

## COMMENTS AND NOTES

### SECURITIES REGULATION: LEGISLATIVE AND ADMINISTRATIVE TREATMENT OF THE "HOT ISSUE" PHENOMENON

*Neither federal nor state laws, nor the rules of the National Association of Securities Dealers have centered on control of the serious matter of highly-inflated first-issue securities offerings. After discussing the factual context from which these "hot issues" arise, this comment digests the various means of dealing with "hot issues" within our current legal framework and suggests revisions of that framework to more effectively curtail the problem.*

SINCE THE early 1940's, the securities markets have been periodically beset by a phenomenon known as "hot issues."<sup>1</sup> Expressed in the language of the securities industry, "hot issues" are defined as first-issue securities which sell at a substantial premium above their official offering price in the public distribution aftermarket.<sup>2</sup> Generally, such a dollar premium is the result of the market's natural operation, an investor being willing to pay more than the offering price because of his optimistic outlook concerning the future of the particular company and the industry in general.<sup>3</sup> Although no irregularity occurs when market conditions produce this

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<sup>1</sup> The term "hot issue" is used to refer to a public issue of stock which trades at a substantial premium above the offering price immediately after the issue is placed on the market. For some examples of "hot issues" in the 1960's, see Rotberg, *The "Hot Issue,"* 17 BUS. LAW. 360, 361 (1962). The most outstanding recent examples have been in the electronics and fast-food industries. However, Comstat, a space communications corporation, is the most publicized example of the past few years.

<sup>2</sup> The public distribution aftermarket is the public trading market which is established for the securities after they have been distributed to the public. Thus, as soon as one share is distributed during a distribution, any opportunity to resell that share is a part of the aftermarket. See *id.* at 361.

<sup>3</sup> The "hot issue" phenomenon is periodic because its basic catalyst is a general speculative fervor among investors. Thus, as speculation grips the market, the probability of "hot issues" rises. See Interview with Manuel F. Cohen, FORBES 43 (February 15, 1968). Mr. Cohen, chairman of the Securities & Exchange Commission, vividly portrayed public behavior toward "hot issues": "Well, look at the new-issue market. It's fast approaching the rate of 1961-62. Some people think the quality now might be a shade better than it was then, but I've seen some pretty bad ones coming through. Once again, you're getting the glamorous names that get to be hot. In the last six months of 1967, there were 379 new issues, up 150% from the same period a year before. Of 51 issues that came out between July and October, the average issue price was \$11. The average price on the first day of trading was \$15. The average price on January 12th was \$20. That's an 83% gain, and no corporate developments can justify that. These new issues come out when companies and their

higher price, the integrity of the stock distribution process is challenged when a market insider<sup>4</sup> yields to the temptation inherent in the "hot issue" situation to artificially influence the price. This potential danger has often been recognized and discussed,<sup>5</sup> but neither federal nor state security laws, nor the regulations of the National Association of Security Dealers have been adapted to deal *specifically* with the "hot issue" phenomenon as a whole. Nevertheless, many practices surrounding the distribution of a "hot issue" may, and in fact often do, violate various security law prohibitions. After an examination of the background and the causes and effects of "hot issues," this comment will focus upon the possible violations of the federal securities statutes and regulations, state securities provisions, and the rules of the National Association of Security Dealers which may arise in connection with "hot issue" transactions.

#### PUBLIC FINANCING CONDITIONS AND PRACTICES CREATING HOT ISSUES

The "hot issue" phenomenon results from a securities market which simultaneously distributes all new issues of stock and allows prices to be fixed by the interaction between buyer demand and seller supply.<sup>6</sup> Unlike the normal issue of securities, however, the demand for "hot issue" shares greatly exceeds the limited number of shares made available for public distribution. Under these conditions, the laws of supply and demand dictate that the price of the "hot issue"

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underwriters think they can sell them, that is, in a speculative market. And they feed on themselves. A guy sees one new issue going up, he wants to be in on the next one." *Id.* In 1962, when there was a dearth of speculative activity, there was no "hot issue" problem. However, the periodic "hot issue" situation once again manifested itself in 1967 when speculation was once more rampant in the market. Compare *Israels, Throop, Cohen, Loomis, Kennedy and Blackstone, Panel Discussion: Offerings of New Securities*, 18 BUS. LAW. 37, 55 (1962) [hereinafter cited as *Israels*] with T. Nelson, *Monthly Bulletin of State of Wisconsin Commissioner of Securities*, September 1967, at 1.

<sup>4</sup> "Market insider" refers to persons in a position to take advantage of their knowledge or manipulative power to influence the market price. This term would primarily include the issuer, broker-dealers and underwriters who participate in the public distribution of the security. See generally 1-3 L. LOSS, *SECURITIES REGULATION* 557-58, 1215-17, 1295-99, 1500-08 (2d ed. 1961) [hereinafter cited as *Loss*].

<sup>5</sup> See generally, e.g., REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as *SPECIAL STUDY*]; Rotberg, *supra* note 1.

<sup>6</sup> See *SPECIAL STUDY* at Pt. 1, 518. The market may be established as over-the-counter, an organized exchange, or through private placement. The key figure in this distribution-price setting function is the broker-dealer or underwriter who is responsible for finding investors willing to buy the new issue at an established price.

will rapidly rise above the official offering price,<sup>7</sup> enabling initial purchasers who manage to obtain securities at the official price to sell at an immediate profit.

The exceptional public demand which produces the "hot issue" price increase has occurred historically whenever a closely-held corporation decides to issue shares to the public for the first time.<sup>8</sup> If such a company is part of an industry with rapid growth tendencies, market investors have traditionally attached an aura of optimism to its securities resulting in a speculative fervor which produces an excessive demand for the company's shares.<sup>9</sup> In most instances, such speculation has been reinforced by a favorable outlook enveloping the entire market at the time.<sup>10</sup> Because the issuing corporation distributes only a fixed number of shares at a fixed offering price, and because the newly-issued securities are the only ones then publicly available, supply is inherently limited, and the pre-conditioned demand for the stock quickly produces inflated prices in the aftermarket.<sup>11</sup>

As long as the "hot issue" dollar premium in the aftermarket is simply the natural product of supply and demand, no federal securities law problems arise.<sup>12</sup> Indeed the securities acts embody the philosophy that public corporate financing will be most successful if

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<sup>7</sup> Rotberg, *supra* note 1, at 360: "Typically, since the number of shares available for public sale is limited, an 'aftermarket' develops between those who purchased the security at the original offering price and those who were unable to do so. Often, within a matter of hours after the selling syndicate has effected the distribution, this 'after market' will reflect quotations in the security two or three hundred percent in excess of the original price."

<sup>8</sup> See Israels, *supra* note 3, at 55.

<sup>9</sup> See Nelson, *supra* note 3. "However, many of them involve untried new companies with negligible earnings histories, where no apparent justification exists for the proposed offering price except for the glamour attached to the particular industry in which it may be operating." *Id.* "More than any single activity or incident, it is this climate of speculative fervor which provides a key to the new-issue phenomenon. . . . It is sufficient to note that its roots are presumably deep in human nature, and its manifestations include a willingness by more and more of the public to purchase securities at prices less and less in line with experience and reasonably foreseeable earnings." SPECIAL STUDY at Pt. 5. 67.

<sup>10</sup> See Cohen, *supra* note 3, at 43.

<sup>11</sup> In contrast to this first issue situation, if an unrestricted amount of a particular security is publicly available, as when the issuer has made previous public distributions, the "hot issue" phenomenon does not occur, for the speculative outlook would have been reflected in the already outstanding securities and the issuer would set the price of its new issue with this factor taken into consideration. Furthermore, when the securities are privately placed, by definition there is little opportunity to take advantage of any great upsurge in the public aftermarket since to qualify as a private placement the securities must be held for investment purposes. See note 4 *infra*. For a general discussion of primary distributions to the public, see S. ROBBINS, THE SECURITIES MARKETS 165-75 (1966).

<sup>12</sup> Israels, *supra* note 3, at 55.

the nation's capital markets are free to operate according to the laws of supply and demand.<sup>13</sup> Thus, the objective of the Securities Act of 1933,<sup>14</sup> and Securities and Exchange Act of 1934,<sup>15</sup> as well as their implementing regulations, is to protect the integrity of the free marketing process. To achieve this end, the securities acts require any public issuer of stock to disclose fully all information which might aid an investor in making an informed investment decision,<sup>16</sup> and proscribe all efforts designed to manipulate artificially the free operation of the markets.<sup>17</sup> Where a potential "hot issue" is involved, the probability of either lack of full disclosure<sup>18</sup> or artificial manipulation is increased by the unfamiliarity with security registration requirements which necessarily accompanies the corporation's first public issuance. More significantly, the already

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<sup>13</sup> "The Federal securities laws were not designed to prevent investors from losing money in the stock market; indeed, it is extremely doubtful whether any laws could do this in a free economy. These laws seek, by requiring disclosure of the facts about issues of securities offered in interstate commerce or traded on exchanges, by prohibiting fraud in such transactions, and by other means, to secure the dissemination of accurate information to investors and to foster sound securities markets. More fundamentally, they aim to require that those who deal with the investments of the American people observe high standards of conduct." 25 SEC ANN. REP. XIII (1959).

<sup>14</sup> 15 U.S.C. §§ 77a-aa (1964).

<sup>15</sup> *Id.* §§ 78a-jj.

<sup>16</sup> "The Securities Act of 1933 is *designed to provide disclosure to investors of material facts concerning securities publicly offered for sale by the use of the mails or instrumentalities of interstate commerce, either by an issuing company or by any person in a control relationship to such company, and to prevent misrepresentation, deceit, or other fraudulent practices in the sale of securities generally.* Disclosure is obtained by requiring the issuer of such securities to file a registration statement with the Commission which includes a prospectus containing significant financial and other information about the issuer and the offering. . . . The Commission has no authority to control the nature or quality of a security to be offered for public sale or to pass upon its merits or the terms of its distribution. Its action in permitting a registration statement to become effective does not constitute approval of the securities, and any representation to the contrary to a prospective purchaser is made unlawful by Section 23 of the Act." 32 SEC ANN. REP. 21 (1966) (emphasis added).

<sup>17</sup> "The [Securities Exchange] Act also provides for the registration and regulation of national securities associations and of brokers and dealers doing business in the over-the-counter markets, *contains provisions designed to prevent fraudulent, deceptive and manipulative acts and practices on the exchanges and in the over-the-counter markets and authorizes the Board of Governors of the Federal Reserve System to regulate the use of credit in securities transactions.* The principal purpose of the various statutory provisions is *to ensure the maintenance of fair and honest markets in securities transactions on the organized exchanges and in the over-the-counter markets.*" 32 SEC ANN. REP. 37 (1966) (emphasis added); *see* Thornton & Co., 28 S.E.C. 208, 224, *aff'd sub nom.* Thornton v. SEC, 171 F.2d 702 (2d Cir. 1948).

