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CONTROLLING A HOT ISSUE MARKET

David Clurman†

At the end of May 1969 New York State Attorney General Louis J. Lefkowitz requested that a study[1] be made of the "hot issue" securities market that had caused severe upswings in the prices of certain new issues of stocks sold in New York State. Pursuant to this request, I assigned several members of the bureau I head to research the matter. We conducted an inquiry during a ninety-day period ending on September 1, 1969, and analyzed various facets of 103 companies that went public for the first time in 1968-69.[2]

I

THE STUDY

The first matter examined was the quality of the companies and the securities involved. A notable factor was the pattern of dilution of the public equity in these new issues. Corporate insiders acquired

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1 The study was made pursuant to N.Y. GEN. BUS. LAW § 352 (McKinney 1968). This section authorizes the Attorney General to conduct an investigation into transactions relating to the offering and sale of securities within or from the State of New York when he deems it to be in the public interest.

2 The choices were almost literally from "out of a hat." Approximately half of the choices were from companies that had been involved in a full registration with the Securities and Exchange Commission (SEC). The remainder were of the Regulation A variety, usually involving an offering of less than $300,000.

The following table presents details as to the size of the new issue security offerings selected for use in this study:

Size of Offering	Number of New Issues
$ 300,000 or less	52
300,001 to 500,000	5
500,001 to 1,000,000	17
1,000,001 to 2,000,000	15
2,000,001 to 3,000,000	5
3,000,001 to 4,000,000	4
4,000,001 to 5,000,000	1
6,000,001 to 7,000,000	1
8,000,001 to 9,000,000	2
13,390,000	1
	103

large blocks of stock at nominal prices. As a result, public investors purchasing at the offering price suffered substantial reductions in the book value of their shares. The average dilution was sixty-five percent, and in one case reached the preposterous amount of eighty-nine percent.[3]

The reductions in book value are of particular significance because these ventures frequently had no other objective criteria of value for investors. Our findings showed that earnings per share, prior to the public offering, were nonexistent for sixteen percent of the companies, and where such figures were present, they were negative in an additional twenty-nine percent. The only other key factor upon which a company could be judged was its potential for future development. Yet there was little in the prospectuses of most of these new issues to indicate that the issuing companies had any great promise. Indeed, as will be seen, faith in a company's long-term prospects was not a significant factor in inducing purchases of its securities.

The study reached the conclusion that, rather than being bona fide new enterprises seeking capital in the securities market, many companies were merely created by underwriters for stock profits. As a result, the underwriters were in an awkward position with respect to disclosure of adverse information about the company during issuance or trading. For example, one case involved an underwriter who had made a $250,000 loan to create a new issue. When embarrassing information was later obtained about one of the new company's officers, the underwriter's financial commitment was too great to permit abandonment of the issue. Direct loans, guarantee of loans, and similar machinations by underwriters destroyed much of the protection the public should expect from a dealer in securities. Moreover, in sixty-seven percent of the issues analyzed, underwriters obtained warrants, generally at a price of one cent each, which could be exercised at or within ten percent of the original offering price during a three- to five-year period beginning one year after the offering. The blocks of stock involved in such arrangements ranged from five to twenty-five percent of the amount of the original issue.

Public participation and price movement were sometimes shocking. Despite the obviously weak quality of most of the new issues analyzed, they were readily sold out and almost inevitably rose in price in the after-market. For example, the stock of one company with an appropriate space-age name was issued at two dollars per share and ran up to $7.50 per share before severe swings downward. This particular

3 This stock, issued at $4 per share, reached a high bid of 9¼ before the decline began.

company represented in its prospectus that sixty percent of the proceeds were to be used for such items as past due accounts, repayment of loans, back wages, back rents, and similar items. The issuer was a constant loser in operations and had a working capital deficit. We concluded that the public issue was the method used to delay bankruptcy. Yet the price of the stock more than tripled in a short period of trading.

To determine the motivations of purchasers of these issues, the study interviewed 122 persons who bought initial offerings.[4] Certain patterns of behavior clearly emerged. In only a small minority of cases did investors state that the prospectus had any influence in their decision. In fact, investors largely disregarded the typical "high risk" language of these documents; many were less than certain of what business the company was in.

Investor selection of stock based upon judgment as to merit was rare. The most potent component of the decision to buy was a desire to obtain a new issue—preferably one regarding which they had received an "inside tip." In the great majority of instances, investors purchased at the original offering price with the intent of a quick resale at a premium above that price. Approximately seventy-three percent of the group that bought at the original issue price did in fact resell, usually quite soon after the time of purchase.

In part, this investor mentality may have been created by a generally rising market that made cheaply-priced stock attractive. However, what may have begun as a natural economic phenomenon was exploited by issuers and the investment banking community. Members of this group used various techniques to generate interest in these securities to increase their subsequent price moves. They then took full advantage of the rising temperature in the new issue market.

