CHAPTER IV

PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

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CHAPTER IV

PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

A. Introduction

1. SCOPE OF CHAPTER

The securities markets serve two functions—they are markets both for the distribution of large blocks of securities to the public and for trading in outstanding securities. Through the distribution facilities of the financial community, corporations are able to tap the capital markets and to obtain funds vital to their own expansion and to the economic growth of the country. During the year 1961, for example, American corporations made expenditures of about $30 billion on plant and equipment of which $7.5 billion was obtained through the issuance of corporate securities.[1] The financial community also provides for the efficient transfer of blocks of securities held by institutions and other large shoreholders to smaller investors. In 1961, broker-dealers made such secondary distributions, both registered under the Securities Act and unregistered, of over $1.8 billion in such securities.[2]

The mechanisms, practices, and rules for distributions in the securities markets are substantially different from those for the trading markets. Without attempting to describe each of these differences, the following are of particular significance:

In most distributions, broker-dealers form temporary syndicates or selling groups to distribute blocks of securities over-the-counter. Underwriting syndicates are dissolved upon completion of the distribution.[3] Since the adoption of the Federal securities laws, the exchange markets have been infrequently used for distributions requiring extensive retail activity.[4]

In order to place large amounts of securities with investors in a short period of time, distributions usually require concentrated selling efforts. For the greater expense, and sometimes risk, in distributing an issue, the underwriter receives a larger commission or "spread" (the difference between the amount received by the issuer or other seller and the price at which it is sold to the public) than in ordinary trading transactions.

Most distributions of corporate securities are made at a fixed public offering price in markets which may be "stabilized": underwriters

[1] SEC Statistical Bulletin, March 1962.

[2] See sec. 2, below. In general, a secondary distribution is the disposition of a block of securities by any person other than the issuer. Registration under the Securities Act may be required for secondary distributions if they emanate from controlling stockholders. For a discussion of unregistered distributions by stockholders, see pt. C of this chapter.

[3] Open-end investment companies are unique in that they have permanent selling organizations to make continuous offerings of fund shares. See ch. XI.

[4] See pt. C of this chapter.

peg or fix the market price of a security, through bids for or purchases of that security, for the limited purpose of preventing a decline immediately prior to or during a public offering. Similar activity in the regular trading markets might be regarded as manipulative.

In general, the Securities Act governs distributions; the Exchange Act, the trading markets. For distributions subject to its registration requirements, the Securities Act compels disclosure of material information concerning the issuer, the terms of the offering, and the distribution arrangements and places certain restrictions upon the dissemination of selling material or information about the offering immediately prior to and during the distribution. Both registered distributions and those exempt from registration under the Securities Act may be subject to specific restrictions upon, among other things, trading both prior to and during the distribution and compensation of salesmen.

The Special Study has attempted to explore only certain of the distribution aspects of securities, and the results are reflected in this chapter as follows: the balance of this part A provides a brief statistical picture, first showing general trends in corporate issues during the postwar period and then looking more closely at the characteristics of equity issues during the years 1959–61. Part B, by far the major component of the entire chapter, covers the distribution of issues offered by companies making their first public offering, an important phenomenon in the securities markets in recent years. The large volume of distributions not subject to the registration requirements of the Securities Act are the subject of part C. Parts D and E concern two special problem areas relating to distributions—the first, the use of the intrastate exemption under the Securities Act, and the second, the distribution of real estate securities. The last part of the chapter—part F—does not cover a specific factual matter but outlines a regulatory program for simplifying the disclosure requirements under the Securities Act in the case of issuers subject to continuous reporting requirements under the Exchange Act.

2. DISTRIBUTIONS OF CORPORATE SECURITIES

By way of background for the study of "new" issues and other special categories of distributions considered below, it may be helpful to show broadly the trends and characteristics of all corporate financing in recent years, with particular emphasis on equity financing in the immediate past.

a. General trends in corporate issues during the postwar years

Reflecting the great expansion in plant and equipment and working capital in the postwar period, new corporate securities offered for cash sale reached a volume of over $13 billion in 1961—a tremendous growth from the low levels of the early war years, when such flotations averaged about $2 billion (table IV–1).[5]

[5] This total includes stocks and bonds registered under the Securities Act and issues exempt from registration, such as privately placed issues, intrastate offerings, and securities of banks and railroads. It does not, however, include investment company issues or other types of securities sold on a continuous basis.

Tables and charts appear in two places in this chapter. Some of those which are integrally related to the discussion are included in the text and are identified by a lower case letter; e.g., table IV–a. Some are not mentioned in the text, or are less integral, and are located at the close of the chapter, prior to the appendixes. These tables and charts are identified by an arabic numeral (e.g., table IV–1).

During the years 1940 to 1961, registered issues averaged 56 percent of total corporate cash offerings. Except in the years 1948 to 1951, they constituted more than one-half the total and reached the highest proportionate levels in the years 1957 to 1958, averaging 65 percent. The total dollar volume of registered stocks and bonds offered for cash sale by corporations since 1940 has varied from about $600 million in 1942 to a peak of over $8 billion in 1957, with the volume in 1958 and 1961 being almost as large.

The major part of unregistered cash offerings has been private sales to institutional investors. Most securities sold in this manner have been debt issues of established corporations. Issues exempt under regulation A, including equity as well as debt issues, have accounted for only a small part of total dollar amount but have represented a large number of issues by small corporations, including many newly organized firms.[6] The lowest dollar amount of these issues was in 1945, the year that the regulation A exemption was increased from $100,000 to $300,000; and the highest was in 1955, during the uranium boom. In 1961 this record was almost equaled. Regulation A issues have ranged from roughly 1 percent to 2½ percent of the dollar volume of all new cash financing in the years 1945 to 1961.

Corporations generally used considerably more debt financing than equity financing for raising capital during the past two decades. In the postwar years through 1954 less than 16 percent of all corporate securities offered for cash for the account of the issuers were common stock issues. The dollar volume of common stock flotations rose from $1.2 billion in 1954 to $2.2 billion in 1955, or from 13 to 21 percent of the total volume of all securities offerings. By 1961, the dollar volume of common stock issues had reached a record of $3.3 billion, or about one-quarter of total offerings, reflecting a large increase both in the number of small offerings by companies issuing securities publicly for the first time and in the number of major-sized issues.

The increase in stock issues was accompanied by changes in the kinds of companies seeking public money (table IV–2). During the period from 1953 to 1961 equity financing by utilities and extractive industries decreased, while finance and real estate, manufacturing, and commercial companies sought increasing amounts of capital through public offerings.

The rising stock market also encouraged large stockholders in many companies to reduce their holdings through secondary distributions (table IV–3). The dollar volume of stock offerings by persons other than issuers rose to a record level in 1961. In that year, secondary distributions of common and preferred stock registered under the Securities Act totaled $1.2 billion, or almost one-quarter of the total offerings of corporate stock. In addition, a volume of at least $588 million of common stock was sold in blocks on exchanges or over the counter in unregistered secondary distribution.[7]

It is against this background of rising stock prices and wider resort to equity financing through public offerings that the composition

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[6] The Securities Act provides that offerings of securities not exceeding $300,000 in amount may be exempted from registration, subject to such conditions as the Commission prescribes for the protection of investors. Pursuant thereto, the Commission adopted regulation A which permits companies to make exempt offerings not exceeding $300,000 in amount, provided certain specified conditions are met.

[7] See pt. C of this chapter.

of recent public financing and particularly the new-issue phenomenon must be examined.[8]

b. Characteristics of corporate equity issues, 1959–61

During the years from 1959 to 1961, the dollar volume of equity offerings registered under the Securities Act or exempt under regulation A, covered in this analysis, totaled over $9 billion (table IV–4).[9] In 1961 a record volume of about $4 billion was registered, including an issue of American Telephone & Telegraph Co. (A.T. & T.) which alone amounted to almost $1 billion. Most of the volume during the 3-year period represented common stock flotations; [10] preferred stock offerings amounted to less than $200 million in each of the years 1960 and 1961 and to about $400 million in 1959. The bulk of the equity financing during these years consisted of new stock issued by corporations. Although secondary distributions rose in amount between 1959 and 1961, they continued to represent about the same percentage of all offerings.

Less than $160 million of equity issues were offered under regulation A in each of the 3 years surveyed. The picture is quite different, however, with regard to the number of issues offered. In 1959 and 1960 there were about three-fourths as many regulation A issues as there were registered issues. In 1961 the proportion of regulation A issues fell to about 60 percent, not because of an absolute decline but because of a large increase in the number of fully registered small issues.

Manufacturing companies issued a larger volume of equity issues than any other kind of industry in each of the 3 years from 1959 to 1961 (table IV–5). This was true both for issues registered under the Securities Act and for those exempt under regulation A; in fact, among the latter, more than half of the total equity financing in 1960 and 1961 consisted of issues of manufacturing companies. Electric, gas, and water companies ranked next in volume for the 3 years as a whole, although there was some decline in their relative importance in 1961. Including the large A.T. & T. issue in 1961, communication companies were third in volume for the 3-year period, but in 1960 comprised less than 10 percent and in 1959 less than 3 percent. The remaining important groups of companies floating stock issues during the period were commercial firms and financial and real estate firms. Commercial companies, including those in the service and amusement industries, were an important category among regulation A issues in all years. Relatively few equity issues were publicly offered in recent years by companies in the extractive and transportation industries.

A few large issues accounted for a substantial dollar volume of registered equity offerings in the 3-year period. In 1959 about $1.6 billion or 57 percent of the total dollar amount of stock registered represented issues of $10 million and over; in 1960 this figure dropped to 42 percent, but in 1961 it rose to 63 percent (table IV–7). These large issues, however, accounted for less than 10 percent of the number

[8] See pt. B of this chapter.

[9] The information concerning registered and regulation A stock issues which appears in the following pages is based on statistics prepared for the years 1959, 1960, and 1961. Not all offerings of corporations are included in these statistics; excluded are issues exempt from registration, such as bank stocks, private placements, and intrastate issues, and also certain special categories of registered issues, such as investment company issues not pertinent to this aspect of the study. The difference between the scope of the statisics presented in tables IV–1 to IV–3 and that of the other tables in this section is explained in footnote 1 of table IV–4.

[10] Convertible issues are included with preferred stock and debt issues.

of issues each year. At the other end of the scale, registered issues of under $1 million made up about one-third of the number of issues in each of the years 1959 and 1960, but more than two-fifths in 1961, with offerings of between $300,000 and $500,000 showing the greatest rise. The median size for registered issues was $1,700,000 in 1959, $1,600,000 in 1960, and less than $1,400,000 in 1961. A substantial portion of regulation A offerings were at the $300,000 limit of the exemption during the 3-year period, close to two-fifths of the number of issues and over half the dollar amount being in this category. Fewer than 10 percent of the number of issues each year were under $50,000.

A breakdown of stock offerings registered under the Securities Act shows an increased use of the capital markets by smaller companies during the years surveyed. For example, in 1959 only one-fifth of the companies registering equity issues had assets of under $1 million, but in 1960 almost one-fourth and in 1961 almost one-third of the issues were of this size. On the other hand, offerings by corporations in the largest size category, those with over $100 million in assets, made up less than 8 percent of the total number for the entire period.

For the 3-year period as a whole, four-fifths of the volume of registered equity issues were offered through facilities of investment bankers or dealers, the remaining issues being offered by issuers directly (table IV–8).[11] If the 1961 A.T. & T. offering, which was sold directly by the company to stockholders, is excluded, underwritten issues comprised 90 percent of the total dollar volume of registered offerings for the 3-year period. A high proportion was maintained regardless of size of offering, except that the proportion underwritten was lower for issues under $300,000. In 1960, the average size of underwritten issues was $400,000 larger than that of issues offered directly and $600,000 larger in 1959 and 1961.

The proportion of underwritten regulation A issues was lower than for registered issues, being about 70 percent. Slightly more than 80 percent of issues exactly $300,000 in size were underwritten, but underwriting was less frequent in the case of smaller issues. For the smallest issues, those of under $50,000, only 20 percent were handled by underwriters.

Rising stock prices, especially in 1961, brought a large number of companies into the public market for the first time. For example, in 1959, 63 percent of common stock issues were "unseasoned"; in 1960, 72 percent; and in 1961, 76 percent.[12] By comparison, less than 30 percent of the stock offerings during the late 1940's were unseasoned. A much higher proportion of regulation A issues than registered issues were unseasoned. In 1961, 72 percent of the registered issues were unseasoned, while 83 percent of the regulation A issues were in this category (table IV–9).

[11] The classification "underwritten" as used here and in the appendix tables includes issues offered both on a "firm commitment" and a "best efforts" (or agency) basis, no separation being made by type of underwriting contract or agency arrangement. In a firm commitment underwriting, the underwriting group purchases the entire issues outright from the issuer at the offering price, less a discount, and thus assures the issuer of receiving a certain amount of money, whether or not the entire issue can be successfully sold to the public. The term "best efforts" is used to refer to various arrangements with underwriters in which the issuer receives no such assurance.

[12] For purposes of analysis, an issue was classified as "unseasoned" if the issuer had not registered stock previously under the Securities Act or regulation A, and if its stock was not listed on a national securities exchange or known to be traded over the counter. On occasion, this classification resulted in the inclusion of large, well-established companies offering their securities to the public for the first time.

Unseasoned registered issues were, on the average, smaller than seasoned issues. The median size of unseasoned registered issues in 1959 and 1960 was approximately $1,300,000, or between $300,000 and $400,000 lower than the median size of all types of registered issues, seasoned and unseasoned. In 1961, the median size of unseasoned issues was slightly more than $1 million, compared to $1,400,000 for all issues. Because of the preponderance of unseasoned issues among regulation A offerings, not much difference existed in average size between all such issues and those being sold publicly for the first time.

More than half of the registered unseasoned common stock offerings in 1959, and around 60 percent in 1960 and 1961, were initially offered at less than $10 (table IV–15). (The average price of shares traded on the New York Stock Exchange in 1961 was about $41.) The median price for registered issues offered to the public for the first time in 1959 was $9.20; in 1960, $8.60; and in 1961, $8.10.

The largest number and volume of unseasoned issues were of manufacturing companies, although commercial as well as real estate and finance company offerings also were significant (table IV–13). In the last few years, unseasoned issues of companies in certain industries attracted unusual public interest (table IV–14). Between 1959 and 1961, the number of such issues rose from 192, or about one-quarter of the total number offered, to 437, or about one-third of the total. Many of the offerings in these "selected" industries met with a spectacular reception and contributed to the buoyancy of the market; these have been popularly referred to as "hot issues." In many cases there was little to support the public enthusiasm for a particular issue except the magic words indicating the issuer's membership in a selected industry, which appeared in the company's name or in the description of its business.[13]

Issues in these selected industries comprised less than one-fourth of the dollar volume of all unseasoned issues for the years 1959–61 as a whole. Most prominent among the selected issues were those in the electronic and electrical equipment group; these were popular in all 3 years, accounting for more than half of the issues and almost half of the dollar amount of the selected industry total. In 1961, over 200 firms in this category issued new stocks, with the number about evenly divided between registered issues and those using the regulation A exemption. Other industries which became increasingly popular were scientific instruments and research, photography, printing and publishing, and sporting goods and amusements.

Over 85 percent of the registered issues in these selected industries represented companies with less than $5 million in assets. In 1959 and 1960, about one-third of such issues were offered by companies with less than $1 million in assets (table IV–16). An even greater number of small unseasoned issues in these industries made their appearance in 1961. In that year almost half of the registered issues in the selected industries were of companies with under $1 million in assets, compared with only 37 percent unseasoned issues in other industries. A similar statistical distribution of company size was not made of the regulation A issues, but these companies were undoubtedly even smaller than those that underwent full registration.

[13] See pt. B of this chapter.