<sup>18</sup> The complexity of the registration process itself is sufficient assurance that full disclosure is more difficult for a "first issuer." However, some of this problem is eliminated by the issuer's ability to amend the statement to correct any deficiencies. *See generally* 1 Loss at 265-351.

limited market supply, coupled with excessive but natural demand for a "hot issue" and the resulting inflationary effect on the price,<sup>19</sup> increases both the opportunity and the incentive for broker-dealers to tamper with normal free market operation.<sup>20</sup>

#### DEALER-UNDERWRITER PRACTICES AFFECTING HOT ISSUE PRICE DETERMINANTS

##### *Manipulative Practices*

The key figure in the securities market's distribution-price setting function is the broker-dealer-underwriter who has the responsibility of finding investors willing to buy newly-issued shares at or above the fixed offering price. In order for corporate financing through the medium of stock distribution to succeed, the dealer-underwriter of a particular security must "make the market": He must stand ready to buy or sell the security for his own short term account to prevent the price from plummeting when there is an excess of sellers, or from skyrocketing if buyer demand outstrips the supply normally provided by independent sellers. "Making the market" is especially important to the first public distribution of a security since the practice assures initial investors in the security that there will be an organized market in which to trade. However, it also creates a substantial possibility of manipulative activity by the dealer-underwriter, who has power both to control the supply of shares of a "hot issue," and to exercise a degree of influence over the extent of demand for that security.

To prevent dealer-underwriter artificial influences on the market, Congress has enacted a number of provisions which are designed to eliminate manipulative practices that are detrimental to the operation of a free market.<sup>21</sup> Although these provisions have primarily been

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<sup>19</sup> Where the public is especially sensitive to any stimulus concerning a security and the security is also in limited supply, the opportunity for manipulating the price is greatly increased. "[A]n under-priced security holds forth the prospect of trading profits which in some cases is too much temptation to the underwriters. . . . In this situation, if the underwriters sell all of the issue at the public offering price, they will make perhaps a 10% 'spread' or commission. If they hold back say 1/3 of the issue until the market rise, they may make 110% on that portion. The resulting restriction of the supply helps to insure that the market rise will occur." R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 672 (1963).

<sup>20</sup> See *Israels*, *supra* note 3, at 55. Specifically, opportunity is increased because it takes much less manipulation to effect the sensitive and highly elastic market. Incentive is augmented since the desired profits or results from manipulative effort are more easily attained.

<sup>21</sup> See *In re Rentz & Co.*, Securities Exchange Act Release No. 8134 (July 27, 1967), [1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,461 at 82,898. "And the gravamen of applicant's

enforced and interpreted in non-"hot issue" situations, they are equally applicable to similar practices used in a "hot issue" setting. These anti-fraud provisions make it unlawful to employ any device, scheme or artifice to defraud, or to obtain money or property through false or misleading statements, or to participate in any deceitful act involving a purchase or sale of securities.<sup>22</sup>

Specifically, fraudulent broker-dealer marketing activities surrounding "hot issues" may be regulated under section 17(a) of the Securities Act of 1933<sup>23</sup> and section 10(b)<sup>24</sup> of the Securities Exchange Act of 1934 (as implemented by Rule 10b-5)<sup>25</sup> which prohibit manipulative, deceptive and fraudulent actions in the securities markets. These provisions are intended to provide broad protection "against the defrauding of unwary investors"<sup>26</sup> and to guarantee that there will be no "impediments to a free and open market created by artificial stimulants or restraints."<sup>27</sup> Fraudulent interstate transactions are prohibited by section 17(a) of the Securities Act.<sup>28</sup> Section 10(b) of the Securities Exchange Act proscribes the offer or sale of any security by "any manipulative or deceptive device or contrivance."<sup>29</sup> To implement section 10(b), the SEC adopted Rule 10b-5 which incorporates the prohibitive language of section 17(a), with the notable difference that it applies both to purchases and sales

misconduct is not specific loss to particular investors or profit to applicant on the transactions in question, but the impairment of a free securities market, to the indirect or potential advantage of the member." *Id.*

<sup>22</sup> See notes 23-33 *infra* and accompanying text.

<sup>23</sup> 15 U.S.C. § 77q (1964).

<sup>24</sup> *Id.* at § 78j.

<sup>25</sup> 17 C.F.R. § 240.10b-5 (1967).

<sup>26</sup> 15 U.S.C. § 78o(c)(1) (1964).

<sup>27</sup> Masland, Fernon & Anderson, 9 S.E.C. 338, 344 (1941). *See generally* Comment, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509 (1947).

<sup>28</sup> 15 U.S.C. § 77q (1964) states that "(a) It shall be unlawful for any person in the offer or sale of any securities . . . in interstate commerce . . . directly or indirectly—(1) to employ any device, scheme, artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. (b) It shall be unlawful for any person . . . in interstate commerce . . . to publish, give publicity to, or circulate any notice, circular, advertisement, paper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

<sup>29</sup> 15 U.S.C. § 78j provides that it shall be unlawful "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security"

whereas section 17(a) was interpreted to pertain only to sales.<sup>30</sup> Although section 15(c)(1) of the Securities Exchange Act only specifically proscribes "any manipulative, deceptive or other fraudulent device or contrivance," Rule 15c1-2 has incorporated into it the substance of section 17(a).<sup>31</sup> Thus, the only significant variations between these three sections are: (1) that section 17(a) applies only to sales, whereas sections 10(b) and 15(c)(1) apply to both purchases and sales;<sup>32</sup> and (2) that section 15(c)(1) applies only to a "broker or dealer" while sections 17(a) and 10(b) apply to "any person."<sup>33</sup> Where there is a revocation proceeding against a broker-dealer involving allegedly fraudulent sales of "hot issues," the SEC uniformly cites all three sections and their related rules, indicating that all three are relevant to fraudulent and manipulative problems raised by "hot issues."<sup>34</sup>

Although common law fraud or deceit consisted of *knowingly* misleading a person as to a material fact,<sup>35</sup> the SEC antifraud

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not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

<sup>30</sup> 17 C.F.R. § 240.10b-5 (1967) reads as follows: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

<sup>31</sup> 15 U.S.C. § 78o(c)(1) (1964) reads as follows: "No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent." 17 C.F.R. § 240.15c1-2 (1967) provides that "(a) The term manipulative, deceptive, or other fraudulent device or contrivance, as used in section 15(c)(1) of the Act, . . . is hereby defined to include *any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.*"

<sup>32</sup> Compare 15 U.S.C. § 77q (1964), with *id.* § 78j, and *id.* § 78d(c)(1).

<sup>33</sup> *Id.*

<sup>34</sup> See R. JENNINGS & H. MARSH, *supra* note 19, at 693.

<sup>35</sup> Common law fraud consisted of six elements: (1) a false representation of (2) a material (3) fact with (4) the defendant knowing of the falsity (*scienter*) and intending for the plaintiff to (5) justifiably rely on it, (6) suffering consequential damages. 3 Loss at 1431. For the differences between common law fraud and the SEC anti-fraud provisions, see Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

provisions provide some remedy—civil,<sup>36</sup> criminal,<sup>37</sup> or administrative<sup>38</sup>—as long as there is *any deception* concerning a material fact. Thus, the focal point of the antifraud provisions is whether or not the practice involves *material deception* of any

<sup>36</sup> Civil liability—a private suit by a defrauded party against the wrongdoer for rescission or damages—is the least specific remedy of the securities acts. Particularly problematic are the requirements of intent and scope of deception, see note 43 *infra*, especially where Rule 10b-5 is concerned. While an implied civil remedy under 10b-5 was found in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), section 12(2) of the Securities Exchange Act, 15 U.S.C. § 77l (1964), expressly provides for the civil liability of defrauding sellers: “Any person who—(1) offers or sells a security in violation of section 5, or (2) offers or sells a security . . . by the use of . . . interstate commerce or [use] of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.” Furthermore, section 18 of the Securities Exchange Act, 15 U.S.C. § 78r (1964), provides that any person who purchases or sells a security in reliance upon any false or misleading statement contained in an application, document or report filed pursuant to the act, or any rule and regulation thereunder, shall have a cause of action for resulting damages against anyone responsible for misrepresentation. Sections 9(a)(3) and (4) of the Act, 15 U.S.C. § 78i (1964), also provides for civil liability where a security is listed on a national exchange. See generally Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 17-19 (1957). See also 15 U.S.C. § 77k (1964).

<sup>37</sup> Securities Exchange Act § 24, 15 U.S.C. § 77x (1964): “Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$5,000 or imprisoned not more than five years, or both.” Section 32 of the Securities Exchange Act, 15 U.S.C. § 78ff (1964), provides for penalties similar to those of section 24 of the Securities Act for violations of Exchange Act provisions.

<sup>38</sup> Securities Exchange Act § 20(b), 15 U.S.C. § 77t(b) (1964): “(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received.”

Section 21 of the Securities Exchange Act, 15 U.S.C. § 78u (1964), provides for penalties similar to those of section 20(b) of the Securities Act for violations under the Exchange Act.

description.<sup>39</sup> If this minimum standard is satisfied, then the SEC administrative measures are always available.<sup>40</sup> For civil sanctions, there is the added requirement of some measure of scienter,<sup>41</sup> and criminal sanctions cannot be applied unless the deception is willful.<sup>42</sup> However, "material deception," as defined by the antifraud provisions, is the important guideline to the scope of unlawful manipulation,<sup>43</sup> since matters of intent determine only the breadth of remedies available.

*Manipulation of Supply.* One method of material deception frequently used to affect the price of a "hot issue" is manipulation of supply.<sup>44</sup> The Special Study of the Securities Markets submitted to Congress in 1963 provides the only detailed analysis of how professional dealer-underwriters limit the supply of hot issues.<sup>45</sup> Not all of these limiting practices are unlawful, as only those practices involving material deception are within the proscriptive ambit of the anti-fraud provisions.<sup>46</sup> However, intent to defraud may be enough to

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<sup>39</sup> See notes 23-24 *supra* and accompanying text for a definition under the securities law of "material deception." The practices defined under the SEC anti-fraud provisions allow for practically any conceivable form of deception. See, e.g., *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Vine v. Beneficial Finance Corp.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

<sup>40</sup> The SEC can apply its own administrative sanctions whenever a rule is likely to be or is violated. See note 38 *supra*.

<sup>41</sup> Both section 12(2) of the Securities Act and section 18 of the Securities Exchange Act provide for civil liability only if there is negligent or intentional misstatement. See 3 Loss at 1699-1712. However, even this small clement of scienter may not be required for civil liability under Rule 10b-5. See generally *id.* at 1763-97; Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); Comment, *Private Enforcement Under Rule 10b-5: An Injunction for a Corporate Issuer?* 115 U. PA. L. REV. 618 (1967).

<sup>42</sup> See note 37 *supra*.

<sup>43</sup> For a more detailed analysis of this area, see generally 3 Loss, at 1421-1862; Berle, *Stock Market Manipulation*, 38 COLUM. L. REV. 393 (1938); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

<sup>44</sup> Generally, "hot issues" are more frequently created by natural or artificial limitations upon the supply of a security than from any excess demand. "Hot issues" almost invariably arise where there is a first issue of a security and thus no already existing supply. See SPECIAL STUDY at Pt. 5, 69-70. Thus, it may logically be maintained that the excess demand exists only because there is a limited supply. However, this conclusion actually depends on one's perspective of the market, as there is never a real excess demand as long as the supply is sufficient.

