales were made from these accounts to trading firms which filled orders coming in from retail wire houses. By April 3, 1961, the price of Universal Electronics stock had risen to approximately 19, or about 375 percent since the issuance of the Dynamics Letter.

Retail firms indicated that some of their customers were solicited to buy Universal Electronics stock; others indicated that customers were not solicited. In most cases, however, it was the Dynamics Letter which directed the attention of registered representatives and their customers to the stock. For example, customers of Dominick & Dominick purchased about 6,600 shares at prices ranging from 9½ to 18½, principally through its Buffalo branch office. When questioned about these purchases, a representative of the firm stated:

> Our firm maintains a large staff engaged in investment research. This staff never made an analysis of the stock of Universal Electronics Laboratories Corp., and made no recommendation for its purchase. However, Mr. Knox [a partner of Dominick & Dominick] some time prior to March 1961, had subscribed to the Dynamics Letter, published by the Dynamics Letter, Inc., of 141 East 44th Street, New York 17, N.Y. The letterhead of this organization indicates that it is registered as an investment adviser with the Securities and Exchange Commission. Following the receipt of the Dynamics Letter dated March 24, 1961, in which the Universal Electronics' stock was strongly recommended, Mr. Knox entered orders on March 27 and March 28, 1961, for the purchase of 2,000 shares of this stock for his personal account. The Dynamics Letter referred to above was available to other registered representatives in the Buffalo office and, of course, was also available to the portion of the public subscribing to the letter.

Customers of Bernstein & Co.'s branch office in McKeesport, Pa., purchased about 3,000 Universal Electronics shares. A representative of the firm stated:

> The information that was relied on was public information published in the Dynamics Letter, a service which we had subscribed to. We did not sell this stock in the offering and therefore I did not have a copy of the offering circular. I checked the stock with our research department and they advised me to instruct all customers that this was a highly speculative security and we so advised our clients. Some of our clients who were in the habit of reading the Dynamics Letter in our office purchased the stock without our immediate solicitation. However, in most cases their attention was drawn to this matter by our suggestion, which you might construed as a solicitation.

It is to be noted that many of the ultimate purchasers of Universal Electronics stock did not receive the offering circular. Instead the interest of registered representatives and their customers was aroused and stimulated by a crude tout in an advisory service. On November 2, 1962, the stock was quoted at 1⅜ bid and 1⅝ asked.

In the Custom Components offering, Draper, Sears, a co-underwriter of 7,500 shares, published a highly favorable market letter concerning the company on July 26, 1961, approximately 3 months after the effective date.[136] This market letter was wholly based on a memorandum

[135] Pursuant to the requirements of regulation A, the company filed a notification with the Commission that the offering had been "completed" by Mar. 29, 1961.

[136] For a discussion of other aspects of the Custom Components underwriting, see subsecs. 3.b(1) and 3.b(2)(f)i, above.

received from the managing underwriter which purported to summarize a meeting that had been held between the president of Custom Components, the managing underwriter, and representatives of three other brokerage firms. Draper, Sears did not contact the company or check the factual accuracy of the market letter in any other manner.[137] The market letter stated that the president of the issuer had estimated sales of $2.5 million for the fiscal year ending July 31, 1962, and of 1½ times to double that amount for the 1963 fiscal year. It concluded as follows:

> The company operates in what is considered at present as one of the most promising scientific fields and its management appears well able to take full advantage of this position.
>
> At the current quotation, the stock appears to offer an extremely good opportunity for appreciable capital gains.

In fact, the company had sales of approximately $360,000 in fiscal 1962, compared with $384,000 in the previous year. The president of the company told the Special Study that sales for fiscal 1963 would amount to $400,000. He also stated that as of January 1963, the company still did not possess the equipment to manufacture sufficient products to generate sales of $2.5 million. He conceded that his statements upon which the market letter was based were probably overly optimistic.

Copies of the Draper, Sears market letter were given to the firm's registered representatives and to the managing underwriter. In the 2 months following its publication, customers of Draper, Sears purchased 2,955 shares of Custom Components stock in a market that gradually declined from 6¾ to 2¾ in early September.

An examination of the distribution lists of the underwriters for the 22 new issues reveals that in at least 11 of these offerings financial journalists and publicists received allotments. The full extent of such allotments cannot be measured, since, in the lists submitted to the study, the underwriters did not always identify the customers who received shares. Among the recipients of shares of these new issues were the financial editor of a New York City newspaper, the author of a weekly column on the over-the-counter market which appeared in another New York City paper, the author of a publication circulated on Wall Street which gave advice on the market, an editor of a nationally circulated business and financial magazine, the business editor of a national news magazine, a member of the news staff of a national broadcasting network, and several financial public relations men.

In itself, the allocation of shares of new issues to publicists may not be surprising. It should be noted, however, that the names of certain public relations men turned up more than once, appearing in the distribution lists of several of the 22 issues. In addition, an examination of the accounts of a number of these individuals at the underwriters reveals that in some instances the allotment was the first, or only, transaction in the account. It would appear that in these instances the underwriters were deviating from their stated practice of making allocations of new issues only to regular customers.

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[137] The managing underwriter of Custom Components stated that he approached an analyst at Paine, Webber, Jackson & Curtis to write up the company but that broker-dealer firm refused to do so until the company accomplished some of its objectives.

During 1961, Globus made allotments of new issues to several journalists and publicists, including financial writers for four New York City newspapers. One of these received allocations of 50 or 100 shares of 8 new issues of which Globus was an underwriter between August 1961 and March 1962. During this period there were no other transactions in this individual's account at Globus. According to Morton Globus, the allocations were made in the hope that the firm would receive publicity. He testified:

> One of the reasons why I was interested in [the journalist] when I met him, I did know that he was a financial writer and he did have a financial column and that occasionally he would write an article about new issues or new issues market and assuming that he would do so, naturally I would be gratified if my name was mentioned in a favorable light and the only way I had felt they could know about the things that we were doing, or one of the ways that he would know about the things I was doing, was by receiving new issues and reading our prospectuses, and following the price thereafter.

Although this column frequently reported on Globus underwritings, there is no evidence that the journalist was improperly influenced by his receipt of shares of new issues. In general, allotments seem to have been made by underwriting firms in order to establish and maintain a friendly relationship with the press, rather than to encourage touting of any specific issue of securities. The practice, however, has ugly undertones. For example, Globus testified that a member of the press whom Globus did not know telephoned him, and after identifying himself, asked for an allotment of Rocket Jet. Globus allotted 50 shares to this individual because of his press connections. His explanation to the Special Study was: "You know the guy can hurt you."

c. The managing underwriter in the after-market

(1) *Relationship to the issuer and the market for its stock*

The managing underwriter remained a key figure in the after-market of many new issues offered to the public in the years 1959 to 1961. It was not uncommon for the managing underwriter to hold a large block of stock or options which he had received for providing interim financing to the issuer or as underwriter's compensation. Whether these securities are taken for purposes of "investment" or with a view to resale, their presence in the underwriter's hands gave him a substantial interest in the market for the stock. The managing underwriter often became the principal market-maker—and in the case of small issues, sometimes the sole market-maker—as long as the stock continued to be traded over the counter. Usually an "integrated" firm with retail customers, the managing underwriter may use its sales organization to solicit customers to purchase stock acquired either from the issuer or in the course of making a market. In addition, its partners or officers may serve as directors of the issuer, enabling them to obtain information concerning the issuer's financial condition and prospects not available to the public.

The combination of some or all of these continuing relationships with the issuer and the market for its stock may place the underwriter in situations where its duties and obligations to the issuer's stockholders, its own customers, and the general investing public may come into conflict and where its access to information gives it an advantage over other broker-dealers and the general public in its own transactions. The potential danger in such a situation was well expressed by the New York Stock Exchange in a recent circular to its members:

> In the recent past a member organization that believed itself fully aware of the responsibilities inherent in the acceptance of a directorship, by a partner or employee, encountered unforeseen difficulties when other aspects were added to the relationship. In addition to the directorate, the firm participated actively in the after-market and held options to acquire the stock. The combination of insider knowledge available to the director, coupled with a dominant after-market activity and the fact the firm had options to acquire the stock at prices below the quoted market later placed the firm in the position of being unable to defend its actions from charges of manipulation. Usually the responsibilities of a director are clear cut and recognized by a member organization. What may not be as evident is that more than ordinary diligence is required when the director relationship is combined with options to acquire the security while dominant participation in the market by the firm may enhance the value of such options.[138]

The records of the Commission show that the opportunities for manipulation inherent in these relationships have not always been foregone.[139] Nevertheless, a financial relationship between the underwriter and the issuer which continues beyond the period of distribution is quite normal and of course is not, of itself, necessarily manipulative or otherwise objectionable. The underwriter may have or feel certain responsibilities both to the issuer which it has sponsored and to its shareholders. Loeb, Rhoades described its responsibilities after the distribution of a public issue in this manner:

* * * * * * *

> B. We feel a responsibility for seeing to it that an orderly after-market in the security is maintained so that persons who have purchased the issue will be able to liquidate or increase their investments if they desire. Normally, we make a market ourselves in unlisted issues whose underwritings we manage after the initial distribution is completed.
>
> C. We advise the company on a broad range of their financial problems including such matters as the need for new financing, the methods of obtaining new financing, either publicly or privately, dividend policy, the desirability of mergers, acquisitions, etc., and the best terms on which these can be effected.
>
> D. We are frequently asked to help new issuers with general problems of a company going public for a first time such as advising them on the basis of our experience on handling stockholder relations, stockholder reports, meetings with the investment community and analysts, etc.
>
> E. Related to point D above, we are available as a sounding board as to how the financial community and the public generally might react to proposed corporate actions such as stock splits, restricted stock option plans, management changes, major decisions, etc.
>
> F. Where justified by the company's performance or prospects, we circulate informatories, or other memoranda to keep the public advised of the company and its prospects.

Loeb, Rhoades stated that the services described above which it renders to an issuer are not necessarily related to membership on the issuer's board of directors.

In all of the 22 new issues selected for study, either a representative of the managing underwriter was on the issuer's board of directors prior to the public offering or the underwriting agreement provided that the issuer would use its best efforts to elect a representative of the underwriter to its board. In the underwriting agreements covering most of the 22 new issues, the issuer agreed to furnish periodic

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[138] NYSE, M.F. Educational Circular No. 152 (Dec. 26, 1961).

[139] See, e.g., *Bruns, Nordeman & Co.*, Securities Exchange Act release No. 6540 (Apr. 26, 1961).

financial information to the managing underwriter. Six of the managing underwriters for the 22 issues stated that they had a formal agreement with the issuer that the latter would provide periodic financial information to its shareholders. Several of the managing underwriters indicated that they had informal understandings with issuers that such information would be provided. Underwriters had varying views on the necessity or desirability of membership on the board of directors of companies going public for the first time.[140]

The managing underwriter may feel an obligation, as described by Loeb, Rhoades above, to maintain a trading market for the issue. Kidder, Peabody felt a similar obligation to customers purchasing new issues:

> * * * When a customer buys a security in a new offering, we believe that he is entitled to expect that he is buying a security with reasonable liquidity and that there will be an orderly market in which he can sell the security at some future time if he so desires. It is no answer to say that others than the managing underwriter could make a market. In many securities the appearance of dealers in the "sheets" does not mean that they are actively making a market. Frequently, their willingness to buy or sell is for very limited volume.

Of the 22 new issues, 10 had trading markets maintained by their managing underwriters on November 2, 1962.[141] The issues having "sponsored" trading markets were, in general, those issues underwritten by the older investment banking firms.[142]

(2) *Disposition of equity interests*

In general, the Special Study found that managing underwriters who received shares or options purchased in interim financing or as underwriter's compensation tended not to dispose of them during or shortly after the offering. At the time of answering questionnaire OTC–1, only 3 of the 15 managing underwriters who received noncash compensation had disposed of their interests. The Special Study selected an additional 33 new issues offered pursuant to registration statements and regulation A in 1959 and early 1960, in which the underwriter received equity compensation. Of these, only 12 had disposed of their compensation as of the date of the questionnaire. It is perhaps not surprising that underwriters tend to retain these equity interests, since they generally take the position that such interests are received for purposes of long-term investment.[143]

Since 1947 the Commission has required that stock or options received by underwriters in connection with a public offering must be registered along with the shares being offered, even if the underwriter does not intend to offer its securities to the public immediately.[144] The issuer is also required to undertake to file a posteffective amendment to the registration statement when the compensation stock is finally distributed. Within the past 2 years, it has also been the practice to require an undertaking to file, prior to any public offering of these securities commenced after 90 days from the effective date of the original registration, a posteffective amendment disclosing such cur-

[140] For a discussion of the role of underwriters and other broker-dealers as members of the boards of directors of publicly held companies and the problems that arise from this relationship, see pt. F of ch. III.
[141] On Nov. 2, 1962, 4 of the 22 new issues were listed on the American Stock Exchange.
[142] For further discussion of the role of the managing underwriter in the after-market, see ch. VII and subsec. 3.c(2), below.
[143] See subsec. 2.c(2)(b), above.
[144] Securities Act release No. 3210 (Apr. 9, 1947).

rent information as would be required in a new registration statement. In the case of offerings made pursuant to regulation A, compensation stock is usually put into escrow for 13 months, in order to insure that the total offering to the public does not exceed the $300,000 limitation of the exemption. After this "sterlization" period, the managing underwriter may sell the stock to the public or otherwise; if the sale is public, the stock must be registered or offered pursuant to regulation A.

