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MR. EMERSON. Today we are going to explore the most technical and most nearly incomprehensible series of rules the Commission ever adopted. Part of the difficulty arises from the fact that many traditional methods of securities distribution, like Harriet Beacher Stowe's Topsy, "just growed." Many experiments were tried and if a plan was recognized as a valuable contribution to our distribution system its use was permitted whether or not its operation was in contradiction to other equally good arrangements already in use.

The American underwriting system whereby a large quantity of securities is rapidly sold to the public by a large number of investment banking concerns at a cost of money to the issuer which is not exorbitant, requires some guarantee or insurance scheme to minimize market fluctuations which might destroy the relatively slender margin of profit which the bankers depend on in re-offering high or intermediate grade securities. Stabilizing purchases furnish such a guarantee.

Stabilizing is necessary even in the case of a new security because some investors will change their minds and resell the security they have just bought. In addition, there is always a speculative element in the market known and hated by the trade as "free riders," who purchase with the hope of making a quick resale at a profit. If a price rise is not forthcoming, they sell anyway; for many of them do not have the capital to take down the securities they have ordered. Underwriters stabilize to absorb this open market selling. They do this by purchasing a sufficient amount of the securities to prevent or retard a price decline.

Where an additional amount of an already outstanding security is offered, there is an even greater chance for a price decline because every day some stockholders sell shares, and many of the persons who might otherwise have bought those shares in the open market have been button-holed by one of the underwriters. Consequently, the market is under exceptional selling pressure during an offering.

The Act therefore recognizes that some element of market control must be furnished during a period when large blocks of a security are

coming to market. To govern stabilizing and prevent fraud and manipulation the Commission has adopted Rules X-10B-6, X-10B-7 and X-10B-8.

Rule X-10B-6 enumerates the kind of transactions that persons distributing a security may make. Rule X-10B-7 covers the mechanics of stabilizing and X-10B-8 governs the special problems encountered in rights offerings. X-10B-8 is also useful in controlling underwritten exchanges of securities.

Rule X-10B-6 prohibits an issuer, vendor, underwriter, or other participant in a distribution to bid for or purchase the security being distributed or any other security of the same class and series, or to induce anyone else to bid for or purchase such a security, prior to or during a distribution. It then sets forth 11 exceptions designed to permit the distributors to purchase and distribute the offering, to stabilize, and to service their customers. The following are the most important exceptions and their purposes:

Exception 1 is to enable the distributors to buy the offered security from the issuer and to split it up among the group. Exception 2 is to enable an underwriter who has bought a block for distribution to buy another large block from another vendor and make one offering out of the two lots. Exception 5 is to permit participants to execute unsolicited agency transactions. In other words, an order initiated by a customer may be executed by the underwriter. To prohibit the underwriter from effecting his customer's purchase orders would only mean that the customer would go to a different broker to get the stock he wants. The result on the market would be exactly the same.

Exception 6 enables participants to solicit the purchase of the offered securities and other securities offered by them as principal. Exception 7 enables them to excercise rights or options owned or to effect conversion of securities owned. Exception 8 permits stabilizing. Exception 9 permits rights plans operation.

Exception 11 requires considerable explanation. It is applicable when an additional block of an outstanding security is offered. Obviously existing stockholders should not lightly be deprived of a market for their securities. If the security is listed, the exchange provides such a market. However, in many offerings of over-the-counter securities, the very dealers who make the market are apt to underwrite the new shares. Exception 11 makes provision for such participants gradually to discontinue purchases as principal and to remain out of the market for a short time before the distribution is begun. Thus, on the 9th, 8th, 7th, 6th and 5th days prior to the commencement of the offering participants may only purchase such amounts of the security as are offered to them. And they may do nothing to initiate any such purchase transaction. On the 4th, 3rd, 2nd and 1st days before the distribution begins, participants may not make any purchase unless another exception is available. Frequently the manager stabilizes during those four days. In the nine business days participants may not appear in the quotation sheet except (1) if it is necessary to do so in order properly

to stabilize, (2) if it is necessary to do so to execute a customer's unsolicited agency order, or (3) to show an offering. In the latter case, they should not show a bid or appear OW, (offers wanted) or name only.

