

## CHAPTER 2

# **The Market for Corporate Securities**

---

*45 out of 100 Questions on the Exam*

### **Primary Market: Issuing Corporate Securities**

When a company decides to raise money by issuing stocks or bonds, it is not allowed to simply sell these securities to anyone in any way it pleases. Because the government wants to protect potential investors, there are many rules about how stocks and bonds can be issued and sold. The most important piece of legislation that you will need to know regarding how securities are issued is the **Securities Act of 1933**. The 1933 Act was born out of the fraudulent and unrestrained investment practices that led to the stock market crash of 1929.

The Act has two main purposes: (1) to require that companies publicly disclose all relevant financial information about their securities prior to offering them for sale, and (2) to prohibit fraud and deceit in the marketing of securities. The heart of the law is Section 5, which requires that securities be registered with the federal government prior to their sale. Regulators decided that not all securities need to be registered at the federal level, however, and Section 4 of the Act exempts certain securities and transactions from the registration process.

### **PUBLIC SECURITIES OFFERINGS**

---

When a company issues and offers new securities for the first time, the issue is said to be sold in the primary market. Proceeds from sales in the **primary market** always go to the company that issues them. Once new equity or debt securities have been registered with the SEC and sold in the primary market, the shares can then be freely traded with other investors. When securities are being bought and sold between investors, they are said to be sold in the **secondary market**. The proceeds from sales in the secondary market do not go to the issuer, **but to the party who sells the shares**.

Most primary offerings must register with the SEC prior to offering securities to the general public. Shares are then issued to the public through a highly regulated public process.

New issues may also be offered privately to a small, select group of investors without registering with the SEC. This is called a **private placement**. Issuers of private offerings must meet certain conditions to qualify.

### TYPES OF PUBLIC SECURITIES OFFERINGS THAT NEED TO BE REGISTERED

#### Primary Offering

If the company has never issued shares before, the first offering of shares is called an **initial public offering** (IPO). When an issuing company that has already had an IPO offers additional shares to the public, it is called a **subsequent** or **follow-on offering**. With both an IPO and a subsequent offering, new shares are being offered to the public, and proceeds go to the issuer. Both sales are conducted in the primary market and are types of **primary offerings**.

#### Secondary Offering

Sometimes a major stockholder, an institution, perhaps, or a corporate founder, will want to sell a large block of shares, either to diversify her own holdings or to enable other institutions to acquire a significant stake in the company. This is called a **secondary offering**. As in a primary offering, secondary offerings are handled by an underwriter, who purchases shares at a discount and sells them at a fixed offering price. Unlike a primary offering, the securities being sold in a secondary offering have previously been issued, and its proceeds will go to the shareholder, not the issuing company.

### UNDERWRITING A PUBLIC OFFERING

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 to the public.

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 underwriter's 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 Underwriting.** 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. It would be a misrepresentation of the offering and a violation of Rule 10b-9 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, unless these actions had been specifically anticipated and permitted in the prospectus. This rule also applies to private placements.