

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION  
CONCERNING THE HOT ISSUES MARKETS

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REPORT OF THE SECURITIES AND EXCHANGE COMMISSION  
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SECTION I -- INTRODUCTION

A “hot issue” is an initial public offering (“IPO”) in which the price of a security in the aftermarket quickly rises to a substantial premium over the initial offering price. Because the demand for the security exceeds the size of the offering, the price of the security rises rapidly once trading commences and in some cases may trade at a multiple of the offering price within a few days or weeks.

The markets for such hot issues must be considered in perspective. A total of 6,100 registration statements were filed with the Commission during its fiscal year ending September 30, 1983, representing a dollar volume of \$243 billion. Of these offerings, slightly less than 2,000, aggregating \$57 billion, were initial public offerings.<sup>1</sup> Of this number, even fewer became hot issues. Most hot issues represent companies with significant assets, revenues, and equity. Some, of course, are highly speculative offerings by companies with little or no operating history and negligible net worth, but these factors do not necessarily mean a company is not legitimate. Problem hot issues (those characterized by fraudulent or manipulative practices) constitute a very small portion of all initial public offerings.

There are many legitimate reasons why a substantial number of initial public offerings rise to a premium, especially during a rising or bull market. A generally rising market creates public confidence, widespread investor interest, and profits from securities already held. The immediate success of a few highly-publicized offerings fuels demand for other new issues from

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<sup>1</sup> The Commission’s statistical base of IPOs includes all offerings of securities by issuers not previously subject to the reporting requirements, including recapitalizations and exchange offers. Thus, the amount of securities issued by companies going public for the first time is a substantially smaller figure.

investors hoping for spectacular overnight profits. The process of registration and the sales effort that follows also focus public attention on new offerings; and, where a company has new ideas that capture the imagination, it is not surprising that demand is created.

Some hot issues result, of course, from inadequate disclosure and/or manipulative and other trading abuses by underwriters or market makers. Many of the abuses commonly associated with hot issues, however, also are found in offerings other than initial offerings or relate to secondary trading in the securities of unseasoned companies. The bull market and the success of many initial public offerings create a favorable psychological climate for a variety of abuses in the secondary markets for small, unseasoned companies with thinly-traded securities. Because these abuses generally accompany hot issues markets and often create price behavior comparable to initial public offering hot issues, enforcement cases involving such abuses are relevant to this Report and will be discussed.

This Report analyzes past and present hot issues markets, the types of abuses that have occurred, relevant Commission enforcement actions, and recent actual or proposed statutory or regulatory changes. Section II discusses past hot issues markets and the response of the Commission and self-regulatory organizations. Section III analyzes the most recent hot issues markets. This Report identifies the 735 initial public offerings of securities, from January 1, 1980 to August 31, 1983 that subsequently were quoted in the NASDAQ system. Of these offerings, 231, or 31 percent, rose above the offering price by at least 25 percent in the first five trading days. While it is not feasible to ascertain the extent to which these offerings are representative of other over-the-counter hot issues, the sample represents a significant portion of

the hot issues traded during the period covered.<sup>2</sup> A detailed analysis of data concerning these offerings is set forth in Section III.

Section IV describes the abuses identified by the Commission's regulatory and enforcement efforts, and relates these abuses to enforcement case summaries set forth in the appendix. These case summaries are not drawn from matters currently under investigation by the Commission. While the case summaries do not necessarily cover all hot issues actions taken by the Commission, they indicate the range of abuses that have taken place. In addition, investigations presently are pending. Section IV also analyzes the role of the Commission's disclosure rules in minimizing potential hot issues abuses. Section V briefly sets forth the Commission's relevant statutory and rulemaking authority, concluding that this authority is broad enough to cover abuses that have been identified during hot issue markets.

## SECTION II -- HISTORICAL PERSPECTIVE

### A. A Cyclical Phenomenon

The surge in the market for small new issues witnessed in recent years, albeit only a small part of an overall market surge, is by no means unprecedented. Hot issues markets are a cyclical phenomenon, typically occurring in the late stages of a bull market. These markets represent only a small part of an overall market surge. The heightened investor confidence accompanying bull markets facilitates highly promotional new offerings, even those with virtually no chance for economic success. Typically, hot issues markets have revolved around the latest high-tech glamour industry -- electronics, computers and medical technology have been the stars of most hot issues markets.

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<sup>2</sup> A comprehensive analysis of the over-the-counter securities not included in NASDAQ would require price and quotation data that would be highly impractical to gather. See infra n. 36.d

In the past twenty-five years, there have been three major surges in the market for small new issues,<sup>3</sup> all occurring in the late stages of and representing a small fraction of broad bull markets. There were two major periods of heightened investor interest in these public offerings, from 1959 through 1962 and 1967 through 1971. The current market began in 1979, peaked and declined in 1981 and is now rising again. Coinciding with these markets have been concerted efforts by the Commission to alleviate problems engendered or exacerbated by new issues by small start-up companies.

B. 1963 Special Study of the Securities Markets

The Special Study of the Securities Markets, transmitted to Congress in 1963, was the most extensive examination of the securities markets since the 1930s.<sup>4</sup> Included in this study was a thorough analysis of new issues.<sup>5</sup>

This aspect of the Special Study was spurred by the new issues upsurge of 1959-1962, which reached the “highest level in history.”<sup>6</sup> In the year ending June 30, 1962, 2,307 registration statements were filed, of which 1,377 (or 60 percent) were by companies that had not previously filed a registration statement. In fiscal 1961, 1,830 registration statements were filed,

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<sup>3</sup> While there is considerable similarity between past and present hot issues markets, there are evolving constantly permutations that affect the trading market. For example, there are several closed-end funds that intend to invest a major portion of their funds in penny stocks.

<sup>4</sup> Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

<sup>5</sup> Id. Pt. 1, pp. 487-559.

<sup>6</sup> Id. at 487.

of which 958 (or 52 percent) were first-time filings. The comparable figures for fiscal 1950 were 496 and 112 (or 23 percent).<sup>7</sup>

The Special Study found that the new issues activity took place in a climate of “general optimism and speculative interest”<sup>8</sup> -- a description that remains true for later new issues markets. The Special Study concluded that a climate of “speculative fervor,” whose roots were “presumably deep in human nature,” was crucial to an understanding of the new issues phenomenon<sup>9</sup> -- also true today.

The Special Study brought into sharp focus, for the first time, the role of the underwriter in the new issues markets. Many of the problems targeted by the Special Study related to underwriting practices, distribution and aftermarket trading. Specifically, the Special Study observed that many underwriters, under pressure from customers and salesmen, lowered their standards of quality in determining what issues they would underwrite.<sup>10</sup> Broker-dealers were hastily organized to participate in the new issues boom. One result was public offerings based on carelessly prepared registration statements that seriously misrepresented the issuers’ activities.<sup>11</sup>

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<sup>7</sup> Id. at 487. See also Annual Reports of the Commission for the fiscal years 1950, 1961 and 1962.

<sup>8</sup> Special Study, supra note 4, Pt. 1, at 487.

<sup>9</sup> Id. at 553.

<sup>10</sup> Id.

<sup>11</sup> Id. at 554.

The Special Study also found problems with underwriter compensation agreements.<sup>12</sup> In many instances, broker-dealers underwriting a new issue or providing interim financing in a venture capital arrangement exacted excessive compensation from the issuer in the form of large amounts of cheap stock,<sup>13</sup> options, or warrants.<sup>14</sup> The Special Study identified two regulatory concerns. First, when an underwriter or selling group member<sup>15</sup> acquired a large amount of cheap stock, options or warrants, it penalized: (a) the issuer, who received a lower price for the stock than the initial public offering price; and (b) public investors, who were precluded from purchasing stock in the initial public offering.<sup>16</sup> Second, the Special Study observed that broker-dealers holding large amounts of a new issue had greater incentive to manipulate the secondary market for the security since they would substantially benefit from any upward price movement in the aftermarket.<sup>17</sup>

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<sup>12</sup> Id.

<sup>13</sup> Cheap stock, in general, is the sale of securities to the underwriters at a price below the public offering price.

<sup>14</sup> Special Study, supra note 4, Pt. 1, at 506.

<sup>15</sup> A “selling group” is:

any group formed in connection with a public offering, to distribute all or part of an issue of securities by sales made directly to the public by or through members of such selling group, under an agreement which imposes no financial commitment on the member of such group to purchase any such securities except as they may elect to do so.

NASD Rules of Fair Practice, Art. II § 1(h), NASD Manual (CCH) ¶ 2101 and id. at § 2, ¶ 2102.

<sup>16</sup> Special Study, supra note 4, Pt. 1, at 511.

<sup>17</sup> Id. at 506.

The Special Study also found that certain techniques employed by broker-dealers exacerbated the “hotness” of an issue, often creating immediate and substantial premiums over the initial offering price.<sup>18</sup> Trading markets for new issues tended to reflect a distorted picture of supply and demand. Several factors contributed to this. First, in the typical hot issue, over-the-counter trading began immediately with the effectiveness of the registration statement. Stocks could therefore be traded in the aftermarket before all customers knew of their allotment or received their stock certificates, making it more difficult for selling interest in an issue to keep pace with demand and facilitating a price increase. Many broker-dealers also restricted supply by (a) allotting only to customers who would not resell quickly, (b) penalizing salesmen whose customers sold their allotment in the immediate aftermarket, and (c) refusing to execute sell orders. “Withholding” and “free-riding” also restricted supply. Withholding occurs when a broker-dealer shelves substantial blocks of a new issue in order to restrict supply of the security, thus facilitating a price increase. Free-riding occurs when the shares are placed in the accounts of affiliates or insiders of a broker-dealer, who then trade at a profit once the price rises due to the artificially restricted supply.

The Special Study also focused on disclosure and found that, while many investors receiving initial stock allotments were highly sophisticated and able to assume the risks of a new issue, those who purchased in the aftermarket tended to be less sophisticated and were more impressed by quick upturns in a stock’s price. For these investors, the disclosure provisions of the securities laws assumed a particular importance.<sup>19</sup>

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<sup>18</sup> Id. at 555.

<sup>19</sup> Id. at 556.

The Special Study's recommendations were aimed at alleviating these problems and resulted in a number of legislative and regulatory changes. Some changes were accomplished almost immediately with the Securities Act Amendments of 1964, which implemented many of the Special Study's recommendations and affected the markets for small new issues in several important respects. A new section, Section 15(c)(5), was added to the Securities Exchange Act of 1934. Section 15(c)(5) gave the Commission authority to suspend trading in over-the-counter securities. This Section is now incorporated in Section 12(k) of the Exchange Act, which gives the Commission the authority summarily to suspend trading in any security, including small new issues.<sup>20</sup> Broker-dealers are prohibited from trading in the security for the duration of the suspension.

The 1964 amendments also made major changes in the prospectus delivery requirements. In accordance with the recommendation in the Special Study,<sup>21</sup> under what is now Section 4(3) of the Securities Act of 1933, the 40-day period during which a prospectus must be delivered was extended to 90 days in the case of first issues of common stock.<sup>22</sup>

Also in accord with the recommendations of the Special Study, the National Association of Securities Dealers, Inc. ("NASD"), the self-regulatory organization responsible for oversight of the over-the-counter markets, undertook to improve its rules and enforcement policies on free-riding, withholding, and underwriting arrangements. As a result, standards are more stringent and penalties for free-riding and withholding violations are much stricter today than 20 years ago; NASD guidelines regarding reasonable underwriting arrangements are much more

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<sup>20</sup> 15 U.S.C. 781(k).

<sup>21</sup> Special Study, supra note 4, Pt. 1, at 558.

<sup>22</sup> 15 U.S.C. 77d(3).

extensive; and NASD rules provide far more severe restrictions on underwriters receiving options, stock or warrants as part of a compensation package. (See Section V, *infra*).

C. 1972 SEC-NASD Task Force and 1972 Commission Hearings

In 1967-1971, the new issues markets experienced a resurgence. In response, the Commission and the NASD created a joint task force in mid-1972 to combat the problems caused by hot issues. Teams of Commission and NASD personnel conducted intensive examinations and investigations of certain broker-dealers. A considerable number of enforcement actions resulted from the violations that were uncovered.

In addition, in February 1972, the Commission began public, fact-finding hearings on the hot issues experience.<sup>23</sup> The purpose of the hearings was to determine the adequacy of existing disclosure requirements and other investor protection programs. The hearings were extensive. The first phase, which lasted from February through June of 1972, focused on the methods of financing available to start-up companies, the adequacy of existing disclosure requirements, and the patterns of distribution and aftermarket trading that caused new issues to trade at immediate, substantial premiums. The second phase of the hearings began in September 1972, and focused totally on problems in distribution and aftermarket trading.

On July 26, 1972, the Commission, in a series of releases, proposed a number of amendments to its rules to curb the excesses of hot issues.<sup>24</sup> As discussed below, these proposals related to improved disclosure requirements and the delivery of offering circulars. On that same

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<sup>23</sup> SEC File No. 4-148.

<sup>24</sup> See Securities Act Release Nos. 5274, 5276, 5277, 5279, (July 26, 1972); Securities Exchange Act Release No. 9673 (July 26, 1972).

date, the Commission adopted amendments to Rules 425A and 426<sup>25</sup> under the Securities Act of 1933 and amendments to then-existing Guides 5, 6 and 21 to improve the readability of prospectuses.<sup>26</sup>

Also on July 26, 1972, the Commission issued a release that discusses the obligations of underwriters and broker-dealers in distributing securities, especially those of new, high-risk ventures.<sup>27</sup> The release's purpose was to

place the investment banking community on notice as to the need to diligently investigate the disclosure provided to the public in connection with the securities they are distributing; to assure that the recommendations they make concerning such securities are suitable to their customers; and to make a bona fide public offering of the securities so that trading may develop with an adequate supply of such securities.<sup>28</sup>

On June 1, 1973, the Commission adopted many of its July 26, 1972 rule proposals.<sup>29</sup> The amendments resulted in significant changes to registration statements (Forms S-1 and S-2 under the Securities Act and Form 10 under the Exchange Act), periodic reports (Forms 10-Q and 10-K), and to Rules 13a-13 and 15d-13 under the Securities Exchange Act of 1934. The amendments to the registration and periodic reporting forms required more meaningful disclosure regarding management, the status of new product development, general competitive conditions, the position of the issuer in the industry in which it operated, and, in the case of

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<sup>25</sup> Rule 425A requires that a statement be printed on prospectuses as to the prospectus delivery requirements of dealers. Rule 426 requires a statement in prospectuses regarding over-allotment or stabilization if there is an intent to engage in either of those practices.

<sup>26</sup> Securities Act Release No. 5278 (July 26, 1972).

<sup>27</sup> Securities Act Release No. 5275 (July 26, 1972).

<sup>28</sup> Id.

<sup>29</sup> Securities Act Release Nos. 5395, 5396, and 5397 (June 1, 1973).

certain registrants offering securities for the first time, a description of their plan of operation.<sup>30</sup> Particular emphasis was placed on the disclosure of such plans relating to new ventures.

Significant amendments to then-existing disclosure guidelines were also implemented. For example, a new guide, Guide 59 of the Guides for the Preparation and Filing of Registration Statements under the Securities Act, was added. It required that all prospectuses on Forms S-1 and S-2 include a summary highlighting the salient features of the offering. Guide 5, relating to the preparation of prospectuses, was revised to provide more meaningful disclosure of the risk factors associated with an issuer's business for first-time public offerings. Greater information regarding the estimated maximum offering price and number of shares or other units to be offered also was required in preliminary prospectuses. Further, disclosure was required of the factors that were considered in establishing the offering price.<sup>31</sup>

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<sup>30</sup> For example, prior to 1972, Forms 10 and 10-K required a ten-year litigation history with respect to directors. During the Commission's 1972 hearings, securities professionals testified that disclosure relating to the background and prior performance of management was also material to an investment decision, particularly when a registrant had no operating history. As a result, the Commission required disclosure of background information with respect to both directors and executive officers in registration statements. Securities Act Release No. 5395 (June 1, 1973). Subsequently, the disclosure item was moved to Regulation S-K. Securities Act Release No. 5949 (July 28, 1978).

<sup>31</sup> All disclosure requirements, including those relating to hot issues, were recently scrutinized and re-evaluated in connection with the development of the integrated disclosure system, which incorporates the 1973 disclosure amendments. For example, Guide 59, which had its genesis in the 1973 hot issues amendments, was refined and now appears as a part of Item 503 in Regulation S-K.

The Commission also amended Rule 256 of Regulation A<sup>32</sup> under Section 3(b) of the Securities Act to require, in the case of new ventures, delivery of the offering circular to prospective purchasers 48 hours in advance of the mailing of a confirmation of sale. This amendment made the delivery requirements for the offering circular parallel to those pertaining to the final prospectus under the Act.<sup>33</sup>

Also on June 1, 1973, the Commission issued a release discussing the obligations of underwriters with respect to discretionary accounts.<sup>34</sup> This release was issued in response to the problems uncovered in the 1972 hearings and was a reminder to the industry of its obligations under the federal securities laws. Specifically, the release reminded underwriters that whenever an underwriter has a self-interest in the success of an offering, placement of a portion of that offering in a discretionary account raises a potential conflict of interest.

