WHEN-ISSUED SECURITIES TRADING IN LAW AND PRACTICE

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THE securities markets of the nation are not confined to the purchase and sale of securities which are outstanding and available for immediate delivery. There is lively trading in unissued securities which is effected in contemplation of their issuance; this is so-called "when-issued" trading. Trading occurs also from time to time in contemplation of the distribution of a block of securities which has been physically issued but is in the hands of a parent company or some other large holder; this goes under the name of "when-distributed" trading. Both types of trading are analogous in many respects to trading in commodity futures; for both involve the sale at a definite price of a thing which has yet to come into existence or is not yet in deliverable form. But the analogy can be pushed too far. Trading in unissued or undistributed securities has its wholly distinctive problems—legal, economic, and technical.

When-issued trading has venerable if obscure origins. Its companion, when-distributed trading, is still in swaddling clothes. The prevailing practices in these fields, largely the result of trial and error, are today in a state of rapid evolution. The regulatory restraints are at a comparable stage of development. The reason for the condition of flux is that trading on a when-issued or when-distributed basis is tied up closely with the reorganizing and reshuffling of the public-utility and railroad enterprises of the country—a process which has proceeded at a rapid rate in recent years and which bids fair to continue for some years to come. It is largely because of this movement that when-issued trading and when-distributed trading have run into hundreds of millions of dollars annually in recent years.

Restraints upon such trading have in many cases been the consequence of provisions of various federal laws not primarily intended for

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its control. Moreover, aside from the problem of operating under ill-fitting statutory provisions, there has been the problem of learning the facts in a rapidly changing era; for the nature of when-issued trading has changed substantially since the passage of the federal securities laws, and when-distributed trading as we now know it is not three years old. Since the development of policy cannot always wait on exhaustive investigations, the factual basis has lagged behind the legal doctrine.

The time is ripe for a systematic exploration of the functions, practices, and problems of when-issued and when-distributed trading. The meager literature in the field must be supplemented by more detailed study.¹ This article is intended to serve as the forerunner of such a study. Its purpose is to pull together into one document the known facts, the relevant legislative provisions, and the strands of administrative policy which have been developed. It is intended to delineate, rather than to fill in, the gaps in existing information and policy.

THE WHEN-ISSUED CONTRACT

An agreement for the purchase and sale of a security "when issued" (or "when, as and if issued") is a conditional contract. The parties are bound to perform only if the security is ultimately issued in accordance with some plan or proposal, as yet unconsummated, which is specified in their contract. If the plan or proposal is carried out and the contemplated security issued according to its terms, the seller delivers and the buyer pays; if the security is not issued as contemplated, the parties are returned to the status quo.² Unissued securities are traded both on exchanges and in the over-the-counter markets (under certain conditions discussed below) as if they were existing property,³ and the financial community thinks of the holder of a when-issued contract as

1. The writers are aware of only one general discussion of when-issued trading, now somewhat dated. TWENTIETH CENTURY PRESS, TRADING IN "WHEN ISSUED" SECURITIES (Booklet No. 3, 1938).

2. In a strict sense, transactions effected in connection with the offering of any block of new securities may sometimes be considered transactions in unissued securities, since there may be a lapse of a few days between the agreement to sell and the last ministerial act of issuance. But we are not concerned here with this type of trading, since it is only technically trading in unissued securities. Nor are we concerned with trading in issued securities for "delayed delivery" or for delivery at "seller's option" or "buyer's option." See NYSE (New York Stock Exchange) Rules 109(c), 112(b)-(c), 113, 164(a)-(b), NYSE DIRECTORY AND GUIDE E-22 to E-24, E-59; NASD (National Association of Securities Dealers, Inc.) NATIONAL UNIFORM PRACTICE CODE (1941, as amended May 1, 1943) § 4(c)-(e), NASD MANUAL F-5 to F-6, cited *infra* note 5.

3. The legality of such contracts is not disputed; even where the purchaser expects to sell the security before delivery, that fact does not make the contract one for the settling of differences or a gaming contract. *Clucas v. Bank of Montclair*, 110 N. J. L. 394, 166 Atl. 311 (1933); *cf. Clews v. Jamieson*, 182 U. S. 461, 489 *et seq.* (1901).

the owner of a security, albeit a security yet to be issued, rather than the owner of a chose in action.⁴

In the customary transactions in *issued* securities, there is little need and less use of elaborate written contracts. The lapse of time between the making of a contract of purchase or sale and its actual performance is usually but a few days. The terms of such agreements are standardized either by express rule of an exchange, or by settled practice when the transaction is not effected on an exchange; and in the latter area the settled practice has been partly codified in the National Uniform Practice Code of the National Association of Securities Dealers, Inc., a nation-wide association of brokers and dealers registered with the Securities and Exchange Commission as a "national securities association."⁵ Moreover, the principals in most transactions are brokers or dealers, who rely in the conduct of their business upon a mutual trust and confidence developed by the financial community over many years. Accordingly, comparatively heavy commitments can be and commonly are undertaken with impunity in a fashion which would appear to flaunt the fundamentals of good legal and business practice in any other field. Commitments are made by word of mouth; the names of securities are designated by cryptic symbols or by nicknames; and in the usual case nothing is expressly said about the conditions of payment or delivery.

These seemingly slipshod but actually quite adequate practices carry over in a large measure to trading in when-issued securities. In this

4. *Clucas v. Bank of Montclair*, 110 N. J. L. 394, 166 Atl. 311 (1933). For purposes of the Securities and Exchange Commission's short-selling rules under the Securities Exchange Act of 1934, which define a "short sale" to include "any sale of a security which the seller does not own," a person is deemed to be the owner of a when-issued security if (1) he has entered into a binding contract to purchase the security subject only to the condition of issuance or (2) he will be entitled, by virtue of his ownership of an issued security, to receive the when-issued security without the payment of any consideration; in either case, of course, he is not deemed to be the owner to the extent that he has already disposed of the when-issued security. Securities Exchange Act Release No. 1571, Feb. 5, 1938, reprinted in 2 BLACK, THE LAW OF STOCK EXCHANGES, STOCK BROKERS AND CUSTOMERS (1940) 1148, 1151. (All releases cited in this article are releases of the Securities and Exchange Commission unless otherwise identified, and the term "Commission" refers to the Securities and Exchange Commission unless the context requires a different meaning.)

5. NASD MANUAL F-3 *et seq.* The Association is registered under Section 15A of the Securities Exchange Act of 1934 and is the only association so registered. Application by National Association of Securities Dealers, Inc., 5 SEC 627 (1939). [In view of the large number of references to several of the statutes administered by the Commission, separate citations to the Statutes at Large and the United States Code will be omitted. The Securities Act of 1933 appears at 48 STAT. 74 (1933), 48 STAT. 905 (1934), 15 U. S. C. §§ 77a *et seq.* (1940), the Securities Exchange Act of 1934 at 48 STAT. 881 (1934), 49 STAT. 1375 (1936), 52 STAT. 1070 (1938), 58 STAT. 117 (1944), 15 U. S. C. §§ 78a *et seq.* (1940), the Public Utility Holding Company Act of 1935 at 49 STAT. 803 (1935), 15 U. S. C. §§ 79 *et seq.* (1940), and the Trust Indenture Act of 1939 at 53 STAT. 1149 (1939), 15 U. S. C. §§ 783aa *et seq.* (1940).]

area, however, they serve somewhat less adequately; for in the case of when-issued securities the lapse between the initial commitment and the ultimate performance may be months or years rather than a few days.⁶ Moreover, since performance is contingent upon the consummation of a plan and the issuance of securities, fertile areas for dispute exist, centering primarily about the question whether the plan contemplated by the parties was sufficiently altered in the course of its consummation to change the identity of the security underlying the when-issued contract.

When a transaction in when-issued securities is effected between brokers or dealers, the contract is evidenced by an exchange of documents. The selling broker or dealer sends an original and duplicate contract to the buying broker or dealer stating: "We have this day sold to you, when, as, and if issued, X units of Y security at Z dollars." The buyer sends a similar document to the seller with appropriate differences in wording. Each retains the original of the document sent to him and returns the duplicate, properly verified, to the other party.⁷ When the dealer or broker effects a transaction with or for a customer, the contract with the customer is evidenced in a different manner. The broker or dealer simply sends to his customer a printed confirmation stating the essential details of the transaction and the capacity in which he acted.⁸

6. An analysis of railroad reorganizations consummated in recent years under Section 77 of the Bankruptcy Act, 47 STAT. 1474 (1933), 49 STAT. 911 (1935), 11 U. S. C. § 205 (1940), shows that for the cases studied the lapse of time between district court approval of a plan and consummation was over one year in thirteen cases, under one year in five; the longest period was four years and four months, the shortest approximately 100 days. In six recent situations involving the issuance of securities by utility companies pursuant to plans of reorganization under Section 11 of the Public Utility Holding Company Act of 1935, the average period between the Commission's approval order (or the district court's enforcement order where such an order was entered) and the date of issuance was approximately four months; the longest period was about fourteen months and the shortest nine days.

7. In the case of when-issued or when-distributed transactions on the New York Stock Exchange, written contracts in form approved by the Exchange must be exchanged not later than the business day following the transaction. Rule 148, NYSE DIRECTORY AND GUIDE E-54; Forms 24, 25, *id.* at E-612 to E-613. This does not apply to transactions effected by Exchange members over the counter. The National Association of Securities Dealers has no similar rule with respect to over-the-counter transactions, but exchange of written contracts is the practice.

8. If the broker or dealer is a member of the National Association of Securities Dealers, his confirmation must "adequately identify the security and the plan, if any, under which the security is proposed to be issued." NATIONAL UNIFORM PRACTICE CODE § 11, NASD MANUAL F-8; see also *id.* at E-71. This code is not necessarily binding on members. See note 20 *infra*. However, when-issued transactions are in any event subject to the confirmation requirements which are applicable to transactions in securities generally under the Securities Exchange Act of 1934 and the Commission's rules. In general these requirements relate to disclosure of such matters as the capacity in which the broker or dealer is acting and the source and amount of any brokerage commission. § 11(d)(2); Rule X-15C1-4; *cf.* Hay, Fales & Co., — SEC —, Securities Exchange Act Release No. 3697, June 8, 1945, p. 15.

The description of the security contained in when-issued contracts and confirmations may vary from a cryptic "E" to a detailed "Minneapolis, St. Paul & S. S. Marie Rwy. Co. General Mortgage Income 4's 1991 in Accordance with Plan Approved by Federal Court 1/17/42." When the transaction is effected on an exchange, the controlling description of the security is that carried on the official list of the exchange,⁹ since only the security there described has trading privileges on the exchange. When the transaction is not effected on an exchange, however, cryptic and incomplete descriptions may well lead to dispute and litigation. A classic illustration of the confusion which can arise out of the slipshod designation of a security occurred in connection with the reorganization of the Erie Railroad Company in 1941. The plan of reorganization provided that the new company would issue common stock to existing preferred and common stockholders and certain certificates of beneficial interest to existing bondholders in part payment of their claims; holders of certificates of beneficial interest would be entitled to the proceeds to be derived from the sale of the common stock, a block of which would be held in escrow for sale to the preferred and common stockholders pursuant to purchase warrants.¹⁰ The market placed a lower value on the when-issued certificates than upon the when-issued common stock, the difference usually running well over 20 percent.¹¹ However, many dealers who were entitled only to the certificates when-issued were selling the common stock when-issued, apparently giving no thought to the differences in the two securities.¹² As the plan matured, the dealers' dilemma became apparent. The National Association of Securities Dealers thereupon ruled that when-issued contracts for the common stock could be satisfied by delivery of the certificates.¹³ A few weeks later, however, counsel for the Association added that this ruling "under all the circumstances . . . should be deemed as of an explanatory and advisory nature."¹⁴

This reservation is illustrative of the uncertainty whether the Association's rulings are binding upon when-issued transactions effected over the counter. In transactions effected on an exchange not only are members bound by exchange rulings concerning delivery of when-issued or when-distributed securities,¹⁵ but it is customary to place the cus-

9. See, e.g., New York Stock Exchange Rule 103, NYSE DIRECTORY AND GUIDE E-21.

10. MOODY'S RAILROADS (1941) 1312-4.

11. N. Y. Times, Aug. 10, 1941, § 3, p. 2, col. 3.

12. Wall Street Journal, Aug. 6, 1941, p. 15, col. 3.

13. Wall Street Journal, Aug. 7, 1941, p. 4, col. 3. For a discussion of the nature and basis of these rulings see *infra*, pp. 745-6, 750-1.

14. N. Y. Times, Aug. 22, 1941, p. 21, col. 6. One of the "circumstances" to which the Association's counsel apparently referred was the fact that the authority of the Association to issue peremptory rulings regarding when-issued contracts was not express at that time. Subsequently, however, this authority was clarified. See note 19 *infra*.

15. See, e.g., New York Stock Exchange Rule 108, NYSE DIRECTORY AND GUIDE E-22.

tomer on notice, by an appropriate legend in his confirmation, that his contract is subject to the rules and customs of the exchange. The courts will give effect to exchange regulations, and presumably exchange rulings thereunder, when the regulations are thus made part of the customer's contract.¹⁶ Some over-the-counter houses use a form of contract, recommended but not required by the Association, which contains the clause: "Payable and deliverable 'when-issued' in accordance with requirements of the National Association of Securities Dealers, Inc., its By-Laws, Rules of Fair Practice and Uniform Practice Code."¹⁷ But, absent such a specific provision in the contract, the probability is that in the present stage of development of the over-the-counter market a customer will not be held to the rulings of the Association concerning payment and delivery on the ground of well-established usage.¹⁸ Although it is clear that the rulings of the Association are normally binding upon its own members,¹⁹ even members may agree between themselves not to be bound.²⁰

There are a number of questions peculiar to when-issued trading which have resulted in a certain body of precedent, to some extent in

16. *Clews v. Jamieson*, 182 U. S. 461, 481-2 (1901) (rule of Chicago Stock Exchange with respect to substitution of principals for their brokers in mechanics of clearing house); *American Cotton Mills v. Monier*, 61 F. (2d) 852, 854 (C. C. A. 4th, 1932) (rule of New York Cotton Exchange requiring closing out of contracts on broker's insolvency). In fact, even where a customer does not specifically agree by contract to be bound by the general customs and usages of a particular market, the courts have held that he is nevertheless bound by them when he sends an order to a broker established in that market; so long as the usage is well established, the customer's ignorance of it is immaterial. *Samuels v. Oliver*, 130 Ill. 73, 22 N. E. 499 (1889) (custom of Merchants' Exchange of St. Louis to adjust differences by "ringing out"); *Bibb v. Allen*, 149 U. S. 481, 489-90 (1893) (rule of New York Cotton Exchange requiring covering of futures contracts for failure to deposit margin); see MEYER, *THE LAW OF STOCK BROKERS AND STOCK EXCHANGES* (1931) 157-63.

17. NASD MANUAL E-71.

18. Ruling No. 59 of the Association's National Uniform Practice Committee, Jan. 27, 1944, was of the peremptory type. (These rulings appear in alphabetical order in NASD MANUAL F-301 *et seq.*) After the circuit court of appeals had remanded to the Interstate Commerce Commission in July 1943 a plan of reorganization of the Missouri Pacific Railroad Company under Section 77 of the Bankruptcy Act, the Committee ruled that outstanding when-issued contracts made in contemplation of the plan were "canceled." Nevertheless, the Stock Clearing Corporation of the New York Stock Exchange, which was receiving members' "marks to the market" (see *infra*, pp. 752-4), refused to release such funds (unless both parties agreed) until approval of a modified plan by the Interstate Commerce Commission in July 1944, a year after the remand. *N. Y. Times*, April 23, 1944, § 5, p. 4, col. 8; *id.*, July 19, 1944, p. 25, col. 5. Apparently the Clearing Corporation had some doubt as to the binding effect of the Association's ruling.

19. NASD BY-LAWS, Art. XIV, §§ 2-3, NASD MANUAL B-45; NATIONAL UNIFORM PRACTICE CODE §§ 1-2, *id.* at F-5. Section 2(b) of the Code, which expressly provides for rulings on the settlement of when-issued contracts, was not adopted until September 1, 1942, more than a year after the original adoption of the Code.

20. NASD BY-LAWS, Art. XIV, § 3. NATIONAL UNIFORM PRACTICE CODE § 1, *ibid.*

the courts and to a larger extent in the rulings of the Association and the exchanges:

(1) *When is the security "issued"?* The word "issued" has been given a variety of meanings—from bare authorization of the security to the entire process, concluding with execution and delivery—depending upon the context.²¹ In the case of bonds the courts are apt to require actual delivery,²² but not invariably.²³ On the other hand, stock is usually held to be "issued" upon its subscription,²⁴ at least where there is payment;²⁵ but apparently where this view would prevent the court's reaching a desired result delivery may be held essential to the issue of a stock just as it is in the case of a bond.²⁶ All that can be gleaned from the cases is that "issue" is a term of many hues which is colored by the surrounding circumstances.²⁷

It is not surprising, therefore, that a special criterion has been developed for purposes of when-issued trading. The leading case is *Zimmermann v. Timmermann*, which, despite its name, was decided not by the Lord High Chancellor of some mythical land of Gilbert and Sullivan but by the Court of Appeals of the State of New York. In March 1902, the defendants contracted to sell the plaintiffs 100 bonds in contemplation of a \$20,000,000 issue to be offered to the public by February 1903 in connection with the consolidation of certain San

21. *People v. Bullock*, 305 Mich. 380, 9 N. W. (2d) 647 (1943) (dissenting opinion); *Yesler v. Seattle*, 1 Wash. St. 308, 322-3, 25 Pac. 1014, 1019 (1890); *Gage v. McCord*, 5 Ariz. 227, 233-4, 51 Pac. 977, 979 (1898); *Turner v. Roseberry Irrigation Dist.*, 33 Idaho 746, 753-5, 198 Pac. 465, 467 (1921). *Cf. Shaw v. United States*, 131 F. (2d) 476, 480 (C. C. A. 9th, 1942) (state law held not determinative of meaning of term "issue" in Section 3(a)(11) of Securities Act of 1933).

22. *Brownell v. Town of Greenwich*, 114 N. Y. 518, 530, 22 N. E. 24, 27 (1889); *Zimmermann v. Timmermann*, 193 N. Y. 486, 493, 86 N. E. 540, 543 (1903); *Bankers' Trust Co. v. Denver Tramway Co.*, 233 N. Y. 604, 605, 135 N. E. 936, 937 (1922); *Vans Agnew v. Fort Myers Drainage Dist.*, 69 F. (2d) 244, 245 (C. C. A. 5th, 1934). *NEGOTIABLE INSTRUMENTS LAW* § 191, *Jacksonville v. Renfroes*, 102 Fla. 512, 136 So. 254 (1931).

23. *Walton v. Ark. Construction Comm.*, 190 Ark. 775, 80 S. W. (2d) 927 (1935); *Estabrook & Co. v. Consolidated Gas, Electric Light & Power Co. of Baltimore*, 122 Md. 643, 90 Atl. 523 (1914); *Love v. Mayor of Yazoo City*, 166 Miss. 322, 329-30, 143 So. 382, 383 (1933).

24. *Edwards v. Wabash Ry.*, 264 Fed. 610 (C. C. A. 2d, 1920); *San Francisco Commercial Agency v. Miller*, 4 Cal. App. 291, 87 Pac. 630 (1906).