<sup>45</sup> See note 5 *supra*. Congress in September of 1961 directed the Securities and Exchange Commission to make a study and investigation of the securities markets for the purpose of determining the adequacy of investor protection. The Study, conducted by a special staff appointed by the Commission, is the most comprehensive of its kind since the federal securities laws were enacted. The Study Report was submitted to Congress in three segments—April 3, 1963; July 17, 1963 and August 8, 1963. See CCH FED. SEC. L. REP. at ¶ 65,000 (1966) (Explanatory Note).

<sup>46</sup> See note 39 *supra* and accompanying text.

turn a common security practice into "a scheme to defraud."<sup>47</sup> On the other hand, if the practice operates as an "artifice to defraud" in itself, no specific intent is required.<sup>48</sup>

Several dealer-underwriter practices restrict the supply of a "hot issue," yet are deemed lawful as a method of facilitating distributions in a free market. One common supply-restricting practice occurs when the distributor of the security sells only to customers who plan to retain their allotment for a substantial period of time.<sup>49</sup> Often this selection process is reinforced by monetary penalties imposed by the distributor upon salesmen selling allotments to customers who do not retain them for the required investment period.<sup>50</sup> Similarly, underwriters can enforce their policy directly against buyers by threatening to eliminate such buyers from future allotments if they sell new issues within a stated period after the offering date.<sup>51</sup> However, these practices may be considered evidence of the fraudulent design of the distributor.<sup>52</sup> Unless the broker-dealer is the "market maker," even buying and selling during the distribution period with intent to affect the supply and influence prices may constitute activity which operates as a "fraud upon purchasers."<sup>53</sup>

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<sup>47</sup> By nature of the definition there is a scheme to defraud if the requisite intent is present. *Cf.* Federal Corp., 25 S.E.C. 227, 230 (1947); *Gates v. United States*, 122 F.2d 571, 575-76 (10th Cir. 1941), *cert. denied*, 314 U.S. 698 (1942).

<sup>48</sup> See notes 35-40 *supra* and accompanying text. *Cf.* Harold T. White, 3 S.E.C. 466, 513 (1938): "But we have concluded that these factors are without controlling weight in this case, especially since the violation of Section 9(a)(2) and the consequent injury to investors does not hinge upon the existence of criminal intent or a 'bad' purpose. Violation of the statute occurs whenever transactions are effected in a registered security for the purpose of inducing the purchase or sale of that security by others for the purpose of manipulating the market." See also note 121 *infra*.

<sup>49</sup> "Underwriters agreed that customers who sell their allotments in the immediate after-market are to be avoided. . . . New issues were allotted to customers who were known to principals of the firm and whose investment decisions were often strongly influenced by their recommendations." SPECIAL STUDY at Pt. 1, 523-24; see Rotberg, *supra* note 1, at 365. This policy may be facilitated by making sales to institutional investors, such as insurance companies.

<sup>50</sup> The salesman may be deprived of his commission or threatened with dismissal. See Rotberg, *supra* note 1, at 365. "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." SPECIAL STUDY at Pt. 1, 525.

<sup>51</sup> The policy can be justified since the broker-underwriters do not consider customers who quickly resell as "investors," entitled to an allotment. SPECIAL STUDY at Pt. 1, 525.

<sup>52</sup> See Federal Corp., 25 S.E.C. 227, 230 (1947); note 48 *supra* and accompanying text.

<sup>53</sup> See *Batten & Co.*, 40 S.E.C. 997 (1962), *aff'd*, 345 F.2d 82 (D.C. Cir. 1964); *Woods & Co.*, 41 S.E.C. 725 (1963); *Landau Co.*, 40 S.E.C. 1119 (1962); *Bruns, Nordeman & Co.*, 40 S.E.C.

Although direct restrictions on sales are the most overt form of supply control, some of the more subtle forms may prove just as effective, while evidencing even greater fraudulent intent. For example, the distributor can dramatically limit the new security supply by allocating securities to discretionary accounts which the distributor necessarily controls, and which permit him to withhold securities for any desired period of time.<sup>54</sup> Similarly, the distributor may delay notifying the customer that he has received an allotment and thus deny him an early opportunity to sell.<sup>55</sup> More directly, the distributor may simply refuse to handle any "sell" orders of the recently marketed security,<sup>56</sup> or may delay the stock certificate

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652 (1961). A finding of fraudulent activity assumes that the buying and selling is not exempted as falling under the stabilization provisions of Rule 10b-7, 17 C.F.R. § 240.10b-7 (1968). Rule 10b-7(f) covers fraud problems and stipulates that "[n]o stabilizing shall be initiated at a price which the stabilizer knows or has reason to know is the result of activity which is fraudulent, manipulative, or deceptive under the act or any rule or regulation thereunder."

<sup>54</sup> Discretionary accounts are those in which the customer does not give an explicit indication to buy the stock prior to receiving the confirmation reflecting his purchase. The syndicate group of underwriters that is to distribute the security can thus retain de facto control of these securities until the investor is notified of his purchase. If the syndicate member can also sell without prior notice, then his control over the security is proportionately increased. For a background on syndicates and underwriting see LOSS at 163-72. However, case law and rules under the securities acts have placed limitations on the broker-dealers operations with discretionary accounts. See *Hay, Fales & Co.*, 19 S.E.C. 397 (1945) (cross-trading between customer accounts, purchases of securities arbitrarily priced, purchases of securities not issued and not received, and confirmation of the transactions without appropriate disclosure to customers are fraudulent violations when dealing with discretionary accounts). Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1968), dealing with fraudulent activity concerning discretionary accounts reads: "(a) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account."

<sup>55</sup> Customers who do not know that they have purchased a security cannot possibly be in a position to sell them. This delay in notification may be only one or two days, but it is enough to effectively restrict the supply in the immediate aftermarket. See *SPECIAL STUDY* at Pt. 1, 526-27. However, SEC cases and rules have imposed stringent restrictions on this practice. See *Weston & Co.*, 30 S.E.C. 296, 309 (1949) (broker-dealer was found to have willfully violated Exchange Act requirements by failing to deliver written confirmation of a securities transaction even though the customer had requested no communication in order to cloak her actions with secrecy). Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1968), specifically covers confirmations as follows: "The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the act is hereby defined to include any act of any broker or dealer designed to effect with or for the account of a customer any transaction in . . . any security . . . unless such broker or dealer, at or before the completion of each such transaction, gives or sends to such customer written notification disclosing (a) . . . [whether acting as broker or dealer] . . . (b) [commission, remuneration, etc.]"

<sup>56</sup> The syndicate may refuse to accept sell orders for a certain period, or refuse to execute them

delivery to impede any customer sales through other brokers.<sup>57</sup> However, none of these restrictive practices, when done openly, is unlawful unless its purpose is to limit the supply in order to influence the security price, as opposed to facilitating the distribution of the security.<sup>58</sup>

The most frequently criticized limitation of supply occurs when a member of the selling group withholds stock for related or affiliated accounts.<sup>59</sup> Commonly, this "affiliated" withholding consists of allocating a portion of the limited supply of "hot issue" securities to the accounts of partners, officers or employees of the distributing firm, relatives of such persons, or persons associated with other broker-dealers with whom the distributor may have a reciprocal agreement.<sup>60</sup> Through this withholding process, the distributor takes advantage of its position to allocate profits to affiliates, to limit the supply available to the public, and thus possibly to increase further the ratio of demand to supply. Failure to reveal that these securities are intentionally being withheld may violate the Securities Act's anti-fraud provisions as an "omission to state a material fact."<sup>61</sup> In any case, if the offering price of a security is announced at a certain figure,

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until a minimum time period has passed. Of course, the customer could place his order through another dealer, but this is an added hardship that most investors do not care to endure. See SPECIAL STUDY at Pt. 1, 525.

<sup>57</sup> Stock certificate delay, in conjunction with nonacceptance of sell orders, provides an effective method to prevent the original purchaser from disposing of his securities in the immediate aftermarket. "Although physical control of the certificate is not always necessary to sell a security, many broker-dealers were reluctant to sell for a customer unless he had a certificate, particularly if the buying broker-dealer insisted on regular 4-day delivery. As a practical matter, the ability of public purchasers to sell was often limited until they received certificates." *Id.* at 527. "One underwriter stated that certain houses deliberately delayed delivery of certificates because many customers 'think they could not sell it until they have possession of it.'" *Id.*

<sup>58</sup> See notes 46-52 *supra* and accompanying text. However, a history of restrictive activity not itself violative of the securities laws might be used as evidence of an overall fraudulent scheme.

<sup>59</sup> See SPECIAL STUDY at Pt. 1, 528. See generally Comment, *The SEC's Rule 10b-6: Preserving a Competitive Market During Distributions*, 1967 DUKE L.J. 809, 932-35, for a discussion of sales to related and affiliated persons with particular emphasis on rule 10b-5 violations.

<sup>60</sup> SPECIAL STUDY at Pt. 1, 528.

<sup>61</sup> See *R. A. Holman & Co.*, SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77, 313 at 82, 549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967); *Preferred Sec., Inc.*, 41 S.E.C. 769 (1963). A fraud violation is involved when the public is not informed that securities are being withheld, since investors have no way of knowing that the supply of the security is being limited other than by purchases in the public market. Disclosure of this information alerts the public to the "hot issue" problem of demand having a great effect upon the market price.

the public is defrauded if it actually makes its purchases at an artificially inflated price from insiders or affiliates who have withheld securities.<sup>62</sup>

When the dealer-underwriter distributes a substantial portion of a "hot issue" to an affiliate, there is a high likelihood that the dealer-underwriter may violate the Rule 10b-6 prohibition against a distributor trading in any security until he has completed his participation in the securities distribution.<sup>63</sup> Although a Rule 10b-6 violation in the case of a sale results only when a distributing broker-dealer is actually implicated in a "manipulative scheme," this restriction is primarily academic where "hot issues" are concerned, since any inside activity in their distribution is likely to be considered manipulative.<sup>64</sup> In any case, if the account to which the securities are sold is one in which the broker-dealer may be deemed to have a

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<sup>62</sup> See *Batten & Co.*, 40 S.E.C. 997 (1962), *aff'd*, 345 F.2d 82 (D.C. Cir. 1964); Preferred Sec., Inc., 41 S.E.C. 769 (1963); Preliminary Report of Practices In Distribution of "Hot Issues," SEC Securities Act Release No. 4150, Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,671 at 80,524. See also *Edgerton, Wykoff & Co.*, 36 S.E.C. 583 (1955). Where shares were withheld in good faith and not to restrict supply, the withholding was found to be no willful violation of the anti-fraud provisions.