#### D. Recent SEC-NASD Efforts

The most recent hot issues markets have been centered in Denver, Colorado and New York. The Commission, working closely with the NASD, has maintained a vigilant enforcement presence in these markets.

##### 1. Denver Hot Issues Market

During the period 1979 to 1983, numerous broker-dealers were formed in the Denver area to take new companies public. A substantial number, however, lacked funding, operational

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<sup>32</sup> Very briefly, Regulation A grants an exemption from registration for public offerings of no more than \$1.5 million in a 12-month period. The issuer must file a notification and an offering circular with the Commission providing basic information about the company, and must use the offering circular in the offering. The information required to be in the circular is not as extensive as that required in a registration statement.

<sup>33</sup> Securities Act Release No. 5397 (June 1, 1973).

<sup>34</sup> Securities Act Release No. 5398 (June 1, 1973).

expertise, sophistication, and the back office capabilities necessary to engage in the securities business in compliance with the federal securities laws.

Commencing in about September 1981, the Denver hot issues market began to “soften.” The staffs of the Commission’s Denver Regional Office and the NASD’s Denver District Office began to meet with increasing frequency. The financial condition of all Denver and Salt Lake City area firms was reviewed to identify those firms that were having difficulty complying with the Commission’s “early warning,” net capital, customer protection, and books-and-records requirements. Also, the staffs exchanged information derived from their respective market surveillance and examination programs concerning suspected sales practice violations, including market manipulation activities.

In late 1981 and early 1982, a significant downturn in the Denver hot issues market was identified through the market surveillance and the broker-dealer inspection programs. Aggregate trading volume decreased and numerous broker-dealers whose business was geared primarily to the underwriting and aftermarket trading of hot issues experienced serious financial losses.

Serious questions arose concerning the financial condition of the various OTC broker-dealers and their compliance with the “early warning” provision of the federal securities laws. The early warning provision requires that the Commission and the NASD be given notice prior to when a broker-dealer is in net capital violation or when a firm is experiencing recordkeeping or customer protection problems.

As a result, in February 1982, the Commission and the NASD organized a joint inspection program of firms heavily involved in the Denver hot issues market. The NASD provided 38 examiners from 14 district offices throughout the United States and three top officials from the NASD’s Washington office. The Commission provided 19 of its most

experienced examiners from all of its regional offices, as well as interpretive staff from the home office.

During the joint examination program, Commission and NASD examiners reviewed the financial, operational and sales practices of 28 NASD member firms. These examinations and subsequent investigations uncovered numerous apparent violations of the securities laws. They included market manipulation; violations of the Commission's net capital, customer protection, and "early warning" rules; falsification of books and records; use of improper accounting methods; failure promptly to transmit offering proceeds to escrow accounts; failure to return investor proceeds from "best efforts" underwritings; and failure to return customers' funds and securities on request.

Of the 28 broker-dealers examined, ten voluntarily ceased business after extensive negotiations with the staff. Four of these reopened after substantial additions to their capital, correction of their books and records, and other corrective measures, and six underwent supervised self-liquidation. Civil actions were instituted by the Commission against six brokerage firms, three of which were the subject of Securities Investor Protection Corporation liquidation proceedings, and three underwent self-liquidation under supervision. Other firms continued to require close monitoring, and additional investigation of approximately 15 firms was required during the following months.

From June 1982 to approximately September 1983, underwritings and secondary market trading increased. Many of the remaining firms became profitable, thereby ameliorating some of the financial problems uncovered by the February 1982 Task Force.

Since September 1983, there has been a renewed softening of the hot issues market in Denver. The Denver Regional Office and Denver NASD staffs are closely monitoring the

financial condition of various Denver and Salt Lake City broker-dealers. There are 21 Denver and 16 Salt Lake City area broker-dealers receiving closer than normal surveillance by the NASD and the Commission.

In monitoring the activities of broker-dealers that are active in underwriting and secondary trading in the Denver and Salt Lake City markets, the Denver Regional Office and Denver NASD have worked closely together and meet regularly. Such joint efforts have included closely scrutinizing monthly profits and losses, transaction volume, and net capital; designating problem firms that subsequently are referred by the NASD to SIPC; and regularly sharing information concerning firms that are experiencing financial problems or engaging in possible manipulative or other sales practice violations.

On April 5, 1983, staff members of the Commission and the NASD met in Washington and discussed measures to cope with the reviving Denver and Salt Lake City hot issues markets. The NASD decided to explore the possibility of new rules of interpretations involving due diligence practices, suitability, discretionary trading authority, best efforts offerings, free-riding, and withholding. In addition, the NASD has implemented a new "Business Restriction" rule enabling it to limit the operations of financially troubled firms and reduce the firm's customer exposure. The NASD also implemented plans to expand its Denver staff from approximately 15 examiners to 21 examiners, and from two supervisors to three supervisors. Two more Denver NASD staff members have been added to process numerous complaints being received from investors. A full-time Regional Attorney has been added to facilitate disciplinary proceedings (approximately 50 as of November 1, 1983) that have been commenced by the Denver NASD office. In addition, the Fraud Unit of the NASD implemented a special examination effort to scrutinize four selected 1982-1983 hot issue offerings. Four two-person investigative teams,

composed of experienced NASD examiners, are inquiring into trading patterns and interviewing investors, salespersons, firm traders, and principals.

## 2. New York Market

In September 1983, the Commission and the NASD, in response to an increase in hot issues activity in the New York area, identified a number of broker-dealers that had been active in the new issues market within the past year. An analysis was made of recent new offerings by these brokerage firms, principally within the first eight months of 1983, as well as aftermarket price characteristics of the offerings. Background material on the regulatory record of the brokerage firms, their principals and registered representatives was accumulated.

A task force was formed consisting of personnel from the Commission's New York Regional Office and Home Office and the New York District Office of the NASD. The Commission committed 20 examiners to the Task Force; the NASD committed seven. The examination teams generally consisted of one or more Commission securities investigators or broker-dealer examiners and an examiner from the NASD. The task force drew on the experience of previous task force examination programs in the New York Region in the early 1970s, the Denver Regional Office new issues examination program in 1982, and other programs by the NASD and other regional offices of the Commission.

Nine of the underwriting firms most active in the hot issues area were selected for examination.<sup>35</sup> Twenty-four public offerings, which raised over \$62,000,000 from public investors, were examined by the task force teams from a much larger group of offerings

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<sup>35</sup> The examination of a tenth brokerage firm was indefinitely postponed because capital problems developed before the examination could begin and the NASD intervened in overseeing the operations of the firm.

analyzed. Nine offerings were priced at less than \$0.10 per share or unit. Nine were priced between \$.10 and \$1.00. Six offerings were priced at more than \$1.00 per share or unit.

The focus of the examinations was not on operational problems or financial problems, as was true of some past examination programs. Rather, they targeted specific problem areas associated with hot issues and focused on sales practices, manner of distribution of the offerings, and aftermarket trading.

Three brokers experienced disruptions of their operations and limitations on business due to cancellation of existing clearing arrangements while the examinations were ongoing. In two instances, new clearing arrangements were signed. In one case, capital problems developed when the firm attempted to self-clear for aftermarket trading in a just-completed new issue, and the brokerage firm ceased operations. Within a few months of the examinations, two more firms ceased operations, and their employees dispersed to other firms. Thus, the New York task force found that capital and operational problems, while not a pervasive characteristic of the current underwriting market due to the prevalence of clearing arrangements through other brokers, can still quickly develop in firms whose principal income-generating activity is the underwriting of initial public offerings and aftermarket trading in new issues.

Five of the offerings examined were of companies that had some operating history or a developed product, including a commuter air service, a restaurant chain, a medical products manufacturer and a propane gas distributor. The majority of offerings examined were of companies with limited or no prior operating experience and in some cases merely an outline of a proposed line of business. The latter group of companies planned to develop medical devices, nuclear medicine products, franchise restaurants, oil and gas interests, real estate agencies using

computer services, insurance, financial consulting, video material production and distribution, and automation consulting services.

Some of the new issues examined turned out to be “cold issues,” that is, they did not trade at a premium in the aftermarket and were in some instances “sticky” or difficult to sell. These issues are more likely to be characterized by parking of shares by underwriters in nominee accounts in order to meet a minimum offering level or create the appearance of a public distribution, and misrepresentations to investors to induce purchases.

The majority of the initial public offerings were more traditionally classed as “hot issues” -- that is, they traded at a substantial premium in the immediate aftermarket and, although high risk and speculative, they attracted the active interest of investors. Fad and high-technology business lines were well-represented, including robotic manufacturing, medical products, computers, video materials and entertainment.

The New York Task Force identified several abusive practices, including abuse of escrow accounts, gun jumping (selling before the effective date), parking, market domination and control that appear to form part of manipulative schemes, free-riding and withholding. As a result of the examinations, the Commission initiated six formal investigations, four of which are now being pursued in New York, and two of which were referred to other offices.

### SECTION III -- CHARACTERISTICS OF HOT ISSUES OFFERINGS, ISSUERS AND UNDERWRITERS, JANUARY 1, 1980 THROUGH AUGUST 31, 1983

To determine the characteristics of issuers and underwriters that have been involved in recent hot issues markets, the approximately 735 initial public offerings of securities that commenced between January 1, 1980, and August 31, 1983, and that subsequently were traded in the NASDAQ system, have been analyzed. Of these offerings, approximately 30 percent, or 233 issues, were quoted at a price 25 percent higher than the initial offering price within five trading

days after the offering. While these 233 offerings are not necessarily representative of all hot issues,<sup>36</sup> they offer a useful basis for comparison and analysis. It should be reiterated that these offerings represent only a small portion of overall market activity during this period.

A. Issuer and Offering Characteristics

Exhibit A analyzes the 233 offerings on the basis of offering price and size of offering. While some offerings were made at prices under \$1.00, the majority were made at prices in excess of \$6.00 per share by issuers having a history of profitable operations. In 53 percent of the issues, the offering price was between \$6.00 and \$20.00, while 7 percent of the offerings were made at a price in excess of \$20.00. Only 5 percent of the offerings were priced under \$1.00 and only 35 percent were priced at over \$1.00 but under \$6.00. The majority of the offerings raised over \$6,000,000, with 11% of the offerings raising in excess of \$35,000,000.

Exhibit B analyzes the offerings on the basis of issuer financial characteristics. Of the 233 companies, only 8 percent had no significant revenues prior to the offering. Only 33 percent had revenues of under \$1,000,000, while 37 percent of the issuers had revenues of more than \$10,000,000 and 9 percent had revenues of over \$50,000,000. While 39 percent of the issuers reported either no operations prior to the offering or that recent operations resulted in a loss, 21 percent of the issuers reported net income of between \$1,000,000 and \$5,000,000 for their latest

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<sup>36</sup> A comprehensive analysis of the most recent hot issues markets would require price and quotation data that are not readily available. To evaluate all hot issues from January 1, 1980 through August 31, 1983, it would be necessary to include those listed in the pink sheets and those that were exchange-traded. The number of exchange-traded hot issues, however, is quite small. Moreover, sufficient data are not available with respect to "pink sheet" hot issues. The stocks involved in many initial public offerings are listed in the National Quotation Bureau's daily "pink sheets," frequently without specific price information. Even where priced quotations are available, they may not appear on a regular basis and do not in any case reflect actual transactions. An attempt was made to analyze those IPOs listed in the pink sheets, using the same parameters used in the analysis of those traded in the NASDAQ system. This effort proved unsuccessful due to inadequate price information.

fiscal year and 6 percent of the issuers reported income in excess of \$5,000,000. In addition, the majority of the issuers analyzed had substantial assets prior to the offering. Of the 233 issuers, only 30 percent had assets of less than \$1,000,000, while 36 percent had assets of more than \$7,500,000 and 5 percent had assets of more than \$50,000,000.

When viewed in terms of dollar volume, the percentage of these offerings made by established issuers is even greater. See Exhibit C. In terms of dollar volume, the percentage of the offerings made at a price in excess of \$6.00 was 87 percent, with 30 percent of the funds raised in offerings priced in excess of \$20.00. Only 3 percent of the funds were raised in offerings priced under \$1.00 and only 10 percent of the funds were raised in offerings priced at over \$1.00 but less than \$6.00. Approximately half of the funds were raised in offerings where the aggregate offering price was over \$35,000,000, while offerings with an aggregate price of under \$6,000,000 accounted for only 10 percent of the funds raised.

Also in terms of dollar volume, 49 percent of the funds raised were invested in companies having assets in excess of \$15,000,000, with 18 percent being invested in companies having assets in excess of \$50,000,000. See Exhibit D. By contrast, only 8 percent of the funds raised were invested in companies having assets under \$1,000,000. A comparison of the revenues earned by these issuers, when viewed in terms of funds raised, also shows that the substantial majority of these funds were invested in established companies. Companies having revenues in excess of \$10,000,000 raised 66 percent of the funds, with issuers having revenues in excess of \$50,000,000 receiving 28 percent of the funds raised in these offerings. Only 2 percent of the funds were invested in companies reporting no significant revenues and only 9 percent of the funds were invested in companies having revenues of less than \$1,000,000.

Of the 233 issuers whose offerings were analyzed, 23 percent were engaged in the production of office equipment, computers or allied activities. See Exhibit E. The next largest industry concentration was in the area of medical and other research and instrumentation, with 16 percent of the issuers engaged in that field. Ten percent of the issuers were engaged in the electrical and electronics field, 6 percent in leisure time activities and 5 percent in radio, television, telegraph, and communications. Issuers engaged in the exploitation of natural resources and related equipment represented 5 percent of the group, as did companies engaged in miscellaneous retailing. Issuers engaged in the fields of drugs and general machinery each accounted for 3 percent of the group, while the remaining 40 issuers were engaged in widely varying activities.

B. Description of Underwriters Involved in Hot Issues

The underwriters involved in the 233 hot issues in the NASDAQ sample reflect a representative cross-section of the underwriting community. Exhibit F lists those underwriters involved in 2 or more hot issues in a calendar year or three or more hot issues during the period covered by the sample. Many of the firms with the greatest net capital are included, as are leading regional underwriters and a number of smaller broker-dealers.

A separate analysis was done for the “hottest” of the hot issues, i.e., those that appreciated at least 100 percent over the initial offering price in the first five trading days following the offering. There were 30 of those offerings, or 13 percent of the sample. The 30 offerings were underwritten by 22 different broker-dealers, 11 of whom underwrote no other hot issues that were included in the sample.

The underwriters that have been involved in the enforcement cases summarized in the appendix are far less diverse than those represented in the NASDAQ sample. See Exhibit G.

These firms are for the most part fairly recently established and tend to be located in the New York City or Denver metropolitan areas. Of the 16 underwriters, 5 are no longer in business.

#### SECTION IV -- HOT ISSUES ABUSES

The Commission has found that the violations of the federal securities laws in connection with the most recent hot issues markets generally have not resulted from the issuer's failure to disclose negative information in prospectuses and registration statements. Rather, issuers often have disclosed in vivid detail that they have no operating history, no experience in the business in which they intend to engage, and no real expectation that they will be successful. Under the federal scheme of regulation, full disclosure of such information is sufficient and investors are allowed to make their own judgments as to the merits of a particular offering.

The abuses that the Commission has found in the most recent hot issues market generally have been selling abuses. In those cases where the Commission found problems, some investors have been subjected to high pressure sales pitches characterized by false information about the issuer and unwarranted price predictions. In some cases, broker-dealers have engaged in fraudulent activities such as parking, tie-in arrangements, and manipulation of the aftermarket.

Although such abuses are not a general problem in the most recent hot issues market, this Section discusses the various disclosure abuses that are typical of hot issues markets, as well as trading abuses, and refers to Commission actions involving these abuses. As discussed in Section V, the statutory system developed by the Congress generally has proven adequate in dealing with these abuses.

##### A. Trading Practice Abuses

Generally, the abuses found in a hot issues market involve either artificial restrictions on supply or attempts to stimulate demand that facilitate a rapid rise in the price of a security.

Because of the widely varying facts of distributions, it is important to distinguish the illegal abuse of legitimate practices from legal practices so as not to preclude legitimate actions. Fraudulent sales practices used in these cases included manipulation of stock prices, parking arrangements under which underwriters park shares in bogus accounts for the benefit of promoters or underwriters, failure to deliver or to deliver timely stock certificates to customers, premature use of investor funds that should have been escrowed until the offering was completed, use of investor proceeds that are supposed to be segregated to buy up or complete an offering, and tie-in arrangements by which underwriters require investors to make economic concessions in order to participate in a hot-issue public offering.<sup>37</sup> Manipulation and parking continued to be significant abuses associated with hot issues, while the other practices, though occasionally present, did not continue to be as significant a problem. A detailed discussion of each of these practices follows.

