

Securities Exempt from Full SEC Registration	No	Yes
Shelf Offerings	X	
Intrastate Offerings		X
Small Businesses (Regulation A)		X
Private Equity Issues		
Private Placements		
Non-reporting Issuers (Regulation D Rule 504)		X
Accredited Investors (Regulation D Rules 505 and 506)		X
PIPES	X*	
Mergers and Acquisitions (new securities)	X	
Mergers and Acquisitions (cash)		X
Offshore Offerings (Regulation S offerings)		X

* registration required after the close of the issue


Primary Market: Underwriting a Securities Issue

To execute and enforce the registration process laid out in the **Securities Act of 1933**, the Securities and Exchange Commission (SEC) has enacted many rules that dictate how stocks and bonds can be issued and sold. Companies that are required to issue their securities in a **public offering** must follow a strict set of rules and procedures set out by the SEC. Private placements have their own set of rules. In this section we describe the process of registering and issuing a new security.

UNDERWRITING A PUBLIC OFFERING

Before selling shares to the public, a company must first engage an investment bank to act as its underwriter. An underwriter is an investment bank, familiar with securities markets, that assists the issuer in administering the registration process. Perhaps more importantly, the underwriter will help market and sell the securities to the public, and it may even buy them from the issuer and assume the risk of selling the securities to the public.

The underwriter will typically be chosen by its reputation. It may be a large investment bank that has underwritten many public offerings in the past, or it may be a “boutique” investment bank that specializes in a particular industry. Typically, the issuer will choose an underwriter after several **pitch meetings**, where various investment banks will pitch their services to the issuer. Pitch meetings are also colorfully referred to as “bake-offs” and “beauty pageants.” Companies generally prefer to work with an underwriter that has a proven track record and credibility with investors.

 **Note:** SEC rules prevent research analysts from participating in pitch meetings unless

the company is an emerging growth company (EGC). If the company is an EGC, the research analyst is allowed to participate in the meeting, but may not solicit investment banking business.

TYPES OF UNDERWRITING COMMITMENTS

Once chosen, the underwriter will enter into an agreement with the issuer that will define who will bear most of the responsibility for selling and marketing the shares, as well as who will take on the financial risk of any unsold shares. The underwriting agreement may take various forms.

Firm Commitment Underwriting

In most cases, the investment bank will enter into a firm commitment underwriting with the issuer of the securities. A firm commitment underwriting is an agreement that the underwriter will purchase all the securities at a discount and then sell the securities to the public at a fixed **public offering price**. In this type of agreement, the underwriter is responsible for the marketing and sale of the securities and assumes all the risk of the offering, including the liability of any unsold shares. The offering is conducted in a single day. This is the most common type of underwriting commitment for a corporate offering, and it is preferred by most issuers.

Firm commitment underwritings may be undertaken in one of two ways. In a **competitive bidding** process, the company solicits underwriters to submit a sealed bid for the underwriting contract. The issuer awards the contract to the underwriter with the most competitive price and contract terms. **Competitive offerings** are common for new issues of municipal bonds and public utilities, but rare for corporate offerings. With a **negotiated bid**, the company elects to negotiate with a single underwriter for the contract. **Negotiated offerings** are the most common type of corporate underwritings.

Best Efforts Underwritings

If the issuer is a smaller, less well-known company, it may engage in a **best efforts commitment** with its underwriter. This is also referred to as a **contingency agreement**. In this kind of agreement, the underwriter agrees to use its best efforts to sell the issuer's securities, but the underwriter does not guarantee that all the shares will be sold. Nor is the underwriter financially responsible for the securities it doesn't sell. The underwriter is allotted a certain period of time to sell the issue, usually between 30 and 90 days. If a certain portion of the issue has not been sold by the end of the subscription period, the offering will be cancelled and the securities returned to the issuer, and the money is returned to the investors.

There are two types of best efforts commitments:

- In an **all-or-none (AON)** commitment, the underwriter sells all the shares in the offering or the offering is voided. More specifically, the underwriter must receive the offering by a certain date and sell it within a specified period of time. Otherwise the entire offering will be returned.

- In a **mini-max commitment**, the underwriter commits to sell a minimum number of shares of the offering or the offering will be cancelled. The underwriter is expected only to use his best efforts to sell the remainder. A mini-max is sometimes called a part-or-none commitment.

