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"WHAT CAN YOU DO IN A RIGHTS OFFERING?"

An address by

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Your chairman gave me a free choice of topics for this evening's talk. He laid down but one condition, and that was -- try to make it interesting to traders.

That proved a bigger order than it at first seemed. Of all those engaged in the securities business, the trader is probably the most realistic. Certainly he is most familiar with market practice and technique. I realized that you would not want to take time out from an interesting and entertaining convention to listen to a theoretical discussion or some high sounding platitudes. On the other hand, I had little desire to come out here as a spokesman from Washington to tell you how to run your business. I think I know better than that!

Because you traders are really technicians, I am going to talk about a subject which I believe to be a problem you live with almost every day. I am going to talk about warrant, or rights offerings and manipulation.

The statutory restrictions which govern these distributions are simple in terms, but extremely complicated in application. They are the anti-manipulative provisions of the Securities Exchange Act of 1934. The provision most pertinent to this discussion is Section 9 (a) (2) which declares it "unlawful for any person, directly or indirectly," and here I quote from the law:

> "To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such securities by others."

There are similar restrictions on over-the-counter securities in other parts of the statute.

It is important to bear in mind that these provisions have in no way been suspended for the rights operations -- the statute remains in full force and effect. The law is clear that an underwriter or a person interested in the distribution of a security may not raise prices or create activity for the purpose of inducing others to buy. The same rules apply as govern in the ordinary security distribution. They apply to both the rights and the stock.

Rights offerings are becoming quite popular of late. Last year, out of 79 principal common stock offerings, 41 used the rights method. Dollarwise, gross proceeds from these rights offerings totalled over $390,000,000. During a period when industry has made great demands on our capital markets to modernize and expand plant, the rights offering has served as a most effective instrument for raising equity capital. For one thing, it sells stock by making an appeal to the group most familiar and most interested in the company, i. e., the existing stockholders. You and I know that the easiest person to whom to sell stock is one who already owns stock in that company, provided he has had a satisfactory experience. It is also a method for satisfying pre-emptive rights required by charter or by state law.

During the last three years two new methods of handling offerings of rights to subscribe have manifested themselves. The first of these

constitutes a firm underwriting, with the underwriters cutting their risk during the standby period, by buying any excess rights that come into the market and laying off equal amounts of stock. This has become known as the "Shields plan."

The other method is known as the participating dealers' plan, or the "Columbia Gas plan." It was first used in a financing by that company just a year ago.

This type of plan does not comprehend an underwriting commitment, although a manager is usually employed to supervise and control the distribution. The plan does, however, recognize that a rights offering needs the help of dealers to be successful, and it recognizes that dealers are entitled to compensation for their services.

The participating dealers' plan is being used increasingly. In subsequent offerings it has undergone substantial modification. These changes appear in the distribution of New York State Electric & Gas by GPU last March and also in the second Columbia Gas offering in August.

What I want to do tonight is outline the operation of each of these basic distribution methods. I will try to explain as best I can the respective functions of the manager and participating dealers.

Before doing that, let me describe briefly the old conventional standby underwriting as it used to be done prior to these innovations. I need not tell those of you who took part in them what highly risky ventures they could be. For the 15 or 30 day subscription period, the underwriter was on the hook while stockholders made up their minds whether or not to subscribe. The underwriter never knew how many shares he would finally get. He was forced to remain subject to market changes over a long period. An underwriter taking this responsibility, naturally, had to have compensation commensurate with the risk. The issuer had the choice of fixing an exercise price low enough to assure full subscription or pay the larger underwriting fee.

One way an underwriter could reduce his risk was by beginning to distribute stock during the subscription period. The danger in this was that he might underestimate the subscription rate and find himself short.

This very thing did happen in several conspicuous cases. In one, which took place in the early summer of 1946 during the post war rise in market prices, a Chicago underwriter estimated that the offering would be about 75% subscribed. To minimize possible loss, he went short and offered approximately one-fourth of the stock concurrently with the general offering to stockholders. The offering was in fact 98% subscribed. The underwriter was forced to cover about 40,000 shares at a two or three point loss.

