6.1.3.2. Rights Offerings

Sometimes companies decide to raise money by carrying out a **rights offering**, in which the company sells new shares to current shareholders only. Current shareholders are offered the right to purchase enough additional stock to keep their ownership in the company proportionate to what it was before the rights offering. The rights granted in a rights offering may be referred to as **subscription rights** or simply **rights**.

Additionally, subscription rights often entitle shareholders to buy the shares at a discount price, called the **subscription price**. A subscription right usually has a life of only two to four weeks and will expire if not used.

Current shareholders may choose to ignore a rights offering, but note that if they do not purchase shares, the value of their current shares will be diluted because more shares will have been issued. Shareholders may also sell their rights. If the company is exchange-listed, the subscription rights may be traded on any securities exchange where the company's common stock is traded.

Many established companies file shelf registrations allowing them to conduct rights offerings as needed.

6.1.3.3. Bond Offerings

The Trust Indenture Act of 1939 states that all companies that issue more than $5 million of corporate bonds must sell these bonds under a **trust indenture** (sometimes called a **bond indenture**). A trust indenture is a contract that spells out the covenants (commitments) to be honored by the issuer and allows a trustee to take action on behalf of the bondholders in the event of default. The indenture is made between the issuer and an outside trustee who represents the bondholders' interests. It is the responsibility of the company to appoint this outside trustee. If the company goes bankrupt, the trustee will try to recoup the bondholders' money through bankruptcy court.

The Trust Indenture Act applies only to corporate bond offerings that are in excess of $5 million issued over one year. Government-issued debt, such as Treasury bonds and municipal bonds, is not covered under the Act. Notes that mature in less than 270 days are also exempted from the Act.

6.1.4. THE PRE-FILING PERIOD

After an issuer decides to proceed with an offering of new securities, it will typically begin the process of selecting an underwriter to assist with the issue, a process that involves writing a registration statement and prospectus, both of which will be filed with the SEC.

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. The letter of intent allows the underwriter 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 performing 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.

At the same time, the underwriter and issuer will be negotiating the **Underwriting Agreement (UA)**, which is a more detailed version of the LOI that is intended to be binding once signed. The UA includes:

- The public offering price of the securities
- The per-share underwriting spread
- A settlement date on which the issuer will receive payment and deliver the securities to the syndicate
- The net proceeds to be received by the issuer and which costs will be borne by which parties
- The details of the offering's over-allotment (greenshoe) option, if there is one (these are discussed later in this chapter)
- Legal provisions allowing the underwriter to terminate the contract under certain conditions

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 **underwriting syndicate**, or just the **syndicate**. Each member of the syndicate will be allotted a certain amount of shares that they will be responsible for selling. The underwriter that was chosen by the issuer and manages the underwriting syndicate has several different names: it might be called the **lead underwriter**, **managing underwriter**, **deal manager**, **book manager**, or even **book runner**. The lead manager may choose to split its management duties with another member of the syndicate, called a **co-manager**.

All syndicate members sign an **Agreement Among Underwriters (AAU)** that:

- Identifies the lead underwriter 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
- Sets the management fee to be paid to the lead underwriter, 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, which are discussed later in this chapter
- Authorizes the lead underwriter to qualify the issue in the various states (to meet individual states' blue sky requirements for the issue)

In addition to (or sometimes instead of) the syndicate, the lead underwriter may also form a **selling group** of broker-dealers who help market and sell the securities. These broker-dealers, called **selected dealers** or **selling group members**, are not actual underwriters. They are compensated for selling shares but are not financially responsible for unsold shares. Because they take on less financial risk, they are compensated less than members of the underwriting syndicate. The blanket term **distribution participants** may be used to refer to both underwriters and selected dealers.

Selected dealers enter into an agreement with the syndicate called the **Selling Group Agreement (SGA)**, which includes:

- Specifics of the dealers' compensation for shares sold
- Provision that compels dealers to follow self-regulatory organization (SRO) requirements and to sell securities at the public offering price
- Price of the securities

The UA, AAU, and SGA are typically not signed until just before the offering officially commences, even though their terms are typically agreed upon much earlier. This is because FINRA requires the price of the securities to be included in the final versions of the UA, AAU, and SGA. As we will discuss later, the final decision about pricing is not made until just before the start of the offering.

