

# Issuing Securities

Earlier we told the story of Frank & Emma's Fruit Pies, who raised money from investors by completing an initial public offering of common stock. As we said, Frank & Emma's had done quite well as a private company, getting financing from the local bank through lines of credit, and financing next year's projects with this year's profits. But, in order to take things to the next level, the corporate officers and owners of the company (Jeremy, Jason, and Jennifer) decided to sell a percentage of ownership to investors. They went through a group of underwriters, who kept a spread for their trouble and raised \$100 million for the company. The investors, who now hold shares of common stock, can either hang onto their investment or sell it to other investors on the secondary market. That liquidity, or ability to turn an asset into cash-money, is a big reason investors are willing to buy the stock in the first place. Few investors, in other words, want to be like the limited partners we looked at, who might not be able to sell their investments for a while, if at all. Frank & Emma's common stock trades on **NASDAQ**, so liquidity has not been a problem.

Or, maybe you don't like little pretend companies like Frank & Emma's Fruit Pies; so, let's use another example. Several years ago Google made headlines with its famous **initial public offering** or **IPO** in which they sold stock to investors at \$85 and those investors then watched the stock climb to the high 600s. The difference between the initial \$85 price and the eventual price of, say, \$650, is the difference between the primary and secondary markets. Securities are issued to investors in the **primary market** to raise capital for the issuer. Securities are traded among investors in the **secondary market**.

To do an initial public offering on the primary market, a company simply sells an ownership stake to investors in exchange for a big infusion of cash that can be used to expand the business. The company takes the money and invests the capital in manufacturing equipment, computers, more employees, a fleet of delivery vans, etc., and the investors end up owning a percentage of the company. Now, nothing makes the securities regulators more nervous than to hear that a company wants to raise money from investors. Let's face it, many business owners would say anything investors wanted to hear in order to get their hands on a few billion dollars. That's why the state and federal securities regulators like to slow down the issuers in much the same way they're slowing you down right now. Just tying you up with a little paperwork, giving you a chance to rethink your whole decision, making sure it's something you really, really want to do.

The SEC wants to see exactly what the issuers will be telling their potential investors in the **prospectus**, which is part of the registration statement. They want the issuers to provide the whole story on the company: history, competitors, products and services, risks of investing in the

company, financials, board of directors, officers, etc. And, like a fussy English instructor, they want it written in clear, readable language. Only if investors clearly understand the risks and rewards of an investment do they really have a fair chance of determining a good investment opportunity from something better left alone. If investors consistently get burned on the primary market, pretty soon investors will stop showing up to provide companies with capital, which means companies would have one heck of a time expanding, hiring more workers, and pushing along the local and national economies. So, the government is very much interested in what goes on in the securities markets, which is why Congress passed the **Securities Act of 1933**. Sometimes referred to as the “Paper Act,” the Securities Act of 1933 simply requires issuers of securities to register the securities and provide full disclosure to investors before taking their hard-earned money. The SEC will make the issuer write and rewrite the registration statement, just like a hard-nosed composition instructor might make you do four rewrites of a research paper before finally agreeing to let you graduate. If this section is awkward and this paragraph is unclear, rewrite it. The SEC calls their equivalent of red pen marks **letters of deficiency** and sometimes, when they’re feeling punchy, **deficiency letters**.

Now, an issuer such as Oracle would know all kinds of interesting things about relational database applications in a non-Unix environment. But, they probably know jack about issuing securities. So, they hire **underwriters**, also called “investment bankers.” An underwriter or **investment banker** is simply a broker-dealer who helps issuers raise money by issuing securities to investors. All the big-name Wall Street firms have major underwriting or investment banking departments. In fact, I may just go ahead and name names such as Morgan Stanley, Goldman Sachs, and Merrill Lynch. The Series 7 is required in order to work in the investment banking/underwriting side of the business or the secondary market/trading side of the business, by the way.

The underwriters/investment bankers advise the issuer how to structure the offering of securities in order to raise the most money possible. Although the underwriters are “advising” issuers here, they are not acting as investment advisers. Investment advisers help clients invest in other people’s securities—the underwriters/investment bankers are acting completely within their scope as broker-dealers when “advising” their clients on how many shares of common or convertible preferred stock should be issued and at what price.