The basic device used to further overheat the market was stimulating demand while simultaneously reducing supply. Brokers increased demand by frequently emphasizing to their customers the difficulty of obtaining shares. Their statements were of course often true, but by playing upon this fact still greater demand was created. Salesmen regularly predicted that the after-market prices would be higher than the original or current prices. Cruder techniques included brokers informing customers that if they did not make additional purchases in the after-market they would be cut off from further new issues. In addition, a steady flow of "tips" was fed into the market, and purchasers often

4 These persons were identified as the result of a questionnaire sent to issuers and underwriters to determine the names of the original purchasers of the new issues under scrutiny. Substantial numbers of such persons were invited to our office for questioning.

stated that this type of information had stimulated their interest in a particular security. The question of the validity of such information is not even a logical one to ask—these companies were generally in such an early stage of development that all predictions as to their future were unwarranted.

The study group uncovered instances where intra-office brokerage memoranda were inconsistent with offering literature. The former material no doubt provided ammunition for customers' men. One such memo contained the following gem: "OTC initially, NYSE eventually." In another case where the prospectus contained a "substantial-risk" section and a cover legend emphasizing such risks, the confidential underwriter memo contained a section called "Factors Limiting Risks" as an obvious offset. Moreover, some of the names chosen by companies were misleading on their face. Thus, a company with the word "aerosystems" in its title was mainly involved in manufacturing ball point pen parts.

Concurrently, various methods of reducing supply were used. In nearly all of the offerings substantial percentages of shares registered for sale—in certain instances up to twenty-five percent—were reserved for employees, principals, and the like. In some cases, the underwriters held back shares either for their own accounts or for those associated with or related to them. At other times, underwriters made efforts to limit supply after trading began. Thus, some customers were told that if they sold without permission, they would not participate in the underwriters' future distributions. In other instances, underwriters advised customers that a stock had good long-term investment potential and should not be quickly resold.[5] As another means of limiting supply, underwriters made heavy purchases of a new issue for discretionary accounts, thereby gaining a large degree of effective trading control.[6]

The effect of all the increased pressures of demand upon a shortened supply was a sharp upswing in prices in the after-market. A sampling was made of the price rises of forty companies[7] from the time of initial offering through January 1969. The results follow:

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5 How an underwriter could make this determination regarding an untried company is, of course, impossible to answer.

6 Some underwriters who used this method did not deal with the general public except for new issue distributions and trading. In one case involving such an underwriter, a new stock moved up in price from $10 per share to approximately $100; at the close of our inquiry it was being sold in the $12 range.

7 The required speed of the inquiry limited an accounting study to 40 companies. This aspect of sharply increased prices was so notorious that additional documentation was not deemed necessary.

Number of Companies	Percentage of Increase
7	Up to 50%
5	Between 51% and 100%
10	Between 101% and 200%
11	Between 201% and 300%
3	Between 301% and 700%
4	Over 1,000%
40	

Company insiders and investment bankers took full advantage of the opportunities presented to them by the generally heated situation —a situation that was partially of their own creation. The most obvious method was the acquisition of shares at a low price for resale when the time appeared right. At times, underwriters withheld part of the issue for their own accounts and then sold when they thought the market had reached its peak. Company insiders frequently did the same with stock they received. Resales by insiders occurred in approximately twenty-three percent of all cases analyzed. This figure, which is based on our questionnaires, is undoubtedly low since further insider resales must have occurred after we received the completed questionnaires. Furthermore, in at least one instance, insider resales appear to have been concealed.

Beyond this, both underwriters and issuers fully utilized the opportunity to reward business associates, friends, or favorite customers for either past transactions or anticipated future ones. As new issues grew more difficult to obtain, the ability of issuers and their underwriters to allocate shares became a matter of considerable import. Approximately two-thirds of the new issue purchasers interviewed had prior business or social contacts with either company insiders or the brokers through whom the purchases were made. Several underwriters who were interviewed during the study stated that allocations were based upon the customer's prior business dealings with the firm and the likelihood of a continued relationship.

The ability to allocate is enhanced in a hot issue market because underwriters can usually predict which stocks will be mercurial in price. Indications of interest received during the registration period, an excellent gauge of future volatility, were in extreme cases six times the number of shares available for public sale. The likelihood that such shares would sell at a substantial premium in the after-market was evident to even the most obtuse. In this type of situation, the power to allocate was the capacity to make a gift to the favored few.

Obviously, investors in the favored group received neither threats nor suggestious that they hold the shares for any prolonged period. As noted earlier, most original investors purchased for quick resale, and of those interviewed who did resell, only two percent took a loss on the transaction. While this group was able to quickly turn over shares at substantial profits, members of the public who purchased after the stock had risen in price were not so fortunate. A random sampling of thirty-seven new issues indicated that in a seven-month period[8] the price level in the majority of these companies declined more than forty percent from the original issue price.