Several of the firm interviewed by the Special Study stated that they surround their disposition of compensation stock with careful safeguards. Representatives of Hayden, Stone stated that in order to avoid any possible effect of their market-making or retail activities on the price of the securities being distributed, the following steps would be taken where the compensation took the form of warrants distributed to principals of the firm; the holders of the warrants would exercise them, a posteffective amendment would then be filed, and at the same time the firm would suspend all trading as principal and instruct its research department to stay away from the stock and its salesmen to stop soliciting orders. In order to obtain capital gains tax treatment, the firm generally would not sell the underlying shares until six months after exercise of the warrants, so these restrictions would be in effect for a 6-month period. It was pointed out that the firm's withdrawal from trading may create problems, since rumors are apt to start that something is wrong with the issuer when the "sponsor" ceases to make a market.

Other firms, however, do not believe that it is necessary to impose similar restrictions on their activities as soon as the decision to file a posteffective amendment is taken. A partner of Loeb, Rhoades stated:

> * * * you might be talking about 6 months before the registration statement becomes effective, which we think is an unnecessarily long length of time.

This firm does not forbid all solicitation after filing of the posteffective amendment to the registration statement, but discourages solicitation by taking the stock off the firm's recommended list; trading continues until an estimated 10 days before effectiveness of the amendment.[145]

Underwriting firms receiving substantial amounts of stock or options prior to an issuer's first public offering often state that such securities are received not as underwriter's compensation but as part of interim financing arrangements.[146] In many instances these firms do not register the securities with the public offering, on the grounds that they are taken for investment with no intention of resale. A partner of Lehman Bros. testified, for example, that this is the practice of his firm and that in many such instances the stock is sold in a nonpublic offering. Loeb, Rhoades gave similar testimony but with the difference that when warrants taken for investment are eventually exercised or sold, they will either be registered or an opinion from counsel will be obtained that no registration is needed.

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[145] Rule 10b–6 under the Exchange Act does not prohibit "purchases or bids by an underwriter, prospective underwriter or dealer otherwise than on a securities exchange, 10 or more business days prior to the proposed commencement of [a] distribution (or 5 or more business days in the case of unsolicited purchases), if none of such purchases or bids are for the purpose of creating actual, or apparent, active trading in or raising the price of [the] security."

[146] See subsec. 2.c(2)(b), above.

The methods by which underwriting firms dispose of compensation stocks vary considerably. Some firms take the position that it is unethical to solicit retail customers to purchase stock being sold out of the investment accounts of the firm or its principals. A partner of Lehman Bros. stated:

> We have a standing rule that we never sell a share of stock that is owned for investment to any retail customer. We sell it to brokers. As to who buys that stock eventually, we don't know. But it is not sold by us on any solicitation to any customers of ours.

Where stock has been listed on an exchange, Hayden, Stone stated that it would sell shares on the exchange in small lots over a long period of time, in order not to disturb the market. In other instances, firms will place their compensation stock with institutional buyers. The attitude of many firms was expressed by a partner of Sutro Bros. who stated that "we would not dream of" selling compensation stock under a posteffective amendment to public customers after having solicited their purchases, and that "we would not use our customers for an unloading operation." A representative of Maltz, Greenwald & Co. stated, in much the same vein, "I cannot very well sell stock to my customers if I think it is time it should be sold; therefore, I sell it in the open market." On the other hand, some firms do not see anything wrong with soliciting customers to purchase compensation stock if a prospectus is used and the Securities Act is complied with.

These attitudes contrast sharply with the methods of disposition used by some firms during the years 1959–61. The views of a small underwriter who had just entered the business help explain the importance of disposition of non-cash compensation:

> Actually [in] the underwriting business, the big profit is made in options and in positions * * * . I felt that if I had only one or two very good underwritings per year, the cash compensation would pay for the rent, salaries, and what have you, and the so-called gravy would be the options which, if the underwritings were the right kind, if the company grew well, et cetera, could be quite substantial.

Globus' disposition of its noncash compensation illustrates some of the problems in this area.[147] On February 20, 1961, Globus, with Ross, Lyon as co-underwriter, made an offering of 150,000 shares of Geochron Laboratories, Inc. (Geochron) common stock at $1 per share. Although the offering could have been made pursuant to regulation A, a registration statement was used, because, according to Globus' counsel, if the "front" stock which Globus had received for providing interim financing were included with the issuer's stock the regulation A limit of $300,000 would have been exceeded. About 4 months prior to the offering Morton Globus and his associates, Ross, Lyon, a trading firm, and the wives of principals of two other trading firms, together advanced $31,500 to Geochron and received notes convertible on the effective date of the registration statement into 30,000 shares of stock and 60,000 warrants exercisable at $1 per share for a period of 5 years. The stock and the warrants were registered for sale as part of the Geochron offering and were proposed to be sold from time to time at the then prevailing market price. Thus, 2 underwriters and

[147] The Globus underwritings used as illustrations here were not among the 22 new issues. The Globus issues were selected for study to illustrate the problems of an uncontrolled distribution of compensation stock. Some of the findings of this study were derived from an NASD examination of Globus underwritings.

persons connected with 3 trading houses were offering 90,000 shares or warrants, or 60 percent as much as offered by the company.

Geochron had no operating history—the purpose of the interim financing was to keep the company going until it could make a public offering. Two of Globus's employees were elected to the board of directors and Globus received fortnightly progress reports from the company's president. During the months of April, May, and June of 1961, the broker-dealer firm of Harold Shore (whose wife had made an investment in Geochron) and Shaskan & Co. the clearinghouse for Shore) appeared in the sheets with steadily increasing bids.[148] By May 8, Geochron stock was quoted by these firms at 4⅞ bid, 5⅜ asked, or about five times its initial offering price. By June 28, 1961, Globus and the others who had provided the company with interim financing had sold 23,175 shares and 17,525 warrants which they had received, for a total consideration of $164,800—an amount exceeding the total public offering.

Most of the "front" stock and warrants held by this group were first sold to Shore, who in turn sold them to Shaskan, who then sold the shares to Northeastern Securities Co.[149] The latter firm, through a sales campaign, sold about 50,000 shares of Geochron stock to public customers—who did not receive the statutory prospectus—in a 2-month period at prices ranging from 3¾ to 6¼. These securities were disposed of at a time when the president of Geochron was reporting little progress to Globus and no earnings. One such report indicated that after 5 months of effort the company, whose business was determining the age of rocks, had been able to obtain only three rock samples for testing. By October 1961, one of Globus's employees, after visiting the company, reported to him in a memorandum headed "Geochron—Time To Pull the Chain," that the company was failing. On February 15, 1963, Shaskan—the only firm quoting Geochron in the sheets—was bidding 3⁄16 and offering ⅜.[150]

Some underwriters distributed options and warrants received as compensation to salesmen and traders at their own or other firms. For example, a customer's man at Irving Weis & Co. stated that this firm gave part of its compensation options or warrants to customers' men "for payments of services rendered in the distribution of the stock." [151]

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[148] Shaskan first appeared in the sheets on Apr. 14, and Shore on Apr. 21. During the 24 trading days between May 1 and June 5, 1961, Shaskan quoted the high bid and asked in the sheets on 9 days and the high bid on 1 day.

[149] The president of Northeastern testified that he received an allotment of 600 shares of Geochron stock from Ross, Lyon in the original public offering though he did not place an order for the stock. Northeastern also received an additional 2,500 shares of Geochron from Ross, Lyon at a price of $1 below the lowest asked price.

[150] Geochron was not an isolated example. Globus, Inc., and Morton Globus received 4,000 shares and 13,600 warrants to purchase Wings & Wheels, Inc., common stock as compensation for underwriting 85,000 shares of this company's stock in February 1961. The warrants were exercisable at $3, equal to the public offering price. Morton Globus was on the board of directors of the company. During the period from Nov. 17, 1961, through January 1962, he sold personal holdings of warrants and stock equivalent to nearly 10,000 shares through Shore and other trading firms at prices ranging from 3¾ to 7. Late in December 1961, about midway in the distribution of his shares, he recommended Wings & Wheels at a price of $6 per share to his customers and those on his mailing list in a brochure entitled "Science and Investment Survey," subtitled "Our Choices for 1962 ! ! !" On Nov. 2, 1962, the stock was quoted at 2⅛ bid, 2½ asked.

[151] Under an unwritten policy of the New York Stock Exchange, registered representatives apparently are permitted to share in cheap stock, options, or warrants only if received by their firm as a finder's fee and not as underwriting compensation (unless the employees are in the syndicate department).

(3) *Controls over trading activities*

The basic antimanipulative rule governing market activities is rule 10b–6 under the Exchange Act, which makes it "a manipulative device or contrivance" for a person in any of certain specified categories, including underwriters and prospective underwriters in a particular distribution of securities—

> to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class or series, or any right to purchase any such security or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution * * *.

The rule, which exempts from its prohibitions certain specified transactions, has an important impact on the underwriter who sells in the after-market securities of issuers which he has brought out.[152]

The varying approaches which underwriting firms have taken to making markets, soliciting customers, and sending out investment advice in connection with their disposition in the after-market of securities acquired as an investment or as compensation in part reflect their uncertainties concerning the scope and meaning of rule 10b–6. Where an underwriter receives stock from an issuer with a view to immediate resale, the distribution is not complete until the stock has been sold, and the prohibitions upon trading and the solicitation of agency purchases remain in force during such period. If, on the other hand, the stock is taken "for investment" with no immediate intention of resale, the picture is not so clear. The Commission recently informed one underwriting firm that, where its partners had purchased cheap stock a few months prior to a public offering but stated that they had no present intention of selling these shares, rule 10b–6 prohibited the firm from soliciting agency transactions in the stock until after the partners' shares had been sold. Nevertheless, the Commission told the firm that, under an exception to rule 10b–6 permitting an underwriter to bid for or purchase the securities in the course of making a normal trading market until 10 or more business days before a distribution, it might maintain a market until 10 days before beginning to distribute the investment stock. The basis for the Commission's view apparently was that the distribution of the investment stock constituted a new distribution separate from the original offering and that this new distribution was contemplated from the time of the original offering.[153]

The applicability of rule 10b–6 to the retailing and advisory activities of underwriters or other broker-dealers holding investment positions, both in the period when the investment remains "locked up" and when disposition is undertaken, would appear to be in need of clarifica-

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[152] See pt. C of this chapter for a discussion of the term "distribution" and of the application of rule 10b–6 to unregistered distributions.

[153] The investment stock was registered in a shelf registration (see below) at the request of the Commission. For further discussion of trading markets in connection with unregistered distributions, see pt. C of this chapter.

tion in view of the conflicting understandings and practices of different firms.[154]

Where an underwriting firm acquires securities not from an issuer but in the course of trading as a market-maker, the scope and applicability of rule 10b–6 is even more difficult to define. The discussion of the over-the-counter market in chapter VII demonstrates that managing underwriters which are "integrated" firms in that they have both trading and retail departments,[155] frequently purchase large amounts of stock in the course of trading activities and then sell these shares to their own retail customers by means of organized and aggressive selling efforts which include special compensation to salesmen, optimistic market literature, and personal solicitation. These activities are frequently conducted for the purpose of "stabilizing" or making "orderly" the over-the-counter market in the security in fulfillment of the managing underwriter's professed duty to the issuer, the other underwriters, and the purchasers in the original offering. Stabilizing purchases apparently are made in the course of trading activities without regard to rule 10b–6 or the stabilizing rule (rule 10b–7) of the Commission, on the ground that they are not made to facilitate a distribution.[156]

Thus, Blyth, managing underwriter of the Grosset & Dunlap offering, acquired (as described elsewhere in this report) a sizable amount of Grosset & Dunlap stock in the course of stabilizing the after-market for that stock, and "redistributed" many of these shares by soliciting its retail customers.[157] These sales were made while the firm was bidding for and purchasing the stock in the course of its trading activities.

Interviews with trading firms in the course of the study of the over-the-counter markets disclosed that firms frequently sold large inven-

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[154] The policies underlying "shelf" registration of compensation stock may raise a number of important problems under rule 10b–6. Pursuant to a "shelf" registration the Commission has permitted registration of shares which may not be offered at the time of the effective date of the registration statement but which are expected to be offered on a deferred basis. The Commission has, in fact, required "shelf" registration of compensation stock even though the underwriter does not contemplate an immediate distribution. See subsec. c.2, above. When shares registered "for the shelf" are actually offered at the prevailing market price, there is some doubt whether inexperienced underwriters and issuers take into account the restrictions in rule 10b–6 upon market activities. The Commission in the *Hazel Bishop* case (Securities Act release No. 4371) pointed out the dangers in an uncontrolled "at the market" distribution of an exchange security engaged in by a number of persons and taking place over a considerable period of time. The dangers inherent in such distribution in the over-the-counter markets are considerably greater because of the mechanics of these markets where the participants in a distribution may be simultaneously making markets, soliciting retail customers, and giving investment advice for the security being distributed. Registration statements covering compensation or investment stock usually state that the shares may be sold "from time to time" at such price or prices as may prevail for such securities in the market at the time of such sales. This is an affirmative representation that compensation stock will be sold at a price or prices established in an independent market free of any artificial market restraints. This representation may be misleading if, in fact, the trading market is one created or under the control of the firm or firms interested in a distribution of such stock. See rule 15c1–8.

[155] For a discussion of the activities of "integrated" and "nonintegrated" firms in the over-the-counter market, see ch. VII.

