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Hugh L. Sowards

James S. Mofsky

THE "HOT ISSUE": POSSIBLE HIDDEN CAUSES

HUGH L. SOWARDS*

JAMES S. MOFSKY**

In 1968-1969 the securities industry and the investing public experienced a dramatic "hot issue" market. After a subsequent period of depressed market conditions, "hot issues" are now beginning to reappear in increasing numbers.[1] The "hot issue" phenomenon occurs when securities trade in the after-market at an immediate, and often substantial, premium over the public offering price. A corporation whose securities are already traded publicly would generally offer additional securities of the same kind or class at the existing market price at the time of the offering. Accordingly, such a company would not usually participate in a "hot issue" market. But there is no market price for the shares of a closely-held corporation, and if such a firm were to contemplate a public financing, the public offering price per share of stock would be determined through negotiations between the underwriter and corporate officials. It is in connection with first public offerings of this latter group of corporations that the "hot issue" phenomenon may arise.

WHAT CAUSES A "HOT ISSUE"?

The explanations offered to date for this unique occurrence include analyses of the supply of and demand for the new issues.[2] For example, it has been suggested that a number of practices of underwriters and dealers artificially influence supply or demand and thus result in after-market quotations which may, on the day the public offering becomes effective, be one, two or three hundred percent greater than the initial offering price.[3] When some such practices are

* Professor of Law, University of Miami, School of Law. B.S., Trinity College, 1941; LL.B., Yale University, 1946.

** Associate Professor of Law, University of Miami, School of Law. B.A., Wesleyan University, 1956; LL.B., Cornell University, 1959; LL.M., University of Miami, 1966; S.J.D., The George Washington University, 1971.

1 *See* Wall St. J., Feb. 26, 1971, at 1, col. 6.

2 *See* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 1, at 514 (1963) [hereinafter SEC SPECIAL STUDY]; Rotberg, *The "Hot Issues,"* 17 BUS. LAW. 360 (1962); Comment, *Securities Regulation: Legislative and Administrative Treatment of the "Hot Issue" Phenomenon*, 1968 DUKE L.J. 1137.

3 Some of the practices suggested include (a) distribution of the securities only to purchasers who plan to retain their holdings for a substantial period of time, the underwriter sometimes enforcing such long-term retention by refusing to allot future "hot

affected with an intent to limit supply or increase demand as opposed to facilitating an orderly distribution, such activities amount to manipulation.[4] Other practices may amount to unlawful manipulation without the necessity of showing an intent to artificially limit supply or increase demand.[5]

But it is difficult to believe that a large percentage of the recent "hot issues" has resulted from manipulation. The Securities and Exchange Commission has sufficient statutory authority to adopt new rules or enforce existing ones to deal with such practices,[6] and yet the Commission has done little in this connection.[7] If a primary cause of "hot issues" has indeed been the manipulative techniques of underwriters and dealers, the inactivity of the Commission is especially surprising in view of the recommendations of the *Special Study of the Securities Markets*, published in 1963, six years before the end of the last "hot issue" market.[8] Perhaps, the members and staff of the Commission do not believe that manipulation is such a significant factor. In any event, there have been no empirical studies supporting the manipulation theory.

Some of the explanations contain statements about the phenomenon which are undoubtedly true. By way of illustration, it is undeniable

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issues" to purchasers who immediately resell and by penalizing registered representatives whose customers immediately resell; (b) allocation of the securities to discretionary accounts managed by the underwriter so that the time of resale is within the control of the underwriter; (c) late notification to purchasers of their allotments; (d) refusal to effect sell orders; (e) late delivery of stock certificates; (f) allocation of a portion of the "hot issue" to officers, partners and employees of the underwriting firm or members of the underwriting syndicate or to relatives of such persons; (g) recommendations of "hot issues" for customers whose accounts are too conservative to justify purchase of such securities; (h) untrue statements concerning the company's financial condition, dividend prospects, the plan of distribution, or other matters involving the market conditions relating to the security; (i) creation of a false appearance of an independent market; (j) creation of an artificial appearance of trading activity; (k) execution of sham transactions; or (l) unfair withholding or free-riding in contravention of the rules of the National Association of Securities Dealers (NASD). For discussion of these and other practices, see the materials cited in note 2 *supra*.

[4] *See* Comment, *supra* note 2, at 1146.

[5] *See id.* at 1148-58.