B. New Issues

1. INTRODUCTION

a. The new-issue phenomenon

From 1959 until the market decline of early 1962, the distribution of securities by companies that had not made a previous public offering reached the highest level in history. This activity in new issues took place in a climate of general optimism and speculative interest. The public eagerly sought stocks of companies in certain "glamour" industries, especially the electronics industry, in the expectation that they would quickly rise to a substantial premium—an expectation that was often fulfilled. Within a few days or even hours after the initial distribution, these so-called "hot issues" would be traded at premiums of as much as 300 percent above the original offering price. In many cases, the price of a "hot" issue later fell to a fraction of its original offering price.

During this period, registration statements under the Securities Act and filings under regulation A and surveillance of the distribution and trading of these issues in the "after-market" [14] consumed much of the time and energy of the Commission and its staff. A few figures will illustrate the rapid increase in filings. In the year ending June 30, 1962, 2,307 registration statements were filed, of which 1,377 (or 60 percent) were by companies which has not previously filed a registration statement. In fiscal 1961, 1,830 registration statements were filed, of which 958 (or 52 percent) were first filings. The comparable figures for fiscal 1950 were 496 and 112 (or 23 percent).[15]

Although the floodtide of filings has since subsided, the new-issue phenomenon is of more than historical interest. The fact that periods of intense speculation tend to be accompanied by an increase in distributions of new securities indicates that the acute interest in new issues evident the years 1959–61 could easily recur. Moreover, the role of underwriters in the rising markets of these years tested their standards and brought into focus their responsibilities and obligations to issuers and to the investing public. It also subjected to their most severe test the provisions of the Federal securities laws by which Congress sought to assure "truth in securities" and to prevent abuses in public offerings and after-market trading in securities.

At the time of the hearings on the legislation authorizing the Commission to make the Special Study, the new-issue phenomenon represented one of the principal regulatory and enforcement problems facing the Commission. In his statement on that legislation before a subcommittee of the House Committee on Interstate and Foreign Commerce, the Chairman of the Commission stated that the public offering of speculative or unseasoned securities and the after-market trading of these issues would be an area of study.[16] In subsequent statements by the chairman and in the first public release of the study, the new-issue phenomenon was designated as an area of inquiry.[17]

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[14] The trading market for a new issue will be referred to in this report as the "after-market."

[15] See annual reports of the Commission for the fiscal years 1950, 1961, and 1962.

[16] Hearings on H.J. Res. 438 (1961) before a subcommittee of the House Committee on Interstate and Foreign Commerce, 87th Cong., 1st sess., 4–7 (1961).

[17] See Rept. 882 of the Committee on Interstate and Foreign Commerce, House of Representatives on H.J. Res. 438, 87th Cong., 1st sess.; Rept. 1703 of the Committee on Banking and Currency, Senate, on H.R. 11670, 87th Cong., 1st sess. (1961) ; Special Market Study release No. 1 (Dec. 19, 1961).

In this part of chapter IV, the study sets forth the results of its inquiry into the new-issue phenomenon and makes recommendations with respect to various problems in connection with the distribution and trading of new issues. The study describes in section 2 the origination of new issues, including the role of the underwriter in the issuer's decision to go public, the pricing of new issues, the costs of public financing and the extent of preparation by the issuer and the underwriter for a public offering of a new issue. In section 3, "hot" issues and various factors contributing to a premium in the aftermarket are examined, including the activities of trading firms, the factors resulting in restriction of supply and stimulation of demand, the role of the managing underwriter in the aftermarket, and the use made of statutory prospectuses. Section 4 describes the postoffering experience of issuers going public for the first time during the past 10 years. Finally, section 5 sets forth conclusions and recommendations with respect to "new" or first issues generally.

As will be seen, the policies and practices of broker-dealer firms in the distribution and trading of new issues reflect wide differences in points of view and standards of responsibility both to the issuer and to the investing public. The study has attempted to describe both similarities and differences, drawing generalizations where they appeared justified by the evidence and making distinctions where this appeared necessary to give a full and accurate picture. Some of the discussion is devoted to questionable and, in some cases, manipulative or fraudulent practices engaged in by a small minority of underwriting firms. It should be emphasized that these practices are not representative of the underwriting community as a whole, but it has been necessary to consider a wide range of practices in order to consider whether remedial measures may be devised to deal with the troublesome and sometimes dangerous phenomenon of "hot" issues. It is believed that such measures can be devised without interfering with established legitimate practices of underwriters or with the flow of venture capital into new business.

b. Methods of study

The methods used by the Special Study to examine the new-issue phenomenon combined the use of questionnaires, examination of trading data, private hearings, informal interviews, and analyses of statistical and other materials in the files of the Commission.

The principal emphasis was placed upon an intensive study of 22 new issues which were offered to the public during the period from 1959 to 1961 and which immediately went to a premium.[18] In selecting these issues an attempt was made to avoid choosing companies or securities which had homogeneous characteristics that might reasonably account for the existence of the premium. Some of the companies chosen were large, nationally known enterprises, while others were small unknown companies with no operating history. In each case the offering represented the first public issue of securities of the company. Twenty of the offerings were filed pursuant to the registration provisions of the Securities Act, while two were filed pursuant

[18] See app. IV-A: "Profiles of Each of the 22 Issues." The information in these profiles is derived from the prospectuses of the issuers, from replies to questionnaire OTC-1, and from lists of selling group members supplied to the Special Study by the managing underwriters.

to the exemption from registration afforded by regulation A. The offering price varied from $2.25 to $29 per share; the number of shares offered, from 50,000 to 436,086; and the total amounts of the offerings, from $247,500 to $12,646,494. None of the issues was selected because of any adverse information known about it.

The size of the distributing syndicates also varied greatly; some of the issues had few underwriters and were distributed by large selling groups; in others, the converse was true; and in still others, there were few underwriters and small selling groups. Some of the managing underwriters had sizable capital positions and long experience in the financial community, while others had limited capital and had only recently registered as broker-dealers. Both "best efforts" and "firm commitment" underwritings were represented. In 15 of the 22 issues, the managing underwriter or persons associated with it acquired an equity interest in the company, either as compensation or in connection with financing the company's activities prior to the public offering.

There also were wide variations in the history of the issues subsequent to the offerings. Four of the issues were eventually listed on a national securities exchange, while 18 have continued to be traded solely over the counter. The premiums which the stocks reached on the first or second day of trading ranged from 5 percent to 150 percent of the offering price. By November 2, 1962, 7 were still above the offering price (1 by more than 100 percent), 1 was at the offering price, 13 were below the offering price (10 by 50 percent or more), and 1 issuer had been merged into another company.

Questionnaire OTC-1 and attached forms were sent to the managing underwriter and each co-underwriter of the 22 issues and to most of the dealers in the selling group, and to almost every broker-dealer who appeared in the National Quotation Bureau daily "sheets" on any one of 4 selected days during the 2-week period following the commencement of each distribution.[19]

Questionnaire OTC-1 was designed to obtain information concerning the process by which the offering was originated, distributed, and traded in the immediate after-market. Among the specific topics covered were the negotiations between issuers and underwriters; the investigation made by underwriters as to the issuers' affairs and the contents of the registration statements; the form and amount of underwriting compensation; the methods of allotting issues to broker-dealers and retail customers; the use of "red herring" and final prospectuses; the use of other written material and publicity in connection with or after the offering; and representation of underwriters on the issuers' boards of directors.

The questionnaire also required recipients to report all transactions in the issue, including any participation in the initial distribution and after-market transactions during the 40-day period following the offering date, whether with customers or other dealers and whether on a principal or agency basis.[20] Recipients were also required to report their transactions at principal until December 20, 1961.

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[19] See app. IV-B.

[20] Under the Securities Act, dealers are required to deliver prospectuses to customers in transactions involving the registered security, except in unsolicited brokerage transactions, during a 40-day period from the commencement of the offering. See subsec. 3.d, below.

The responses to questionnaire OTC-1 for 17 of the issues were reviewed in order to determine whether any broker-dealer that had not received the questionnaire had had a significant number of transactions in the security in the after-market. Such firms received a followup questionnaire[21] requiring them to report their transactions during the 40-day period following the effective date of the issue. Generally these firms did not participate in the distribution; they executed orders primarily on behalf of customers purchasing shares in the after-market, with dealers who were making a market in the security.

Questionnaire OTC-2 was sent to each of the 22 issuers.[22] This questionnaire requested information concerning negotiations between the issuer and the underwriter, the relationship of the issuer to the underwriter, personal transactions by principals of the issuer in its securities, representation of the underwriter on the issuer's board of directors, and other matters. Officers of five of the issues were interviewed in private hearings concerning certain aspects of the distribution and after-market trading.

Another questionnaire was sent to a random cross section of public customers of broker-dealers whose responses indicated substantial purchases by the public at premium prices, asking whether the purchase was solicited, the source of any recommendation to purchase, the nature of any restrictions on resale, and related questions.[23] This questionnaire also was sent to customers whose purchases in the after-market were significantly larger than the average.

At the time of answering questionnaire OTC-1, only 3 of the 15 managing underwriters who had 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 noncash compensation. Each managing underwriter was sent a questionnaire seeking information concerning the disposition, if any, of such compensation and the method of disposition.[24]

In addition, representatives of 26 broker-dealer firms were interviewed in private hearings concerning their activities in connection with those of the 22 offerings in which they were participants, and their general policies and practices as underwriters or selling-group members.[25] Among the topics upon which testimony was taken were underwriters' compensation, due diligence, use of prospectuses, after-market trading, and membership on the boards of directors of issuers. Some of the most active "wholesale" trading houses which made markets in new issues in 1960 and 1961 were questioned on their transactions in the 22 issues and other new issues, and on their general trading activities and practices in the over-the-counter market.[26] Finally, a

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[21] See app. IV-C.
[22] See app. IV-D.
[23] See app. IV-E.
[24] See app. IV-F.
[25] These firms were: Bioren & Co.; Blyth & Co., Inc.; Milton D. Blauner & Co., Inc.: Chace, Whiteside & Winslow, Inc.; Draper, Sears & Co.; Drexel & Co.; George, O'Neill & Co., Inc; Globus, Inc.; Hayden, Stone & Co., Inc.; H. Hentz & Co.; Hill, Thompson & Co., Inc.; Kidder, Peabody & Co.; Michael G. Kletz & Co., Inc.; M. L. Lee & Co., Inc.: Lehman Bros.; Carl M. Loeb, Rhoades & Co.; Maltz, Greenwald & Co.: Manufacturers Securities Corp.; Richard Bruce & Co., Inc.; Ross, Lyon & Co.: Stroud & Co., Inc.; Sutro Bros. & Co.; C. E. Unterberg, Towbin Co.; White, Weld & Co.; William, David & Motti, Inc.: and Thomas Jay, Winston & Co., Inc.
[26] These firms included: Singer, Bean & Mackie, Inc.; Gold. Weissman Co.; New York Hanseatic Corp.; Wm. V. Frankel & Co., Inc.; Troster, Singer & Co.; Siegel & Co.; Gregory & Co; Casper Rogers Co., Inc.: Harold C. Shore & Co., Inc.; May & Gannon.

series of informal interviews was held with other broker-dealers in order to obtain their views on various topics relating to the distribution and aftermarket trading of new issues.[27]

To complete the study of new issues, questionnaire OTC–7 was sent to a random sample of 960 companies whose securities had been offered to the public for the first time in the period from 1952 through early 1962.[28] The purpose of the questionnaire was to obtain information on the postoffering experience of small companies using public financing. The sample, which included both regulation A and fully registered offerings, was limited to companies not subject to the reporting requirements of the Exchange Act,[29] the vast majority of which would have been smaller companies.

Questionnaire OTC–7 asked issuers to state, with respect to their first public offering, the number of shares sold, the date the offering was completed, and the net proceeds received. Information was also sought concerning postoffering mergers, corporate reorganizations, receiverships, liquidations, and dissolutions. The issuers were requested to furnish copies of their most recent financial statements and a brief description of the nature of their primary current activities. Additional steps were taken to ascertain the present status of companies failing to respond within a reasonable time to the questionnaire.[30]

2. ORIGINATION OF NEW ISSUES

a. Issuer's decision to go public

The majority of the 22 issuers that received intensive examination by the special study were medium-sized or small companies which had been in existence for several years. One had been incorporated in 1889, another in 1926, but most were organized during the 1940's and the 1950's. Several of them, prior to issuing stock to the public, were owned wholly or substantially by members of one family. It would appear that these companies constitute a fair cross section of issuers that "went public" during the years 1959 to 1961.

A review of the prospectuses of these issuers reveals that the reason for "going public" in most instances was to obtain funds needed for the issuers' businesses, as distinguished from enabling holders of outstanding shares to dispose of them. Thus Leaseway Transportation Corp. (Leaseway) needed $1 million to augment its working capital and to expand its operations. Shore-Calnevar, Inc. (Shore-Calnevar) was seeking operating capital in order to purchase new manufactur-

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[27] The study frequently quotes the views and opinions of the broker-dealer firms interviewed on the various topics described above. In most instances, these quotations represent the views and opinions not only of the particular firm but of other firms as well.

[28] See app. IV–G.

[29] A systematic selection was made of companies offering securities pursuant to a registration statement or under regulation A. Excluded from the sample were all companies which were listed on an exchange or subject to sec. 15(d) reporting requirements at the time of the offering. Offerings covering employee stock-option and other compensation plans, theatrical ventures, oil and gas interests, investment company shares, nonconvertible debt securities and American Depositary Receipts were also excluded. In the tabulation of the replies to questionnaire OTC–7, offerings in which the proceeds amounted to less than $5,000 were excluded. It is estimated that the resulting sample included 1 out of every 3 companies in the group to be studied.

[30] Questionnaire OTC–7 was remailed to each of such companies, its principals, its counsel at the effective date, and the agent for service of process in its domiciliary state. In addition, letters were sent to the secretary of state of the State of incorporation to determine the company's present corporate status. If this procedure failed to adduce information or if the information was incomplete, telephone calls were placed to the last known address of the company or to affiliated persons to seek information concerning the company.

ing equipment and to increase its inventories. Associated Testing Laboratories, Inc. (Associated Testing) needed $450,000 to expand its operating facilities and research and development program and to conduct an advertising and sales campaign. Geophysics Corp. of America (Geophysics) needed funds for the purchase of laboratory and technical equipment. Others of the 22 issuers decided to "go public" in order to raise funds for similar purposes.

Several of the 22 offerings included outstanding shares of major stockholders. These persons gave various reasons for selling their holdings. In the case of Maryland Cup Corp. (Maryland Cup), the controlling stockholders decided to sell 213,728 shares partly for the purpose of giving employees an opportunity to purchase stock. Members of the family which controlled the Reynolds & Reynolds Co. (Reynolds & Reynolds) offered stock to the public in order to be able to diversify their own investments. In the case of Rocket Jet Engineering Corp. (Rocket Jet), certain stockholders sold stock for estate-planning purposes. In the case of such "secondary" offerings by stockholders, the general receptiveness of the market presumably afforded a favorable opportunity to realize maximum cash proceeds without relinquishing dominant ownership and control.

Other issuers went public for more complex and esoteric reasons. In the case of Quality Importers, Inc. (Quality Importers), an importer of Scotch whisky, competition seems to have been an important factor. According to officers of this company, a competitor had recently gone public and had allocated a number of shares, which had gone to a premium, to its liquor dealers. These dealers favored the competitor's merchandise over that of Quality Importers.