1. Market Manipulation and Domination

Market manipulation can take any form; the scope and content of a manipulative scheme is limited only by the ingenuity of its perpetrator. Some common elements, however, exist in any manipulation. One critical element is manipulative purpose, i.e., an intent to raise or lower the price of a security by artificial means. These artificial means include inducing transactions

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<sup>37</sup> As noted previously, when the Commission studied the hot issues markets of the early 1960s, it found that non-cash underwriter compensation in the form of cheap stock, options, or warrants often contributes to aftermarket manipulation of underwritten securities. In response to these practices, the NASD adopted policies governing cash and non-cash underwriter compensation. (See Section V, infra). While underwriters in more recent hot issues markets have continued to receive non-cash compensation, especially in offerings of low-priced stock underwritten on a best-efforts basis, such compensation does not appear to have resulted in severe manipulative abuses.

by others (demand-related activity)<sup>38</sup> as well as complex arrangements to control the supply of the securities being sold (supply-side activity). Generally, market manipulations are actionable under the antifraud provisions, Securities Act Section 17(a), Exchange Act Sections 10(b) and 15(c), and Rule 10b-5, and if the security is exchange-traded, pursuant to Exchange Act Section 9.

One common method of controlling supply is domination and control by the broker-dealer of the market (both retail and wholesale) for the security. It is not uncommon for one broker-dealer, often the managing underwriter, to dominate trading in a new issue for a period after the underwriting. This is not in itself illegal. However, when that domination is combined with efforts to suppress the development of an independent market and prices are determined by an internally created system controlled by the broker-dealer rather than by the forces of supply and demand prevailing in an open market, it violates the antifraud provisions of the federal securities laws. Although the Commission has held that domination and control can be an independent violation of the federal securities laws, such activity has clearly manipulative overtones and can constitute an element of the manipulation itself.<sup>39</sup>

In some cases, a broker dominates the market by virtue of the large share it receives as managing underwriter of an initial public offering. This in itself is not illegal and can serve a

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<sup>38</sup> Nothing in the federal securities laws prohibits aggressive sales efforts per se. An underwriter may, however, violate the securities laws by promoting an issue by improper means, such as where there is an orchestrated campaign to drive up the price in the aftermarket and provide a ready source of supply for aftermarket orders and: 1) salesmen disseminate fraudulent information as to a company's prospects; or 2) salesmen given conflicting advice so as to create the appearance of high trading volume and active interest in the security, and there is no reason to make differing recommendations to particular customers based upon their objectives or any reasonable basis for differing recommendations from different salesmen.

<sup>39</sup> See generally Wolfson, Phillips and Russo, Regulation of Brokers, Dealers and Securities Markets ¶2.13 (1977 ed.).

valid purpose in the distribution and trading of a security. However, where this share is used to facilitate placement of securities in accounts that are controlled by the underwriter to facilitate aftermarket manipulation of the stock, there is a violation of the securities laws. Case 14 is an example of this practice. This case concerned a firm commitment offering of 1,000,000 common shares of a company engaged in the development of water desalinization filters. The offering, priced at \$3.25 per share, was the company's initial public distribution. Of the offering, approximately 15 percent of the shares were placed in accounts controlled by the managing underwriter or other related parties. On the first day of aftermarket trading, the stock price was manipulated to a high of \$7-3/4. This was done by arbitrary pricing, artificial restriction of the available supply of stock, domination of the market, use of the firm trading account to absorb the substantial excess of supply over demand for the stock, and other devices. Certain of these manipulative devices continued to be employed until the price reached \$10-1/2. Thereafter, the broker-dealer that had managed the offering continued to dominate the market for the stock and the price increased to \$17. Such activities were violative of Exchange Act Sections 10(b) and 15(c)(1) and Rules 10b-6 and 15c1-8. Further, the use of nominee accounts to hide the true beneficial ownership of the stock caused the firm to violate the Exchange Act books and records provisions.

Other cases characterized by price manipulation and/or domination include Numbers 5, 8, 13, 22, and 25. These cases involved the violation of a number of provisions of the securities laws including the antifraud and antimanipulative provisions.

2. Free-riding and Withholding

Free riding and withholding are related means of restricting the supply of stock of a new issue. Stock is withheld when a broker-dealer places portions of an issue in restricted accounts<sup>40</sup> in order to limit public supply and thereby encourage a price rise. Free-riding occurs when withheld shares are held in accounts of the broker-dealer or its affiliates, who profit when the shares are sold at the premium price encouraged by the withholding. The 1963 Special Study observed that at the point of that study it was common for underwriters to withhold -- or park -- stock in accounts of officers or employees of the firms, relatives of such persons, or persons affiliated with other broker-dealers with whom they may have had reciprocal arrangements. These activities violate the NASD's Rules of Fair Practice as well as the antifraud rules of the federal securities laws. They have continued, however, to be a problem in recent hot issues markets.

In Case 13, for example, an underwriter established a Swiss broker-dealer beyond the regulatory reach of the Commission to park stock involved in its underwritings. By using the foreign broker-dealer to remove large blocks of stock from the U.S. markets to purported foreign customers controlled by the underwriter, the underwriter was able to drive the price of the security to a premium. Such activities may violate the anti-fraud and antimanipulation provisions.

Parking also can be used to disguise the inability of an underwriter to close a best efforts, "all or none" offering or to allow premature market making activities before the offering actually is completed and the securities come to rest in the hands of legitimate public investors. Case 5 typifies such conduct. This case involves a broker-dealer with a Denver branch office that

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<sup>40</sup> For a description of restricted accounts, see infra page 73.

underwrote, on a best-efforts, all or none basis, the stock of a company founded to develop a casino. The company's major asset was a small tract of land in Atlantic City, and its primary activities had consisted of exploring the feasibility of building and operating a casino hotel. The offering of 10 million units<sup>41</sup> at a price of \$2.50 per unit was ten times larger than any public offering previously underwritten by the firm. Despite the broker-dealer's efforts to sell the securities, which included the use of materially false and misleading statements,<sup>42</sup> the firm could not sell the entire offering by the required date. To avoid the failure of the offering, the broker-dealer engaged in a series of transactions (including using the offering proceeds to close the offering) to create the impression that the securities were sold in accordance with the all or nothing representation in the prospectus.<sup>43</sup> Subsequent to the purported completion of the public offering, the broker-dealer, together with its principal, continued the public distribution while bidding for and purchasing the securities. A federal district court found that the activity violated

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<sup>41</sup> Each unit consisted of one share of common stock and two warrants.

<sup>42</sup> The broker-dealer's sales force aggressively promoted the offering. The broker-dealer's principal told the firm's senior sales personnel that the price of the company's stock would double in the immediate aftermarket. He announced that his expectation was based on the fact that the issuer had entered into negotiations to buy additional land for the casino and that a necessary joint venture agreement would be reached. Senior personnel of the broker-dealer related this information to the firm's salesmen, who in turn repeated the information to their customers. Salesmen also told potential buyers that the supply of securities was "tight" and that only a few shares were available. Contrary to these statements, the issuer had not entered into such negotiations and no joint venture agreement was in fact reached. The salesmen also omitted to disclose the nature and circumstances surrounding the improper closing of the offering, as described in the text.

<sup>43</sup> Broker-dealers have used several different techniques to facilitate non bona-fide distributions of securities. These include, in addition to parking and use of investor proceeds to complete an offering, exercise by securities salesmen of unauthorized discretion over customer accounts to purchase distribution securities, guaranteeing purchasers of hot issues securities against loss, and material misstatements or omissions of fact concerning the issuers' prospects.

Rules 10b-6, 10b-9, and 15c2-4,<sup>44</sup> in addition to the Commission's general antimanipulative rules. The district court's ruling has been affirmed on appeal. Other cases that illustrate parking are Numbers 14 and 22. These cases involved the violation of various provisions of the Securities Act and Exchange Act.

Closely allied to the parking described in Case 5 is the failure properly to escrow investor funds in best efforts offerings conducted on an all or none or minimum-maximum basis. In Case 12, a registered broker-dealer served as the underwriter of the securities of a company engaged in the manufacture and sale of precision electronic instruments. The offering was structured on a best efforts, all or none basis for 12 million units, each of which consisted of two shares of common stock and one callable stock warrant. Each unit was priced at 25 cents. The order for public proceedings alleges that part of the purchases were not paid for by the expiration date of the offering and that a portion of the offering was sold in non bona fide transactions. Funds that

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<sup>44</sup> Rule 10b-9 prohibits underwriters and others from representing that securities are being sold on an "all or none" or "minimum or none" basis unless the offering is contingent on the prompt refund of proceeds to subscribers if the entire offering or minimum is not sold at the specified price within the specified period of time and the total amount due to the seller is not received by him by a specified date. Rule 15c2-4, which operates in tandem with Rule 10b-9, prohibits a broker-dealer from accepting funds from investors for the purchase of securities offered on an "all or none" or "minimum or none" basis unless those funds are maintained in a separate bank account or escrow account. The rule requires that proceeds must be returned promptly to investors if the terms of the offering are not met.

Subject to certain exceptions, Rule 10b-6 prohibits persons who are engaged in a distribution of securities from bidding for or purchasing, or inducing others to bid for or purchase, such securities or related securities until they have completed their participation in the distribution. The rule's purpose is to prevent participants in a distribution from artificially conditioning the market for the securities to facilitate the distribution. In many cases in the hot issues markets, a large percentage of a new issue is bought back from the original purchasers by the original underwriter who is acting as market maker. The stock is then resold to other public investors. Such activity may give rise to a continuing distribution for purposes of Rule 10b-6 and thereby subject the broker-dealer to the rule's proscriptions during the purported aftermarket period. See Wolfson, Phillips and Russo, Regulation of Brokers, Dealers and Securities Markets (1977 ed.) at ¶3.04.

were received were commingled with the broker-dealer's general revenues and were never forwarded to the escrow account that was established to hold investor funds. In order to close the offering, the broker-dealer caused its clearing broker to wire to the escrow account the amount of money needed to satisfy the all or none contingency. Such actions would be violative of the antifraud provisions of the Securities Act and Exchange Act.

### 3. Tie-in and Reciprocal Arrangements

A few cases involve "tie-in" arrangements by which underwriters of hot issues require customers, as a condition of participation in a hot issue offering, either (1) to agree to purchase additional shares of the same issue at a later time and at an increased price, or (2) to participate in another hot issue offering. This practice stimulates demand for a hot issue in the aftermarket, thereby facilitating the process by which stock prices rise to a premium. Selling securities in this manner often violates the antifraud and antimanipulative provisions of the federal securities laws.<sup>45</sup>

The practice of tie-ins, which can be traced to the early hot issues markets in the 1960s, is illustrated by Case 13. This case involved violations of various antifraud provisions in connection with the initial public offerings of five companies underwritten by a Colorado broker-dealer active in the Denver hot issues markets. The broker-dealer manipulated the aftermarket prices of the various stocks. For example, in connection with one underwriting, the broker-dealer controlled the supply and created demand for the stock through various improper methods. Supply of the stock in the aftermarket was controlled by, among other things, directing sales in the underwriting to nominee accounts and obtaining, prior to the opening of aftermarket trading,

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<sup>45</sup> As early as 1961, the Commission indicated that tie-ins involve violations of the antimanipulative provisions of the securities laws. See Securities Exchange Act Release No. 34-6536 (April 24, 1961).

a substantial block of aftermarket limit orders at prices five times the public offering price. To generate demand for the stock, salesmen were told to advise their customers that the company had good financial prospects (it did not) and that the stock would open in the aftermarket at a substantial premium. In one instance, salesmen reportedly were advised that the stock was “going to the moon”. The broker-dealer held public “due diligence” meetings prior to the effective date of the registration statement, at which investors falsely were told that the corporation had a tremendous future.<sup>46</sup> During the underwriting period, the broker-dealer also required a substantial number of its customers to place aftermarket purchase orders for the company stock at substantial premiums above the one dollar per share offering price as a quid pro quo for obtaining shares in the underwriting. As a consequence of its activity, the broker-dealer was able to drive the price to over \$4 per share only a few hours after the commencement of aftermarket trading.

A variant of the tie-in is where broker-dealer firms having no nominal connection with the initial distribution may be used to market an issue in the aftermarket at premium prices. In these situations, a substantial redistribution of shares held by persons receiving original allotments can be made to a new group of customers purchasing at premium prices. Broker-dealers engaging in this activity often may “trade-off” so that each one takes an active role in the other’s underwritings. In this way, the original underwriter seeks to avoid the pitfalls of Rule 10b-6 and to mask its control of the market for such securities. To the extent that there is a manipulative scheme to artificially affect prices, there may be a violation of Exchange Act Section 10(b), Rule 10b-5, and perhaps Section 9. If a scheme is used to mask conduct that otherwise would violate Rule 10b-6, there may be a violation of that provision.

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<sup>46</sup> See infra page 61 for an additional discussion of such meetings in the context of disclosure in issuer prospectuses.

4. Failure to Deliver Stock Certificates and Restricting Sales Orders

Two classic ways in which hot issue underwriters have limited supply of stock in the aftermarket involve non-delivery of stock certificates and restricting sell orders by customers who have purchased stock in the original offering. Each of these methods, described in considerable detail by the Special Study<sup>47</sup>, are additional techniques by which a broker-dealer limits the supply of stock and thereby avoids a depressive effect on the price of the security in the aftermarket. These methods, when part of a manipulative scheme, may violate the antifraud and antimanipulative provisions. As an example of this sort of practice, in case 13, discussed above at pages 34 and 39-40, one factor used by the underwriter to restrict supply and drive up the price of the securities was to discourage or delay customer sales in the aftermarket.

5. Net Capital and Customer Protection Rules

A by-product of the hot issues markets has been the severe financial problems experienced by several broker-dealers (especially in the Denver area) when the securities markets have softened. During the fall of 1981 and spring of 1982, when the Denver hot issues markets turned downward, several broker-dealers that concentrated in underwriting or dealing in penny stock issues found themselves in severe financial difficulty. Many of these broker-dealers failed to give the Commission early warning of their financial difficulties, as required by Commission rule, and instead continued to operate with insufficient capital. As a result, the Commission brought several administrative and injunctive actions against these brokers-dealers.

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<sup>47</sup> Special Study, supra note 4, Pt. 1, at 522-528.

See Cases 3, 7 and 13.<sup>48</sup> In addition, several other broker-dealers discontinued business and went into voluntary self-liquidation after inspections by the NASD and SEC.

B. Role of Disclosure and Disclosure Abuses

While disclosure abuses have occurred in the recent hot issues markets, obtaining adequate disclosure generally is not a problem. See infra Part C. During hot issues markets, issuers are aware that the marketing of securities rarely is hampered by adverse disclosures.

As a hot issues market develops, many initial public offerings are able to be sold merely because they are new offerings. The market's acceptance of initial public offerings made by experienced entities with customer-accepted products and services creates an atmosphere in which other more speculative offerings can be sold more easily. Even at the height of a hot issues market, some initial public offerings are difficult to sell and others sell quickly but soon thereafter trade in the secondary market at less than their initial offering prices. Typically, these offerings involve highly speculative ventures in the development stage, with no operating history and headed by management with little or no experience in the proposed field of endeavor. Nonetheless, although many of these offerings do not become hot issues, their acceptance in the marketplace is aided by the large number of other initial public offerings that have become hot issues.

The prospectuses used in connection with these highly speculative offerings generally describe clearly the stage of the venture's development and contain prominent cautionary

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<sup>48</sup> In fact, in one case (no. 7), the broker-dealer engaged in various activities over the course of several months to hide such activity. These activities included engaging in unauthorized trades in customer accounts to "park" stock at month end, submitting false information to regulatory authorities, falsifying books and records, claiming non-existent assets, and using customer funds from an underwriting to pay daily business expenses.

language as to the degree of risk. It is not uncommon for these prospectuses to contain additional warnings that potential investors should be prepared to lose their entire investment.

For example, one company successfully sold 600,000 units<sup>49</sup> to the public at a price of \$5 per unit. The prospectus disclosed that:

These securities involve an extremely high degree of risk. . .

The company was incorporated on January 6, 1983 and has engaged in no business whatsoever and has no plan of operation other than that it will not engage in exploration for oil or gas, fuel distribution or minerals extraction business. It has no operating history and is embarking upon on a novel type of enterprise. The Company has no plan of operation and can provide the investor with no information whatsoever as to its intentions.

[I]nvestors will entrust their funds to management on whose judgment they must depend with no information about management's intentions.

No facts exist at this time upon which to base an assumption that the Company will operate profitably in any business in which it decides to engage and, if not, stockholders may lose all or a substantial portion of their investment.

The Company cannot accurately project, or give any assurance with respect to management's ability to control the Company's operating costs and expenses.