[156] With respect to the stabilizing function, rule 10b–7 under the Exchange Act permits stabilizing purchases under certain conditions. In 1959 the Commission proposed an amendment to rule 10b–7 which would have prohibited stabilizing activity which is not for the purpose of facilitating a particular distribution of securities (Securities Exchange Act release No. 6127 (Nov. 30, 1959)).

It is interesting to note that rule 10b–7 prohibits stabilizing "to facilitate any offering at the market." The Commission in proposing rule 10b–7 stated: "It has generally been considered to be unlawful to engage in stabilizing in connection with an over-the-counter offering at the market. * * * It has been suggested that there is an inherent contradiction in representing that an offering is being made 'at the market' when the price of the security is being artificially maintained" (Securities Exchange Act release No. 5040).

[157] For a more complete discussion of this incident see ch. VII.

tory positions by means of selling effort and at the same time continued to maintain a trading market for the issues involved. One such firm indicated to the study that it had never even considered the possibility of rule 10b–6 applying to such a situation. Hayden, Stone, which withdraws from the market and halts solicitation of agency transactions and publication of advisory material 6 months before disposing of compensation stock, places no such restriction on itself in connection with the disposition of stock acquired in the market. Donald B. Marron, principal of one of the smaller underwriting firms, thinks that there is a conflict of interest in selling compensation stock to customers of the firm pursuant to solicitation, but sees no conflict in soliciting customers to purchase stock that has been acquired in the market.

Other examples of differing interpretations and practices in these and related areas appear in chapter VII. These are set forth not to suggest that any one or more of the practices described are or are not in violation of rule 10b–6, but rather to point up the need for clarification by the Commission of the intended impact of the rule in various types of situations.

d. Use of the prospectus

A major purpose of the Securities Act was to insure that dealers and investors might have access to, and an opportunity to consider, material facts about the issuer and the offering disclosed in the registration statement and prospectus or offering circular. The act requires an interval of time before the distribution, to permit dissemination of such information. During the distribution, it requires delivery of a statutory prospectus to the purchaser no later than confirmation of sale.[158] In order to insure that persons purchasing in the immediate after-market also have access to the statutory prospectus the Securities Act provides that a prospectus must be delivered in every transaction involving a registered security by any dealer during a 40-day period after the commencement of the offering, but not in unsolicited brokerage transactions.[159] Under the provisions of regulation A, an offering circular must be delivered to original distributees but there is no requirement of delivery in after-market transactions.

In view of the speculative nature of many new issues, the disclosure provisions of the Securities Act assume a particular importance to the purchaser in the after-market, especially in periods of intense demand. The study of new issues indicates that many persons who received original allotments of new issues were sophisticated investors aware

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[158] "Dissemination of information contained in the registration statement is basic to the statutory objective of investor protection. This is accomplished by the large-scale distribution of the prospectus to all members of the underwriting and distributing or selling groups as well as to prospective investors. The law requires the delivery of the prospectus to any person to whom a written offer is made through the mails, and to each and every purchaser" (S.E.C. 25th Annual Report, p. xxi (1959)).

[159] See secs. 4(1) and 4(2) of the Securities Act. Originally the Securities Act required that all dealers, whether or not engaged in the distribution, deliver prospectuses for 1 year after the first public offering of a registered security. The period of 1 year was arbitrarily taken because it was felt that the usual offering was distributed within that period. In 1954, sec. 4(1) was amended to require delivery of prospectuses during a 40-day period after commencement of the offering. According to the House committee report:

"The 1-year provision with respect to trading transactions has long been recognized as unrealistic. Moreover, dealers trading in a security publicly offered within 1 year find themselves unable to obtain prospectuses. This fact has rendered compliance by dealers and enforcement by the Commission difficult" (H. Rept. 1542, 83d Cong., 2d sess., p. 14 (1954)).

Various spokesmen for the industry called the amendment "a realistic approach" making "good sense."

of and able to assume the risks of investing in a speculative issue. On the other hand, persons who bought in the after-market often were less sophisticated and more susceptible to the allure of publicity and rumor about "hot issues." These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never saw a prospectus or offering circular.

The use made of the preliminary or "red herring" prospectus varies from firm to firm. Some underwriters attempt to deliver a preliminary prospectus to every customer submitting an indication of interest, while others disseminate the preliminary prospectus to underwriters and selected dealers only. One large investment banking firm described its practice as follows:

> We have no requirement that our registered representatives give each potential purchaser a copy of the red herring and we do not think such a requirement would be either necessary or sensible. In many important States (particularly in the Midwest and West) counsel have advised us there are blue sky problems involved in the circulation of red herring prospectuses, especially since it is fairly well along before it is known what States clearance will be sought in or obtained. Furthermore there are serious legal problems relating to underwriters' liability on a red herring prospectus, particularly one which is subsequently changed, to which we are told no clearcut answer exists. The mechanical problems and cost of the followup mailings to a large group of persons are very considerable.

Another large firm summarizes the information contained in the preliminary prospectuses and disseminates this summary to its salesmen, together with a market comparison of similar securities. According to an officer of the firm:

> In the first place, the salesman will not read the prospectus. This is entirely too much work to ask him to do. If we only had one issue a month, maybe. If you got 10 a week, he will not read this prospectus, so we try to give him the salient points of the issue on a page or two, plus a market comparison, that will allow him to form his own appraisal of this.

In order to insure dissemination of information to purchasers of the most speculative new issues, the Commission has required as a condition to acceleration of the effective date of the registration statement covering such issues that a preliminary prospectus, amended to comply with staff comments, be furnished to each customer to whom the underwriters and selling group members expect to confirm.[160] This requirement has the desirable effect of insuring dissemination to investors of information in the statutory prospectus prior to the effective date and prior to the time that investors were committed to their purchases. With respect to speculative regulation A filings, the Commission has not, however, conditioned clearance of such filings upon delivery of the offering circular to customers prior to their investment decision. It appears that in most instances purchasers of regulation A issues did not see the offering circular until they received their confirmation of sale.

Although the policy described above guarantees that original purchasers of registered issues receive the preliminary prospectus, it does not insure delivery of any prospectus to purchasers in the after-

[160] Under sec. 8(a) of the Securities Act, the Commission in ruling upon a request for acceleration of the effective date of a registration statement is required to make a determination as to the adequacy of information respecting the issuer theretofore available to the public. See rule 460 under the Securities Act.

market who may be in greater need of the disclosures than are original distributees. Of particular pertinence to the new-issue inquiry, therefore, were the practices of firms with respect to delivery of prospectuses during the 40-day period after commencement of the offering. In some of the issues studied, there was substantial selling by the original distributees in the immediate after-market, which amounted to a redistribution of a portion of the original offering to another group of purchasers. In many issues, there was heavy solicitation of customers to purchase the issue at premium prices.[161]

Solicitation of customers often occurred after the expiration of the 40-day period during which firms were required to deliver prospectuses. The price charts appended to the profiles of each of the 22 new issues in appendix A indicate for each of the registered issues the expiration of the 40-day period.[162] In some of these offerings, extensive retail activity occurred after the 40-day period. In the Cove Vitamin offering, during the period from March 26, 1961, to April 10, 1961, a trading firm accumulated in the market 7,718 warrants and 9,900 shares of stock on behalf of Stearns & Co. at prices ranging from 8¼ to 14 for the warrants and 11¾ to 17 for the stock. The original offering covered 108,000 units, each consisting of one warrant and one share of common stock at an offering price of $3.125. On April 10, 1961—almost 3 months after the original offering—the block accumulated by the trading firm, consisting of almost 10 percent of the total issue, was sold to public customers of Stearns & Co. at 16⅜ per share.[163] Stearns continued to recommend the security to its customers through May 15, 1961, when the units were being quoted at $65.

Where substantial redistributions of new issues occurred in the after-market, many firms did not deliver prospectuses to customers even in solicited transactions during the 40-day period.[164] Since delivery of the offering circular had to be made only to original distributees, customers purchasing regulation A issues in the after-market rarely saw copies of the offering circular.[165] Many firms apparently made no attempt to deliver prospectuses to public purchasers in the after-market—in fact, some expressed surprise that such a requirement existed. Other firms, including long-established ones, indicated in response to questionnaire OTC–1 that they had been failing to deliver prospectuses during the 40-day period but that procedures were being established to insure delivery of prospectuses in the future. Still other firms omitted a reply to the question in OTC–1 concerning delivery of the statutory prospectus during the 40-day period. Although Lehman Brothers stated that they did deliver prospectuses during the 40-day period, they acknowledged that the statutory provision was "widely ignored."

The practice among some of the larger firms was to deliver a prospectus in every transaction, whether principal or agency and whether solicited or unsolicited, to every public customer purchasing in the after-market. Some of the other large firms stated that they did not deliver prospectuses to customers in unsolicited agency transac-

[161] See subsec. 3.b(3)(a), above.
[162] See app. IV–A.
[163] Stearns sold these shares to its customers at its average cost plus commissions.
[164] For example, in the Geochron offering described under subsec. c(2), above, customers of Northeastern Securities did not receive the prospectus.
[165] See, e.g., description of Universal Electronics redistribution in subsec. 3.b(3)(b), above.

tions or in sales to other broker-dealers. However, these same firms indicated that when new issues of all kinds were in great demand, it was often difficult to obtain copies of prospectuses. As one underwriter phrased it, firms had "to scrounge around" to get prospectuses for delivery.

As indicated above, substantial redistributions of new issues occurred in the after-market through trading firms. In such cases, prospectuses were rarely if ever delivered to trading firms, either on the ground that the law did not require delivery in that situation, or that firms retailing the stock could obtain copies from the managing underwriter. The views of Lehman Brothers again are interesting. The firm stated that the 40-day rule was "ridiculous" in this regard, "since there was absolutely no requirement that anybody furnish the poor dealer with a prospectus."

Although no intensive study was made as to compliance with the 40-day requirement in the case of seasoned issues, it would appear that the requirement is more carefully observed in connection with these issues if only because more of them are handled by experienced underwriters with established standards and practices. These, however, are the issues about which there is most likely to be a reservoir of publicly available information if the issuer is subject to periodic reporting requirements.[166] On the other hand, in the offering of new issues, about which there is no reservoir of existing information, inexperienced and even experienced firms often fail to comply with the 40-day prospectus requirement.[167]

4. POST-OFFERING EXPERIENCE OF SMALL COMPANIES "GOING PUBLIC"

During the past decade, many small companies, including many speculative ventures in the promotional stage, which in the depression and war years would generally have been unable to use the capital markets for financing, found a public receptive to investment in new issues. The Special Study conducted an inquiry in order to determine what happened subsequently to a sampling of such companies.

Questionnaire OTC–7 was sent to a systematic sample of about 1,250 companies going public for the first time between July 1, 1952, and June 30, 1962, for the purpose of obtaining information concerning their present status.[168] After rejection of some questionnaires as inapplicable because the offerings were never completed, or for other reasons, there remained for study 960 companies, or about 33 percent of the total number of companies going public in those years that were neither subject to the reporting requirements of the Exchange Act, nor excluded from study for other reasons.[169] The companies in the sample tended to be relatively small, since all listed companies and, in general, unlisted companies registered under the 1933 act with securities outstanding of a value of $2 million or more were excluded.[170]

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[166] See ch. IX and pt. F of this chapter.

[167] In a written statement to the study, Loeb, Rhoades indicated that although it was doubtful about the value of protections afforded by the 40-day prospectus rule, "if the rule were retained at all," it should be "limited to underwriters and selling group members participating in the offering of a new issue of previously private companies."

[168] See sec. 1.b, above, and app. IV–G.

[169] For a description of the kinds of issues that were excluded from the sample, see note 29, above.

[170] See sec. 15(d) of the Exchange Act.

The companies were divided into two categories: "promotional" companies and "operational" companies.[171] A "promotional" company was defined as a company organized or incorporated within 1 year prior to the filing of the notification or registration statement which had not had net income from operations, or a company organized or incorporated more than 1 year prior to such date which had not had net income from operations of the character in which it intended to engage for at least 1 of the 2 preceding fiscal years.[172] All other companies were designated as "operational."

The following table summarizes the status, as of the latter part of 1962, of the companies sent questionnaire OTC–7:

TABLE IV–b.—*Status at the end of 1962 of a sample of 960 small companies going public during the period 1952–62*

Present status	All companies		Promotional companies		Operational companies	
	Number	Percent of total	Number	Percent of total	Number	Percent of total
Total	960	100.0	504	100.0	456	100.0
Companies that could not be located	80	8.3	60	11.9	20	4.4
Companies known or believed to be inactive, liquidated, dissolved, in receivership or reorganization	275	28.6	216	42.8	59	12.9
Companies reporting a net loss on latest income statement	230	24.0	130	25.8	100	21.9
Companies showing a net profit on latest income statement	330	34.4	73	14.5	257	56.4
Companies known or believed to have merged	45	4.7	25	5.0	20	4.4

The study indicates that 37 percent of these companies either could not be located or were inactive, liquidated, dissolved, or in receivership or reorganization. Eight percent of the total could not be located after diligent efforts had been made to obtain information about them;[173] 5 percent were in receivership or reorganization; 5 percent had been liquidated or dissolved; and 18 percent were inactive.[174] Applying these findings to all offerings during the 10-year period, it may be estimated that about 1,050 companies making their first public offerings during this decade had failed by 1962, after having raised over $100 million from investors.

Promotional companies fared worse than operational companies. Fifty-five percent of the promotional companies could not be located or were inactive, liquidated, dissolved, or in receivership or reorganization by the end of 1962, compared to 17 percent of the operational companies.[175]

[171] Of the 960 companies in the sample, 86—of which only 13 were promotional—made registered offerings; and 874, of which 491 were promotional, made offerings pursuant to regulation A.