In the case of Hydro-Space Technology, Inc. (Hydro-Space), the issuer was incorporated shortly before the offering for the purpose of acquiring an operating division of Lithium Corp. of America, Inc. (Lithium), which had been operating at a deficit for several years. According to the president of Hydro-Space, representatives of Lithium informed him that the losses of the division were creating too great a burden on the resources of Lithium and that the company could no longer afford to divert its capital into its unprofitable division. Lithium therefore decided to make a public offering of the stock of the company acquiring the assets of its Hydro-Space division.[31]

The desire to initiate stock-option plans may have played a part in several decisions to go public. If the stock had a public market, such plans might be more effective in attracting new talent and compensating management. Seventeen of the 22 issuers instituted stock-option plans shortly before or at the time of their public offerings. A comparison of the number of shares of outstanding stock of some of the issuers with the number of shares subject to option reflects the importance of stock-option plans. For example, Geophysics' stock-option plans covered 143,209 shares, or over 35 percent of its outstanding stock, and Universal Electronics Laboratories Corp's. (Universal Electronics) stock-option plan covered 60,000 shares, or 31 percent of its outstanding stock.[32]

[31] About one-half of the proceeds of the total offering were received by Lithium.

[32] In this connection, it is interesting to note that the New York Stock Exchange suggests to listed companies that stock-option plans cover no more than 5 percent of their outstanding stock.

For a discussion of the Grosset & Dunlap, Inc., stock-option plan in relation to the pricing of that issue, see subsec. c(1), below.

Under the Securities Act, all issuers have the right of free access to the capital markets so long as the requirements of full disclosure are met.[33] Undoubtedly, the right of free access was abused by some issuers, as well as underwriters, during the new-issue phenomenon of recent years.[34] Some issuers having the slimmest chance for survival made public offerings of stock which could be sold by their underwriters only through questionable or clearly illegal techniques. On occasion, major stockholders of hopelessly insolvent companies made public offerings of their shares. Shortly after some of these issues were sold, the issuer filed a petition in bankruptcy.[35]

b. Role of the underwriter

The underwriter plays a particularly important role with respect to new or unseasoned securities. In the first place, under the statutory scheme of free access with full disclosure, the determination of which issues are suitable for public ownership depends primarily upon the underwriter who originates and sells the issue. Secondly, since corporations going public for the first time are unlikely to be well-known to the public and their managements are frequently inexperienced in public finance, the issuer or selling stockholders usually have to rely heavily upon the advice and assistance of the underwriter. Accordingly, consideration of the "hot-issue" market of recent years requires an understanding of the broker-dealer community underwriting new issues, and the degree to which differences among broker-dealers influence the types of securities offered and the distributions undertaken.[36]

For this reason, a statistical study was made of all managing underwriters of unseasoned common stock issues offered to the public in 1961. Included were registered and regulation A issues, and both primary and secondary offerings. A total of 923 such issues were underwritten during the year, managed by 503 different broker-dealers. The characteristics of these managing underwriters were analyzed and related to the various types of offerings in which the firms participated as managers. The results of this analysis are summarized in tables IV-17 to IV-21.

(1) *Characteristics of the underwriter*

To a large extent, broker-dealers who managed the underwriting of unseasoned issues of common stock in 1961 were relative newcomers to the field (table IV-17). More than half (271) of these underwriters had been organized less than 6 years before the offer-

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[33] Unlike the Federal Government, many States impose substantive or qualitative standards on issuers making public offerings.

[34] The statements in this paragraph, and various other statements throughout this chapter, are not necessarily applicable to any or all of the 22 issues.

[35] See sec. 4, below.

[36] The offerings covered in this subsection are the same as in the statistical material contained in pt. A of this chapter, with respect to underwritten common stock of companies issuing securities to the public for the first time. However, in tables IV-9, IV-10, IV-11, IV-12, and IV-13 the apparently larger number of issues covered is due to the following: (*a*) Common stocks offered in combination with preferred stocks or bonds are included in these tables; (*b*) each offering in which stock was sold for the account of both issuer and others than the issue is counted as two issues, while in tables IV-19 to IV-21 such offerings are classified according to the major seller and counted as one issue; and (*c*) tables IV-19 to IV-21 do not include nonunderwritten issues. The fact that directly offered issues are excluded from tables IV-19 to IV-21, but included in table IV-15 (as well as tables IV-9 to IV-14, inclusive), is the reason for the difference in numbers of issues in these tables.

ing, while over one-fourth (146) were formed in either the year preceding or the year in which the offering was made.[37]

The typical underwriting of a new security is a complex undertaking and those responsible for its direction may have to make important financial decisions. Yet many of the new underwriters were managed by individuals who themselves were new to the securities industry. In only about 25 percent of the 271 new broker-dealer firms did a majority of the principals (i.e., partners, officers, or directors) have 5 or more years' experience. When the very new firms that were formed in 1960 or 1961 are considered as a separate group, the lack of background in the securities field becomes even more striking. Of the 146 underwriters in this category, only about 15 percent had a majority of principals with 5 or more years' experience, while in 30 percent all of the principals had less than 2 years' experience.

The more recently created underwriters operated with only modest amounts of capital. Ninety-five (or 35 percent) of the 271 new firms had net capital of less than $10,000 in 1961, and only 1 percent ranked among the relatively big underwriters with net capital of $500,000 or more (table IV-18). This tendency toward smallness is even more manifest among the 146 new firms formed in 1960 or 1961. Sixty-six of these firms (or 45 percent) had net capital of less than $10,000 and none was in the large-sized category. By contrast, one-half of the firms that had been in business before 1956 had net capital of $500,000 or over, while only about 4 percent had less than $10,000.[38]

(2) *Nature of the underwriting*

Despite their small capital and the comparative lack of experience of their principals, broker-dealers that came into existence between 1956 and 1961 succeeded in obtaining 444, or almost half, of the 923 issues first publicly offered in 1961 (table IV-19). Since there was a large number of such firms, each obtained a somewhat smaller average share of the market than the older firms: Each new firm underwrote an average of 1.6 issues, compared with 2.1 issues for each member of the older group. Firms organized in 1960 or 1961 were involved as a group in 204 distributions, or 22 percent of the total, but each of these firms underwrote an average of only 1.4 issues.

This picture of the new firms obtaining relatively less—but nevertheless almost half—of the number of new offerings during 1961 changes sharply when the comparison is made on the basis of the dollar amounts of offerings. As might be expected from their limited capital and experience, the firms organized after 1955 tended to obtain the smaller issues. As a result, they participated in only about 20 percent of the dollar amount of offerings. Each of these firms underwrote an average of $712,000 of issues, compared with $3,555,000 for the older group.

In the typical "firm commitment" distribution, the underwriter must meet the requirements of the net capital rule under the Exchange Act and incurs the financial risks of an unsuccessful offering.[39] The

[37] Of the 25 managing underwriters of the 22 new issues selected for study, 7 were organized less than 6 years before the offering. These firms presented wide variations in size, experience, and business activities.

[38] For a discussion and recommendations concerning proposed minimum capital requirements for broker-dealers, which consider the special circumstances of underwriters, see ch. II.

[39] See rule 15c3-1.

underwriter, however, may contract to sell the issue on a "best efforts" basis, thereby avoiding both the net capital requirement and any danger of loss on the unsold portion of the distribution. In 1961, many of the newer underwriters favored "best efforts" arrangements rather than "firm commitments," even though market conditions were such that issues could be sold quickly. In that year, the newer broker-dealers underwrote about 65 percent (285) of their issues on a "best efforts" basis. By way of contrast, in the same year the older broker-dealers took 85 percent (409) of their underwriting on a "firm commitment" basis.[40]

The difference in the type of underwriting done by the newer and older broker-dealers is shown by the degree to which each group handled issues exempt from full registration under regulation A. Such offerings represented 21 percent of the issues underwritten in 1961 by underwriters organized prior to 1956, 61 percent of those underwritten by underwriters organized from 1956 through 1961, and 67 percent of those underwritten by underwriters organized in 1960 and 1961 (table IV–20). It may be concluded that new underwriters in general tended to handle a relatively large number of small, speculative offerings.

(3) *Efforts of the underwriter to obtain business*

While in many instances the issuer initiated the steps leading to a public offering, in many others the management of companies going public had given little or no thought to it until they were solicited by underwriters or professional "finders."[41] This was particularly true during the years from 1959 to 1961. Of the 22 new issues studied, 5 were brought about through the efforts of the broker-dealer who eventually became the managing underwriter; 2 were brought to the managing underwriter by another broker-dealer who had initially contacted the issuer but had decided the company did not meet its underwriting standards; and 4 were brought to the managing underwriter by professional finders.

Public enthusisam for new issues, as well as their profitability both to firms and to their salesmen, combined to channel much energy of the financial community into the origination of these issues. During the period studied, a number of Wall Street firms managed the underwriting of small companies which probably would not have met their standards in previous years. In most instances, these firms provided vigorous and expanding companies with needed public financing and expert advice. However, on occasion, companies without consistent earnings records and with weak managements enjoyed the sponsorship of well established investment banking firms.

A broker-dealer who was active as a finder in the underwriting of small companies in the applied physics field has testified that prior to 1959, the attitude of investment bankers to whom he brought com-

[40] Of the 22 new issues studied, 6 were underwritten on a "best efforts" basis.

[41] A finder is a person who brings issuers and underwriters together, for compensation, usually paid by the underwriter. The finder may be engaged specifically in this business and earn all or a substantial part of his income in the form of finder's fees, which may consist of a percentage of the underwriter's cash compensation or of options or the right to purchase a portion of the offering at a low price. Other finders are attorneys or accountants whose professional or other contacts with underwriting firms and potential issuers enable them to perform the functions of a finder. Still others are broker-dealers who are unwilling to underwrite an offering which comes to them and instead refer the issuer to another broker-dealer in return for a finder's fee.

panies with irregular or nonexistent earnings was one of "complete disinterest." In 1959, however, a few of the larger firms began to take an interest in underwriting public offerings of small companies which appeared to have possibilities of rapid growth. One of these firms was Hayden, Stone & Co., Inc. (Hayden, Stone), which embarked on a program of finding prospective issuers in the electronics field. An officer of that firm stated that it lowered its previous standards with respect to prior earnings of the companies which it underwrote because—

> * * * one of the philosophies which we have held is that * * * if the free enterprise system is going to survive, that the facilities in Wall Street must be extended to struggling young companies. How else can they get capital as the lifeblood of the creation of jobs? It puts men to work, and without it, there are not going to be jobs.

Another reason why many investment firms let down their standards with regard to the issues which they would underwrite was pressure both from customers, who were eager to purchase newly issued shares of electronics and other "glamor" companies, and from salesmen who were eager for the higher compensation in the sale of such issues.[42] A partner of one of the older New York Stock Exchange member firms stated:

> I would like to say that during the years 1960 and 1961, that my salesmen were continually beset by customers insisting on buying what was known as the hot new issues. These were mostly low price stocks in the scientific field in which they felt they could have a quick profit. In order to keep these customers, and particularly in order to keep my salesmen with the firm, my firm was forced to deal in these cheap, untried issues which normally our investment experience would keep us from having anything to do with. As a result of trying to supply this demand, we have several times found ourselves associated with other houses which we didn't particularly care for as we did not know them well and felt that they were in general inexperienced.[43]

Although several large underwriting firms were willing to manage the offerings of issuers whose size or earnings record was unimpressive, they generally selected such issuers with extreme care. According to an officer of Hayden, Stone, the firm turned down "many, many, many times" the number of companies it agreed to underwrite. Basically, it set its standards in terms of prospective growth.

> You have probably noticed in the last few years we have been identified with small, relatively small issues, smaller companies, usually offering a million or a million and a half dollar class, sometimes even smaller in rare cases. I think the basic thing we are looking for here, and this is strictly from the buying department side now, we are trying to find companies with real growth possibilities. Our basic rule is easy to state, hard to follow. We are looking for companies we feel have a very good chance of being listed on the New York Stock Exchange in 5 years. The amount of profit we make in the underwriting on a million or a million and a half dollar issue is not very great. This is not what we are looking for. We are looking for the long-term association, with companies which we feel will grow and be big companies later on, that we will be very proud to be associated with.

Few of the larger investment banking firms would, however, underwrite public offerings exempted from full registration pursuant to regulation A.[44] Various reasons have been given for this reluctance.

[42] See pt. B of ch. III.

[43] The same partner testified that his salesman received 50 percent of the underwriting discount—a commission considerably higher than that received on other securities transactions by the firm's salesmen.

[44] See sec. 4, below.

A partner of Carl M. Loeb, Rhoades & Co. (Loeb, Rhoades) testified that it would be "a very unusual circumstance" for his firm to participate in a regulation A offering, because it would be difficult to obtain information concerning the company for the firm's customers and because of the limited market for such securities. Other firms cited the high cost in legal, accounting, and printing fees. Still another reason given by one firm was that these offerings are "of questionable reputation." In fact, a number of representatives of underwriting firms expressed the belief that the regulation A exemption should be abolished, either because the limited disclosure required under the exemption failed to give necessary protection or because such offerings were uneconomical. One broker-dealer said:

> I can't really see why a company that needs as small an amount of money as $300,000 has the need for going public.

Nevertheless, several of the larger Wall Street houses managed or participated in the underwriting of regulation A offerings during the years 1959 to 1961. For example, in February 1961 Kidder, Peabody & Co. (Kidder, Peabody) acted as managing underwriter of a new issue of 110,000 shares of the common stock of Filmohm Corp. (Filmohm) at a price of $2.25 per share, pursuant to the regulation A exemption. The gross sales of Filmohm for 1960 had amounted to less than $500,000, falling far short of Kidder, Peabody's normal requirement that issuers have gross sales of approximately $10 million. It is not completely clear why the firm agreed to waive its usual requirements in the case of this "small and essentially undeveloped company." It is worthy of note that Filmohm was in the business of manufacturing electronic components, one of the "glamour" industries which, at the time, particularly attracted public interest.

In order to locate and attract companies in the electronics and other scientific and technical fields which would offer securities to the public for the first time, some of the larger underwriting firms expanded their corporate departments by employing individuals with technical backgrounds. An officer of one large underwriting firm testified:

> [We] had a young associate we employed * * *. He had sensed the glamour and excitement and the really tremendous future possibilities in the electronics field * * *. And I think he would certainly be classified, even at the time we hired him, as a full-fledged expert on the so-called "scientific electronics company." And he had attended all of the shows and he was intimately familiar with the horrifying details of these gadgets and devices, a great deal of which was way over the ordinary layman's head.
>
> And we largely follow[ed] * * * his advice and guidance in this area. He had a very systematic way of working * * *. He not only relied upon his own judgment, but having come to a conclusion, he checked with every company that he thought had any association with the particular problem he was investigating. I could not tell you the number of times we have checked with the procurement people, with the Army Headquarters in Dayton, and we have even gone so far, on occasion—I cannot give you the details—as to hire outside independent appraisers, if you want to call them that, experts in this field.

It was not unusual for persons connected with broker-dealer firms to travel extensively in search of prospective new issuers. These individuals would attend meetings and exhibitions of the Institute of Radio Engineers and other organizations associated with the electronics, engineering, and aerospace industries. For example, the underwriting of Endevco Corp. (Endevco) came about as a result of a

visit by a vice president of White, Weld & Co. (White, Weld) to the annual exposition of the Institute of Environmental Sciences. Impressed by Endevco's products which he saw on display there, he obtained an introduction to its president, with the result that White, Weld became managing underwriter of its public offering.

Some companies with prosaic names were rechristened in order to give the impression, correct or not, that they had some connection with electronics, in much the same way as Hollywood starlets are renamed and glamorized to satisfy the public's craving for romance.[45] Monumental Engineering Corp. became Astrotherm Corp.; North Shore Name Plate Corp. became Anodyne Corp.; Iresco, Inc., became Aero Space Electronics, Inc.; Safety Tower Ladder Co., Inc., which manufactures safety belts and attachments, became Air Space Devices, Inc. A representative of American Orbitronics Corp. told prospective customers, "I'm told the name alone is worth $5 a share in this crazy market."