Either of these best efforts commitments may have a **market-out clause**, where the underwriter is permitted to cancel the agreement without penalty for certain specified reasons. An unexpected downturn in the market, for example, or a looming recession would make sales of the new issue difficult or impossible at the agreed upon price. Major investment bankers rarely participate in best efforts offerings, because the size of the offering offers limited profitability.

Anti-Fraud Rules for Best Efforts Commitments. Two Exchange Act rules govern the conduct of a best efforts commitment underwriting. **SEC Rule 15c2-4** requires that payments for securities in an “all or none” or “mini-max” offering be deposited into a separate segregated escrow account of an independent bank until the conditions of the offering are satisfied. The bank is called the escrow agent. This rule was put into place to ensure that purchasers will get their money back if the offering is cancelled.

An **escrow account** is an account where funds are held by a third-party (the escrow agent), but the funds do not belong to this party. The funds in an escrow account cannot be commingled with the third party’s funds. Under Rule 15c2-4, the escrow agents may only invest in safe investments, such as bank accounts, bank money-market accounts, short-term CDs issued by the bank, or short-term securities issued by the U.S. government.

The following investments are specifically not allowed under the rule:

- Money-market funds
- Corporate equity or debt securities
- Repurchase agreements
- Banker’s acceptances
- Commercial paper
- Municipal securities

SEC Rule 15c2-4 requires that all checks, drafts, and money orders received from prospective purchasers be delivered promptly to the escrow agent for deposit in an escrow account. In this case promptly means by noon of the next business day after receipt. The escrow agent must be a U.S. commercial bank that is unaffiliated with either the issuer or the underwriter. It may also be a savings and loan institution that is FSLIC-insured and FHLBB-regulated.

SEC Rule 15c2-4 applies to private placements as well as public offerings.

SEC Rule 10b-9 is an anti-fraud rule that prohibits any person from misrepresenting the terms of an all-or-none or part-or-none offering. For example, suppose an issuer offers a specified number of shares of common stock for sale to the public in 90 days on an all-or-none basis. If the issuer were to buy a portion of its own offering to meet the all-or-none commitment or to extend the 90-day deadline, it would be a misrepresentation of the

offering and a violation of Rule 10b-9, unless these actions had been specifically anticipated and permitted in the prospectus.

Standby Offering

A standby offering is a type of underwriting commitment used for a rights offering. A **rights offering** is the issuance of new shares that are offered exclusively to the company's existing shareholders for a limited period of time. Shareholders may have two to four weeks to purchase the securities at the subscription price.

In a **standby offering**, an underwriter commits to pay the subscription price for any unsold shares at the end of the subscription period so that shareholders have the option to maintain their current proportional ownership (their preemptive right). A standby underwriting guarantees the issuing company that its shares will be sold at its given price. The underwriter is paid a fee for taking the risk of a decline in the market price from the original subscription price during the period of the rights offering.

UNDERWRITING PROCESS: THE QUIET PERIOD

After an issuer decides to proceed with an offering of new securities, it will begin the process of selecting an underwriter and writing a registration statement and prospectus for filing with the SEC. Once a letter of intent has been signed with the lead underwriter, an organizational meeting will kick off the process, in which the parties will discuss the terms and structure of the offering, propose a registration timetable, and assign among themselves their responsibilities and tasks. This period of time is called the **quiet period**, because improper public disclosures concerning the proposed offering prior to filing the registration statement could jeopardize the undertaking.

Letter of Intent and Due Diligence

With the issuer's selection of an investment bank to underwrite the offering, both parties will sign a *non-binding* agreement called a **letter of intent (LOI)**. The letter of intent is a tentative agreement between the two parties, setting out the basic terms of their relationship and the terms of the offering. If a syndicate is to be formed to help underwrite the offering, the underwriter will use this time to invite other investment banks to help with the offering. The underwriter will also help the issuer with the preparation of the registration statement for the offering.

The letter of intent also allows the investment bank to conduct due diligence on the issuer before agreeing to take on the financial responsibility of the offering. **Due diligence** typically involves examining the issuer's books and records to evaluate its financial viability and assessing the state of the market for the new issue. The investment bank will look for any evidence that the issuer's securities might not be a good investment. Key elements of the due diligence process include background checks on senior officers; examining the company's financial data; analyzing any pending or potential lawsuits; evaluating corporate bylaws; studying relevant contracts, patents, and copyrights; and conducting industry research.