25. *Federal Deposit Ins. Corp. v. Gunderson*, 106 F. (2d) 633, 635 (C. C. A. 8th, 1939); *Savic v. Kramlich*, 52 Idaho 156, 12 P. (2d) 260 (1932); *cf. Pacific Nat. Bank v. Eaton*, 141 U. S. 227 (1891).

26. *Smith v. McAdams*, 206 S. W. 955, 957 (Tex. Civ. App. 1918). *Cf. Blythe v. Doheny*, 73 F. (2d) 799, 803 (C. C. A. 9th, 1934) (mere authorization of stock is not "issue").

27. Compare *Smith v. McAdams*, 206 S. W. 955, 957 (Tex. Civ. App. 1918), with *Ga. Life Ins. Co. v. Lasseter*, 17 Ga. App. 621, 623, 87 S. E. 922, 923 (1916). In both cases judgment was given on a note executed upon a stock subscription. In the context of the former case this result required a holding that delivery was essential to issuance; in the context of the latter case, that it was not.

Francisco traction lines. In June 1902, \$3,500,000 of the bonds were executed and delivered to a syndicate. The syndicate immediately sold large blocks of the bonds to the public, and they were thereafter traded almost daily in the San Francisco market. Holding that the defendants' failure to make immediate delivery of the 100 bonds at the plaintiffs' demand constituted a breach of contract, the court stated that "the most that they [the defendant sellers] could properly insist on was . . . that the issue should be sufficiently large to permit compliance in the exercise of due diligence."²⁸ Although this case involved a bond issue, the principle would seem to be equally applicable to securities generally.

In a much more recent situation, in late 1937, *buyers* apparently considered themselves obligated to perform when-issued contracts even though the available supply of the issue to be delivered was a mere fraction of what had been expected. Common stockholders of Pure Oil Company were to be given rights to subscribe to one share of a 5-percent preferred stock for each nine shares of common. In all, about 442,000 shares of preferred stock were to be issued, and the company entered into an agreement with an underwriting group whereby the latter were to take up any of these shares which were unsubscribed. Various persons entitled to subscription rights sold the preferred stock on a when-issued basis at prices a few points above par. Just as the books were opened for subscription by stockholders, there was a severe slump in the stock market. As a result only 8,000 shares of the 442,000-share offering were subscribed for, and the underwriters had to take up the balance under their contract. Among the stockholders who had refrained from exercising their rights were some who were obligated under when-issued contracts to deliver the preferred stock on issuance; they had reasoned that they would be able to buy the preferred stock more cheaply when the underwriters dumped it on the open market than they would by the exercise of their rights. But the underwriters did the unexpected. They accepted the stock from the company and withheld it from the market. The stock had been "issued" in a technical sense, but since only 8,000 shares had been subscribed for pursuant to the rights practically none was available for delivery. The sellers tried their utmost to obtain stock for tender to buyers in order to get their above-par prices, and the underwriters were finally prevailed upon to make 5,000 shares available at par, thus giving the sellers a profit of a few points.²⁹ Why the buyers did not refuse to consummate the transactions in reliance on the

28. 193 N. Y. 486, 493-4, 86 N. E. 540, 543 (1908). Benjamin N. Cardozo was counsel for the plaintiffs.

29. N. Y. Times, Nov. 6, 1937, p. 21, col. 6; *id.*, Dec. 8, 1937, p. 42, col. 2.

Zimmermann case is an unanswered riddle, unless they were for the most part professional traders who preferred not to make a fuss.³⁰

(2) *What if the contemplated issue is abandoned altogether?* The short answer is that "all bets are off." A number of securityholders of Cities Service Company learned this the hard way shortly after the 1929 stock market crash. At the crest of the wave, when Cities Service stock was selling at 65, the company made an offer to its stockholders of record as of a date four weeks in the future to subscribe to one additional share of stock at 45 for each ten shares held. The warrants to be issued to stockholders on the record date were immediately traded when-issued on the New York Curb Exchange at about 2. The market break intervened before the record date, the stock fell to 22, and the offer was withdrawn. At this point, of course, there was no longer any interest in acquiring the warrants in order to *exercise* them. Persons who had sold warrants when-issued, however, still had an interest in obtaining them in order to deliver them to their purchasers at the prices specified in the when-issued contracts. Accordingly, they sought a decree of specific performance against the issuer. But they found themselves as frustrated³¹ as were their when-issued contracts.³²

(3) *What changes will render a security different from that contracted for?* More controversy has been caused by changes in the contemplated security or in the plan calling for its issuance than by complete abandonment of the issue. In another case which originated in the frenzied financing of the late twenties, the Second Circuit Court of Appeals laid down the general rule that a change in the plan, if substantial enough, can be sufficient ground for terminating when-issued contracts. Rights had been sold on a when-issued basis at a time when it was contemplated that they would entitle holders to purchase a given stock at \$110. However, the plan as finally executed called for the payment of

30. Whatever the point of maturity of the seller's duty to deliver, the buyer's duty to pay matures when delivery is made. *Pistell, Deans & Co. v. Obletz*, 232 App. Div. 313, 249 N. Y. Supp. 616 (4th Dep't 1931); cf. *Daniel v. Dalton News Co.*, 43 Ga. App. 772, 173 S. E. 727 (1934).

31. *Cohn v. Cities Service Co.*, unreported, S. D. N. Y., Jan. 23, 1930, *remanded with instructions to dismiss for want of federal jurisdiction*, 45 F. (2d) 687 (C. C. A. 2d, 1930). There is a good description of the facts in Comment (1930) 39 YALE L. J. 1163.

32. The Curb Exchange declared all when-issued trades null and void. See *Sices v. Ungerleider*, 142 Misc. 402, 255 N. Y. Supp. 314 (Sup. Ct. 1931). Whether the issuer may be answerable in damages is another question. See *ibid.* Cf. RESTATEMENT, CONTRACTS (1932) § 90 (doctrine of promissory estoppel). The issuer is subject to a suit for rescission where it has itself sold a security on a when-issued basis and subsequently abandoned the particular issue. See *Bahr v. Breeze Corporations, Inc.*, 126 N. J. Eq. 124, 127-3, 8 A. (2d) 185, 187 (Ch. 1939). In any event the financial fraternity can breathe freely on the question of brokerage commissions; they are payable whether or not the when-issued security is actually delivered. *Sices v. Ungerleider*, *supra*. Of course, if there is an express agreement to the contrary, as there sometimes is in over-the-counter transactions, the agreement is controlling.

\$125, for which the stockholder received not only the contemplated share but also a share of another stock. The court recognized that there would be no legal difficulty in making a when-issued contract which would bind the parties to sell and buy whatever rights might be issued to stockholders upon a consolidation of certain companies. "But such a contract would be unlikely, and, if the plan finally adopted was far enough from the plan originally proposed, it would be hard to imagine that the contracting parties had agreed to deal in rights which had so utterly changed since the contract was made."³³ Subsequently, in a case in which when-issued trading occurred in contemplation of a 20-for-one split-up in the stock of Ford Motor Company of Canada, a New York state court followed the Second Circuit's lead in upholding a buyer's refusal to accept the 20 shares on the ground that 19 of them were non-voting.³⁴

Since its creation in 1938 the National Association of Securities Dealers has made a number of rulings as to the necessity of consummating when-issued contracts. For example, in the reorganization of the Chicago, Milwaukee, St. Paul & Pacific Railroad Company the original plan was modified in a manner largely reflecting an improvement in the road's financial condition in the period following the plan's adoption. Certain bonds which were to have been sold to increase the road's working capital were allocated under the revised plan to holders of outstanding bonds. Moreover, claims for accrued interest by holders of one issue were to be satisfied by issuance to them of a new preferred stock. In addition, the terms of the bonds and of certain other securities contemplated by the plan were altered somewhat, one of the more material changes being a new sinking fund provision to retire the contemplated bond issue.³⁵ These changes were deemed sufficient to cancel obligations under all when-issued contracts entered into in contemplation of the original plan.³⁶

In the Minneapolis & St. Louis Railroad reorganization, on the other hand, the National Association of Securities Dealers ruled in favor of consummation of when-issued contracts notwithstanding certain changes in the plan. When-issued trading had occurred pursuant to a plan calling for the issuance of \$4,000,000 of First Mortgage Bonds to the Reconstruction Finance Corporation for a loan to meet its cash requirements. In addition, the company was to have issued \$2,015,000 of Second Mortgage Income Bonds to existing securityholders. Improvement in the road's financial position made it possible on March 1, 1943, to amend the original plan by doing away entirely with the

33. *In re Civic*, 34 F. (2d) 624, 626 (C. C. A. 2d, 1929).

34. *Ernst v. Miller*, unreported, N. Y. Sup. Ct., App. Term 1st Dep't, Jan. 29, 1930.

35. MOODY'S RAILROADS (1944) 1110-2.

36. Ruling No. 65, National Uniform Practice Committee, Aug. 17, 1944, NASD MANUAL. Cf. also Ruling No. 59 *re* Missouri Pacific R. R., cited *supra* note 18.

\$4,000,000 First Mortgage issue; the other issue was retained but renamed a general rather than a second mortgage.³⁷ The Association ruled that when-issued contracts for the second mortgage bonds must be completed by delivery of the general mortgage bonds.³⁸

The Securities and Exchange Commission has had only one occasion to consider in a formal proceeding the effect of changes in a plan on outstanding when-issued contracts. The Commission had approved under the Public Utility Holding Company Act of 1935 a plan of dissolution calling for the distribution by The United Light and Power Company of its principal asset, the common stock of The United Light and Railways Company. Under the plan approximately 95 percent of the stock was to go to the preferred stockholders of the parent and the remainder to the common stockholders. The district court approved the plan in August 1943. On appeal by a preferred stockholder who objected to the 5-percent participation by the common stockholders, the circuit court of appeals affirmed. In October 1944, while a further appeal was awaiting argument in the Supreme Court, the parent sought the Commission's approval of a proposal to amend the plan in order to make an immediate distribution of the 95 percent of the common allocated to the preferred stockholders, with the understanding that the remaining 5 percent would be held for distribution, cancellation or such other disposition as would be consistent with the decision of the Supreme Court. In rejecting this proposal the Commission referred to the substantial volume of when-issued trading which had occurred.³⁹ The contention had been made that consummation of the proposed interim distribution might be viewed either as requiring cancellation of outstanding when-issued contracts or as making them immediately enforceable. It had been asserted that in the latter event any *common* stockholders of the parent who had sold the subsidiary's common stock when-issued would be unable to meet their commitments. It had been argued also that, if the common stockholders of the parent should ultimately be denied participation by the Supreme Court and the 5 percent reserved for them should be cancelled, the *preferred* stockholders of the parent who had been required to deliver the subsidiary's common would have delivered something worth approximately 5 percent more than what they had sold on a when-issued basis. The evidence before the Commission showed that no official body had the power to direct a settlement of outstanding contracts binding on individual investors, and the Commission concluded that effectuation

37. MOODY'S RAILROADS (1943) 1381-3.

38. Ruling No. 55, National Uniform Practice Committee, Nov. 9, 1943, NASD MANUAL.

39. See note 42 *infra*.

of an interim distribution might cause confusion and dislocation in the when-issued market and lead to considerable litigation.⁴⁰

(4) *How do buyer and seller secure each other against market fluctuations?* In order to protect each of the parties against the possibility that the other might not fulfil the terms of his contract, the securities industry has developed the practice of "marking to the market." In general, a buyer of a when-issued security, who has committed himself to pay a given price for the security when-issued, is required under this practice (upon penalty of having his contract closed out) to deposit any amount by which the open market price of the when-issued security falls below the price which he has contracted to pay. Thus, if in an extreme case the price of the security should have fallen to zero before settlement, the buyer would have deposited the whole of his purchase price, thereby insuring the seller against a breach of contract. The seller, in his turn, is required to deposit any amount by which the open market price rises above his sale price. Whether and how the deposits are made depend upon the circumstances of the transaction and the terms of the contract.

In contracts between its member firms the Stock Clearing Corporation of the New York Stock Exchange accepts and holds funds representing "marks to the market" and also facilitates the ultimate settlement of the contracts. The services of the Corporation have always been available, of course, for transactions effected on the Exchange. In such cases the right on the part of one member to require "marks" of a second member and the privilege of the second to deposit such "marks" with the Stock Clearing Corporation rather than with the first member are provided for by the Exchange's rules.⁴¹ The services of the Cor-

40. United Light & Power Co., — SEC —, Holding Company Act Release No. 5370, Oct. 26, 1944. The Commission also referred to the "advanced stage of the proceedings," which were then close to being decided by the Supreme Court, as well as the fact that "the interim distribution at best appears to have but slight advantage over the existing plan." It cannot be said, therefore, that the when-issued problem was the controlling consideration in the Commission's decision. The Supreme Court ultimately affirmed. *Otis & Co. v. SEC*, 323 U. S. 624 (1945).

This case is interesting also because it illustrates how delivery can sometimes be conditioned upon both issuance *and* distribution. Had the plan called simply for a distribution by the parent of its subsidiary's common, the trading would have been when-distributed rather than when-issued. But the proposed distribution was to be preceded by a reclassification of the subsidiary's common. Therefore the actual security traded had yet to be issued before it could be distributed. Sometimes, in similar plans, there is a gap between the reclassification of the subsidiary's common and its distribution by the parent, so that there is a period of when-issued trading followed by a period of when-distributed trading. See, e.g., *Standard Oil Co. (N. J.)*, — SEC —, Holding Company Act Release No. 4617, Oct. 12, 1943, p. 3, n. 4; *United Gas Improvement Co.*, — SEC —, Holding Company Act Release No. 4173, March 18, 1943 (reclassification and distribution of Philadelphia Electric stock).

41. Rules 290-3, NYSE DIRECTORY AND GUIDE E-131; see also Forms 24, 25, *id.* at E-612 to E-613. If the "marks" are deposited directly with the first member rather than

poration are used by its members, through mutual agreement, for the marking and settling of when-issued contracts even when they are entered into elsewhere than on the New York Stock Exchange, and the use of this service for such transactions is growing rapidly.⁴² Moreover, the usefulness of the Stock Clearing Corporation lies not only in the fact that it is a responsible repository of funds belonging to its members but also in the fact that it undertakes intermediate clearances of when-issued contracts, the effect of which is to reduce the amount of funds needed to mark contracts to the market. These clearances serve much the same purpose as those effected by a bank clearing house. Assume a firm has bought 100 shares and sold 200 shares of a stock when-issued to other member firms. The market having risen, the firm is entitled to receive "marks" to offset the price rise in the 100 shares which it has bought; but it is also obliged to deposit sums sufficient to mark the 200 shares which it has sold. By means of intermediate clearances, the Stock Clearing Corporation offsets debits against credits, so that firms which on balance are on the right side of the market need deposit no "marks" at all, while other firms need deposit only a net amount representing the excess of sums owing over sums owed.

In order to provide some uniform practice among brokers and dealers in marking to the market when the Stock Clearing Corporation's facilities are not used, the National Association of Securities Dealers has incorporated certain procedures into its National Uniform Practice Code; this Code, it will be recalled, is not necessarily binding on members of the Association.⁴³ The provisions, in effect, follow the practices of the Stock Clearing Corporation but provide for the use of a bank or some other person mutually agreed upon, in lieu of the Corporation, as repository for the "marks."⁴⁴

The relationship between one broker or dealer and another as to

the Clearing Corporation, they bear interest at the current renewal rate for call loans. Rule 290 *supra*.

42. Only Stock Clearing Corporation members are eligible for this service; non-members who wish to have the benefits of the service must clear through members. New York Stock Exchange Rule 292, *id.* at E-131; Stock Clearing Corp. Rule 4, *id.* at D-29. The clearing house of the New York Curb Exchange performs a similar service for its members. Rule 810, NEW YORK CURB EXCHANGE GUIDE 162. For example, on May 3, 1944, the New York Curb Exchange Securities Clearing Corporation conducted an intermediate clearance with respect to 2,722 when-issued transactions in the common stock of The United Light and Railways Company to be issued pursuant to the plan of The United Light and Power Company under Section 11 of the Public Utility Holding Company Act of 1935; the clearance involved 1,097,020 shares of stock having a market value of \$5,855,670. United Light and Power Co., — SEC —, Holding Company Act Release No. 5370, Oct. 26, 1944, p. 4, cited *supra* note 40.

43. See note 20 *supra*.

44. NATIONAL UNIFORM PRACTICE CODE § 58, NASD MANUAL F-18 to F-19; see also *id.* at E-72 to E-73.

marking to the market is one thing, of course, and the relationship between a broker or dealer and his customer is another. In the absence of a specific provision in the contract the customer is not obligated to mark to the market unless there is a prevailing custom to that effect; but in most cases today the customer's confirmation bears an appropriate legend, at least where the when-issued transaction is effected on an exchange.⁴⁵

45. See *supra*, pp. 745-6. Ten years ago practices in connection with marking to the market were not nearly as uniform as they are today. The experience of some persons in the stock of Baldwin Locomotive Works traded when-issued over the counter (and, in the later stages of the reorganization, on the New York Stock Exchange) is indicative of the kind of situation that could conceivably arise in isolated cases today. A plan of reorganization was filed under Section 77B of the Bankruptcy Act in August 1935 and was not finally confirmed until September 1937. During that period the price of the new common stock when-issued rose from \$15 to \$33 and then receded to \$17. In the course of the rise buyers called on sellers to mark their contracts to the market, and in the subsequent decline the process was reversed. The need for sellers to mark to the market as the price went up and for buyers to do so as it went down placed a heavy financial strain on some firms. The New York Curb Exchange and New York Stock Exchange eased the strain to some extent for their respective members by undertaking intermediate clearances of contracts, the effect of which was to offset marks deposited to the credit of their members against marks which the members were required to deposit. Despite these clearances, however, some member firms found it difficult to supply the funds needed for marks; these difficulties were due partly to the fact that some of the contracts which they had entered into with non-members were not eligible for clearance, and these contracts either were not marked at all or were marked by placing sums in escrow with a bank. At any rate, numerous firms were caught in a squeeze wherein they were being called on to supply marks on some contracts but were not receiving credits on offsetting contracts from which they had paper profits. As a result one New York Curb Exchange member and several western firms closed their doors. N. Y. Herald Tribune, July 24, 1937, p. 19, col. 5; N. Y. Times, July 24, 1937, p. 19, col. 4. This episode was responsible in some degree for the more explicit contracts and more uniform practices which were subsequently adopted.