<sup>63</sup> 17 C.F.R. § 240.10b-6 (1968). The rule makes it a "manipulative or deceptive device or contrivance" for an underwriter, issuer, broker or dealer who is participating in a distribution "to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution. . . ." A Rule 10b-6 violation may be found whenever the distribution is deemed still in effect, see note 88 *infra*, since the broker-dealer would be selling or purchasing securities before he has completed his participation in the distribution. See Preliminary Report on Practices of Distribution of "Hot Issues," SEC Securities Act Release No. 4150, Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,671 at 80,524. See generally Comment, 1967 DUKE L.J., *supra* note 59, at 832-35 & n.111.

A more difficult problem is defining "distribution" under rule 10b-6. While distributions registered under the Securities Act are within the rule, exemption from registration does not mean that they do not fall within the ambit of 10b-6. See *S.E.C. v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959). In *Bruns, Nordeman & Co.*, 40 S.E.C. 652 (1961), the SEC defined distribution in terms of rule 10b-6's purpose, and held that it applied whenever the distributor's open-market purchasing must be prohibited to insure a market price determined in an independent competitive market. For a detailed discussion of this definitional problem, see Comment, 1967 DUKE L.J., *supra* note 59, at 819-29.

<sup>64</sup> A crucial factor is whether or not the manipulative activity extends to the period of distribution. If there is no manipulation during distribution (defining manipulation as being any subterfuge involving the security rather than an allotment for investment), then there is nothing wrong with repurchases from an affiliate or any other purchases of the security. See H. BLOOMENTHAL, *SECURITIES LAW* 305 n.18, 306 (1966) [hereinafter cited as BLOOMENTHAL]. "The Commission takes the position that securities dealers ordinarily acquire securities for distribution and not for investment even though they may purport to have acquired same for

beneficial interest, the consequential violation is covered by Rule 10b-6(a), which specifically prohibits bidding or purchasing for such accounts.<sup>65</sup> Otherwise, any Rule 10b-6 violation depends upon a finding that the distribution was not completed until after the affiliate disposed of the securities. If incomplete, any purchases by the broker-dealer in that period would be in violation of Rule 10b-6.<sup>66</sup>

*Manipulation of Demand.* Since the primary determinant of the demand factor is a somewhat irrational public psychology,<sup>67</sup> demand for "hot issues" can often be as easily manipulated by distributors as can supply. The most frequently employed device to manipulate demand is active solicitation of sales of the new issue in the aftermarket.<sup>68</sup> This practice is unlawful when it is done to influence the price by affecting demand, rather than to "make a market."<sup>69</sup>

Initially, demand is considered to be artificially stimulated by a fraudulent device when a broker-dealer induces customers to buy securities through the use of false and misleading statements in a market letter.<sup>70</sup> Indeed, a broker-dealer may be found to have employed

investment. This would appear to be particularly true of so-called 'cheap stock,' that is, stock made available to underwriters below the market by the issuer often through sales to them by insiders eager to have the proposed offering underwritten." *Id.* See also Comment, 1967 DUKE L.J., *supra* note 59, at 835.

<sup>65</sup> 17 C.F.R. § 240.10b-6 (1968). There is no precedent that specifically defines a "beneficial interest," although the primary consideration appears to be whether or not the broker-dealer makes the decisions as to when the securities will be sold from a nominal account. See Comment, 1967 DUKE L.J., *supra* note 59, at 833-34; *cf.* Batten & Co., 40 S.E.C. 997 (1962), *aff'd*, 345 F.2d 82 (D.C. Cir. 1964).

<sup>66</sup> "In addition, in the course of distributing the repurchased shares, registrant engaged in the manipulative activity of entering bids for and purchasing such shares in the over-the-counter market in violation of Rule 17 C.F.R. 240.10b-6 under the Exchange Act." R. A. Holman & Co., SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,313 at 82,549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967); see Mayo & Co., SEC Exchange Act Release No. 7310 (May 8, 1964); Batten & Co., 40 S.E.C. 997 (1962), *aff'd*, 345 F.2d 82 (D.C. Cir. 1964); Bruns, Nordeman & Co., 40 S.E.C. 652 (1961).

<sup>67</sup> "Without public expectation of a rising market and public appetite for quick profits in such a market, . . . 'hot issues' could not have existed." SPECIAL STUDY at Pt. 1, 533. "The dizzy heights to which such stocks would leap could not be justified on rational investment analysis of underlying values, but resulted from speculative fever which created a demand that exceeded the supply." Israels, Throop, Cohen, Loomis, Kennedy and Blackstone, *Panel Discussion: Offerings of New Securities*, 18 BUS. LAW. 37,55 (1962). See SEC Securities Act Release No. 4150, Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76, 671 at 80,524.

<sup>68</sup> "When demand [for hot issues] was stimulated by active solicitation and the use of publicity techniques, the price could be expected to rise dramatically." SPECIAL STUDY at Pt. 1, 533.

<sup>69</sup> See notes 46-48, 52 & 58 *supra* and accompanying text.

<sup>70</sup> Articles in financial journals, releases of information about the company, and

an "artifice to defraud" or "misleading statements," whenever it appears that "hot issue" recommendations are knowingly contrary to the customers' needs. Such advice to buy could easily be considered a "scheme to defraud," a "misleading statement," or be otherwise encompassed as a fraudulent activity.<sup>71</sup> A more obvious violation occurs when a broker-dealer attempts to increase "hot issue" demand by employing an "untrue statement of material facts," such as falsely representing the market conditions that surround the security.<sup>72</sup> There is also an "untrue statement of material fact" when the public demand is increased by prospectuses, selling solicitations, and advertisements stating that a certain number of shares are being offered at the prospectus price, when in fact the initial supply is

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advertisements are other forms of planned publicity. Sometimes favorable reports are solicited through granting an allotment of the "hot issues" to financial journalists and publicists. SPECIAL STUDY at Pt. 1, 535-39. Several cases have found these practices to be fraudulent. J. H. Goddard & Co., SEC Exchange Act Release No. 7618 (June 4, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,251 at 82,373, held that a broker-dealer and investment adviser who manipulates the market in securities through false and misleading statements concerning their recommendations, omitting adverse information and misstating ratios and book values in market letters to its customers and investment advisory clients, willfully violated the anti-fraud provisions. In Heft, Kahn & Infante, Inc., SEC Exchange Act Release No. 7020 (February 11, 1963), [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,897 at 81,313, the underwriter had its registration revoked for unwarranted predictions of price increase and misrepresentation of the issuer's sales and prospects in a market letter to customers concerning the new issue. See Bruns, Nordeman & Co., 40 S.E.C. 652, 661-62 (1961); G. J. Mitchell, Jr., Co., 40 S.E.C. 409, 411-13 (1960). See also Axe Sec. Corp., SEC Exchange Act Release No. 7442 (October 14, 1964), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,148 at 82,163.

<sup>71</sup> See Shearson, Hammill & Co., SEC Exchange Act Release No. 7743 (November 12, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,306 at 82,509. A registered broker-dealer violated the anti-fraud laws by making reckless and irresponsible representations to customers in view of its information and of circumstances that should have forewarned of unreliability. In addition, there was the supporting factor that these recommendations were often contrary to the customers needs. *Id.*; see Hamilton, Waters & Co., Inc., SEC EXCHANGE ACT Release No. 7725 (October 18, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,298 at 82,485 (fraudulent representations through boiler-room tactics); Schmidt, Sharp, McCabe & Co., SEC Exchange Act Release No. 7690 (August 30, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,280 at 82,444 (no reasonable basis for representations by the salesmen). See also Capitol Leasing Corp., SEC Securities Act Release No. 4714 (August 18, 1964), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,128 at 82,111 (misleading offering circular); Charles E. Bailey & Co., 35 S.E.C. 33, 41-42 (1953) (false and misleading statements).

<sup>72</sup> See R. A. Holman & Co., SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,313 at 82,549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967) (broker-dealer falsely represented subscriptions, market price, distribution plan, and that the market was free and open); Charles E. Bailey & Co., 35 S.E.C. 33, 41-42 (1953) (broker-dealer made false and misleading material statements concerning issuer's orders, financial prospects and dividends). See also Mutual Employees Trademart, Inc., 40 S.E.C. 128 (1960), in which the offering circular was materially misleading as to effect of the offering on insider holdings and their relative control of the issuer.

restricted.<sup>73</sup> An example of an analogous practice, which operates as a "device to defraud," is a broker-dealer's purchase of stock while engaging in the distribution, in order to induce other brokers and dealers to make quotations, without revealing that he is creating only the appearance of an independent market for the security.<sup>74</sup> In such a situation, when the broker-dealer controls the only market for the stock, there is a direct violation of Rule 15c1-8, since the broker-dealer represents that he is selling "at the market" when the only market is the one that is controlled and maintained by him.<sup>75</sup> Furthermore, even if the broker-dealer is not creating the appearance

<sup>73</sup> Lawrence Rappee, 40 S.E.C. 607, 610 (1961). "When a broker-dealer engages in the security business he impliedly represents to customers that they will be dealt with fairly and honestly, that the prices they are charged are, or are reasonably related to, the prevailing market prices, and that the market is a free and independent market insofar as that broker-dealer is concerned." *Id.*; see Masland, Fernon & Anderson, 9 S.E.C. 338, 347-48 (1941). The failure to advise the customer that the seller had artificially manipulated the market price and market is a violation of the anti-fraud laws. "A prospective purchaser is entitled to rely on a representation concerning the market or market price freely arrived at by natural forces, at least so far as the seller is concerned." *Id.* at 347; see SEC v. Electronics Security Corp., 217 F. Supp. 831, 836-37 (D. Minn. 1963) (broker controlled market represented as being independent); W. K. Archer & Co., 11 S.E.C. 635 (1942) (selling and purchasing at other than prevailing market price); Jansen & Co., 6 S.E.C. 391 (1939) (securities sold from personal account at excess of market).

<sup>74</sup> See Woods & Co., 41 S.E.C. 725 (1963). While engaged in distribution of stock the broker-dealer bid and sold shares and induced other brokers and dealers to make quotations on the stock creating the appearance of an independent market. *Id.* In Sterling Securities Co., 39 S.E.C. 487, 489-92 (1959), the broker-dealer made no disclosure to investors that it "dominated and controlled the market" and that the price was not established in a competitive market. See R. A. Holman & Co., SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,313 at 82,549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967) (price artificially established by dealer's activities). In Landau Co., 40 S.E.C. 1119, 1122-23 (1962), the broker-dealer misrepresented that securities were being offered at market when the market was made and controlled by the broker-dealer or associated persons. In SEC v. Scott Taylor & Co., 183 F. Supp. 904, 907 (S.D.N.Y. 1959), the bids of the broker-dealer created "unwarranted impression of interest and activity" in the security. In M.S. Wien & Co., 23 S.E.C. 735, 738-39 (1946), the broker-dealer created the "impression of a broader and more active market than actually existed" by its own quotations, and transactions in conjunction with those it induced others to make; cf. Duval Sec., Inc., SEC Exchange Act Release No. 7655 (July 23, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,264 at 82,399 (where the broker-dealer entered quotations at increasing prices to create an "appearance of an independent market"); Elizabeth Sec., Inc., SEC Securities Act Release No. 4778, Exchange Act Release No. 7589 (April 30, 1965) [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,232 at 82,355 (where fraudulent price quotations were made in sheets in anticipation of a public offering).

