

MEMORANDUM

October 30, 1961

TO: Staff Attorneys  
FROM: Eugene H. Rotberg and Frederick Moss [also signed by hand]  
RE: Proposed Inquiry: "Hot Issues"

The principal factual question which must be determined in the study of distribution and trading of new issues is whether the price quotations in the after market following the initial public distribution of the security, is a reflection of a "bona fide" public demand in appreciable volume at the premium price. Stated in another way, the question posed is whether the quoted price in the after market is a reflection of "artificial" activities which either maintain or create the premium price. These formulations are not mutually exclusive nor are they necessarily opposites without more precise definition of the words "bona fide", "demand", "artificial", "maintained", etc. The questions are posed merely as a starting point to assist in the evaluation of the documents and records which will soon be forthcoming. The following points should be carefully considered in your review of the materials which will be supplied pursuant to our questionnaire:

1. Is the after market a dealers market or is it a public customers market? We must determine whether the after market transactions are those between and among dealers who are acting as principals, or whether the public customer is actually buying the stock at the premium prices in any appreciable quantity.

2. If the market is substantially a dealers market, the existence of prior arrangements to bid and purchase the security must be investigated. If it appears that a particular dealer or group of dealers are purchasing the securities in significant amounts for their own accounts, it may be necessary to interrogate such dealers under oath in order to obtain the facts and circumstances surrounding their activity. (Cases have come to the Commission's attention in which dealers transactions have been financed by a participant in the distribution for the purpose of maintaining the market in a security in consideration for a prearranged guaranteed profit to the purchasing dealer.)

If it appears that the buyers of the security in the after market are members of the public, we must determine their affiliation, if any, with syndicate members. Some of this information will be available in the records supplied to us. In most cases, however, it will be necessary to cross-check the names of such purchasers against other distributions by the same underwriters as a lead to determine the control over their activities by the selling syndicate member. If these public customers resell the securities after purchasing them at the premium price, they should be interrogated under oath as to the reason for purchase and the circumstances relating to the financing of their purchase. The point of the foregoing is to determine whether the purchases in the open market at the premium have been arranged by or pursuant to understandings with members of the selling syndicate. Every possible avenue must be explored to determine whether that is the case.

3. Careful scrutiny should be exercised to note if any original distributees also purchased stock in the open market either through the original broker from whom they bought the stock or from any other. If such were the case, it would indicate an agreement for a "tie-in" sale whereby, in consideration for obtaining a portion of the original

allotment, the distributee agreed to repurchase the security in the open market. The purpose of such activity of course would be to absorb all of the selling which occurred after the syndicate was closed for the purpose of maintaining the premium price.

4. Analysis should be made of the extent of original distribution to corporate insiders or insiders of syndicate members or institutional type investors. The purpose of this analysis is to determine the extent to which the floating supply was limited. If such placement was designed to or had the effect of restricting the floating supply that fact must be evaluated in context of the Federal Securities laws. In this connection, I think it would be helpful to read the First California Corporation case, a recent Commission review of a NASD proceeding and also to become familiar with the NASD's interpretation of "free-riding" and "with-holding". Your attention is addressed to considering whether, in an attempt to circumscribe "free-riding", situations are fostered, which in some degree create the very premium which the NASD seeks to control.

5. Records should also be examined to determine whether all of the syndicate members and all of the selected dealers and all of the sub-dealers, in short, every one in the stream of distribution, sold the stock to a public customer at the offering price and no higher. (The problem of what is a public customer, of course, cannot be separated from the free-riding problem.) Our rules specifically require that the securities registered must be sold at the offering price to the public and that there can be no trading (buying) by a broker-dealer firm who is engaged in the distribution until that firm sells all of its stock at the offering price to the public. In this connection, we should become completely familiar with Rule 10(b)(6) under the Exchange Act. Any device which is used to create

the appearance of a complete public distribution by any given dealer prior to that fact must be investigated.

6. We should be aware of the date on which the public customer was first notified of his purchase from the original distribution and if such notification occurred after the commencement of the offering. If such were the case, then for the period of time between the offering date and the date of notice to the public customer, the underwriter controlled the outstanding supply of that security since, a fortiori, a public customer could not sell that which he did not know he owned. In such a case the underwriter would have control of the market supply (a critical factor in determining the price), a position which might preclude him from buying at the same time under 10(b)(6) and might require at the least, considerable disclosure in the registration statement. The same argument applies to discretionary accounts and inquiry should be geared to determine whether such accounts made up a substantial portion of the syndicate members original distributees.

We should determine whether there have been any understandings, formal or otherwise, with customers of syndicate members requiring that they do not sell the newly issued shares on the open market when trading begins. It will be quite difficult to uncover such arrangements, but it may be the crux of the problem. It may be necessary to call a number of customers, under oath, in selected issues to determine if they were put under any restriction in connection with their rights to resell. In this connection, of course, certain clues will be evident from the date of notice to the purchasers, whether he was delivered the security, the length of time the security was held, his other participations and activities with the underwriter, etc. We should also look for situations

in which salesmen were deprived of their commission if their customers resold, or dealers were deprived of their discounts or allowances if their customers resold. While such activity is typical during stabilization, its propriety is subject to question after a syndicate is closed. It has the effect of seriously limiting the amount of securities available for open market trading.

8. [sic] We must determine whether the purchases in the after market are pursuant to agreements between syndicate members wherein certain members have been guaranteed a fixed profit if the shares are sold to a particular member. All arrangements to buy or sell through pre-selected broker-dealers and pre-determined prices in order to assure the managing underwriter control over the supply and price of the after market must be evaluated if they exist. This will be quite difficult. We will have to examine microscopically who is selling to whom, the time of sale, the price paid in such transaction in relation to the market quotations, the reasons for heavy volume in certain firms at certain periods and related matters.

9. In each case a careful analysis must be done of the first day's trading in order to determine how the premium was made. We must determine whether the premium price merely reflects a 100 share bid to purchase made by telephone call to one of the pink sheet dealers. We must determine the method by which the pink sheet dealer arrived at his price and whether he had any prior information or arrangements with respect to the immediate premium which in some cases was 200% to 300% of the offering price within minutes after the distribution began. To this end, it will probably be necessary to call the makers of the market (Troster, Singer; New York Hanseatic; L. D. Sherman & Co., etc.)

and examine them personally in addition to reviewing their records which will be before us.

10. If there is any delay between the effective date and the first transaction we should know the reasons therefor. If there is any delay in closing a syndicate (we can tell this from the records) the reasons therefor should be evaluated since none of the issues chosen are “sticky” and the trading should commence immediately in the absence of any artificial procedure.

### CONCLUSION

I think that if we get the facts, the policy questions and legal determinations will easily fall into place. It may be that such expressions, as “artificial”, “demand” or “bona fide purchasers” are meaningless in the context of a modern day distribution. Because of the thinness of the market and the ease with which prices can be maintained, it may be necessary to require certain over-all changes in the structure and operations of that market. These problems, of course, will be discussed in later memos as the facts evolve.

EHRotberg/rsp