The study made a random investigation of the use of proceeds by issuing companies and compared the results with representations in their prospectuses. We concluded that, in some cases, promoters interpreted prospectuses quite liberally. In one $300,000 new issue that more than tripled in price, the various purposes of the public issue enumerated in the prospectus did not include personal loans to officers. Yet $19,000 of the $247,000 net proceeds was used to make such loans. In addition, the prospectus indicated that $130,000 of proceeds was to be used for asset acquisition; however, only $59,000 was used for that purpose. The company did adhere to its representation that $40,000 would be used for management salaries.

Although the purpose of this inquiry was to report on the mechanics of new issues, we were forced to recommend immediate remedial action by one company with respect to its use of proceeds. There a "prestige" offering that jumped seventy-five points within four weeks of being marketed applied $13.5 million of its proceeds to investments considered by this office inconsistent with the prospectus representations. At our insistence, the money was immediately redirected to where it should have gone in the first place. We concluded that this situation and similar ones were the result of a desire to maintain the initial high market prices by stimulating company performance.

II

RECOMMENDATIONS

Confronted by these findings, the study group tackled the problem of making recommendations that would eliminate, or at least reduce, some of the problems revealed by the study. We were very little aided

8 The end of January 1969 through the end of August 1969. Considering the premium paid over the issue price by such after-market purchasers, their real losses were, in many cases, much more substantial.

by suggestions made in writings on the securities market or by extant state and federal legislation. Much of the existing regulation of new issues is aimed principally at curbing old-fashioned "boiler-room" frauds; it has not been adapted to deal with the more sophisticated maneuverings of a hot issue market.[9] Based on our own experience and the results of this study, we urge appropriate government regulatory agencies and the securities industry to consider the following recommendations.

1. The problems surrounding new issues have tended to recur periodically, usually at five- or six-year intervals, when the securities market is sought out by numerous investors interested in "hot" new issues because of the likelihood of major upswings in prices. Therefore, it would not be appropriate to impose rules or regulations that might endanger or obstruct the free flow of capital to new issue financing during periods of time when the problems uncovered by the study do not exist. Instead, state legislation that would authorize the Attorney General to cool the type of new issue market that existed in 1968-69 may be necessary. Such authorization should specifically include: (*a*) stand-by power to act when the Attorney General determines that the new issue market is approaching dangerous levels of heated activity, and makes a formal finding to that effect; and (*b*) authorization to act whenever the price of a specific new issue suddenly begins to spurt in the absence of available financial information about the company or its activities.

This authorization would add to new issue, over-the-counter transactions the "halt in trading" concept now employed by national stock exchanges when unusual price variations in listed stocks are not substantiated by sufficient business information. Just as such regulation by the exchanges has proved helpful in avoiding the untoward effects of

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9 *See* SEC Securities Act Release No. 4963 (April 14, 1969); 35 SEC ANN. REP. 26-41 (1969); SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 481 (1963); Landis, *The Legislative History of the Securities Act*, 28 GEO. WASH. L. REV. 29 (1959).

The SEC studies of 1963 and 1969 strengthen only slightly the limited safeguards provided by the prospectus requirements. Not much has been added to the basic regulatory concept since President Roosevelt said in his March 29, 1933, message to Congress:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 93 (S. Rosenman ed. 1938).

rumors and misrepresentations, similar authority vested in the State Attorney General's office would assure adequate disclosure of information about companies involved in heated initial trading based largely on rumors. Furthermore, the Attorney General should be authorized to impose a standard three- to five-day trading hiatus between the issue date and the start of after-market trading (and the receipt of orders) whenever a general pattern of huge differentials between issue price and opening price begins to emerge in market trading, evidencing high pressure activities in the new issue market.[10]

2. Legislation should be considered that would forbid a new issue company to use proceeds of an offering for purposes other than those specified in the prospectus for a reasonable period of time after issue. Most securities laws applicable to new issues concentrate on practices at the time of offering and sale of securities; there is too little concern for the use of proceeds as measured against the representations contained in the prospectus. Later reporting by a balance sheet and profit and loss statement is not adequate. Examination of such financial statements by the study group led to the conclusion that inappropriate use of funds can easily be hidden by standard accounting practice.

3. To effectuate the second recommendation, certain companies should be required, for a period of at least a year, to submit detailed monthly statements to the State Attorney General indicating the use of proceeds, and such information should be made available to the public immediately.

4. The appropriate state and federal government agencies should consider a prohibition, by administrative act or by new legislation, that would bar securities salesmen and others in the underwriting firm from having any discussion with customers regarding the likelihood of a future new issue exceeding the offering price. The pervasiveness of this practice clearly indicated that the general anti-fraud provisions of existing laws are inadequate, and that specific and detailed regulations prohibiting this type of salesmanship are needed.