Once those details have all been worked out, the underwriters help the issuer file a **registration statement** with the SEC under the Securities Act of 1933. Now, the **cooling-off period**, which will last a minimum of 20 days, begins. This process can drag on and on if the SEC is issuing deficiency letters, but no matter how long it takes, the issuer and underwriters can only do certain things during this “cooling off” period. Number one, they can’t sell anything. They can’t even advertise. About all they can do is take **indications of interest** from investors, but those aren’t sales, just names on a list. And those who indicate their interest have to receive a **preliminary prospectus** or “**red herring**.” This disclosure document contains almost everything that the **final prospectus** will contain except for the **effective/release date** and the final **public offering price** or “**POP**.” Remember that the registered representative may NOT send a research report along with the red herring and cannot highlight it or alter it in any way.


It is what it is. Part of the registration statement is the prospectus that investors will receive. Please understand that the SEC is reviewing the documents for clarity and to make sure that at least the boiler plate disclosures have been made. If a section looks incomplete or unclear, they’ll make the issuer/underwriters rewrite it. But at no time is the SEC determining that the information is

accurate or complete. They couldn't possibly do that—they don't know the issuer's history, and the financial statements the issuer provides—who knows if they're accurate? Since the SEC can't and does not verify information, the issuer and the underwriters hold a **due diligence meeting** during the cooling-off period, which just means they make sure they provided the SEC and the public with accurate and full disclosure. The issuer does not have to, but they are allowed to publish one very specific type of "advertising" during the cooling-off period—a **tombstone advertisement**. A tombstone, as we saw in the Municipal Securities chapter, just lays out the basic facts: the issuer, the type of security, number of shares, amount to be raised, and then the names of the underwriters. I'm not convinced it's a hugely testable document, but it may help to make this process more tangible if we glance at an actual tombstone ad:

This announcement is under no circumstances to be construed as an offer to sell or as a solicitation of an offer to buy any of these securities.  
The offering is made only by the Prospectus.

New Issue April 26, 2000


**\$10,620,000,000**



**Group Tracking Stock**

360,000,000 Shares

Price \$29.50 Per Share

The New York Stock Exchange symbol is 

Global Coordinators and Joint Book-Running Managers

**Goldman, Sachs & Co.      Merrill Lynch & Co.      Salomon Smith Barney**

Copies of the Prospectus may be obtained in any State or jurisdiction in which this announcement is circulated from only such of the undersigned or other dealers or brokers as may lawfully offer those securities in such State or jurisdiction.

306,000,000 Shares

The above shares were underwritten by the following group of U.S. Underwriters.

<b>Goldman, Sachs &amp; Co.</b>	<b>Merrill Lynch &amp; Co.</b>	<b>Salomon Smith Barney</b>
Credit Suisse First Boston	Lehman Brothers	Morgan Stanley Dean Witter
Banc of America Securities LLC	M.R. Beal & Company	Bear, Stearns & Co. Inc.
Chase H&Q	Deutsche Banc Alex. Brown	Donaldson, Lufkin & Jenrette
J.P. Morgan & Co.	PaineWebber Incorporated	Prudential Vantage Technology Group <small>a unit of Prudential Securities</small>
<b>Sanford C. Bernstein &amp; Co., Inc.</b>		
<b>Thomas Weisel Partners</b>		