[6] *See* the materials cited in note 2 *supra* for a collection of the applicable federal statutes and rules of the Securities and Exchange Commission.

[7] In 1946 the SEC proposed a rule which would have made it a fraudulent practice to offer an undistributed portion of an issue at a price greater than the initial public offering price, unless for a reasonable time period a bona fide offer had been made to distribute the securities at the initial public offering price. *See* Proposed Rule X-15C2-3, (April 16, 1946). This proposed rule was never adopted.

[8] The *Special Study* made extensive recommendations in connection with the "hot issue" phenomenon. *See* SEC SPECIAL STUDY, pt. 1, at 557-59. Such recommendations have not resulted in new Commission rules, except that the Commission has announced a policy that it will deny acceleration of effectiveness of certain registration statements unless the prospectus in substantially final form is delivered to prospective purchasers at least forty-eight hours prior to sale. *See* SEC Securities Act Release No. 4968 (Apr. 24, 1969).

that the phenomenon generally applies to close corporations whose public offerings coincide with periods when investors' optimism is sufficiently great to generate heated speculative activity in the securities markets.[9] It is also true that such speculation and optimism contribute to a greater demand for the limited number of shares sold publicly than would exist during a less speculative period.[10]

But these statements merely describe the symptoms of the phenomenon. They do not provide an answer for the most significant question: why, during a period of speculative market activity, would controlling shareholders of the close corporation agree to an initial public offering price substantially below prices which would prevail in the immediate after-market? Superficially, such arrangements would appear contrary to the best interests of the corporation and its shareholders, because less than maximum amounts would be generated from the public offering. Yet such agreements must be made regularly; otherwise, the "hot issue" phenomenon would not exist, unless the phenomenon were explained on the basis that controlling shareholders of closely-held corporations often mistakenly judged after-market prices. But experience indicates that controlling shareholders have substantial information regarding the pricing of first public issues and after-market quotations. Thus, the answer to the above question must be based on some conscious motive of controlling shareholders and underwriters. The behavior of underwriters and controlling shareholders in this connection might best be considered through the use of a hypothetical situation. Such a model is presented below in the form of a highly simplified problem.

A corporation was organized several years ago as a closely-held firm. For the usual reasons, its controlling shareholders have decided to pursue a public offering of its common stock. For purposes of simplicity, assume that the corporation will have twenty shares of common stock outstanding (of course there would be many times that number of shares outstanding in an actual public offering) upon conclusion of the public offering and that the underwriters and promoters agree that the promoters should retain a 50 percent interest in the firm. Thus, the promoters will hold an aggregate of ten shares subsequent to the completion of the offering. These ten shares (or the shares representing them before the usual split) were probably issued during the past several years for promotional activities, services, property, cash, and intangibles

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9 *See* SEC SPECIAL STUDY, pt. 1, at 514-59; STATE OF WISCONSIN COMMISSIONER OF SECURITIES, MONTHLY BULL., Sept. 1967, at 1. *Interview with Manuel F. Cohen*, FORBES, Feb. 15, 1968, at 43; Israels, Throop, Cohen, Loomis, Kennedy & Blackstone, *Panel Discussion: Offerings of New Securities*, 18 BUS. LAW. 37 (1962).

10 *See* Comment, *supra* note 2, at 1138-41.

such as ideas and patents. If the net worth of the firm before the public offering is \$500 and the public investors pay \$150 per share (a figure determined by negotiation between the underwriters and promoters) for their ten shares, the net worth of the firm after the offering will be \$2,000 and the book value per share will be \$100 (\$2,000 ÷ 20 shares). Again to simplify the model, expenses of the offering such as underwriters' discounts and commissions are not taken into account.

Assume further that, immediately after the public offering and before there is any significant change in the company's financial conditions or earnings, the common shares are trading heavily in the over-the-counter market at \$300 per share (100 percent more than the public offering price). If the firm had offered its stock at its after-market price of \$300 per share, its aggregate net worth would have been \$3500 rather than \$2000 and the book value per share would have been \$175 instead of \$100. Thus, by virtue of offering its shares at \$150 per share rather than at \$300, the firm has sustained a total book value loss of \$1500 and a net worth loss per share of \$75. This example is not exaggerated when compared to some of the "hot issues" which appeared during 1961 and 1969.[11]

The previously posed question may now be asked in more concrete terms: if the corporation and indirectly, the promoters are damaged to the extent of 50 percent of the company's book value, why would the underwriters and promoters negotiate the \$150 per share public offering price? Underwriters profit in two respects from this kind of pricing. First of all, such a "hot issue" often generates a significant amount of after-market trading. Since the underwriter generally makes the initial market after the offering, he will earn substantial dealer mark-ups and broker commissions, sometimes amounting to as much as the total underwriting discount. Second, the publicity of this successful "hot issue" may attract syndicate members and retail customers for the underwriter's next offering.