Rule X-10B-6 further provides that an offering of a security then convertible into or exchangeable for another security, or which carries a warrant to buy such other security, is an offering of the other security. Thus an offering of a debenture convertible into common is considered also to be an offering of the common and participants may not trade the common stock. The reverse is not true. An offering of common stock would not require an underwriter to discontinue purchases of an outstanding convertible debenture. The rule permits issuers and vendors again to resume normal purchases after the completion of the distribution. Completion for an underwriter is when he has sold his participation, including any shares bought in stabilizing when all stabilizing arrangements to which he is a party have been terminated, and when trading restrictions have been removed by the manager. Completion for a selling group member is when he has distributed his participation. Shares taken for investment are considered to be distributed.

Notice that Rule X-10B-6 is applicable to any distribution. A distribution under the 1934 Act differs from the concept of a distribution as set forth in Rule 154 under the Securities Act. Rule 154(b) only determines whether or not registration is required in connection with certain offerings. Such offerings may still be distributions under Exchange Act standards.

The term "distribution" is extremely difficult to define and no attempt is being made accurately to do so here. The major factor, in deciding whether or not a series of sales is a distribution, is the sales effort involved. A dealer does not have to discontinue purchases just because he happens to acquire a block somewhat larger than his normal trading position. But if a dealer is required to call in retail salesmen, or otherwise set up the usual distributive machinery, it is difficult to conclude that a distribution is not involved.

Rule X-10B-7 sets forth permitted and prohibited practices in connection with stabilizing bids and stabilizing purchases. In the first place, a stabilizer is by definition an unwilling buyer, and he should make no transactions not necessary to prevent or retard a price decline. For this same reason, he should grant priority to any other buyer at the same level. This is reasonably easy to do on an exchange. In the over-the-counter market, however, a stabilizer, while he must defer to any other bid at the same price placed with or given to him, is not required to refer offers to other dealers before accepting their offers.

When a group stabilizes, control of all the stabilizing bids should be in the same hands. In any case, only one bid in any one market should be placed at the same price at the same time. This does not prevent a stabilizer, however, from placing over-the-counter bids in New York, Chicago, and San Francisco at the same level.

The most important consideration when placing a stabilizing bid is finding the proper stabilizing level. If there is no market for a new security, a stabilizing bid may be placed at any price not in excess of the offering price. Incidentally, it is never proper to stabilize at a level above the price at which the stabilizer is currently offering the security. But a special price due to a special group, such as employees or holders of rights, would not make unlawful the placing of a stabilizing bid at the higher level of the independent market.

In the over-the-counter market an initial stabilizing bid should never exceed the bid of the highest independent dealer. On an exchange, however, if the last price exceeds the current bid, then the stabilizer may bid at that last price, provided, of course, that the last price is not stale. Prices can become stale by lapse of time. If the security has not traded yesterday or today, or in the case of a holiday week-end, on the last previous business day, the price is deemed stale by lapse of time. On the other hand, if the current asked price on the exchange is below the last sale price, such last sale price is also stale. In any stale price situation the stabilizing bid should not exceed the current bid price. But if the first sale that occurs thereafter is higher, the stabilizer can raise his stabilizing level to the level of such first sale.

Once a stabilizing bid is placed, it may be retained or reduced, but a stabilizing bid may not be raised except under either of two conditions: If a stabilizer has made no purchases for three successive business days, on the fourth day he may raise his stabilizing bid up to any level at which he could have begun stabilizing. If a stabilizing bid is placed before the offering price is set and the independent market is higher when the offering is priced, then the stabilizing bid may be moved up to a level not to exceed the lower of the offering price, or the independent market.

Dealers sometimes buy after the close of an exchange a block of a security for secondary distribution. Can a stabilizing bid then be placed and at what level? If the security is traded on another exchange then open, the stabilizer should look to current prices on the open exchange. If, however, all exchanges are closed, the stabilizer can still stabilize at the closing price, unless he knows or has reason to know that other persons have offered or sold the security at a lower price after the close.

Certain other provisions of the stabilizing rule merit attention. A stabilizing bid should be lowered when the stabilized security goes ex-dividend, ex-rights, or ex-distribution. It is improper to stabilize an offering held out to be sold "at the market." If a security is being called or redeemed, it is improper to stabilize at a level above the call or redemption price, except that if such security is then convertible, it may be stabilized at a level not in excess of the value of the securities which may be received in exchange for it. Lastly, stabilizing should be disclosed. This is usually done by stamping the confirmation given to a person for whom the stabilizer effects a purchase order. However, if a prospectus is used, and such prospectus carries a statement similar

to the 426 legend, the passing of such a prospectus to the customer is deemed sufficient disclosure.