A converse problem sometimes arises when a broker obtains substantially greater amounts from his customers in marks or margin (see *infra*, p. 759) than he is required to deposit in connection with such customers' transactions. The broker frequently uses such excess funds for his own business purposes. See *Hearings before House Committee on Interstate and Foreign Commerce on Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934 and H. R. 4344, H. R. 5065, and H. R. 5832*, 77th Cong., 1st Sess. (1942) 1078-9. At present there is no federal statutory requirement that such funds be segregated; and under existing provisions of the Bankruptcy Act, § 60e, 52 STAT. 869 (1938), 11 U. S. C. § 96e (1940), it is not clear that the actual segregation of such funds would prevent the depositors from being treated as ordinary creditors in the event of the broker's bankruptcy. Cf. proposed Securities Exchange Act § 8(e) on segregation of customers' free credit balances, COMPARATIVE PRINT SHOWING PROPOSED CHANGES IN THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, H. R. COMMITTEE PRINT, 77th Cong., 1st Sess. (Oct. 18, 1941) 81; REPORT OF THE SEC ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, H. R. COMMITTEE PRINT, 77th Cong., 1st Sess. (Aug. 7, 1941) 30-2; REPORT ON THE CONFERENCES WITH THE SEC AND ITS STAFF ON PROPOSALS FOR AMENDING THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, BY THE REPRESENTATIVES OF INVESTMENT BANKERS ASSOCIATION OF AMERICA, NATIONAL ASSOCIATION OF SECURITIES

THE DEVELOPMENT AND STRUCTURE OF THE WHEN-ISSUED MARKET

Prior to 1933, when the first of a series of federal statutes was passed regulating the nation's capital and securities markets, when-issued trading could occur as a hypothetical possibility in any unissued security at any stage in the proceedings leading up to its ultimate issuance. It could occur even when there was no more tangible reason for expecting the ultimate issuance than some vague hunch in the minds of two parties. In the days before 1921, when an outdoor stock market flourished on the curbstones of New York, when-issued trading sometimes developed in that market on the merest rumor of the issuance of new securities. In at least one instance, when-issued trading occurred in the securities of a company which had been neither incorporated nor christened.⁴⁶

At other times, however, when-issued trading was based on less nebulous circumstances. Typically, when the issuance of rights was contemplated which would entitle holders of an outstanding issue to buy some new issue at favorable terms, a double when-issued market sprang up: (1) in the unissued rights and (2) in the security called for by the rights if units of that class of security were not already outstanding. Another type of situation conducive to when-issued trading was the anticipated split-up of stock whereby holders of one share of an outstanding stock were to receive, say, three shares of a new stock. Still another type of situation—probably least common of all—was the case of a pending reorganization, recapitalization, or merger of a company. By and large, however, when-issued trading in connection with the contemplated issuance of new securities for cash, whether by means of rights or otherwise, was probably the most common of the situations giving rise to when-issued trading.

Since 1933, two major changes have occurred in when-issued trading: a pronounced decline in such trading on the securities exchanges ac-

DEALERS, INC., NEW YORK CURB EXCHANGE, AND NEW YORK STOCK EXCHANGE (July 30, 1941) 207-9; *Hearings, supra*, at 1057-90.

46. *Gingold, New York's "Little" Stock Exchange Grows*, *Barron's*, Dec. 25, 1944, p. 16, col. 3. After its formal organization in 1921, and prior to the Securities Exchange Act of 1934, the New York Curb Exchange would permit when-issued trading in the securities of a corporation proposed to be created in connection with a merger or consolidation but not yet organized or named; if the plan of merger or consolidation did not indicate a tentative name for the new company, it would be given a name for trading purposes. For example, the unissued preferred and common stocks of Standard Brands, Inc. were admitted to when-issued trading on the Curb on June 21, 1929, as the stock of "NEW COMPANY to be organized under the laws of the State of Delaware, and which, for purposes of trading only, shall be known as 'Fleischmann-Royal New.'" Communication to authors from N. Y. Curb Exchange. There is no indication, however, that when-issued trading of this kind on the Curb after 1921 was attended by the sort of abuse which had previously occurred in the outdoor markets.

accompanied by a relative increase in such trading in the over-the-counter market, and a change in the kind of situation giving rise to when-issued trading. The shift in the locus of when-issued trading has been due in large measure to the Securities Exchange Act of 1934 and the regulations promulgated thereunder.⁴⁷ The change in the kind of situation giving rise to when-issued trading has been due in part to the limitations directly or indirectly placed upon such trading by the Securities Act of 1933 and the Trust Indenture Act of 1939, which are discussed below; these provisions, in effect, have severely restricted the possibilities of when-issued trading in contemplation of cash offerings. The latter change has been due also to the new types of when-issued situations which have developed in connection with the reorganization of many of the major railroads of the country, first through equity receiverships and later under Section 77 of the Bankruptcy Act, as well as the institution of proceedings for the geographical integration and corporate simplification of utility holding-company systems under Section 11 of the Public Utility Holding Company Act of 1935. A lesser role in the process has been played by the corporate reorganization provisions of Section 77B and, subsequently, Chapter X. Since the reorganization sections of the Bankruptcy Act were not promulgated until 1934 and the reorganization provisions of the Holding Company Act were not actively enforced until several years later, the reorganizations and dissolutions undertaken pursuant to them were to a large extent novel. Under these various situations, extended periods of time exist in which holders of the outstanding securities of a railroad or public utility are prospectively entitled, pursuant to some well-defined plan yet to be consummated, to securities as yet unissued.

Within the framework of the restrictions imposed by the various statutes, markets have sprung up in these unissued securities. Since 1940, when-issued trading has developed in the securities of at least 18 major railroad systems as a result of receiverships and reorganizations, and in at least 8 major utility systems as a result of plans of reorganization or liquidation. When-issued trading of the types prevalent in the 1920s—trading in rights or warrants and in the underlying securities prior to the offering of those securities for cash—has taken place on occasion for brief periods. But by reason of the great drop in new cash offerings of securities, and various regulations which have

47. The decline in when-issued trading on the exchanges is reflected in data prepared by the New York Curb Exchange which show that in the years from 1924 to 1934 that exchange alone admitted 1,505 issues of stocks and rights to when-issued dealings. N. Y. Curb Exchange, Supp. Memo, Exhibit B, Niles-Bement-Pond Co., 11 SEC 59 (1942). By contrast, from the effective date of the 1934 Act through August 1945, only 238 registrations of issues for when-issued dealing occurred on all exchanges. See notes 159 and 170 *infra*.

tended to limit the duration of these types of trading to a few days, they have become relatively unimportant.⁴⁸

The shift since the 1920s is important to an evaluation of when-issued trading. It comes to this: Prior to 1933 a major portion of when-issued trading occurred on the floors of the various securities exchanges, but thereafter such trading declined in volume and shifted to some extent into the over-the-counter markets. Moreover, when-issued trading before 1933 commonly occurred in contemplation of cash offerings or stock split-ups, whereas since that date the typical when-issued market has been in a security to be issued to existing security-holders as part of a plan of reorganization, usually of a utility or a railroad.

Since the typical present-day situation which gives rise to when-issued trading contemplates the exchange of outstanding securities for new securities, the when-issued markets in the new securities are closely linked to existing markets in outstanding securities. For example, if under the terms of a plan the holder of an outstanding bond will be entitled to a stated number of shares of a new preferred stock, the market for the outstanding bond is necessarily linked to the when-issued market in the preferred stock. The linkage exists not only in the market prices of the securities, which are bound to be closely related, but also to some extent in the identity of the dealers and customers buying and selling the securities.

To be sure, the prices of the outstanding issue and the when-issued security are usually not identical; on the contrary, there are persistent and systematic differences in the two. For reasons subsequently to be explained, the outstanding security in most situations sells typically at a price lower than that of the equivalent amount of the when-issued security, the difference gradually diminishing as the date of issuance approaches. Accordingly, an opportunity for arbitrage exists. Dealers who buy the old security and sell the new on a when-issued basis stand to profit from the operation. Most when-issued markets are built around a few professional dealers who do exactly that. They sell the when-issued securities to other dealers or directly to their public customers.⁴⁹

48. As a matter of fact, there have been over 150 instances since 1935 of when-issued dealing on exchanges in rights and warrants. But such markets have ordinarily existed for only a few days. See note 159 *infra*.

49. The recent reorganization of The Laclede Gas Light Company under Section 11 of the Holding Company Act was exceptional in that for a long time the outstanding common stock sold on the New York Stock Exchange at a price substantially *higher* than the new common when-issued was selling over the counter. The plan called for the reclassification of the old preferred and common stocks into a single class of new common, the old common to become new common share-for-share. Laclede Gas Light Co., — SEC —, Holding Company Act Releases No. 5062, May 24, 1944, No. 5071, May 29, 1944, No. 5459, Dec. 4, 1944, *enforced sub nom. In re Laclede Gas Light Co.*, 57 F. Supp. 997 (E. D.

Who buys when-issued securities and why? Many persons buy when-issued securities because they anticipate a rise in the old securities and a corresponding rise in the new ones. Some of these persons may be interested in speculating for the rise; others may wish to acquire and hold the new securities at the most favorable terms possible. In any case, though they can accomplish their objectives by buying either the old securities or the new ones, there are definite advantages to buying the new.

The first advantage is avoidance of the possibility that the plan may ultimately be abandoned; if that occurred, the customer with the outstanding security might be holding something he did not want. Another advantage is that the purchaser of a when-issued security—if he gets anything—gets only what he wants. On the other hand, the purchaser of an outstanding security may find himself entitled also to something he does not want, as in the case of an outstanding bond which is changed into a few shares of preferred and a few shares of common. In such a case the security which is not desired would have to be "sold off." Still another difficulty with buying the old security is the fact that the amount of the new security which the holder of, say, an outstanding \$1,000 bond will ultimately receive may be some odd figure such as $7\frac{5}{8}$ shares. Many investors prefer to own a round amount such as 50 or 100 shares, and may therefore find it desirable to buy the round amount on a when-issued basis.

Another advantage of buying the new securities on a when-issued basis rather than the outstanding securities is that usually less money is required to purchase a given amount of the new than of the old.

Mo. 1944), *appeal pending sub nom.* Mass. Life Ins. Co. v. SEC, C. C. A. 8th. Upon the entry on December 4, 1944, of the court's order enforcing the plan, when it first became legal to sell the new common on a when-issued basis (see *infra*, pp. 776-8), it was quoted over the counter at $5\frac{1}{2}$ bid, 6 offered; at the same time the old common was traded on the Exchange at $9\frac{1}{2}$. It was obvious that there was either an overpricing of the old or an underpricing of the new, and subsequent market movements demonstrated that it was the former. The reason the price of the old common remained high on the Exchange was that 85 percent of it was held by Ogden Corporation, Laclede's parent; consequently persons selling short had to pay substantial premiums in order to borrow stock for delivery, and the corner later became so tight that "shorts" had to buy in for purposes of delivery. There was thus a vicious circle. The buying-in to cover short positions kept the market up, and the holders of the small floating supply of common who were in a position to sell "long" found it more lucrative to hold on to their stock and lend it to the "shorts" at the unusual premium, which went as high as \$3 per 100 shares per day. After Ogden made old common available for loan "flat" (that is, without a premium) and Laclede registered the new common under the Securities Exchange Act for when-issued trading on the Exchange—where for a time the old common was traded "regular way" and the new common "when issued" at the same post—the discrepancy between the old and new gradually narrowed. N. Y. Times, Jan. 11, 1945, p. 28, col. 7; *id.*, Jan. 19, 1945, p. 27, col. 6; *id.*, Jan. 23, 1945, p. 25, col. 5. On March 24, 1945, the last day of trading in the old common, it was quoted at $5\frac{1}{4}$ - $5\frac{3}{8}$ with no sales, and the new common when-issued closed at $5\frac{1}{4}$.

This situation arises from inherent differences in the character of outstanding and when-issued securities, as well as from certain regulatory provisions. Regulation T, the margin regulation adopted by the Board of Governors of the Federal Reserve System pursuant to Section 7 of the Securities Exchange Act, makes provision for so-called "general accounts," in which margin transactions may be effected, and for "special cash accounts," in which customers are expected to make prompt payment of the full purchase price of their securities.⁵⁰ The regulation provides, however, that if the customer buys an *unissued* security in a special cash account he need not make payment until after it has been issued and made available for delivery.⁵¹ This means that a customer may buy securities when-issued without putting up any money at all so far as Regulation T is concerned.⁵² He will be required to make some payment only if the broker or dealer insists on it for his own protection or is a member of an exchange whose rules require a deposit.

The two New York exchanges adopted rules in 1944 which in effect require their members to have customers maintain margin of 25 percent in connection with purchases of when-issued (and when-distributed) securities, whether in general accounts or special cash accounts and whether over the counter or on an exchange; only the transactions of certain types of professional and institutional customers are exempted.⁵³ But even this requirement is far more liberal than the best terms on which an issued security can be bought. If the issued security is not registered on a national securities exchange, Regulation T prevents the customer from borrowing any money from a broker or dealer

50. Reg. T, §§ 3, 4(c).

51. *Id.* at § 4(c)(3). Similar dispensation is extended to purchasers of an issued utility security to be distributed pursuant to a plan under Section 11 of the Holding Company Act and approved by a national securities exchange for when-distributed trading. *Id.*, Amend. No. 3 to Reg. T, effective July 24, 1943.

52. There is some doubt, however, whether all customers' transactions in when-issued and when-distributed securities are entitled to be effected in special cash accounts. Section 4(c)(1) of Regulation T limits the transactions which may be effected in such accounts to those effected in reliance upon an agreement accepted by the broker or dealer in good faith that the customer (1) "will promptly make full cash payment for the security" and (2) "does not contemplate selling the security prior to making such payment." As will appear below, customers frequently undertake when-issued transactions without the intention of holding their contracts to maturity or with the intention of making offsetting sales on a when-issued basis.

53. New York Stock Exchange Rules 550(b), 550(d)(3), NYSE DIRECTORY AND GUIDE E-388, E-391 to E-392; New York Curb Exchange Rules 462(b), 462(d)3, NYCE GUIDE 125-6, 130-1. The rules requiring deposits against when-issued and when-distributed commitments do not apply to non-member brokers and dealers who are customers of member firms except to the extent of requiring them to mark their commitments to the market. Of course, customers of non-member firms are not directly affected by the rules of the exchanges.

to finance its purchase; the customer is required to pay 100 percent of its purchase price at once.⁵⁴ If the issued security is registered, the effect of Regulation T is to require the buying customer promptly to deposit 75 percent of the purchase price;⁵⁵ what is more, since the seller must receive the full price of the issued security, the buying customer is obliged to borrow the remaining 25 percent of the purchase price, paying interest charges which ordinarily run at the rate of 3 to 6 percent.⁵⁶

These various provisions are definitely conducive to when-issued trading. Their effect is to permit a customer with a given sum of money to buy four times as much of a when-issued security in a special cash account as he can of its issued and *unregistered* counterpart, and three times as much of a when-issued security as he can of its issued and *registered* counterpart. Moreover, in purchasing when-issued securities there is no occasion for borrowing money and incurring interest charges.

Some buyers confine their purchases to the when-issued security not because of the advantages of such trading but because of the limitations imposed by federal or state statute or by corporate charter upon their selection of investments. For example, whereas an outstanding issue might be ineligible for the portfolio of an investment company because of interest unpaid and overdue, a contemplated issue free of arrearages might well be eligible. Under such circumstances there is a potential customer for the when-issued security.

The public's participation in the when-issued market is not confined

54. Section 3(c) of Regulation T provides in part: "No collateral other than registered securities or exempted securities shall have any loan value in a general account." The term "exempted securities" is defined in Section 3(a)(12) of the Securities Exchange Act to include for the most part United States Government, state, and municipal issues. Although Regulation T applies only to loans by brokers or dealers who are members of exchanges or who "transact a business in securities" through the medium of such members, most active customer traders do not find it convenient to go elsewhere for their financing.

55. Reg. T, § 3(b); *id.*, Supp. effective July 5, 1945. The Board's Regulation U, adopted pursuant to Section 7(d) of the Securities Exchange Act, subjects banks which make security loans to restraints roughly similar to those of Regulation T, though in a narrower area: Regulation U applies only to loans "secured . . . by any stock" for the purpose of purchasing or carrying registered stock. For five months prior to July 1945, a 50-percent margin requirement was in effect under both regulations, and for seven years before that it was 40 percent. Regulations T and U, Supplements effective Feb. 5, 1945, and Nov. 1, 1937. But even at those levels, of course, there was a distinct financial advantage in buying in a special cash account under Regulation T.

56. Even if for some reason the when-issued purchase is effected in a margin account rather than in a special cash account (see note 52 *supra*), a financial advantage in purchasing a when-issued security—as compared with purchasing an outstanding registered security on margin—still remains. In either case, to be sure, a minimum deposit of 75 percent is required as margin; to that extent the scales are evenly balanced. But in the purchase of the issued security on margin the remaining 25 percent has to be borrowed at once in order to pay the seller in full, whereas in the purchase of the unissued security no borrowing is necessary because payment to the seller is not due until maturity of the contract. Accordingly, interest charges are incurred only in the purchase of the issued security.

solely to the buying side. Public customers also effect sales of when-issued securities, supplementing those of the professional arbitrageur. One motive for such sales is a desire on the part of the holder of the old security to take advantage of the price differential in favor of the new. Public selling occurs also when a customer wishes to retain his interest in the company's outstanding securities but does not want to acquire, or is prohibited from retaining, the securities to which a pending plan will entitle him. A typical case is that of a bank whose investments are limited by law to debt securities. If under a given plan the bank expects to acquire equity securities in exchange for debt securities which it holds, it might well sell equity securities when-issued.⁵⁷

A somewhat different type of trading which has become increasingly common is the assignment of contracts to buy or sell when-issued securities. For example, when the holder of a when-issued contract has an unrealized profit on his contract by reason of price increases, one way in which he can avoid the hazards of subsequent price fluctuations is to offset his obligation to buy by making a contract to sell when-issued at the current price. Then, upon the consummation of the plan, his obligation to receive a security from one party at a stated price is offset by an obligation to deliver the security to another party at a higher price. But there is another way to achieve the same result. The contractholder can assign to another party his obligation to buy, in consideration for an immediate cash payment of some part, perhaps 80 percent, of the unrealized profit. In like manner, the holder of the when-issued contract to *sell* can secure a profit resulting from a market *decline*. In that way the contractholder realizes his profit at once and in addition secures certain tax advantages.

The tax advantages arise from the difference in treatment of short-term and long-term capital gains under the federal income tax laws. A short-term gain, in general, is a gain from the purchase and sale of a capital asset which has been held less than six months. Such a gain, when received by an individual trader, is treated for tax purposes as

57. In connection with the reorganization of the Associated Gas and Electric system pursuant to Chapter X, the when-issued market in the common stock of the new company performed a unique service for holders of some of the issues of the old Associated Gas and Electric Company. Pursuant to the terms of the plan, only "original holders" of some of the old company's issues were to be entitled to the common stock of the new company; this meant that any new buyers of these old securities would not receive the right to participate in the plan. Associated Gas and Electric Co., — SEC —, Holding Company Act Release No. 4985, April 15, 1944, *plan approved sub nom. In re Associated Gas & Electric Co.*, 59 F. Supp. 743 (S. D. N. Y. 1944), *aff'd*, 149 F. (2d) 996 (C. C. A. 2d, 1945), *cert. denied*, Oct. 8, 1945, *plan confirmed*, S. D. N. Y., Aug. 9, 1945; see also Securities Act Release No. 3071, June 9, 1945, C. C. H. Fed. Sec. Law Serv., Current Vol. ¶ 75,548. Therefore, the only market available to a holder of one of these old securities which gave a dollar-and-cents expression to the value of his participation in the plan was the when-issued market in the common stock of the new company.

if it were ordinary income and is subject to the usual normal and surtax rates. A long-term capital gain, on the other hand, is taxable at an effective rate of only 25 percent if the taxpayer so elects.⁵⁸ Obviously, it is to the advantage of the taxpayer to have long-term rather than short-term taxable gains. Paradoxically enough, the sale of contracts without recourse sometimes creates a long-term gain where the holding of the same contracts to maturity would result in a short-term gain. This seeming contradiction comes about as follows:

The Bureau of Internal Revenue takes the position that if a when-issued contract is sold without recourse prior to the time of a plan's consummation the capital asset in which the taxpayer is dealing is not a security but a contingent profit or loss. Hence the question whether the gain or loss is long- or short-term is determined by the length of time between the date of purchase of the when-issued contract and the date of its assignment by sale; when that period is longer than six months, a long-term gain or loss is created. On the other hand, if a contract is held until the plan is consummated and delivery and payment are required, the taxpayer who sells the security obtained pursuant to the plan is regarded as having traded in the security itself, and the length of time of the holding is measured by the interval of time between the acquisition and disposition of the security.⁵⁹ Since this interval is likely to be a few days or less, at least for a trader who holds matured contracts requiring him both to buy and to sell the same security, his gain or loss will inevitably be short-term for tax purposes.