SUMMARY

SYNDICATE AGREEMENTS

Agreement	What Is Included
Underwriting Agreement (UA)	• Per-share underwriting spread • Over-allotment (greenshoe) option, if there is one • Public offering price
Agreement Among Underwriters (AAU)	• Duties and rights of each member of the syndicate • Allocation of shares and the liability of each underwriter • Identity of the lead underwriter and any co-managers • Authority of the lead underwriter to make stabilizing bids and enter into the underwriting agreement on behalf of the syndicate • Compensation for each underwriter and the compensation offered to the brokers who are selling the securities • Public offering price
Selling Group Agreement (SGA)	• Specifics of the dealers' compensation for shares sold • Provision that compels dealers to follow SRO requirements and to sell securities at the public offering price • Public offering price

6.1.4.1. Testing the Waters

An issuer that is considering whether to conduct a registered offering may **test the waters** with potential investors before filing anything with the SEC. **Test-the-waters communications** are oral or written communications meant to gauge investor interest in a contemplated securities offering. Testing the waters allows an issuer the flexibility to change its mind about an offering based on the level of investor interest. An issuer that never goes beyond testing the waters can decide not to conduct the offering without having to withdraw any filings or take any further action. For registered offerings, testing the waters is limited to two categories of large institutional investor: institutions that qualify as accredited investors, discussed in the section on Regulation D (see page 197); and QIBs, discussed in the section on Rule 144A (see page 207).

6.1.5. THE COOLING-OFF PERIOD

Once the lead underwriter and the issuer have completed the registration statement, they will file it with the SEC. As soon as the filing takes place, a 20-calendar-day **cooling-off period** ensues, during which the SEC and the public have time to study the information in the registration statement and the accompanying **preliminary prospectus** (also called a **red herring**).

The information that must be in the preliminary prospectus includes:

- All material information about the offering (e.g., price, amount of stock offered, expenses, commissions, net proceeds, use of proceeds, underwriters)
- General information about the issuer (e.g., issuer's market capitalization, info about insiders and their holdings)
- Financial information about the issuer (e.g., income statements, balance sheets, cash flow statements)
- Copies of other relevant documents (e.g., underwriter agreements, issuer's articles of incorporation, indentures)

When reviewing a registration statement, the SEC will never judge the merits of the securities or evaluate whether the offering is a good investment. In fact, the Securities Act makes it unlawful to portray the allowing of a registration to take effect as any sort of SEC approval. It's even unlawful to portray it as a finding by the SEC that the registration statement is truthful, despite the fact that the SEC makes a good-faith effort within the limitations of its review process to identify inaccuracies. The same prohibitions apply to the filing of a registration statement—it may not be represented as anything but a filing. This part of the Securities Act is very broadly worded, and any statement that remotely sounds like an attempt to trade on the reputation or prestige of the SEC should be strictly avoided.

Remember: The SEC never "approves" a registration statement for a securities issue. Instead, if it finds no material omissions or misleading statements, it simply allows the registration statement to become effective.

During the cooling-off period, both the issuer and the lead underwriter will try to solicit investor interest in the new issue. This often involves a **road show**, where the lead underwriter and the issuer's management will meet with potential investors, especially institutional ones. Potential investors will be given a preliminary prospectus as a disclosure document. The preliminary prospectus is part of the registration statement and is described in detail later in the chapter. Broker-dealers that participate in the distribution must provide a copy of the preliminary prospectus to anyone who requests it. The preliminary prospectus contains almost all the same information as the final prospectus, other than the public offering price, which is typically set the night before the offering.

All sales of the offered securities are prohibited during the cooling-off period. Only limited offers of the securities are allowed, but note that these offers are only made to drum up sales made after the registration statement has become effective. Written offers may be made in the form of a free writing prospectus, which in most cases must be filed with the SEC prior to use. A **free writing prospectus (FWP)** is a written offer to sell or solicitation to buy the securities in an offering, made after the registration statement has been filed. Depending on the issuer, an FWP might or might not need to be accompanied by a preliminary prospectus. Oral offers may also be made during the cooling-off period.

Note: WKSIs, and only WKSIs, may conduct road shows and distribute FWPs during the pre-filing period.

Note: SPACs may not use FWPs.

Because sales cannot yet take place, orders from buyers may not be accepted. However, non-binding **indications of interest (IOIs)** may be accepted from prospective buyers. IOIs help the issuer and underwriters assess demand for the securities, which may help determine the price. IOIs help the prospective buyer because, later on, the issuer and underwriters are permitted to give priority to orders from those who previously submitted IOIs. Note that the issuer and underwriters are not permitted to promise to accept a future order from a potential buyer based on an IOI. Such a promise assumes that the offering will be allowed to take place. The issuer and underwriters can merely give priority to those who submitted IOIs *if* sales are later permitted.