<sup>75</sup> Preliminary Report on Practices of Distribution of "Hot Issues," SEC Securities Act Release No. 4150, Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,671 at 80,524; see *Otis & Co. v. SEC*, 106 F.2d 579, 582-83 (6th Cir. 1939) (dealer using control of supply to mislead the public by implying that sales were "at the Market"); cf. *United States v. Brown*, 79 F.2d 321 (2d Cir. 1935); *Rickard Ra-*

of a market, a "scheme or device to defraud" exists if he engages in activities that are designed to artificially affect market prices in order to induce extensive trading.<sup>76</sup> Creating the appearance of activity,<sup>77</sup> making sham transactions,<sup>78</sup> inducing other dealers to make markets

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more Gold Mines, Ltd., 2 S.E.C. 377 (1937); Canusa Gold Mines, Ltd., 2 S.E.C. 548 (1937).

17 C.F.R. § 240.15c1-8 (1967) (emphasis added) reads as follows: "The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any representation made to a customer by a broker or dealer who is participating or otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange that such security is being offered to such customer 'at the market' or at a price related to the market price unless such broker or dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by him, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling or under common control with him." See Preliminary Report *supra*. See also R.A. Holman & Co., SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,313 at 82,549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967); Harry Marks, 25 S.E.C. 208, 213 (1947).

<sup>76</sup> See Duval Sec., Inc., SEC Exchange Act Release No. 7655 (July 23, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,264 at 82,399 (broker-dealer entered quotations at arbitrary and increasing prices to effectuate high prices); Elizabeth Sec., Inc., SEC Securities Act Release No. 4778, Exchange Act Release No. 7589 (April 30, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,232 at 82,335 (broker-dealer inserted arbitrary prices in quotation sheets to raise the price prior to a public offering); Archie H. Chevrier, SEC Exchange Act Release No. 7579 (April 22, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,231 at 82,333 (corporate merger shell, dubious acquisitions, and an increased tempo of trading at increasing prices to induce sales); Floyd A. Allen & Co., 35 S.E.C. 176, 183 (1953) (actual and apparent activity created by successively raising bids and employing misleading statements to inflate market price); R.L. Emacio & Co., 35 S.E.C. 191 (1953); Halsey, Stuart & Co., 30 S.E.C. 106, 125-26 (1949); Masland, Fernon & Anderson, 9 S.E.C. 338, 343-45 (1941); Barrett & Co., 9 S.E.C. 319 (1941) (dealer manipulated "inside" market quotations to other dealers to advance the price of securities and induce their purchase).

<sup>77</sup> Market insiders may influence demand by creating an illusion of active trading in the security, by entering fictitious quotations in the sheets at increasingly higher bids, and by allocating cheap stock or options of value to wholesale dealers to induce them to make a market in the security. These activities can collectively be called aftermarket arrangements and almost invariably involve a violation of existing federal securities law. See SPECIAL STUDY at Pt. 1, 539-45; Rotberg, *The "Hot Issue,"* 17 BUS. LAW. 360, 365, 367 (1962).

In *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904, 907 (1959), the broker-dealer was found guilty of creating "an unwarranted impression of interest and activity" in the security. In *M.S. Wien & Co.*, 23 S.E.C. 735, 742-46 (1946), the broker-dealer created a "false appearance of trading activity" to induce purchases of securities. See *Adams & Co.*, 33 S.E.C. 444, 457 (1952) (broker-dealer through a series of transactions created "actual and apparent trading" to induce others to buy). See note 76 *supra*.

<sup>78</sup> In *Floyd A. Allen & Co.*, 35 S.E.C. 176, 179-83 (1953), there was a sham transaction with the wife of a trader to enable the trader to sell at a price above the distribution offering price. In *M.S. Wien & Co.*, 23 S.E.C. 735, 741-42 (1946), the broker-dealer employed matched-order transactions, and "wash sales," in order to raise quoted prices. See Archie H. Chevrier, SEC Exchange Act Release No. 7579 (April 22, 1965), [1964-66 Transfer Binder] CCH SEC. L. REP. ¶ 77,231 at 82,333, which involved a merger with a corporate "shell" and acquisitions of "worthless" companies.

for short periods of time,<sup>79</sup> and any other practices that create the facade of an active market are probable violations, since as part of an artificial price setting mechanism they can be deemed a "scheme, device, or artifice to defraud."<sup>80</sup>

Although the language of the SEC anti-fraud provisions applies to "any person" who manipulates securities,<sup>81</sup> persons other than broker-underwriters generally are not a problem where "hot issues" are concerned, since such persons are not involved in the distribution process and thus are not in a position to take unfair advantage of a "hot issue" situation.<sup>82</sup> Issuers themselves, although involved in the distribution, do not generally gain from "hot issues" since no profits are available to them through the aftermarket.<sup>83</sup> If a case of outside involvement should arise, however, persons not dealer-underwriters themselves, who cooperate in a "scheme or artifice to defraud," would be subjected to the same proscriptions and sanctions of the security laws,<sup>84</sup> at least insofar as the available remedies would be applicable.

### *Distribution Violations*

In addition to creating fraud and manipulation problems, certain "hot issue" practices may result in violations of federal security laws dealing with the *distribution* of securities. Like the anti-fraud provisions,<sup>85</sup> these distribution regulations embody a philosophy that is designed to "provide disclosure to investors of material facts concerning securities."<sup>86</sup> These sections apply to the issuer of the

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<sup>79</sup> In *Woods & Co.*, 141 S.E.C. 725, 726 (1963), the broker-dealer "induced other brokers and dealers to place bids and asked quotations in the National Daily Quotation Service Sheets." See *M.S. Wien & Co.*, 23 S.E.C. 735 (1946), in which the broker-dealer employed another broker to publish quotations and make transactions on behalf of the Wien Co. at increasing prices.

<sup>80</sup> See cases discussed in notes 68-79 *supra* and accompanying text for suggestions of other artificial practices.

<sup>81</sup> Although section 15(c)(1) applies only to brokers or dealers, sections 17(a) and 10(b) apply to "any persons." Due to the similarity of the provisions, however, practically the same anti-fraud proscriptions actually apply to any person. See notes 28-34 *supra* and accompanying text.

<sup>82</sup> There is nothing inherently unfair in receiving an allotment of "hot issues" from a distributor and then reselling, as long as the allotment is acquired through a normal free market distribution process.

<sup>83</sup> Issuer non-involvement in "hot issue" violations assumes that none of the securities are withheld for issuers' accounts. In the withholding situation, issuer would be subject to the anti-manipulative provisions regarding that practice—especially Rule 10b-6. See notes 59-66 *supra* and accompanying text.

<sup>84</sup> See note 81 *supra*.

<sup>85</sup> See notes 22 & 27 *supra* and accompanying text.

<sup>86</sup> "The Securities Act of 1933 is designed to provide disclosure to investors of material facts concerning securities publicly offered for sale by the use of the mails or instrumentalities of

securities, or any person "in a control relationship" to the issuer.<sup>87</sup>

Section 5(b)(2) of the Securities Act of 1933 makes it unlawful for any person to sell, or deliver after sale, any security for which a registration statement has been filed, unless accompanied by a prospectus which satisfies the requirements of section 10.<sup>88</sup> Unless the transaction is exempted under section 4<sup>89</sup> any person who attempts to sell without delivery of such a prospectus violates section 5 and is subject to civil liabilities under section 12.<sup>90</sup> In addition, trading in the security may be suspended under section 8.<sup>91</sup> A person may violate section 5 by failing to comply with its requirements even though he trades under the mistaken belief that he falls outside the groups subjected to the requirement of section 5 by section 4. This precise situation has frequently arisen with the practice of allocating a portion of a "hot issue" offering to an insider or affiliate who,

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interstate commerce, either by an issuing company or by any person in a control relationship to such company . . . . Disclosure is obtained by requiring the issuer of such securities to file a registration statement with the Commission which includes a prospectus containing significant financial and other information about the issuer and the offering. The registration statement is available for public inspection as soon as it is filed." 32 SEC ANN. REP. 21 (1966).

<sup>87</sup> *Id.*

<sup>88</sup> Securities Act of 1933, 15 U.S.C. § 77e(b) (1964): "It shall be unlawful for any person, directly or indirectly—(1) to . . . carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or (2) to carry or cause to be carried . . . any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10." See Preferred Sec., Inc., 41 S.E.C. 769 (1963); Preliminary Report of Practices In Distribution of "Hot Issues," SEC Securities Act Release No. 4150, Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,671 at 80,524.

<sup>89</sup> Securities Act of 1933, 15 U.S.C. § 77d (1964). Section 4 exempts from section 5 "(1) transactions by any person other than an issuer, underwriter, or dealer; (2) transactions by an issuer not involving any public offering; (3) . . . (B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer through an underwriter after such effective date . . . ; (4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."

<sup>90</sup> *Id.* § 77l. Section 12 provides: "Any person who—(1) offers or sells a security in violation of section 5, . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

<sup>91</sup> *Id.* § 77h. Section 8(d) reads: "If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and after opportunity for hearing (at a time fixed by the Commission) within

believing himself to be exempt from section 5, intends to resell the security rather than hold it for investment.<sup>92</sup> The term "underwriter" has been defined to include a person who buys securities for further distribution rather than for investment.<sup>93</sup> Therefore, the distributing insider or affiliate may be deemed an underwriter under section 2(11)<sup>94</sup> and, consequently, may be subjected to all securities laws applicable to true underwriters. Also, any failure by the prospectus to identify the insider as an underwriter, to state any profits realized through his activities, or to describe the effect of the insider allocation on the supply available for distribution would render the prospectus misleading,<sup>95</sup> thereby invoking the civil liability provisions of section 12(2)<sup>96</sup> and subjecting the registration statement to suspension of effectiveness under section 8.<sup>97</sup>

The broker-dealer is also subject to the section 5(b) requirement of

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fifteen days after such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order the Commission shall so declare and thereupon the stop order shall cease to be effective." Such suspension, of course, must result in a suspension of trading.

<sup>92</sup> For liability of the original underwriter, see notes 94-103 *infra* and accompanying text.

<sup>93</sup> See generally at 551-57, 665-73. There does not have to be a contract relation with the issuer—any participation in the distribution is sufficient. See *SEC v. Chinese Consol. Benev. Ass'n*, 120 F.2d 738, 740-41 (2d Cir. 1941). See also Securities Act, Rule 142, 17 C.F.R. § 230.142 (1968). "The record establishes that at least 26 persons purchased shares of stock from registrant with a view to their distribution and accordingly were underwriters within the meaning of Section 2(11) of the Securities Act . . ." *Ambrosia Minerals, Inc.*, 39 S.E.C. 734, 736-37 (1960).