Some firms used advertising and publicity in order to obtain underwriting business. For example, in January 1961, Edwards & Hanley inserted an advertisement in the New York Herald Tribune,[46] New York World Telegram & Sun,[47] and Long Island Commercial Review,[48] which stated, in part:

> THINKING OF GOING PUBLIC?
>
> Discuss the matter with Edward & Hanley's underwriting department. There are many reasons for firms to arrange a public offering of securities * * * and many advantages. Raising capital for expansion is only one. Prestige is another. In addition, there are estate benefits, incentive for employees, the possibility of other company acquisitions.

Globus, Inc. (Globus) placed advertisements in publications as diverse as the New York Times, Aviation Week, Public Relations Journal, and Electronic News. A Globus advertisement which appeared in the latter publication read:

> Wanted: Inventor or company with meter reading device in need of financial assistance.[49]

The activities of finders were of considerable importance during this period. It was not uncommon for broker-dealer firms to employ professional finders. For example, Sutro Bros. & Co. (Sutro Bros.) employed a finder in 1960 who received a nominal salary of $35 a week plus expenses, with the understanding that he would receive a percentage of the firm's compensation, including any stock or warrants, for any underwritings that he generated. Myron Lomasney & Co. (Lomasney) was the managing underwriter of seven public offerings between February 1961 and May 1962, six of which were brought to the firm by finders. Lomasney employed a professional finder who received a salary of $300 a week and 17½ percent of net underwriting profits, including any stock or warrants.

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[45] That the problem of the use of misleading names is not new can be seen from the opinion of the Commission in a wartime case:

"In addition we consider the name of the new series['National Victory Series'] misleading. The title of the new shares, the statement of 'investment objectives' and the so-called eligible list when considered with the introductory portions of the prospectus, in our opinion, might well have invited the conclusion that the shares of the new series were identified with or that their purchase might in some manner contribute to the war effort." (*National Securities and Research Corporation*, 12 S.E.C. 167, 172 (1942).).

See also *National Educators Mutual Ass'n., Inc.*, 1 S.E.C. 208, 213 (1935)

[46] Jan. 7, 1961.

[47] Jan. 8 1961.

[48] Jan. 25, 1961.

[49] For a further discussion of advertising by broker-dealer firms, see ch. III.B.2.a.

In the offering of 100,000 shares of common stock of Gremar Manufacturing Co., Inc. (Gremar), which took place on December 8, 1960, the issuer approached partners of Hayden, Stone, who decided that the company did not meet its standards with regard to size and net worth. Hayden, Stone referred the issuer to Milton D. Blauner & Co. (Blauner), who became the managing underwriter. A corporation substantially owned by the partners of Hayden, Stone received, for a payment of $5,000, warrants exercisable into 10,000 shares of Gremar common stock at the offering price of $4.25 a share. Globus too collected finder's fees from issuers which it referred to other underwriters because it did not wish to participate in the offering.

Specialists on the American Stock Exchange and over-the-counter trading firms have also acted as finders.[50] Prior to September 1, 1961, it was the policy of the exchange to allocate newly listed securities to specialists who were instrumental in obtaining the listings. It was not uncommon for specialists to spend considerable time and energy to find publicly owned companies and persuade them to list, and to induce privately owned companies to go public with a view to their eventual listing. James F. Rafferty was one specialist particularly active in this respect. From 1958 to 1960 Rafferty was instrumental in bringing several small companies in the electronics field together with underwriters. He received no finder's fees, but eventually became the specialist in the stocks of these companies upon their admission to trading on the American Stock Exchange. Another specialist, Louis Herman, acted as finder in introducing representatives of Arco Electronics, Inc. (Arco), to Michael G. Kletz & Co., Inc. (Kletz). Herman was the specialist in one other stock of which Kletz had been underwriter. Herman not only received shares of Arco stock below the offering price, as a finder's fee, but he also became specialist in the stock when it was listed.

In many instances, the efforts of the underwriting community expended in the origination of new issues resulted in a salutary flow of venture capital into small companies. In other instances the results were less certain. A number of public offerings made during this period appear to have been the result not of any genuine corporate need for funds, but rather of calculations by promoters that a large profit could be made by satisfying investors' demand for new issues. These promoters would in many cases organize the company, provide it with interim financing, find an underwriter (which the promoter frequently controlled), provide an accountant and attorney, hire a public relations firm to promote the offering, and even aid in soliciting sales. For these services the promoter would receive a substantial interest in the issuer's stock, as well as cash compensation.

One such promoter, between August 1960, and October 1962, filed registration statements or notifications under regulation A for 23 companies, many with names redolent of space, electronics, and data processing. All of these companies were incorporated shortly before filing and each had little or no previous earnings.[51] The promoter

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[50] See Securities and Exchange Commission, "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange" (Jan. 3, 1963), pp. 15–16. For a description of the current listing requirements of the American Stock Exchange, see ch. XII.

[51] Of 17 full registration statements filed, 8 became effective, 8 were withdrawn, and 1 was still pending as of December 1962. Of six notifications under regulation A filed, two became effective, three were withdrawn, and one was pending.

arranged for interim financing for each company, provided a law firm and an accountant and received substantial fees as a finder or promoter in cash, stock or options. Of the 10 issues which became effective, 8 are selling below their original offering price and prices for 2 are no longer quoted.

Certain law firms were also active in the packaging of new issues. During 1960 and 1961, one law firm represented 17 issuers which filed notifications under regulation A or registration statements.[52] Through a variety of underwriting, consultant's and finder's fees, legal fees and expenses, and other arrangements, the public moneys brought into these companies through the offerings were substantially siphoned off to persons affiliated with the law firm. Relatives and close friends of partners of the firm in several instances lent issuers money at high rates of interest. A corporation controlled by one partner, for example, lent an electronics company $25,000 for 1 month, for which the corporation received interest payments of $2,500. In three offerings, clients of the law firm received 70 percent of the issuers' stock prior to the public offering. In one instance the underwriting was managed by a broker-dealer firm controlled by a partner of the same law firm. Partners of the law firm solicited orders for the stock of these and other issuers from friends and clients. In other offerings in which the firm represented the issuer, a friend of a partner received fees from the issuer for helping to sell the stock. In two offerings, the firm received $4,000 in undisclosed fees from the underwriter for its efforts.

Of the 11 public offerings in which the law firm was involved, all went to a premium immediately after the offering price. In November 1962, eight of these issues were no longer quoted in the sheets and three were quoted below their offering price.

c. *Terms of the offering*

(1) *Pricing of new issues*

The pricing of new issues involves a double—and sometimes conflicting—role of the underwriter. In the words of a representative of one firm: "We wear two hats * * *. We represent our clients and we represent these companies." Actually there may be three hats because clients include those purchasing at the offering price and those purchasing in the immediate aftermarket. As will be seen, firms which underwrote several of the 22 new issues solicited customers immediately afterward to purchase at substantial premiums over the offering price.[53]

As reported by underwriters and issuers to the Special Study, the offering price of the 22 new issues was based on a variety of criteria, and in most cases was arrived at through negotiations between the issuer and the managing underwriter. In all but a few of the issues, the company's earnings record was said to be a major, if not the determining, test. The price earnings ratio (normally based on the company's last fiscal year prior to the offering date) of 5 of the new issues was below 15, the lowest being 6.9. Eight of the issues had a price-earnings ratio in the range of 15 to 20; and in 6 of the issues it was above 20, the highest being 125. Two of the issuers had no history of earnings, and one had just commenced profitable operations.

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[52] Eleven of the regulation A filings became effective and two were withdrawn. All four registration statements were withdrawn.

[53] See subsec. 3.b(3), below.

Underwriters employed a number of other yardsticks, both in order to arrive at a suitable price-earnings ratio and as an independent method of evaluation. Michael G. Kletz, for example, testified that he prices new issues at a price-earnings ratio of between 10 and 15, and that within these limits the offering price—

> * * * will vary depending on my own appraisal of whether the company is going places, whether the rate of growth is good, whether the product is good and naturally, whether the management is efficient or not and it is subject to negotiation.

Other factors considered by managing underwriters in reaching an evaluation were current sales, ratio between liabilities and assets, growth pattern over the previous 5 years, ability of management, asset value (including estimated good will), future potential, net worth, amount of money needed by the issuer, and the initial offering and market prices of comparable companies in similar fields of business. In the offering of Geophysics, the managing underwriter, C. E. Unterberg, Towbin Co. (Unterberg, Towbin), ignored the company's rather meager earnings in setting the offering price because of its short history of operations (2 years) and the unique character of its business (physical research concerning the atmosphere and environment of the earth, planets, and space). In arriving at an offering price that turned out to be 54 times the earnings of the previous fiscal year, the underwriter took into consideration its assessment of the issuer's personnel and management and its estimate of the issuer's future.

An underwriter has a difficult dilemma in fixing the offering price of a new issue—especially a "glamor" issue—during a period of speculative boom. Several of the underwriters interviewed pointed out that the offering prices they set were often less than the maximum that might have been obtained. In part, such decisions were motivated by a sense of obligation to customers and a desire to give them a bargain. Some underwriters suggested that it would have been improper to try to get as much as the market would bear, where such a price was not justified by any of the usual yardsticks of value. For example, a representative of Unterberg, Towbin said:

> There is no doubt that [for] some of the issues we could have gotten higher prices but I am not sure that would have been the right thing to do.

A representative of Lehman Bros. put it this way:

> * * * In a number of cases we have had a pretty good idea that the market was going to price it higher than our price but that wouldn't mean we were going to sponsor it in a public offering at a price as high as we might even expect.

A related reason for keeping the price below the maximum obtainable was to ensure a successful offering and thus to make the investing public receptive to any future issue which the company might wish to float. It must also be remembered that, in a period of speculative boom, even an "underpriced" new issue may be substantially overpriced in relation to seasoned, publicly traded stocks even while the latter are at unprecedentedly high prices.

In a period characterized by "hot" issues, the interaction of causes and effects may be quite complicated. A "premium" price in the after-market means, of course, that the public offering price was set lower than the market's evaluation, but it is not simply a matter of subtracting one figure from another: The expected or intended pre-

mium itself enters into the determination of both figures and thus in a sense causes and justifies its own existence. The offering price of a new issue may be set by the underwriter with the very intention of producing a premium and generating "hotness," whereas public anticipation of hotness provides the demand that produces the premium. In such a context there is a tendency to equate a "successful" offering with one that goes to a substantial premium in the after-market. Since nothing succeeds like success, whatever premium which comes about as a result of underpricing by the underwriter becomes even larger as the public eagerly seeks and seizes upon premium issues. The psychological significance of a premium in achieving a successful offering in this climate was expressed by one underwriter as follows:

> We believe—and it's just my own personal feeling—that you can offer a stock at 20 and it can go to 35, but you could very well offer that same stock at 28 and it would go to 26.

The pricing of an issue for purposes of a public offering might vary considerably from contemporaneous pricing of the stock made by the issuer for other purposes. In the Grosset & Dunlap offering, Blyth & Co., Inc. (Blyth) priced the issue at $29 although 2 month prior to the offering the issuer's board of directors, according to the prospectus, determined that the "fair market value" of its stock was $13.05 per share for purposes of its stock option plan.[54]

Quite a different kind of problem is presented, of course, where the entire issue is not in fact offered for sale initially at the price stated in the prospectus or offering circular. In these situations, the public offering price and the amount of the offering stated in the prospectus or offering circular are being misrepresented because shares are deliberately withheld from the market until they can be sold at premium "after-market" prices. Despite NASD [55] and Commission [56] prohibitions against such withholding, precisely this occurred in the case of some of the offerings by marginal underwriters during 1959 to 1961. Substantial blocks of shares were sometimes allotted to accounts owned or controlled by the underwriter and selling group members in the expectation of reoffering them to the public at a higher price in the after-market.[57] Under these circumstances, the question of what criteria were used to fix the public offering price as set forth in the prospectus or offering circular became academic.

(2) *The cost of public financing*

The principal cost in going public is the compensation of the underwriter. This subsection discusses underwriters' compensation in connection with the offering of unseasoned common stock issues. For comparative purposes, underwriting costs in connection with the distribution of seasoned issues are also included.

The statistical materials in this subsection were based upon common stock issues registered with the Commission or exempt under regulation A during the years 1949, 1953, 1960 and 1961. The sample ex-

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[54] 111,780 Grosset & Dunlap shares, or about 10 percent of the outstanding shares, were subject to its stock-option plan. Most of the options were exercised prior to the public offering and most of the underlying shares were registered at the time of that offering.

[55] Interpretation with respect to "Free-Riding and Withholding," NASD Manual, G-23.

[56] See, for example, *Lewisohn Copper Corp.*, 38 S.E.C. 226 (1958); Securities Exchange Act release No. 6097 (Oct. 23, 1959).

[57] See subsec. 3.b(2)(f), below.

cluded investment company issues and all issues sold directly without the services of investment bankers, but it included offerings to stockholders.[58] This discussion is based also upon the findings concerning the costs of public financing in connection with the 22 new issues selected for study.

Cash compensation, as used in the statistical tables, refers, in the case of firm commitment underwritings, to the difference or spread between the price paid by the underwriter to the company and the price paid by the public. In the case of "best efforts" underwritings, cash compensation refers to the fee paid, which is usually on a per-unit basis. Finders' fees, if any, are included in cash compensation. Additional cash payments to the underwriter for expenses were included as cash compensation if it could be ascertained that they were paid for selling expenses rather than for the preparation of the issue for registration or qualification. Generally, expenses classified as cash compensation were payable on the basis of the number of shares sold. In the case of the 22 new issues, however, expenses were considered separately from the underwriter's "spread" or discount. To facilitate comparison, compensation has been expressed as a percentage of gross proceeds, i.e., the offering price multiplied by the number of shares covered by the offering.

Items of noncash compensation covered in the statistical tables were restricted to stock and warrants or options to purchase stock. Other benefits that might be considered, such as the preferential right to underwrite future financings of the company or agreements to seat a representative of the underwriter on the company's board of directors, are not covered. If the sole compensation was in noncash form, the issue was included at zero cash compensation. . No evaluation of noncash compensation was made.

It should be emphasized that the cost of underwriting cannot be thought of exclusively in terms of the issuer and the underwriter. Compensation arrangements between issuer and underwriter may also have a serious impact on public investors, particularly where noncash compensation is involved. It is therefore necessary to assess underwriters' compensation in any specific case from the point of view of all three groups: the issuer (or its selling stockholders), the underwriting and selling group, and the investing public.

(a) *Cash compensation.*—An analysis of the cash compensation of the underwriters of the 22 new issues indicates wide variations. In the offering of 436,086 shares of Grosset & Dunlap at a price of $29 per share, the underwriters received $1.60 per share, or 5.5 percent of the total proceeds. At the other end of the scale, both the Cove Vitamin & Pharmaceutical, Inc. (Cove Vitamin) and Universal Electronics offerings involved underwriting spreads of 15 percent of the public offering price.

In general, the amount of cash compensation varied inversely with the size of both the issuer and the underwriter. There is a connection between these two facts. The older and larger underwriting firms are reluctant to handle the smaller, more speculative offerings, and

[58] The inclusion of rights offerings, which usually have low rates of compensation and do not involve the granting of noncash compensation, has a pronounced effect on the averages shown in these statistics, especially for utilities issues.

consequently these fall to the newer and smaller broker-dealer firms. As one representative of an underwriting firm stated:

> I recognize that the small dealer in regulation A is entitled to a higher percentage than in larger deals that come to market.[59]

Of the 8 issues out of the 22 studied amounting to more than $1,000,000, 7 were among the lowest 8 in cash compensation. The managing underwriters of these issues, in all of which cash compensation amounted to less than 9 percent of the offering, were in almost every case large and well established firms.[60]

On the other hand, almost every one of the managing underwriters of the remaining 14 issues was a small firm specializing in small underwritings.