[172] See rule 253(a) under the Securities Act.

[173] See note 30, above.

[174] No determination was made of the number of companies dissolved, liquidated or inactive that had at any time been profitable ventures.

[175] Some 5 percent of companies studied were found to have merged and no evaluation of their subsequent financial position was attempted. A further breakdown indicates that whereas 56 percent of the promotional companies under regulation A could not be located or were inactive, liquidated, dissolved, or in receivership or reorganization, only 23 percent of promotional companies which made registered offerings fell into this category. The better performance of registered companies was evident also among operational companies.

At the other end of the scale, 34 percent of the companies studied showed a net profit on their latest income statement. Another 24 percent, though registering a net loss, were fully operational.[176]

Here too the contrast between promotional and operational companies is noteworthy. Of the 504 promotional companies in the sample, only 14 percent showed a net profit on their latest income statement.[177] In this connection, none of the 16 issues (or 1.6 percent) which were later listed on an exchange was a promotional offering.[178] In contrast, of the 456 operational companies, 56 percent were operating profitably at the time of this study, and 22 percent were operating at a loss.

It is perhaps not surprising that lack of success should be so common among new, small ventures brought to the public during a period of high market receptivity. Nevertheless the results do not suggest the adoption of a public policy of exclusion: in an economic system based on enterprise and risk-taking, neither the speculative venture nor the established one should be denied access to capital markets by the Federal Government. It is specially important, however, that the underwriting role of the financial community and the disclosure role of the Federal Government be performed with particular sensitivity to the special needs of "first" issues.

The role of the underwriter in the marketing of new issues has historically included the functions of selection and guidance—selection in the sense of determining whether public financing is an appropriate source of capital for a particular company, and guidance in the sense of advising corporate management on the timing, method and terms of such financing. High standards of qualifications are important for the whole broker-dealer community, but it is particularly important that broker-dealers presiding over the entry of new enterprises or privately owned companies into the public markets be qualified in experience, integrity, and financial capacity to discharge this special responsibilty.[179]

Under the Federal scheme of regulation, the role of the Government is essentially to assure adequate disclosure. In "first" issues, the disclosure process must be especially refined and adapted to enable decisions to invest in new and unknown securities to be made with awareness of the special characteristics and risks of such issues. The disclosure process in "first" filings has in recent years been improved by requiring a summary of important facts to appear early in the prospectus, but further steps toward giving prominence and emphasis to crucial data may be possible; [180] the disclosure process might be further

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[176] Of the 491 promotional regulation A offerings in the sample, only 66, or 13 percent, showed a net profit on their latest income statement, and 117, or 24 percent, were registering a net loss.

[177] This percentage does not take into account the 25 promotional companies known to have merged. The study did not determine the status of their successors.

[178] Fourteen of the 504 promotional companies were, however, later merged with listed companies.

[179] See ch. II and the discussion in sec. 2.b, above, concerning the background of underwriters of new issues.

[180] The following comment is of interest here:

"We have a concrete suggestion on this point. It is that each prospectus be accompanied by a 1-page summary of the more important facts about the issue, in a form approved by the SEC. The summary should contain at least a brief reference, citing page numbers, to every unfavorable factor described in the prospectus itself and deemed to be of more than incidental importance. Such a 1-page summary could tell the investor pretty well what he is getting for his money. If he has any sense at all, he will read it. If he has no sense, nothing will save him." (Graham, Dodd & Cottle, "Securities Analysis," p. 677 (4th ed. 1962).)

improved by requiring that prospectuses be delivered to prospective purchasers in the original distribution early enough to be the basis for their investment decisions and to purchasers in the after-market for an increased period after the offering date. Not least, the importance of continuous reporting of data after the initial disclosure—as generally advocated in chapter IX—is made particularly evident by the subsequent experience of the small new issues studied.

5. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The new-issue market, which gathered force in 1959, reached its peak in 1961, and subsided with the market decline of early 1962, can now be seen in perspective. The intensive and extensive examination made by the special study reveals a picture—which perhaps will not be surprising to the financial community or to investors—of a general climate of speculation which may rank with excesses of previous eras.

More than any single activity or incident, it is this climate of speculative fervor which provides a key to the new-issue phenomenon. Its causes need not be dwelt on here. It is sufficient to note that its roots are presumably deep in human nature, and its manifestations include a willingness by more and more of the public to purchase securities at prices less and less in line with experience and reasonably foreseeable earnings.

The "hot" issues which thrived in this climate, being the plainest evidence of the riches attainable through the purchase of stocks without regard to earnings or other fundamentals, also helped to nourish it. This kind of interaction between cause and effect appears throughout any analysis of the new-issue market. The interaction may make it more difficult to identify underlying causes of particular problems and excesses in individual cases, but it may also assist in the search for practical solutions: the vicious circle of cause and effect can perhaps be broken by relatively limited remedies applied at strategic places.

With public expectation of continuously rising stock prices, hundreds of nonpublic companies and their major stockholders found unprecedented opportunities in recent years to make public offerings of their stock that would not have been possible in a different climate. The number of companies making their first public offerings climbed steadily during the period from 1953 to 1961, reaching an historic high in the years 1959 to 1961 when the bull market attained its peak. The new-issue phenomenon provided many small companies with the opportunity to raise funds for legitimate corporate purposes. It also provided an opportunity, however, to sell stock in companies that in a different climate would not have been deemed ready or appropriate for public financing.

The underwriter played an important role in the new-issue phenomenon not only by originating and distributing stock in companies going public but also, in many cases, by encouraging the speculative climate. Most of the older firms exercised careful investment banking judgment in determining which companies were suitable for public ownership, and in so doing still provided many small companies with access to the capital markets. Other firms, under pressure from customers and salesmen hungry for new issues, lowered their standards of quality and size of issuers whose securities they would underwrite. Broker-dealers whose principals had little experience or knowledge of the underwriting business and whose capital commitment was minimal were hastily organized in order to participate in the new-issue boom. Professional finders, either self-employed or employed by broker-dealer firms, occupied themselves in bringing issuers and underwriters together.

It is against this background of excitement and expectation of profit that the details of the offering of new issues must be seen. In the pricing of new issues, underwriters could not help but be influenced by the knowledge that the prices of many issues would subsequently rise in the immediate after-market to prices hardly justified by traditional standards of value. A high offering price might not be justified by these standards, yet a low offering price, which might seem to be called for by a sober regard for fundamentals, merely assured an initial premium that whetted the public's appetite for the next issue. For the careful underwriter, these conflicting considerations posed a difficult dilemma in the pricing of a new issue. Others set low offering prices in the expectation of withholding substantial portions of the issue in accounts of insiders to be sold out to the public at premium prices.

Some underwriters found opportunities with the strong public demand for new issues to obtain very high amounts of compensation from small speculative companies. Thus, the weakest companies financially had to carry the heaviest burden and the investor in these companies paid the highest cost to assume the greatest risk. Since many of these offerings were made by newer underwriters on a "best efforts" or agency basis, there was very little or no risk for the underwriters.

It also became increasingly common for underwriters of new issues to receive a substantial portion of their compensation in stock, options, or warrants of issuers. Instead of serving as a substitute for cash compensation, equity compensation tended to appear in those offerings with the highest rates of cash compensation. The practice of taking unreasonable amounts of noncash compensation, particularly among the smaller and more aggressive underwriters, not only diluted the equity in the company of the public purchasers of the stock in the public offering, but it also gave the underwriter holding the stock, options, or warrants a special kind of interest in the after-market for the issue.

In general, some investment banking houses carefully investigated issuers whose offerings they brought to the public market and registration statements reflected the meticulous standards of these underwriters and the lawyers and accountants involved in preparing them. Other underwriters, anxious to merchandise stock in public demand, were lax in performing their responsibilites to investigate issuers whose securities they intended to offer to the public. Under these circumstances carelessly prepared registration statements, if they were not corrected by the Commission's staff, might contain serious misrepresentations about the issuer and its affairs.

If the general background outlined above was a sine qua non of the new issue boom, the premium prices of particular stocks were the results of the mechanics of the market and in many cases of the techniques and activities employed by particular broker-dealers. In a typical "hot issue," over-the-counter trading began simultaneously with effectiveness of the registration statement or clearance of the regulation A filing. Stocks were being quoted at premium prices in the aftermarket before all customers knew of their allotments, before the closing at which the managing underwriter remitted the proceeds of the offering to the issuer, and before customers received their stock certificates. Thus, the trading markets for new issues tended to reflect a distorted picture of demand and supply. While potential buying interest in an issue was often communicated to trading firms prior to the offering date, potential selling interest in the aftermarket was more difficult to assess and was seldom adequately reflected.

It was of prime significance that a limited number of shares of new issues were available for trading in the immediate aftermarket. Many new issues involve a relatively small number of shares. Moreover, most distributors of new issues had a policy of confining their allotments to customers who would not immediately resell in the open market. They implemented this policy by such measures as: (*a*) Allotting only to customers with a record of not reselling prior new issues; (*b*) alloting to discretionary accounts or to a relatively small number of customers who customarily relied on the advice of the distributor; (*c*) advising customers of a "requirement," "necessity," or "expectation" that they would not immediately resell, or that immediate resale would reduce their chances of being allotted future issues; (*d*) penalizing salesmen whose customers sold their allotments in the immediate aftermarket; or (*e*) simply refusing to execute sell orders of customers in the immediate postdistribution period. Although a policy of selling new issues to "investors" rather than to "speculators" may be based on excellent motives, such as assuring a successful distribution and discharging responsibilities to the issuer or to codistributors, the effect of the policy was to reduce the shares available for immediate trading in the aftermarket.

Supply was also reduced by delays in notifying customers that shares had been allotted to them and in sending them their stock certificates. Whereas trading markets may commence immediately upon effectiveness, customers normally did not receive notice of their allotments for 24 to 48 hours and sometimes for several days or weeks. Delay in notifying customers of their allotments gave added importance to the initial premium since the decisions of customers whether to accept allotments could be made on the basis of prices quoted in the aftermarket, rather than on information provided in the prospectus. Some underwriters did not deliver stock certificates for weeks or even months after the effective date, thus discouraging customers from selling. Thus, in the critical hours and days immediately following effectiveness the potential supply (including potential selling by owners who might have sold had they known of their ownership) might be artifically limited; and for a considerable period thereafter selling was hampered by the difficulty of making delivery. In short, the opening quotations and the opening "market" were based on trading of but a fraction of the outstanding shares, and on information that could not be said to reflect accurately the potential supply at the premium or any other price.

Supply of the stock of many "first" offerings also was restricted by the practice of "free riding and withholding." Despite NASD and

Commission prohibitions against the practice, participants in distributions would place portions of new issues in the accounts of insiders of the firm and their families. In some offerings, substantial amounts of stock were thus "shelved," while demand was being stimulated by trading activities, publicity, and solicitation of customers. Withheld shares were then sold to customers at premium prices in what amounted to a redistribution of the shares offered.

Buying interest, unlike selling interest, was likely to be reflected in the trading markets at the very outset. Buying interest was frequently communicated to the trading markets prior to the effective date, by both distributors and nondistributors of the security. Trading firms based their opening quotations on orders placed with them prior to effectiveness. Moreover, solicitation of aftermarket purchases was common and might be actively engaged in by one or more of the major distributors. While it was often difficult to determine whether solicitation of purchases in the aftermarket occurred prior to or immediately following the effective date, the study indicates that significant public buying on the first day of trading was usually by customers of one or two or several participants, thus suggesting the presence of active solicitation or recommendation by such participants at least as early as the notice of effectiveness. To add to the aftermarket excitement, some managing underwriters arranged for solicitation of customers at premium prices through nonparticipating firms. Demand for new issues was further stimulated in some cases by market letters, advisory recommendations, articles in the financial press and other planned publicity, usually optimistic in tone.

The disclosure provisions of the Securities Act assume a particular importance to the purchaser of a new issue in the aftermarket, especially in periods of intense demand. The study of new issues indicates that many persons who received original allotments of new issues were sophisticated investors aware of and able to assume the risks of investing in a speculative issue. On the other hand, persons who bought in the after-market often were less sophisticated and more susceptible to the allure of publicity and rumor about "hot issues." These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never received a prospectus as required during the first 40 days of the offering.

In extreme cases it appears that the original distributees, whether "insiders" or favored customers of the underwriters and selling group members, and the trading firms which made markets in the stock served merely as conduits through which the shares were funneled to the "real" distributees of the new issues—the customers who purchased at premium prices, often pursuant to direct solicitation and influenced by favorable publicity and market letters, rather than the prospectus.

A separate inquiry undertaken by the Special Study showed a high degree of failure among small companies which went public during the past decade. Under the philosophy of the Securities Act it is not the role of the Federal Government, of course, to pass on the merits of securities or decide which companies should receive the investor's dollar. The role of the Government is to insure disclosure of information and fairness of the markets in which securities are distributed and traded. Certain specific improvements in disclosures and market practices, with particular regard to new issues, are suggested by the study's data.

Determination of the suitability of issuers for public financing has traditionally been part of the role of the underwriter, a role demanding particular skill, experience and sense of responsibility. Many of the broker-dealers who undertook the role of underwriter under the stimulus of the new-issue boom not only were lacking in these qualities but were substantially judgment proof with respect to their statutory liability under the Securities Act to those purchasing issues underwritten by them. These underwriters usually sold stock on a "best efforts" basis and in some cases were organized to merchandise only one or two issues. The recommendation in chapter II of this report, that all underwriters have a minimum capital commitment, should help to eliminate the paradox that underwriters who fail to make even the most rudimentary investigation of an issuer can be immune from the basic sanctions contemplated by the Congress in enacting the civil liability provisions of the Securities Act.