Ameritrade	Allos & Company	BMO Nesbitt Burns Corp.	Baylock & Partners, L.P.	CBTC World Markets
A.G. Edwards & Sons, Inc.	Amegy Capital Markets	First Union Securities, Inc.	Geisman & Company	
Edward D. Jones & Co., L.P.	Lasert Fries & Co., L.L.C.	RBC Dominion Securities Corporation	Robertson Stephens	SG Cowen
Marist Slebert & Co., Inc.	Utsunohi Capital Partners, L.P.	Wasserman Perella Securities, Inc.	Wit SoundView	
Advest, Inc.	Robert W. Baird & Co.	William Blair & Company	J. C. Bradford & Co.	Chaseworth Securities LLC
Friedman Billings Ramsey	Gerard Klauer Mattina & Co., Inc.	J. J. R. Hilliard, W. L. Lyons, Inc.	Janney Montgomery Scott LLC	C. I. Kling & Associates, Inc.
Logg Mison Wood Walker	McDonald Investments Inc.	Morgan Keegan & Company, Inc.	Neudham & Company, Inc.	Neuberger Beriman, LLC
Pryst, McClellan, Counts & Co., Inc.	Ragen MacKenzie	Ramirez & Co., Inc.	Raymond James & Associates, Inc.	The Robison-Humphrey Company
Scott & Stringfellow, Inc.	Stephens Inc.	Sifit, Nicholas & Company	SunTrust Equitable Securities	Sutro & Co. Incorporated
C.E. Caterberg, Towbin	U.S. Bancorp Piper Jaffray	Wachovia Securities, Inc.	The Williams Capital Group, L.P.	
Adams, Harkness & Hill, Inc.	Arnold & S. Blitchwelder, Inc.	George K. Baum & Company	Breen Murray & Co., Inc.	Bardham Securities, Inc.
Crowell, Woodson & Co.	Davenport & Company LLC	D.A. Davidson & Co.	Duff & Co., Inc.	Daley Securities, Inc.
Gardner Rich & Co., Inc.	Gruntal & Co., L.L.C.	Jackson Securities Incorporated	Janco Partners, Inc.	Jefferies & Company, Inc.
Kaufman Bros., L.P.	Loop Capital Markets	May Davis Group Inc.	Melton Financial Markets LLC	Malvin Securities Corporation LLC
Pennsylvania Merchant Group	Pineberg Institutional Inc.	Radwood Securities Group, Inc.	SBN Broker Investments Corp.	Santora Morris Harris
Sinds Brothers & Co., Ltd.	The Seidler Companies	Shardlow & Co., Inc.	H. C. Wainwright & Co., Inc.	Wentz Morgan Securities

54,000,000 Shares

The above shares were underwritten by the following group of International Managers.

<b>Goldman Sachs International</b>	<b>Merrill Lynch International</b>	<b>Salomon Smith Barney International</b>
ABN AMRO Rothschild	Credit Suisse First Boston	Deutsche Bank
BANCA IMI	BNP Paribas Group	Cazenove & Co.
		Daiva SBGM Europe
		HSBC
		ING Barings Limited
		Warburg Dillon Read

The lead underwriters often have a commemorative tombstone made in Lucite that the various players receive as souvenirs of the journey once the offering is completed. The regulators actually write this item into the gift rules as an exception, no matter how much it costs to make the "gifts." In other words—they're kinda cool, but their re-sale value would be pretty low. And how much influence could really be purchased at other firms by sending a paperweight?

Anyway, even though the SEC makes issuers jump through all kinds of hoops, once it's all done, the SEC pretty much washes its hands of the whole affair. They don't approve or disapprove of the security. They don't guarantee accuracy or adequacy of the information provided by the issuer and its underwriters. In other words, if this whole thing goes belly-up because of inaccurate or incomplete disclosure, the liability still rests squarely on the shoulders of the issuers and underwriters, not on the SEC. And there has to be a disclaimer saying basically that on the prospectus. In fact, take a look at the cover of any mutual fund prospectus. The one I'm looking at now says it this way:

The Securities and Exchange Commission has not approved or disapproved of these securities. Further, it has not determined that this prospectus is accurate or complete. Any representation to the contrary is a criminal offense.

Note: the "criminal offense" referred to would be various forms of fraud (securities fraud, wire fraud, mail fraud), but that doesn't mean the SEC is a criminal prosecutor—they are not. The SEC only uses civil courts and their own administrative hearings to make wayward investment advisers, insider traders, and various other ne'er-do-wells cut it out and promise not to do it again. If someone commits crimes within the securities industry, the SEC would refer the case to the Department of Justice, and then some hard-nosed prosecutors from the U.S. Attorney's office for that region of the country would start going after the poor S.O.B. the way they tore into my state's former Governor Rod Blagojevich--twice. No thanks. So, it's like really important that when registering securities and writing the prospectus all the important facts are disclosed and are as clear and accurate as possible. Mislead your investors, and getting sued is probably your *best* outcome—yikes!

In any case, if the issue of stock is authorized for listing on **NYSE**, **NASDAQ**, or other major exchanges, the issuer and underwriters will only register with the SEC. But, if the issue will not trade on those exchanges, the stock will also have to be registered with all the states where it will be offered and sold. This state-level registration could be referred to as **blue sky-ing** the issue. Both the securities and all the firms and their agents must be registered in all the states where these securities will be offered and sold.

