CHAPTER FOUR

Supervision of Investment Banking and Research

(32 questions on the exam)

The securities industry is fundamentally about raising and investing money. When a company wants to raise money, it has two options. First, it can sell partial ownership in the business by issuing equal units of ownership called "shares" or "stock" (the terms are used interchangeably and mean the same thing). Investors buy shares and become partial owners of the company. The more shares investors purchase, the more of the company they own. Raising money this way is called **equity financing**, and the purchased shares or stock are called **equity securities**. In accounting terms, "equity" means what is left over after all debts have been paid. This is the portion that is owned outright, without debt. So equity financing can be seen as selling a stake in "what's left over," or the ownership in the business.

The second option for a company that wants to raise money is for it to issue **debt securities**. A debt security is a promise by the company (the issuer) to pay the investor a specific amount of money in the future and also to pay periodic interest along the way in exchange for a fixed amount of money from the investor now. **Bonds** and notes are two common types of debt securities.

When a company raises money by issuing debt securities, it is called **debt financing** because the borrower (the company/issuer) will have to pay back the lender (investor) in the future. Equity financing (selling ownership) is not generally available to governments because they cannot sell ownership, so governmental organizations raise money through issuing bonds and other debt securities. A bond issued by the federal government is a Treasury bond, and a bond issued by a state, city, or county is a municipal bond.

In sum, there are two ways to raise money through the securities markets. Issuing stock means selling equity in the business (equity is ownership, so buying an equity security means purchasing ownership). Issuing bonds means issuing debt securities; investors who buy debt securities are in effect lending money to the issuing company.

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4.1. UNDERWRITING A SECURITIES ISSUE

To execute and enforce the registration process laid out in the Securities Act of 1933, the 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 new securities to the public.

Before selling shares to the public, a company must first engage an investment bank to act as its underwriter. An **underwriter** 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 at a discount and assume the financial 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.

4.1.1. 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:

1. 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**

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offerings are common for new issues of municipal bonds and public utilities but rare for corporate offerings.

2. 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 or a private placement, 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 required portion of the issue has not been sold by the end of the subscription period, the offering will be cancelled, the securities are returned to the issuer, and the money is returned to the investors.

There are two types of best-efforts commitments:

1. 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.

2. 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 its 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**, in which 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.

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

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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. 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.

Note: Issuers of private placements typically engage underwriters in a best-efforts commitment.

EXERCISE

MATCH THE FOLLOWING TERMS WITH THE BEST RELATING STATEMENT

A. All-or-none commitment
B. Best-efforts commitment
C. Firm commitment
D. Mini-max commitment

1. **____ 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 its best efforts to sell the remainder.**

2. **____ The underwriter agrees to purchase all the securities at a discount and then sell the securities to the public at a public offering price. The underwriter assumes all the risk of the offering, including the liability of any unsold shares.**

3. **____ The underwriter sells all the shares in the offering or the offering is voided.**

4. **____ 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 and is not financially responsible for the securities it does not sell.**

Answers: 1. D; 2. C; 3. A; 4. B

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4.1.2. TYPES OF SECURITIES OFFERINGS

When a company issues and sells new shares to the public, it is called a **primary offering.** The proceeds of a primary offering go to the issuer of the securities. When new shares are sold for the first time to the public, the offering takes place in what is called the **primary market**. If the company has never issued shares before, the first offering of shares is referred to as an **initial public offering (IPO).** Once the shares have been registered with the SEC and purchased in the public offering, the shares can then be freely traded with other investors. The market for the shares that are being bought and sold by the public at large is called the **secondary market**. The proceeds of these sales do not go to the issuer, but instead go to the party that is selling the shares.

Sometimes a major stockholder, an institution, perhaps, or a corporate founder, will want to sell a large block of shares, either to diversify its 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, which purchases shares at a discount and sells them at a fixed offering price. Unlike a primary offering, proceeds from a secondary offering go to the shareholder, not the issuing company.

4.1.2.1. Follow-On Offering

If a company decides to sell additional shares to the public after the initial public offering, it is called a **follow-on offering**. A follow-on offering may constitute a primary offering, a secondary offering, or a combination of the two. A follow-on may be offered by a seasoned company that is funding new growth, a struggling company strapped for cash, or a major investor that wishes to liquidate some or all of her holdings. Follow-on offerings are also known as **additional issue offerings**, **add-ons**, and **seasoned equity offerings.**

4.1.2.2. Shelf Offering

In most public offerings, an issuer will register and issue a specified number of securities and will attempt to sell all the securities in one day. An alternative is to file a shelf registration and conduct a shelf offering. A **shelf registration** is a registration statement filed for a large number of securities, which the issuer does not intend to sell immediately. Instead, the issuer puts the securities "on a shelf" and "takes them down" to sell when the market is favorable. A shelf registration may be used for either equity or debt securities. An offering made using a shelf registration is called a **shelf offering**, and the portion of a shelf offering being taken down off the shelf at a particular time is sometimes referred to as a **takedown**.