The statistical material showed similar results. For common stock issues of $300,000 or less, mostly regulation A filings, the median rate of cash compensation was about 11 percent in 1949 and 1953 and 15 percent in 1960 and 1961 (table IV–22), while for registered common-stock issues of more than $300,000, the median percentage was about 6 percent in 1949 and 1953 and about 9 percent in 1960 and 1961.[61]

Data on rates of cash compensation paid on seasoned and unseasoned issues were also compiled (table IV–23). Although the rates of the seasoned issues in most instances are lower, the differences are not very wide. It should be noted that seasoned issues were quite infrequent in the smaller-sized groups, so that the averages may not be as representative for seasoned as for unseasoned issues. When the method of underwriting is employed as a criterion, the rate of cash compensation paid in all the size groups was higher for best efforts underwritings than for firm commitment underwritings (table IV–24).

While it is scarcely surprising to discover that it costs more to offer to the public a small, speculative issue than a large and strong one, there are nevertheless certain anomalies in this situation. The weakest companies financially have to carry the heaviest burden; and, looking at it from the other side, the public purchaser pays the highest cost to assume the greatest risk. Moreover, risk to public purchasers is not necessarily correlative to underwriters' risk: Many of the riskiest issues in the former sense involved, in a period of "hot" issues, very little or no risk of the underwriters' capital.

There was a wide variation in rates of cash compensation among issues in different industries (table IV–25). The median rate for registered issues of utilities companies in 1960, for instance, was 4 percent, and in 1961 somewhat less, with few of these issues involving additional noncash payments. Registered issues of manufacturing companies had rates of compensation of about 8 percent in both 1960 and 1961 for those with only cash compensation, while for those with noncash compensation the median rate was 12 percent. Median rates in the extractive group tended to be higher than in any other industry group while the rates for issues of commercial and finance companies,

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[59] It is interesting to note that in the Filmohm offering made pursuant to regulation A the underwriter, Kidder, Peabody, received cash compensation of 6.2 percent of the total offering—considerably less than that of most of the 22 offerings. Kidder, Peabody also received noncash compensation from Filmohm.

[60] The firms were Blyth; Kidder, Peabody; Lehman Bros.; Hayden, Stone; Drexel; White, Weld; Sutro Bros.; H. M. Byllesby & Co.; Grant Brownell & Co. (The latter two firms were co-underwriters of one issue.)

[61] These figures include issues in which there was noncash compensation as well as those in which there was none.

which make up most of the "other" category, followed a pattern similar to manufacturing company issues.

Rates of compensation in issues offered by issuers in 1960 and 1961 were somewhat higher than in those offered by selling stockholders (table IV-26). In regulation A offerings involving cash compensation only, the median rate of compensation in 1960 for primary issues was 15 percent of gross proceeds, compared with 10 percent for secondary issues; in 1961 the figures were 12 and 7 percent. There were too few secondary offerings pursuant to regulation A involving noncash compensation on which to base a comparison. In larger sized issues with cash compensation only, the rates did not differ significantly, being slightly less than 8 percent for secondary issues and slightly more than 8 percent for primary issues. Where there was noncash compensation involved, the rates of cash compensation were substantially higher for primary issues than for secondary issues.

The underwriter's spread often may constitute only a part of the cash compensation which he receives because the amount charged to prepare the issue for registration may be in excess of that required.[62] For example, as one author, in writing on the financing of small manufacturing companies, put it:

> The expenses cover legal and accountant's fees in conjunction with the preparation of the statement for submission to the SEC, printing of the prospectus, registration fees in selected States under their blue-sky laws, and miscellaneous items. It is customary for the underwriting agreement to stipulate a fixed amount for these expenses with the provision that an excess of this allowance over actual expenses is to be regarded as an added commission for the underwriter.[63]

The expenses of the 22 issues, including both those expenses which were borne directly by the issuer and those which were paid to the underwriter but were apart from the underwriting spread as such, varied from 0.86 percent of the total proceeds in the case of the Mother's Cookie Co. (Mother's Cookie) offering to 11.4 percent in the case of Cove Vitamin. In at least 7 of the 22 issues, the underwriter was not accountable to the issuer for the amount paid for expenses.[64] Although a certain proportion of these sums were used to pay expenses of the underwriting that normally would fall on the issuer, it is likely that some of these arrangements contained a good deal of "fat" or added compensation to the underwriter. One broker-dealer testified:

> Now if he [the underwriter] is paying for instance for the printing expenses of the prospectus I think that should be taken out. That is a company expense. If he is paying for blue skying that should come out. But with regard to a blank check * * *. I would say that it definitely was additional compensation.

(b) *Noncash compensation.*[65]—During the years 1959-61, the belief that new issues would go to an immediate premium caused many broker-dealers to seek an equity interest in issuers whose stock they

[62] As noted above, underwriters' selling expenses paid by the issuer were included as cash compensation in the preparation of the statistical material.

[63] Flink, "Equity Financing of Small Manufacturing Companies in New Jersey," p. 103 (1961).

[64] The seven issues were Associated Testing Laboratories, Inc.; Boonton Electronics Corp.; Bristol Dynamics, Inc.; Cove Vitamin & Pharmaceutical, Inc.; Gremar Manufacturing Co., Inc.; Seaboard Electronics Corp.; and Universal Electronics Laboratories Corp.

[65] Included under this heading for convenience, but without intending to prejudice what may sometimes be an open question of fact or law, are certain arrangements which the parties would assert do not amount to "compensation." See below.

underwrote. Thus, it became a common practice for participants in underwritings of new issues to acquire options, warrants, or "cheap stock," either as part of their underwriter's compensation or in connection with interim financing of issuers prior to the offerings. Such equity interests of underwriters and selling group members contained potentialities of control and manipulation of the after-market for the stock, which are discussed below.[66]

More than 40 percent of the registered common-stock issues of over $300,000 in 1961, and 35 percent in 1960, involved noncash compensation. By contrast, in 1953 only 12 percent had noncash compensation, and in 1949 such payments for registered issues were even less frequent (table IV–27). Among offerings of $300,000 or less, chiefly consisting of issues exempt under regulation A, the practice was more frequent. In 1961, 71 percent of these issues carried noncash compensation; in 1960, 46 percent; in 1953, 21 percent; and in 1949, 13 percent.

Arrangements for noncash compensation were more frequent in the flotation of smaller, unseasoned issues than in larger, less speculative issues (table IV–28). In 1960 and 1961, when there was a sharp rise in the number of speculative new issues, such arrangements became quite common. In 1961, noncash compensation was paid in over three-quarters of the unseasoned issues of under $300,000 in size compared with only one-sixth of seasoned issues of the same size category.

Studies of underwriter's compensation conducted by industry self-regulatory bodies similarly revealed a high incidence of noncash compensation. In a survey of 302 issues offered to the public in 1960 and 1961, the NASD found that 201, or approximately 67 percent, included some form of equity compensation. The New York Stock Exchange reviewed proposed offerings of new issues at $15 per share or less in which member firms were to participate as underwriters during 1960, 1961, and the first quarter of 1962. For these three periods, the percentage of proposed offerings in which options or warrants were granted were, respectively, 36 percent, 53.5 percent, and 48.3 percent.

The managing underwriters of 15 of the 22 new issues examined by the Special Study received noncash compensation in addition to the underwriter's spread. All the common forms of equity compensation are represented in these 15 offerings—sales of stock to the underwriter below the offering price, sales or grants of warrants exercisable either below, at or above the offering price, and sales of notes convertible into common stock or warrants upon effectiveness of the registration statements covering the public offerings.

It is not unusual for an underwriting firm to purchase a substantial block of stock from the issuer or the selling stockholders prior to or simultaneous with the offering, at prices significantly below the offering price. In connection with the Arco offering of 170,000 shares at a price of $5 per share, Kletz, who managed the underwriting, purchased 10,000 additional shares at 50 cents per share. In the Gremar offering of 100,000 shares at $4.25 a share, Blauner, the managing underwriter, purchased 7,500 shares for the president and sole stockholder at a price of $1 per share. In 4 others of the 22 new issues,

[66] See subsec. 3.c(2), below.

the managing underwriters purchased cheap stock, which was placed either in account of the firm or principals of the firm and their associates. In all six cases in which cheap stock was purchased, the purchase price was less than 50 percent of the offering price and in two cases it was less than 10 percent.

In 10 of the 22 new issues, the managing underwriter or persons connected with it received warrants or options to purchase stock. The amounts and terms of these warrants varied considerably. In only one instance were the warrants exercisable below the offering price of the stock. This was the Custom Components offering of 165,000 shares at an offering price of $3. In this instance, the principal stockholder of the issuer granted to the managing underwriter, Manufacturers Securities Corp., warrants to purchase up to 16,500 shares at a price of $1 per share. The grant of the warrants was conditional upon a successful offering, 1,000 warrants being granted for every 10,000 shares sold by the underwriter. For these warrants, the underwriter paid 1 mill each, or a total of $16.50.

Although there was only one example among the 22 issues, the granting of warrants to the underwriter exercisable below the offering price was not at all uncommon during 1959–61. For example, in the offering of 150,000 shares of the common stock of Admiral Plastics Corp. on January 11, 1960, at $4, the managing underwriters received options to purchase 10,000 shares at 75 cents per share. Similarly, the managing underwriter of Astrex, Inc., which offered 100,000 shares to the public on September 20, 1960, at $4, received warrants to purchase 12,500 shares at a price of $2.25 per share. The study of underwriters' compensation conducted by the New York Stock Exchange revealed that out of 186 issues in 1960 that were reviewed, 36 (or 19.4 percent) involved warrants exercisable below the offering price, and of the 342 offerings in 1961, 61 (or 17.8 percent) involved warrants of this type. The percentage for the first quarter of 1962 dropped steeply to 1.7 percent.[67]

Doubts as to the propriety of accepting warrants exercisable below the offering price were expressed by some of the larger underwriting firms. For example, Hayden, Stone testified that it never takes options below the offering price, "[so] we can never make money unless our customers make money." A partner of H. Hentz & Co. (Hentz) put it this way:

> Hentz never wants to be in a position of getting something for 10 or 25 cents or a buck that they are selling to the public at $8, $9, or $10. * * *
>
> When we elect to take warrants on a public issue above the market, we automatically know that, unless this company does well * * * these warrants aren't going to be worth the paper they are written on.
>
> We feel, depending on what the case may be, that the compensation should have this potential additional reward, and we don't think anybody is being hurt by that. But I would feel very differently if I were a buyer of a stock on a public issue and I read in the prospectus that I was buying it at 10, and the underwriters had options at 5. To me, this is a big difference because one is predicated on what I have right now in black and white as against what I may or may not have at a later date, depending on the success of the company.

Accordingly, the firm's general policy is not to take warrants except where exercisable at 110 to 125 percent of the public offering price.

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[67] It should be noted that the NASD and the New York Stock Exchange began to examine the reasonableness of underwriters' compensation at about this time. See subsec. 2.c(2)(c), below.

Warrants received by underwriters are usually restricted as to the time of exercise. In some cases, the exercise price is stepped up on an annual basis. For example, warrants which were granted to the underwriters of Cove Vitamin were exercisable at $3.50 during the first year after the offering, $4 during the second year, $4.50 during the third year, and $5 during the fourth and fifth years. In many cases, warrants are not exercisable until 1 year after the offering date and they expire after a given length of time, usually between 3 and 5 years. For example, in the Leaseway offering of 150,000 shares, which became effective on March 2, 1961, warrants to purchase 10,000 shares at the offering price were exercisable on or before January 31, 1966.

It is not unusual for underwriting firms to provide interim financing to issuers prior to their going public and to receive stock or options as part of the financing arrangements. For example, partners of Lehman Bros. testified that in a number of instances the firm made investments in issuers several months before their public offerings and in return, received shares of the issuer's stock, usually at prices above the offering price. In some of these instances no public offering was contemplated at the time that the financing was arranged. One firm stated that these shares are usually taken into the long-term investment accounts of principals in the underwriting firm purchasing them.

Ross, Lyon & Co., Inc. (Ross, Lyon), which acted as managing underwriter of an offering of 60,000 units (60,000 shares and 30,000 warrants) of Boonton Electronics Corp. (Boonton) at $5.50 per share, purchased prior to the offering, for a total consideration of $55,000, a $55,000 face amount 3-percent convertible note and warrants to purchase 5,000 shares of common stock. The note was convertible on the effective date of the offering into 10,000 shares of common stock. In addition, Ross, Lyon and co-underwriter Globus and persons connected with the latter firm purchased 17,500 shares and 17,500 warrants for a total consideration of $19,250. These warrants were exercisable at the offering price of $5.50 during the first year after the offering and at $6.50 during the second year.

In order to understand the significance of these interim financing arrangements, it is necessary to note that tax considerations play an important role. This report is not the proper place for an analysis of the tax consequences of noncash compensation, but it can be said that it is generally to the advantage of an underwriter to establish that any stock or options received from issuers do not constitute compensation for risks assumed or services performed as underwriters, but rather are an investment undertaken by the firm or its principals, unconnected with its underwriting business.[68] Several firms testified that they never take stock or options as compensations, even though they frequently acquire an equity interest in issuers which they underwrite. A partner of Loeb, Rhoades stated:

If we were to negotiate with a company for one reason or another for what we consider a fair price or fair number of options we would be very happy to take them. But we would never get them as compensation, nor was it ever discussed as part of the compensation. * * *

[68] See Fleischer & Meyer, "Tax Treatment of Securities Compensation: Problems of Underwriters," Tax L. Rev., pp. 119–152, November 1960; Israels ed., "SEC Problems of Controlling Stockholders and in Underwritings," pp. 302–309 (1962).

According to a partner of Unterberg, Towbin:

> We have never taken securities as compensation. We have in a number of instances purchased at the offering price to the public securities for our own account and in two instances recently we bought securities quite a bit prior to the public offering at prices below the offering price. In one instance we had not even agreed to do the underwriting.

Another underwriter, when asked whether he considered warrants which he received to have been compensation, stated candidly, "For Securities Act purposes, yes; for income tax purposes, no." [69]

Although underwriting firms usually pay for these warrants, the price paid is often a nominal one. For example, in the offering of 100,000 shares of the common stock of Bristol Dynamics, Inc. (Bristol Dynamics) the managing underwriter, William, David & Motti, Inc., and its officers and employees, purchased 20,000 warrants exercisable at the offering price for 1 mill per warrant, or a total consideration of $20. Some underwriters, however, pay more substantial prices for warrants. A partner of Hayden, Stone stated that the firm pays the "fair value" based on an appraisal by an expert, which on the average amounts to approximately 8 or 9 percent of the exercise price.

The cheap stock or warrants received by underwriters are usually freely transferable. They are sometimes placed in the accounts of participants in the distribution and of others, for their services in arranging or placing the issue. In the Bristol Dynamics offering, a registered representative of the managing underwriter received 5,000 warrants as a finder's fee. In the Filmohm offering two registered representatives in the managing underwriter's syndicate department and a finder each received 4,100 warrants. According to partners of the firm, the registered representatives received the warrants "because of their connection with the deal." These warrants were exercisable for a period of 2 years from the offering date at the offering price of $2.25. In some cases, compensation stock or warrants were transferred to persons, such as traders and registered representatives, having no apparent connection with the distribution of the issue.[70]

Members of the underwriting community explain the acceptance of noncash compensation on several grounds. Principally, they state that the normal underwriter's spread cannot possibly compensate for the varied service which investment banking firms perform on behalf of small growing companies. The chairman of the board of Hayden, Stone put it this way:

> * * * [H]ere you are really extending the investment banking profession into a new area which is providing managerial and financial and even business guidance of small struggling firms during the early years of their development which the original underwriting compensation * * * cannot possibly begin to compensate you. We maintain an organization that I would shudder to figure the cost of. I am sure that if you take the partners' time and the expenses of our corporate organization in Boston and New York and Chicago, that it runs well into the hundreds of thousands of dollars * * * per year.
>
> Now the facilities and the abilities, time, and effort of all these people or any number of them are available for the solution and guidance and assistance of these firms and companies that we do our underwriting. You just can't get out of the initial commission sufficient compensation to permit the maintenance of that kind of establishment.