In another instance, an offering currently is being made by a company that intends to manage and operate bingo halls on Indian reservations under contract with Indian tribes. These contracts would be sought in one or more states where prohibitions on conducting bingo games as a money-making business cannot be enforced on Indian reservations. The prospectus graphically discloses that after the public offering, and assuming the most optimistic circumstances, the individuals who invested prior to the public offering will hold 77.8 percent of

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<sup>49</sup> Consisting of 20 shares of common stock and four warrants to purchase four additional shares of common stock.

the company's outstanding securities, even though the amount they paid for their holdings represents only 1.3 percent of the company's total equity funds.

The prospectus also discloses, among other things, that:

Bingo games involve substantial amounts of cash presenting a high risk of theft or other illegal activity. The company will attempt to implement and maintain adequate controls and security to minimize this risk.

In October 1972, [the chief executive officer of the company] was convicted in the United States District Court for the Southern District of Florida of conspiracy and mail fraud with regard to [a casualty insurance company.] He was sentenced to a three year prison term, but spent 18 months in the Witness Protection Program of the Department of Justice.

[A director/consultant] pleaded guilty in the United States District Court for the District of Columbia to obstruction of justice regarding a stock manipulation investigation conducted by the Securities and Exchange Commission in 1973. His sentence included a \$10,000 fine, five years probation and incarceration for six months. In 1977, in settlement of an action in the United States District Court for the District of Columbia brought by the Securities and Exchange Commission for actions related to its 1973 investigation, [the director/consultant] without admitting or denying the allegations in the complaint, consented to the entry of a final judgment permanently enjoining him from violating the antifraud provisions of the federal securities laws and a provision prohibiting manipulative activity during a stock distribution. In September, 1973, a still pending involuntary bankruptcy proceeding was filed against [the director/consultant] in the United States District Court for the District of Maryland. [The director/consultant] is also the subject of federal tax liens totaling approximately \$909,000.

These examples demonstrate that obtaining adequate disclosure in prospectuses generally has not been a problem in connection with the hot issues markets. However, the extent to which disclosure documents are made available to investors and are considered by them in connection with the purchase of securities is an area of continuing concern. As a result, the Commission has

developed detailed disclosure rules that are intended to assure that information is properly transmitted to persons making investment decisions. These rules are described below.

1. Dissemination of Preliminary Prospectus

In 1969, when the number of companies filing registration statements for their first public offering rose by almost 300 percent, the Commission expanded the requirements for the distribution of preliminary prospectuses in connection with the initial public offering of a company's securities.<sup>50</sup> The Commission announced that, in the exercise of its responsibilities in accelerating the effective date of a registration statement, it would consider whether the persons making an initial public offering had taken reasonable steps to furnish the preliminary prospectus not only to the members of the selling group, but also directly to the individuals who may reasonably be expected to purchase the securities. The Commission also stated that it would consider the extent to which such persons were given a reasonable time to consider the information contained in the prospectus.<sup>51</sup>

For this reason, in connection with any request for acceleration of the effective date of a registration statement relating to an initial public offering, it is generally required that the managing underwriter furnish the Commission with a written statement that it has been informed by participating underwriters and dealers that copies of the preliminary prospectus have been or

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<sup>50</sup> Securities Act Release No. 4968 (April 24, 1969). In making the announcement, the Commission noted the increase in the number of companies filing registration statements for the first time and emphasized that the investing public should be aware that many such offerings were highly speculative and that the prospectus should be examined carefully before an investment decision was reached.

<sup>51</sup> This policy of requiring, in connection with the initial public offering of the securities of an issuer, that, generally, copies of the preliminary prospectus be furnished to prospective purchasers has remained in effect since 1969 and in 1982 was codified as a part of the regulations governing the distribution of a prospectus by a broker-dealer. Rule 15c2-8, 17 C.F.R. 240.15c-8.

are being distributed to all persons to whom it is then expected to mail confirmations of sale, not less than 48 hours prior to the time it is expected to mail such confirmations. In accepting these representations, the Commission expects that specific inquiry has been made of all members of the selling group.

2. Publication of Information Prior to The Effective Date of a Registration Statement

While the federal securities laws were designed to provide investors with certain material business and financial facts upon which to base their investment decisions, they also impose certain responsibilities and limitations upon the dissemination of information by persons engaged in the offer and sale of securities.

Unless an exemption is available, a security may not be offered prior to the filing of a registration statement. However, an offer is permissible after the statement has been filed and before it has become effective, provided that any prospectus employed for that purpose meets the statutory requirements of the Securities Act. Therefore, during the period between the filing date and the effective date of a registration statement, no written communication may be used to offer a security other than a prospectus authorized by the statute.

In light of these provisions, companies conducting or contemplating a public offering of securities must exercise caution before making any public pronouncements. Caution must be exercised not only in connection with public announcements regarding the specific offerings or intended offerings but also in connection with corporate advertisements of existing product lines and other public releases of financial and business information.

a. Announcements of Public Offerings

While a security may not be offered for sale by means of a written document other than an authorized prospectus, the applicable regulations permit certain public notices of proposed or pending offerings. Under these regulations, companies are permitted to announce a proposed public offering prior to the time the registration statement is actually filed as long as the announcement is limited to a brief description of essential information. Generally, the announcement may only contain a brief description of the title, amount and basic terms of the securities to be offered, the anticipated time of the offering and a brief statement of the manner and purpose of the offering.<sup>52</sup>

Subsequent to the filing of a registration statement, the announcement may include, in addition to the limited information referred to above, certain specified additional information, such as identification of the general type of business conducted by the issuer, the price at which the securities will be offered, the name of the managing underwriter, and the terms and manner in which the offering is to be conducted. If the registration statement has not become effective, the announcement also must include, among other things, the name and address of a person from whom a prospectus can be obtained and the following statement:

A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. . . .<sup>53</sup>

These rules permit and encourage issuers to provide the marketplace with notice of forthcoming offerings and to advise potential investors of the availability of a prospectus. The

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<sup>52</sup> 17 C.F.R. 230.135.

<sup>53</sup> 17 C.F.R. 230.134.

content of these notices has been limited by the Commission to retain their status as announcements and to curb their use as selling tools. These announcements are intended to function solely as a means of notification and may not be employed to make or imply any promise or benefit, which would constitute an attempt to sell the securities.<sup>54</sup>

b. Corporate Announcements and Product Advertising

To assure that selling efforts are made on the basis of adequate and accurate information, the federal securities laws, as interpreted by the Commission, place considerable restrictions on the methods and timing of such selling efforts. Issuers must exercise caution before making any public announcements, whether in the form of press releases, interviews, product advertisements or the like, during the time period beginning a reasonable time prior to a public offering through the final disposition of securities. During this period, any significant public exposure given to the issuer for the purpose of, or which has the effect of, conditioning the market or arousing interest in the issuer may be viewed as offers to sell in violation of Section 5 of the Securities Act. For these reasons, publicity efforts, including the publication of information or press

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<sup>54</sup> During 1983, the Commission filed a complaint in United States District Court for the Southern District of New York in which it alleged that an issuer published an advertisement in Barron's and the Wall Street Journal containing statements not permitted under the statute and the applicable rules adopted thereunder. SEC v. American Completion and Development Corporation, Litigation Release No. 9865 (S.D.N.Y. Jan. 12, 1983). Though not a hot issues case, this action illustrates the strong stand taken by the Commission in this area. The Commission further alleged that the advertisements conveyed the materially misleading impression that, among other things, an investment in the issuer had little, if any, risk; the investment was a unique opportunity; the investment was appropriate for conservative investors; and affiliated persons were investing on the same terms as members of the public. The issuer was enjoined from further violations of the antifraud provisions of the securities laws and was ordered to make offers of rescission to those investors who committed to purchase securities after the date of the first advertisement. The issuer consented to the entry of the judgment without admitting or denying the allegations in the Commission's complaint.

releases in advance of a proposed offering, must be carefully reviewed to assure that they do not violate these provisions.<sup>55</sup>

In connection with initial public offerings, objectionable increases in public exposure historically have occurred most frequently either shortly before the actual filing of the registration statement or during the period between the filing of the registration statement and its effective date. Various methods have been used to obtain increased public awareness of the company. Interviews have been arranged with major newspapers, journals or magazines in which glowing reports are given of the company, its management and products. These interviews are timed to assure widespread public dissemination shortly before the filing of the registration statement.

Such issuers also may substantially increase their budgets for product advertisements shortly before an offering. Advertisements for the company's products or employment opportunities may appear much more frequently in the general press and the issuer may change its previous advertising practices and place many of these additional advertisements in the financial press.

The frequency and timing of these activities are intended to arouse sufficient public interest in the company to assure that a demand for the securities exists by the time the registration statement is filed and becomes effective. Where questions arise whether the activities conducted artificially conditioned the market, the Commission's practice is to delay

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<sup>55</sup> 17 C.F.R. 230.134, 230.135, 230.135a.

accelerating the effective date of the registration statement until any market activity which may have resulted from the publicity has subsided.<sup>56</sup>

Moreover, when a company publicly releases material information concerning corporate developments in advance of a securities offering, the information generally must be included in the registration statement as filed. If the information is released during the pendency of the

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<sup>56</sup> With respect to issuers with publicly held securities, the restrictions regarding unusual and unwarranted publicity are not intended to restrict the normal communications between an issuer and its stockholders or the announcement to the public generally of information with respect to important business and financial developments.

In this area the Commission has stated that:

We realize, of course, that corporations regularly release various types of information and that a corporation in which there is wide interest may be called upon to release more information, more frequently about its activities than would be expected of lesser known or privately held enterprises. In the normal conduct of its business a corporation may continue to advertise its products and services without interruption, it may send out its customary quarterly, annual and other periodic reports to security holders, and it may publish its proxy statements, send out its dividend notices and make routine announcements to the press. This flow of normal corporate news, unrelated to a selling effort for an issue of securities is natural, desirable and entirely consistent with the objectives of disclosure to the public which underlies the Federal securities laws. Carl M. Loeb Rhoades & Co., 38 SEC 843, 853 (1959).

The obligation of a corporation to make timely disclosures concerning its corporate affairs can pose a possible conflict with the restriction on publication of information concerning an issuer that has securities in "registration."

Such a conflict is, however, more apparent than real. Neither a company in registration nor its representatives should instigate publicity for the purpose of facilitating the sale of securities in a proposed offering. However, events resulting in a duty to make prompt disclosure under the antifraud provisions of the securities laws or the timely disclosure policies of self regulatory organizations generally can be announced in a manner that will not unduly influence the proposed offering. Factual disclosures of material events ordinarily are not subject to restriction under the Securities Act provided they are done in the same manner as that customarily used by the company.

registration statement, the information must be included by a pre-effective amendment filed prior to or promptly after the release of the information.

Serious questions arise in this area when the information being disseminated is omitted from the prospectus or is different from that which appears in the prospectus. For the unseasoned or smaller company, it usually is difficult to reconcile the position that an event is sufficiently material to warrant public dissemination at the time securities are in registration but is not sufficiently material to warrant inclusion in the registration statement.

c. Road Shows-Sales Meetings

Meetings with prospective investors are permissible during the period between the filing of a registration statement and its effective date provided that the written materials used meet the requirements for a preliminary prospectus. The information presented at these meetings, either orally or in writing, may be the basis for certain civil actions if the information is false or misleading or if information necessary to make the statements made not false or misleading is omitted. Potential civil actions include private damage actions, injunctive actions brought by the Commission by the Commission and suspension of the effectiveness of a registration statement.

Meetings of this type are held frequently and afford a useful opportunity for investors to meet the principals involved in the offering. Generally, these meetings are properly conducted. There have been instances, however, in which the information disseminated at such meetings was at wide variance with that contained in the registration statement. At one sales meeting (Case 6), a scientific expert hired by the issuer stated that the registration statement did not disclose certain oil and gas properties in which the issuer owned an interest. This statement stood uncorrected either by the management, its representative or by representatives of the underwriters who attended the meeting. As a result of the statements made at that meeting, the

Commission authorized an investigation and, based upon the results of that investigation, the effectiveness of the registration statement was suspended.

At another sales meeting held in connection with a different offering (Case 11), copies of the preliminary prospectus were distributed to all persons in attendance. That prospectus contained significant disclosures regarding the company's plans to produce denatured ethanol for use in making gasohol. The prospectus commented on the cost of the ethanol plant, the management of the plant, the plant's annual production, the market area for production and the land upon which the plant was to be built. The prospectus stated that 42 percent of the net proceeds of the offering were to be used to construct the ethanol plant. However, the principal officer of the underwriter advised the persons attending the meeting that the registrant knew that the ethanol business was a risky one and that management was going to conduct studies to decide whether to go into the ethanol business. Further, members of the management made statements at the meeting to the effect that the issuer was currently involved in a study regarding the ethanol aspects of its operations and that the study would not be completed for about two to three months. Again, the Commission investigated this case and the effectiveness of the registration statement was suspended.

Meetings and materials relating to preliminary negotiations or agreements between an issuer and any underwriter are not subject to the preliminary prospectus requirements.<sup>57</sup> The types of meetings referred to above, however, do not fall within this exemption. The exemption permitting negotiations with and "due diligence" investigations by an underwriter does not extend to meetings with members of the public nor does it extend to members of the selling group who will function only as dealers in the distribution.

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<sup>57</sup> 15 U.S.C. 77b(3).

Further, an issuer or an underwriter may not escape responsibility for using written materials during this period which do not meet the requirements of Section 10 simply by labelling such materials are NOT FOR PUBLIC DISSEMINATION -- FOR USE OF UNDERWRITERS ONLY.” Should this type of material ultimately find its way into the hands of potential investors, the persons responsible for its drafting and distribution may be considered to have made such information available to potential investors.

C. Disclosure Abuses

Though during hot issues markets most offerings can be sold successfully regardless of the number or the severity of the risks described in the prospectus, disclosure abuses do still occur. For the most part, the disclosure abuses discussed in this section occurred in offerings of highly speculative or start-up companies making their first public offering.

The disclosure abuses, all of which violate existing statutory or regulatory proscriptions, generally fall into four broad categories: misstating the firm’s financial statements or abusing generally accepted accounting principles; misstating management’s experience or omitting material facts about management’s background; falsely describing the current state of the firm’s business or the uses of the offering proceeds; and making statements during the selling effort that are inconsistent with or not addressed in the prospectus. A discussion of each of these areas follows.

1. False or Misleading Financial Statements

During a hot issues market, there are likely to be more companies making public offerings that have had little or no operations. In some cases, these issuers attempt to manipulate their financial statements in order to give the firm a more substantial appearance. Such financial fraud is not, of course, limited to or necessarily more prevalent in a hot issues market.

The manipulation of financial statements by small, start-up companies generally is characterized by an overstatement of the company's assets. Often the overvalued properties or rights had been obtained in transactions between the company and its officers or directors. A few companies have gone so far as to record non-existent assets. Others have not disclosed encumbrances that exist on assets, such as the pledge of certificates of deposit or properties as security for loans.

Some of these start-up companies have overstated their revenues in an attempt to improve market acceptance of their securities. Although there have been instances of companies recording revenues on nonexistent transactions, most cases have involved companies recording revenues prematurely. This occurs when a company records revenues before a sale has actually been completed or where the transaction was not a bona fide sale.

For instance, in Case 29, a company had recorded as an asset a note receivable for the sale of the rights to the opportunity the company had to purchase a plant. The company had also recorded the "sale" as revenues. This transaction accounted for 93.7 percent of the company's assets and 99.4 percent of the company's revenues. However, the company had no legally enforceable right to purchase the plant and thus the note receivable was essentially worthless.

Another device used to mislead by means of financial statements is the failure to disclose contingent liabilities, such as guarantees given in connection with sales. The shareholders' equity section of a firm's balance sheet also may be overstated. This occurs most often when the firm has issued stock for property or other assets and the value of the assets has been overstated. As a consequence the stock sale also is recorded at an inflated value.

Cases that involve false or misleading financial statements include Numbers 1, 17, 18, 24, 28, and 29.

## 2. Management's Background and Experience

Some prospectuses offering securities of highly speculative, start-up companies have not fully disclosed the experience and background of the company's management. While in some instances this may involve only artful wording to convey an impression of a greater depth of experience than actually exists, there also have been instances of deliberate omissions of required disclosures such as criminal convictions, past securities law violations, disbarments, and Commission actions barring individuals from association with any broker-dealer.

In Case 23, an offering circular failed to disclose that one individual was a control person of the company. It also did not disclose that this individual had been barred by the Commission from association with any broker or dealer and from practicing as an attorney before the Commission and had been convicted of criminal violations of the federal securities laws. In another instance, the prospectus described management personnel who did not exist.

Other cases that have involved management's background and experience include Numbers 6, 19, and 26.

## 3. Description of Business and Use of Proceeds

Some of the highly speculative or start-up companies offering their securities to the public for the first time have misrepresented the viability of their business. The more extreme attempts to do this have involved misstatements of the firm's interest in plants or property by overstating the firm's own interest or failing to disclose the interest or claims of other parties.