<sup>94</sup> Securities Act of 1933, 15 U.S.C. § 77b(11) (1964): "The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

<sup>95</sup> See, e.g., *Dale v. Rosenfeld*, 229 F.2d 855 (2d Cir. 1956) (failure to state exact nature of the underwriter's agreement made the prospectus misleading).

<sup>96</sup> Securities Act of 1933, 15 U.S.C. § 771 (1964): "Any person who—(2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction . . ."

<sup>97</sup> *Id.* § 77h. See note 91 *supra* and accompanying text. In addition, the misleading prospectus could be deemed a fraudulent practice under Rule 10b-5, section 15c(1) and section 17(a). See notes 70-73 *supra* and accompanying text.

prospectus delivery during distribution.<sup>98</sup> Because the distribution may be deemed in effect until any "withheld" hot issue stock is fully distributed,<sup>99</sup> the prospectus delivery requirement may extend over a lengthy period of time. Thus the period of potential civil liability under section 5 is considerably extended, as is the danger of revocation of broker-dealer registration under section 15 of the Securities Exchange Act. The lengthy distribution period may also cause the security to lose any possible intra-state<sup>100</sup> or private exemptions<sup>101</sup> from the prospectus delivery requirements of section 5. Furthermore, if the total of such deferred distribution exceeds \$300,000, the issuer may lose his exemption from registration,<sup>102</sup> thus

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<sup>98</sup> Securities Act of 1933, 15 U.S.C. § 77e(b) (note 88 *supra*).

<sup>99</sup> See R.A. Holman & Co., SEC Exchange Act Release No. 7770 (December 15, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,313 at 82,549, *aff'd*, 366 F.2d 446 (2d Cir. 1966), *cert. denied*, 389 U.S. 991 (1967). Distribution was deemed in effect until shares repurchased from "affiliates" were resold to the public. Batten & Co., 40 S.E.C. 997 (1962), *aff'd*, 345 F.2d 82 (D.C. Cir. 1964). The public distribution was continuing when stock was "reacquired" from control accounts for sale to the public. Lewisohn Copper Corp., 38 S.E.C. 226 (1958). Where securities were purchased for resale to the public, the period of public distribution includes the period when such resales are made. "A distribution of securities comprises 'the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public.'" *Id.* at 234.

<sup>100</sup> Securities Exchange Act § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1964): "The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, suspend for a period not exceeding twelve months, or revoke the registration of, any broker or dealer if it finds that such censure, denial, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming so associated—(D) has willfully violated any provision of the Securities Act of 1933, or of the Investment Advisers Act of 1940, or of the Investment Company Act of 1940, or of this title, or any rule or regulation under any of such statutes."

<sup>101</sup> *Id.* § 77c. Section 3(a)(11) reads: "(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities: . . . (11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

SEC Securities Act Release No. 4386 (July 12, 1961) comments as follows: "Not only the original sale but any further transactions effected as part of the process of distribution to the public must be limited to residents. It should be emphasized, therefore, that the exemption is not necessarily available simply because initial sales are confined to residents of the state. If any person, whether or not a professional underwriter or dealer, purchases the securities offered with a view to resale and does, in fact, resell them to non-residents, such person may be a statutory underwriter engaged in transactions forming a part of the distribution to investors. Where, as a result of such a chain of transactions, the process of distribution is not completed prior to the time the securities are acquired by non-residents, the exemption is not available to the issuer or any other person participating in the distribution."

<sup>102</sup> Securities Act of 1933, 15 U.S.C. § 77d (1964). "Purchasing for the purpose of future sale is nonetheless purchasing for sale and, if the transactions involve any public offering even at some future date, the registration provisions apply unless at the time of the public offering an

bringing the transaction within the provisions of section 5(a).<sup>103</sup>

### *NASD Sanctions*

While the anti-fraud and distribution controls of the federal security acts are general laws applicable to any stock, the National Association of Security Dealers (NASD) has adopted specific rules and regulations controlling "hot issues." The NASD, sanctioned by the Securities Exchange Act, is a voluntary self-policing body of over-the-counter brokers and dealers having as its purpose the "promotion of just and equitable principles of trade."<sup>104</sup> Approximately 85% of registered broker-dealer firms have joined the organization. Under its "Rules of Fair Practice,"<sup>105</sup> which ultimately depend on the SEC for enforcement,<sup>106</sup> the NASD has adopted rules to prevent unfair withholding and free-riding by its members. "Withholding" oc-

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exemption is available." Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825, Exchange Act Release No. 5562 (August 12, 1957).

<sup>103</sup> Under section 3(b) of the Securities Act of 1933, 15 U.S.C. § 77(c)(b) (1964), the Securities and Exchange Commission has the power to exempt from registration certain classes of securities. However, the aggregate offering price of the securities may not exceed \$300,000. "Regulation A" is the general rule adopted by the Commission governing such exemptions. 17 C.F.R. §§ 230, 251-63 (1968).

The issue would violate section 5(a) since no registration statement would be in effect. Section 5(a) reads as follows: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) . . . to sell . . . such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried in . . . [interstate commerce] . . . any such security for the purpose of sale or for delivery after sale." *Id. See, e.g., Preferred Sec., Inc.*, 41 S.E.C. 769 (1963); *Lewisohn Copper Corp.*, 38 S.E.C. 226 (1958). "Where such a method of distribution, which carries with it a probability of resale to the general investing public, is employed by an issuer or underwriter and resales are made at prices which result in the \$300,000 limitation being exceeded, it cannot be claimed that the offering is entitled to Regulation A exemption." 38 S.E.C. at 235.

<sup>104</sup> Congress has provided for self-policing bodies among over-the-counter brokers and dealers in the Securities Exchange Act § 15A, 15 U.S.C. 78o-3 (1964). The rules of these bodies are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions . . . and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market . . ." *Id.* § 78o-3(b)(8). Only one association has complied with this law and registered with the SEC—the National Association of Securities Dealers, Inc. [hereinafter cited as NASD].

<sup>105</sup> "Rules of Fair Practice" Article III, § 1, NASD MANUAL D-5 to D-27 (1967), proscribes the general standard of conduct for NASD members. Section 1 reads: "A member in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." These rules are interpreted by the Board of Governors of the NASD pursuant to Article 1, § 3(a) of the By-Laws of the Rules of Fair Practice. *Id.* These rules ultimately depend on the SEC for enforcement. Securities Exchange Act § 15A(g)-(b), 15 U.S.C. § 78o-3(g)-(h) (1964).

<sup>106</sup> Securities Exchange Act § 15A(g)-(h), 15 U.S.C. § 78o-3(g)-(h) (1964).

curs when members of the selling syndicate retain for their own accounts or for affiliates a portion of the issue to be distributed, a practice which has the effect of limiting the supply and therefore of inflating prices. In the view of the NASD, such withholding is "in contravention of ethical practices, and impairs public confidence in the fairness of the securities business."<sup>107</sup> Due to the interpretation of free-riding and withholding under the "Rules of Fair Practice," a member is obligated to refrain from selling to an affiliate as long as there are unfilled orders from the public, if there has been no bona fide public offering of the securities.<sup>108</sup> An affiliate is defined by the NASD as "any officer, director, partner, employee, or agent of the member or of any member or . . . a member of the immediate family of such person."<sup>109</sup> However, even when there has been no bona fide offer to the public, the securities may be sold to affiliates or withheld for the seller's account *if* the selling member can demonstrate that he sold or withheld the securities as a "bona fide investment" in accordance with his "normal investment practice."<sup>110</sup>

"Normal investment practice" has been defined both by case law and by NASD interpretation.<sup>111</sup> Under the latter, normal practice is

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<sup>107</sup> Interpretation with respect to "Free-Riding and Withholding," NASD MANUAL G-23 (1967).

<sup>108</sup> *Id.* See Introduction to "Free-Riding and Withholding" in the NASD MANUAL, which reads: "Members have an obligation to make a bona fide offering, at the public offering price, of securities acquired by a participation in any distribution, whether acquired as an underwriter, a selling group member, or from a member participating in the distribution as an underwriter or selling group member. The failure to make a bona fide public offering when there is a great demand for an issue can be a factor in artificially raising the price. Not only is such failure in contravention of ethical practices, but it impairs public confidence in the fairness of the securities business . . . [because] [a] member is in a position of trust, when it has information with respect to a particular security, the indicated demand, and other factors bearing on its future price not generally known to the public. To take unfair advantage of such a position as a participant in an offering indicates a lack of commercial honor."

<sup>109</sup> Interpretation with respect to "Free-Riding and Withholding," NASD MANUAL G-23, G-24 (1967).

<sup>110</sup> *Id.* at G-25.

<sup>111</sup> Several cases have interpreted the composition of a "bona fide public offering." *In re Rentz & Co.*, SEC Exchange Act Release No. 8134 (July 27, 1967), [1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,461 at 82,898, held that there was no bona fide public offering where Rentz sold its entire allotment in one day, and made no claim that it tried to resell to members of the general public shares sold to "affiliates." There was also evidence that the shares *could have been sold* to the general public. According to this case there is an inference, where hot issues are concerned in the absence of evidence to the contrary, that "additional public purchases were available." Furthermore, it is not necessary to show any relationship between the price increase and the prohibited sales; this is not relevant since such conduct is per se prohibited.

In *A.J. Gabriel Co.*, SEC Exchange Act Release No. 7696 (September 3, 1965), [1964-66

defined as "the history of investment in accounts with the member."<sup>112</sup> Moreover, if that history involves continual purchase of "hot issues," such record would not constitute a "normal investment practice."<sup>113</sup> If the NASD member's account is involved, there is the added requirement that the account must "be clearly an investment account as distinct from a regular inventory or trading account."<sup>114</sup>

Whether or not the account is for investment depends upon the purchaser's intent, which is a question of fact, with regard to which the purchaser's *statement* of his intent is merely evidentiary.<sup>115</sup> However, regardless of the investment history or normal investment practice of an insider account, there is no bona fide offering if the sale

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Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,283 at 82,450, the Commission held that there was no merit in defendant's argument that public purchasers were not available, and that in any event, the NASD has failed to prove otherwise and thus had not proved there was no bona fide public offering. Since the issue sold at an immediate premium of approximately 33 1/3%, the SEC concluded: "These facts lead to the inference that public purchasers were available at the time of the underwriting and applicants have made no showing to the contrary." See *Bailey & Co.*, SEC Exchange Act Release No. 7241 (February 14, 1964), [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,972 at 81,615. In *Leonard H. Zigman*, 40 S.E.C. 954 (1962), the NASD member's contention that he had filled "all orders on hand" from customers was rejected, especially in view of the fact that the offering price was less than the contemporaneous trading price. "Zigman's appropriation of part of the distribution and immediate resale above the offering price was a violation of his obligation to make a *bona fide* public offering of the securities concerned." *Id.* (emphasis added). See SPECIAL STUDY at Pt. 2, 568 n.81, for details of a 1960 case where the NASD fined several member firms \$500 each for depriving the public of the opportunity to purchase the allotted shares at the public offering price and thus violated the "free-riding and withholding" policy. The NASD members had argued that they had only made the allotments to ensure orderliness in the aftermarket and to prevent the market from being "artificially influenced by a lack of supply on the offered side," since they anticipated excess demand in the aftermarket.