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[69] It should be noted that under certain circumstances securities received by underwriters as part of interim financing arrangements are required by the Commission to be included in the prospectus and registration statement as "underwriting commissions and discounts."

[70] See subsec. 3.c(2), below.

A partner of Drexel & Co. stated that his firm only rarely takes noncash compensation, and then only in the case of issuers which cannot afford to pay adequate cash compensation, "Where we did not want to take any cash out of the company's till." The argument that noncash compensation is taken as a substitute for cash compensation would be open to question in most situations, however, since the statistical survey shows that the rate of cash compensation for common stock issues in which additional noncash compensation was paid was significantly higher than for those without additional payments. This was true both for issues of under $300,000 and larger issues. The median rate of cash compensation for common stock issues in all industries of over $300,000 in 1960 and 1961 was 8 percent where only cash payments were made, and 12½ percent for those having additional noncash payments. The corresponding percentages in these years for issues of under $300,000 were 12 percent and 17½ percent (table IV-22).

An examination of the compensation arrangements for the 22 new issues shows a similar pattern. Of the nine offerings involving the least cash compensation, only two also included the grant of cheap stock or warrants to the underwriter. Every one of the 13 higher compensated offerings included some form of equity compensation. It would appear that the smaller and more aggressive underwriters which managed offerings in the latter category were demanding as much as the market would bear.

Another reason frequently given by underwriters for receiving cheap stock or warrants is that it is to compensate for risks assumed in the underwriting of issues of smaller and less well established companies. For example, Donald B. Marron testified that while he disapproved of the practice of public relations firms taking stock options as compensation for their services, he did not feel the same way about such compensation to underwriters:

> * * * [W]e are being compensated for taking a risk in underwriting the initial job, whereas I fail to see where the public relations firm is taking a risk.

There is no doubt that issues of small unseasoned companies may involve a greater risk to the underwriter than more substantial, seasoned offerings. Nevertheless, the extent to which an appraisal of the risks determines the existence, or the amount, of noncash compensation is open to question. In the first place, during the new issue market of 1959-61, when offerings of securities in the glamour industries almost invariably went to a premium, the incidence of noncash compensation did not decrease; on the contrary, it was more frequent than in former years. Secondly, in many new issues in which the underwriter received stock or warrants, he assumed no risk at all but arranged to handle the offering on a "best efforts" basis. In fact, noncash compensation was granted more frequently in connection with best-efforts underwritings than with firm commitments, although a large proportion of firmly underwritten issues of less than $1 million carried noncash remuneration in 1960 and 1961 (table IV-29). Six of the twenty-two new issues were best efforts underwritings, and every one of these was among the 15 issuers in which the managing underwriter received noncash compensation.

Several of the underwriting firms interviewed in the course of the study stated that it was their policy not to take noncash compensation. By and large, these were the larger and older firms, which had

comparatively rigorous standards as to the kind of issues which they would handle. For example, a representative of Blyth stated:

> We believe that only companies that might be considered as marginal, either from a size standpoint or the fact that they are still in the promotional stage, may have to resort to giving stock or options as part of the underwriting compensation. We do not underwrite companies of that nature, so that our policy is to take a cash compensation for our [services] without any options.[71]

A partner of White, Weld, another firm which does not take noncash compensation, used these words to explain the firm's policy:

> Well, practically all of the underwritings that we participate in as a manager or otherwise have a cash underwriting discount or spread which is sufficient for the underwriting risk and the distribution expense and compensation to sales people, and that is what the job requires, it is sufficient for the purpose and the management of the company. We have no basis for demanding it nor would the management have any basis for granting it as a general proposition.[72]

Similar views were expressed by other firms.

It is not always easy to measure the cost to the issuer of stock options or cheap stock granted as underwriters' compensation. When the exercise price of options is below the offering price, and the options can be exercised at the time of the offering, the issuer may lose the difference between the offering price and the exercise price, if the underlying shares could have been sold as part of the public offering. Where the underwriter receives options exercisable at or even above the offering price, there may nevertheless be a cost to the issuer, in that the existence of such options may make it more difficult for the issuer to obtain additional financing at a later date.

In any event, it is the investing public rather than the issuer which generally has to bear a large part of the burden of underwriters' compensation. This is so because of the dilutive effect of such compensation. In any given instance, the amount of dilution caused by the grant of stock options will, of course, depend upon the relationship between the number of options granted and the total amount of stock outstanding at the completion of the distribution.

(c) *Controls.*—Registration statements and offering circulars filed with the Commission are required to disclose underwriters' compensation, and many of those filed in recent years indicated that underwriters of new issues were taking very high amounts of compensation. Under its statutory authority the Commission cannot, however, impose any limitation upon levels of compensation though the amounts might be clearly unconscionable. In the absence of regulation by the NASD and the exchanges, control over the level of compensation depended entirely upon State regulation. While this has been vigorous in some States, it has been absent in most, including some with important financial centers.[73]

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[71] Blyth was the managing underwriter of the Grosset & Dunlap offering, which amounted to $12,646,494, by far the largest of the 22 new issues studied. The underwriter's sole compensation consisted of a cash discount totaling 5.5 percent of the offering.

[72] A partner of this firm testified, however, that "there have been instances where we have acquired stock of companies at some stage of the game during the formation of a new company or a situation of that sort but we do not take cheap stock at 10 cents a share or something of that sort as a means of supplementing our cash underwriting or discount."

[73] In this connection, it should be pointed out that through the efforts of the North American Securities Administrators and the Midwest Securities Commissioners Association, a statement of policy has been developed to guide those States having regulatory power over the form or level of underwriters' compensation. See Calvin, "A History of State Securities Regulation of Options and Warrants to Underwriters," The Business Lawyer, pp. 610–640 (April 1962).

The New York Stock Exchange had shown an interest in the subject of underwriters' compensation as early as 1959, and during 1961 its staff conducted studies looking toward the development of an appropriate policy. The NASD in December 1961 announced that a special committee of its board of governors would review all offerings of unseasoned companies to determine whether the underwriting arrangements were fair and consistent with just and equitable principles of trade under its rules of fair practice.[74] No precise standards were announced by the NASD as to what compensation would be considered "unreasonable" or "unconscionable." It would appear that these determinations were to be made on a case-by-case basis.

Simultaneously, the Exchange called the attention of its membership to the NASD statement and cautioned them about the underwriting of low-priced new issues.[75] In the following month, member firms active in underwriting were informed of the standards that would be used by the Exchange in judging the reasonableness of compensation.[76]

It is too early to say whether these measures will be adequate to prevent the abuses prevalent during the past few years. Essentially the matter of underwriters' compensation is one of business ethics, with which the self-regulatory agencies ought to have special concern and the capacity to deal effectively.

d. Preparation for a public offering

(1) *Investigation of the issuer*

In general, the older investment banking houses carefully investigated the 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. These firms would in most cases make a careful check of the issuer before undertaking any commitment. This was done not only for the purpose of insuring that the issuer met the firm's standards but also to perform the "reasonable investigation" required to avoid liability for false statements or omissions to state material facts in the registration statement under section 11 of the Securities Act.[77]

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[74] Letter dated Dec. 26, 1961, from the executive director of the NASD to the members. In further letters, dated June 7, 1962, and Mar. 4, 1963, the executive director requested all members to file copies of registration statements and offering circulars (other than those covering certain debt issues) with the NASD to facilitate review of underwriting arrangements. In the most recent letter on the subject, the NASD has indicated the factors that will be taken into account in determining the reasonableness of compensation.

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

[76] Under its current policy, the Exchange requires a member to justify total underwriting compensation in excess of 20 percent of the aggregate public offering price and may require justification of compensation in excess of 15 percent. These percentage limits include the normal underwriting spread plus all expenses paid to the member. Members are not to receive warrants exercisable below the public offering price. If a member purchases cheap stock in the issuer more than 4 months before the offering and its investment is not less than $25,000, then the stock will not be considered as compensation.

[77] Section 11 of the Securities Act imposes an absolute liability on certain categories of persons, including the underwriter, for material statements or omissions in the registration statement, unless, as to a statement not purporting to be made on the authority of an expert, such persons had, after reasonable investigation, reasonable ground to believe and did believe that the statement was true, and as to a statement made upon the authority of an expert, that they had no reasonable ground to believe and did not believe the statement was untrue. An underwriter willfully violates the antifraud provisions of the Federal securities laws if a prospectus used in the sale of securities contains fraudulent representations. He must "exercise a degree of care reasonable under the circumstances of [the] offering to insure the substantial accuracy of representations made in the prospectus and other sales literature." Reliance on the information furnished by the issuer does not constitute a discharge of this duty; the underwriter should independently take steps to verify the information especially where the issuer seeks funds from the public to finance "a new and speculative venture." (*Charles E. Bailey & Co.*, 35 S.E.C. 33, 41, 42 (1953).) The Commission has recently held that an underwriter by associating himself with a proposed offering, impliedly represents that he has made such an investigation in accordance with professional standards. The underwriter "who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public." (*The Richmond Corp.*, Securities Act release No. 4584 (Feb. 27, 1963)).

Loeb, Rhoades has given the Special Study the following picture of the type of "due diligence" investigation it performs when it manages the underwriting of securities of a company which has not previously had public stockholders. The firm emphasizes that the steps vary from case to case, but expresses the belief that the procedures which it follows are not essentially different from those of "most of the good houses around the Street."

1. Fairly soon after deciding that we would like to look into the matter, we obtain Dun & Bradstreet's and similar investigative material and ask our research department to round up such information as they may have on the company and its principals. We also check the references they may have given us and contact people in banking and other circles who may have come into contact with them.

2. We request complete financial data on the company normally for 5 years and this is very carefully analyzed. We sit down with the accountants who have prepared the financial data and ask them to go over the data with us, particularly items which we do not at first understand. We visit the company's plant. In addition, in appropriate cases such as the financing of a new chemical or similar project we request engineering reports, and similarly, as in the case of a real estate company, we request appraisers' reports. These reports are also reviewed carefully with their authors.

3. Once we decide to go into the deal, exploratory discussions with the company, its lawyers and its accountants preparatory for the drafting of the registration statement are commenced. Most usually, the first draft of the registration statement is prepared by the company and their counsel. This draft is carefully reviewed by us and we and our counsel participate in the preparation of further drafts. This is a process lasting over several weeks. Presentation of the financial data in the prospectus normally varies from the form used in a private company's prior internal reporting so that we again go over with the accountants the financial data in the form in which it is actually to be used in the registration statement to make sure we understand the treament of all items. We also ask the accountants to do as much checking as they can, without an audit, of the unaudited financial data in the registration statement.

4. We, of course, request a good deal of data which cannot be used in selling the securities or made available to retail customers such as information as to the plans of the company, financial and earnings forecast to the extent available, etc.

In addition, a "due diligence" meeting is usually held, at which representatives of the issuer and the managing underwriter and their attorneys and accountants meet with representatives of all the participating underwriters in order to go through the prospectus and to answer any questions about it. According to partners of Lehman Bros., although due diligence meetings are "a complete formality" when securities of well-known companies are being offered, they serve a real purpose in disseminating information about new companies.

Before the closing of the underwriting, the accountant for the issuer makes a final review of the company's affairs and gives the managing underwriter a so-called "cold comfort" letter in which it indicates that no material adverse changes in the company's business have come to the accountant's attention since the date of the audited financial statements included in the registration statement and prospectus.

Some of the newer underwriters that flourished during the period covered by this study performed little or no investigation of the issuers for which they acted as managers. In fact, many of the companies offering stock to the public through such firms had no history of earnings, no plant, no product, and management with no experience in the industry in which the compay claimed to be engaged. In other words, they had nothing but hope. In 1961, for example, Richard

Bruce & Co., Inc., was managing underwriter of a registered offering of 72,200 shares of the common stock of Transition Systems, Inc., at an offering price of $4.50 a share. The product of this company was an "all-purpose correlator," a machine that was supposed to detect cancer and heart disease as well as oil, but there was neither any plant nor a "correlator" in existence at the time of the offering and the company had had no history of sales, earnings, or operations. The managing underwriter testified that his knowledge of the machine was mostly based on hearsay, and he characterized this new issue as "sort of a risk-capital deal."

For a number of reasons, many of the newer underwriters were lax in performing their responsibilities to investigate issuers whose securities they intended to offer to the public. Many of these firms were relatively inexperienced and their principals often unfamiliar with the complex controls governing underwriting. Their capital commitment was usually minimal thus making them judgmentproof with respect to their statutory liabilities and therefore less impressed by the sanctions of section 11.[78]

(2) *The registration process*

The underwriter plays a particularly important role in the registration process for new issues. Many companies going public for the first time during recent years were small companies whose managements, accountants, and lawyers were not familiar with the registration requirements of the Securities Act. For example, the books and records of many of these companies could not readily yield the financial information required by a registration statement. The statute contemplates, as an adjunct to its civil liability provisions, described above, that the underwriter will make a "reasonable investigation" of the issuer and its affairs. This investigation is particularly important in connection with speculative new issues where managements may tend to be overoptimistic about the prospects of the issuer and where their statements about its present financial condition may be self-serving.[79]

The failure of many new and inexperienced underwriters to make reasonable investigations and to ensure that registration statements were properly prepared cast the burden of careful review upon the staff of the Commission. Some issuers filed obviously deficient and inexpertly drafted registration statements in the expectation that the Commision staff would correct them. Failure of the staff to comment or compliance with the staff's comments was then interpreted as absolution for the registration statement. Informal review and comment by the staff, which is not required by statute, became a substitute in many offerings for the careful exercise of the duties imposed upon the issuer and its representatives by the Securities Act to ensure the accuracy and adequacy of the registration statement.[80]

3. THE "HOT" ISSUE

During the years 1959 to 1961 the "hot" issue was a familiar part of the financial scene. Issues that were expected to be "hot" were

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[78] See subsec. 2.b, above. Sec. 15 of the Securities Act, however, extends liability under sec. 11 to "controlling persons" of the underwriter.

[79] See *Charles E. Bailey & Company*, note 77, above.

[80] In some filings, the Commission indicated to issuers filing flagrantly defective registration statements that stop-order proceedings under sec. 8(d) of the Securities Act would be institued unless registration statements were withdrawn.

eagerly sought after by broker-dealers who wished to participate as underwriters or selling group members, by registered representatives who wished to satisfy their customers' demand for shares, and by members of the public.

It was not uncommon for underwriters to receive, prior to the effective date, public "indications of interest" for five times the number of shares available. Indeed, indications of interest received by the managing underwriters alone sometimes exceeded the total amount of the offering.

In each of the 22 issues studied, the managing underwriter, counderwriters, and selected dealers reported a demand for the security at the offering price considerably exceeding the number of shares available for disposition. Even in the larger of the 22 offerings, such as Grosset & Dunlap, Maryland Cup, and Endevco, the demand for the security at the offering price, as reflected by public indications of interest, substantially exceeded the amount offered. Certain underwriters who acquired a reputation for offering "hot" issues were especially deluged with requests for allotments.[81]

Almost without exception, participants in the offering of new issues in significant demand refused to make an allotment to any customer who had not formerly done business with them. One broker-dealer testified that until January 1962 his firm received "a thousand calls on every issue," and all requests for allotments by other than established customers were denied.

Customers who were denied allotments or who were alloted fewer shares than they had requested in their indications of interest sometimes used other methods to obtain shares at the offering price.[82] The files of the Commission contain numerous complaints from public investors who erroneously believe that "first come, first served" was the rule of allocation and who contended that they were unfairly treated because they failed to receive a new-issue allotment. Broker-dealers were similarly besieged with complaints. Some underwriters stated that the difficulty of satisfying customers in their requests for allotments occasionally outweighed the profit or public relations value of participating in a successful distribution, particularly where the distribution of new issues was not a significant factor in the firm's business.