In summary, the when-issued market is built about a core of professional arbitrageurs who, by and large, purchase outstanding securities and sell when-issued securities against them. The arbitrageurs rely for their public demand upon sophisticated speculators who prefer the when-issued security to the outstanding security as a speculative vehicle because the financial demands involved in carrying the former are lighter. Public demand for when-issued securities comes also from persons who have no desire to own the outstanding issues but are interested in their successors. Among those who contribute to the selling side of the when-issued market are persons who propose to divest themselves of part or all of their interest in the issuer if a given plan is consummated. Activity in the market is supplemented by a traffic in assignments of the unrealized and contingent profits or losses which go with outstanding when-issued contracts.

To attempt to appraise the desirability or necessity of when-issued markets requires a good deal more information on the relative impor-

58. INT. REV. CODE §§ 117(b), 117(c)(2) (1939), as amended by Revenue Act of 1942, § 150.

59. See 1 Prentice-Hall 1945 Fed. Tax Serv. ¶ 6256-B; *cf.* Lewis K. Walker, 35 B. T. A. 640 (1937). For a discussion of more complex tax situations which may arise, see INT. REV. BULL. No. 6, at 4-14 (1945).

tance of the different classes of these buyers and sellers. How much of the when-issued selling is done by holders of outstanding securities; how much by persons holding when-issued contracts to buy; how much by short sellers? How much of the when-issued buying is done by persons who intend to hold the securities which will come out of the plan; how much is done with the intention of selling on consummation; how much to cover short sales? How do the patterns change over time? The answers to these questions and many others are needed for even a tentative appraisal of when-issued trading.

WHEN-DISTRIBUTED TRADING

When-distributed trading anticipates the distribution to the public of an issued security which is held in only a few hands. Whereas when-issued trading occurs in contemplation of a *primary* offering by the issuer, when-distributed trading occurs in contemplation of a *secondary* distribution by one or more existing securityholders. The when-distributed contract is very much like the when-issued contract except that the contingency governing performance is not issuance but distribution.

To all intents the entire history of when-distributed trading in this country involves a handful of securities, all of them common stocks. Such trading has generally been looked upon as an entirely new phenomenon; the occasional precedents it may have had before the late 1930s are now lost in obscurity. Brokers and dealers, the exchanges, and the Commission have had to appraise it and to develop the appropriate techniques accordingly.

In every case the when-distributed market developed out of the approval by the Commission, pursuant to Section 11 of the Public Utility Holding Company Act, of a pro rata distribution by a holding company to its stockholders of certain securities of subsidiaries which were in its portfolio. In each case the distribution was practically assured some weeks or months before the actual event. But in each case distribution was delayed in part by technical considerations, such as the need to convert the global certificate—that is, the single certificate held by the holding company and representing the full amount of its interest in the subsidiary—into the numerous individual certificates to be issued to the holding company's securityholders. It was during this period of delay that when-distributed markets for each of the securities developed.⁶⁰

60. The several securities (all common stocks) were as follows:

<i>Holding company making distribution</i>	<i>Common stock distributed</i>	<i>Holding Co. Act Rel. No.</i>	<i>Market</i>
United Gas Improvement Co.	Public Service Co. of N. J.	4173, March 18, 1943	NYSE

These when-distributed markets have operated with comparative smoothness, adopting the techniques of when-issued trading wherever necessary. But the technical problems of the when-distributed market have been simple by comparison with those of when-issued trading. This has been true largely because when-distributed trading so far has not lasted longer than a few months in any security and has not involved amended plans and the other trouble-breeding features of when-issued trading.

What functions have such markets served? This depends in part on whether the security which is being traded when-distributed has at the same time a regular market where the security may be bought for immediate delivery—as was the case with the common stocks of Public Service of New Jersey and Public Service of Indiana—or whether the when-distributed market is the only market for the issue. In the first case, buyers of the security have a choice of purchasing in either the regular market or the when-distributed market; that is to say, they have a choice of either immediate or delayed delivery. Since there is no

United Gas Improvement Co.	Philadelphia Electric Co.	4173, March 18, 1943	NYSE and Phila. SE
Standard Oil Co., N. J.	Consolidated Natural Gas Co.	4617, Oct. 12, 1943	NYSE
United Gas Improvement Co.	Del. Power & Light Co.	4784, Dec. 29, 1943	Phila. SE
Hugh M. Morris, Trustee of Estate of Midland United Co.	Public Service Co. of Indiana	5317, Sept. 28, 1944; 5317A, Oct. 25, 1944	Over-the-counter

The Third Circuit Court of Appeals has recently reversed an order of the District Court for Delaware disapproving a Section 11 plan of Standard Gas & Electric Company, which provides for the distribution of common shares of five operating utilities now in Standard's portfolio; when-distributed trading may develop in a number of those securities if this or a similar plan is ultimately enforced. *Standard Gas & Electric Co., — SEC — (1944)*, Holding Company Act Release No. 5430, Nov. 18, 1944, *disapproved sub nom. In re Standard Gas & Electric Co.*, 59 F. Supp. 274 (D. Del. 1945), *rev'd*, C. C. A. 3d, Sept. 14, 1945. When-distributed trading may develop also in four portfolio securities to be distributed by The Commonwealth & Southern Corporation if its Section 11 plan is ultimately enforced, as well as the 5% preferred stock of South Carolina Electric & Gas Company and the common stock of Florida Power Corporation to be distributed by General Gas & Electric Corporation pursuant to a recently enforced plan. *Commonwealth & Southern Corp., — SEC — (1945)*, Holding Company Act Releases No. 5825, June 1, 1945, No. 5895, July 2, 1945, *review dismissed sub nom. Lownsbury v. SEC*, C. C. A. 3d, Sept. 11, 1945, *review pending sub nom. Shassol v. SEC*, C. C. A. 2d, cited *infra* note 93; *General Gas & Electric Corp., — SEC — (1945)*, Holding Company Act Release No. 5950, July 25, 1945, *enforced sub nom. In re General Gas & Electric Corp.*, S. D. N. Y., Oct. 15 and 22, 1945.

particular advantage in buying for delayed delivery,⁶¹ the seller must offer an inducement to the buyer by offering the stock when-distributed at a discount from its regular market price.⁶² If the stock which is being traded when-distributed has no regular market, the when-distributed market affords the buyer an opportunity to assure his purchase of the stock at a price certain on a date some weeks or months earlier than otherwise would be possible.

Persons entitled to the when-distributed security by reason of their present holdings of an outstanding security look to the when-distributed market in about the same way as do persons who expect to receive a security when-issued. That is to say, if they do not like the security, or if they wish immediately to fix the cash value of the security they are to receive, or if corporate charter or state law prohibits them from retaining it, or if they have an aversion to acquiring an odd lot to which they may be entitled, the when-distributed market affords them a means of immediate divestment.

It should be observed also that, after the record date of distribution has occurred and the persons entitled to the prospective distribution have been definitively fixed, such persons are in effect the owners of two securities. They own the pro rata share of the portfolio security, which is yet to be distributed; and they own the security of the distributing company, which no longer carries with it any rights of distribution. Thus, record holders who wish to divest themselves entirely of the interest which was formerly represented by their shares must sell not only those shares but also the security to which they are entitled when-distributed. Unless the exchange on which the securities are traded makes some special provision permitting the sale of both securities as a unit in the period between the record date and the distribution date, a separate when-distributed market is essential if such holders are to be able to divest themselves of the undistributed security.⁶³ During this

61. The only conceivable advantage lies in the fact that payment for the stock which is purchased when-distributed can be deferred until the distribution date. See note 51 *supra*. But the cost-of-financing factor, which looms so large in the pricing of when-issued securities, can be of little importance in when-distributed situations so long as they follow the pattern thus far set, because of the relative brevity of the period between purchase and delivery.

62. Public Service Company of New Jersey common stock, for instance, sold on a when-distributed basis at a price as much as 5 percent below its regular price. Theoretically such a price difference might be due in part to the fact that the buyer of a security "regular way" is entitled to all dividends declared after the date of his purchase, whereas the buyer of the same security when-distributed may not have an equally clear right to dividends declared between the date of his purchase and the date of the distribution. Thus far, however, this factor has not been the cause of the observed price differences.

63. In connection with the distribution of the common stocks of Public Service Company of New Jersey and Philadelphia Electric Company to the stockholders of United Gas Improvement Company (see note 60 *supra*), the United Gas Improvement stock sold on the New York Stock Exchange and Philadelphia Stock Exchange with "due-bills" attached

phase of the contemplated distribution, sellers of the types enumerated earlier will desire even more acutely to get rid of the securities which are the subject of the distribution. Buyers will presumably be of the same kind as those who absorbed the offerings prior to the record date.

When-distributed trading, like when-issued trading, needs to be analyzed further before it can be appraised. And the nature of the analysis should take lines very much like those suggested with respect to when-issued trading.

IMPACT OF THE SECURITIES LAWS ON WHEN-ISSUED AND WHEN-DISTRIBUTED TRADING

In all the laws administered by the Securities and Exchange Commission there is only one specific reference to when-issued trading and none to when-distributed trading. The one reference is a provision in Section 12(d) of the Securities Exchange Act of 1934 prescribing the circumstances under which the Commission's rules may permit the registration of an unissued security for trading on a national securities exchange. There are several general provisions in the Securities Exchange Act under which rules might be adopted regulating both when-issued and when-distributed trading over the counter,⁶⁴ but the Commission has never resorted to them for that purpose.

Nevertheless, entirely apart from any rules under the Securities Exchange Act, other statutes administered by the Commission automatically have the effect of severely restricting both when-issued and when-distributed trading. Since this effect follows whether the trading is over the counter or on an exchange, the precise impact of the several securities laws can best be analyzed by first considering their effect on over-the-counter trading and then examining the additional requirements imposed by Section 12(d) of the Securities Exchange Act in the case of when-issued trading on an exchange.

When-Issued and When-Distributed Trading Over the Counter

The direct impact of the securities laws on when-issued and when-distributed trading comes from the registration and prospectus provisions of the Securities Act of 1933 and the provisions of the Trust In-

in the period between record and distribution dates; this meant that buyers received not only United Gas Improvement stock but also the two stocks which were to be distributed. However, in the distribution by the same company of its Delaware Power & Light stock, and in the distribution of Consolidated Natural Gas stock to the stockholders of Standard Oil of New Jersey, the Philadelphia and New York Stock Exchanges, respectively, ruled that the stock of the distributing companies should sell "ex-distribution"—that is, without the buyers' acquiring a right to the stock to be distributed—during the period between record and distribution dates.

64. See notes 167 and 169 *infra*.

denture Act of 1939.⁶⁵ Section 5 of the Securities Act prohibits the offer or sale of any security by use of the mails or any means or instruments of interstate commerce unless a registration statement is in effect containing prescribed information as to the security and the issuer, and unless a prospectus summarizing that information is delivered to the purchaser.⁶⁶ The Trust Indenture Act contains a similar prohibition as to the sale of any *debt* security unless a trust indenture providing for an independent trustee and meeting certain other conditions has been qualified with the Commission, and unless a written summary of certain of the indenture provisions is delivered to the purchaser.⁶⁷

Since both acts include in the definition of "security" any "investment contract" or "interim certificate,"⁶⁸ the question was very early mooted whether a when-issued (or when-distributed) contract was not a separate security created by the seller of the contract and subject to registration by him as the issuer, just as a "preorganization certificate or subscription" is a separate security⁶⁹ which is issued by the promoter rather than by the issuer of the ultimate security and which must be registered by him before it is offered to the public. The Commission, however, never adopted this view. The thrust of the two statutes is on the security which underlies the when-issued or when-distributed contract.

In measuring the precise force of that thrust, it is important to understand the structure of the two acts. The statutory technique adopted by the draftsmen of the Securities Act was to frame an all-inclusive prohibition in Section 5—which applies, without limitation, to "any person" and "any security"—with exemptions in Sections 3 and 4 for certain types of securities and transactions;⁷⁰ and this technique was borrowed in the Trust Indenture Act, which is closely integrated with the Securities Act.⁷¹ The significance of this statutory pattern is the emphasis which it places on comprehensive coverage and the

65. For citations of the several statutes here considered see note 5 *supra*.

66. A registration statement automatically becomes effective on the twentieth day after filing or such earlier date as the Commission may determine, unless stop-order proceedings are instituted because of false or inadequate information. § 8.

67. §§ 305, 306. In the case of a debt security required to be registered under the Securities Act the prescribed indenture summary is part of the prospectus. TRUST INDENTURE ACT § 305(c).

68. SECURITIES ACT § 2(1); TRUST INDENTURE ACT § 303(1).

69. *Ibid.*

70. For a discussion of the exemptive provisions generally see Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933* (1937) 4 LAW & CONTEMP. PROB. 89.

71. The Trust Indenture Act is Title III of the statute of which the Securities Act is Title I and the Corporation of Foreign Bondholders Act, 1933, 48 STAT. 92 (1933), 15 U. S. C. § 77bb *et seq.* (1934), never declared effective, is Title II. The definitions and exemptions in the Securities Act are with certain exceptions incorporated into the Trust Indenture Act. §§ 303, 304; see also § 308.

burden of proof which it puts on any person claiming an exemption to demonstrate that the security or transaction falls clearly outside the general policy of the statute.⁷²

If Section 5 of the Securities Act (and the similar provisions of the Trust Indenture Act) stood alone, it would be unlawful for Citizen Jones to mail to Citizen Smith an offer to sell a \$1,000 bond of United States Steel unless it had been registered under the Securities Act and an indenture had been duly qualified. Offers or sales of securities by ordinary investors are excluded from the registration and qualification provisions of the two acts only because Section 4(1) of the Securities Act (which is carried over into the Trust Indenture Act) exempts "Transactions by any person other than an issuer, underwriter, or dealer."⁷³ However, there is no universal exemption for transactions by a "dealer"—a term which is used in the two acts to include a broker as well⁷⁴—and as a practical matter it is as difficult to trade when-issued or when-distributed without the intervention of a broker or dealer as it is without using the mails or some instrumentality of interstate commerce. Although an ordinary investor could sell to a dealer under the Section 4(1) exemption, dealers would presumably not buy in any volume unless they were free to sell.

The statutes do contain an exemption for certain types of transactions involving a dealer. The same Section 4(1) goes on to exempt "transactions by a dealer," but that exemption by its terms applies only to transactions effected more than one year after the first date of public offering. In other words, a dealer may not offer or sell at all in advance of effective registration (and, in the case of a debt security, qualification of an indenture); and for a year thereafter he may do so only if he furnishes the required prospectus (and, in the case of a debt security, the required indenture summary).⁷⁵

72. *SEC v. Sunbeam Gold Mines Co.*, 95 F. (2d) 699, 701 (C. C. A. 9th, 1938).

73. The exemption applies only to the registration and qualification provisions. See also TRUST INDENTURE ACT § 304(b). None of the exemptions in either act applies to the civil and criminal liabilities for fraud, SECURITIES ACT §§ 12(2), 17(a), 20(b), 24, except that federal, state, municipal, and bank issues which are exempted by Section 3(a)(2) of the Securities Act are excluded also from the civil liability provisions of Section 12(2) of that act. See, e.g., Shulman, *Civil Liability and the Securities Act* (1933) 43 YALE L. J. 227. Whatever when-issued or when-distributed trading is permitted by the two acts is subject to the anti-fraud provisions of those acts, as well as the civil, administrative and criminal liabilities for fraud contained in the Securities Exchange Act of 1934, §§ 9(e), 15(b), 15A(b)(4), 15A(l)(2), 19(a)(3), 21(e), 29(b), 32(a), to the same extent as regular trading in issued securities.

74. SECURITIES ACT § 2(12); TRUST INDENTURE ACT § 303(1). These acts do not contain a separate definition of the term "broker" as does the Securities Exchange Act. § 3(a)(4). The term "dealer" as used in this article includes a broker unless the context requires otherwise.

75. The exemption applies literally to "transactions by a dealer . . . except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter . . ." In the statutory context

It follows (subject to various exceptions spelled out below) that when-issued or when-distributed trading is outlawed prior to effective registration (and, in the case of a debt security, prior to qualification of an indenture).⁷⁶ And the incidence of such trading *after* registration (and qualification) is severely restricted by the fact that securities ordinarily may be registered only for immediate offering and not to be "put on the shelf."⁷⁷ As a result, only one situation commonly occurs in which there is an opportunity for when-issued trading after effective registration (and qualification in the case of a debt security). This situation is where a security is registered in contemplation of an offering to one or more classes of existing securityholders, perhaps pursuant to preemptive rights, to be followed after a lapse of time by an offering of the unsubscribed balance to the public. In this kind of situation there may be when-issued trading of two kinds: in the security which is the subject of the rights during the period after effective registration when it is being offered to securityholders alone; and in the rights themselves (or in the warrants evidencing the rights) during the period between the date of effective registration and the date of actual issuance of the rights.⁷⁸ Of course, under such circumstances, a dealer who offers

the "except" clause has always been construed by the Commission to apply also to transactions *prior* to the first date of public offering—or, rather, the first date upon which a public offering may legally be made by the issuer, namely, the effective date of the registration statement. See Securities Act Release No. 2613, July 9, 1941; H. R. REP. NO. 85, 73d Cong., 1st Sess. (1933) 6. See also COMPARATIVE PRINT, cited *supra* note 45, at 17, where it was proposed some eight years after the act's passage to provide specifically that the dealer's exemption should not apply to any offer or sale "prior to and in contemplation of the effectiveness of a registration statement." This was intended as a codification of the present construction, and the proposal, which was part of a broad program instituted by the securities industry to amend the two acts, was concurred in by the representatives of the industry. See REPORT ON THE CONFERENCES, *op. cit. supra* note 45, at 65. This amendment program is now pending before a subcommittee of the House Committee on Interstate and Foreign Commerce.

76. In the case of securities which are offered at competitive bidding (see, e.g., Rule U-50 under the Public Utility Holding Company Act of 1935) the registration statement becomes effective initially, to the extent necessary to legalize the offering involved in the invitation for bids, before the required information as to the underwriting terms and the public offering price is available. In practice the issuer files with the statement an undertaking to file a post-effective amendment supplying that information before the security is offered to the public generally by the successful bidder, and there is usually an interval of ten days between the original effective date of the statement and the effective date of the amendment. Since the original statement does not satisfy the requirements of the act and the Commission's rules and forms with respect to public offerings generally, but is effective only for the limited purpose of the competitive bidding, there may be no when-issued or when-distributed trading in the securities covered by the registration statement until the effectiveness of the amendment.

77. Section 6(a) of the Securities Act provides that "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." This has been interpreted by the Commission to mean "presently proposed to be offered."