The most significant change in the method of securities distribution in the last decade has been the development of the various rights plans. Rights purchases under these plans should not be confused with stabilizing. A certain amount of agressiveness is permissible. The Commission has encouraged the development of these plans for two reasons: One, they have greatly diminished the risks of underwriting, and therefore have drastically reduced the costs of floatation of rights offerings; and two, they protect existing stockholders who otherwise might not receive a fair price for such rights as they do not wish to exercise.

It is interesting to note how these rights plans came about. To offer a stockholder the right to subscribe presupposes that he will receive enough time to exercise his right. Ordinarily he is given three weeks to do so. This means that underwriters are at the risk of the market for long periods of time. Further, unless the subscription price is at a handsome discount from the market price, any stockholder who is at all market conscious sensibly waits until the end of the period before exercising his right. This placed underwriters in a dilemma. Some waited until the rights expired before beginning their offering. If the price went down, they found that they owned the bulk of the issue and by then their goods were slightly shop-worn. Other underwriters made educated guesses as to how much of the security would not be subscribed for, and immediately distributed that many shares. If the market went up and more stockholders subscribed than had been estimated, the underwriters would find themselves short of large blocks of stock at rising prices. To avoid these difficulties, the late Gene Barry of Shields & Co. proposed the plan which bears the name of his firm. He argued that if an underwriter was permitted to buy the excess rights which stockholders did not wish to exercise, the underwriter could make offerings of the security as they bought the rights and thus safely work off the unwanted shares. After several conferences, at which the staff proposed a number of safeguards, the Commission agreed to give the scheme a try. Those safeguards are now embodied in Rule X-10B-8.

Rights offerings, underwritten, or with dealers assistance, fall into three general classes: The simplest rights plan is a compensated dealer offering in which dealers generally are eligible to receive a fee merely for soliciting exercises of the rights by the persons originally receiving them. In this plan dealers are not expected to make a concurrent distribution of the offered security.

In the Columbia Gas type plan, so named for the reason that it was first used in connection with an offering of that stock, dealers are compensated not only for soliciting exercises, but they are also expected to make open market purchases of rights and exercise them and distribute the security.

The most usual situation is an underwritten Shields Plan offering, with the syndicate manager making a concurrent offering of the security

and protecting himself by the open market purchase of rights. Nineteen out of twenty rights offerings fall into this category.

X-10B-8 aims at preventing fraud and manipulation in connection with rights offerings by controlling (1) the price at which the distributions can sell the offered security, and (2) the conditions under which they may buy rights. However, the proviso clause of Rule X-10B-8(a) exempts from the operation of the rule a dealer who receives a fee merely for soliciting exercises of rights by the original holder thereof. That is the first plan I mentioned. Yet any such dealer as a person participating in a distribution is still subject to Rule X-10B-6. As a result, dealers operating under such a plan may not make open market purchases of the offered security, but they may buy and sell the rights, exercise them, and sell the offered security without restriction.

Section (b) of the rule makes it unlawful to offer or sell the security at a price in excess of the price set from time to time by the manager, and not raised more frequently than once in any day. The latter provision is to identify the offering as not being an offering at the market, and so make stabilizing possible. If the security is traded on an exchange, the offering price, when set, may not exceed the last price on such exchange, plus the equivalent of the stock exchange commission and accruals. If the security is not traded on an exchange, the offering price may not exceed the highest price at which an independent dealer is then offering the security to other dealers, plus the amount of the dealer's concession and accruals. If no independent dealers are offering the security, the offering may be priced just as any other offering is priced.

Section (c) lists certain exceptions to this price formula. These exceptions are to permit transactions between participants in the distribution in the case of a market break, the execution of unsolicited brokerage orders at the best possible price, and the sale of securities previously owned by the participants.

The Columbia Gas type plan is particularly adapted for a non-underwritten offering. This is the plan where dealers not only solicit exercises, but also distribute securities. Operations under this plan are not likely to be manipulative in character, for the dealers may not make open market purchases of the offered security, nor may they buy rights unless they have already sold the offered security at the pre-set price and are therefore short on balance. Since an increased price for rights will cut into or eliminate profit, dealers buy rights carefully. They may, however, if they are short, pay any price that they must to obtain the rights to cover their position.