In other cases, registrants have failed to disclose all the obstacles to carrying out stated business plans. In describing their proposed course of business, some highly speculative ventures, despite including extensive risk factors, have omitted disclosures that would show their proposed business had little chance of economic success. One company failed to disclose that it

did not have the managerial, technical, or financial resources to develop its proposed product commercially. Another registrant failed to disclose that it was engaged in a fraud by submitting health insurance claims for an unapproved treatment on ineligible patients.

Some registrants have falsely described the intended use of proceeds.<sup>58</sup> In a few instances this has been the result of pressure from the underwriter on the registrant. Highly speculative offerings have been made through underwriters who specialize in low price, highly speculative offerings. When the underwriter could not complete the distribution of some offerings, the underwriter would threaten a registrant whose offering was selling well with withdrawing its sales effort unless that registrant agreed to purchase some of the unsold securities of the slow selling offerings. The registrant was put in the position of receiving some of its hoped-for proceeds or none of the proceeds.

In Case 26, a company did not disclose in its prospectus that it had agreed to invest substantial sums from its public offering in speculative equity securities underwritten by same underwriter that was marketing its offering. The company also failed to disclose that further substantial sums were to be loaned to a company organized by one of the principals in the offering.

Other cases that involved the description of business and the use of proceeds included Numbers 6, 9, 16, and 29.

#### 4. Disclosures Outside the Prospectus

In certain cases, statements have been made beyond what is included in the prospectus to encourage the buyer's interest in offerings by highly speculative companies. These statements

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<sup>58</sup> In addition to the prospectus requirements regarding the use of proceeds, Rule 463 requires that, in an initial public offering, an issuer must file a form SR following the completion of the offering that discloses the application of the offering proceeds.

have included non-specific statements about the company's bright prospects that are not supported by the prospectus disclosure. They also have included statements that contradict the disclosure in the prospectus on the value of certain properties or the actual proposed business.

At the purported "due diligence meeting" for one offering, an expert representing the company making the offering stated that the company had oil and gas interests that were not disclosed in the prospectus. This directly contradicted the prospectus in which the company represented that it was describing all its interests.

Other cases that have involved statements made outside the prospectus include Numbers 5, 11, 13, and 23. These case variously involved, among other things, the violation of the antifraud and antimanipulative provisions.

## V. Current Regulatory Authority

The statutory scheme developed by Congress for the regulation of the securities markets generally has proven adequate in dealing with the abuses endemic to hot issues markets. Every abusive sales and trading practice discussed in this Report clearly violates the federal securities laws as implemented by the Commission pursuant to its rulemaking authority. This Section of the Report will discuss the Commission's statutory and regulatory authority to deal with hot issues abuses, and relevant rules promulgated by the NASD.

### A. The Antifraud Provisions

The antifraud provisions of the federal securities laws, a cornerstone of Congress' system of promoting free and open markets for capital formation, are indispensable weapons in combating hot issues abuses. Taken together, these prohibitions offer broad protection to investors. Under the Securities Act of 1933, Section 17(a) prohibits fraudulent or deceptive

practices in connection with the offer or sale of a security.<sup>59</sup> Section 10(b) of the Securities Exchange Act of 1934 applies to both purchases and sales, and prohibits such manipulative or deceptive devices or contrivances as the Commission specifies by regulation.<sup>60</sup> The Commission

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<sup>59</sup> Sec. 17(a). It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly -

- (1) to employ any device, scheme or 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 the 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.

15 U.S.C. 77q(a). Rules 10b-6 and 10b-9 are described briefly infra at page 66.

<sup>60</sup> Sec. 10. 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 -

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security 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.

15 U.S.C. 78j(b).

has developed detailed regulations pursuant to Section 10(b), one of which, Rule 10b-5, is modeled upon the prohibitions of Section 17(a).<sup>61</sup> Also under the Securities Exchange Act of 1934, Section 15(c)(1) prohibits manipulative, deceptive or other fraudulent devices on the part of broker-dealers. The section provides that the Commission shall define such devices or contrivances by rule.<sup>62</sup> Section 15(c)(2) prohibits broker-dealers from engaging in any

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<sup>61</sup> Rules 10b-1 to 10b-18, 17 C.F.R. 240.10b-1 to 10b-18. Rule 10b-5 provides:

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>62</sup> Section 15(c)(1) provides:

No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce any attempt to induce the purchase or sale of, any security (other than commercial paper, banker's acceptances, or commercial bills) otherwise than a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

fraudulent, deceptive or manipulative act or practice and provides that the Commission shall by rule define, and prescribe means reasonably designed to prevent such acts and practices.<sup>63</sup> As with Section 10(b), the Commission has exercised its broad rulemaking authority to specify a variety of unacceptable conduct.<sup>64</sup>

Section 17(a) applies only to offers or sales of stock, while Sections 10(b), 15(c)(1), and 15(c)(2) apply to purchases and sales. Sections 17(a) and 10(b) apply to “any person”, while Sections 15(c)(1) and 15(c)(2) apply only to broker-dealers. Also, state of mind requirements differ; the Supreme Court has held that scienter must be proven in Section 17(a)(1) and Rule

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<sup>63</sup> Section 15(c)(2) provides:

(2) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation, and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

15 U.S.C. 78o(c)(2).

<sup>64</sup> Rules 15c1-1 to 15c3-3, 17 CFR 240.15c1-1 to 15c3-3.

10b-5 actions, while negligence is sufficient in actions under Section 17(a)(2) and 17(a)(3).<sup>65</sup> In general, the antifraud provisions are similar in import, and reach many hot issues abuses.<sup>66</sup>

For example, use of nominee accounts to park securities or to create the illusion of a bona fide distribution may be intended to disguise the inability to close a “best-efforts all or nothing” offering or to allow premature market making activities before the offering is actually completed. Such activity gives rise to violations of Rule 10b-6, which prohibits an underwriter who is engaged in a distribution of securities from bidding for or purchasing for his own account any security being distributed until, participation in the distribution has been completed. Rule 10b-9 is violated by any failure to honor a representation that proceeds will be returned to investors if less than a minimum number of shares are not sold through a bona fide distribution. This practice also violates Section 17(a) and Rule 10b-5 since statements in the prospectus regarding manner of distribution are rendered materially false. These examples are merely illustrative of the manner in which regulations adopted pursuant to the antifraud provisions of the securities laws are tailored to address the abusive practices common to hot issues markets. These regulations give the industry specific guidance on unacceptable behavior.

B. Registration Provisions -- Securities Act of 1933

Investors in hot issue markets receive further protection from the registration provisions of the Securities Act of 1933, which regulate the distribution of securities to the public. Section 5, the heart of the Securities Act, contains provisions that prohibit the public offering and sale of

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<sup>65</sup> Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

<sup>66</sup> Investors receive further protection under the Investment Advisers Act of 1940, 15 U.S.C. 80b-1-80b-21. Sec. 206 of the IAA imposes similar anti-fraud proscriptions upon investment advisers in their dealings with clients.

securities until sufficient information is available to investors.<sup>67</sup> Section 5(c) prohibits any offers to sell or offers to buy prior to the filing of a registration statement. After a registration statement is filed but before it become effective, Section 5 permits offers, but not sales. The Commission, with certain limited exceptions, considers every offer in writing to be a prospectus, and Section 5(b)(1) prohibits the distribution of any prospectus after a registration statement is filed unless it meets the requirements of Section 10 of the Securities Act.<sup>68</sup> After the effective date, offers and sales may be made freely. Section 5(b)(2), however, provides that every sale must be accompanied by the delivery of a prospectus. Taken together, these sections ensure that investors have available extensive information concerning the issuer prior to any investment decision. The quality and type of information available to investors is subject to continuous review and modification under the Commission's disclosure program, as discussed in Section II.

C. Commission Enforcement Actions

The antifraud and disclosure provisions are fully enforceable under current statutory authority. Section 20 of the Securities Act and Section 21 of the Exchange Act authorize the Commission to seek injunctive relief for failure to comply with any rule or regulation established under those Acts.<sup>69</sup>

Under Section 8 of the Securities Act, the Commission has broad power to take action against defective registration statements.<sup>70</sup> Section 8(b) provides that if it appears to the Commission that a registration statement is on its face incomplete or inaccurate in any material

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<sup>67</sup> 5 U.S.C. 77(e).

<sup>68</sup> 5 U.S.C. 77(j).

<sup>69</sup> 17 U.S.C. 77t(b), 78u(d). Similar injunctive power is found in Section 209(e) of the Investment Advisers Act, 15 U.S.C. 80b-9(e).

<sup>70</sup> 5 U.S.C. 77h.

respect, the Commission may within ten days of filing, and after opportunity for hearing, issue an order refusing to permit the statement to become effective. In addition, the Commission is empowered, under Section 8(d) of the Securities Act, to issue a stop order suspending the effectiveness of a registration statement, again after opportunity for hearing. Further, under Section 12(j) and (k) of the Securities Exchange Act of 1934, the Commission may suspend or revoke the Exchange Act registration of a security or summarily suspend trading in a security if, in the Commission's opinion, such suspension or revocation is in the public interest and necessary for the protection of investors.<sup>71</sup> The Commission's Section 12(k) summary suspension powers may be exercised for a period not to exceed 10 days. Its Section 12(j) powers may be exercised only after notice and an opportunity for a hearing. Section 15(b) of the Exchange Act authorizes the Commission to sanction broker-dealers that violate the federal securities laws or that fail to supervise associated persons who violate such laws.<sup>72</sup>

#### D. NASD Rulemaking Authority

The Commission's enforcement actions are supplemented by disciplinary proceedings by the NASD. Section 15A(b)(6) of the Exchange Act specifically authorizes the NASD to adopt rules "designed to prevent fraudulent and manipulative acts and practices" and to "promote just and equitable principles of trade."<sup>73</sup> Several NASD rules regulate new issues of securities in general and hot issues in particular. These regulations include rules regarding (1) underwriter's

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<sup>71</sup> 17 U.S.C. 78l(j), (k).

<sup>72</sup> 17 U.S.C. 78o(b).

<sup>73</sup> 17 U.S.C. 78o-3(b)(6).

compensation; (2) free-riding and withholding and (3) unauthorized transactions and related confirmations (“wooden tickets”).<sup>74</sup>

### 1. Underwriter’s Compensation

The 1963 Special Study found underwriter compensation agreements to be a particular problem in the hot issues market. Today, the NASD’s Interpretations of the Board of Governors Relating to Section 1 of Article III of the Rules of Fair Practice -- Review of Corporate Financing (“CFI”)<sup>75</sup> provides, among other things, that NASD members may not participate in any public distribution of securities in which the underwriter’s compensation is unfair or unreasonable. The CFI states that the underwriting group may receive as compensation a maximum of 10 percent of the aggregate amount of securities issued. This limitation as to non-cash compensation includes stock, options, or warrants.<sup>76</sup> Because the 10 percent limits the amount of securities that an underwriter can receive, the CFI prevents the underwriter from retaining control over an excessive amount of a new issue and thereby limits the underwriter’s

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<sup>74</sup> The NASD rules also require that a broker-dealer charge its customers a “fair” price in over-the-counter transactions. NASD Rules of Fair Practice, Art. III, 4 NASD Manual (CCH) ¶ 2154, at 2054. Indeed, NASD rules go further to specify that, as a general matter, broker-dealers should not charge their customers a mark-up of more than 5 percent over the prevailing market price for a security. NASD, Interpretation of the Board of Governors - NASD Mark-Up Policy, NASD Manual (CCH) ¶ 2154, at 2054. While these rules apply to all over-the-counter transactions, they have particular significance in connection with “hot issues” because a broker-dealer that attempts to manipulate the aftermarket for a new security often will charge excessive mark-ups. In addition, the Commission takes the position that excessive mark-ups violate Rule 10b-5.

<sup>75</sup> NASD Manual (CCH) ¶ 2151, at 2019-33. The NASD has submitted to the Commission a proposed rule change (SR-NASD-83-27) that would replace the CFI with a Corporate Financing Rule that codifies and modernizes the NASD’s requirements.

<sup>76</sup> The CFI, at 2028-29, delineates the specific factors that the NASD uses to determine whether securities will be included in underwriting compensation. See also, In re May & Company, Inc. 44 S.E.C. 412 (1970).

incentive to engage in manipulative practices.<sup>77</sup> Moreover, the CFI defines certain types of compensation as unfair and unreasonable per se.<sup>78</sup>

The CFI addresses the “cheap stock” problem by requiring that stock received in connection with or related to the offering by an underwriter be included in underwriter’s compensation. Securities are valued at the difference between the acquisition cost of the security and either the proposed public offering price or, if there is an established market for the stock, the market price at the date of purchase. The issuer, therefore receives the maximum value for its security if an underwriter chooses to accept securities as compensation.

The NASD also has imposed a “lock-up” or holding period of one year on securities received by an underwriter as underwriter’s compensation. This lock-up period limits an underwriter’s ability to sell stock for one year after the effective date of the offering.<sup>79</sup> As a result, an underwriter’s incentive to manipulate the aftermarket for a new issue also should be reduced.

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<sup>77</sup> The CFI, at 2024-27, requires the underwriter to disclose all items of compensation in the documents filed with the NASD.

<sup>78</sup> For example, the CFI provides, at 2032, that options or warrants for terms in excess of five years or that are exercisable below the initial offering price are an unfair and unreasonable underwriting arrangement.

<sup>79</sup> Moreover, an underwriter must not sell these securities under circumstances that cause it to violate Section 5 of the Exchange Act. Sellers often avoid this liability by selling these securities according to the applicable requirements of Rule 144 (17 CFR 230.144), which include various holding periods. Briefly, Rule 144 operates as a safe harbor and sets forth conditions under which sales by affiliates and sales of restricted securities may be made. If a seller complies with the provisions of Rule 144, the seller will not be deemed to be engaged in a distribution, and therefore not an underwriter as defined in Section 2(11) of the Securities Act, 15 U.S.C. 77b(11).

2. Free-riding and Withholding

The NASD's Interpretations of the Board of Governors Relating to Section I of Article III of the Rules of Fair Practice -- "Free-Riding and Withholding" ("FRW")<sup>80</sup> address abusive practices regarding the artificial restriction of the supply of stock in an underwriting. The FRW requires that a member selling securities in an initial public offering of a hot issue<sup>81</sup> must sell those securities to the public at the public offering price.<sup>82</sup> A member violates the FRW if (1) the member withholds from the distribution any of the securities that are part of the public offering; or (2) sells the securities to restricted accounts; that is, accounts held by certain persons including officers, directors, general partners, employees, or agents of a broker-dealer or a member of their

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<sup>80</sup> "Rules of Fair Practice, Article III, § 1, Interpretations of the Board of Governors -- "Free-Riding and Withholding," NASD Manual (CCH) ¶ 2151, at 2039-3.

<sup>81</sup> The FRW, at 2039-3, defines a hot issue as "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins."

<sup>82</sup> The underlying intent of the FRW is to ensure that genuine public investors receive the benefit of any increase in price of a hot issue and to curb manipulation.

immediate family, their accounts, or accounts in which they have a beneficial interest.<sup>83</sup>

In administering this rule, the NASD reviews new issue offerings to evaluate their aftermarket trading characteristics. If an issue appears to have been a “hot issue,” the NASD inquires whether any of the securities were sold to restricted persons. In this manner, the NASD seeks to establish an ongoing presence in monitoring the hot issues markets.

### 3. Unauthorized Transactions and Related Confirmations

The sales efforts of a broker-dealer in connection with a new issue also may include unauthorized purchases of securities for a customer. The broker-dealer then sends a confirmation (a “wooden ticket”) to the customer, advising him of the purchase and demanding payment. A customer who complains about receiving a “wooden ticket” is often persuaded to

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<sup>83</sup> The FRW, at 2040. The FRW also prohibits the sale of hot issues to a number of other persons and businesses including finders (generally, the person, who may or may not be a broker-dealer, who introduces an underwriter to an issuer and receives compensation for that service), certain bank employees, investment partnerships and corporations. *Id.* at 2040-41, 2043-44. For purposes of this discussion, the term “restricted persons” refers to those persons to whom the FRW prohibits an underwriter from selling a hot issue.

Nevertheless, the FRW recognizes certain exceptions to allow some restricted persons, such as finders, bank officers, or certain members of the immediate family of a general partner of a member, to buy a hot issue. These restricted persons can buy a hot issue if the member can demonstrate for each of these purchasers that: (1) the securities were sold according to the restricted person’s normal investment practice, (2) the total amount of the securities sold is insubstantial and not disproportionate when compared to other public sales, and (3) the amount sold to any one restricted person is insubstantial.