78. For indications of the volume of such trading see note 159 *infra*. Even though the

or sells a registered security on a when-issued basis must make available the formal prospectus required by the Securities Act (and the summary of indenture provisions required by the Trust Indenture Act in the case of a debt security) just as if the security were issued.⁷⁹

What has been said thus far about when-issued trading applies also, with some modifications, to when-distributed trading. Secondary distributions are subject to registration under the Securities Act (although not to the provisions of the Trust Indenture Act) where (1) the person distributing controls the issuer or is controlled by or under common control with the issuer *and* (2) the distribution is made through an underwriter.⁸⁰ Theoretically, dealers may freely trade when-distributed in contemplation of a secondary distribution where either or both of these circumstances are not present; that is to say, dealers may trade when-distributed in contemplation of an offering to be made (1) on behalf of a person not in a control relationship with the issuer or (2) on behalf of a person in a control relationship who will not employ an underwriter. But few secondary distributions which are large enough to give rise to when-distributed trading are made on behalf of persons not in control of the issuer; and it is equally uncommon for so large a distribution to be made without the intervention of an underwriter.⁸¹ Accordingly, any dealer engaging in when-distributed trading in contemplation of a large secondary distribution would be taking a risk both as to the existence of control and as to the intervention of an underwriter in the forthcoming distribution.

rights may be given away rather than sold to existing securityholders, neither issuance of the rights nor when-issued trading in them is permissible until the effective date of a registration statement for the principal security, because an offer or gift of a right necessarily involves an offer of the security called for by the right. Since the principal security must thus be registered in any event, many issuers register the rights at the same time. A "warrant or right to subscribe to or purchase" a security is itself defined as a security. SECURITIES ACT § 2(1); TRUST INDENTURE ACT § 303(1).

79. SECURITIES ACT § 5(b); TRUST INDENTURE ACT §§ 305(c), 306(b). For a discussion of the circumstances under which a dealer must deliver the official prospectus in offering or delivering a security, whether issued or unissued, see Securities Act Release No. 2623, July 25, 1941, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,183.

80. This follows from Sections 2(11) and 4(1) of the Securities Act. Section 4(1), as we have seen, exempts "Transactions by any person other than an issuer, underwriter, or dealer." And the term "underwriter" is defined in Section 2(11) to include any person who buys a security from the issuer or from any person in a control relationship with the issuer with a view to a distribution, or who sells a security for an issuer or for any such person in connection with a distribution. Since control situations were studiously omitted from the coverage of the Trust Indenture Act, §§ 303(4), 304(b), secondary distributions are never subject to that act; but this is irrelevant for purposes of when-distributed trading in contemplation of a registerable offering by a person in a control relationship with the issuer, because the dealer's exemption in Section 4(1) of the Securities Act is still not available in advance of effective registration.

81. Even where there is to be no underwriter, *caveat* as to secondary distributions which are subject to the Public Utility Holding Company Act of 1935. See note 101 *infra*.

Were this the whole story of the impact of the Securities Act and Trust Indenture Act on when-issued and when-distributed trading, the significance of such trading would be mostly historical. The story is not quite so simple—and the impact not quite so harsh—because of a number of statutory exemptions:

(1) There is a separate exemption in the two statutes for brokers' transactions which are executed upon customers' orders *without any solicitation*.⁸² Consequently, so long as there is no solicitation of any buy orders, when-issued or when-distributed transactions may be freely effected on a brokerage basis at any time. This exemption does not loom large in practice.

(2) There are various categories of securities which, because of the nature of their issuers, are exempted from the registration and qualification provisions of the two acts. These are federal, state, and municipal bonds,⁸³ bank issues,⁸⁴ securities issued by non-profit organizations⁸⁵ or building and loan associations,⁸⁶ and railroad and motor carrier issues which require the approval of the Interstate Commerce Commission.⁸⁷ Brokers and dealers are entirely free to effect when-issued or when-distributed trading at any time in contemplation of any offering of these securities.⁸⁸ Nevertheless, there has apparently been little when-issued or when-distributed trading of any consequence in any such cases, except in contemplation of railroad reorganizations;

82. SECURITIES ACT § 4(2); TRUST INDENTURE ACT § 304(b). The exemption is not too artistically worded. It refers to "Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders." What it apparently means is that solicitation of a customer's buy order will destroy the exemption for the entire transaction of offer and sale. See Brooklyn Manhattan Transit Corp., 1 SEC 147, 171 (1935).

83. SECURITIES ACT § 3(a)(2).

84. *Ibid.*

85. *Id.* at § 3(a)(4).

86. *Id.* at § 3(a)(5).

87. *Id.* at § 3(a)(6). Section 214 of the Motor Carrier Act, 49 STAT. 557 (1935), 52 STAT. 1240 (1938), 49 U. S. C. § 314 (1940), exempts from Section 20a of the Interstate Commerce Act offerings by motor carriers where the par value of the securities to be issued together with the securities of the issuer outstanding does not exceed \$500,000. Such offerings, not being subject to Section 20a, do not come within the exemption afforded by Section 3(a)(6) of the Securities Act.

88. These several Securities Act exemptions are all incorporated into the Trust Indenture Act. § 304(a)(4). In addition, that act exempts certain offerings which are not exempted by the Securities Act. Section 304(a)(8) exempts any security to be issued otherwise than under an indenture, to the extent of \$250,000 aggregate principal amount for one issuer within any period of twelve consecutive months; and Section 304(a)(9) exempts any security issued under an indenture which limits the aggregate principal amount of securities at any time outstanding thereunder to \$1,000,000 or less, so long as not more than that amount of securities of the same issuer is so exempted within any period of thirty-six consecutive months. These exemptions qualify everything that is said in the remainder of this discussion as to the necessity of compliance with the Trust Indenture Act.

in some of these reorganizations, as pointed out below, proposals to exchange outstanding securities for new securities have given rise to when-issued trading.

(3) The major possibility of when-issued or when-distributed trading arises from several exemptions which are available for various types of *exchange* offerings—that is, offerings of securities in exchange for outstanding securities, claims, or property interests—upon the occurrence of certain administrative or judicial action. These exemptions account for most of the when-issued and when-distributed trading which takes place today. The various types of exempted exchange offerings may best be considered under the categories of (a) utility securities issued pursuant to plans approved by the Commission under Section 11 of the Public Utility Holding Company Act of 1935, (b) securities issued in corporate reorganizations under Chapter X of the Bankruptcy Act, and (c) securities issued in railroad reorganizations under Section 77 of the Bankruptcy Act.

(a) *Utility Plans under Section 11.* Plans of integration, simplification or reorganization of holding-company systems under Section 11 of the Holding Company Act have set the stage for much of the when-issued trading and all of the when-distributed trading since 1933.

Section 11(b) makes it the duty of the Commission to require each registered holding company and each subsidiary company to take appropriate action toward geographical integration and corporate simplification of its holding-company system. This action may vary, among other things, from a reclassification of securities⁸⁹ to a divestment of certain holdings⁹⁰ to outright liquidation.⁹¹ Following a Commission order which specifies what action is necessary under Section 11(b)—or without waiting for such an order—any holding company or subsidiary may submit a voluntary plan under Section 11(e) designed to bring it into compliance with the provisions of Section 11(b). If the Commission, after hearing, enters an order under Section 11(e) approving the plan as “fair and equitable” and “appropriate to effectuate the provisions of section 11,” the plan is then carried out either by the Commission’s applying to an appropriate district court for an enforcement order at the company’s request under Section 11(e)⁹² or, on occasion, by the company’s taking a vote of security-holders or directors pursuant to applicable state law.⁹³ The Commis-

89. *Commonwealth & Southern Corp. v. SEC*, 134 F. (2d) 747 (C. C. A. 3d, 1943).

90. *North American Co. v. SEC*, 133 F. (2d) 148 (C. C. A. 2d, 1943), *cert. granted*, 318 U. S. 750 (1943). Argument of this case in the Supreme Court has been delayed by quorum difficulties.

91. *Todd v. SEC*, 137 F. (2d) 475 (C. C. A. 6th, 1943).

92. *Otis & Co. v. SEC*, 323 U. S. 624 (1945).

93. *Miss. River Power Co., — SEC —*, Holding Company Act Release No. 5776, May 5, 1945. The Commission is not sympathetic to this method of enforcement because

sion may also approve a plan which is not made binding as against an entire class of securityholders by either method, but which merely provides for an exchange offer whose acceptance is optional with each member of the class.⁹⁴

Securities issued by registered holding companies or their subsidiaries are not automatically exempted from any of the securities laws. However, Section 3(a)(10) of the Securities Act exempts from registration under that act:

"Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."

Appropriate action under Section 11 of the Holding Company Act results in an exemption under Section 3(a)(10) of the Securities Act.⁹⁵ The effect of the interrelation of these two sections upon when-issued and when-distributed trading presents two questions:

(i) The effect of Section 3(a)(10) is not to exempt the *security* as such, in the sense that municipal and bank issues, for example, are exempted.⁹⁶ There is nothing in the inherent nature of such a security which makes it different from any other industrial or utility security. It is the particular *transaction* rather than the particular security which becomes exempted upon judicial or administrative approval of the

of the possibly disparate treatment given dissenters under state law. *Id.* at 27-8. In Commonwealth & Southern Corp., — SEC —, Holding Company Act Releases No. 5825, June 1, 1945, No. 5895, July 2, 1945, *review dismissed sub nom.* Lownsbury v. SEC, C. C. A. 3d, Sept. 11, 1945, *review pending sub nom.* Shassol v. SEC, C. C. A. 2d, the Commission approved a plan providing for both a stockholders' vote and, if the vote should be favorable, court enforcement under Section 11(e); the Commission emphasized that the vote was not legally necessary [Release No. 5825 at 49-50] and has since heard reargument on the question whether the vote provision should be deleted [N. Y. Herald Tribune, Oct. 20, 1945, p. 17, col. 1].

94. Standard Gas & Electric Co., 7 SEC 1089 (1940); United Corp., — SEC —, Holding Company Act Release No. 5440, Nov. 25, 1944, *review pending sub nom.* Phillips v. SEC, C. C. A. 2d (offer of exchange of Philadelphia Electric common held by United for outstanding preference stock of United); United Corp., — SEC —, Holding Company Act Releases No. 5812, May 23, 1945, No. 5859, June 11, 1945, *review pending sub nom.* Phillips v. SEC, C. C. A. 2d (similar offer of exchange of Delaware Power & Light common held by United).

95. Section 11 is the only section of the Holding Company Act which can result in an exemption under Section 3(a)(10) of the Securities Act. An order of the Commission permitting a sale of securities by a holding company or a subsidiary under Section 6, 7 or 12(d) of the Holding Company Act does not satisfy the requirements of Section 3(a)(10).

96. SECURITIES ACT § 3(a)(2); TRUST INDENTURE ACT § 304(a)(4). See *supra*, p. 771.

terms of the exchange pursuant to Section 3(a)(10); in other words, Section 3(a)(10) applies only to the offer and sale involved in effecting the exchange.⁹⁷ Since this is so, it does not necessarily follow that a dealer may automatically offer or sell the new security when-issued or when-distributed whenever he pleases, as he may in the case of a security to be issued by a municipality or a bank. Technically, the dealer must look to a different section to exempt his dealing in a security which is not itself exempt but which is issued pursuant to a 3(a)(10) exchange, whether that dealing is on a when-issued, when-distributed, or regular basis. He must rely upon the exemption in Section 4(1) for all "transactions by a dealer" except those effected in the year following a registerable public offering.⁹⁸ This raises the question whether the dealer's exemption is available for when-issued (or when-distributed) trading *prior to and in contemplation of* the administrative or judicial action which gives the issuer (or holding company) itself an exemption under Section 3(a)(10). May a dealer offer or sell on a when-issued (or when-distributed) basis on the theory that performance of the contract is expressly or impliedly conditioned on the availability of an exemption for the issuer (or holding company) prior to the security's issuance? Or is he prohibited from offering or selling in advance of the date when the issuer may legally offer pursuant to its 3(a)(10) exemption, just as he is prohibited from offering or selling a registerable security in advance of the date when the issuer may legally offer it pursuant to an effective registration statement?

(ii) If the latter of these alternatives is the correct one, at what point does the 3(a)(10) exemption become available to the issuer? Upon the entry of the Commission's order approving the plan under

97. This is true notwithstanding the legislative accident which placed Section 3(a)(10) among the "exempted securities" in Section 3 of the Securities Act rather than the "exempted transactions" in Section 4. Section 3(a)(10) was originally Section 4(3). 48 STAT. 77 (1933). The exemption was shifted from Section 4 to Section 3 in 1934. 48 STAT. 906. The expressed purpose of this shift was merely to codify the Commission's previous interpretation that, where the issuer was excused from registration under Section 4(3), dealers could trade immediately notwithstanding the non-applicability of the dealer's exemption in Section 4(1) to "transactions within one year of the first date upon which the security was bona fide offered to the public." H. R. REP. NO. 1838, 73d Cong., 2d Sess. (1934) 40; see Securities Act Release No. 646 (Class C), Feb. 3, 1936, 1 C. C. H. Fed. Sec. Law Serv. ¶ 2237.32; Throop and Lane, *supra* note 70, at 97, 103. As sometimes happens, solving one problem created another which was even more serious—namely, the anomaly of having a transaction exemption appear among the security exemptions—and in the 1941-42 amendment program it was jointly proposed by the Commission and the representatives of the securities industry to correct this condition by moving Section 3(a)(10) back to Section 4 and taking care of the dealer's problem in another way. See REPORT OF THE SEC, *op. cit. supra* note 45, at 24, ¶ (9); REPORT ON THE CONFERENCES, *op. cit. supra* note 45, at 65.

98. The "except" clause in Section 4(1) has no application in this context. See note 97 *supra*.

Section 11(e)? Or only upon entry of the district court's order enforcing the plan? Or not until expiration of the period for appealing from either the Commission's order or the district court's order and the termination of all pending appeals?

On the first question—whether the dealer's exemption is available prior to and in contemplation of the issuer's 3(a)(10) exemption—it is arguable that the reason for interpreting the Securities Act as forbidding when-issued (or when-distributed) trading prior to the date at which the issuer (or holding company) may legally offer pursuant to an effective registration statement does not apply where the exchange offering will be exempt. In the case of a registered security it was the Congress' intention that the investor should have the protection of the official prospectus when considering a dealer's offer, whereas in the 3(a)(10) situation the offeree of a when-issued (or when-distributed) security will not have the protection of an official prospectus even after the date at which the 3(a)(10) exemption becomes available to the issuer (or holding company).

The difficulty with this argument is that it overlooks the basic theory of Section 3(a)(10). The approval following full notice and hearing was deemed by the Congress to be an adequate substitute for the disclosure inherent in the registration process. It would seem to follow that an investor should have the benefit of that hearing and the opinion of the court or administrative agency *before* he is asked to commit himself rather than afterwards. Actually, the probability is that those who drafted and adopted the Securities Act never thought of the question of when-issued or when-distributed trading in contemplation of a 3(a)(10) exemption. As we have seen, the literal wording of the dealer's exemption indicates that no specific thought was given even to the possibility of such trading in advance of an effective registration statement.⁹⁹ But courts must find and declare the legislative intention every day in the year when actually there is no evidence that the legislature thought one way or the other about the particular problem *sub judice*. The most one can say is that if the Congress had considered the problem it would probably not have permitted trading by third party professionals in advance of the date upon which the issuer or controlling person might legally make an offering, whether pursuant to an effective registration statement or pursuant to some exemption. Or, as a lawyer would put it, this construction of the dealer's exemption is more consonant with the legislative intention and the statutory scheme.¹⁰⁰ This is the official view of the Commission's legal

99. See note 75 *supra*.

100. See note 72 *supra*. The Supreme Court has recently emphasized, speaking of the Securities Act, that "courts will construe the details of an act in conformity with its domi-

officers.¹⁰¹

The answer to the second question—the date upon which the 3(a)(10) exemption becomes available—depends upon whether the Commission's order under Section 11(e) of the Holding Company Act contemplates district court enforcement. Where the plan is to be consummated by a vote of securityholders pursuant to state law, or solely by a voluntary exchange of securities, the exemption follows immediately upon entry of the Commission's order.¹⁰² Where there is to be court enforcement, however, the 3(a)(10) exemption does not exist (and hence the dealer's exemption is not available for when-issued trading) until entry of the district court's order.¹⁰³ The effect of the Commission's action is suspended pending the concurrence of the district court in much the way in which a court may grant a stay of its judgment pending an appeal.¹⁰⁴ Since the *United Light and Power* case

nating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." SEC v. C. M. Joiner Leasing Corp., 320 U. S. 344, 350-1 (1943).

101. See Securities Act Release No. 3000, June 7, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,462. Where a Section 11(e) plan provides for the distribution of a security of a subsidiary to the securityholders of a public-utility holding company [e.g., Standard Gas & Electric Co., — SEC — (1944), Holding Company Act Release No. 5430, Nov. 18, 1944, *disapproved sub nom. In re Standard Gas & Electric Co.*, 59 F. Supp. 274 (D. Del. 1945), *rev'd*, C. C. A. 3d, Sept. 14, 1945], the absence of an underwriter will result in an exemption for the distribution under the first clause of Section 4(1) of the Securities Act (see *supra*, p. 770) independently of Section 3(a)(10). But, since the Holding Company Act precludes the parent company from making definite and certain announcement of its distribution until the official action has occurred which creates a 3(a)(10) exemption, the 4(1) exemption does not become clearly available any earlier than that under Section 3(a)(10); it may, therefore, be disregarded as merely cumulative in effect. Suppose, for example, that in the interval between original submission of a plan and its ultimate approval—a period which may be considerable in the vent of litigation (again as in the *Standard* case, *supra*)—market or other conditions should result in amendment of the plan to provide for a cash offering of the subsidiary's security to the public through normal underwriting channels. See Commercial and Financial Chronicle, Sept. 20, 1945, p. 1342, col. 3; see also note 107 *infra*. The contemplated exemption, whether under Section 3(a)(10) or under Section 4(1), never materializes; instead, the distribution is registered under the Securities Act; and Section 5 of that Act beclouds any preliminary trading which has occurred on a when-distributed basis. Cf. note 133 *infra*.

102. See Standard Gas and Electric Co., 7 SEC 1089, 1097 (1940). A Section 11(e) order which does not contemplate court enforcement is a final order in the sense that it is subject to judicial review in the appropriate circuit court of appeals under Section 24(a) of the Holding Company Act. SEC v. Chenery Corp., 318 U. S. 80 (1943); Central Maine Power Co., — SEC —, Holding Company Act Release No. 5506, Dec. 21, 1944, *review dismissed on petitioner's motion sub nom. Bowers v. SEC*, C. C. A. 1st, July 2, 1945; cf. L. J. Marquis & Co. v. SEC, 134 F. (2d) 822 (C. C. A. 3d, 1943), cited *infra* note 106.

103. See Securities Act Release No. 3000, June 7, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,462.

104. In such a case the Commission's action under Section 11(e) is no more final than is a Commission order approving a plan under Section 11(d) or 11(f), where the Commis-

in April 1943,¹⁰⁵ the Commission has uniformly conditioned its 11(e) orders upon court enforcement wherever court enforcement was contemplated.¹⁰⁶

In any event, whether or not the Commission's order is conditioned on district court enforcement, nothing in Section 3(a)(10) suspends the effect of the exemption until the expiration of the period for taking an appeal from the district court's order or for filing a petition in the circuit court of appeals to review the Commission's order, as the case may be.¹⁰⁷ Consequently, the commencement of when-issued trading

sion's action can never be more than a preliminary to court approval. *Cf. Lownsbury v. SEC*, C. C. A. 3d, Sept. 11, 1945 (concurring opinion). Section 11(d) provides a sanction for enforcing a Commission order of integration or simplification where a company does not voluntarily submit a plan under Section 11(e); under Section 11(d) a plan proposed by any interested person or by the Commission itself and approved by the Commission may be enforced by an appropriate district court without any action by the company. *In re Standard Power & Light Corp.*, 48 F. Supp. 716 (D. Del. 1943). Section 11(f) provides that no reorganization plan for a registered holding company or a subsidiary shall become effective in any proceeding in a United States court unless it is approved by the Commission; this means that even a plan of reorganization under Chapter X of the Bankruptcy Act must first be approved by the Commission if it involves a registered holding company or a subsidiary. *In re Associated Gas & Electric Co.*, 149 F. (2d) 996 (C. C. A. 2d, 1945), *cert. denied*, Oct. 8, 1945. A Commission order under Section 11(f) is not final for purposes of judicial review. *Gilbert v. SEC*, 146 F. (2d) 513 (C. C. A. 7th, 1944).