In another case involving an exchange of securities, the underwriter went short as a hedge against a falling market and found he had to pay a premium averaging three or four dollars in covering. The cost of that "guess" was almost $200,000 to the underwriting group.

The risk, of course, is even more costly in a falling market, for then the underwriter in the conventional standby may find himself with all or nearly all of the stock unsubscribed.

The Shields plan was formulated in late 1946 by a committee of the Investment Bankers Association after several rather disastrous underwritings of rights offerings had caused large losses. In July 1946 Willys-Overland offered rights to its holders to subscribe to 155,145 shares of $100 preferred stock. Only 6,024 shares were subscribed for by the stockholders and within weeks the market fell to the middle 60's. You may remember the Cincinnati Gas & Electric and Industrial Brownhoist rights offerings, which had the misfortune to coincide with the September 3, 1946, market break. In both instances the market price fell below the subscription price and, as a result, many shares came into the hands of underwriters at a time when the market price was considerably below the underwriters' purchase price.

The Shields plan permits underwriters, through the manager, to buy rights during the period of the offering to stockholders. They may exercise these rights prior to their expiration, and they may sell the security being underwritten before the expiration of the rights at a price consistent with the prevailing market for the security. In other words, the Shields plan is insurance against the underwriter having to take down a large block of a security at the expiration of the subscription period. It also removes the risk involved in guessing the amount which can be sold short. It is essential that all purchases of rights be channeled through the manager in order to control the situation and to avoid members of the group bidding against each other. In one case where it was expected that there would be a large demand in the area where the company was located, the local underwriter as well as the manager both purchased rights, but they acted in unison.

The participating dealer plan is an outgrowth of the Shields plan. A year ago Columbia Gas proposed to offer an additional block of stock to its common stockholders by means of rights. The amount of new equity being raised -- over $12 million -- was a large figure at the time, although we since have had some quite a bit larger. They had figured a price about 20% below the then market for the stock, and since they had what appeared to be a readily salable commodity, they attempted to dispense with most of the cost of an underwriting. They proposed to adopt the rights purchasing feature of the Shields operation, but not to use any standby. Instead, brokers or dealers would be paid a commission for placing the stock. This commission could be earned by persuading an existing stockholder to subscribe, or by the purchase of rights for the dealer's own account, plus a sale of the stock obtained by conversion of such rights. In this way they would only pay a fee on the shares actually placed. Our staff objected to the plan in that form because it would encourage dealers to bid against each other in the purchase of rights and would undoubtedly result in a substantial run-up of the price in violation of the anti-manipulative provisions of the statute. After some hours of discussion a compromise plan was agreed on. This has become known as the "Columbia Gas plan."

The Columbia Gas plan permits participating dealers -- a group which may be as large as to include every registered dealer in the country -- to sell the security being distributed and acquire rights to cover those sales. The safeguard against excessive buying of rights is provided by requiring that the purchase of rights can be made <u>only</u> after the short sale of the stock at a price fixed by the manager. Participating dealers may not buy rights if they are not short stock. Of course they may not trade in the stock.

Under the plan, dealers agree to make all sales at the figure announced by the manager, which predetermined price is to hold good for twenty-four hours. This price is usually the last sale price on the previous evening, if the security is listed on an exchange. If the security is not listed, the price is either the low or average offering price of the previous evening.

Since there is no underwriting of unsubscribed shares in a dealer participation plan, some disposition has to be made of the remaining stock which is not taken up. A new custom is for stockholders to be given the privilege of oversubscribing, in addition to their allotment. This reduces the likelihood of there being unsubscribed shares. Any shares which remain are generally made the object of a separate underwriting. If the number is small, they may be disposed of in the open market. However, in the first New York State Electric & Gas offering, only about 90% of the issue was allocated for subscription and there was no oversubscription privilege. The remaining 10% was made the subject of a distribution by the participating dealers concurrently with the rights offering. Of course, dealers were paid an extra commission for selling these shares.