A shelf registration is an exception to the normal rule that the preliminary prospectus must contain everything in the final prospectus except for the price. A shelf registration is permitted to omit information that is unknown or not reasonably available at the time of filing. However, before the issuer may perform any takedowns, it must amend the registration statement to include this information. This amendment also specifies the pricing to be used for the takedown.

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As a result, when the securities are taken down off the shelf to sell, the issuer must distribute both the preliminary prospectus from the original shelf registration statement (called the **base prospectus**) and the newly filed amendments to Part I of the registration statement (called the **prospectus supplement**). The prospectus supplement contains information specific to the takedown, whereas the base prospectus applies to the shelf registration as a whole. You can think of the base and supplement together as being like a final prospectus.

A shelf offering may take place over a longer-than-normal offering period, or an offering period that begins well after the effective date of the registration statement. A **continuous offering** is a shelf offering that begins promptly after the effective date, but remains open continuously for more than 30 days following the effective date. By contrast, a **delayed offering** does not begin until some future date, perhaps well after the effective date.

Some options with regard to shelf registrations/offerings are only available to certain issuers. With some exceptions, the ability to conduct delayed offerings is limited to issuers eligible to file registration statements using Form S-3, whereas continuous offerings are available to those filing registration statements using either Form S-3 or the longer and more demanding Form S-1. **Form S-1** is used by issuers who do not qualify or choose not to use a different form. It is used for almost all IPOs. **Form S-3** is an abbreviated registration statement form that is available for use by companies that are already reporting issuers and meet certain other requirements. Shelf registrations filed on Form S-1 expire after two years, whereas shelf registrations filed on Form S-3 expire after three years.

Another advantage of being able to file a shelf registration using Form S-3 instead of Form S-1 is the ability to conduct an at-the-market offering. An **at-the-market offering** is one in which securities may be sold at whatever the market price is at the time of the sale. An at-the-market offering merely introduces into the market new shares of an existing class of shares. It allows an issuer to dribble these shares into the market and, in so doing, hopefully minimize the impact on the security's share price. Because they do not require management to go on road shows to sell the securities, at-the-market offerings are typically lower cost and require less management involvement than traditional follow-on offerings. At-the-market offerings tend to be smaller than other follow-on offerings and therefore raise less money for the issuer. They tend to be used by issuers that need to regularly raise small amounts of capital.

Which issuers may use Form S-3 is discussed later in this chapter. One category of issuer that will be discussed is called a well-known seasoned issuer (WKSI). For now, just know that only a WKSI may file an **automatic shelf registration**, which is a shelf registration that becomes effective when it is filed, without having to wait for the SEC's review.

SEC Rule 415

SHELF REGISTRATIONS: FORM S-1 VS. S-3

	Form S-3	Form S-1
Used by	Large issuers that have issued securities before	Issuers who are not able to meet S-3 requirements, such as most IPOs, business combinations and small issuers

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SHELF REGISTRATIONS: FORM S-1 VS. S-3

	Form S-3	Form S-1
Used for	Delayed and continuous offerings	Continuous offerings only
Lasts	Three years	Two years
At-the-Market Offerings?	Yes	No
Automatic Shelf Registrations by WKSIs?	Yes	No

4.1.2.3. Rights Offering

When a company issues additional shares in a follow-on offering, current shareholders may have the right to retain their proportional ownership in the company. In order to meet this obligation to existing shareholders, companies carry out a **rights offering**, in which the current shareholders are offered enough new stock to keep their proportionate ownership. Often, a shelf registration is used to conduct a rights offering. Rights offerings are usually conducted before a follow-on offering, and the stock is usually sold at a discount. Shareholders do not have to exercise their right to buy the discounted stock. In response to this, the issuer may enter into an agreement with a **standby underwriter**, which agrees to purchase any shares that were not bought in the rights offering in a firm commitment. This is called a **standby underwriting**.

4.1.2.4. 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**. 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 bondholder's 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 bondholder's 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.

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