Under certain circumstances, it is also proper for the issuer to direct an underwriter to sell securities to restricted persons. For example, an issuer may wish to sell securities to a supplier or distributor as a means of encouraging a continuing business relationship. Accordingly, the FRW permits the issuer to direct its securities to certain restricted persons, provided they satisfy the tests of normal investment practice, proportionality and insubstantial amounts. If the issuer directs its securities to restricted persons who do not satisfy the normal investment practice requirement, such sales may be made only with the permission of the Board of Governors of the NASD. The Board will permit these sales only if the issuer demonstrates a valid business reason for them and if the sales satisfy the proportionality and insubstantiality tests.

keep the securities through high-pressure sales techniques or because the price of the security is now higher than at the time of the alleged purchase. Because “wooden tickets” artificially stimulate demand for a security, the NASD Rules of Fair Practice prohibit this practice.<sup>84</sup>

4. Parking

As described in Section IV above, parking transactions artificially withhold shares of the new issue from the secondary market and may be used to force up the issue’s price. The NASD’s rules prohibiting free-riding and withholding, discussed supra, would reach parking transactions where there is a hot issue, though it may be difficult to identify every type of account over which an NASD member has control and in which a security may be parked.

In addition, the Commission staff has advised the NASD that parking may be prohibited by Rule 10b-6.<sup>85</sup> This rule, among other things, prohibits an underwriter from bidding for, or purchasing for, any account in which it has a beneficial interest, or from attempting to induce any person to purchase any such security, until the underwriter has completed its participation in a distribution. The Commission staff has further advised the NASD that, in the staff’s view, securities sold to an account over which the member, or a person associated with a member, controls, directly or indirectly, the time, price, amount, or manner of resale, including any restricted account, may be considered in continuing distribution and, accordingly, the underwriter may still be subject to Rule 10b-6, unless the securities were purchased by those

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<sup>84</sup> Art. III, §§ 1 and 18 of the NASD’s Rules of Fair Practice, NASD Manual (CCH), ¶ 2151 at 2079. See In re L.B. Securities Corp. & Marx, Securities Exchange Act Release No. 7806 (January 28, 1966), [1964-66 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,326.

<sup>85</sup> 17 CFR 240.10b-6.

accounts for investment purposes only.<sup>86</sup> In response, the NASD issued Notice to Members 83-16 (April 8, 1983), advising all NASD members of the Commission staff's views and stating that the NASD would exercise close surveillance to detect such violations.

## VI. CONCLUSIONS AND RECOMMENDATIONS

Existing statutory authority provides the Commission with the necessary flexibility to adopt rules that address hot issues abuses, and, as more fully discussed in Section II of this Report, the Commission has exercised this authority in a timely and effective manner. All of the abuses described in this Report are prohibited by the existing federal securities laws, and the Commission periodically reviews its regulations to assure that they are current. The Commission has brought enforcement actions wherever appropriate.

Hot issues markets are a cyclical phenomenon. In the later phases of bull markets, initial public offerings have been as much as 64 percent of the total number of public offerings filed with the Commission.<sup>87</sup> As discussed in Section III of this Report, the majority of these offerings have involved companies with a history of operations. Problem hot issues are a very small portion of the broader hot issues markets.

The euphoric stages of hot issues markets do foster abuses. When the general market is very buoyant, some investors fail to exercise normal caution and fall prey to the manipulative and fraudulent activities of a relatively small number of issuers, underwriters, and broker-dealers. Each hot issues cycle witnesses instances of the manipulations and other abuses

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<sup>86</sup> Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon Macklin, President, NASD, September 9, 1982.

<sup>87</sup> Written statement of John S.R. Shad, Chairman, and John M. Fedders, Director, Division of Enforcement, Securities and Exchange Commission, before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, regarding the hot new issues markets, S. Hrg. 98-603, December 15, 1983.

described in this Report. A small number of underwriters and broker-dealers have been guilty of practices such as free-riding, withholding, manipulative domination and control, and abuse of escrow accounts. Also, a small number of issuers have distributed false and misleading registration statements and prospectuses to investors that fail to describe accurately use of proceeds, management experience, plans of operation, and related topics.

The Commission has responded with vigorous enforcement action. As shown in the Appendix to this Report, the Commission has brought enforcement actions against those perpetrating hot issue abuses. The hot issue markets, particularly in Denver and New York, are subject to continuing surveillance. Twice in the last three years, the Commission has established special task forces with the NASD to deal with hot issues problems.

Regulatory responses by the Commission and the NASD also have succeeded in lessening, and in some cases dramatically reducing, these abuses. For example, as discussed at pages 71-73, supra, the NASD's efforts have reduced substantially non-cash underwriter compensation as a hot issues problem. Moreover, the Commission has continually refined its disclosure system, which has improved the flow of information about new issuers.

Prospective improvements in NASD surveillance programs should expedite initial detection and investigation of manipulative trading practices in hot issues. For example, the NASD is constructing a computerized audit trail for transactions in all NASDAQ securities. Such a data base will enable the NASD to produce exception reports that identify manipulative trading patterns in individual NASDAQ issues and the responsible market participants. With respect to detection of free-riding and withholding abuses, the Commission is conducting a series of inspections to evaluate the NASD's performance during the most recent hot issue cycle. The Commission expects to convey its findings, including any remedial recommendations, to the

NASD later this year. Finally, Commission oversight of the NASDAQ qualifications process has prompted more rigorous screening by the NASD of the issuers seeking inclusion of their securities in NASDAQ. The Commission will continue to monitor these regulatory programs through periodic inspections.

While the Commission has adequate authority to reach virtually all hot issue abuses, several legislative and regulatory initiatives have been commenced and are discussed below.

A. Amendments to Commission's Disclosure Requirements

On December 15, 1983, the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, chaired by Alfonse M. D'Amato, held hearings on the hot issues markets. The hearings focused in part on the lack of disclosure to investors concerning prior commodities law violations of key management such as directors and officers and, for new issuers, the lack of disclosure concerning prior criminal convictions of principals such as promoters and major shareholders. As a result of these hearings, on May 2, 1984 the Commission published amendments to Item 401 of Regulation S-K dealing with background information relating to officers and directors.<sup>88</sup> The amendments (1) add legal proceedings involving violations of the Commodity Exchange Act to those legal proceedings required to be disclosed with respect to executive officers and directors and (2) require new registrants to disclose the same legal proceedings involving promoters and control persons that all registrants must disclose regarding executive officers and directors. Registrants that have not been subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act for the twelve

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<sup>88</sup> Securities Act Release No. 6545 (August 9, 1984). The legal proceedings enumerated in Item 401 include bankruptcy proceedings, criminal proceedings, securities (and, pursuant to the amendments, commodities) violations, and certain other legal proceedings that reflect on the competence and integrity of management. See Securities Act Release No. 5949 (July 28, 1978).

months prior to the filing must provide the disclosure with respect to control persons.

Registrants that were organized within the past five years also must include the disclosure with respect to promoters.

B. The Securities Fraud Prevention Act

The December 15, 1983 hearing also resulted in Chairman D'Amato's introduction of legislation, S. 2326, the "Securities Fraud Prevention Act," which the Commission supported. The provisions of this bill were incorporated in Section 6 of the Insider Trading Sanctions Act, signed into law by the President on August 10, 1984 (Pub. L. No. 98-376). Briefly, this law authorizes the Commission and the self-regulatory organizations to bar brokers from the securities markets if they have been barred from the commodities markets by the Commodity Futures Trading Commission. This new law is intended to prevent disreputable commodities brokers from continuing their illegal practices in the securities markets. Specifically, the law subjects individuals who committed commodities violations to a statutory disqualification under Section 3(a)(39) of the Exchange Act,<sup>89</sup> enabling the national exchanges, the NASD and clearing agencies to bar such individuals from membership or from association with one of their members. The self-regulatory organizations also may bar any one of their members associated with such an individual. Further, the law amends Section 15(b)(4) of the Exchange Act<sup>90</sup> to authorize the Commission to institute administrative proceedings against a broker-dealer who

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<sup>89</sup> 15 U.S.C. 78c(a)(39).

<sup>90</sup> 15 U.S.C. 78o(b)(4).

committed commodities violations to determine what restrictions on the broker-dealer's activities are appropriate.<sup>91</sup>

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The Commission has maintained vigilant oversight over the hot issues markets and has effectively utilized its adequate statutory and rulemaking authority to reach abuses. The Commission has aggressively ferreted out fraudulent conduct and preserved the integrity of the markets while avoiding unnecessary restrictions on first-time issuers that may stifle creativity, deny essential financing to legitimate businesses, and deter legitimate conduct.

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<sup>91</sup> The Insider Trading Sanctions Act provided the Commission with other enforcement powers. This law authorizes the Commission to seek a court-ordered penalty of up to three times the profit gained or loss avoided by persons who violate the Securities Exchange Act by tipping or trading while in possession of material nonpublic information. It also authorizes the Commission to institute administrative proceedings for violations of Section 14 of the Securities Exchange Act and to bring administrative proceedings against persons who cause violations of Sections 12, 13, 14 and 15(d) of the Exchange Act.

## CASES FOR HOT ISSUES

## Case 1

This case involves the filing of a registration statement by a speculative new issuer to be underwritten by a broker-dealer active in the hot issues market. The registration statement was declared effective but before any offers or sales of securities took place, the Commission entered an order instituting Stop Order proceedings pursuant to Section 8(d) of the Securities Act. The Statement of Matters to be considered at the hearing alleged that the registration statement and the prospectus allegedly contained false statements of material fact and omitted to state other material facts concerning, among other things:

- (1) A \$125,000 certificate of deposit, representing about one-third of the company's assets in a certified financial statement, was pledged with a bank to secure a loan of approximately the same amount to an unrelated third party, and the third party had defaulted on the loan.
- (2) The nature and source of the company's assets and income were misrepresented by improperly claiming interest from the \$125,000 certificate of deposit.
- (3) The disclosure in the unaudited interim financial statements of the company's sales was overstated by approximately 100% due to the recording of a sale for which no product was ever delivered and no payment received.

A hearing was held and an initial decision issuing a stop order was entered by the Administrative Law Judge. The registrant appealed to the Commission and the Commission affirmed the entry of the stop order.

## Case 2

This case involved alleged violations of the antifraud and registration provisions by the company, its officers, directors, and a major shareholder. The issuer allegedly distributed a series of false and misleading press releases which gave the impression that the company was in sound financial condition and that it was in the process of mining a gold “ore body.” These releases created trading activity in the OTC market and caused the price of the common stock to rise from \$.25 bid to over \$5 bid.

The insiders allegedly sold their stock during this period at artificially high market prices and funnelled a majority of the proceeds back to the company in order to keep the company in business as a scheme to circumvent the disclosure requirements of the registration provisions. Some of these sales were sales of restricted stock allegedly sold in violation of the Rule 144 holding period. In addition, the company made an unregistered offering of 120,000 shares for approximately \$109,000.

The Commission instituted an injunctive action and a ten day trading suspension alleging violations of the registration and antifraud provisions. The complaint requested a temporary restraining order, a preliminary injunction, and certain equitable relief. Injunctions were entered against all defendants.

### Case 3

Two administrative proceedings and one civil injunctive action have been brought against a leading underwriter located in Denver. In the first administrative proceeding, the firm and its principals consented to remedial sanctions and findings that they had engaged in fraudulent misconduct in connection with the firm's market-making activities in two speculative OTC issues: to wit, market manipulation, charging retail customers unfair and unreasonable prices, bidding for and purchasing securities during the distribution of such securities, and maintaining false books and records pertaining to these violative activities.

The Commission instituted another administrative proceeding against the firm and certain of its principals and other associated persons based on allegations that they violated the provisions of a prior Commission order; permitted a disqualified person (the former president) to become associated in a supervisory capacity without the permission of the Commission; engaged in fraudulent and manipulative misconduct in connection with three speculative new issues; to wit, the merchandising efforts of firm salesmen, who made inconsistent buy and sell recommendations to customers at or about the same time and projected future price increases without a reasonable basis, domination and control, charging customers unfair and unreasonable prices, use of a false and misleading prospectus, and failure to conduct proper due diligence. The Commission also alleged in the same proceeding that the firm and the other respondents failed to escrow investor monies in connection with the firm's underwriting of another speculative new issue in violation of the antifraud provisions, and violated the net capital, customer reserve, recordkeeping, financial reporting, and early warning requirements.

The firm defaulted and its broker-dealer registration was revoked. Of the seven individual respondents, five have consented, without admitting or denying the allegations, to findings of violations as alleged and to sanctions ranging from suspension to bars with the right to reapply, and to certain undertakings. As to the two remaining individual defendants, a hearing has been conducted and an initial decision by the Administrative Law Judge is expected soon.

The Commission brought the civil injunctive action against the firm in the U.S. District Court for the District of Colorado based on alleged violations of the Commission's net capital, customer protection, recordkeeping, financial reporting, and early warning requirements, as well as the antifraud provisions. The firm consented to a permanent injunction without admitting or denying the allegations in the Commission's complaint. Recently, the firm became the subject of a SIPC liquidation.

#### Case 4

This matter involved three enforcement actions against one of the leading Denver hot issue brokers and persons associated with it alleging violations of the antifraud, broker-dealer filing, customer protection, recordkeeping, and reporting provisions of the federal securities laws. The defendants consented to the entry of an order enjoining them from future violations of the aforementioned securities laws. The final order also included unique ancillary relief in the form of an order designed to bring the broker's records and reports into compliance and to initiate procedures to prevent future violations.

Subsequently, the Commission brought two separate administrative proceedings against the firm and its associates. These cases involve, among other things, allegations of a chronic failure promptly to escrow offering proceeds of numerous issues (Rule 15c2-4), and the use of the monies in the firm's operations. The Division of Enforcement alleged that the firm, aided and abetted by its principal, failed promptly to escrow offerings proceeds from a series of offerings over a five month period and, at the same time, deposited these funds in the general account of the firm which was overdrawn, thus allowing the firm to satisfy its day-to-day obligations from the float created by the offering proceeds. In a separate case, persons associated with the firm were charged with aiding and abetting this misuse of offering proceeds and aiding and abetting recordkeeping violations. The firm's registration was revoked and various sanctions were entered against and the principal and several associated persons ranging from suspensions for certain periods of time to bars from acting in certain capacities for certain periods of time. After a hearing, a censure was imposed against one respondent which is presently on appeal to the Commission. The matter is pending as to one respondent.

## Case 5

Case 5 concerns a well-known broker-dealer with several branch offices that employs approximately 500 persons and carries several thousand active customer accounts. The underwriting and aftermarket trading of low-priced speculative securities of start-up companies represent a significant part of the firm's business. In late 1979 and early 1980, the broker-dealer underwrote, on a best efforts, all or none basis, the securities of a company founded by, among others, the controlling principal of the broker-dealer, to develop a casino. The company's major asset was a small tract of land in Atlantic City, New Jersey, and its primary activities had consisted of exploring the feasibility of building and operating a casino hotel. The offering of 10 million units at a price of \$2.50 per unit\* was ten times larger than any public offering previously underwritten by the broker-dealer.

The offering was to remain open for 90 days. The broker-dealer's sales force aggressively promoted the offering. It was common practice of the firm's salesmen to say without a reasonable basis that the securities would open at a premium in the aftermarket and some suggested that \$5 or more could be expected as the opening price. It also was an established sales practice to suggest that the broker-dealer's personnel had inside information about pending developments that would make the stock increase in price. Much of what the salesmen said to customers was generated by the controlling principal of the broker-dealer at a sales meeting for sales managers. The majority principal told sales managers that negotiations were proceeding for the issuer to obtain essential additional land and a public announcement would be made. Contrary to the statements made to the purchasers of the securities, no negotiations were then in progress.

Notwithstanding the broker-dealer's efforts to sell the securities, which included materially false and misleading statements, the firm could not sell the entire offering by the required date and cancellations soon began to exceed new purchases. To avoid the failure of the offering, the broker-dealer, the issuer, and those associated with the issuer engaged in a series of transactions to create the impression that the securities were sold in accordance with the prospectus' all or nothing representation. These transactions included the broker-dealer's purchase of one million unsold units with commissions distributed from escrow prior to the completion of the offering and a purchase of units by an investor financed through a loan collateralized by two certificates of deposit, one of which bore a below-market interest rate. The funds used to purchase the certificates came from offering proceeds. Neither of these purchases was bona fide; instead, they were made strictly to enable the offering to close. Subsequent to the purported completion of the offering, the broker-dealer, together with its principal, continued the public distribution while bidding for and purchasing the securities. The broker-dealer's salesmen also omitted to disclose to the public the nature and circumstances surrounding the improper closing.

A federal district court found the broker-dealer's activity violated the antifraud and antimanipulative provisions of the federal securities laws, and permanently enjoined the firm along with its principal. The district court's ruling was affirmed on appeal.

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\* Each unit consisted of one share of common stock and two warrants.

## Case 6

This case involves a speculative new issue, a Denver penny stock broker, and false statements at a purported “due diligence meeting.” The Commission, in an administrative proceeding, instituted a Stop Order proceeding pursuant to Section 8(d) of the Securities Act of 1933 because the issuer’s Form S-2 registration statement contained untrue statements of material fact and omitted to state material facts.