5. Consideration should be given to prohibitions or limitations on the sale of new issue securities to discretionary accounts controlled by the underwriter when that control could easily result in manipulation of the market for the new issue.

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10 While the SEC has on a few occasions taken similar steps under the Investment Company Act, 15 U.S.C. §§ 80a-1 to -52 (1964), regarding mutual funds, there has been no substantial government activity along the lines recommended for new issues in general. Because the great majority of transactions in the new issue market commence within the State of New York, it would be appropriate to amend Article 23-A of the General Business Law to give the above-recommended stand-by power to the Attorney General.

6. Prospectuses used in the securities market for new issues should be simplified so that interested members of the public can at least understand them.

CONCLUSION

In examining the new issue market of the 1968-69 period,[11] perhaps the most striking feature is the nearly total ineffectiveness of the traditional disclosure approach to regulation of securities offerings. The basic philosophy behind disclosure is that it will have some effect in deterring "fraudulent" promotions and in directing the flow of capital resources into those ventures which can make most effective use of them. Obviously, disclosure alone cannot achieve these goals; still, its complete failure here is too serious to overlook.

In this recent new issue market, a pattern emerged whereby substantial sums of money went into new and highly speculative ventures. The securities of these companies generally rose in price, frequently beyond all rational value, and then returned to earth when the inevitable cooling-off period began. Investments in these companies were rarely made on the basis of their merits. The atmosphere became one of pure gambling, and in the process it was not too difficult to rig the game. The big winners were underwriters, insiders of the issuing companies, and those with contacts in these groups. The losers were those investors who purchased at inflated prices and the economy itself. As money poured into newly-formed companies, these ventures had little choice but to seek quick investment of the funds received, thereby placing greater inflationary pressure on an already troubled economy.

Following the submission of the study group's report to Attorney General Lefkowitz, remedial legislation was introduced during the New York State Legislature's 1970 session.[12] That legislation failed to be released from committee, perhaps because the depressed condition of the market made the problem appear academic. However, in order to prepare for future hot issue markets, the states and the Securities and Exchange Commission should consider the problems uncovered by the study group and its recommendations at once.

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11 Gross new issue activity peaked in the second half of 1968. Gross common stock offerings totaled almost $2.4 billion, involving over 700 new common stock issues (a rise of approximately 70% over the first half of 1968). FED. RESERVE BANK OF N.Y. MONTHLY REV., April 1969, at 84-86.

12 (1970) Sen. Int. No. 8439 (Mr. Dominick), (1970) Assy. Int. No. 5703 (Mr. Biondo). This bill is included in the Appendix.

APPENDIX

The following legislation was drafted by the author at the request of Attorney General Louis J. Lefkowitz:

Section 1. Article twenty-three-A of the general business law is hereby amended by adding thereto a new section, to be section three hundred fifty-nine-gg, to read as follows:

§ 359-gg. New financing. 1. Whenever the attorney general determines that the opening market for new issues of securities, of companies which have never previously issued securities directly or indirectly to the public, has resulted in selling practices constituting a danger to the investing public and the economy of this state because of rampant speculation in new issues in their opening markets in this state, he may hold a public hearing at which interested members of the securities industry, issuing companies and members of the public may testify as to the need for further action to be taken pursuant to this section.

2. If the attorney general finds that circumstances warrant, within one year after such public hearing, he may take all or any of the following steps:

a. He may issue an order suspending the trading in a particular stock, but not longer than a ten-day period, where he finds that there is a lack of business information to substantiate price variations of stock newly issued or about to be issued.

b. He may issue an order imposing a standard one to three day trading gap between the issue date and the start of after market trading for all new issues, whenever he finds the pattern of large differentials between issue prices and opening prices emerging in market trading, evidencing general high pressure activities in the new issue market.

c. He may issue an order cancelling or suspending the registration, filed under section three hundred fifty-nine-e of this article, of any broker, dealer or salesman who it is found, after a hearing, based on substantial evidence on the record as a whole, has predicted, promised, estimated or suggested to members of the public what the opening after market price or prices of particular new issues will be.

3. Anyone aggrieved by any rule or determination by the attorney general under this section shall be entitled to a review thereof under article seventy-eight of the civil practice law and rules.

4. The provisions applicable to subpoenas contained in section three hundred fifty-two of this article shall be applicable to hearings and proceedings conducted under this section.

5. Nothing contained in this section shall diminish, reduce or affect the other provisions of this article.

6. Any violation of any rule, order or regulation issued by the attorney general under this section shall constitute a fraudulent practice and subject the perpetrator to an injunctive proceeding under section three hundred fifty-three of this article and shall constitute violation of law under section three hundred fifty-nine-g thereof.