<sup>112</sup> Interpretation with regard to "Free-Riding and Withholding," NASD MANUAL G-25 (1967).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Cf.* *Crowell-Collier Publishing Co.*, SEC Securities Act Release No. 3825 (August 12, 1957); *Opinion of General Counsel*, SEC Securities Act Release No. 1862 (December 13, 1938): "Although it is not impossible to conceive of a situation in which a person who had purchased securities for investment changed his mind in good faith on the next day, and proceeded to dispose of the securities, it must nevertheless be remembered that a state of mind can ordinarily be ascertained only by weighing evidentiary factors, and that a person's actions may be of far greater evidentiary significance than his statements as throwing light on what his state of mind was at a given time. Thus, self-serving statements that a particular purchase was made for investment would carry very little weight in the face of more concrete facts and circumstances inconsistent with such an intention." Nevertheless, a broker-dealer is guilty of an unfair practice if its actions fall outside the definitive "Rules of Fair Practice," even though he lacks a subjective intent to violate the rules. See *Bailey & Co.*, SEC Exchange Act Release No. 7241 (February 14, 1964), [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,972 at 81,615.

of a security is made to such an account in an amount which is disproportionate in comparison to the amount being offered to the public by the member.<sup>116</sup> *First California Co.*,<sup>117</sup> the first case to discuss the NASD's withholding interpretation in a "hot issue" setting, held that allotting 26.6% of a 1500 share allotment to affiliates was disproportionate, and thus there was no bona fide public offering. Furthermore, the SEC concluded that the "disproportionate" test is separate from and in addition to the "normal investment practice" criterion.<sup>118</sup> In *L. H. Rothchild & Co.*,<sup>119</sup> the SEC ruled that in determining what is insubstantial and not disproportionate, withheld securities are to be compared to the member's allotment rather than to the "amount of the total offering."<sup>120</sup>

By prohibiting withholding by its members, NASD concurrently prohibits the practice of "free-riding" hot issues.<sup>121</sup> The term was originally applied to the broker-dealer practice of purchasing at the public offering price and selling before the end of the seven day "cash period."<sup>122</sup> By purchasing and selling within the seven day period, the broker-dealer could take advantage of any immediate price rise in

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<sup>116</sup> Interpretation with regard to "Free-Riding and Withholding," NASD MANUAL G-24 (1967).

<sup>117</sup> 40 S.E.C. 768 (1961).

<sup>118</sup> Even if the sale of a "hot issue" is to be investment account, it still must not be disproportionate when compared to the amount that the member offers to the public. "It is clear that the 'disproportionate' test is a principal [*sic*] element in the requirement that a public distribution be bona fide, and in our opinion the interpretation did not subordinate such test to that of the investment character of the insider account." 40 S.E.C. at 771. The SEC further held that the test is sufficiently definite since the rule states that application of the test is to be controlled by "fairness," and this constitutes an adequate guide to members. In fact, they felt a more precise guideline would be impractical since "[a]n allotment to an insider which might be fair under the facts of one case, such as where very little or no market premium and no material restriction of supply was involved, might be unfair and disproportionate under the facts of another." *Id.* at 772.

<sup>119</sup> SEC Exchange Act Release No. 7182 (December 3, 1963).

<sup>120</sup> The defendant NASD member contended that the policy against free-riding and withholding is violated only when the total shares withheld or sold by participants to affiliates in a public offering are disproportionate and substantial when measured against the amount of the total offering. The SEC disagreed, reasoning that use of this test would permit easy evasion, since each individual dealer could claim that he had no knowledge of the amount withheld by other dealers. If this were the case and the individual allotments were all small, the whole issue might be withheld and not constitute a violation.

<sup>121</sup> "The professionals who withheld shares from the public at the initial public offering in a hot issue are taking a 'free ride,' to use the jargon of the industry, because they sell their shares at a handsome profit in the trading market." Israels, note 67 *supra*, at 528.

<sup>122</sup> Securities Exchange Act § 11(d)(1), 15 U.S.C. 78k (1964), prohibits the extension of credit by broker-dealers who participate in the distribution with the exception of allowing seven days, as specified under Regulation T, 12 C.F.R. 220 (1968), within which to make cash payment.

the "hot issue" after-market without the outlay of any funds. Recently the term has been used more broadly to refer to the practice of purchasing during distribution and selling after a subsequent rise in price in the aftermarket.<sup>123</sup> Although the latter practice is not specifically proscribed by federal security laws, the NASD forbids it since it allows the broker-dealer an unfair advantage from his position as a distributor of securities.<sup>124</sup>

Through its sanctions against withholding,<sup>125</sup> the NASD effectively prohibits free-riding by its members, since if securities cannot be withheld in the first place, a broker-dealer would have no opportunity to sell them later for his own account. Moreover, if securities are properly withheld by a NASD member in his investment account, he will be discouraged from free-riding since an early resale might create an inference of improper intent.<sup>126</sup>

Although the SEC has jurisdiction over NASD members, it has usually deferred to NASD enforcement since it has the power to review NASD decisions.<sup>127</sup> Because the NASD sanctions apply only to its members, federal security law sanctions must be relied upon to prevent unfair withholding and free-riding practices of non-members. Although there is no specific federal proscription of withholding or free-riding, non-members are effectively regulated by distribution and prospectus requirements, the anti-fraud provisions and Rule 10b-6.<sup>128</sup> In addition the SEC has the power to adopt rules making the restrictions against non-members equivalent to those enforced by NASD.<sup>129</sup>

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<sup>123</sup> See *Israels*, note 67 *supra*, at 55.

<sup>124</sup> See notes 105-110 *supra* and accompanying text.

<sup>125</sup> See NASD MANUAL G-23 to G-25.

<sup>126</sup> *Id.* Although it is probable that if the dealer indicated in the prospectus that he was withholding to resell later, there would be no fraud violation; but the dealer would still have to meet the more stringent NASD requirements which are designed to preclude any unfair profit taking by this practice. See note 108 *supra*. See also *Israels*, note 67 *supra*, at 55.

<sup>127</sup> The SEC's deferment to NASD authority is compatible with the purpose of NASD—to promote self-regulation of security dealers. See generally *White, National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959). A NASD decision can be appealed to the SEC, which reviews the decision and decides "(1) whether the evidence warrants the board's finding of violations, and (2) whether, if the finding of violations is upheld, the penalty imposed is 'excessive or oppressive.'" *Id.* at 258. The SEC may either cancel, reduce or "require the remission" of any penalty that has been imposed by the NASD. Securities Exchange Act of 1934, § 15A(h)(2), 15 U.S.C. § 78o-3 (1964).

<sup>128</sup> See notes 23-34 *supra* and accompanying text.

<sup>129</sup> "The Commission now has authority (like the registered associations) to establish standards of training, experience and other qualifications for registered broker-dealers who are not members of an association, and for their executive and sales personnel. The requirements

*State Blue Sky Laws and Hot Issues*

Since the federal securities laws do not preempt state legislation,<sup>130</sup> Blue Sky laws can be administered concurrently to govern "hot issues." However, state regulations typically do not specifically provide for the hot issue situation. Although many states have anti-fraud laws comparable to the federal statutes,<sup>131</sup> these are rarely invoked, as the states must primarily concentrate on the *registration* of securities.<sup>132</sup> In any case, the fraud standards of the states are no more strict than those imposed by the federal acts<sup>133</sup> and may carry with them some procedural disadvantages.<sup>134</sup> The states primarily deal with "hot issues" by authorizing securities administrators to reject registration of stocks which have "worked or tended to work a fraud upon purchasers or would so operate."<sup>135</sup> Furthermore, their chief criterion for registration is the intrinsic worth of the security offered for sale, and there is little consideration of what would happen to the security *after* issue.<sup>136</sup> Thus, the principal

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established to date consist of examinations to be taken by designated personnel, or in lieu of its examination, a passing grade on the NASD exam or certain other specified examinations. The Commission also has authority to adopt rules designed to promote 'just and equitable principles of trade,' a power applicable to non-members. The Commission on October 25, 1966 proposed Rule 10b-1, which would regulate non-NASD members with respect to such matters as discretionary accounts; supervision of associated persons; suitability of recommendations, and would generally require adherence to high standards of commercial honor. The Commission has authority with respect to non-members to impose fees designed to cover the regulatory duties assumed by the Commission." BLOOMENTHAL 533; Securities Exchange Act §§ 15(b)(8), (9), (10), 15 U.S.C. 78o-3(b)(8), (9), (10) (1964).

<sup>130</sup> Securities Act § 18, 15 U.S.C. § 77r (1964). "Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." Section 28(a) of the Securities Exchange Act reiterates this preservation of state authority. *Id.* at § 78bb(a).

<sup>131</sup> Twenty-five states and the District of Columbia have adopted in substantial form the Uniform Securities Act. CCH BLUE SKY LAW REP. ¶ 4901 (1967). Section 101 of the Uniform Act is substantially the same as section 17(a) and Rule 10b-5 of the Federal Acts. *Id.* at ¶ 4903.

<sup>132</sup> "The processing of applications for registration leaves the average administrator very little time to devote to the enforcement of the various anti-fraud provisions of his statute . . . . So long as administrators are given staffs scarcely adequate to handle the licensing duties imposed by the statutes, they cannot be expected to achieve more than a superficial enforcement of the various post-registration, anti-fraud and criminal provisions." L. LOSS & E. COWETT, BLUE SKY LAW 86 (1958).

<sup>133</sup> See note 131 *supra*.

<sup>134</sup> See Note, *Fiduciary Suits Under Rule 10b-5*, 1968 DUKE L.J. 791, 797 n.36.

<sup>135</sup> UNIFORM SECURITIES ACT § 306(E). See L. LOSS & E. COWETT, note 132 *supra*, at 328-29, for a discussion of § 306(E) as an almost universal rule among the states.

<sup>136</sup> "Unlike the federal securities act which is based on a 'disclosure' philosophy, most of the state statutes relating to the registration of securities reflect an approach that permits to a degree at least denial of registration because of the quality of the security or the terms on which it is being offered." BLOOMENTHAL at 25.

thrust of state regulation is directed toward whether or not the security should be registered rather than toward subsequent action in the aftermarket.<sup>137</sup>

A survey of state security administrators produced thirty-six varying approaches to handling the problems involving "hot issues." Several administrators reported that their states had experienced no problems<sup>138</sup> or gave "hot issues" no special treatment.<sup>139</sup> Others advised that while they have no specific policy, they do give "hot issues" closer scrutiny.<sup>140</sup> A number of states which do give special consideration to "hot issues" place particular emphasis on the options

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<sup>137</sup> For the most part the security administrator is concerned with the value of securities at the time of submission for registration; if he does take the aftermarket into account, however, the fact that the security has an even greater value than on the initial offering would probably militate in favor of registration. "Under our present law we have no direct jurisdiction over secondary trading in securities, and what sanctions we do impose are usually directed to the broker-dealer who is making the market." Letter from Anthony R. Pierno, Chief Deputy Commissioner, Division of Corporations of California, December 18, 1967.