As I stated a moment ago, the two basic types of rights offerings which I have described to you have been modified, changed, and elaborated in subsequent cases. The Columbia Gas plan was so successful in enlisting dealer aid in getting existing stockholders to exercise rights that this participating dealer feature was incorporated into the Shields plan. Today many standby underwritings provide for dealer participation and compensate those dealers whose names appear on the exercise warrant. That is what took place in the Colorado Central Power Company offering. The recent West Penn Electric offering was also of that type, although it combined a very interesting exchange offer to preferred stockholders.

The basic Columbia Gas plan has also been expanded. You may have noticed that under the original plan the manager did not buy rights. This restriction was modified in the New York State Electric & Gas distribution and in the second Columbia Gas offering to enable the manager to purchase rights in the open market. Dealers can then acquire stock from the manager for sale by them away from the market, as in the Shields plan. As these offerings are now set up, the following distributions take place simultaneously:

First, dealers are engaged in soliciting the exercise of warrants by stockholders;

Second, dealers sell stock short and cover by buying rights in the open market;

Third, the manager buys rights in anticipation of expected ability to sell stock, and dealers acquire stock from him for distribution.

The New York State Electric & Gas operation introduced one additional feature which so far as I know has been used again only in the Rochester Gas offering last month. You will recall that involved there was a distribution by General Public Utilities to its shareholders, pursuant to a Section 11 (e) plan, of the stock of one of the subsidiaries. A large amount of money had to be raised through the warrants -- some $34,000,000 -- so that the exercise price had to be fairly close to the full value of the stock. Moreover, since

none of the stock was outstanding, it was extremely difficult to place a value on the stock.

Because of these factors, it was felt that the rights at first might have little or no value and that small stockholders would be inclined to let their rights run out. The registrant, therefore, during the first twelve days of the offering, undertook to buy all rights offered it by stockholders at the prevailing market price, or at a minimum price of 5¢ each. This service had a double purpose. It encouraged the small holder to sell his few rights by making it extremely easy for him to do so. It also provided the manager with a supply of rights and securities with which to begin the operation, and tended to protect against over-commitment. As you know, the New York State distribution was very successful and the rights before the end of the period were worth several times five cents.

A further variation appeared in the Bangor Hydro Electric offering of preferred and common stock. Participating dealers there received a fee for soliciting subscriptions but they were not entitled to purchase rights themselves. The manager made purchases of rights as in the Shields plan and laid off stock through the dealers. There was no underwriting committment.

I don't suppose we have seen the end of this evolution. New variants will undoubtedly appear as the basic theories are adapted to individual company and market situations. The Commission thus far has not called a halt to experimentation. But our duty under the statute is to examine each proposal and to eliminate any thing which might violate the statutory restrictions.

Let us now consider some of the things which can and cannot be done in these distributions in the light of the anti-manipulative provisions of the statute.

A firm may execute at any time unsolicited brokerage orders to buy or sell the security being offered, and the rights. The important word here is "unsolicited." Extreme care must be taken not to create activity. We have had one or two instances lately where at critical junctures in the bidding process, the market price was affected by a printed transaction involving a customer of one of the houses engaged in the bidding or negotiations. Such transactions are most unfortunate. Like Caesar's wife, it is important to so conduct the business as to be above suspicion.

Stabilization transactions are permitted under all of the plans, with this very important restriction: Under the participating dealer or Columbia Gas type of plan all dealer activity, save the solicitation of subscriptions, must be suspended during the period of stabilization. This is because the manager's supporting bid would cause other members of the group, who were attempting to purchase rights to cover their sales of new stock, to make numerous raises in the price and thus undoubtedly be engaged in activities prohibited by the anti-manipulative sections of the Securities Exchange Act.

Let me say a word here about stabilization. It is a word which is frequently misunderstood. The law prohibits injection of artificial activity into the market. One exception is stabilization -- which is a legal form of manipulation. But it is permissible only when it is used to prevent or retard a decline. No moving around of the market under the label of a

stabilizing operation is permitted. Stabilization means maintenance of a price independently reached in the market.