Also allowed during the cooling-off period are so-called **tombstone ads**, which consist of plain text enclosed in a simple border (and thus somewhat resemble a tombstone). Tombstone ads typically include basic information such as the issuer, the type of the security (stock, bond, etc.), the amount being offered, and the name of the underwriter. A tombstone ad must include a legend stating that the securities may not be sold and offers to buy may not be accepted prior to the effective date. It must also state where a preliminary prospectus may be obtained.

This announcement is not an offer of securities for sale or a solicitation of an offer to buy securities

150,000 shares

MEGAHUGE CORPORATION

Common Stock

Copies of the Prospectus may be obtained from such of the undersigned (who are among the underwriters named in the prospectus) as may legally offer these securities under applicable securities laws.

Selle & Proffitt Co.

Wheeler & Dealer Co.

F.R. Palomino & Co.

6.1.5.1. Delaying Amendments, Deficiency Letters, and Acceleration

The 20-day timeframe for the cooling-off period is how things are supposed to work in theory, and you definitely need to know it for the exam. But in practice, registrations have grown in number and complexity since 1933, and today the SEC is not able to fully review every registration statement within the 20-day window stated in the Securities Act.

To address this fact, registration statements are routinely filed with a **delaying amendment**, which acts as a sort of rolling amendment that constantly pushes off the end of the cooling-off period. As long as the delaying amendment is there, the end of the cooling-off period is always treated as being 20 calendar days in the future. Despite being an "amendment," it is typically filed at the same time as the registration statement. SEC staff review the registration statement, and then issue comments or suggest corrections via a deficiency letter. (The SEC does not actually review every filing, although it does review every IPO filing.)

If the SEC finds material omissions, misleading statements, or other problems, it will send a deficiency letter. A **deficiency letter** is an order to amend the registration statement, often by providing additional information. Once an amendment has been filed, the SEC will review the amended registration statement. If the amendment did not satisfy the SEC's concerns, the SEC will send another deficiency letter and the issuer will need to file another amendment.

An amendment filed in response to a deficiency letter does *not* start the clock over on the 20 days, provided the SEC finds that the amendment actually addressed the deficiencies. Amendments that the issuer makes on its own initiative generally *do* start the clock over, although the SEC is allowed to grant exceptions.

Once the SEC is satisfied that the registration statement contains no material omissions or misleading statements, and that various criteria have been met—for example, widespread dissemination of the preliminary prospectus—then the issuer may request acceleration. **Acceleration** is said to occur when the SEC issues an order allowing the cooling-off period to end immediately. When acceleration is granted, the registration statement becomes **effective**, meaning that the securities described in the registration statement may be sold. Granting acceleration is, for all practical purposes, how the SEC gives its go-ahead to conduct the offering.

6.1.6. THE POST-EFFECTIVE PERIOD

The **post-effective period** is the period that begins on the **effective date**, which is the date that the registration statement is allowed by the SEC to become effective. After the effective date, the offering may officially begin. The date on which the formal start of the offering occurs is called the **offering date**. While the offering date typically follows close on the heels of the effective date, they are not the same thing. There are still a few things to be done between the effective and offering dates, including:

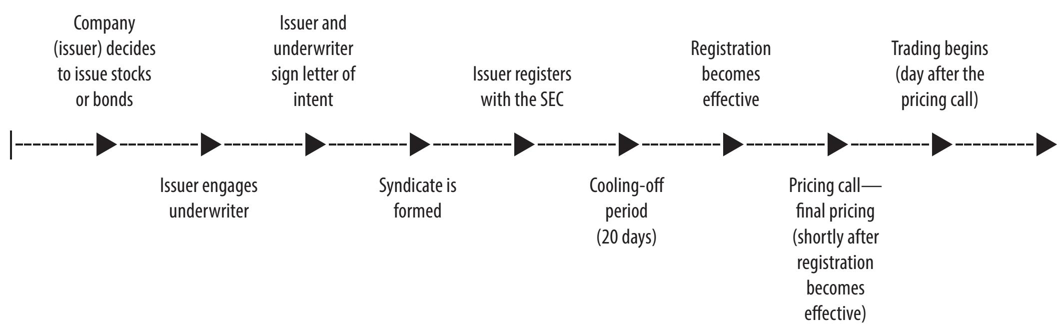
- **Bring-down due diligence.** Recall that due diligence begins early in the pre-filing period, when the lead underwriter and issuer sign a letter of intent. Circumstances can change between this initial due diligence and the beginning of the offering. Just before the offering date, the underwriter confirms that the information discovered or verified by previous due diligence is still valid. This is known as bring-down due diligence.