This case first came to the staff’s attention when sources provided information to the staff regarding the background, experience, and past employment history of a key management figure of the company which was inconsistent with information contained in the registration statement. The staff was then consulted as to the materiality of these misrepresentations. The staff attended a so-called “due diligence” meeting for the offering. There a scientific expert employed by the company stated, in contradiction to the registration statement which indicated that it was setting forth all of the issuer’s oil and gas interests, that the company had other oil and gas interests not declared in the registration statement. The staff’s further investigation revealed an undisclosed IRS tax lien filed against the above-mentioned key management figure and that the registration statement falsely stated percentages of net revenue interests in three of its four geological interests.

The Commission’s administrative proceedings suspended the registration statement before any of the shares could be sold in the underwriting. The Stop Order was issued by consent.

## Case 7

This case involves, among other things, allegations of a fraudulent scheme to conceal the insolvency of a small Denver brokerage firm, the failure to escrow customer funds in an underwriting and diverting the funds for the firm's use, operating in violation of the net capital and customer protection requirements, and falsifying the firm's books and records and financial reports. The administrative proceeding followed a civil injunctive action and the appointment of a SIPC trustee.

This case is important in that its allegations are of practices that typify the fraudulent conduct found in relation to the financial and operational problems of various Denver "Hot Issue" broker-dealers as they concealed their financial condition from the self-regulatory organizations and the Commission in an attempt to stay in business during the eclipse of the Denver "Hot Issue" market in 1982.

The broker-dealer's registration was revoked and three of its principals were barred for a period of time from acting as principals in the securities business. After a hearing, the remaining respondent was suspended for a period of time from the securities business by the Administrative Law Judge. An appeal to the Commission is pending.

## Case 8

This matter involves a speculative new issuer that was formed to explore for oil and gas on leases in Illinois and Oklahoma. The company filed a registration statement with the Commission covering an offering of twenty million shares. The underwriter, a Denver penny stock broker at the time, was registered as a broker-dealer.

Subsequent to the completion of the public offering, the firm embarked upon a scheme to manipulate the price of the issuer's stock and acquire the entire public supply. The brokerage firm dominated and controlled the market and raised the price at will, hoping to pay for its purchases from its customers by correctly guessing the amount of short selling by other brokers from whom it also was purchasing the issuer's securities. Interposed were the numerous public investors who had purchased the stock at the ever-increasing price from the firm and other brokers. The public was unaware that the price rise was artificial and bore no relationship to the value of the securities.

A civil injunctive action was filed by the Commission and a SIPC trustee was appointed to liquidate the firm. Preliminary consent injunctions were entered against all defendants.

## Case 9

This case involves the alleged intentional filing of a false and misleading Form S-18 registration statement with the Commission for a speculative new issue to be underwritten by a Denver penny stock broker of 4,000,000 shares of a company purportedly organized to market an experimental, non-traditional treatment and rehabilitation program for drug and alcohol abusers to hospitals and other health care institutions. The program purported to cure alcohol and drug addicts through large doses of vitamins and psychological counseling. It was not recognized as an approved medical treatment.

During the company's first eighteen months of operation, it incurred operating losses aggregating approximately \$800,000. It also had a significant amount of debt, including debts to affiliates, and did not have the ability to repay that debt. Over 25% of the offering proceeds were targeted for repayment of debts to or on behalf of affiliates, officers, and directors.

The preliminary prospectus allegedly contained false and misleading statements concerning inappropriate patients, false billings, and eligibility of the program for medical insurance.

The Commission issued an Order for Public Hearing to determine if a Stop Order should issue. The registrant submitted an offer of settlement, which was accepted by the Commission, and a Stop Order was issued.

## Case 10

This case involved an initial public offering of 6,500,000 shares of common stock on a “best-efforts, 5,000,000 or none” basis. The Commission alleged that the broker-dealer and its president bought “left over” shares in the offering for their own accounts or accounts they controlled to conceal the weakness of the offering and to give the appearance of having sold the entire offering to the public. The Commission further alleged that the broker-dealer, its president, and an undisclosed underwriter then continued the distribution to the public of the “left over” shares within a short period of time after the offering was announced to be “closed.” Moreover, the Commission alleged that the broker-dealer, its president, and another officer had violated the Commission’s recordkeeping requirements and that the firm and its president failed to supervise.

The Commission alleged that the broker-dealer and its president violated Rule 10b-6 under the Exchange Act in that, while participating in this distribution, they bid for and purchased offering shares for accounts in which they had a beneficial interest prior to the completion of their participation in the distribution. The Commission also alleged that the broker-dealer failed to disclose the actual plan of distribution, the undisclosed underwriter’s disqualification barring him from association with any broker-dealer, and the undisclosed underwriter’s conviction for criminal violations of the federal securities laws.

The firm and its two principals submitted an Offer of Settlement which the Commission accepted whereby they consented to findings of violations as alleged and to remedial sanctions involving suspensions ranging from 45 to 120 days.

## Case 11

This case involved a speculative new issuer and a Denver penny stock broker. Information was received by the staff that certain underwriters were holding so-called “due diligence” meetings at which representations were being made contrary to statements made in prospectuses.

Two staff members attended such a “due diligence” meeting hosted by a Denver penny stock dealer and attended by approximately 600 people. The principal officer of the issuer in the presence of the principal officer of the underwriter told those present to disregard that portion of the prospectus that stated that 42% of the net proceeds would be used to construct an ethanol plant. Attendees were informed that the management of the issuer had not yet decided to build an ethanol plant and further studies would be made before such a decision was taken.

Subsequently, the Commission issued an Order Fixing Time and Place for Public Hearing. After settlement negotiations, the Commission issued Findings and a Stop Order. The Stop Order would cease to be effective upon the filing of an amendment correcting all deficiencies. The Registrant then withdrew the filing.

## Case 12

This pending public administrative proceeding concerns a best-efforts, all or none offering of 12,000,000 units. Each unit was priced at \$.25 and consisted of two shares of common stock and one callable common stock purchase warrant. The terms of the offering provided that if all units were not sold by the termination date set forth in the prospectus, all funds were to be returned to subscribers. Pending satisfaction of the all or none contingency, all funds received from investors were to be held in escrow at a designated bank.

Nine days prior to the offering's termination date, a certain broker-dealer became a member of the selling group. A supplement to the prospectus stated that the broker-dealer was to be deemed the "statutory underwriter" for the offering. The order alleges, however, that another broker-dealer affiliated with the broker-dealer functioned as the "selling arm" of the broker-dealer, and that the affiliated broker-dealer used the broker-dealer to be the named underwriter for certain speculative offerings, including the instant offering of units.

The order alleges that the affiliated broker-dealer violated various provisions of the federal securities laws in connection with the offering and sale of the units. According to the order, a portion of the units was distributed by the firm and several of its account executives by exercising unauthorized discretion in placing units in customer accounts and by engaging in other non-bonafide transactions. The order alleges that the affiliated broker-dealer's selling efforts generally were characterized by material omissions and misrepresentations concerning, among other things, the issuer's financial condition and the speculative nature of the offering. The order states that this firm caused purchase price payments for the units to be commingled with its general revenues rather than promptly depositing these payments into escrow as represented in the offering prospectus. As of the termination date of the offering, more than half of the offering was not fully paid for. The firm caused its clearing broker to wire \$3 million to the escrow account and closed the offering even though only a small portion of the monies wired represented purchase payments by investors. No refunds were made to investors.

## Case 13

This case involved alleged violations of various antifraud provisions in connection with the initial public offering of four companies\* underwritten by a Colorado broker-dealer that was active in the Denver hot issue market. The broker now has ceased all operations and is being liquidated under the supervision of a SIPC trustee.

Each of the five issuers whose securities were underwritten by the broker-dealer share certain common characteristics. The companies, by and large, were poorly capitalized, had little or no history of operating profits, and were generally highly speculative ventures ranging from oil exploration companies to a small air carrier. The offering price for the stocks of these companies was generally one dollar per share, although in one case the price was as little as 10 cents per share and in another the price was \$3 per share. Each offering was conducted on a firm-commitment basis.

The allegations are that, in connection with most of these offerings, the broker-dealer manipulated the aftermarket prices of the various stocks. For example, in connection with the underwriting of a company engaged in the sale and manufacture of remote imaging systems, the broker-dealer is alleged to have manipulated the aftermarket price of the company's securities by controlling the supply of stock and creating demand for the stock through various improper methods. The broker-dealer is alleged to have managed to control the supply of stock in the aftermarket by, among other things, directing sales in the underwriting to controlled accounts and obtaining, prior to the opening of aftermarket trading, a substantial block of aftermarket limit orders at prices five times the public offering price. It is alleged that, to generate demand for the stock, salesman were told during the offering period by senior officials of the broker-dealer to advise their customers that the company had good financial prospectus and that its stocks would open in the aftermarket at a substantial premium. It also is alleged that, in one instance, salesmen were reportedly advised that the stock was "going to the moon." It also is alleged that, during the underwriting period, the broker-dealer required a substantial number of its customers to place aftermarket purchase orders for stock at substantial premiums above the one dollar per share offering price as a quid pro quo for obtaining shares in the underwriting. The allegations are that, as a consequence of its activity, the broker-dealer was able to drive the price of the stock to over \$4 per share only a few hours after the commencement of aftermarket trading. It is further alleged that, by controlling the supply of stock in the aftermarket and discouraging or delaying its customers from selling in the aftermarket, the broker-dealer was able to dominate that market on the first day of aftermarket trading.

In connection with another of the broker-dealer's underwritings, it is alleged that the principals of the firm established a Swiss broker-dealer beyond the regulatory and investigative reach of the Commission to park stock in underwritings managed by the firm. Allegedly, by using the foreign broker-dealer, the firm was able to remove large blocks of stock from the U.S. market through the sale of securities to purported foreign customers controlled by the firm. It is

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\* A fifth company (a small air courier) also is involved, but the allegations of fraud pertain to a research report disseminated by an employee of the broker-dealer one year after the initial underwriting.

alleged that such stock was transferred back to U.S. markets for the purpose of aftermarket trading at premium prices. Involvement of the foreign broker-dealer served to insulate records of customer names and transactions from regulators' review and substantially hampered investigation and prosecution of the firm's activities.

The firm has ceased doing business as a result of substantial net capital and other financial problems, which it is alleged the firm originally sought to conceal by falsifying its books and records. The Commission has obtained preliminary injunctive relief against the firm as a consequence of the firm's manipulative activity and recordkeeping violations. The firm presently is being liquidated under the supervision of a SIPC trustee.

## Case 14

This matter concerned an initial offering of common stock of a technology company engaged in the development of water desalinization filters. The firm commitment underwriting was at \$3.25 per share with proceeds to the company of approximately \$1,000,000.

At the offering, about 15% of the shares were placed in nominee accounts for the beneficial interest of the principals of the brokerage firm and one other person. For the most part, these shares were paid for from the proceeds of aftermarket sales and did not constitute a bona fide distribution to the public. Prior to completing the actual distribution of these shares, the firm actively bid for and purchased the stock and therefore violated Section 10(b) of the Exchange Act and Rule 10b-6 thereunder. No disclosure was made that the firm controlled the market while continuing to be financially interested in the distribution. The staff alleged that this omission violated Section 15(c)(1) of the Exchange Act and Rule 15c1-8 thereunder.

On the first day of after-market trading the staff alleged that the respondents manipulated the price of the issuer to a high of \$7-3/4. This was done by arbitrary pricing, artificial restriction of the available supply of stock, domination of the market, use of the firm trading account to absorb the substantial excess of supply over demand for the stock, and other devices. Certain of these manipulative devices continued to be employed until the price reached \$10-1/2.

Finally, the use of nominees to hide the true beneficial ownership of stock caused the books and records of the firm to be inaccurate. These practices caused the firm to violate the books and records provisions of the Exchange Act.

## Case 15

In this civil injunctive action in the United States District Court for the District of Columbia the Commission alleged violations of the anti-fraud provisions, the reporting provisions, and the beneficial ownership reporting provisions.

The Commission's complaint alleged that with one exception, all of the defendants engaged in a scheme to defraud and failed to disclose certain material facts in connection with a ten million dollar public offering of securities.

Specifically, when it became apparent, prior to the effective date of the issuer's registration statement, that the offering was undersubscribed, it was suggested to the underwriter for the offering that a related entity buy the remaining shares. Notwithstanding the fact that this entity did not have the financial ability to pay for such stock, it placed an order to purchase the remaining shares. After the closing date of the offering, and after the issuer had obtained the proceeds of the offering from the underwriter, the order was cancelled. A joint venture was then authorized to use \$1 million of the proceeds of the offering to purchase from the underwriter 100,000 of the shares unsold in the offering. The remaining 40,000 shares unsold in the offering were purchased by four persons with bank loans guaranteed by an affiliate of the issuer. These facts were not disclosed in the prospectus and registration statement for the offering. Furthermore, the annual report to shareholders and annual report on Form 10-K did not disclose adequately the circumstances surrounding the stock purchases by the issuer's joint venture partner and failed to disclose that the loans for the purchase of 40,000 shares of the offering were guaranteed by an affiliate of the issuer.

In addition, the Commission's complaint alleged that reports required by Section 13(d) of the Exchange Act were not filed in connection with their attempt to sell as part of a group approximately 60% of the outstanding common stock of the issuer to a Bahamian corporation and that an officer, director, and owner of the issuer's stock failed to file reports required by Section 16(a) of the Exchange Act reflecting such ownership.

## Case 16

This action was filed in the United States District Court for the Southern District of New York, seeking preliminary and permanent injunctions against the issuer and related parties. The Commission's complaint alleged that the defendants violated the anti-fraud provisions of the Securities Act and the Exchange Act. Two of the defendants additionally were charged with having violated and aiding and abetting violations of the registration provisions of Sections 5(a) and 5(c) of the Securities Act.

The Commission's complaint alleged that the defendants engaged in courses of business which operated as a fraud upon purchasers of the issuer's securities and other persons. As part of and in furtherance of this conduct the defendants made untrue statements of material fact concerning the business, assets, and freely tradeable nature of the issuer's stock. In addition, the complaint alleged that two of the defendants sold shares of the issuer in violation of the registration provisions. Simultaneously with the filing of the Commission's complaint, without admitting or denying the allegations set forth in the complaint, two of the defendants consented to the entry of a final judgment of permanent injunction.

## Case 17

In this injunctive action, the Commission's complaint alleged that, in connection with a public offering of common stock under which the company raised more than \$3.5 million, the defendant officers falsified the company's financial statements by prematurely recording revenue and income relating to transactions that were not yet consummated. By reason of the alleged improper accounting practices, the prospectus provided to investors in the public offering overstated revenue and income by material amounts. The complaint named the issuer, which was a producer of data communications processing systems, and six of its current and former executive officers. The complaint alleged that the prospectus misrepresented or failed to disclose material facts concerning the issuer's business operations.

The complaint further alleged that the defendant officers continued to employ improper accounting practices subsequent to the public offering, thereby inflating the revenue and income disclosed in annual and periodic reports filed with the Commission. In connection with the preparation of such reports, the defendant officers are alleged to have falsified corporate records and misrepresented material facts to the independent accountants who examined the financial statements.

Without admitting or denying the allegations of the complaint, the issuer and the defendant officers consented to the entry of a Final Judgment and Order under which they were permanently enjoined from violating the antifraud, reporting, and recordkeeping provisions of the federal securities laws. The defendant officers were further enjoined from violating Commission rules which prohibit the falsification of corporate records and the misrepresentation of material facts to independent accountants who examine corporate financial statements. The Court also ordered the issuer to establish an audit committee of its Board of Directors to monitor the corporation's accounting practices.

## Case 18

The Commission's complaint in this matter alleged in substance that during the period in question, the defendant filed or caused to be filed with the Commission three fraudulent registration statements for the offer and sale of securities to the public. The issuer, which was a holding company for two wholly-owned subsidiaries that provided aircraft charter services, raised approximately \$32.5 million through these offerings. The largest of the offerings was for \$25 million and was underwritten both by a large nationally-recognized firm and a medium-sized regional broker-dealer.

The complaint further alleged that a wholly-owned subsidiary of the issuer reported revenues for the two prior years of approximately \$1,300,000 and \$4,450,000, when in fact its actual revenues during these periods did not exceed \$600,000 per year. Further, the subsidiary reported that during these periods it flew total revenue miles of 484,595 and 1,230,130, when in fact the total revenue miles did not exceed 250,000 for each of those years. In addition, the subsidiary reported that during these periods it flew 1,038 and 2,383 charter flights, when in fact the actual number did not exceed 300 for each of the years.

The complaint further alleged that for the two prior years another wholly owned subsidiary reported gross revenues of \$5,247,000 and \$14,074,000, without any basis for these figures.