A manager purchasing rights under the Shields plan must be careful not to create a rising market or create activity that gives the appearance of strength to a stationary market. He may not enter the market for rights until purchases by others have established the price at a free level. In the over-the-counter market, it is generally proper to enter orders on the bid side. If the rights are traded on an exchange, orders should not be entered in excess of the higher of the last sale price or the bid price, except that if the current offering price is below the last sale price, orders may not be entered in excess of the bid price.

Further, purchases should not be in such quantity that they will dry up offerings at that level, for then any other buyer attempting to buy rights will be forced to set a higher price and the underwriting may be deemed to have raised the price indirectly. Inasmuch as rights are being bought only to reduce risk, any purchases of rights in excess of the underwriter's intention and ability to lay off stock may well be an unnecessary creation of activity, and therefore manipulative. Similarly, sales of rights (except to fill orders which are in fact unsolicited) may indicate excessive buying and carry the same implication. There is, however, no prohibition under the Shields plan against going short more shares of stock than are covered by the rights being bought.

Shields plan purchases of rights differ from stabilizing purchases of a security in that it is almost never proper to raise a stabilizing bid. However, if in fact your purpose under the Shields plan is only to cut the risk of underwriting, it may well be perfectly proper to raise your bid for rights. This may be done, though, only if the independent market for the rights has moved above your bid. Even so, the Commission feels that no bid should be raised until twenty-four hours have elapsed from the time of your last purchase at the old price.

This sounds very technical, as indeed it is. Perhaps a few examples will illustrate what I have been saying and point up some of the pitfalls.

Stabilization can be a hazardous activity if not carefully supervised. In the latter part of 1945 one of the steel companies made a rights offering with a standby underwriting. In order to insure the success of the offering, the underwriters placed a stabilizing bid on the New York Curb Exchange where the stock was traded. The underwriters did not have to make any stabilization purchases throughout the subscription period, and when the rights ran out at 2 P. M. on the last day, they were informed that the unsubscribed portion amounted to only 148 shares. It was decided to sell this amount the following day. Not having purchased any stock in stabilizing during the rights period, they felt secure in leaving their bid on the Curb until the close of that session. However, much to their consternation and dismay, a few minutes before three o'clock they were suddenly hit with 4,700 shares of stock. Thus we had the unusual phenomenon of an underwriter purchasing 4,700 shares to facilitate an offering of 148 shares.

In one of the earliest offerings under the Shields plan involving a security in which there was no existing market, the managing underwriters received orders during the subscription period for about 10,000 shares from

institutional buyers. They bid a price which they left the underwriters to determine as a fair price for the stock. The underwriters filled the order at a price about four dollars above the subscription price, going short to do so. This sale price was equivalent to a much higher price for the rights than the rights were then selling for. Consequently, the underwriters felt they might bid up to parity in covering their short position. This activity was largely instrumental in raising the price of the rights from 2¢ to 16¢. Inasmuch as the whole matter had been undertaken on an experimental basis, the Commission took no action other than to caution the underwriters, although it was of the opinion that the transactions which raised the price of the warrants were manipulative transactions. Of course, this particular underwriter has been careful ever since to avoid transactions of a similar nature.

I have tried, in these few minutes, to cover a very complicated and very difficult field in finance. I have not been able to explore all the ramifications nor blueprint for you precisely what you can and what you cannot do in each and every situation which may come up. That would be an impossible task, even if we had the time, for many cases must be decided on the particular facts as they present themselves in a given context.

My purpose this evening has been to give you a picture of what takes place in rights offerings so that you may better understand the reasons for the Commission's rulings in individual cases. I think the staff of the Commission has a real appreciation of the problems you encounter in these rights offerings; and I am happy to say that those in the industry with whom I have come in contact have, in turn, displayed an underwriting and acceptance of the statutory standards which Congress has set up.

The development and application of the Shields plan and the Columbia Gas plan and the other variants which I have described reveal in a significant way the adaptability and flexibility which I have always felt the investment industry to possess. Prudent regulation has permitted the industry to change its methods with changing conditions. The result has been that the primary function of the investment industry -- which is to supply American industry with the capital it needs -- is being achieved.

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