With respect to the motivation of the promoters or controlling shareholders, they may be willing to accept the loss to the corporation if the underwriter can provide them with a method of recouping their individual indirect loss on the book value of their shares. It is submitted that an often used method to accomplish this objective is the allocation to controlling shareholders of shares of "hot issue" stock in other offerings by the same underwriter, in sufficient quantities so that the profits from the sale of such stock approximate the book value loss on the shares of controlling persons. However, this conclusion will be appli-

11 *See, e.g.*, Rotberg, *supra* note 2, at 360.

cable only if the controlling shareholders elect, or are forced, to retain their shares rather than to sell them at the maximum public offering price which would be supported by the market (in this case, a price in excess of $150 per share and possibly as much as $300).

If such persons sell their shares at $300 per share, then of course, they would be maximizing their interests without harm to the corporation, and there would be no reason for them to engage in the previously described trade-off with underwriters. But, as will be seen below, there are state securities laws and regulations and a rule of the National Association of Securities Dealers,[12] sanctioned by the Securities and Exchange Commission,[13] which frequently have the effect of precluding controlling persons and promoters from selling their shares publicly at the time of their company's initial public offering. These laws and rules may have significantly contributed to the large number of "hot issues" which have occurred during speculative periods in the securities markets.

BLUE SKY LAWS AND NASD CONSIDERATIONS

With respect to the Blue Sky laws, absent some exemption, the shares of a controlling person or promoter which are offered for sale in a public offering must be registered prior to sale. In connection with a registration, state administrators may order under certain circumstances that such shares be escrowed pursuant to state statutes or rules, and thus such shares may not be freely transferable even if registered under the Securities Act of 1933. If the controlling person's shares qualify under the Blue Sky definition of promotional shares,[14] the statutes or rules in forty states require escrow of such shares before the state administrators may permit the company's issue to qualify for public sale in their respective states.[15] Of these states, nineteen do not permit

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12 *See* "Rules of Fair Practice" article III, § 1, NASD MANUAL D-5-D-27 (1967).

13 With respect to the registration of a national securities association under section 15A of the Exchange Act, the Commission is authorized

> to abrogate any rule of a registered securities association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this title.

15 U.S.C. § 78o-3 (1964).

14 *See* note 18 *infra* for a definition of promotional securities.

15 ALA. CODE tit. 53, § 34(b) (Supp. 1967); ALASKA STAT. § 45.55.110(g) (Supp. 1966); ARIZ. REV. STAT. ANN. § 44-1876 (1967); ARK. STAT. ANN. § 67-1245(g) (1966); CAL. CORPS. CODE § 25141 (West Supp. 1969); COLO. REV. STAT. ANN. § 125-1-10(7) (1963); FLA. STAT. ANN. § 517.18 (1962); GA. CODE ANN. § 97-104.1(C) (1968); HAWAII REV. LAWS § 199-14 (Supp. 1965); IDAHO CODE ANN. § 30-1428 (1967); ILL. REV. STAT. ch. 121½, § 137.11(E) (Supp. 1970); IND. ANN. STAT. § 25-860(j) (Supp. 1969); IOWA CODE § 502.20 (1966); KAN. STAT. ANN. § 17-1259(d) (Supp. 1969); KY. REV. STAT. § 292.380 (1963); LA. REV. STAT. § 51:713 (1965);

release from escrow until dividends aggregating 5 to 6 percent have been earned and paid on the public investors' shares.[16] The remaining jurisdictions allow release at the discretion of the regulators or after a prescribed period.[17]

Because of the broad definitions adopted by many states for the term promotional securities,[18] many or all of the promoter's or controlling person's shares will be subject to the escrow restrictions. Thus, the laws of most states may force such persons to be locked in and unable to profit on their shares even if they were willing to have their shares registered for immediate public sale. Consequently, promotors affected by these escrow arrangements may be willing to negotiate a less than maximum public offering price if they can be compensated *immediately* for their proportionate loss in their firm's net worth.