The Shields Plan is the standard rights plan. Section (d) of the rule is wholly concerned with buying of rights under this plan. Shields Plan operations are entirely in the hands of the manager, who makes all of the rights purchases, sets the prices, makes the lay-offs through the underwriters or others who act as the selling group. Since he will receive the unsubscribed securities anyway, he ordinarily maintains an even or short

position on balance. Under the anti-manipulative restrictions imposed on the plan the manager may not make open market purchases of rights until an independent market for such rights has been established, and he may not buy rights at a price in excess of such independent level. There is a provision in the rule, however, for purchases at a price not in excess of the theoretical value of the rights in those few instances where no market exists for the rights. Having initially purchased rights, the manager may maintain or lower his bid. He may not, however, raise it to a higher existing independent level unless he has not purchased rights as principal for a full business day. That means, say, from 11:15 a.m. on one day to 11:15 a.m. on the next business day. Or, alternately, he may raise his bid if the independent price for rights in the principal market for a security has exceeded the manager's price for a full business day.

There are many exceptions to Section (d). They permit such things as (1) the underwriters to negotiate with large holders of the security to which the right attaches, and buy from them such rights as those holders do not wish to exercise; (2) a quick purchase from any retail customer who comes in of his own volition without requiring the dealer to obtain permission and instructions from the manager; (3) stabilizing of the rights, something which in practice is never done for the underwriters get better price control by stabilizing the offered security; (4) transactions between participants; (5) a combination Columbia Gas type Shields Plan operation in the case of a non-underwritten issue. These latter are extremely rare, however.

As in all rights plans, participants in a Shields Plan are subject to X-10B-6. Unlike the other rights plans, however, Shields plans are frequently stabilized, and thus, also, come under Rule X-10B-7.

The area covered by these rules is so fluid, so vital, and in a field so subject to new ideas and techniques that we even wrote into X-10B-6 and 8 an escape provision--Section (f) in each case--so that we could experiment or deal with unusual or entirely new situations as they arose without going through the agony of amending the present rules. As a Federal agency our rules should be precise and understandable. It takes a lot of red tape and sometimes months of time to amend an existing rule which, after all, has the full force and effect of law. Therefore, we have left ourselves room, on application by an outsider or on our own motion, by the simple expedient of the Commission approving a motion, to suspend or alter any existing provision, or to adopt any new plan presented in connection with a specific proposal or a hardship case presented to us. Any such relief granted does not of itself set a precedent which might be arbitrarily adopted by the next person who would take advantage of any such relaxation. He, also, must secure his own permission to proceed. In the two years that the rules have been in effect there have been nine applications for relief presented by the industry. The Commission has granted five and refused four--some of the former only in part. If we discover a real need for any new plan, we will write it into the rules. That is how our system makes progress.

Any questions?

QUESTION: What is a secondary distribution?

MR. EMERSON: A secondary distribution is just an ordinary distribution except that it doesn't raise new capital. One takes place whenever a stockholder, a person who may or may not be in control of the issuer, decides to sell out a large block. If this block is so large that it cannot be handled by ordinary market means, in other words, if he cannot go down to his broker and tell him to sell 500 shares, and when he gets through with that, sell 500 more, and then sell 500 more, etc., some distributive effort is necessary. So he sells the block to a dealer and the dealer proceeds to make a distribution of it. If the security is listed, the distribution is usually made after the close, at the last price on the exchange.

MR. LOOMIS. I might add to that that the stabilizing rules apply equally to all distributions, whether they are under Regulation A, whether they are registered, whether they are exempt from registration, for any reason, as where the buyer distributes on behalf of a person in control, or where a security is exempt from the ordinary registration requirements such as a bank security or railroad security. Subject only to the fact that these rules do not apply to distributions of Government securities and others of that category. That is about the only exception.

QUESTION. Has there been any difficulty in enforcing the rules? Have there been cases of violation?

MR. LOOMIS. There is quite an elaborate system of stabilizing reports under the stabilizing reporting rule where all persons engaged in stabilizing are required to file reports of what they are doing. We find quite a number of minor violations when people get a little out of line on the technical requirements of the rules. But we have not had too much trouble with significant violations.

MR. EMERSON. I think there have been two series of violations that we have considered **significant** since the rules were put down on paper and adopted two years ago. The first occurred almost immediately after they were adopted. Some dealer was simply ignorant. The other I think we might make a case out of.

QUESTION. Are members of the exchanges subject to these rules?