During the years 1959–61, the "truth in securities" philosophy of the Federal securities laws became irrelevant for many investors. An accurate prospectus is of little value to a purchaser who does not care about a company's asset value, operating history or prospects but who buys only in the expectation of an immediate premium for its stock. Neither the disclosure philosophy nor the registration requirements of the Securities Act and the procedural machinery which has grown up around them is in any way invalidated by the results of this study. What these findings do demonstrate, however, is that particular problems exist in the distribution and trading of new issues, and that certain requirements, not applicable to distributions of securities by seasoned issuers but designed to reach some of the specific excesses revealed in the new-issue phenomenon of 1959–61, should be instituted and enforced.

The Special Study concludes and recommends:

1. The Commission's administration of the registration provisions and related exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable. Nevertheless, there are limited respects in which provisions of that statute and the administration thereof or of related provisions of the Exchange Act should be modified in order to adapt them more closely to experienced needs. The troublesome and sometimes dangerous phenomenon of "hot" issues is primarily associated with "first" issues, i.e., first public offerings of securities of a particular issuer. Accordingly, such "first" issues, whether fully registered or exempt under regulation A, should receive particular attention, with a view to preventing certain practices that appear to have contributed unnecessarily to "hotness," while not interfering with normal and legitimate practices in connection with underwriting of "first" or any other issues or the flow of venture capital into new business.

2. Appropriate rules should be adopted by the NASD and/or the Commission, applicable to "first" issues of common stock gen-

erally, designed to eliminate or temper certain factors which, either independently or in interaction with each other, appear to have produced artificially high but ephemeral premiums in many instances. Among the types of rules that would appear appropriate for consideration and adoption would be rules (a) requiring that, with respect to allotments resulting from solicitations or indications of interest prior to the effective date, notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible, any delay of more than (say) 24 hours after the effective date to be deemed prima facie unreasonable; (b) requiring that, again with respect to allotments resulting from solicitations or indications of interest prior to the effective date, certificates of stock be delivered or made available for delivery to purchasers as promptly as reasonably possible, any delay of more than (say) 2 weeks after the effective date or more than (say) 1 week after the underwriting closing to be deemed prima facie unreasonable; (c) prohibiting all broker-dealers from initiating a trading market for a limited period of (say) 72 hours after the effective date, except for stabilizing activities in conformance with rule 10b-7 and such other exceptions as may be provided by rule or in specific circumstances; (d) clarifying or defining restrictions on soliciting, holding, or transmitting, prior to the effective date, indications of interest or orders to purchase in the open market after the effective date; and (e) prohibiting all participants in the public offering, until the distribution is completed or for a period of (say) 40 days after the effective date, whichever is later, from soliciting or recommending purchases of the stock (including placing stock in discretionary accounts) at a price in excess of (say) 120 percent of the public offering price.

3. Acceleration by the Commission of the effective date of a registration statement or permitting clearance of a regulation A filing, with respect to any "first" issue of common stock, should normally be conditioned on delivery of a prospectus or offering circular in substantially final form to each person to whom any participant in the distribution expects to make original allotments at least (say) 48 hours before any sales are made.

4. The 40-day period during which all dealers are required to deliver prospectuses should be extended to 90 days in the case of "first" issues of common stock, except as may be otherwise permitted by rule or in specific circumstances. The same provisions should apply to offering circulars under regulation A exemptions. (It is recommended below that the 40-day requirement be eliminated in connection with offerings of securities of issuers subject to the continuous reporting requirements of sections 13, 14, and 16 of the Exchange Act.)

5. The NASD should strengthen its enforcement of the prohibitions against "free riding and withholding" by requiring, in the case of any "first" issue of common stock for which a price in excess of (say) 120 percent of the public offering price is reached within (say) 40 days after the effective date, a report of the managing underwriter showing all stock allotted to any participant in the distribution (other than stock resold at or below the

public offering price) or its principals or members of their immediate families or to any broker-dealer other than a participant, and the disposition thereof, if any. In general, since those violating the "free riding and withholding" prohibitions may be in a position to realize profits greatly surpassing the fines customarily imposed by the NASD, substantially severer penalties should be imposed in flagrant cases so as to provide an adequate deterrent.

6. The NASD has taken a forward step in providing for the review of underwriting arrangements in connection with offerings of unseasoned companies. To provide guidance to its membership, the NASD should periodically publish summaries of specific rulings relating to the amounts of compensation and types of compensation arrangements that have been considered unacceptable in given circumstances.

7. Underwriters receiving options, warrants, or "cheap stock" in connection with any public offering should be required to report to the Commission and the NASD: (a) upon exercise of options or warrants, the date and price; (b) upon transfer of options or warrants, the date, consideration, and identity of transferee; and (c) upon disposition of underlying securities without a posteffective amendment, the date, consideration, identity of distributee, or class of distributees, and the exemption relied on. The general subject of transfer of such options, warrants, or "cheap stock" to registered representatives, traders, or others not directly involved in the underwriting of an offering should receive greater attention of the NASD, with a view to adoption of rules or a statement of policy defining circumstances in which such transfer is deemed consistent or inconsistent with high standards of commercial honor and just and equitable principles of trade.

8. In light of widespread misunderstandings or uncertainties among broker-dealers, as discussed in this and other portions of the report, the Commission should take appropriate steps to clarify the application of rule 10b–6 (a) during a period when stock is being held "for investment" by a broker-dealer, (b) in connection with various forms of "shelf" registration, (c) in connection with a planned reduction of inventory or "workout," and (d) in connection with unregistered distributions generally.

C. Unregistered Distributions

1. INTRODUCTION

The Securities Act requires the registration of a public offering of securities by an issuer or by an underwriter for an issuer or for a person in a control relationship to the issuer. A prospectus, containing material information about the issuer, the security, the terms of the offering and the distribution arrangements, must be delivered to investors to whom sales are made. The registration process also requires delay between the filing of a registration statement and the effective date, to permit dissemination of information contained in the registration statement to the financial community and the public.

Whether or not investors receive the full disclosures contemplated by the Securities Act depends, however, upon the source of the securities being distributed. If the distribution emanates from an issuer or from an underwriter for an issuer or a person in a control relationship to the issuer, registration is required; if it does not, though the size of the offering may be as large and the need for protection of investors no less, no disclosure is required by the Federal securities laws even as to the distribution itself.[181] There is, of course, a practical reason for the basic legal distinction between a registered and unregistered distribution: Persons making a public offering of securities who are not in a position of control could not be expected to obtain or prepare a registration statement disclosing material facts about the company. The Securities Act therefore imposes the obligation to register a public offering only when the offering is by the issuer itself or a person or persons controlling the issuer. This practical difference applicable to furnishing information about the issuer is, however, not applicable to furnishing material facts about the distribution itself, since these facts are fully known to the broker-dealers handling it. Yet the legal distinction exists and the investor purchasing securities in an unregistered distribution usually receives no disclosures as to either the issuer or the distribution.

The narrowness of the distinction which sometimes exists between an offering subject to registration and one which is not is pointed up by the "no action" letter. The circumstances surrounding a given distribution often make it difficult to determine whether or not registration is required. In such a situation an issuer or a stockholder may seek to obtain a "no action" letter from the Commission's Division of Corporation Finance which states that, with respect to a given transaction in securities, the Division will not recommend to the Commission that any action be taken under the Securities Act if the securities are sold without registration. If a "no action" letter is granted, the distribution may go forward without registration and purchasers will not receive a prospectus that would have been required had the distribution been registered.

This part briefly canvasses the various types of unregistered distributions and provides an estimate of the volume of such distributions in the securities markets. It then makes recommendations which seek to remove some of the sharp differences between registered and unregistered distributions in the extent of disclosure.[182]

The study has made no independent investigation of the subject of unregistered distributions. The material in this part has been principally derived from other factual inquiries made by the study and from information in the files of the Commission. In the course of analyzing material derived from these sources, it was the conclusion of the study that the subject of unregistered distributions warranted separate treatment.

2. TYPES OF UNREGISTERED DISTRIBUTIONS

Most distributions, if they are to be effected in a short period of time, require concentrated selling effort, e.g., a syndicate or selling

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[181] If the issuer has a security listed on an exchange or if it is subject to the reporting requirements of sec. 15(d) of the Exchange Act, the investor has access to a reservoir of filed information. (See ch. IX.) However, this information would not include recent developments concerning the issuer and pertinent facts concerning the offering itself.

[182] The recommendations in this part should be considered in conjunction with those in pt. F of this chapter which outlines a regulatory program for simplifying the disclosure requirements under the Securities Act in the case of issues subject to continuous reporting requirements under the Exchange Act.

group, extra compensation to salesmen or the use of selling literature. Because of restrictions upon retail activity in connection with distributions on an exchange, most such distributions occur in the over-the-counter markets.[183] The exchanges, however, have developed a number of techniques for disposing through their own facilities of large blocks of securities that cannot be absorbed in the course of routine trading activities on the floor.[184] This section briefly describes some of the methods employed both on the exchanges and in the over-the-counter markets to make distributions of securities, particularly those involving a selling effort greater than that required in ordinary trading transactions.

a. Exchange distributions

In the exchange markets, the available trading market for a security may have sufficient depth that a distribution can be effected in the course of normal trading activity without the stimulus of selling effort.[185] However, for a number of reasons, including the size of the block, the extent of trading activity in the security being distributed, or the desire for speed, the available auction market may not be satisfactory for effecting the distribution.

Among the techniques developed by the exchanges to dispose of large blocks of securities quickly, using the facilities of an exchange but outside of the auction market, are the exchange distribution and special offering plans.[186]

Most exchange distributions and special offerings take place with respect to the New York Stock Exchange (Exchange) securities and under the rule of that Exchange. A written application to use one of these plans giving pertinent information about the distribution is submitted by the syndicate manager to the Exchange.[187] Certain questions specifically request information known to the manager or the seller as to any unpublished "derogatory" or "optimistic" information about the issuer. Approval will not be granted unless the Exchange determines that the regular floor market cannot absorb the block to be sold within a reasonable time and at a reasonable price or prices. In making this determination, a number of factors are taken into consideration: Price range and volume on the trading floor in the

[183] See the discussion of rule 10b-2 under the Exchange Act, note 189 below. Before the Exchange Act, distributions of blocks of listed securities were commonly effected directly on an exchange. Although such distributions were undoubtedly effected at times without the use of manipulative devices, the use of such devices to facilitate a block distribution was commonplace. With the adoption of the Exchange Act, price manipulation was outlawed and manipulative devices were subject to Commission regulation. These factors, together with economic developments, spurred the development of off-board techniques for the distribution of blocks of securities.

[184] See the discussion of institutional participation in the securities markets in ch. VIII. Many of these techniques have been developed by the New York Stock Exchange to attract block transactions to the floor of that Exchange.

[185] One institution, for example, reported to the study the sale on the New York Stock Exchange of 236,300 shares of General Telephone & Electronics for an aggregate amount of $6,063,655. The sale was accomplished primarily in trading transactions on the Exchange (3 other exchanges were also used to a limited extent) by 7 broker-dealers in 87 separate transactions. This liquidation was accomplished over 53 calendar days and sales were effected on 34 days. See ch. VIII.

[186] Reference will be made throughout this part to the plans existing under the rules of the New York Stock Exchange. The exchange distribution plan is set forth in Exchange rule 392; and the special offering in rule 391. It should be noted that the American, Boston, Cincinnati, Detroit, Midwest, Pacific Coast, and Philadelphia-Baltimore-Washington Stock Exchanges have adopted one or both of these plans. The exchanges have also developed a third plan for disposing of blocks by sale to a specialist. This plan, called the specialist block purchase, is not considered in this part since it does not involve retail selling effort.

[187] Because of the speed with which these distributions occur, the information required in a written application may be given to the Exchange over the telephone and the formal application may be filed after completion of the distribution. See sec. 4, below.

preceding 30 days; attempts which have been made to market the security on the floor; the existing condition of the specialist's book and floor quotations;[188] the apparent past and current interest in the security in the auction market; and the size of the block proposed to be offered.

In an exchange distribution member firms solicit orders with respect to the block and the offsetting buy orders are then "crossed" on the floor of the Exchange with the block sale order. The selling price is within the prevailing bid and offer for the security in the regular auction market. The purchaser usually pays a net price and the seller pays at least the equivalent of a double commission. No public announcement is made of the distribution until it is completed, at which time the transaction appears on the tape preceded by the term "Dist." Salesmen receive a higher rate of compensation in making sales of the security involved in an exchange distribution than would be paid with respect to normal trading transactions.[189]

In the special offering plan, a block of a listed security is distributed through the facilities of the Exchange at a price not in excess of the last sale or the current offer for the security on the floor of the Exchange, whichever is lower. The special offering is announced on the tape before it becomes effective, including information as to stabilizing, and all member organizations are entitled to solicit bids and send them to the floor.[190] The special offering is suspended as long as an offer exists "regular way" on the Exchange at a price which would permit purchases at a lower net cost.