105. *United Light & Power Co.*, — SEC —, Holding Company Act Release No. 4215, April 6, 1943, *enforced sub nom.* *In re United Light & Power Co.*, 51 F. Supp. 217 (D. Del. 1943), *aff'd sub nom. Otis & Co. v. SEC*, 142 F. (2d) 411 (C. C. A. 3d, 1944), *aff'd*, 323 U. S. 624 (1945).

106. The *United Light and Power* order followed a case in which the Third Circuit Court of Appeals directly reviewed a Commission order under Section 11(e) upon the petition of a minority stockholder despite the fact that enforcement proceedings were pending in the district court; enforcement proceedings had not been contemplated at the time of entry of the Commission's order, and the Commission had not been requested to institute them until after the filing of the stockholder's petition in the circuit court. *L. J. Marquis & Co. v. SEC*, 134 F. (2d) 822 (C. C. A. 3d, 1943); *Application of SEC (Columbia Oil & Gasoline Corp.)*, 50 F. Supp. 965 (D. Del. 1943). Recently the Second and Third Circuits have held that an 11(e) order which is conditioned upon district court enforcement is not final for purposes of judicial review. *Olin v. SEC*, 145 F. (2d) 206 (C. C. A. 2d, 1944), *vacated and remanded on other grounds*, 65 Sup. Ct. 1569 (U. S. 1945); *Lownsbury v. SEC*, C. C. A. 3d, Sept. 11, 1945.

107. See Securities Act Release No. 3000, June 7, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,462; Securities Act Release No. 3011, Aug. 28, 1944, *id.* at ¶ 75,469. The Commission has not taken the position administratively that the 3(a)(10) exemption must await expiration of the five-day period for filing a petition for rehearing with the Commission, SEC RULES OF PRACTICE XII(d), or, where there is court enforcement, the ten-day period for filing a motion for a new trial with the district court, FED. RULES CIV. PROC. 59. However, where an 11(e) plan is initially *disapproved* by the district court and the court's order is later reversed on appeal, the reversal is not the equivalent of the entry of an enforcement order by the district court. Entry of such an order, which is a condition precedent to the creation of a 3(a)(10) exemption and the commencement of when-issued or when-distributed trading, must await the handing down of the circuit court's mandate, which is normally held up for some time in order to permit the filing of a petition for rehearing or

need not be postponed while appellate proceedings are pending or may still be instituted.¹⁰⁸

In the case of debt securities, the Trust Indenture Act introduces an additional element. Since that act contains no exemption comparable to that afforded by Section 3(a)(10) of the Securities Act,¹⁰⁹ there can be no when-issued trading in *debt* securities to be issued under an 11(e) plan in advance of effective qualification of an indenture. The dealer's exemption (which is carried over into the Trust Indenture Act) is no more available for when-issued trading in advance of indenture qualification than it is for when-issued trading in advance of registration where no exemption is available for the issuer under the Securities Act.¹¹⁰ This means that the commencement of when-issued trading in contemplation of the issuance of debt securities in an exchange offering is restricted to the same degree as the commencement

certiorari. The only instance thus far of such initial disapproval and reversal on appeal is Standard Gas & Electric Co., — SEC — (1944), Holding Company Act Release No. 5430, Nov. 18, 1944, *disapproved sub nom.* *In re* Standard Gas & Electric Co., 59 F. Supp. 274 (D. Del. 1945), *rev'd*, C. C. A. 3d, Sept. 14, 1945. In that case there is pending in the district court, on remand from the circuit court of appeals, a petition by certain stockholders looking toward the disapproval of the plan or its remand to the Commission because of a change in market conditions since its original approval. See N. Y. Herald Tribune, Oct. 19, 1945, p. 29, col. 2.

108. The filing of a petition to review a Commission order does not operate as a stay without a specific order by the court. PUBLIC UTILITY HOLDING COMPANY ACT § 24(b). The same is true of the filing of an appeal from a district court order enforcing a plan under Section 11(e) or 11(d). FED. RULES CIV. PROC. 62(d), 62(g). The effect of a stay order upon the 3(a)(10) exemption would presumably depend upon the type of stay entered, but no stay of any kind has been entered in any of the 11(e) appeals so far taken, whether from Commission orders or district court orders. *N. Y. Trust Co. v. SEC*, 131 F. (2d) 274 (C. C. A. 2d, 1942), *cert. denied*, 318 U. S. 786 (1943); *L. J. Marquis & Co. v. SEC*, 134 F. (2d) 822 (C. C. A. 3d, 1943); *SEC v. Chenery Corp.*, 318 U. S. 80 (1943); *City National Bank & Trust Co. of Chicago v. SEC*, 134 F. (2d) 65 (C. C. A. 7th, 1943); *Okin v. SEC*, 145 F. (2d) 206 (C. C. A. 2d, 1944), *vacated and remanded on other grounds*, 65 Sup. Ct. 1569 (U. S. 1945); *Central Maine Power Co., — SEC —*, Holding Company Act Release No. 5506, Dec. 21, 1944, *review dismissed on petitioner's motion sub nom.* *Bowers v. SEC*, C. C. A. 1st, July 2, 1945; *United Corp., — SEC —*, Holding Company Act Release No. 5440, Nov. 25, 1944, *review pending sub nom.* *Phillips v. SEC*, C. C. A. 2d; *United Corp., — SEC —*, Holding Company Act Releases No. 5812, May 23, 1945, No. 5859, June 11, 1945, *review pending sub nom.* *Phillips v. SEC*, C. C. A. 2d; *Commonwealth & Southern Corp., — SEC —*, Holding Company Act Releases No. 5825, June 1, 1945, No. 5895, July 2, 1945, *review dismissed sub nom.* *Lownsbury v. SEC*, C. C. A. 3d, Sept. 11, 1945, *review pending sub nom.* *Shassol v. SEC*, C. C. A. 2d; *Otis & Co. v. SEC*, 323 U. S. 624 (1945); *Disman v. SEC*, 147 F. (2d) 679 (C. C. A. 10th, 1945), *cert. denied*, 65 Sup. Ct. 1200 (U. S. 1945); *In re Laclede Gas Light Co.*, 57 F. Supp. 997 (E. D. Mo. 1944), *appeal pending sub nom.* *Mass. Life Ins. Co. v. SEC*, C. C. A. 8th; *In re United Gas Corp.*, 58 F. Supp. 501 (D. Del. 1944), *appeal pending sub nom.* *Okin v. SEC*, C. C. A. 3d; *In re Standard Gas & Electric Co.*, C. C. A. 3d, Sept. 14, 1945. The first nine cases involve petitions to review Commission orders under Section 11(e) and the remaining cases appeals from district court orders.

109. See TRUST INDENTURE ACT §§ 304(a)(4), 306, 307.

110. As we have seen, the Trust Indenture Act has no effect on when-distributed trading, since it does not apply to secondary distributions. See note 80 *supra*.

of when-issued trading in contemplation of cash offerings of equity securities.¹¹¹ Moreover, just as a broker or dealer who sells a registered security (issued or unissued) must supply the prospectus required by the Securities Act, a broker or dealer who sells a debt security must make available the summary of indenture provisions required by the Trust Indenture Act.¹¹²

(b) *Chapter X Plans.* Section 3(a) (10) of the Securities Act effectively exempts an exchange of securities pursuant to a plan of reorganization under Chapter X of the Bankruptcy Act just as it does an exchange pursuant to a utility plan under Section 11 of the Holding Company Act. And for much the same reasons the exemption becomes available not upon preliminary court approval of the plan¹¹³ but only upon its ultimate confirmation.¹¹⁴ Again, as in the case of utility plans, this means that the dealer's exemption is not available for when-issued trading until final confirmation of the plan.¹¹⁵

Apart from the general exemption created by Section 3(a)(10), Section 264 of Chapter X of the Bankruptcy Act creates a specific exemption from the Securities Act for "any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued. . . ." ¹¹⁶ This section, however, adds nothing of

111. Compare Securities Act Release No. 3011, Aug. 28, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,469; Securities Act Release No. 3038, Jan. 4, 1945, 1 Prentice-Hall Sec. Reg. Serv. ¶ 8020. See *supra*, pp. 767-9.

112. TRUST INDENTURE ACT §§ 306(b), 305(c), 304(b); see Securities Act Release No. 3038, Jan. 4, 1945, 1 Prentice-Hall Sec. Reg. Serv. ¶ 8020. A fortuitous result of the application of the Trust Indenture Act to 3(a)(10) exchanges is that, where a plan of reorganization entitles the holder of an old bond to a new bond plus a new share of stock, the holder may legally sell the new stock when-issued through a dealer at an earlier date than the new bond.

113. § 174, 52 STAT. 891 (1938), 11 U. S. C. § 574 (1940).

114. § 221, 52 STAT. 897 (1938), 11 U. S. C. § 621 (1940). The court's order approving a plan is appealable. BANKRUPTCY ACT §§ 24a, 121, 52 STAT. 854, 885 (1938), 11 U. S. C. §§ 47, 521 (1940), *Meyer v. Kenmore Granville Hotel Co.*, 297 U. S. 160 (1936). But this does not make it any more final than an order of the Commission under Section 11(f) of the Holding Company Act, which is not subject to judicial review. See notes 104 and 106 *supra*. In exceptional cases the convenience of permitting interlocutory review outweighs the public policy against piecemeal appeals. The order of approval under Section 174 authorizes nothing but submission of the plan to creditors and stockholders under Section 175; the exchange is not finally "approved" within the meaning of Section 3(a)(10) of the Securities Act until entry of the court's confirmation order under Section 221.

115. See Securities Act Release No. 3011, Aug. 28, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,469. In the nature of Chapter X proceedings when-distributed trading would be uncommon. But see note 60 *supra*: the when-distributed trading in the common stock of Public Service Company of Indiana occurred in connection with the reorganization of Midland United Company instituted under Section 77B of the Bankruptcy Act.

116. 52 STAT. 902 (1938), 11 U. S. C. § 664 (1940). Similar exemptions are contained in Section 393 of Chapter XI (arrangements) and Section 518 of Chapter XII (real prop-

substance to Section 3(a)(10), and hence has no effect upon the conclusion that the dealer's exemption is not available until confirmation.¹¹⁷

Here again, as in the case of utility securities, neither the exemption created by Section 3(a)(10) nor that created by Section 264 is conditioned upon expiration of the period for appealing from the court's confirmation order; therefore, there is nothing to prevent when-issued trading pending an appeal. Finally, in the case of *debt* securities issued pursuant to a plan, there may be no when-issued trading until qualification of an indenture, and a dealer engaging in such trading after qualification must furnish the written summary of indenture provisions required by the Trust Indenture Act,¹¹⁸ for Section 264, like Section 3(a)(10), is not incorporated into that act.

(c) *Railroad Reorganizations*. The problem of when-issued trading in contemplation of a railroad reorganization¹¹⁹ is unique because of the exemption in Section 3(a)(6) of the Securities Act (which is incorporated into the Trust Indenture Act)¹²⁰ for "Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20a of the Interstate Commerce Act, as amended."¹²¹ Since the issuance of a rail security even on the basis of a court-confirmed plan under Section 77 of the Bankruptcy Act is still subject to authorization by the Interstate Commerce Commission in order to conform with the standards of the Interstate Com-

erty arrangements by persons other than corporations). 52 STAT. 914, 928 (1938), 11 U. S. C. §§ 793, 918 (1940). But when-issued or when-distributed trading is hardly possible in contemplation of a Chapter XI arrangement in view of the unavailability of that chapter to companies with public securityholders. SEC v. U. S. Realty & Improvement Co., 310 U. S. 434 (1940). Nor is it very likely in contemplation of the type of arrangement dealt with by Chapter XII. Section 77B(h), 48 STAT. 920 (1934), contained an exemption somewhat comparable to Section 264 of Chapter X, except that it was broader in that it applied also to reorganization offerings made exclusively for cash.

117. See Securities Act Release No. 3011, Aug. 28, 1944, C. C. H. Fed. Sec. Law Serv., '41-'44 Decisions ¶ 75,469. The additional effect of the exemption in Section 264 for securities issued upon the exercise of a right or conversion privilege is to permit when-issued trading in the security called for by the right or the conversion privilege between the date of confirmation of a plan and the ultimate issuance or distribution pursuant to the right or privilege; but there does not seem to have been any such trading. The writers know of only one Chapter X plan containing such a provision. In the reorganization of Bell Lumber Company a plan was confirmed which provided for the issuance to common stockholders of warrants to purchase new common stock; none of the new common was issued directly to any class of securityholders. *In re Bell Lumber Co.*, E. D. Wis., July 12, 1945. But the number of shares involved was so small as to make when-issued trading infeasible.

118. See note 112 *supra*.

119. There does not seem thus far to have been any occasion for when-distributed trading in the railroad field.

120. § 304(a)(4).

121. 41 STAT. 494 (1920), 49 U. S. C. § 20a (1940).

merce Act, the Section 3(a)(6) exemption seems to apply to "reorganization rails" just as it does to rail issues offered for cash.¹²²

It is rather odd that the Congress, when it was thinking specifically in terms of reorganizations of railroads, created a special exemption from the Securities Act which is a good deal narrower than the general exemption for railroad issues in Section 3(a)(6). Section 77(f) of the Bankruptcy Act exempts from the Securities Act "All securities issued pursuant to any plan of reorganization confirmed by the judge in accordance with the provisions of this section. . . ." ¹²³ This exemption is even more explicitly conditioned upon actual confirmation than the comparable exemption in Section 264 of Chapter X and the general exemption contained in the omnipresent Section 3(a)(10) of the Securities Act. Consequently, if the dealer's exemption for when-issued trading were dependent upon the issuer's having an exemption under Section 77(f), there could be no when-issued trading in "reorganization rails" until actual confirmation of a plan by the district court.

Actually, however, when-issued trading in "reorganization rails" customarily commences over the counter immediately upon court approval of a Section 77 plan, or even in some cases upon the initial certification of a plan to the court by the Interstate Commerce Commission.¹²⁴ Such trading has occurred in tremendous volume and the Securities and Exchange Commission has never interfered with it. This can mean only that in the Commission's view (1) the 3(a)(6) exemption applies to railroad securities issued *in reorganizations*, notwithstanding the later adoption of the more specific and more narrow exemption in Section 77(f), and (2) the 3(a)(6) exemption literally applies, even *prior* to approval by the Interstate Commerce Commission, to any security whose issuance "is subject to" the provisions of Section 20a of the Interstate Commerce Act.¹²⁵ This settled ad-

122. The ICC, when it authorizes the issuance of securities pursuant to a court-confirmed plan under Section 77, makes the findings required by Section 20a—namely, that issuance of the new securities is for lawful objects and reasonably necessary and appropriate for the proper performance of the corporation's service to the public as a common carrier—plus the additional findings required by Section 77(f) that the issuance is contemplated by the confirmed plan and is not inconsistent with the provisions and purposes of the Interstate Commerce Act. See, e.g., *Fonda, Johnstown & Gloversville R. R. Reorganization*, ICC Finance Docket No. 9954 (Feb. 29, 1944).

123. 49 STAT. 920 (1935), 11 U. S. C. § 205(f) (1940).

124. A plan of reorganization under Section 77 must first be approved by the ICC after notice and hearing, then certified to the appropriate district court and approved by the judge after further notice and hearing, then submitted to the creditors (and under certain circumstances to the stockholders), and finally confirmed by the judge.

125. Additional evidence supporting the view that the 3(a)(6) exemption applies to reorganization issues is the fact that the Commission has never required qualification of indentures for debt securities issued in railroad reorganizations, notwithstanding the failure of the Congress to extend the Section 77(f) exemption to the Trust Indenture Act when that statute was passed in 1939. Apparently this was an oversight. See 84 CONG. REC.

ministrative policy would seem to resolve any doubt which might otherwise arise as to the applicability of Section 3(a)(6) to permit when-issued trading in reorganization rails at any time.¹²⁶

(4) There are several other exemptions and dispensations pursuant to which when-issued or when-distributed trading is permissible without the necessity of any judicial or administrative action:

(a) The Commission very early announced its view that there is no "sale" of a security within the meaning of the Securities Act¹²⁷ when the security is issued or distributed pursuant to the vote of a requisite majority of stockholders (*not* bondholders) which, under applicable state law or charter provisions, will bind all stockholders, subject only to dissenters' appraisal rights. When stockholders vote in this manner, they are deemed to be taking corporate action rather than to be exercising that individual volition which is an essential element of a "sale." The principle underlying this interpretation applies equally to votes on reclassifications, mergers, consolidations, and sales of assets. The new securities resulting from such corporate action are excluded from the Securities Act not because of any specific exemption but because the operative section of the statute, Section 5, applies only where there is a "sale."¹²⁸

5020 (1939). In the 1941 amendment program the Securities and Exchange Commission proposed an amendment to Section 77(f) extending the exemption to the Trust Indenture Act. COMPARATIVE PRINT, cited *supra* note 45, at 67. The fact remains, however, that the only justification for not applying the Trust Indenture Act to railroad reorganizations is the exemption carried over from Section 3(a)(6) of the Securities Act.

126. To be sure, if Section 3(a)(6) applies to reorganizations, the special Section 77(f) exemption is supererogation. But the exemption in Section 264 of Chapter X is largely superfluous also in view of the general exemption afforded by Section 3(a)(10) of the Securities Act. Apparently both the Bankruptcy Act exemptions were included out of an abundance of caution. Compare also the exemption in Section 77(f)(3) for securities issued by the trustee pursuant to Section 77(c)(3), as well as the similar exemptions for trustees' securities contained in the first clause of Sections 264, 393 and 518 of the Bankruptcy Act. These exemptions substantially duplicate the exemption in Section 3(a)(7) of the Securities Act for "Certificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court."

127. § 2(3).

128. The "no sale doctrine" was announced in a Note to Rule 5 of the Rules as to the Use of Form E-1 under the Securities Act, 1 C. C. H. Fed. Sec. Law Serv. ¶ 7035. Form E-1 is the form for registration of securities issued in a reorganization where for some reason no exemption is available, and Rule 5 defines the term "reorganization" for purposes of the rules accompanying the form. The interpretation was sustained in *National Supply Co. v. Leland Stanford Junior University*, 134 F. (2d) 689, 694 (C. C. A. 9th, 1943), *cert. denied*, 320 U. S. 773 (1943). Since the Trust Indenture Act [§ 303(2)] substantially incorporates the definition of the term "sale" contained in the Securities Act, presumably this "no sale doctrine" applies equally to the Trust Indenture Act. *Cf.* *Phoenix Securities Corp.*, 9 SEC 241 (1941) (doctrine *held* applicable to definition of "sale" in Investment Company Act of 1940). However, since the "no sale doctrine" applies only to corporate action taken by *stockholders*, the Trust Indenture Act can have no bearing on when-issued trading unless stock is reclassified into debt securities by a vote binding on all stockholders.