MR. EMERSON. Yes. The exchanges do not have any rules to govern stabilizing. They have quite a few general rules. For instance, if during a distribution a member was discovered to be "washing" sales, running the price up, or something of that sort, the exchange would take action without waiting for us. I remember one particular case some years ago in which an exchange discovered just such a thing and expelled a man. But the exchanges have no rules to cover offerings or stabilizing, except as they have adopted special offering rules. A special offering is, in effect, a secondary distribution brought to the floor of the exchange, under specific rules, to bolster the exchange's volume.

QUESTION. Is every distribution subject to stabilizing?

MR. EMERSON. Bonds are practically never stabilized for the simple reason that they don't tend to have the fluctuations that more volatile common stock would have. In the case of a rising market where offerings go out the window,

there is no need to stabilize. After all, stabilizing costs the stabilizer money. He has to dispose of those shares through his distributive organization. To do that he has to sell them at a discount--the concession--and to make the purchases he probably has to pay a commission. So he prefers not to stabilize.

MR. LOOMIS. Any offering can be stabilized if they want to--they don't have to--so long as the stabilizing is done in conformity with the rule. Unless the open market purchases are conducted in accordance with the stabilizing rules, it is very likely that the person making such purchases would be violating X-10B-6. Through watching the market we see whether he is buying, and if he is not buying in accordance with the stabilizing rules, he is probably violating X-10B-6.

MR. EMERSON. May I add to that that we have a unit that watches the market for every security being offered. When a registration statement is filed, we set it on the "watch list." When a Regulation A letter of notification is filed, the security goes on the watch list. We watch the broad-tape. If we notice that this afternoon a certain one is going to have a secondary distribution, we begin to watch it to see what happens to the market for that security. If we notice any bulge, we ask one of the regional offices to send a man around to take a look.

QUESTION. Are there any rules which cover stabilizing activities by the company?

MR. EMERSON. X-10B-6 specifically covers the issuer or the vendor and prohibits him from making open market purchases. X-10B-7 says "any person." Person doesn't mean an individual in the legal sense. It means corporations, firms, or what have you, including the issuer.

QUESTION. Is the public given any notice of stabilizing transactions?

MR. EMERSON. In the case of a registered offering, Rule 426(b) under the Securities Act requires that any shares bought in stabilizing prior to effectiveness be noted in the prospectus. Thereafter we simply depend, as a practical matter, on the statement in the Rule 426 paragraph that the market may be stabilized. Otherwise, any prospectus would become a paper-hanger's delight, with one amendment after another plastered against the front every single day.

QUESTION. Are stabilizing reports available to the public?

MR. EMERSON. Stabilizing reports are non-public until all of the required reports have been filed with the Commission, then we make them, as a matter of course and for future study, public documents. We keep them private during that period so they won't be used as a springboard for market operations. In other words, if a smart operator--and quite a few of them try to find this information out--discovers that a stabilizing bid is pegging the market at a certain price, he will try to buy shares in competition with the stabilizing bid. He will acquire several hundred shares and then start to bid the price up just a little bit. He may buy 500 shares at 10,100 shares at 10-1/8 and 100 at 10-1/4. Having moved the market up to 10-1/4, he tries to sell the 700 at that price. He figures that he cannot lose much, anyway, because there is

always the stabilizing bid at his purchase level to fall back on where he can dump the shares if he is stuck. We don't make stabilizing reports public as they come in for that reason.

QUESTION. Is there any bibliography on stabilizing?

MR. EMERSON. Parlin and Everett wrote an article for the Columbia Law Review in 1949. I revised it for them before publication. It shows the stabilizing concepts of that time. It doesn't show some of the compromises we had to enter into with the industry in actually putting the rules into cold type. Louis Loss has something about stabilizing in his book, but that was written in 1951 and is not up to date either. I don't know of anything else.

QUESTION. When may an underwriter begin to purchase rights?

MR. EMERSON. Not until a market for the rights is established at a level. On an exchange that is probably the third or fourth or fifth transaction--somewhere in there. There is provision, however, so that if no market arises on the first day in which the rights may lawfully be traded, then on the second day, if a theoretical value can be established, they can make purchases at not in excess of that theoretical value.

QUESTION. Do the rules attempt to restrict the price that stabilizers may attempt to set?

MR. EMERSON. There are two prices involved in an offering: One, the price at which the offering is made. There isn't any rule, except under the rights plans, to control that price except that it should bear a reasonable relationship to the market. The other price to be considered is the pricing of the stabilizing level. That is very severely controlled, as I have explained.