To circumvent the escrow problem, promoters and controlling persons might consider an offering only in those states where there is no escrow requirement. It may, however, be impossible to successfully sell the entire issue in those states. But even if the underwriting could be so accomplished, there are legal and practical reasons why investment bankers do not underwrite first public issues when the controlling group sells a substantial percentage of its holdings.

Generally speaking, the cream of the underwriting business lies in

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MICH. STAT. ANN. § 19.776(305)(f) (Supp. 1969); MISS. CODE ANN. § 5364 (Supp. 1968); MO. REV. STAT. § 409.305(f) (Supp. 1969); MONT. REV. CODES ANN. § 15-2011 (1967); NEB. REV. STAT. § 8-1108(2) (Supp. 1965); N.J. REV. STAT. § 49:3-61 (Supp. 1969); N.M. STAT. ANN. § 48-18-19(C) (1966); N.C. GEN. STAT. § 78-11(1) (1965); N.D. CENT. CODE § 10-04-08.1(1) (Supp. 1969); OHIO REV. CODE ANN. § 1707.09(K) (Page 1964); OKLA. STAT. tit. 71, § 305(g) (Supp. 1969); ORE. REV. STAT. § 59.085(3) (1967); S.C. CODE ANN. § 62-165 (1962); TENN. CODE ANN. § 48-1650 (1964); UTAH CODE ANN. § 61-1-23 (1968); VT. STAT. ANN. tit. 9, § 4223 (1958); VA. CODE ANN. § 13.1-510(h) (Supp. 1968); WASH. REV. CODE § 21.20.250 (1961); W. VA. CODE ANN. § 3273(16) (1966); WIS. STAT. AM. § 551.27(7) (1969); WYO. STAT. ANN. 17-117.11(g) (1965); Minn. Admin. Rules & Regs., S. Div. 43 (2 BLUE SKY L. REP. ¶ 26,604 (Aug. 12, 1966)); S.C. Regs. Comm'r. Sec., pt. 11G (3 BLUE SKY L. REP. ¶ 44,609 (Nov. 15, 1967)). Tex. Sec. Bd. Admin. Interp. (3 BLUE SKY L. REP. ¶ 46,634 (1970)).

16 Alabama, Arkansas, Colorado, Florida, Hawaii, Iowa, Kansas, Kentucky, Louisiana, Nebraska, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Vermont, Virginia, West Virginia. For citations see note 15 *supra*.

17 Alaska, Arizona, California, Georgia, Idaho, Illinois, Indiana, Michigan, Minnesota, Mississippi, Missouri, Montana, New Jersey, Oklahoma, South Carolina, South Dakota, Tennessee, Utah, Washington, Wisconsin, Wyoming. For citations see note 15 *supra*.

18 An example of such broad definition is the one adopted by Division of Securities, Department of Law, State of Colorado:

> PROMOTIONAL SECURITIES (CHEAP STOCK):
> Where an issuer is in the promotional, exploratory, or development stage, securities which have been issued within three years of the date of filing, or are to be issued to underwriters, promoters or insiders for an amount less than the public offering price, or for a consideration other than cash (unless the value of such consideration can be conclusively established) will be subject to the following conditions and restrictions.

Rules and Regs. Colo. Div. Sec., Rule V (1 BLUE SKY L. REP. ¶ 9706 (Jan. 1, 1967)).

the profits which may arise in connection with warrants and bargain stock allocated to investment bankers in connection with a public offering. Such warrants and the stock underlying them are usually purchased for investment purposes, and these securities may not be sold publicly until a post-effective amendment to the registration statement has been declared effective in connection with the warrants.[19] In short, such warrants are restricted until they are registered under the 1933 Act and the appropriate state securities laws.[20]

However, underwriters will not wish to register their warrants for sale at the time of the company's initial public offering because of the six months holding period requirement under the provisions of the tax laws. But even if underwriters were willing to forego capital gains treatment of their profits on warrants, an NASD rule precludes its members (and most underwriters belong to the NASD[21]) from transferring underwriters' warrants for at least twelve months from the date of receipt.[22] Similar registration and tax considerations apply to cheap stock which may be purchased by investment bankers in lieu of warrants.