Nevertheless, although there is no "sale" by the issuer, a *dealer* who engages in when-issued trading in contemplation of such corporate action clearly does effect a "sale." And, as always where there is neither an effective registration statement nor an exemption for the security per se, any dealer who offers or sells the security must bring himself within the dealer's exemption in Section 4(1) or he violates Section 5. The question, therefore, is whether the dealer's exemption is available prior to and in contemplation of a stockholders' vote, although it is not available prior to and in contemplation of an effective registration statement or the official action which results in an exemption under Section 3(a)(10).

Although the answer to this question is by no means clear, business prudence would seem to dictate the postponement of when-issued trading until the necessary vote has actually been obtained.¹²⁹ Otherwise the dealer would be running the risk that the new security might actually be issued under circumstances involving a "sale" and requiring registration, in which event he would be guilty of having sold a security prior to an effective registration statement. A dealer who trades when-issued following final action of the Commission or a district court under Section 11 of the Holding Company Act, or following confirmation of a plan of reorganization under Chapter X of the Bankruptcy Act, does so only after an exemption has definitely become available for the issuer; reversal on appeal may frustrate outstanding contracts, but it does not have the effect of retroactively destroying the exemption and rendering unlawful the when-issued trading which has occurred since final action of the Commission or the district court. However, where there is merely a stockholders' vote without any final approval by a court or administrative agency, the vote itself is the definitive action

129. But see *Niles-Bement-Pond Co.*, 11 SEC 59 (1942). In that case the New York Curb Exchange sought when-issued trading privileges under the Securities Exchange Act (see *infra*, pp. 787-94) in contemplation of a proposed stock reclassification which was not to be submitted to the stockholders for their approval until some weeks in the future. By the time the case was decided, the stockholders' vote had occurred and the case had become moot. The Commission nevertheless announced its willingness to consider revision of the rules governing when-issued trading on an exchange (see *infra*, pp. 791-3) so as to permit such trading in some circumstances during the period between the directors' recommendation and the stockholders' approval. The question whether such trading by brokers or dealers would violate the Securities Act was not raised in that proceeding. Again, the Commission took no action to prevent when-issued trading which occurred in September 1945 prior to the stockholders' votes on a proposal to merge three Delaware corporations under circumstances falling within the "no sale doctrine." Consolidated Film Industries, Inc., the parent of Setay Corporation, and Republic Pictures Corporation, a subsidiary of Setay, were to merge into Setay, which was then to change its name to Republic Pictures Corporation. When-issued trading in the new Republic Pictures stock began about two weeks before the stockholders' meetings. The Commission's failure to interpose any objection to such when-issued trading is not conclusive, of course, in the event of a civil action by a buyer. See note 130 *infra*.

that obviates registration. Until that vote is taken no dealer can be certain that a when-issued sale would be exempted by Section 4(1) of the Securities Act; and the burden of proving an exemption rests upon him who claims it.¹³⁰

(b) When a corporation distributes a portfolio security to its securityholders as a partial liquidating dividend, there is again no "sale" requiring registration under the Securities Act or qualification under the Trust Indenture Act. Moreover, a direct distribution (one not made through an underwriter) even by a controlling person is exempted from both statutes as a transaction by a person "other than an issuer, underwriter, or dealer."¹³¹ Here again, however, the distributing corporation may be required under state law to submit the proposed dividend to its stockholders for their approval. If so, it would be safer for dealers to await a favorable stockholders' vote on the proposed distribution before engaging in when-distributed trading. On the other hand, in so far as such a distribution may be authorized by the directors without a stockholders' vote, there is nothing to prevent when-distributed trading upon the announcement of the directors' action. Similarly, since a stock dividend payable in the issuer's own shares likewise involves no "sale,"¹³² dealers may begin when-issued trading in the stock immediately upon final authorization of the dividend, whether under local law that authorization be represented by directors' action alone or by a vote of stockholders.

(c) Finally, certain types of exchange offerings which do involve a "sale" of a security are exempted from the Securities Act (although not from the Trust Indenture Act) by Section 3(a)(9), which applies to "Any security exchanged by the issuer with its existing securityholders exclusively where no commission or remuneration is paid or given directly or indirectly for soliciting such exchange." This exemption, however, is a fragile thing. Until the exchange offering is actually

130. See note 72 *supra*. A dealer who sells an unregistered security must always be prepared to assume this burden in the event the market price of the security goes down and his buyer decides to bring a civil action against him under Section 12(1) of the Securities Act. That section provides that any person who sells a security in violation of Section 5 shall be liable to the purchaser for rescission or damages. See, e.g., *National Supply Co. v. Leland Stanford Junior University*, 134 F. (2d) 689 (C. C. A. 9th, 1943), *cert. denied*, 320 U. S. 773 (1943), cited *supra* note 128. When the question is close, this may be of more practical concern to the dealer than the more drastic sanctions of injunctive action by the Commission or, where the violation is wilful, criminal prosecution or administrative proceedings to revoke the dealer's registration or suspend or expel him from any registered securities association of which he is a member. SECURITIES ACT §§ 20(b), 24; SECURITIES EXCHANGE ACT §§ 15(b), 15A(l)(2).

131. SECURITIES ACT § 4(1); TRUST INDENTURE ACT § 304(b). See *supra*, p. 770. But *caveat* as to utilities. See note 101 *supra*.

132. H. R. REP. NO. 152, 73d Cong., 1st Sess. (1933) 25; Securities Act Release No. 929, July 29, 1936, 1 C. C. H. Fed. Sec. Law Serv. ¶ 2125.20.

made—or, for that matter, until it is completed—there can be no assurance that the issuer will not find it necessary to pay commissions for soliciting, or that it will not decide to extend the offering to persons other than existing securityholders. If the issuer should decide to make its offering on a registered basis—or if half-way through it should start paying commissions and file a belated statement—any dealer who had sold on a when-issued basis would find himself in a position of having acted on the strength of an exemption for the issuer which had never existed.¹³³ Here, again, as in the case of Section 3(a)(10), the dealer's exemption in Section 4(1) must stand or fall with the exemption for the exchange offering by the issuer. The question thus resolves itself largely into one of the degree of risk. It would border on the reckless to begin when-issued trading before the exchange offering is made by the issuer. And the only course which would be entirely safe would be to wait till the exchange offer has been completed. This limits the opportunity for trading on a when-issued basis to the interval between the closing of the exchange offer and the actual issuance of the security, a brief period at best.¹³⁴

There have been only a few instances of when-issued or when-distributed trading under any of these circumstances.¹³⁵ But the

133. Certain dealers actually found themselves in this predicament in connection with a Brazilian debt refunding in 1944. The Brazilian Government had five series of bond issues outstanding and various political subdivisions had twenty-five series. According to a plan of readjustment which was originally proposed, the federal government was to issue five series of new bonds in exchange for the five old series of its own bonds, and the bonds of the political subdivisions were to be refunded by new bonds which were to be issued by those subdivisions and guaranteed by the federal government. The refunding of the federal bonds was entitled to an exemption under Section 3(a)(9), but a registration statement was filed to cover the federal guaranty of the subdivisions' twenty-five series. After a substantial amount of when-issued trading had occurred in the new federal bonds which it was thought would be exempted under Section 3(a)(9), the registration statement was amended to reflect a radical change in the plan of readjustment: the federal government offered thirty new series of its own bonds in exchange for both the five outstanding series of federal bonds and the twenty-five outstanding series of political subdivision bonds. Since there was to be a single new federal issue part of which was to be exchanged with persons other than existing securityholders of the federal government, there could be no 3(a)(9) exemption for any part of the new bonds, and a serious question arose as to the status of outstanding when-issued contracts. In view of the fact that the trading had occurred in good faith in reliance on the original plan, the Commission did not interfere with the consummation of the contracts. *N. Y. Herald Tribune*, May 27, 1944, p. 17, col. 6; *N. Y. Times*, July 3, 1944, p. 18, col. 6. No opinion was expressed, however, on the legality of these contracts; the buyers were left to whatever civil remedies they might have. See note 130 *supra*.

134. There could be no when-distributed trading in this context, since the 3(a)(9) exemption is designed for primary offerings. Moreover, in so far as a *debt* security is to be offered under the conditions specified in Section 3(a)(9), the fact that that exemption is not incorporated into the Trust Indenture Act would preclude when-issued trading prior to the qualification of an indenture in any event.

135. A recent case did occur, however, when on May 23, 1944, stockholders of R. H. Macy & Co., Inc., authorized the creation and distribution to themselves of 165,000 shares

possibility is there, and a different set of economic conditions may some day cause the bulk of when-issued and when-distributed trading to be effected in contemplation of these voluntary corporate actions rather than the involuntary or semivoluntary reorganizations effected in recent years under the Holding Company Act and the Bankruptcy Act.¹³⁶

Summary. The Securities Act and Trust Indenture Act prohibit any offer or sale of a security, whether before or after issuance or distribution, until a registration statement is in effect and, in the case of a debt security, until a trust indenture is qualified. However, there are certain exceptions. From the point of view of when-issued and when-distributed trading the significant ones are as follows:

In the case of a utility plan under Section 11 of the Holding Company Act which contemplates court enforcement of the Commission's order, when-issued or when-distributed trading may not begin until the date of the district court's enforcement order. Where court enforcement is not contemplated, trading may begin on the date of the Commission's order. In either case the pendency of an appeal from the court's order or of a petition to review the Commission's order is immaterial; *caveat* where the order of the court or the Commission is stayed pending the appeal. Moreover, where the plan calls for the issuance of a *debt*

of preferred stock, in the ratio of one share of preferred for each 10 of common, the distribution to occur on August 1, 1944. STANDARD CORPORATION RECORDS (1945) 5615. The new preferred stock was traded on the New York Stock Exchange on a when-issued basis from May 25 to July 31, 1944.

136. There is one further exemption—this one for cash offerings—pursuant to which there might be when-issued or when-distributed trading. Section 3(b) of the Securities Act authorizes the Commission to exempt by rule any issue of securities whose aggregate offering price to the public does not exceed \$300,000—a figure recently raised from \$100,000. Pub. L. No. 55, 79th Cong., 1st Sess. (May 15, 1945). The exemptive regulation adopted pursuant to this section permits primary offerings by issuers up to the maximum of \$300,000 yearly and secondary offerings by controlling persons up to \$100,000 yearly. Reg. A, Rules 220-4, Securities Act Release No. 3066, May 22, 1945, C. C. H. Fed. Sec. Law Serv., Current Vol. ¶ 75,545. In the five months following the increase to \$300,000, there were four applications for when-issued trading on exchanges (see *infra*, pp. 791-3) in connection with offerings exempted under Regulation A; all the applications sought trading in warrants calling for additional shares of common stock to be issued under the regulation. A condition of the exemption is the filing of a letter of notification five days before the offering. *Id.* at Rule 222. Therefore, there may be no when-issued or when-distributed trading under the dealer's exemption until the expiration of the waiting period.

To the extent that such trading is permitted in contemplation of one of these exempted offerings, or of a 3(a)(9) exchange offering or one of the various sorts of corporate action which do not involve a "sale," the rationale applies equally to certain utility issues emanating from plans under Section 11 of the Holding Company Act and certain issues arising from plans of reorganization under Chapter X. See, e.g., Miss. River Power Co., — SEC —, Holding Company Act Release No. 5776, May 5, 1945 (stockholders' vote on merger); United Gas Improvement Co., — SEC —, Holding Company Act Releases No. 4173, March 18, 1943, No. 4784, Dec. 29, 1943 (vote on distributions of portfolio securities). See also note 101 *supra*.

security, when-issued trading must await also the qualification of an indenture, and thereafter it is conditioned upon the dealer's supplying the summary of indenture provisions required by the Trust Indenture Act; these requirements do not apply, however, to when-distributed trading in contemplation of secondary distributions, since the Trust Indenture Act applies only to primary offerings.

In Chapter X cases when-issued trading may not begin until the date of court confirmation of a plan of reorganization. What has been said in the preceding paragraph as to plans calling for the issuance of debt securities and as to the effect of an appeal applies equally here.

In railroad reorganizations when-issued trading may begin at any time.

In the case of a voluntary reorganization, merger, or consolidation effected by a stockholders' vote under circumstances not involving a "sale" within the meaning of the Securities Act, when-issued trading is not clearly permissible until a favorable vote has been obtained.

Where one corporation proposes to distribute to its stockholders as a partial liquidating dividend a security of another corporation which is in its portfolio, when-distributed trading is permissible as soon as the proposed distribution has been authorized, whether that authorization requires approval by the board of directors alone or a favorable vote of stockholders; the same thing is true with respect to when-*issued* trading in contemplation of a stock dividend.

Where an exchange offering is expected to be made by the issuer in reliance upon Section 3(a)(9) of the Securities Act, the safest policy would be not to trade until the closing of the exchange offer; at the very earliest such trading should not begin until the offer has actually been made by the issuer; and, where a *debt* security is offered in exchange, the effect of the Trust Indenture Act is to prevent the dealer's trading when-issued until qualification of an indenture, and thereafter to require that the dealer supply buyers with a summary of indenture provisions.

When-Issued and When-Distributed Trading on National Securities Exchanges

When-issued or when-distributed trading on exchanges is, of course, subject to whatever restrictions the Securities Act and Trust Indenture Act automatically place upon such trading over the counter. In addition, it is subject to the separate requirements of the Securities Exchange Act of 1934.

The Securities Exchange Act is constructed upon the premise that there are certain benefits to be derived from the privilege of trading a security upon a national securities exchange—benefits which are unavailable if trading is limited to the over-the-counter markets. These benefits stem principally from the public character of the exchange

market and the greater publicity regarding the quotation and transaction prices of exchange securities.¹³⁷ The Act provides, with certain exceptions, that an issuer may obtain these benefits for its security-holders only by registering the particular security with the Commission for trading on the particular exchange.¹³⁸ An issuer assumes various obligations when it registers. It is required to file annual and other periodic reports keeping current the information contained in the application for registration;¹³⁹ solicitations of proxies in respect of any such security must comply with the Commission's proxy rules;¹⁴⁰ and corporate insiders (officers, directors and principal stockholders as defined in the Act) are subject to certain restrictions in trading in the issuer's equity securities.¹⁴¹

These requirements apply only to securities which have been fully listed on an exchange by the issuer. The Act also permits "unlisted trading" in certain limited categories.¹⁴² Unlisted securities may be admitted to trading by the Commission alone upon application of an exchange; they may not be admitted to trading by an exchange upon application of the issuer; and, although they are deemed to be "registered securities" for purposes of the Act, they are exempted by Commission rule from the obligations described above.¹⁴³

Where a particular security is either listed or admitted to unlisted trading privileges on an exchange, there are no special restrictions in the Securities Exchange Act with respect to when-distributed trading on the exchange. The exchange itself has complete control over such

137. See *Shawmut Ass'n, — SEC —*, Securities Exchange Act Release No. 3564, May 13, 1944, *aff'd sub nom. Shawmut Ass'n v. SEC*, 146 F. (2d) 791 (C. C. A. 1st, 1945); *Torrington Co., — SEC —*, Securities Exchange Act Release No. 3687, May 2, 1945.

138. §§ 12(a), 12(b). Registration under the Securities Exchange Act is not to be confused with registration under the Securities Act. The registration provisions of the Securities Act apply to *distributions* of securities and the registration provisions of the Securities Exchange Act apply to *exchange trading*. Registration under one act has no effect on the necessity of registration under the other. An application for registration under the Securities Exchange Act must contain certain information about the issuer and the security, roughly along the lines of the information required in a registration statement filed under the Securities Act. It becomes effective automatically 30 days after the exchange certifies to the Commission that it has approved the security for listing and registration or within such shorter period as the Commission may determine. §§ 12(b)-(d). And the Commission may at any time suspend or deny registration, after notice and opportunity for hearing, if it finds that the registrant has failed to comply with all requirements. § 19(a)(2).

139. § 13.

140. § 14.

141. § 16.

142. § 12(f), *Applications of New York Curb Exchange, — SEC —*, Securities Exchange Act Release No. 3658, Feb. 20, 1945. There still are more unlisted issues than listed issues on the New York Curb Exchange. The New York Stock Exchange, however, abolished its unlisted department in 1910. See MEEKER, *THE WORK OF THE NEW YORK STOCK EXCHANGE* (rev. ed. 1930) 72.

143. § 12(f), last paragraph; Rule X-12F-4.

trading, subject to the powers of the Commission under the Securities Exchange Act with respect to the rules of the several exchanges governing the listing of any security.¹⁴⁴

The New York Stock Exchange adopted certain rules with respect to when-distributed trading in June 1943, in connection with the distribution by United Gas Improvement Company of its holdings in Philadelphia Electric Company and Public Service Corporation of New Jersey.¹⁴⁵ The Exchange has announced that it will not approve when-distributed trading in any case unless (1) a definitive plan providing for distribution of the security pro rata to the holders of outstanding securities of the distributor without the payment of any consideration has been approved by an appropriate court or governmental body, (2) the period for appealing has expired and no appeals are pending, (3) the distribution, when completed, will be sufficiently broad to meet the Exchange's customary requirements in that regard, and (4) the distributor has authorized the distribution to holders of record as of a specified date.¹⁴⁶

Although the Securities Exchange Act makes no specific reference to when-distributed trading on an exchange, it does contain a specific provision limiting the circumstances under which there may be when-issued trading on an exchange. The last portion of Section 12(d) provides:

"An unissued security may be registered only in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such rules and regulations shall limit the registration of an unissued security to cases where such security is a right or the subject of a right to subscribe or otherwise acquire such security granted to holders of a previously registered security and where the primary purpose of such registration is to distribute such unissued security to such holders."

The last clause of this section has a curious history. The real concern of the Congress with respect to when-issued trading on an exchange was apparently a desire "to prevent the practice of running up the price of a security prior to its issuance, so that it is finally issued at an

144. § 19(b)(3).

145. See note 60 *supra*; Rules 103, 108, 148, 550(d)(3), NYSE DIRECTORY AND GUIDE E-21, E-22, E-54, E-391 to E-392. The New York Curb Exchange followed suit, although it has thus far had no case of when-distributed trading. Rules 19, 20, NEW YORK CURB EXCHANGE GUIDE 86b.

146. NYSE DIRECTORY AND GUIDE E-49 to E-50. The Exchange does not permit when-distributed trading to commence until one full business day prior to the record date. *Id.* at E-50. Thus far there have been four instances of when-distributed trading on exchanges, two on the New York Stock Exchange, one on the Philadelphia Stock Exchange and one on both these exchanges. See note 60 *supra*.

excessive price.”¹⁴⁷ The running up of prices prior to a cash offering to the public had been a common manipulative practice before 1934. To prevent this abuse, an earlier version of the last clause of Section 12(d) had read: “and where the primary purpose of such registration is *not* to distribute such unissued security to *others than* such holders.”¹⁴⁸ Apparently some one who was thinking of syntax rather than of context changed the sentence into its present form in order to avoid a double negative concept which would have made a little more sense. The effect of the present language is to limit when-issued trading on exchanges to situations which, at best, are unusual. When the security is to be distributed to securityholders without the payment of consideration, as is typically the case with warrants or rights, the clause has no rational literal meaning; for it would seem to limit registration for when-issued trading to a situation which is hard to conjure up, one where the primary purpose of such registration is to facilitate the physical job of distributing the warrants or rights to the securityholders entitled to them. When the security is to be distributed to existing holders for a consideration, the clause may conceivably be meant to limit when-issued trading to cases where the registration is for the *primary* purpose of making the security more attractive to those holders; this situation, while not altogether impossible, would be most uncommon.