An exchange distribution often takes place through a syndicate with a manager. This is not an invariable practice and large blocks have been distributed entirely through one member firm. Thus, in 1961, Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) disposed of a block of 167,174 shares of General Electric Co. for an aggregate selling price of $12,078,359 through an exchange distribution utilizing only its own organization. A firm like Merrill Lynch, with its many branch offices, has sufficient distribution facilities that the assistance of a selling group may not be required.[191]

The exchange distribution and special offering are almost unique in that, unlike other unregistered distributions, broker-dealers participating in such distributions are required to make certain disclosures to customers concerning the distribution itself.[192] A person being

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[188] For a discussion of the specialist's book and the specialist generally see ch. VI.

[189] If a distribution makes use of the facilities of an exchange, the distribution is subject to rule 10b–2 adopted by the Commission under the Exchange Act. That rule is a general prohibition against the payment by persons interested in a distribution of special compensation to salesmen and others to facilitate a distribution of securities on an exchange. It is an antimanipulative rule based upon the general proposition that the exchange markets, where trading activity is concentrated and the tape publicizes transactions, should not be subject to the artificial activity generated by the extra selling effort involved in a distribution.

Under par. 10b–2(d) of the rule, the Commission may exempt from its operation a distribution plan filed with the Commission and declared effective by it. It is pursuant to this exemption that certain exchanges have adopted the exchange distribution and special offering plans described in the text.

[190] The special offering was the first of the exchange distribution plans devised by the Exchange jointly with the Commission. When the British Government in the early 1940's commenced to offer large blocks of stock in the American securities markets, the Exchange sought to bring these offerings to the floor of the Exchange through the special offering technique. Since the development of the exchange distribution plan in 1953, the special offering has been rarely employed. See sec. 3, below.

[191] Merrill Lynch appears to manage more exchange distributions than any other firm. In 1962 it managed 19 out of the 37 approved by the Exchange; Bache & Co., which managed the second greatest number, handled 4. Similarly, in 1961 Merrill Lynch was responsible for 16 out of 26 while Bache & Co. managed 3.

[192] See subsec. b, below.

solicited to purchase part of a block involved in an exchange distribution must be advised before a transaction is effected with him that the shares are part of a specified number of shares being offered; the capacity in which the member is acting and, if the member is acting as broker for the seller, whether the member will receive a special commission; and whether the investor is paying a regular commission, the equivalent of a regular commission, or is purchasing at net price. In a special offering, the same information and also information as to whether stabilizing transactions have been or will be effected [193] must be supplied to prospective purchasers both at the time of solicitation and in the confirmation.

Another technique not recognized in a formal plan for effecting distributions using the facilities of the Exchange involves the crossing of prearranged buy-and-sell orders.[194] This technique has apparently been used with increasing frequency to dispose of large blocks on the Exchange floor, but little is known about the actual extent of its use.[195] Like the exchange distribution, offsetting buy orders may be assembled off the floor by a broker retained by the seller initiating the block sale. The assistance of the specialist and floor brokers may be used in locating offsetting orders. Such crosses normally are larger transactions than pure "auction market" transactions involved in the disposition of blocks but they are not given any distinguishing identification on the tape or on confirmations and thus are not distinguishable from other floor executions. The price at which the cross is affected is within the prevailing bid and offer in the auction market. When a "cross" is involved, the Exchange market is being used to consummate a "negotiated" rather than an auction transaction. The study did not attempt to determine the extent to which special marketing efforts were involved in crossing transactions.[196]

b. Over-the-counter distributions

In the over-the-counter markets dispositions of blocks of securities, both listed and unlisted, occur in many forms. A block distribution over-the-counter may be made by one or more broker-dealers on a principal or agency basis. There may be an informal understanding to participate jointly in such a distribution or it may be the subject of a formal underwriting agreement. Or, such a distribution may simply be a single firm's "work-out" over a considerable period of time of inventory accumulated in trading transactions.

Distributions of listed securities over the counter are effected principally through secondary distributions.[197] These are, technically, off-board dispositions of blocks of securities listed on exchanges. Under the rules of some exchanges, including the New York and American

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[193] A special offering, unlike an exchange distribution, is made at a fixed price and therefore may be stabilized. Under the stabilizing rules of the Commission, stabilizing transactions are not permitted to facilitate an offering "at the market." See rule 10b–7(g).

[194] See New York Stock Exchange rules 76 and 91. For discussion of crossing of orders see ch. VI, and of the use of crosses in connection with institutional transactions on an exchange, see ch. VIII.

[195] For example, one institution reported to the study a disposition on the Exchange through the crossing technique of a block of 76,900 shares of a preferred stock at a price of $28 per share. See ch. VIII.

[196] Unlike the exchange distribution or special offering, special compensation may not be paid to salesmen in connection with the crossing of orders. See note 189, above.

[197] A secondary distribution is generally understood to be the disposition of a block of securities by any person other than the issuer. It is also a term having a specialized meaning: an Exchange-approved off-board disposition of a listed security. When used in the latter sense, the distribution will be termed a "secondary distribution." Since a secondary distribution does not occur on an exchange, rule 10b–2 is not applicable to it. See note 189, above.

Stock Exchanges, any member who participates in an off-board distribution of a listed security must obtain exchange approval.[198] In addition to the findings required for other types of Exchange-approved distributions, described above, the Exchange must find that the block for which a secondary distribution is proposed cannot be absorbed on the floor either in routine trading transactions or through an exchange distribution or special offering. The secondary distribution invariably involves the formation of a selling group.

A secondary distribution is publicly announced on the ticker tape prior to the time at which it becomes effective and the announcement includes information as to stabilization and overallotment.[199] It is ordinarily priced at or somewhat below the last sale price on the Exchange at the time of the offering and the price is net to the purchaser.[200] The selling group profit is made through a "spread" or a commission, depending upon whether the distribution is made on a principal or an agency basis. In either event, compensation paid to salesmen, as in the exchange distribution and special offering, is at a higher rate than would be paid for selling the same security in a routine trading transaction. Under Exchange rules the participating member organization must disclose the capacity, i.e., principal or agent, in which it is acting but, unlike an exchange distribution or special offering, no disclosures are required (either at the time of solicitation or in the confirmation) of the fact that the security is part of a secondary distribution and the total number of shares involved, or that incentive compensation is being paid.[201]

Unlike the exchanges, which have instituted limited disclosure to investors about the distribution arrangements in connection with the exchange distribution and special offering plans, the NASD has no comparable requirements with respect to distributions of unlisted securities.[202] These distributions must meet only the limited disclosure requirements of the Commission set forth in rules adopted under the antifraud and antimanipulative provisions of sections 15(c) (1) and (2) of the Exchange Act.[203]

3. VOLUME OF UNREGISTERED DISTRIBUTIONS

The Commission now receives only limited information with respect to unregistered distributions. The exchanges inform the Commission

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[198] See New York Stock Exchange rule 393. If the transactions involve certain guaranteed and preferred stocks specified under Exchange rule 394, Exchange approval is not required. Reference in this part will be to secondary distributions under the rules of the New York Stock Exchange.

[199] In some cases, when the distribution does not become effective until after the close of the market, announcement may be made by some other means, such as the broad tape or the ticker of a regional exchange which is still open for business.

[200] The price may not exceed the last sale price of the security on the floor without the permission of the Exchange except that the equivalent of a nonmember commission may be added if the price is so represented.

[201] Under Exchange Act rule 15c1-6, a broker or a dealer receiving or expecting to receive an advisory fee from a customer must in over-the-counter transactions give his customer written notice of his financial interest in the distribution prior to completion of the transaction. The rule does not apply to principal transactions where there is no advisory relationship. The general antifraud provisions of sec. 15(c)(2) of the Exchange Act, and the rules underlying that section and sec. 206(3) of the Investment Advisers Act of 1940 also may be applicable.

[202] The NASD has, however, incorporated in its rules of fair practice rule 15c1-6 adopted by the Commission under the Exchange Act. See art. III, sec. 14, "NASD Rules of Fair Practice."

[203] Rule 15c1-4 requires that confirmation of transactions occurring otherwise than on an exchange disclose the capacity in which the broker-dealer is acting and, when he is acting as a broker, he must disclose or make available the name of the opposite party to, and the date of, the transaction and the source and amount of his commission. See also rule 15c1-6, note 201, above.

with respect to exchange-approved distributions after they have occurred.[204] Some information is available in trade publications with respect to other types of unregistered distributions but it is undoubtedly true that many such transactions which might well be styled "distributions" are never publicly reported. The study has used data available within the Commission and in public media to compile the aggregate volume figures below with respect to unregistered distributions. No independent survey has been conducted.

There are a number of respects in which the figures below are understated. First, there are instances in which large blocks of securities are liquidated in the market pursuant to a single investment decision over a rather short period of time, at prevailing prices. Depending on the circumstances, some of these may be "distributions." Only rarely are they publicly reported. Second, the figures with respect to unregistered distributions of listed securities represent transactions for which exchange approval is required, and which are reported to the Commission, e.g., secondary or exchange distributions and special offerings. Distributions of listed securities in which there is no participation by member firms do not require exchange approval and no reports are made to the Commission. Third, the figures given below with respect to unregistered distributions of unlisted securities represent transactions described as "distributions" by the Investment Dealers' Digest and on the Dow-Jones "broad tape." There may have been some distributions of this type which were not reported. Fourth, the figures given below relate solely to unregistered common stock distributions. No information has been compiled as to distributions of other types of securities.[205]

In 1961 unregistered distributions of common stock totaled at least $588 million, an amount more than one-fifth as large as the total of registered common stock offerings by issuers and about one-half as large as the total of registered common stock offerings by persons other than issuers for the same year. Of the total unregistered distributions of common stock, $445 million was represented by unregistered distributions of listed common stocks which were reported to the Commission by the exchanges. Included in the latter amount were 77 secondary distributions of New York Stock Exchange-listed securities with an aggregate market value of $358 million, or slightly more than 80 percent of the total of unregistered distributions of listed common stocks reported by the exchanges.[206] These secondary distributions ranged in size from 6,000 shares of General Finance Corp. having a market value of $253,000 to 729,500 shares of Bethlehem Steel Corp. having a market value of $29,180,000.

In 1962 the volume of unregistered secondary distributions of common stocks approved by the Exchange was substantially smaller: there were 32 such offerings in that year with an aggregate value of $141 million.

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[204] Under present rules, disclosure to the Commission of an unregistered distribution (other than offerings pursuant to regulation A) of an over-the-counter security is required only if there is stabilizing and the aggregate offering price of the securities being offered exceeds $300,000. See rule 17a-2(a) under the Exchange Act.

[205] It should be noted that no intrastate offerings which are exempt from registration under the Securities Act have been included. As explained in pt. D of this chapter, such offerings may be significant in amount but the Commission has no way of knowing their volume.

[206] There were 18 unregistered secondary distributions on all other exchanges in 1961 with an aggregate market value of $21,146,000.

Exchange distributions and special offerings are of less significance. There were, in 1961, 26 exchange distributions on the New York Stock Exchange with an aggregate market value of $63 million.[207] The smallest in terms of aggregate market value involved 10,000 shares of Reliable Stores Corp., having a market value of $190,000, and in terms of number of shares 7,000 shares of R. J. Reynolds Tobacco Co. having a market value of $873,250. The largest exchange distribution in terms of dollar value involved 167,174 shares of General Electric Co. with a market value of about $12 million while the largest number of shares offered was 180,000 shares of the Martin Co. having a market value of $5,985,000.

There were in 1961 only two special offerings on all exchanges, having an aggregate market value of $1,503,750. By way of comparison, there were a total of 87 special offerings in 1944 with an aggregate market value of approximately $32 million.[208]

About $143 million in unregistered distributions of nonlisted common stocks occurring in 1961 came to the Study's attention.[209] The average size of these offerings was considerably smaller than secondary distributions of New York Stock Exchange listed common stocks. Only 7 (or 9 percent) of the exchange secondary distributions were under $1 million, whereas 65 (or 66 percent) of the nonlisted secondary offerings were in this category. Of these offerings, 7 had a value of less than $100,000; 30 were between $100,000 to $500,000, and 19 between $500,000 and $1 million. The smallest involved was 1,000 shares of Whitehall Cement Co. with a value of $41,000; the largest were 218,667 shares of Aetna Life Insurance Co. with a value of $22 million and 254,176 shares of Hartford Fire Insurance Co. with a value of $16 million.

4. PROBLEMS WITH RESPECT TO UNREGISTERED DISTRIBUTIONS

a. Disclosure to customers

As pointed out earlier, there is a wide variation in the kind and amount of information which investors now receive with respect to registered and unregistered distributions, notwithstanding that distributions within each of the two categories may have identical characteristics in other respects. When an offering is subject to registration, the registration statement provides comprehensive and detailed information, not only about the issuer, its business and management and the terms of the securities being offered, but also as to the terms of the offering and the plan of distribution. "Red herring" prospectuses containing most of such information are circulated among broker-dealers for their own information and for information of customers, and all purchasers are required to receive a final pospectus.[210] With respect to unregistered distributions, however, investors and the Commission receive only limited information or none at all. This sharp contrast in required disclosures is inherent in respect of

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[207] There were seven exchange distributions on other exchanges in 1961 with an aggregate market value of about $1,500,000.

[208] See note 190, above.

[209] As previously indicated, the aggregate volume figures given above for unregistered distributions of unlisted securities are incomplete.