The reported public demand should, however, be evaluated in light of two facts. First, many public customers requested allotments of new issues from one or more broker-dealers in amounts considerably greater than they expected to purchase, in the belief—justified by experience—that the requested allotment would either be reduced or

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[81] One such underwriter testified that for each of his issues he received "a flood of letters" some of which threatened that "we will go down to the SEC" if the underwriter refused to give them an allotment.

[82] In the spring of 1961, one investment advisory service suggested to its subscribers a number of techniques for obtaining new issue allotments:

"* * * many firms and customers' men controlling sizable blocks of new issues treat new accounts, especially *large* new accounts, with special favor—seeking to turn a nice profit for the welcome newcomer right off the bat, thus earning his loyalty and stimulating his hopes for more to come. We are not advocating broker hopping, of course. But a certain amount of sophisticated 'mobility,' or merely an artful hint to that effect (not a threat) dropped with your regular broker if you feel he isn't doing as much for you as he might, can sometimes work wonders." [Emphasis in original.]

The same investment advisory service also suggested that its subscribers might be able to obtain allotments through banks "because they frequently have quid pro quo relationships with underwriters." O-T-C Publishing Co., "Techniques for Purchasing New Stock Issues" (1961).

denied. Thus, the public interest in many issues was probably overstated.

Secondly, the demand for new issues often reflected the desire of customers to buy a security whose price was expected to increase immediately in the aftermarket, rather than to have an investment interest in the particular company. The price experience of certain issues showed that oversubscription often evaporated if the first price quotation disclosed an absence of a premium price. In this connection some underwriters emphasized the importance of an initial premium quotation in the aftermarket to forestall customer cancelations.

a. Price experience of new issues

(1) *Characteristics of trading markets for new issues*

The liklihood that a new issue offered to the public during the years 1959 to 1961 would go to a premium is seen from the statistical material. Of the total of 1,671 unseasoned common stock issues publicly offered during this period for which later prices are available,[83] 1,327 (or 79 percent) sold at a premium immediately after the offering and 1,103 (or 66 percent) sold at a premium 1 month after the offering (tables IV-30 and IV-31). The proportion of issues selling at a premium reached a peak in the year 1961, with 85 percent of the unseasoned common stock issues selling at a premium immediately after the offering, and 68 percent 1 month later. These price changes were rather evenly distributed among underwriters of different sizes. The stocks in which the smaller broker-dealers concentrated did not show any greater tendency to react sharply in the aftermarket, either immediatley or 1 month after offering, than did the issues handled by the more substantial underwriters (table IV-21).

Of 1,121 unseasoned common stock issues offered in 1961 price quotations were not available immediately after offering for 11 percent of the issues registered under the Securities Act and 44 percent of the regulation A issues. Sixty percent of the registered issues for which quotations were not available were under $1 million in size. Among regulation A offerings, also, a larger proportion of issues of the smallest sizes lacked quotations.

Among unseasoned issues, regulation A offering rose to higher premiums than registered issues, not only immediately after the offering but also 1 month later. For registered issues the median percentage rise over the offering price in 1961 was 18 percent immediately after offering and 17 percent 1 month later, while for regulation A issues the figures were 25 percent and 29 percent, respectively. Issues offered by companies themsleves generally were more successful in this respect, both immediately and 1 month after the offering, than secondary distributions.

Stocks of companies in the so-called "selected" industries—those attracting especially great public interest[84] were more likely to go to a premium than other unseasoned issues. For example, in 1961 75 unseasoned issues more than doubled in price immediately after offering. Of these, 45 were in the selected industries, representing 15 percent of all issues in selected industries. On the other hand, only 30

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[83] Quotations were obtained by checking the National Daily Quotation Service (Eastern, Western, and Pacific stock sections), as well as the National Monthly Stock Summary and the semiannual National Stock Summary of the National Quotation Bureau, Inc.

[84] See pt. A of this chapter.

unseasoned issues outside the selected industries more than doubled in price immediately after offering, representing only 6 percent of the issues in nonselected industries.

The median price rise for issues in the selected industries was greater than for all unseasoned issues. This is shown by table IV–a, below:

TABLE IV–a.—*Median ratios of market price to offering price*

	1959	1960	1961
	Immediately after offering		
All unseasoned issues	113.1	112.7	121.0
"Selected" issues only	123.9	122.7	129.3
	1 month after offering		
All unseasoned issues	116.3	111.3	120.5
"Selected" issues only	127.0	126.8	129.6

In 1961 almost all of the new issues of companies in the automatic vending machine, scientific instruments and research, printing and publishing, and aerospace businesses went to immediate premiums (table IV–34). In 1960, while the experience of new issues of these industries as a group was less dramatic, issues of companies in scientific instruments and research and in vending machines were especially successful. In 1959 and 1961, 89 percent, and in 1960, 83 percent, of issues of electronic and electrical equipment manufacturing companies, which formed the largest group of "hot" issues, went to immediate premiums.

(2) *Recent price experience of new securities issued in 1961*

An analysis was made of the market prices of those of the 792 unseasoned common stock issues offered in 1961 for which prices were available at the end of September 1962 (tables IV–35 and IV–36). Such a comparison is complicated by the sharp decline in stock prices over this period. Nevertheless, the data can give an insight into the relative behavior of these unseasoned issues according to the characteristics of the various types included.

Of 1,121 unseasoned common stock issues offered in 1961, price quotations were not available in September 1962 for 12 percent of the issues registered under the Securities Act and 48 percent of the regulation A issues.

As of the end of September 1962, only 22 percent of the issues for which prices were available were selling above their offering prices of 1961. By contrast, 85 percent had sold at a premium immediately after offering. The proportion selling at a premium at the end of September was lower for regulation A issues than for registered, and for issues in the selected "hot" industries than for issues in other industries. These groups, which showed the poorest performance, showed the largest rises immediately after offering. Only 11 percent of regulation A issues in the selected industries—the group with largest initial rises—were above their offering price in September, compared with 92 percent immediately after offering. For the group with the smallest rises, registered issues not in selected industries, the comparable figures were 30 and 82 percent, respectively.

The recent price behavior of those issues which showed the most dramatic rises immediately after offering was also examined. Of the issues which more than doubled in price immediately after offering, almost two-thirds were selling below their offering price at the end of September 1962. More than 80 percent of regulation A issues in selected industries initially selling at more than double the offering price were below the offering price by September 1962. These declines can be compared with average stock market prices, which fell about 22 percent from their peaks in 1961 to September 1962.

It is also interesting to note the price declines of the unseasoned issues in the various categories during the period since offering. The median unseasoned stock issue was selling at 40 percent less than offering price at the end of September 1962. The largest declines were experienced by regulation A issues and issues in the selected industries. The median regulation A issue in the selected industries was 62 percent below the offering price. At the other extreme, the median decline for registered issues in nonselected industries was 26 percent. These might be compared with a drop of 16 percent from average 1961 prices and the previously mentioned 22 percent from the high as shown by the SEC stock price index.

A survey was also made of later price experience of the 22 new issues which received intensive anlaysis by the Special Study. All of these offerings sold at premium prices immediately after offering. At the end of September 1962, 8 were above the offering price, while 13 were below. One issuer had been merged into a larger company.[85]

b. Causes of the premium

(1) *Role of the trading firm*

The premium which made a new issue "hot" was reflected primarily in the bids and offers entered in the "sheets" of the National Quotation Bureau by firms making a market in the issue.[86] Markets may be made by the managing underwriter or other participants in the original distribution, by firms specializing in the trading of over-the-counter securities, or by retail firms having trading departments which make markets for such securities.[87]

Trading and retailing activity in a new issue by firms not participating in the distribution may begin immediately after effectiveness of the registration statement or clearance of the regulation A filing. Similar activities by underwriters and selling group members are subject to the prohibitions of the rules of the Commission relating to trading practices prior to and during a distribution, and to the restrictions on such activities in the agreement among underwriters or among the selling group.[88] Trading firms, including firms that have

[85] Each of the profiles of the 22 issues in app. A contains a price chart from the offering date to a date in 1962.

[86] For a discussion of the "sheets," see ch. VII.

[87] In this discussion, broker-dealers who hold themselves out with respect to a particular security as being willing to buy or sell to other broker-dealers are referred to as "trading firms." For a further discussion of professional trading in the over-the-counter markets, see ch. VII.

[88] For a discussion of particular problems arising from the activities of the managing underwriter in the after-market, see sec. 3.c, below. Rules 10b–6, 10b–7, and 10b–8 of the Commission govern trading activities prior to and during a distribution. 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 may bid for or purchase securities of the same class and series, subject to various exceptions for specified types of transactions not deemed to be of a manipulative nature. Stabilizing transactions effected in accordance with rules 10b–7 and 10b–8 are exceptions from the basic prohibitions of rule 10b–6.

completed the distribution of their participations, may be making a market in an issue before some customers have been advised of their allotments. This commingling of distribution and after-market may allow customers to decide whether to accept or cancel an allotment of a new issue on the basis of the quotations made by trading firms, and thus may contribute to the "hotness" of issues already in demand by the public.[89] Several broker-dealers indicated to the Special Study that they would favor a compulsory delay of trading activities for a short time after effectiveness.

The trading markets described in this study of new issues were unusual in that these markets were buoyed by an intense public demand which appeared both prior to and after the offering date. A description of over-the-counter trading markets functioning under more normal conditions is set forth in chapter VII.

In 9 of the 22 issues studied, the managing underwriter maintained a trading market for the issue; in all of the issues, trading firms did so at one time or another. In most issues, trading interest was concentrated in the immediate after-market, when public customers were placing purchase orders at premium prices or when there was an expectation of activity at the retail level.[90] For example, 28 firms appeared in the sheets indicating an interest in Quality Importers stock on the second day of trading, with bids almost double the offering price.[91] On November 2, 1962, when the price had declined to about the offering price, only eight trading firms appeared in the sheets, of which five had appeared on the second day of trading. In the case of Rocket Jet, 12 trading firms appeared in the sheets on the second day of trading, at an average price of 10—twice the offering price. By November 1962, only five trading firms were entering quotations for this issue, which was selling at approximately its original offering price.

The trading firm enters the after-market as a speculator and feels no obligation to maintain a fair and orderly market in the security it trades or to continue trading if it should decide that it is no longer profitable to do so. Most traders indicated that it was the volume of expected activity which made an issue an attractive trading vehicle. The trader expects activity to come from retail houses; when that activity falls off, he loses interest and may discontinue trading. The trader hopes and expects that retail houses having buy-and-sell orders for the security will execute them with him and permit him to make a profit of ⅛s and ¼s on high volume.

For all practical purposes, the prices quoted by trading firms are the market since these prices form the basis for retail quotations given to public customers.[92] Ideally, they are based on public demand and supply for the security. Wholesale traders stated that they follow the public market and that their quotations reflect that market, or rather, their own best judgment of the market—a judgment which

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[89] There is some disagreement among members of the industry whether a customer initially receiving a statutory prospectus with his confirmation may cancel the transaction thereafter. In practice most firms allow customers to cancel.

[90] See ch. VII.

[91] The number of firms making markets on the 2d day of trading was used instead of the 1st day, since in many instances the registration statement of the issue under study became effective late in the day. The 2d day of trading would therefore more accurately reflect initial trading markets being made.

[92] See the discussion of quotation systems in ch. VII.

might be incorrect because of inability to know the full extent of demand and supply.

The trader can make an educated guess as to the approximate range of demand and supply, based on information made available by participants in the distribution and other broker-dealers. He arrives at his first quotation by evaluating such factors as indications of interest at the offering price, the extent of which may be made known to him by participants in the distribution; orders or indications of interest held by broker-dealers, including participants in the distribution, for purchases in the after-market; and expected solicitation of retail customers.

One trader said that he received information to arrive at the opening quotations—

> * * * from other dealers in the Street, other brokers call us up about XYZ stock going over with a bang and they say to let us know as soon as we hear anything, they have got an order and they will pay up to 25 or 26. * * *
>
> The orders come from the customers through the dealers, not through the managing underwriter * * * [from] another retail house. The public customer is maybe Merrill Lynch's customer and Merrill Lynch calls us up and says, "We are going to be interested in this stock; let me know, I think I have customers who will pay up to 25 or 26."
>
> * * * The information he [the trader] gets can be totally wrong. You can make a market at 25 or 26 and * * * you buy the stock at 25 and then it goes to 24 and 23 and so all the way down * * *. But from the available information he thought the market should have been 25; it can be wrong. * * *

Another trader put it this way:

> We have private wires to various stock exchange firms, and about a week or 2 weeks—an issue will be about to be released for registration, and how these fellows know, I don't know—but we would receive a call in the office, "If you intend to trade so-and-so and so-and-so, we will be buyers." We write it down and make a notation of it. Sure enough, the stock comes out and we are in making a market.
>
> We don't even know the market yet, but we call this particular stock exchange firm and ask them whether they are still interested in it, and 9 out of 10 times they say yes.
>
> They say, "If the stock opens up at 2 points above, buy some stock for us."
>
> "How much?"
>
> "Five hundred shares."
>
> We decide to trade some stock.

One of the largest trading firms, Singer, Bean & Mackie, Inc., gave the following picture of how the firm arrives at its initial quotation for a new issue:

> If we decide to trade a new issue which is coming on the market, we will, on occasion, inquire of other broker-dealers as to whether they intend to trade the stock and as to the price at which they believe the stock can be traded. We will also receive inquiries from other broker-dealers as to whether we will be handling the stock and these broker-dealers may give us an indication as to the price at which they would be willing to purchase the stock once it is on the market. We may also call some of the firms that will be participating in the stock issue and attempt to obtain information from them as to indications received by them of the public's interest in the new issue.

Several traders emphasized that their opening quotations were based upon orders—principally buy orders—transmitted to them by retail firms prior to the effective date. These orders were usually orders or indications of interest from customers of retail firms to purchase in the after-market at the prevailing premium price or at a limit above the offering price. Traders and customers both stated that prior to the

effective date retail firms received buy orders or indications of interest from customers to purchase new issues at premium prices in the after-market and that these orders were then transmitted to trading firms for execution in the after-market.[93]

For the trading firm, buying power may be easier to assess than selling pressure. Since the trading firm may be making a market before many of the original distributees know they have an allotment, before the managing underwriter receives notices from the selling-group members that all shares have been allotted and payment received, and before the underwriting closing at which the proceeds are delivered to the company or selling shareholders and the underwriter receives certificates for delivery to customers, the trader's knowledge of selling pressure cannot be said to reflect accurately the potential supply at the premium or any other price.[94]

One of the 22 offerings studied provides an example of trading firms participating in a redistribution of shares in the after-market. The offering is described in some detail because it helps to illustrate a number of other points relating to the new issue phenomenon:

The underwriter for the Custom Components offering was Manufacturers Securities Corp., a firm controlled by James E. Zoes, a finder who had no previous experience in the securities business. Failing to find a firm willing to underwrite the issue, Zoes decided to do so himself. Manufacturers Securities Corp. had no retail customers or trading department.