Underwriters will not want promoters and controlling shareholders to be able to sell their stock until the underwriters' warrants are free from NASD transfer restrictions. This desire is based on the belief that a promoter or controlling stockholder who is locked into a large proportion of his shares will use greater efforts than other corporate executives not so locked-in to manage the corporation's business in such a way as to maximize the market price per share of the company's stock. In other words, the amount of work expended by promoters and controlling persons to increase the value of a company's shares will depend to a large degree on the size of their share ownership which they will be motivated to protect. Consequently, as long as underwriters hold restricted warrants or cheap stock, they will have an economic interest in preventing promoters and controlling persons from disposing of a significant amount of their shares at the time of the company's first public offering.

To protect their interests and to avoid participation in a bail-out, investment bankers may thus refuse to underwrite the issue if significant amounts of promoters' or controlling persons' holdings are sold in

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19 *See Guides for Preparation and Filing of Registration Statements*, No. 10, SEC Securities Act Release No. 4936 (Dec. 9, 1968).

20 However, the rules of some blue sky commissioners restrict the transfer of such warrants indefinitely and preclude their exercise for the first eleven months after issuance. *See, e.g.*, Rules Fla. Sec. Comm'n, 330-1.06 (1 BLUE SKY L. REP. ¶ 13,606 (1968)).

21 For the reasons most underwriters belong to the NASD, see Sowards & Mofsky, *The Securities Industry: Regulatory Control Over Entry*, 8 CORP. PRAC. COMM. 99,101 (1966).

22 *See* NASD Rules, *supra* note 12.

connection with the company's first public issue. Again, in the event such holdings are retained, promoters and controlling shareholders may be willing to agree to a public offering price below the after-market trading price, if they can be compensated for their book value loss in the company's shares. As previously suggested, allocation to them of "hot issue" stock in other companies can be a most satisfactory method for accomplishing this objective.

The controlling person in "hot issue" Company *A* will not be a control person in "hot issue" Company *B* by virtue of being allocated a relatively small percentage of the outstanding stock of Company *B*.[23] Therefore, the controlling person need not be concerned about registration of his shares of Company *B* under the 1933 Act. Furthermore, his shares in Company *B* will not be escrowed under Blue Sky laws, and the underwriter will have no reason to want him locked into his Company *B* shares. Thus, this technique is an efficient one for compensating the controlling shareholder personally and for obtaining agreement on a public offering price below the immediate after-market valuation.

The amount of "hot issue" stock in unaffiliated companies allocated to controlling persons should depend to some extent on their proportionate loss in the book value of their firms' stock. For example, in the fact pattern stated above, the public offering price of $150 rather than $300 per share would result in a book value loss of $75 per share to the control person and the members of his group. On the basis of ten shares, the total book value loss to these persons would be $750. Presumably, the underwriter will allocate to this group sufficient "hot issue" stock which would generate, after taxes, an amount approximating $750.

CONCLUSION

While the authors have observed the distribution of "hot issue" stock in the manner described above, there have been no empirical studies substantiating this theory. However, it has been a common experience for investors to find it extremely difficult to obtain "hot issue" stock at the public offering price. Even retail customers who are regular and substantial traders have found that their brokers may allocate to them perhaps only twenty-five shares of a "hot issue." It is submitted that a substantial portion of the shares of "hot issue" companies may be channeled to controlling persons in firms which are themselves having public offerings.

In sum, Blue Sky escrow requirements and the NASD rule restrict-

23 With respect to the problem of when a shareholder becomes a control person, see Sommer, *Who's "In Control"?—S.E.C.*, 21 Bus. Law. 559 (1966).

ing transfer of warrants may be significant causes of the "hot issue" phenomenon. Of course, promoters and controlling persons may *elect* not to sell their shares for some reason other than the Blue Sky escrow and NASD restrictions, and they may nevertheless engage in the "hot issue" trade-off described above. But this matter has not been studied empirically and the degree to which the securities laws and NASD rules have contributed to the "hot issue" problem is not known. It is a *problem* in the context of the model set forth in this article, because in this hypothetical situation, the only losers are the minority stockholders who purchased shares in the after-market at prices in excess of the public offering price. If the escrow regulations and NASD rule are having the effect indicated, it is submitted that reform in this area is needed. Although revision of the Blue Sky laws on a state-by-state basis would be a most difficult undertaking, the Securities and Exchange Commission — which has approved the NASD rules — has statutory authority to abrogate them.