[210] Apart from full disclosure concerning the issuer and the securities being offered, the prospectus contains the following information with respect to the distribution: The identity of the seller; the underwriting discounts or commissions; and the plan of distribution, including whether stabilizing transactions may be effected.

information which only an issuer can supply concerning itself, but it is not inherent in respect of information about the distribution, which obviously can be supplied by those who handle it. Moreover, unlike the registered distribution where the interval between filing and the effective date of the registration statement affords opportunity for dissemination of all types of pertinent information, the customer purchasing shares in an unregistered distribution has little or no opportunity to obtain material facts about the issuer or the distribution itself. Even when predistribution announcements are made, the actual distributions are often effected so rapidly that there is little opportunity for inquiry or disclosure.[211]

For example, of 80 secondary distributions reported to the Commission by the Exchange in 1961, 9 were completed in less than 15 minutes, another 22 in less than 1 hour, 12 in 1 to 4 hours, and 32 by the close of the following day. Only five secondary distributions remained open for a longer period. Exchange distributions displayed the same characteristics. Of 26 such distributions on the Exchange in 1961, 2 were completed in less than 15 minutes, another in less than 1 hour, 7 between 1 and 4 hours, 3 between 4 and 6 hours, 6 within 1 day, and 7 in more than 1 day.

The speed with which these distributions occur is evidence of the efficiency of the marketing facilities of the financial community, but rapid distribution may not be conducive to an unhurried, informed, and careful consideration of the investment factors applicable to the securities involved.[212] Representatives of one member firm stated to the study that "flash" secondary distributions, occurring on the same day they were announced, were sold by salesmen who had little time to inform themselves about the securities being offered and who, under the incentive of extra compensation, told customers of "a wonderful opportunity" without disclosing the fact of the distribution and the payment of a higher than normal rate of compensation. An official of a large mutual fund selling organization stated to the study that the funds sponsored by it sometimes used secondary distributions to dispose of "sick" situations rapidly. He frankly admitted that on occasion these distributions were sold to customers by salesmen as "bargains" on the ground that the customer was purchasing the security at the last sale price without payment of a commission. In this connection, the following excerpt from a published study of secondary distributions made by the Commission's staff 20 years ago remains pertinent:

> * * * Salesmen rarely have the time to devote to any special study of the position of the security to be distributed. Nor are they usually helped to present the facts by special analyses or information which might be prepared by the manager or by their own firm. While firms sometimes prepare a digest of salient facts regarding an issue in distribution, these summaries are, as a rule, hastily thrown together and are based merely upon the material carried in the "manuals." * * * Even given the facts, salesmen would not have the opportunity to present them adequately, in view of the speed of their solicitations and the fact that they are conducted almost entirely by phone.[213]

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[211] Announcement of a secondary distribution is usually made on the tape. Unless customers saw the announcement, they would not ordinarily be informed of the distribution.

[212] It should be pointed out that most secondary distributions involve the securities of issuers concerning which there is a reservoir of filed or other information available to the financial community and to the investor. However, in view of the speed with which secondary distributions occur, it is doubtful that there is time for either the salesman or investor to make use of it.

[213] "Report to the Commission on Secondary Distributions of Exchange Stocks," Division of Trading and Exchanges, Feb. 5, 1942, p. 28. See also ch. III.B.

b. Market activities

Part B of this chapter described some of the conflicting understandings and practices with respect to the application of rule 10b–6 to offerings of new issues. There is perhaps even greater uncertainty or misunderstanding as to the application of the rule with respect to unregistered distributions.[214]

In 1954 and 1955 when rule 10b–6 was being considered by the Commission and the industry, suggestions were made by a number of industry representatives that "distribution" be defined. In a 1961 opinion in a disciplinary proceeding, the Commission made the following statement as to the scope of the term for purposes of rule 10b–6:

> Rule 10b–6 is applicable to all distribtuions whether or not subject to registration under the Securities Act and whether or not the conventional procedure of utilizing an underwriter or selling group is employed. * * * The term "distribution" as used in rule 10b–6 is to be interpreted in the light of the rule's purposes as covering offerings of such a nature or magnitude as to require restrictions upon open market purchases by participants in order to prevent manipulative practices * * *. For these purposes a distribution is to be distinguished from ordinary trading transactions and other normal conduct of a securities business upon the basis of the magnitude of the offering and particularly upon the basis of the selling efforts and selling methods utilized.[215]

Nevertheless, the statement of a large member firm of the New York Stock Exchange to the study 1 year later indicates that uncertainty still prevails within the industry:

> [A] point which in our view needs clarification under (rule 10b–6) is the meaning of the term "distribution" as used in the rule. We believe that most members of the investment community construe this term to mean an offering registered under the Securities Act of 1933 or an "unregistered secondary," i.e., an offering which because of its size must be syndicated by the dealer handling it or handled in some other way as an organized distribution. We believe that it would be helpful if the SEC were to announce a definition of the term so that a dealer would know for certain when the restrictions of the rule are to be applied. To be helpful, the definition should be precise as to the size of the offering, number of shares, etc., and not phrased in general terms.

Uncertainties and misunderstandings appear to be especially prevalent in respect of the more informal types of unregistered distributions. The fact of registration or the publicity attendant upon what is referred to in the above quotation as an "unregistered secondary" may alert many participating broker-dealers to the restrictions upon trading activities under rule 10b–6, but with respect to other distributions, it would appear that the rule is often not observed and presumably not understood to apply.[216]

5. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Unregistered distributions can be quite sizable individually, and in the aggregate they are a very significant phenomenon in the securities

[214] Rule 10b–6 is one of the basic antimanipulative rules. It provides that no broker-dealer or other person who is making or participating in a distribution of securities shall bid for or purchase securities of the same class and series, subject to various exceptions for specified types of transactions which are not deemed to be of a manipulative nature.

[215] *Bruns, Nordeman & Company,* Securities Exchange Act release No. 6540 (Apr. 26, 1961).

[216] See the discussion in pt. B of this chapter and in ch. VII concerning the reduction of inventories by dealers in the over-the-counter markets. Questionnaire IN–4, described in ch. VIII, which was sent to a sampling of institutional investors reveals a number of substantial dispositions of over-the-counter securities held by such investors by or through firms making trading markets in such securities. Some of these dispositions were as large as many secondary distributions of listed securities and involved organized selling groups. It would appear that many firms participating in these distributions of over-the-counter securities did not consider rule 10b–6 applicable to their trading or other activities while engaged in such distributions.

markets. They are of growing importance because of the increasing participation of institutional investors in the markets. From the point of view of public customers, they are often indistinguishable from registered distributions in respect of disclosure needs. Yet they occur, for the most part, without even the minimum disclosure protections that would seem practical and with a speed that does not permit careful consideration of the merits of the security being distributed.

If a distribution emanates from the issuer or a controlling stockholder, it is the theory of the Securities Act that the issuer, selling stockholder (if any) and underwriter can and should supply comprehensive data about the issuer and the distribution itself. But if the distribution is from any other source, even though the factual distinctions may be narrow ones and the needs of investors may be no different, no disclosures are usually required even as to the distribution itself (except in the case of certain but not all exchange-approved distributions). Granting that the basic distinctions in kinds and amounts of disclosure must be maintained for practical reasons, there is no reason why certain basic data with respect to the distribution itself cannot be provided just as readily in the case of an unregistered distribution as in the case of a registered one. The needs for protection of investors are no less great in the former case than in the latter.

The disclosure requirements applicable to exchange distribution and special offering plans under rules of the New York Stock Exchange and other exchanges, as described above in section 2, provide a useful pattern in considering the minimum disclosures that are needed and practical to obtain. These requirements should be extended to all unregistered distributions in defined categories so that, in addition to notifying the Commission, there will be disclosed to prospective purchasers prior to completion of the transaction the total amount involved in the distribution, whether it is for the broker-dealer's account or on behalf of other persons (with or without identifying the persons); the underwriting arrangements and/or discounts and commissions involved; and whether stabilizing transactions may be effected. Some of this information should also be supplied to the prospective purchaser at the time of solicitation in view of the importance of disclosure at this point in the making of an investment decision. Consideration should be given, also, to the feasibility of requiring a minimum interval between announcement and actual commencement of an unregistered distribution.

In view of the importance of rule 10b-6, the basic antimanipulative rule in respect of distributions and the uncertainty concerning its application to unregistered distributions, it would appear that appropriate measures should be taken by the Commission to clarify its applicability.

The Special Study concludes and recommends:

1. Any broker-dealer managing an unregistered distribution should be required to file with the Commission a brief notification as to the total amount of securities involved in the distribution; whether the distribution represents inventory or investment stock of the broker-dealer and/or is on behalf of one or more other persons (with or without identification of such other persons);

the offering price and underwriting arrangements and/or discounts or commissions involved; and whether stabilizing transactions may be effected. Consideration should be given, also, to the feasibility of requiring, with respect to all or specified categories of unregistered distributions, an interval of time, say 48 hours, between the filing of the notification and the commencement of the distribution (in which case only the method of determining price and spread rather than actual amounts would be set forth). For purposes of this recommendation and the following one, the term "unregistered distribution" should be defined to include the sale by any broker-dealer, as principal (including any planned reduction of inventory or "workout") or as agent, of any block of securities of such size as to require an underwriting or selling group and/or receipt or payment of compensation exceeding normal compensation for routine (nonblock) transactions in similar securities, unless the block is sold to fewer than 25 purchasers and/or at an aggregate price of (say) $300,000 or less.

2. Any broker-dealer participating in an unregistered distribution as principal or as agent should be required to advise each customer in his confirmation of the substance of the matters to be set forth in the notification, and at the time of solicitation as to appropriate portions thereof.

3. Reference is made to the recommendations in part B of this chapter as to clarification of the application of rule 10b–6 in respect of unregistered distributions and otherwise.

D. The Intrastate Exemption

Section 3(a)(11) of the Securities Act exempts from the registration requirements of section 5—

> any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

The Commission, however, is not thereby relieved of all responsibility for such offerings, since the antifraud provisions of section 17 of the act are expressly applicable to offerings exempt under section 3. Exemption under section 3(a)(11), like all other unconditional exemptions contained in the act, is however, not conditioned upon any prior filing with, notification to, or clearance by the Commission.

It is clear from the legislative history that Congress intended to exempt only "sales within a State of the entire issues of local issuers,"[217] and this theme has been reiterated by the Commission in its interpretation and administration of this provision.[218] The exemption reflects a congressional policy expressed, in various provisions of the Securities Act, not to preempt the field of securities regulation or to supersede State control, but rather to fill the gap in those areas where State regulation cannot adequately meet a national need.

When confined within its original purpose, the section 3(a)(11) exemption undoubtedly serves a very useful function. It is typically available for the offering by a small businessman of a limited amount

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[217] H. Rept. 85, 73d Cong., 1st sess. 7 (1933).

[218] See Securities Act release No. 1459 (May 29, 1937); Securities Act release No. 4434 (Dec. 6, 1961).

of securities to his friends, relatives, business associates, and others.[219] There is no way of knowing how many of these offerings occur every year, but the number unquestionably is susbtantial in view of the fact that there are over a million corporations in the United States, most of which are not represented in the trading markets. Some indication of the volume of offerings of this general character is afforded by the experience of those States which do not exempt small or private issues from the permit requirements of their securities laws. One such State, California, issues approximately 15,000 permits a year. This may be compared with approximately 2,307 registration statements and 1,065 regulation A offerings filed with the Commission from the entire country during fiscal 1962. Small local offerings of this character are not a matter of Federal concern, and can be adequately supervised by State authority to the extent that regulation is deemed necessary. Indeed, compliance with the registration requirements of the Securities Act of 1933 in such transactions would not only be unnecessary, but would, as a practical matter, be almost impossible.

While the basic conception of section 3(a)(11) is sound, the exemption nevertheless presents problems when it is used for substantial offerings to the general public, particularly when such offerings are made through the organized channels of the securities industry. These problems fall into two principal categories. In the first place, although section 3(a)(11) is not by its terms unavailable for such offerings, compliance with the strict conditions and limitations of the exemption may be difficult. In the second place, while fraudulent practices in connection with such offerings are prohibited by section 17, the Commission is not notified of such offerings and has no reliable means of learning of their existence, with the result that providing investors with adequate protection against fraud is difficult and problems of enforcement are multiplied.

In keeping with its purpose of exempting only local financing of local issues, section 3(a)(11) is available only if the entire issue of securities is offered and sold only to persons resident within the State in which the issuer is both incorporated and doing business. These limitations have consequences which are not always appreciated. In the first place, the sale of only one share to a nonresident makes the exemption unavailable for the entire issue.[220] Furthermore, residence means more than merely presence in the State—it requires something resembling domicile. The foregoing conditions are not satisfied unless the offering actually comes to rest in the hands of local residents. Thus, as the Commission pointed out in an early case, the exemption is not available where the offering is made to resident underwriters or other intermediaries, who promptly resell to nonresidents.[221]

Compliance with the foregoing requirements in the case of a widespread public offering presents formidable problems, particularly in jurisdictions such as New York, where the local public includes a large number of interstate commuters. In order to be safe, the issuer

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[219] No doubt many such transactions would also qualify for a private-offering exemption under the second clause of sec. 4(1) of the Securities Act, but in view of the limitations of that exemption as interpreted by the Supreme Court in *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953), many would not.

[220] *S.E.C.* v. *Hillsborough Investment Corp.*, 173 F. Supp. 86, 88 (D.N.H. 1958), 176 F. Supp. 789 (D.N.H. 1959), aff'd sub nom. *Hissborough Investment Corp.* v. *S.E.C.*, 276 F. 2d 665, 668 (1st Cir. 1960). *In the Matter of Hunt*, 4 S.E.C. Jud. Dec. 788 (W.D. Wash. 1946), aff'd per curiam sub nom. *Hunt* v. *S.E.C.*, 158 F. 2d 981 (9th Cir. 1947).