Bioren & Co. (Bioren), upon the suggestion of one of its salesmen, became the largest co-underwriter without anyone from its syndicate department either visiting the premises of the issuer or talking to any of its officials. Draper, Sears & Co. (Draper, Sears) and Chace, Whiteside & Winslow, Inc., also became co-underwriters, though they too neither met the officials of Custom Components nor inspected its premises. The fourth co-underwriter, Wm. Stix Wasserman & Co., Inc., participated in the offering, according to its principal, because "two reputable houses" were associated with it and presumably had thoroughly investigated the issuer.[95]

Prior to the effective date, Zoes visited a number of retail and trading firms in order to interest them in stimulating "after-market activity." Salesmen of Sutro Bros. and Model, Roland & Co. were persuaded to solicit customers to purchase Custom Components stock in the after-market. After being told by Bioren that it would not trade the stock in the after-market, Zoes went to Gregory & Sons, the wire correspondent for both Bioren and Draper, Sears, who indicated an interest in trading the stock. According to Zoes, Gregory & Sons stated that if they "like an issue, usually Singer, Bean & Mackie gen-

[93] By accepting market or limit orders under the circumstances described above, broker-dealers may be violating sec. 5 of the Securities Act if they enter into contracts to sell a security prior to the effective date of the registration statement. Also, if broker-dealers are prospective underwriters or have agreed to participate in the distribution, they may, by soliciting such orders, be attempting to induce customers to purchase the security prior to completion of the distribution and thereby violate rule 10b–6 under the Exchange Act.

[94] If the trading firm is also the underwriter of the issue, control over notification of allotments to customers and delivery of stock certificates may give, the trading firm greater ability to assess the potential supply. See sec. 3b(2), below.

[95] Of the 165,000-share offering, Bioren & Co. was allotted 50,000 shares; Wm. Stix Wasserman & Co., Inc., 20.000 shares; Draper, Sears, 7.500 shares; and Chace, Whiteside & Winslow, Inc., 10,000 shares. The managing underwriter retained 77,500 shares for distribution.

erally goes along." [96] Zoes also visited May & Gannon, a Boston trading firm, which agreed to make an after-market and 5,000 shares were allotted to designees of May & Gannon at the public offering price. May & Gannon placed these shares in the accounts of insiders of the firm and of registered representatives of other firms in the Boston area.[97] Another trading firm, Vilas & Hickey, was allotted 1,500 shares in order to encourage that firm to trade the stock.[98]

The Custom Components registration statement covering 165,000 shares at an offering price of $3 became effective on April 20, 1961. Gregory & Sons and another trading firm appeared in the sheets on the same day with bids of 6 and offers of 8. On April 21, May & Gannon began to appear in the sheets. On May 1, 1961, Custom Components reached its high, with a high bid of 9¾.

During the period from April 20 through May 18, 1961, 39,240 shares of Custom Components stock passed from accounts at the underwriters and trading firms holding stock acquired at the public offering price, to retail customers who were in most instances being solicited to buy the security at premium prices. Bioren & Co. accounts sold 30,625 shares, Wasserman's personal accounts 2,500 shares, Draper, Sears accounts 4,305 shares, May & Gannon accounts 1,160 shares, and Vilas & Hickey accounts 650 shares. Most of these shares were funneled through Gregory & Sons, which was the firm most active in trading the stock, to Singer, Bean & Mackie and then on to Sutro Bros. and Model, Roland & Co., who were soliciting their customers to buy at premium prices in the after-market.[99]

Investigations by the Commission staff of several small regulation A issues showed a similar pattern but in more extreme form. For example, in one such offering, the underwriter, a trader at another firm (who had an undisclosed one-half interest in the underwriter), and the issuer allotted all the shares of a regulation A offering to about 300 individuals, most of whom were relatives, friends, and associates of the persons interested in the distribution, with the intention of reoffering these shares at premium prices in the after-market.[100] The regulation A offering bore a public offering price of $6. Trading activity immediately developed in the stock at prices ranging from $17 to $22.50 a share with the trader being the most active participant and the underwriter developing retail activity by telling investors, among other things, that no shares were available at the public offering price of $6. Persons acquiring shares at $6 made substantial sales in the after-market at premium prices.

(2) *Factors limiting supply*

The present study reveals various practices on the part of participants in distributions of new issues that tended to reduce the available supply of stock in the immediate after-market. The number of shares offered in many new issues was relatively small, and it was further re-

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[96] Sutro Bros. and Model, Roland & Co. were wire correspondents of Singer, Bean & Mackie.

[97] See subsec. 3.b(2)(f), below.

[98] The allocation of stock of a new issue to trading firms in the expectation that they will make a market in the stock may be in violation of the "free-riding and withholding" rules of the NASD, and of the securities laws and rules thereunder. See sec. 3.b(2)(f)ii, below; Securities Exchange Act release No. 6097 (Oct. 29, 1959).

[99] For a further discussion of the Custom Components offering, see subsec. 3.b(3)(b), below.

[100] See *Lewis Wolf, Inc.*, Securities Exchange Act release No. 6949 (Nov. 21, 1962).

duced in many instances by selecting customers who were expected to retain their allotments by placing allotments in discretionary accounts, by failing to notify customers that they had been allotted stock, by failing to deliver certificates and by withholding stock from the market. Some of these practices were quite legitimate, others questionable, and still others manipulative. These restrictions on supply, when combined with stimulation of after-market demand,[101] helped produce some of the exaggerated price movements of "hot" issues.

(a) *Choice of customers.*—Most underwriters stated that in making allotments to customers they attempted to place stock where long-term investment was likely. Thus, representatives of several large investment banking firms stated that such a policy was in the best interests of the issuer and of other stockholders. They expressed the view that customers should retain their stock until, in the words of one underwriter, "such time as clearly valid circumstances lead them to sell their stock." A premium price was not considered a circumstance to justify resale.

Hayden, Stone expressed its position in terms of the overall function of the investment banking industry:

> * * * It begins with the absolute necessity in the investment banking business, if it is to survive and continue as it is presently practiced, of selling these new issues to people who have been persuaded that they are attractive at the price they are offered and that they are good investments not for days or weeks or months but for years.
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> * * * * * * *
>
> And all you have to do, I think, is to visualize what kind of chaos we might have by picturing a situation in which as many as 30, 40, 50, or 60 percent of the people who buy new issues might suddenly want to turn around and dump them or sell them.
>
> Raising capital for American industry is a job that must go on, and it can go on only on the basis of attracting long-term commitments from people who have money to [invest in] these securities.

White, Weld expressed a similar view:

> * * * People think that they can buy something today and sell it tomorrow but we do relatively little of that. Most of our customers, by far the biggest majority of them, are cash customers. They are a general investment clientele, varying from widows to businessmen that can afford to take the variety of merchandise and are interested in the variety of merchandise that comes along.
>
> * * * * * * *
>
> * * * We discourage margin accounts. We deal with people for the most part who have long-term investment accounts as distinguished from customers who are the type that walks in off the street, sits down in your board room and tries to pick up several points by buying a stock that looks cheap to him today and which he can sell out a week or 2 weeks or a month later. We discourage that kind of business; our offices are not set up to handle it.

Underwriters agreed that customers who sell their allotments in the immediate after-market are to be avoided. One underwriter stated: "With respect to my personal feelings, I detest free riders."

Certain underwriters had only a small group of customers who participated in each underwriting of the firm. This hard core of clients provided the underwriter with a ready means of distribution as well as an assurance that resale would be circumscribed, particularly if the allotting firm had no facilities for execution of orders. New issues were allotted to customers who were known to principals of the firm and whose investment decisions were often strongly influenced by their

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[101] See sec. 3.b(3), below.

recommendations. For example, Milton D. Blauner, who was an underwriter of 34 new issues during the past 4 years, testified that the only customers who received allotments from him were a group of about 60 persons. He stated that he had no other accounts except those of this small group and that he would not accept accounts for customers who "were to walk in off the street."

Michael G. Kletz conducted his underwriting activities in much the same manner as Blauner. Since 1959, the firm has underwritten 34 new issues, most of which quickly rose to substantial premiums. Kletz employs no salesmen or traders, and he is assisted only by a limited clerical and secretarial staff. The firm has never had more than 200 to 250 customers, most of whom participated in each of its underwritings. Kletz testified:

> * * * My reputation for constancy is good. People get practically the same [number of shares of new issues]. Unless they don't want it, they get the same amount day in and day out.

Kletz indicated that his customers "don't have to" request allotments of forthcoming new issues. Apparently Kletz has discretion in this regard. A partner of Unterberg, Towbin, the managing underwriter of the Geophysics offering, stated that the firm insures that there will be little selling by the public in the immediate after-market by "placing" the shares "with sophisticated buyers who were intrigued with the potential of the company and wished to maintain their position." He also testified that customers who inquired about the stock a week or 2 after the offering date, when the stock was selling at a substantial premium, were advised not to sell.[102]

(b) *Discretionary accounts.*—In several instances, underwriters allotted shares of new issues to discretionary accounts. By this practice, they could, in certain instances, retain continuing control over the after-market. For example, Morton Globus estimated that at least 50 percent of the accounts which received allotments of the new issues that his firm underwrote were discretionary accounts: i.e., accounts in which the customer did not give an explicit indication to buy the stock prior to receiving the confirmation reflecting his purchase.[103] According to Globus, these so-called "house accounts" normally found out that they had purchased a new issue only upon receipt of the confirmation and prospectus.

Globus has testified that the firm practically never sold out a house account during the first week of the offering. Globus' salesmen apparently had discretion not only over purchases of new issues but also over sales from customer accounts. One Globus salesman who was examined by the NASD indicated that 75 percent of his accounts were discretionary both as to purchase and sales. Since the firm did not notify discretionary accounts of their allotments until 2 to 3

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[102] Another underwriter testified as follows:
"I think it is up to the partners—they got their stock—just to tell the public, this is a good stock and you hold it. If you know your customers, you tell a man in a decent way and you say, now, come one, you have a profit; now wait a little while. Give the company a chance, for goodness sake."

[103] Shortly before Globus testified before the Special Study, the Commission had raised a question in connection with the proposed use of discretionary accounts by Globus in an offering of Oceanic Instruments, Inc. The Commission questioned how the delivery of prospectus requirements of the Securities Act could be complied with in connection with discretionary accounts since Globus had indicated that a substantial portion of the offering would be placed in these accounts by his salesmen. Globus indicated that in lieu of distribution of the amended preliminary prospectus to such customers, copies of the definitive prospectuses would be mailed to them after the effective date and at least before confirmation of sales was forwarded to them.

days after the effective date of the registration statement, customers were effectively prevented from selling their shares during this period. Meanwhile, trading firms were quoting markets, at premium prices, for Globus issues, based upon an inadequate estimate of "demand and supply."

(c) *Restrictions on resale.*—Another practice common among underwriters which had the effect of limiting supply of stock in the after-market was the imposition of penalties on salesmen or customers if allotments of new issues were sold within a stated period after the offering date.[104] For example, Hayden, Stone stated that it has a policy of depriving salesmen of their commissions if resales by customers occur within 30 days of the effective date unless the firm specifically shortens the period.[105] Although White, Weld does not have a formal policy, its salesmen are discouraged from permitting resales:

> We would tell the salesman that if this mistake (resale by a customer) or what have you, were continued and done on a regular basis that he would no longer be distributing securities for us.

Some firms place restrictions not upon the salesman but upon the customer. Firms "flagged" or identified customers who sold stock in the immediate after-market by reviewing the transfer sheets; those who sold were unlikely to receive allotments of subsequent oversubscribed issues. A representative of Blyth testified that the firm keeps records for each customer receiving allotments of new issues, which are reviewed to determine whether there have been resales through the firm within the period immediately after the date of offering. Customers found to have resold their allotments "within a relatively short period" are not considered to be "investors." Presumably these customers would not be able to obtain allotments of subsequent underwritings of the firm.

Some firms stated that they "required" or requested that customers "hold for capital gains"; others adopted a policy of refusing to accept sell orders until 1 day after settlement date, or until the syndicate was closed, whichever was later. William, David & Motti, Inc., refused to execute customer "sell" orders during the first 10 days after the effective date of registration statements covering new issues which it managed. Granberry, Marache & Co. would not sell any premium issue for a 30-day period for any of its accounts which had purchased the issue in the original underwriting. Jaffe, Lewis & Co. informed the study that its customers know "if they ever take a quick ride on any

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[104] In some offerings, co-underwriters agree to lose the commission on any shares which the managing underwriter has to repurchase in stabilizing operations.

[105] In its reply to questionaire OTC–1 covering its participation in the offering of Leaseway stock, Hayden, Stone stated:

"For approximately 12 years it has been the policy of Hayden, Stone & Co., Inc., to cancel the commission of any Hayden, Stone salesman on securities sold by such salesman which are resold through Hayden, Stone & Co., Inc., within 30 days following the date of public offering, or such earlier date as such restriction may be terminated. This rule applies with equal force to securities resold through Hayden, Stone & Co., Inc., within the period at prices below the issue price or above the issue price. There have been circumstances of issues selling at substantial premiums when the rule has been suspended within a week or 10 days of the offering date.

"[In the Leaseway offering], no commissions were required under this rule to be so canceled, although special exemption from the rule was granted in a few cases with extenuating circumstances.

"The application of this rule to Leaseway common stock was suspended March 15, 1960, 12 days after the offering."

Leaseway was offered at $15 per share and on the first day of trading sold as high as $26½ per share. Twelve days after the offering, Leaseway was selling at $28 per share.

underwriting, that we could not favor them again." And Mitchum, Jones & Templeton advised its trading department not to accept a sell order on any stock underwritten by the firm until the syndicate delivery date. Similarly, Ferris & Co. stated:

When it became known that the issue would be one of the so-called "hot" ones, all representatives were advised at our sales meeting that the stock should be placed with customers who would hold it and not to solicit sales for a quick profit. They were also advised that unsolicited orders for sales should not be executed until after the stock had been paid for by the purchaser.

Broker-dealer firms communicated these attitudes to customers. The Special Study sent a questionnaire to a random cross section of customers purchasing new issues, asking whether they were advised by their broker not to sell the new issue immediately or for any specific period of time. Some customers stated that they were told not to sell for varying periods, usually 30 or 60 days;[106] others, that the regulations of the Commission or the syndicate agreement prohibited immediate resale; others, that resales were contrary to the policy of the firm against "free riding";[107] still others, that selling in the after-market would break the premium price[108] or that if they sold, they would receive no future allotments of issues.[109]

(d) *Delay in notification.*—Delay in notifying customers that they had received allotments of new issues also had the effect of restricting supply in the after-market. Customers who did not know that they owned a security could not sell their shares. Most firms stated that customers were usually advised of their allotments within 24 hours or at the most 48 hours after the effective date. Nevertheless, some customers were not so advised until several days and, in some instances, several weeks after effectiveness.

In the Mallory Randall offering of 120,000 shares, Johnson, Lane, Space Corp. (Johnson, Lane, Space) received an allotment of 2,000 shares, which were confirmed out to customers over a 3-week period after the effective date of the registration statement. Before customers learned that they had received allotments at the public offering price of 6, the stock was being quoted in the after-market with bids from 9½ to 10. Again, in the 80,000-share Seaboard Electronics offering, Johnson, Lane, Space received an allotment of 3,000 shares,

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[106] For example:

"In some instances had advised me that they could not be traded until they are 'out of syndicate.' This was normally only for a day or two after the issue date."

"No market made by broker for 30 days."

"I was advised by a salesman for ——— that it was a requirement for the new issues purchased by me must be held 7 days before they could be sold."

"He said that he promised the underwriting group that any shares he sold of ——— would not be sold for at least 30 days."

"I understand it was a rule of the exchange to not sell for 60 days on new issues."

[107] For example:

"Because of some SEC regulation forbidding the sale within a few days."

"SEC regulations require new issues be placed in investment type accounts—consequently, should not sell immediately."

"So as not to give the appearance that I am free riding, they suggested that I hold new issues at least 4 days."

[108] For example:

"I was advised by ——— not to sell the stock as they were sure that the price of the stock would go up."

"* * * broker stated that I could not sell his new issues until he suggested, otherwise prices could not be maintained."

"To give market a chance to stabilize and offset short-term speculators."

[109] For example:

"I was told that if I did not sell any new issue within 1 month, I would not be offered any other new issues."

"If the issue was sold before a 3-week period you may be refused shares of any further new issues."

"Not 'cricket' in view of the fact that I was one of those fortunate enough to get some shares of the new issue and also against their 'investment' policy."