Commitment Committee

During the due diligence process, the underwriter will present the transaction to the investment bank's **commitment committee**. The underwriter and a team of research analysts will report their findings to this committee, which will assess any risks the IPO might cause for the firm. The committee ultimately will approve or deny the firm's participation in the offering after reviewing the results of the due diligence process.

Formation of the Underwriting Syndicate

In most cases, the underwriter that is selected by the issuer will not want to bear all the financial risk of the offering. For this reason, the underwriter will invite other investment banks during the due diligence period to join in the underwriting. This group of underwriters is called the **syndicate**, and each member of the syndicate will be allotted a certain amount of shares that they will be responsible for selling. The underwriter that manages the underwriting has several different names: it might be called the **lead underwriter**, **managing underwriter**, **book manager**, or even **book runner**. If there is more than one lead manager, the two lead managers are referred to as co-managers.

The responsibilities of the syndicate manager or lead underwriter include the formation of the syndicate, selecting the firms that will compose the selling group, and establishing the underwriters' retention fee. In addition, the syndicate manager has authority to make stabilizing bids in the aftermarket. Stabilizing purchases are meant to create demand for securities whose price is in a dangerous decline or to cover a syndicate short position in the context of a green shoe or overallocation situation.

Sometimes syndicate members sell their allotment to investors who resell or "flip" their shares at the stabilizing price in the aftermarket. The syndicate manager has authority to impose a penalty bid on a member who sells shares to investors who flip sales. A **penalty bid** is typically the forfeiture of the member's compensation for that transaction. Penalties may also include the withholding of a certain percentage of the member's per share compensation. Penalty bids are meant to encourage syndicate members to be wary of selling shares to potential flippers.

Agreement Among Underwriters

The Agreement Among Underwriters describes the rights and liabilities of the syndicate members with respect to the syndicate manager and among each other. This agreement is also called the **syndicate agreement** and the **purchase group agreement**. Some of the most important characteristics of the syndicate agreement are that it:

- Identifies the lead underwriter and any co-managers and grants authority to the lead underwriter to act on behalf of the syndicate and to execute the final underwriting agreement with the issuer.
- Spells out the duties and rights of each member of the syndicate.
- States the allocation of shares and the liability of each underwriter. If the account is a Western account, members are responsible only for paying for the shares they are

allotted. If the account is an Eastern account, members will be financially responsible for any unsold shares on a pro-rata basis.

- Sets the management fee to be paid the lead underwriter and details the compensation for each of the other underwriters and describes how the delivery and payment for securities will be completed.
- Grants the lead underwriter authority to make stabilizing bids.
- Authorizes the lead underwriter to qualify the issue in the various states (to **blue sky** the issue).

The agreement requires syndicate members to offer securities only at the established price, unless they are released from that obligation by the lead underwriter.

Blue Sky Provisions

A **blue sky law** is a state law that regulates the offering and sale of securities to protect that state against securities fraud. New issues must be registered in each state in which they are offered for sale. State registration may take one of three forms. **Notification registration** requires the filing of an offering document with certain disclosures. It is available in most states for securities already registered with the SEC, but to qualify issuers must have been in continuous operation over the past 5 years and have a specified amount of net earnings over the past 3 years. **Coordination registration** is an automatic registration which goes into effect on the effective date of the SEC registration. **Qualification registration** is available in all states for issues that are not registered by the federal government, and it has stricter requirements than the SEC. The registration only becomes effective when the state approves it. Since a qualification registration is stricter than other registrations, it is applied for only when other registrations are not available to the issuer. So which securities must register in the various states? Any security that does not trade on an exchange or is not issued by a government, bank, or insurance company.

UNDERWRITING PROCESS: COOLING-OFF PERIOD

Once the lead underwriters and the issuer have completed the registration statement and filed it with the SEC, a 20-day **cooling-off period** ensues, in which the public has time to study the information in the registration statement and accompanying preliminary prospectus. The lead underwriter and issuer present the offering to potential investors, usually institutional investors, in a series of road shows in which they both solicit interest in the offering and collect information on its strength in the market. The **road show** consists of a management presentation and a question-and-answer session. Because the investment banker cannot actually sell the securities, it will collect indications of interest from the investors. During this period due diligence continues, the underwriting syndicate continues to be formed and the selling group is assembled. When the cooling-off period ends, the registration automatically becomes effective, unless the SEC finds some reason to issue a stop order.

If there are no material omissions or misleading statements, the registration statement