The complaint further alleged that the issuer and its subsidiaries were experiencing a serious cash shortage. In order to deal with the cash shortage until additional funds could be raised from the public, one of the defendants and others allegedly kited checks between the various accounts of the issuer and its subsidiaries.

Subsequently, the issuer and its two wholly-owned subsidiaries, without admitting or denying the allegations of the complaint, consented to the entry of orders by the court of a preliminary injunction and appointing a receiver until further order of the court.

## Case 19

The issuer in this injunctive action was in the business of manufacturing 20 millimeter projectiles for sale to the military services. It filed a registration statement with the Commission on Form S-18 for a proposed public offering of 2 million shares of common stock at \$.50 per share.\* The underwriter, a small over-the-counter broker-dealer, was a defendant, as were a person who was the Chairman of the Board, President, and a controlling shareholder, and another person who was a principal and a controlling shareholder of the issuer.

The Commission's complaint alleged that the defendants violated Sections 5(a) and 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in connection with the Form S-18 registration statement. The complaint alleged that the Form S-18 and preliminary prospectus filed with the Commission and disseminated to the public contained false and misleading statements concerning, among other things, the financial condition of the company, including the existence of assets; the existence of personnel, management, officers, and directors of the company; the integrity of the principals, officers, and directors of the issuer, such as their background -- which included prior criminal convictions -- and their business experience and reputation; and other material risks relating to investing in the stock.

The defendants consented to the entry of a permanent injunction without admitting or denying the allegations in the Commission's complaint.

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\* The offering subsequently was amended to reflect the intent to offer one million shares at \$2 per share.

## Case 20

This case involved a New York broker-dealer that acted as underwriter for the initial issuance of two unseasoned companies.

In connection with the best-efforts, minimum-maximum underwriting of an issuer engaged in the pay telephone business, the broker-dealer solicited and accepted purchase-price payments for securities when a registration statement for the securities was not in effect, and made offers to sell and sold the securities by means of prospectuses and materials that did not meet the requirements of Section 10 of the Securities Act of 1933. This S-18 offering was for 600,000 shares at \$2.50 per share.

The broker-dealer sold the issuer's securities pursuant to a representation in the prospectus that all subscription payments would be deposited and held in an escrow account pending sale of the minimum number of shares by the required date. In fact, no customer funds were placed in escrow in connection with the offering. Instead, these funds were commingled in the account of the broker-dealer's clearing broker and the funds used for closing were supplied by a broker loan obtained by the broker-dealer's clearing broker. The broker-dealer also improperly made a market for the issuer's stock at a time when the distribution was still continuing.

With respect to a second issuer, a company primarily engaged in rendering consulting services to data communications manufacturers, the broker-dealer made offers to sell the issuer's securities by means of promotional materials that did not meet the requirements of Section 10 of the Securities Act.

The Commission instituted injunctive and administrative proceedings against the broker-dealer and its principals, which have been settled.

## Case 21

The complaint in this injunctive action charged, among other things, that a controlling shareholder of the issuer and the president of the issuer caused the company, an inactive public “snell”, to issue, purportedly pursuant to Rule 504 of Regulation D, two million shares of common stock at four cents a share, ostensibly for sale to residents of Nevada. The entire issue in fact was sold to Israeli residents related to the controlling shareholders by marriage. The stock immediately thereafter was resold, at least in part, in the over-the-counter market, at prices as high as \$7 per share, by persons acting at the direction and under the control of the controlling shareholder. At the same time, the complaint alleged, these two individuals and a registered petroleum engineer and the then Chairman of the Board of the issuer caused a materially false and misleading press release concerning the management of the company and the value of its assets to be issued, claiming, among other things, that the company had “recoverable” reserves of 13 million barrels of oil and 26 billion cubic feet of gas.

The complaint further alleged that the issuer’s president caused 600,000 restricted shares of stock to be issued without appropriate legends, and caused 500,000 unauthorized shares of stock to be issued -- some of which he thereafter exchanged for property in Lake Tahoe, Nevada.

## Case 22

This matter involved an initial public offering by a newly-formed company engaged in investing in oil and gas exploration and development.

The promoters owned shares that had been issued in a private placement to finance the cost of the public offering. These shares, however, had been placed in escrow with a state securities commission, as required by state law. Therefore, the only method for the promoters to profit immediately from an expected increase in the market price was to acquire a large number of shares in the public offering. This could not be accomplished openly, because of the NASD's policy on freeriding and withholding. Accordingly, the promoters supplied the underwriter with a list of investors who wanted shares. Some of the investors were nominee accounts for the promoters, who thus acquired almost 10% of the offering. The offering was oversubscribed and quickly doubled in price. The promoters sold their shares in a series of transactions that resulted in a net profit to them of \$215,000.

The Commission's complaint alleged that the promoters engaged in violations of the antifraud provision of the Securities Act in connection with their undisclosed acquisition and subsequent sale of shares of the registered public offering. Specifically, the complaint alleged that both the president and secretary-treasurer purchased a substantial amount of stock in the public offering at the offering price through nominee accounts in anticipation of making a profit by reselling the stock at a later time. The complaint also alleged, among other things, that the defendants: (i) thereafter resold the stock thus acquired at a profit through nominee accounts; (ii) failed to disclose their intentions to purchase this stock to counsel to the issuer, the underwriter for the registered offering, and others; and (iii) failed variously to disclose their intentions to purchase, and their purchases and subsequent resales of, the stock in a registration statement, prospectus, periodic reports, proxy statements, and statements of beneficial ownership required to be filed by the issuer and/or the defendants with the Commission.

The promoters were charged with violations of the registration provisions (Sections 5(b), 7, and 10 and Rule 408 thereunder) of the Securities Act and the reporting, proxy and beneficial ownership provisions (Sections 13(a), 14(a), 15(d) and 16(a) and Rules 12b-20, 13a-1, 14a-3, 14a-9, 14d-1, and 16a-1 thereunder) of the Securities Exchange Act.

The Commission obtained injunctive relief and disgorgement from both of the promoters by consent.

## Case 23

This case was developed as the result of a broker-dealer examination that found that a one-salesman broker-dealer operation was engaged in suspiciously heavy selling of oil stocks at a time when the price was rising rapidly for no apparent reason. The staff concluded that the firm clearly did not have the capability to be underwriting a new issue per month as it apparently had been doing.

The complaint alleged that a known securities violator who had been barred from association with any broker-dealer and barred from practice before the Commission as the result of his conviction and role as counsel in an offering previously made pursuant to the Regulation A exemption was an undisclosed promoter, control person, and underwriter for two public offerings of securities. Such offerings were alleged to have been made in unlawful reliance on the Regulation A exemption.

The complaint alleged that the defendants used notifications and offering circulars for both issuers that were false and misleading in that they failed to state, among other things, that: (1) one of the promoters was a control person of both companies; (2) he had been barred from association with any broker or dealer and from practicing as an attorney before the Commission and had been convicted of criminal violations of the federal securities laws; and (3) both offerings constituted an attempt to raise funds in excess of the amount permitted by Regulation A. With respect to one offering circular and notification, the Complaint further alleged that they were false and misleading because they failed to state that: (1) two of the defendants were undisclosed underwriters of one of the issues of common stock; (2) shares of that stock were purchased by or for the benefit of persons and entities controlled by three of the defendants; and (3) the Commission had barred one of the defendants from association with any broker or dealer, and that person had been the subject of a civil injunctive proceeding brought pursuant to the federal securities laws.

The Commission's complaint also charged violations of the anti-fraud provisions of the federal securities laws in the aftermarket for one of the securities. Among other things, two of the defendants, both of whom were prior securities violators and associates of a promoter, engaged in purchases and sales of the stock that were effected at substantially the same quantity and at substantially the same price, which caused the market to open at an arbitrarily inflated 50 per share as compared to the subscription price of 12 1/2 per share. The complaint further alleged that certain of the defendants made misrepresentations and omitted to state certain material facts concerning the issuer's interests in gold mining concessions in South America in various press releases and communications to shareholders.

## Case 24

In this matter, the Commission alleged in its complaint that the defendants caused false and misleading financial statements to be included in a registration statement filed by a holding company, the sole operating subsidiary of which was a multiple line casualty and property insurance company, in connection with a public offering of 2.75 million shares of common stock aggregating \$16.5 million. The offering was through an underwriting syndicate headed by a well known underwriter of speculative securities.

Within a year after the offering, the issuer's stock essentially was valueless. The Commission alleged that the loss reserves for both assumed (reinsured) workers' compensation claims and direct insurance business in the financial statements in the registration statement were materially understated and that the issuer should have reported a substantial loss and deficit net worth. The Commission alleged that the reserves for workers' compensation claims were materially understated due to the use of an outdated mortality table to estimate life expectancies of claimants; that lower estimated annual medical costs had been used than reported or recommended by the primary insurers; that there was a failure to consider either the effect of inflation in estimating future claims or unpaid billings from primary insurers in analyses of paid claims used to establish reserves; and that there was an arbitrary reduction in reserves for claims on business from one primary insurer. The Commission also alleged deficiencies in disclosures of cash flow problems and of a proposed settlement with a major primary insurer that required a material reduction in net worth and income.

The Commission further alleged in its complaint that the defendants caused the arbitrary removal of reserves for reported claims in order to make up an apparent deficiency in reserves for incurred but not reported claims. The Commission also alleged that the defendants made or caused to be made materially false or misleading statements, or omitted to make necessary disclosures to the company's accountants.

The defendants consented to the entry of the Final Judgements without admitting or denying the allegations in the Commission's complaint.

## Case 25

The Order for Proceedings in this case alleged that a small Canadian brokerage firm and the named individuals willfully aided and abetted violations of the registration requirements of the Securities Act and the anti-fraud provisions of the Securities Act and Exchange Act.

The respondent broker-dealer was the sole underwriter of a new issue of 800,000 common shares of a Canadian oil and gas exploration company. This was a “firm” underwriting under which the underwriter bought the 800,000 shares from the issuer at a price of 25 cents per share and offered the shares to the Canadian public at 50 cents per share. A Canadian prospectus also covered a “secondary” offering to be made immediately following completion of the “primary” underwriting. The “secondary” offering consisted of 128,000 “bonus” shares the underwriter received from the issuer at no cost to the underwriter and 200,000 shares which were purchased from a promoter for 35 cents per share. The shares were not registered for sale in the United States. The 328,000 “secondary” shares were sold to the public at from 60 cents to 90 cents per share.

The Order also alleged that in the offer and sale of such securities, residents of Canada were solicited to sell such securities to the underwriter; that residents of the United States were solicited to purchase the securities from the underwriter, which securities concurrently or simultaneously were being acquired from Canadian residents; that purchasers residing in the United States were charged excessive prices for the shares, not reasonably related to the underwriter’s contemporaneous costs or to prevailing market prices; that the underwriter dominated and controlled the market in the stock; that prices charged the purchasers were arbitrarily determined and established; and that there was a failure to disclose the above to purchasers residing in the United States. The Order alleged that such acts and practices violated Section 17(a) of the Securities Act, and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-3, 10b-5 and 15c1-2 thereunder.

## Case 26

In this matter the Commission alleged violations of the anti-fraud provisions of the Securities Act and Exchange Act in connection with the underwriting of \$6,000,000 worth of securities of an issuer by a now-defunct broker-dealer which had done numerous underwritings of speculative securities. Some of the defendants were directors and officers of the issuer while others were agents of the underwriter.

Specifically, the defendants failed to disclose to the public in connection with the public offering of securities and thereafter: (1) an agreement to invest substantial amounts of the proceeds from the public offering in other speculative equity securities underwritten by the underwriter; (2) that the issuer did, in fact, invest more than \$1,600,000 in such manner; (3) that one defendant, who had been introduced to the issuer by two of the other defendants, had pled guilty to fraud in connection with an insurance company; and (4) that a criminal record of a director or manager could jeopardize or bar the company from obtaining or retaining a license to do business as a reinsurance company. Furthermore, the defendants failed to disclose that the issuer entered into a contract to loan \$10,000,000 to a corporation organized by one of the other defendants, and that \$3,200,000, i.e., the remaining proceeds of the public offering, were paid to that corporation. As further evidence of the fraud, the Commission alleged that two of the defendants had entered into a purported \$2,000,000 loan of the issuer's funds to a company that may have been connected to the defendants. In addition, more than \$3,200,000 of issuer's funds apparently were missing.

In addition to seeking a preliminary and permanent injunction from further violations of the anti-fraud provisions, the Commission's complaint sought an order, inter alia: (1) compelling the issuer to correct certain filings previously made with the Commission regarding the matters that were the subject of the complaint; (2) appointing a special master to conduct an accounting and to identify the ownership of its securities; and (3) requiring that the individual defendants disgorge stock, warrants, or underwriting compensation obtained unlawfully in connection with this public offering.

## Case 27

In this case, a consent injunction was entered without the defendants admitting or denying the allegations of the Commission's complaint. The defendants were enjoined from further violations of Sections 5(a), 5(c) and 17(a) of the Securities Act, the registration and antifraud provisions, respectively.

The Order of the District Court additionally required the defendants to cause the return of more than \$1.5 million received from investors, together with all interest accumulated on the funds, and required the defendants to provide investors with an explanation of the reason for the return of the investment.

The complaint alleged that, prior to the filing of a Regulation A offering statement, the defendants offered and sold over \$1.5 million of the common stock through a subsidiary of the issuer's nationwide sales force to more than 400 investors located in over 30 states, in violation of the registration provisions.

The complaint further alleged that in the offer or sale of these securities false statements were made, and statements of material facts were omitted from statements made, concerning, among other things, the future issuance of stock by the issuer and the price at which such stock would be issued, the existence of an undisclosed commission to the seller of the securities to be paid out of the investment, the current financial condition of the issuer, the market for its securities, and the liquidity of the investment.

In addition to the litigation described above, the Commission temporarily suspended the Regulation A exemption. The suspension was predicated upon the alleged failure to meet the terms and conditions of Regulation A, the existence of misstatements and omissions of material facts in the offering statement, and violations of Section 17(a) of the Securities Act.

## Case 28

In this matter the Commission filed a civil injunctive action in the United States District Court for the District of Columbia against a machine tool manufacturer and three of its executive officers and directors. The defendant issuer sold 825,000 shares of common stock in a public offering which raised \$3.3 million. This was a firm commitment underwriting by a leading underwriter of new speculative offerings.

The Commission's complaint alleged that the issuer maintained a bank account that was not reflected on its books and records ("off-books account"). It also alleged that the off-books account was used to divert customer payments that the issuer had pledged to a commercial lender as collateral for an operational financing loan. It was further alleged that funds were transferred to the company from the off-books account by means of improperly booked related party transactions between the issuer and its executive officers. The complaint also alleged that these activities resulted in the understatement of the officers' indebtedness to the company, and that they constituted events of default under the company's financing agreement with its lender. It was alleged that the defendant misrepresented and failed to disclose these matters in connection with the public offering and in its annual and quarterly filings with the Commission. It also was alleged that the defendants failed to disclose and materially misrepresented other financial transactions of the company which violated the terms of the loan agreements.

The complaint also alleged that when its independent accountants came to suspect the existence of the off-books account, the defendants concealed the duration, extent, and manner of its use. It was alleged that the defendants prepared and caused to be prepared materially false bank documents that reflected that the off-books account was not opened until after the public offering, that deleted all reference to the related party transactions conducted through the account, and that understated by approximately \$2.2 million the aggregate amount of customer payments diverted to the off-books account. The complaint also alleged that when the independent accountants attempted to confirm the information contained in the false bank statements, two of the defendants intercepted the confirmation statement sent to the bank by the accountants, forged the signature of a bank official, and caused it to be returned to the independent accountants. It was further alleged that these defendants made material misstatements to the independent accountants concerning the off-books account and the false documents.

## Case 29

In this matter the Commission alleged that the issuer and related parties filed and caused to be filed with the Commission a registration statement on Form S-18 for a planned offering which contained untrue and misleading statements of material fact and failed to contain required information and documents. The registration statement contained financial statements of the issuer which reported assets and revenues and net income for the fiscal year when, according to the complaint, the issuer had insubstantial assets, and had no revenue and a loss for the year. In its financial statements, the issuer recognized commission revenue and a note receivable arising from the purported sale of rights to purchase a certain plant. The Commission alleged that the issuer had no enforceable right or option of any kind with respect to the plant and that the sale transaction was a sham. The complaint alleged that the financial statements were materially false and misleading because they gave effect to this transaction, overstating assets, revenues, and income, and because the notes to the financial statements contained false statements, misleading disclosures, and omissions of material facts. These financial statements were distributed separately to the company's shareholders and market makers.

The complaint also alleged that the registration statement contained materially false and misleading statements regarding the issuer's business, profits, contracts and agreements, officers, and legal representation in connection with the planned offering. The Commission alleged that the company was not engaged in the production and sale of the product disclosed in the registration statement, had not generated profits, and had entered into no written supply or distribution contracts, and that the company's special counsel had not passed on legal matters in connection with the offering, contrary to what was stated in the registration statement.