- **Pricing call.** Up to this point, the public offering price—the price at which the offering will be sold to investors—is not yet set. When underwriters present the offering on the road show, they present a possible price range to investors and assess investors' interest. The actual price is usually set the night before the offering date. The meeting between the issuer and lead underwriter at which the final decision about pricing is made is sometimes called the **pricing call**.

- **Signing the UA, AAU, and SGA.** As mentioned previously, the terms of the Underwriting Agreement, Agreement Among Underwriters, and Selling Group Agreement are negotiated in the pre-filing period, but these agreements are not signed until just before the offering begins. This is because FINRA requires the public offering price to be inserted into the finalized UA, AAU, and SGA. If the offering is an IPO, FINRA's New Issue Rule (discussed later in this chapter) requires the lead underwriter to file a list of syndicate and selling group members with FINRA on or before the offering date.

On the offering date, the underwriter may begin selling the securities to investors at the public offering price. The price is inserted into the preliminary prospectus, and the resulting **final prospectus** is filed with the SEC. This document will also serve as the disclosure document for customers who purchase securities in the offering. In most cases, it must also be distributed to those who buy the securities on the secondary market for a period of time after the offering date.

Remember: The contents of the final prospectus are the same as those of the preliminary prospectus, with the addition of the public offering price.



6.1.6.1. Delivery of a Prospectus

A prospectus must be provided to an interested investor before completion of a transaction (settlement) for a security that has been recently issued. To ensure that broker-dealers and agents live up to their obligations with regard to prospectus delivery, the SEC has established the following guidelines:

Prospectuses must be given for new issues only. After an issue is no longer considered to be new, the SEC assumes that there is enough information out in the market for investors to make informed decisions and the prospectus is no longer required.

What is considered a new issue? An IPO conducted on an exchange like the NYSE or Nasdaq is considered a new issue for 25 days after the offering date. A prospectus must be provided to anyone who buys the stock during this time, whether on the primary or secondary market. Over-the-counter IPOs are considered new issues for 90 days after the offering date. There is a difference between the exchanges and the OTC because the SEC assumes that there will be more information out in the market about companies that go public on an exchange than over the counter. For follow-on offerings, an OTC offering is a new issue for 40 days. Follow-on offerings of exchange-traded securities have no prospectus delivery requirement after the offering date.

When does the prospectus need to be given to the customer? A prospectus must be given to a customer by the confirmation of the transaction. This means at the time the trade confirmation is given to the customer, which can be no later than when the transaction settles (usually not later than two business days after the trade date).

Additionally, those who are expected to be among the initial buyers in an IPO need to have received preliminary prospectuses a minimum of 48 hours prior to the offering date. This ensures that the initial buyers have all gotten a preliminary prospectus before they make their purchases.

What these requirements boil down to is the fact that a broker-dealer or agent must keep its customer apprised of all important information related to new issues. This means it must offer full disclosure, which is, in essence, what a prospectus is meant to provide. By making that document available to customers, broker-dealers and agents are performing their duties. Failure to deliver the prospectus in a timely manner will result in regulatory actions against the violating firm.

SEC Rule 174

SAMPLE QUESTION

Jonas purchases 1,000 shares of APXD, which is traded on the NYSE, 30 days after its IPO. When must he receive a copy of the final prospectus?

A. A prospectus is not required for this transaction
B. By the trade date
C. Two business days after the trade date
D. 48 hours before the trade date

Answer: A. Since Jonas purchased shares of an exchange-traded security more than 25 days after it was first sold, no prospectus is required. Had he purchased the shares before 25 days had passed, delivery of the final prospectus would have been required by the time of trade confirmation, which must occur no later than two business days after the trade date.

DELIVERY OF A PROSPECTUS TO BUYERS ON THE SECONDARY MARKET

	Exchange-Listed Securities	OTC Securities
IPOs	25 days after the offering date	90 days after the offering date
Follow-On Offerings	No requirement after the offering date	40 days after the offering date

6.1.6.1.1. Electronic Delivery Requirements

According to the SEC, a company may provide its customers electronic access to prospectuses, shareholder reports, and proxy solicitations if the electronic access satisfies four properties: same content, timely notice, equivalent access, and evidence of delivery.

1. **Same content**. The content of the electronic documents must be the same as the paper version of the documents.

2. **Timely notice**. Investors must be notified in a timely and adequate manner that the electronic documents are available to them. In this case, "timely" means at least by the time paper documents would be or would have been sent out. "Adequate"