At any rate, neither the adopted version nor its predecessor has much bearing on the when-issued trading which goes on today; for when-issued trading today rarely involves an issue proposed to be offered to the public for cash; in almost every case, it involves securities proposed to be issued pro rata to existing securityholders without the payment of cash. In such a setting, when the payment of cash is not involved, there is much less incentive on the part of an issuer or distributor for “running up the price of a security prior to its issuance.” Therefore, in view of the history of the relevant statutory provision and its inapplicability to these situations, any rules permitting the registration of unissued securities for exchange trading would seem to be within the spirit of the statute so long as the unissued securities are to be exchanged for outstanding securities previously registered on an exchange. The same reasoning applies to unissued warrants or rights which are given to existing securityholders without payment of any

147. H. R. REP. No. 1383, 73d Cong., 2d Sess. (1934) 23. The London Stock Exchange, having the same concern, has refused ever since 1914 to grant permission for “dealing before allotment” or “dealing in results,” as when-issued trading is known in Great Britain. In fact, the practice was criticized in that country as early as 1878 by a Royal Commission investigating the Companies Act. *Companies Act, 1929, Minutes of Evidence Taken before the Company Law Amendment Committee* (1944) 301; London Stock Exchange Rule 159(2), RULES AND REGULATIONS OF THE STOCK EXCHANGE (1935) 79.

148. SEN. COMMITTEE PRINT No. 2, 73d Cong., 2d Sess. (April 14, 1934).

consideration; *quaere* how far the rules may go as to unissued securities which are obtainable for cash upon the exercise of rights or warrants.¹⁴⁹

At present there are ten Commission rules, constituting Regulation X-12D3, on the registration of securities for when-issued trading on exchanges. There are separate rules for unissued warrants,¹⁵⁰ for unissued securities other than warrants,¹⁵¹ and for unissued "reorganization rails."¹⁵²

An unissued security other than a warrant must meet four conditions before it may be registered on an exchange for when-issued trading: (a) It must be issuable only in exchange for a security previously admitted to dealing on an exchange (whether on a fully listed or an unlisted basis), or pursuant to a right to subscribe granted to holders of such a security. (b) In order to provide some assurance that the security will be traded on an exchange after its issuance, the unissued security must be "in the process of admission to dealing" on the exchange (or on another exchange in the same city).¹⁵³ (c) The issuer

149. As we have already seen, when-issued trading in contemplation of cash offerings is very largely precluded in any event by the Securities Act (except as to railroad issues). The Commission has thus far had only one occasion to discuss the when-issued clause of Section 12(d). *Niles-Bement-Pond Co.*, 11 SEC 59 (1942), cited *supra* note 129. After a discussion of the legislative history, the Commission refrained from committing itself to any particular construction of the clause (beyond holding that it did not preclude registration of an unissued security whose issuance has been proposed by the board of directors but not yet authorized by the stockholders pursuant to applicable statutory or charter requirements) in view of the fact that it had concurred in a then pending recommendation for its amendment. See COMPARATIVE PRINT, *supra* note 45, at 89-90, where it was proposed to amend the last sentence of Section 12(d) to read as follows:

"Such rules and regulations shall limit the registration of unissued securities to cases where the primary purpose of such registration is to provide holders of a previously registered security with an exchange market for such unissued securities and (1) such securities are rights, or the subject of rights, of which a substantial portion is granted to such holders, or (2) such holders are to receive a substantial portion of such unissued securities by virtue of a reorganization, recapitalization, merger, or consolidation, or (3) such securities are to be issued in substantial part for the purpose of obtaining funds to redeem or discharge an issue or issues of registered securities."

150. Rules X-12D3-2, X-12D3-3.

151. Rules X-12D3-4, X-12D3-5.

152. Rule X-12D3-10.

153. This means one of three things, either (1) that the prospective issuer has filed an application for registration of the security on the exchange upon notice of issuance or (2) that unlisted trading privileges for the new security have been granted by the Commission (not simply applied for) or (3) that the exchange has notified the Commission that it has approved the new security for admission to dealing pursuant to one of the Commission's exemptive rules. Rule X-12D3-1(d). The third clause is most likely to come into operation on the basis of the Commission's Rule X-12A-5, which on certain conditions provides a temporary exemption from registration under the Securities Exchange Act where a security previously traded on an exchange (on either a listed or an unlisted basis) has come to evidence another security. The purpose of the rule is to avoid an interruption in the exchange

must have made formal and official announcement specifying the terms of the plan or offer pursuant to which the security is to be issued, the record date and the approximate date of issuance.¹⁵⁴ (d) The issuer or the exchange must file a simple form designed to show compliance with the conditions of the when-issued rules.¹⁵⁵

Registration of an unissued *warrant* for exchange trading is subject to similar conditions respecting announcement of the terms of the plan and the filing by the issuer or the exchange of a short form designed to show compliance with the rules.¹⁵⁶ However, it is the security called for by the warrant which must be "in the process of admission to dealing"; in addition, it is necessary either that the prospective issuer of the warrant file an application for its registration upon notice of issuance or that the exchange notify the Commission that it has approved the unissued warrant for admission to dealing upon issuance pursuant to an exemption afforded by another Commission rule for certain types of *issued* warrants.¹⁵⁷

Registration of an unissued security, whether a warrant or some other type, automatically becomes effective under the rules after a certain brief period, unless the Commission sends a notice of deficiency, and it expires on the 45th day after the effective date or the fifth business day after issuance, whichever is earlier.¹⁵⁸ The rules reserve to the Commission flexible authority to accelerate or postpone the effective date of registration, to extend the 45-day period, or (after notice and

market (where, for example, an existing preferred stock comes by operation of law to evidence a new common stock pursuant to Chapter X of the Bankruptcy Act or Section 11 of the Holding Company Act), in order to afford time for the issuer to list and register the new security or for the exchange to apply for the extension of unlisted trading privileges.

154. See Niles-Bement-Pond Co., 11 SEC 59, 64 (1942).

155. Rule X-12D3-5, Form 2-J.

156. Rule X-12D3-3, Form 1-J.

157. Rule X-12A-4. The rules on when-issued trading in warrants require also that the warrants expire by their terms within 90 days after issuance. Rule X-12D3-2(a). In July 1945, however, the Commission admitted a 2½-year option warrant of Pan American Airways Corporation to when-issued trading on the New York Curb Exchange, treating it as an "unissued security other than a warrant" for purposes of such admission. Rule X-12D3-4. The Commission's when-issued rules provide further that a registration statement must be in effect under the Securities Act as to the unissued security if it is required. Rules X-12D3-2(e), X-12D3-4(c). This would be so, of course, whether it were expressly stated in the rules or not; and it is equally necessary to comply with the Trust Indenture Act where such compliance is required as to any unissued debt securities, notwithstanding that the Commission did not amend the when-issued rules to incorporate this condition specifically when the Trust Indenture Act was passed in 1939.

158. Rule X-12D3-6. The effective date is the sixth day after the date of filing of the application on Form 1-J or 2-J (see notes 155 and 156 *supra*), or the second day after the exchange's certification that the security has been admitted to when-issued trading, whichever is later.

opportunity for hearing) to deny or revoke registration when in the public interest.¹⁵⁹

In September 1941 the Commission adopted a special rule for when-issued trading in securities (other than warrants) to be issued pursuant to a plan of reorganization, confirmed by a court in a reorganization proceeding under Section 77 of the Bankruptcy Act, in respect of a carrier required to make annual reports under Section 20 of the Interstate Commerce Act.¹⁶⁰ This rule relaxed the requirements otherwise applicable to exchange trading in unissued securities in two respects: The requirement that the unissued security be "in process of admission to dealing" was modified in favor of a requirement that the reorganization managers or other persons entrusted with the duty of consummating the plan of reorganization file a written statement with the exchange and with the Commission advising (a) that the plan has been finally confirmed (or finally approved by court order in the case of a receivership) and that the time for appealing has expired and no appeal is pending,¹⁶¹ and (b) that before the date when the unissued security is made available for delivery application will be made for listing and registration on the exchange in question (or another exchange in the

159. Rules X-12D3-6, X-12D3-8, X-12D3-9; see *Niles-Bement-Pond Co.*, 11 SEC 59, 65-6 (1942). The Commission may also revoke registration if it finds that transactions have been effected on the exchange which (1) create or induce a false, misleading or artificial appearance of activity with respect to the unissued security, (2) unduly or improperly influence its market price, or (3) make a price which does not reflect the true state of the market. Rule X-12D3-9(a)(3). Pending final determination as to revocation the Commission may suspend registration summarily. Rule X-12D3-9(b). These several powers of the Commission apply also to the special rule on reorganization rails. Rule X-12D3-10.

As of August 31, 1945, according to the Commission's public records, there had been 44 registrations of unissued securities other than rights or warrants (and other than reorganization rails, which are examined below) and 181 registrations of unissued rights or warrants. After the registration of eighteen unissued securities other than rights or warrants in 1936, the number was never more than seven in any one year. The largest number of registrations of unissued rights or warrants in any one year was 61 in 1937; since then the total for any one year has never been more than seventeen and has been as low as two, in 1943. In recent years, particularly since Pearl Harbor, there has been a reduction also in the duration of trading in unissued rights and warrants on the New York Stock Exchange, due apparently to a tendency to shorten the period between the declaration of the right and the record date for determining the securityholders entitled to receive it; whereas prior to Pearl Harbor the period of when-issued trading commonly exceeded five days in these securities, more recently the period of when-issued trading has usually been less than five days.

160. Rule X-12D3-10; see Securities Exchange Act Release No. 3024, Sept. 30, 1941.

161. Although there is no provision in the other when-issued rules as to the expiration of any appeal period, the authority to prevent when-issued trading on an exchange before such expiration is implicit in the general power to deny registration when necessary or appropriate in the public interest or for the protection of investors. Rule X-12D3-8(a)(4). So far the Commission has permitted such trading in only a few cases. The New York Stock Exchange and New York Curb Exchange specifically condition their own rules as to when-distributed trading on the expiration of the period for appeal. See note 145 *supra*.

same city). Moreover, the expiration date of registration for "when-issued" dealing was extended to 120 rather than 45 days from the effective date of such registration, or fifteen rather than five days after delivery, whichever is earlier. The chief significance of this special rule concerning reorganization rails is thus to permit when-issued trading on an exchange immediately upon confirmation or final approval of a plan.¹⁶²

So far as the Commission's rules on when-issued trading as a whole are concerned, their effect is to limit such trading on exchanges to situations in which the "if" element relating to the issuance of the security is practically gone. By the time the security is eligible for admission to the exchange floor, the likelihood that it will not be issued or that the plan will not be consummated is practically nil.¹⁶³ Indeed, since when-issued trading on exchanges normally is not terminated until a few days after actual issuance of the security, the so-called when-issued trading which takes place on the exchange in these last few days is not when-issued at all. It is simply trading based upon recognition of the fact that, as long as the amount of the security physically in public hands is not sufficient to permit of ready delivery, it is premature to require final settlement of when-issued contracts and to shift to a regular trading basis. In short, the principle of *Zimmermann v. Timmermann*—that the amount of the security issued must be sufficiently large to enable performance of a when-issued contract before a seller will be held for breach of contract—finds recognition in the rules and practices governing when-issued trading on the exchanges.¹⁶⁴

" . . . WHAT'S PAST IS PROLOGUE"

The problems to which when-issued trading has given rise are easily formulated. In the first place, although actual litigation has been surprisingly rare in the light of the volume and nature of such trading, inadequate or incomplete contracts have caused misunderstanding and dispute. The inadequacies of when-issued contracts have sometimes been reflected in incomplete security designations, in failure to agree specifically on a method for marking to the market, and in failure to agree on a method of determining whether or not the contract is still

162. Securities Exchange Act Release-No. 3024, Sept. 30, 1941.

163. As a matter of fact, in the period from 1921 to 1934 the New York Curb Exchange ruled for the cancellation of outstanding contracts in only fifteen of the 1,744 stock issues admitted to when-issued trading on its floor. For a summary of each of these fifteen cases see N. Y. Curb Exchange, Supp. Memo, Exhibit A, Niles-Bement-Pond Co., 11 SEC 59 (1942). This suggests that even before the Securities Exchange Act of 1934 the exchanges were chary of admitting securities to when-issued dealings as long as a large element of uncertainty existed.

164. See *supra*, pp. 747-8.

valid after changes have occurred in a plan. While these problems rarely arise with respect to exchange transactions, they are always latent with respect to transactions effected over the counter.¹⁶⁵ They call for the earliest possible solution, not only because they place the interests of the customer in jeopardy but also because they imperil the financial stability of dealers. The latter point is worth dwelling on. When dealers have to provide marks to the market without being entitled to receive them, or when some of their contracts are invalidated while others remain enforceable, the strain placed upon them can result in financial failure. These possibilities inhere in almost every when-issued situation.

Such problems could be solved, or at least mitigated, through the adoption by the securities industry of uniform contracts and procedures. In effect, this would simply extend to the entire industry a principle which every securities exchange has found indispensable—the principle that all contracts effected on its floor in a given security shall be governed by the same terms and conditions. The elements which such a program would have to contain include a method of uniform security designation, a uniform agreement on marking to the market, and an agreement to be bound by the rulings of a single body with respect to the validity of contracts and terms of delivery. Suitable provision along these lines would have to be made, expressly or otherwise, in all when-issued contracts.¹⁶⁶

The great practical obstacle to such a program is apparent at once: the difficulty of reconciling conflicting jurisdictions. There are nineteen registered securities exchanges and one registered securities association in the United States. Most of the active brokers and dealers are members of two or more of these twenty organizations. Some brokers and dealers are members of none of them. Each one of the organizations may properly claim the right of some measure of control over the business practices of its members. The question is how to subordinate these individual jurisdictions to a uniform method of control.

It may be that the Commission's rule-making authority under several of the general regulatory provisions of the Securities Exchange Act of 1934 will provide the ultimate solution to these problems. The Commission has ample authority to take measures to protect the

165. These problems have not arisen with respect to when-distributed trading, which so far has taken place largely on the exchanges. However, to the extent that such trading occurs over the counter in the future, the comments contained in this section, though specifically addressed to when-issued trading, apply in some respects to when-distributed trading.

166. Proposals along this line have been discussed by the Commission's staff with the National Association of Securities Dealers and the two New York exchanges. *NASD News*, Feb. 1945, p. 10, col. 1.

financial stability of brokers and dealers and ample justification for exercising that power when such stability is threatened.¹⁶⁷

Another question which is the subject of constant reexamination concerns the stage at which when-issued trading ought to be permitted. It has already been pointed out that the stage at which over-the-counter when-issued trading becomes legal in each of the typical when-issued situations is determined by various statutory provisions which were never framed with a view to the control of when-issued trading; their incidences upon when-issued trading are largely by-products of their principal purposes. The only when-issued trading which is controlled by rules specifically designed for that purpose is the trading which takes place on the exchanges. Plainly, however, there is a point in time prior to the contemplated issuance of securities at which when-issued trading, even though it be confined to the over-the-counter market, may be contrary to the public interest. It would be coincidence indeed if the more or less incidental effects of the statutory provisions governing over-the-counter when-issued trading operated in each of the typical when-issued situations in such a manner as to outlaw when-issued trading prior to that time.

The case of when-issued trading in reorganization rails is in point. The Securities and Exchange Commission does not interfere with such trading over the counter, however early it may arise.¹⁶⁸ Yet one can readily conceive of the development of a when-issued market for securities proposed to be issued in a railroad reorganization which begins at so early a stage in the reorganization process that it serves no useful purpose either for holders of the outstanding securities or for investors interested in the securities which may come out of the plan. At such a stage dealers and customers trading in the market are simply playing a game of "blind man's buff." The basic theory of the Securities Act and Securities Exchange Act is to prevent such games, since there are always some participants in it—corporate insiders or dealers—who have one eye uncovered. To control this situation, the provisions of the Securities Exchange Act might well be invoked which permit the Commission to define fraudulent or deceptive acts or practices on the

167. §§ 8(b), 15(c)(3). Supplementing these powers is the authority of the Board of Governors of the Federal Reserve System to prescribe rules with respect to margin trading. § 7. The Commission's present rule under Section 15(c)(3), which limits the aggregate indebtedness of any broker or dealer to 2,000 percent of his net capital, requires as a margin of safety that there be deducted from a dealer's "net capital" as otherwise computed 10 percent of the value of each net position (long or short) contemplated by any existing when-issued contract; the dealer's "net capital" is also adjusted for any unrealized profit or loss in any such contract. Rule X-15C3-1, clauses (c)(2)(D) and (c)(5); cf. New York Stock Exchange Rule 415, n. (c), NYSE DIRECTORY AND GUIDE E-235 to E-238.

168. See *supra*, pp. 780-2.

part of brokers and dealers in the over-the-counter markets and to prescribe means reasonably designed to prevent them.¹⁶⁹

A collateral problem is how early when-issued trading ought to be permitted on an exchange. The present rules and policies of the Commission create a period, sometimes of considerable duration, in which when-issued trading is permitted over the counter but barred from the exchanges. The period is particularly long with respect to reorganization rails.¹⁷⁰ When the Commission adopted the special rule on when-issued exchange trading in reorganization rails, it emphasized that the rule represented "an experimental approach to the several problems involved."¹⁷¹ Since its adoption, the Supreme Court has decided the *Western Pacific* and *Milwaukee* cases, which leave less room for modification of a plan once it has been certified to the district court by the Interstate Commerce Commission.¹⁷² The exchanges might rely on these decisions to justify some advancement of the date at which they may begin when-issued trading in reorganization rail securities.¹⁷³

Any determination on this score would require consideration of the question whether the resulting increase in competition between the exchanges and the over-the-counter markets would be in the public interest. This would depend in turn on whether the greater publicity attending exchange trading might whet speculative interest of an undesirable type and, if so, whether that development would be offset by the normal advantages of exchange trading—for example, the

169. § 15(c)(2). Cf. Rules X-13A-6(e) and X-15C2-2, which are intended primarily to prevent trading in the equity securities of liquor manufacturers on the basis of contemplated whiskey dividends before adequate information is publicly available as to the nature and amount of the whiskey to be distributed. See Securities Exchange Act Release No. 3587, July 7, 1944.

170. There have thus far been six registrations for when-issued trading in reorganization rails pursuant to Rule X-12D3-10, all of them on the New York Stock Exchange. Three of them involved Erie issues, two of them Chicago & Northwestern, and the sixth Wabash. In these three reorganizations the periods elapsing between the date of court approval and consummation of the plan were respectively 364, 1,290 and 305 days; under the present rule when-issued trading occurred on the Exchange only during the last 146, 149 and 166 days, respectively, the Commission having extended the 120-day period permitted by the rule.

171. Securities Exchange Act Release No. 3024, Sept. 30, 1941.

172. *Ecker v. Western Pacific R. R.*, 318 U. S. 448 (1943); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R. R.*, 318 U. S. 523 (1943).

173. A case might also be made out for a special rule, comparable to the Commission's when-issued rule on reorganization rails, in order to permit when-issued trading on an exchange in a utility security contemplated by a plan approved under Section 11(e) of the Holding Company Act by the Commission and (where the Commission's order is so conditioned) by a district court. Only one of the substantial number of 11(e) plans approved by the Commission has thus far been disapproved by any court, and the district court's disapproval order was reversed on appeal in that case. See note 60 *supra*.

availability of an open auction market and the publication of actual transaction prices rather than merely bid and asked quotations. The answers to these several questions—and others that have been raised above—depend upon policy considerations and studies which are beyond the scope of this article. But the studies need to be made and the policy considerations need to be resolved.