[221] *Brooklyn Manhattan Transit Corporation*, 1 S.E.C. 147 (1935).

must know the actual residence of each purchaser and offeree and must also know his intentions with respect to resale.

In addition to the qualifications which must be met by the offerees, the business itself must also qualify as a local enterprise. This means that it must not only be incorporated in the State in question, but must also conduct its principal business there. Mere compliance with formalities, such as maintaining corporate offices and records within the State, does not meet this condition and it is likely that even if the issuer does have business operations within the State, the exemption would not be available to finance an out-of-State venture.[222]

In view of these problems, it is not surprising that as applied to substantial offerings, the exemption has been described from the issuer's point of view as "loaded with dynamite." [223] As an insurer of the residence of all purchasers, even a conscientious issuer may find itself faced with contingent liability or the possibility of rescission under section 12 of the Securities Act, because of a good faith mistake or the failure of a salesman to observe instructions.

Similarly, the exemption is "relatively dangerous" [224] for underwriters to rely upon. Developments subsequent to the distribtuion may convert an initially valid exercise of the exemption to an improper one, thereby subjecting the underwriter to the risk not only of civil liabilities under section 12, but also possible revocation proceedings or even criminal action. Accordingly, in order to protect themselves, many firms have adopted express policies not only against participating in such offerings but also severely limiting the types of transactions they will effect in securities originally offered pursuant to the intrastate exemption.

There is no reliable source of information either as to the number and dollar volume of offerings made under claim of the intrastate exemption or even as to those offerings which are of substantial size or are of a public nature. The Commission, in the absence of a notice or filing requirement, is without a systematic means of recording the number and volume of such offerings and must rely upon whatever information is occasionally provided in financial publications or obtainable from State securities administrators. While many States require registration of securities offered within their jurisdictions, few State administrators keep records covering securities offerings made exclusively within their jurisdictions. In New York, for example, only real estate securities are required to be registered prior to their offer and sale, and even as to these, there is no readily available record of the offerings claimed to be solely intrastate. Even the standard financial manuals generally do not include information on issues of securities made pursuant to the intrastate exemption because their editors feel they are too small to be of public interest.

Nevertheless, there are indications of the offer and sale of a substantial volume of securities to the investing public under color of the

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[222] *S.E.C.* v. *Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Calif. 1957). The problem becomes particularly acute where an intrastate offering is made to finance the operations of out-of-State subsidiaries or affiliates or where a series of intrastate offerings are made in a number of States by a group of affiliated corportions, each incorporated in the State of offering in order to avail itself of the exemption. In substance, this is an interstate offering for which the exemption is not available.

[223] Gadsby, "The Securities and Exchange Commission and the Financing of Small Business," 14 Business Lawyer, pp. 144, 148 (1958).

[224] Thomas, "Federal Securities Act Handbook," p. 23 (1960).

intrastate exemption.[225] As described in part E of this chapter, issuers of real estate securities frequently claim the exemption. The use of the exemption is not, however, confined to "specialized" securities. Notwithstanding the general exclusory rule of the editors of the financial manuals, Moody's Industrial Manual alone listed during 1961 at least 90 offerings apparently made pursuant to the intrastate exemption. Of these 90, 15 were for amounts totaling at least $1 million, and another 15 were in amounts ranging from $500,000 to $1 million.

Registered brokers and dealers who underwrite or otherwise participate in these offerings might provide a further source of information. In that connection it is to be noted that the NASD recently gave notice to its members that a special committee of its board of governors will review intrastate offerings underwritten by its members.[226] It is believed that this should provide information with respect to certain major offerings in reliance upon the exemption, and its effectiveness should be carefully observed. It appears, however, that a substantial proportion of intrastate public offerings are made by issuers directly and without the use of an underwriter, or are made by underwriters, often affiliated with the issuer, who claim exemption from broker-dealer registration pursuant to section 15(a) of the Exchange Act upon the ground that their business is "exclusively intrastate." Such underwriters rarely need or seek NASD membership. Thus, information obtainable from NASD members or registered broker-dealers is substantially incomplete.

The record of Commission enforcement actions reveals not only intrastate offerings of substantial magnitude but also abuses which can attend such offerings.[227]

The depredations of an itinerant promoter who traveled from State to State, setting up local corporations and making public offerings under section 3(a)(11), are revealed in the Commission's opinion in *Peoples Securities Company*.[228] Another recent case illustrates the impact upon investors of a fraudulent intrastate offering. One-year promissory notes of Florida loan companies, bearing interest rates of 8 percent or more, had been sold by a group of promoters to Florida investors by means of numerous false representations. Mortgages on real estate, automobile paper, and installment notes assigned as collateral for the notes proved to be worthless. Moreover, financial statements which included fictitious assets and excluded liabilities concealed the insolvency of the loan companies. The total amount of notes held by investors at the time of the failure of one of these loan companies was in excess of $500,000, for which no assets could be found. An investigations by the Commission of these fraudulent offerings resulted in the indictment and subsequent conviction of a num-

[225] In 1957, the regional offices of the Commission made a "rough estimate" of the number of filings that would be made annually in their respective regions if issuers making offerings pursuant to the intrastate exemption were required to notify the Commission. The Chicago regional office, for example, estimated 921 such filings within its region; the Fort Worth regional office estimated 510 filings.

[226] See letter dated Mar. 4, 1963, from the executive director to the members of the NASD.

[227] In 1959, former Chairman Gadsby reported to a congressional subcommittee that in 1957 and 1958 alone, the Commission opened 115 investigations relating to intrastate offerings. Hearings on "Amendments to Securities Acts," before Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 86th Cong., 1st sess., p. 29 (1959).

[228] 39 S.E.C. 641 (1960), aff'd sub nom. *Peoples Securities* v. *S.E.C.*, 289 F. 2d, 268 (5th Cir. 1961).

ber of persons for violations of section 17 of the Securities Act.[229] In another very recent case, approximately $3 million of securities were sold under the intrastate exemption to over 4,000 residents of Montana by an enterprise which has suffered continuing losses. The Commission obtained a permanent injunction against fraud in the sale of these securities as well as a court order placing the issuer and several of its subsidiaries in the custody of a conservator to administer the estate for the benefit of investors.[230]

The problems arising from intrastate exemption have received the attention not only of the Commission, but also of Congress. Several bills have been introduced to eliminate the intrastate exemption by repealing section 3(a)(11).[231] The Commission, although it took no formal position on such proposals, apparently did not believe that outright repeal of the exemption was warranted. Another bill, introduced in the 86th Congress at the Commission's behest, would have incorporated certain of the Commission's and the courts' interpretations into the statute and authorized the Commission to promulgate "rules and regulations [imposing] such terms and conditions * * * as may be necessary in the public interest and for the protection of investors" with respect to the various other statutory exemptions as well as the intrastate exemption.[232] This bill, which was never acted upon, would have permitted fairly extensive controls. The proposal was not repeated in subsequent legislative programs of the Commission.

Primary responsibility for investor protection with respect to intrastate offerings would seem to rest with the States, and the securities administrators of many States have made most valuable contributions to this objective. Unfortunately, however, most State administrators lack the resources to adequately supervise and investigate selling practices in widespread public offerings and, accordingly, must rely upon their ability to identify and prevent questionable offerings at the very inception, before the offering commences. This is an exacting task. Consequently, Commission enforcement of the antifraud provisions in connection with these offerings remains, as Congress intended it to be, a significant factor in providing the needed protection. It would be desirable for the Commission to increase the effectiveness of this enforcement by obtaining notice of substantial public offerings under this exemption before they are made. Issuers and others claiming the exemption could thus be made aware of restrictions implicit in its use and the risks of possible enforcement action and civil liabilities. Furthermore, it is believed that prior notice would have a prophylactic effect upon registered broker-dealers who may be subject to administrative sanctions for misuse of the exemption.

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The intrastate exemption reflects a congressional decision to relieve from the registration process local offerings which can be regulated locally and which ordinarily are not of substantial national concern.

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[229] Litigation release Nos. 2049 (June 16, 1961) and 2320 (July 20, 1962).

[230] *S.E.C.* v. *Prudential Diversified Services*, civil action No. 1004 (D. Mont., Mar. 9, 1963).

[231] H.R. 1218, 87th Cong., 1st sess. (1961) (Representative Multer); H.R. 884, 86th Cong., 1st sess. (1959) (Representative Multer); H.R. 11050, 85th Cong., 2d sess. (1958) (Representative Multer). See also H.R. 572, 88th Cong., 1st sess. (1963) (Representative Multer).

[232] H.R. 2488, 86th Cong., 1st sess. (1959) (Representative Harris).

The exemption serves its intended purpose well, when availed of, as it ordinarily is, for small offerings by small businessmen in their home communities. Even in such offerings, investors are entitled to Federal protection against fraudulent practices.

The exemption may, however, be available for public offerings of substantial magnitude, and it is in this area that troublesome problems arise. Reflecting its purpose, the conditions and limitations of the exemption are not well adapted to substantial public offerings, and the likelihood of inadvertent violation of the Securities Act of 1933 in the course of a substantial public offering is high, even where reasonable precautions appear to have been taken. Such violations may expose issuers and underwriters to substantial liabilities, as well as creating possible regulatory difficulties for registered broker-dealers.

While reliable information is not available as to the extent to which the intrastate exemption is availed of for public offerings, the records of the Commission, financial manuals and other sources indicate that sizable public offerings in reliance upon the intrastate exemption are not infrequent. While undoubtedly many of these offerings are entirely legitimate, there is a significant potential for fraud in such relatively unsupervised distributions, and it appears that fraudulent promoters have exploited this potential. The absence of prompt notice to the Commission of such public offerings greatly complicates its efforts to protect the public against fraud. A requirement that notice be given would also provide useful information as to the significance of this type of financing, and provide a basis for determining whether legislation establishing further controls of such offerings is needed.

The Special Study concludes and recommends that:

1. Issuers or controlling persons of issuers (in cases of secondary offerings) who propose to make substantial public offerings in reliance upon the exemption from registration provided by section 3(a)(11) of the Securities Act should be required to file with the Commission an advance notice of such offerings. Such notification, on a prescribed form, would include information with respect to the principal business or businesses of the issuer and their location, the amount, purpose and place of offering of the securities and identification of the person on whose behalf the offering is made, a description of the manner in which the offer or sale is to be accomplished, and disclosure of any recent or proposed offerings by the issuer other than that set forth in the notification. Filing of such notification would not be a condition to the availability of the exemption, but any failure to file would be subject to the usual penalties for violation of the Commission's regulations.

E. Real Estate Securities

1. INTRODUCTION

A phenomenon new to the last decade has been the widespread public distribution of real estate equity securities. The concept of multiple ownership of real estate is not new, and in earlier years there existed a flourishing public market in mortgage participations, or debt instruments secured by an interest in real estate. Nevertheless, the spectacular expansion since approximately 1950 of public participation in real estate equities justifies its description as a new phenomenon in the securities markets, and as might be expected of a new phenomenon, it has brought with it special problems.

It is impossible to state definitely how much the public has invested in real estate investment partnerships, corporations, and trusts, since a major portion of the public offerings have been made locally in intrastate offerings. Such offerings are exempted from registration under the Securities Act of 1933, provided they are made in compliance with the exemption provision.[233] However, the aggregate dollar amount of effective offerings of securities which have been registered with the Commission, from the first registration in 1952 through May 15, 1962, exceeded $800 million. In New York State, the center of real estate offerings, 400 offerings were made totaling $1.3 billion in 1961, and in 1962, 305 offerings totaling over $500 million. Unofficial estimates of all sales, registered and unregistered, run even above $10 billion. Naturally, the spectacular expansion has meant that the pace of real estate offerings has shown a steady increase over the last decade. In 1952, one registered offering of $2,450,000 of real estate securities became effective; in 1961, registration had increased to 70 offerings aggregating $440 million, including a single $39 million offering of Empire State Building Associates. Clearly, real estate offerings have become a significant segment of the securities markets.

As the business of real estate syndication has grown, it has undergone a number of changes. Recent years have shown a trend toward new forms of securities. Those offered by early syndicates consisted largely of limited partnership interests. By 1959, some syndicators were combining various partnerships into real estate corporations, which then proceeded to offer new stock to the public, thus acquiring capital for further real estate ventures. When Congress passed the Real Estate Investment Trust Act of 1960,[234] providing a new taxing formula to encourage public investment in real estate, it stimulated the use of the real estate investment trust, a type of investment entity previously rarely used, which also offers securities to the public. If the statutory provisions are met, the real estate investment trust becomes virtually tax free by distributing its earnings to its shareholders.

Like the real estate investment trusts, both the limited partnership and the corporate entities in the real estate area are carefully designed to take maximum advantage of relevant Internal Revenue Code provisions on the deductibility of depreciation on real property. Indeed, there is no doubt that the entire real estate syndication business is essentially the product of the accelerated depreciation deduction permitted by the Federal income tax laws. The importance of the present Federal tax laws to the structure of real estate syndication is in many respects far greater than securities regulation.

Another significant and unusual aspect of the real estate syndication business is its primarily local nature and its historical concentration in the New York City area. To some extent the syndicators have carried on their activities in the District of Columbia area and elsewhere, but New York has been the center of the syndication universe. In early years, most of the syndicated properties as well as the com-

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[233] Securities Act of 1933, sec. 3(a)(11).
[234] Public Law 86-779, 26 U.S.C. 856-858.