<sup>138</sup> A typical response was, "[y]ou are informed that fortunately Connecticut has not, to our knowledge, had any problems along these [hot issue] lines." Letter from Melvin O. Hall, Connecticut Securities Director, December 7, 1967. Similar replies were received from *New Jersey*, Letter from James L. McKenna, Bureau of Securities Chief, Dept. of Law and Public Safety, December 6, 1967, and *Hawaii*, Letter from James K. Williams, Corporation and Securities Registrar, December 22, 1967.

<sup>139</sup> The Illinois Securities Commissioner stated: "Please be advised that this office does not incorporate any different procedures during the time of 'Hot Issues' than it uses during a normal market." Letter from Thomas J. Hawekotte, December 15, 1967. Other states evidently have similar policies: *Alaska*, Letter from John K. Robertson, Director, Division of Banking and Securities, Dept. of Commerce, December 8, 1967; *Maine*, Letter from Alden H. Mann, Director, Dept. of Banks and Banking, Securities Division, December 7, 1967; *Minnesota*, Letter from George J. Crowe, Attorney, Securities Division, December 8, 1967; *Nebraska*, Letter from Harold Johnson, Counsel, Dept. of Banking, December 7, 1967; *Oklahoma*, Letter from Carl G. Engling, Securities Commission Administrator, December 7, 1967; *South Carolina*, Letter from Bradley Heald, Deputy Securities Commissioner, December 6, 1967; *Tennessee*, Letter from Robert F. Miller, Director, Division of Securities, December 15, 1967; *Wyoming*, Letter from Kim Briggs, Deputy Secretary of State, December 12, 1967.

<sup>140</sup> The West Virginia Deputy Securities Commissioner replied: "We believe it would naturally be inferred that so called 'Hot Issues' would be scrutinized very carefully. We would not be influenced by the fact that the offering had been registered by the Securities & Exchange Commission." Letter from Cecil A. Washburn, December 6, 1967. Noting that each particular "hot issue" requires specific consideration on its own merits, the Texas Deputy Securities Commissioner commented: "This results, of course, in the refusal to register numerous such issues in Texas since our consideration runs to the principles of fair, just and equitable [sic] with the public investor in mind in contrast to outright securities speculators." Letter from Truman G. Holladay, December 7, 1967. Special scrutiny is given to "hot issues" in several other states: *California*, Letter from Anthony R. Pierno, Chief Deputy Commissioner, Division of Corporations, December 18, 1967; *District of Columbia*, Letter from Stanley H. Ragle, Securities Administrator, December 19, 1967; *Idaho*, Letter from W. E. Myers, Jr., Securities Administrator, December 8, 1967; *Louisiana*, Letter from Harold N. Vetter, Deputy Securities Commissioner, December 7, 1967; *Rhode Island*, Letter from Peter G. Barilla, Securities

and warrants to brokers and underwriters which may be involved.<sup>141</sup> Other states emphasize the ratio between previous earnings and the estimated price.<sup>142</sup>

Generally, the interstate scope of most "hot issue" problems makes state regulation an inadequate control. The SEC is undoubtedly in a more advantageous position to supervise "hot issues" which involve several states,<sup>143</sup> especially in view of the fact that most state departments are both undermanned and inadequately financed.<sup>144</sup> It is possible, as some have suggested, that regional groupings of states could effectively control "hot issues,"<sup>145</sup> but it is difficult to see how these bodies would offer any real advantage over SEC control except the avoidance of federal preemption.

### *The Future Regulation of "Hot Issues"*

The "hot issue" problem is a periodic phenomenon, the occurrence of which depends upon current market conditions and the speculative fervor of the "investor." It is apparent that the present hodge-podge of regulations applied to "hot issues" leaves too much uncertainty as

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Examiner, December 12, 1967; and *Washington*, Letter from Bernard G. Lonctot, Securities Administrator, December 8, 1967.

<sup>141</sup> "Our main concern is with the options and warrants involved in the 'hot issue.'" Memorandum Enclosure in Letter from Gregory D. Buckley, Indiana Securities Commissioner, December 20, 1967. Vermont apparently is concerned with this factor in particular. Letter from Mrs. Helen D. Barry, Administrative Assistant, Dept. of Banking and Insurance, January 10, 1968.

<sup>142</sup> "It is the opinion of this office that a mere determination by a managing underwriter that a particular issue can be sold to the public at a high multiple of earnings during the current 'hot issue' market does not constitute the necessary justification for the proposed offering price being 'fair and equitable' to investors." Monthly Bulletin from Thomas Nelson, Wisconsin Commissioner of Securities, September, 1967. Concern with this factor was expressed by other administrators: *Colorado*, Letter from Stanley R. Hays, Securities Commissioner, December 11, 1967; *Ohio*, Letter from N.J. Kiraly, Deputy Commissioner of Securities, January 3, 1968; *Michigan*, Letter from Donald Holcomb, Chief Examiner, Securities Bureau, Dept. of Commerce, March 6, 1968.

Evidently, Iowa has a fairly comprehensive set of unwritten rules which are applied to "hot issues," including examination of underwriting commissions (including warrants and options), issuance of "cheap stock" to underwriters, price-earnings ratio, and capital invested in the venture. Letter from Larry J. Bryant, Attorney, Securities Dept., January 18, 1968.

<sup>143</sup> See at 105-07.

<sup>144</sup> See L. Loss & E. Cowert, note 132 *supra*, at 57-62.

<sup>145</sup> One such body now in existence is the Midwest Securities Commissioners Association. Due to the broad discretionary powers of securities administrators, this body can adopt policies to control securities without changing existing state laws. The members of this group are: Arizona, California, Colorado, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming.

to what is forbidden, what is unfair, and what is specifically controlled. One real difficulty in any regulatory scheme is determining, without the aid of hindsight, whether an issue is in fact "hot," and therefore in need of close scrutiny. Even when the NASD has been able specifically to address itself to a "hot issue" problem such as withholding, it has not provided for sufficient enforcement<sup>146</sup> or reporting.<sup>147</sup> Unethical practices in "hot issue" dealing still prove highly rewarding when the penalties applied bear little relation to the profit gained.<sup>148</sup> The proper solution would appear to be for the SEC to adopt regulations with meaningful enforcement procedures specifically pertaining to "hot issue" situations.

Two proposals to control "hot issues" have been made, neither of which has been adopted. In 1946, the SEC proposed a rule<sup>149</sup> which would have made it a fraudulent practice for any broker-dealer participating in a distribution to offer for sale any undistributed part of an offering at a price above the prospectus price, unless a bona fide offer has first been made for a reasonable period of time to sell the shares to the public at no more than the prospectus price.<sup>150</sup> Although

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<sup>146</sup> "We note here that we view noncompliance with the NASD's free-riding interpretation to be a serious matter, and that we are concerned with the relative leniency with which the NASD has generally treated free-riding violations. In Special Study, it was observed that the interpretation had been ineffective in stemming free-riding practices, and that a major reason for its ineffectiveness was the inadequacy of the penalties imposed, which generally consisted of censure or at most a relatively small fine. Moreover, the NASD's practice since that report, although evidencing some strengthening of enforcement and policy, appears to reflect a continued failure to give appropriate recognition to the seriousness of the offense." *In re Rentz & Co.*, Securities Exchange Act Release No. 8134 (July 27, 1967). See SPECIAL STUDY at 533.

<sup>147</sup> "Aside from the parties to disciplinary proceedings, national and district officials and the Commission are the only recipients of the full texts of association decisions and all treat them as nonpublic material. Until the time of writing this report only expulsions were publicly announced through the press, under association policy . . . . Although factors other than lack of publicity of disciplinary proceedings are involved, it is worthy of comment that of 211 association disciplinary proceedings decided in 1959-61 involving the free-riding interpretation, only one was summarized in the NASD News, and that summary consisted of a discussion of the Commission's public release in July 1961 announcing its affirmance of the board's decision in the first California case, the first Commission decision reviewing an NASD free-riding case." SPECIAL STUDY at 666, 668.

<sup>148</sup> "[I]n most cases NASD has limited the sanction imposed to a fine, and such fine has not exceeded the actual or potential profit of the member or the 'free riders' based on the immediate premium in the after-market." *In re Securities Exchange Act Release No. 8134* (July 27, 1967).

<sup>149</sup> Proposed Rule X-15C2-3 (April 16, 1946).

<sup>150</sup> The underwriting industry, while not opposing the restrictions on unfair withholdings, objected that all investment opportunities in new issues would be severely limited. See SPECIAL STUDY at 531. The argument is somewhat specious since new issues could be purchased if taken for *investment* and if the allocation was disclosed in the prospectus. These requirements do not appear overly burdensome to the investing dealer.

the rule had some merit, in that it restricted dealer use of "hot issues," the market decline of 1946 deprived it the impetus needed for enactment.<sup>151</sup>

In 1962 a second proposal to control "hot issues" was submitted as a result of the Special Study of the Securities Markets. This proposal consisted of detailed recommendations that appear to satisfy the need for a guideline by specifying violations.<sup>152</sup> In general, the Study recommended (1) a rule requiring prompt delivery of prospectuses (24 hours); (2) a detailed report of stock disposition made by the distributor in the event the security rises to 120 percent of the public offering price within 40 days from the initial distribution; (3) more severe penalties for violations; (4) reporting of summaries of rulings; and (5) a clarification of possible violations of existing security laws.<sup>153</sup> Each of these recommendations was designed to prevent unfair "hot issue" practices uncovered by the Study. Regulations following these guidelines would have been a step forward, but these recommendations have never been enacted.

To alleviate the most pressing "hot issue" problems, action needs to be taken in three directions. First, the Special Study recommendations should be enacted to provide more efficient standards by which unfair conduct involving "hot issues" can be judged. Secondly, penalties incurred by violations of either SEC or NASD regulations should be of sufficient economic consequence to make questionable "hot issue" activity an unprofitable risk. A proper penalty might be complete suspension of trading in new issues for a substantial period of time determined by the magnitude of the violation. Such sanctions would put greater emphasis on forcing the broker-dealer to act as a professional in serving the investor community.<sup>154</sup> Third, private civil remedies with extensive recovery should be allowed to reinforce SEC protection of the investor in this area. The publicity resulting from private actions would not only serve as a warning to the broker-dealer community, but would alert the investing public to the dangers surrounding "hot issues."

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<sup>151</sup> *Id.* at 531.

<sup>152</sup> See *id.* at 71-73, for a more detailed explanation of its conclusions and recommendations.

<sup>153</sup> *Id.* at 72.

<sup>154</sup> This trend toward "Professionalism" is best illustrated by the "shingle" theory—"that a dealer by hanging out his shingle to do business impliedly represents that he will deal fairly with his customers." BLOOMENTHAL, at 572. See also Cady, Roberts & Co., 40 S.E.C. 907 (1961). One avowed purpose of NASD is ". . . to promote therein high standards of commercial honor. . . ." Certificate of Incorporation, NASD MANUAL ¶ .1003(1).