An IPO is not to be treated as a quick buy-and-flip opportunity. If some investors are immediately selling their shares on the secondary market, that can push the market price of the stock downward. This is what FINRA has to say about the process:

The term "flipping" refers to the practice of selling new issues into the secondary market at a profit within 30 days following the offering date. Because these sales create downward pressure on the secondary market trading price, underwriters and selling group members may seek to discourage such sales. Under most syndicate selling agreements, a managing underwriter is permitted to impose a "penalty bid" on syndicate members to reclaim the selling concession for allocations that were flipped. Separately, and independent of any syndicate penalty bid, some firms have sought to recoup selling concessions from particular brokers when their customers—typically retail customers—flip a new issue. [FINRA rules prohibit]

any member from recouping any portion of a commission or credit paid or awarded to an associated person for selling shares of a new issue that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate. FINRA believes that it is only appropriate for a firm to recoup a particular broker's compensation for selling a new issue in connection with a customer's decision to flip a security when the firm itself is required to forfeit its compensation to the managing underwriter(s).

So, to review the timeline, remember that nothing really happens until the registration statement is filed with the SEC. At that point, the cooling-off period begins. During this period, investors are asked by underwriters (their registered representatives, really) to give indications of interest, and those who do must receive a preliminary prospectus (red herring). No advertising is taking place and no sales literature is used during this cooling-off period. No binding agreements to buy or deliver securities are entered into. The due diligence meeting is held to make sure all the information in the prospectus is as accurate and complete as possible. When the issuer is finally given the effective date (release date) by the SEC, sales from the underwriters to the investors are finalized, all buyers receive a final prospectus, and the issuer receives the capital it needs, with the syndicate keeping the spread for its trouble.

## EXEMPTIONS FROM REGISTRATION REQUIREMENTS

So, everybody has to register their securities with the SEC, except for everybody who doesn't. The Act of 1933 is a piece of federal legislation, so it's not surprising that the federal government, who came up with the Act, doesn't have to abide by it. That's right, government securities are exempt from this act. They don't have to be registered in this way. Neither do municipal securities.

Why is that? Well, when a corporation tries to take an investor's money, there is always a good chance the investor will lose his money. Companies go out of business all the time, so if their earnings start to evaporate, the bonds go into default, and the shares of common stock are no longer worth the paper they're printed on. That's not the case when the U.S. Treasury sells you a T-note or T-bond. That's just a loan backed by the full faith and credit (the vast taxing powers) of the United States Government.

In other words, you'll get your money back. The U.S. isn't going to pull a Russia on you and suddenly declare, as Russia did back in 1998, "Very sorry—we cannot pay you."

States, counties, cities, etc.—those who issue municipal securities—also got an exemption from the arduous registration process laid out under the Securities Act of 1933. But we're not done handing out hall passes; in fact, we're just getting started. Charitable/fraternal/religious organization securities are exempt from the Securities Act of 1933's registration requirements. So are bank securities, which are already plenty regulated by bank regulators (FDIC, FRB, Comptroller of the Currency). Securities issued by small business investment companies (VC firms) also get a hall pass. Securities issued by Small Business Investment Companies (SBICs) are also exempt, since they are only offered and sold to institutions and other sophisticated investors who don't require so much protection.

And short-term debt securities that mature in 270 days or less—commercial paper, bankers’ acceptances, other promissory notes—are also exempt from this arduous registration process. I mean, if a corporation had to get through the registration process just to borrow money for a few days, weeks, or months, interest rates would likely have moved before the deal could be completed. On the other hand, if they want to borrow money for several years by issuing bonds or sell off ownership stakes the way Jeremy, Jason, and Jennifer did at Frank & Emma’s Fruit Pies, the regulators feel maybe they ought to slow the heck down first and reveal a whole lot of material facts to investors.

So, the state of Oregon is an exempt issuer. Commercial paper is an **exempt security**. There are also transactions that qualify for exemptions. Believe it or not, we call these **exempt transactions**. That just means that if you sell the securities in a certain way you can either avoid registration altogether, avoid registration with the SEC, or perhaps just do a “fast-track” method using a scaled-down disclosure document like an “offering memorandum” or an “offering circular” as opposed to the telephone-book-size standard registration statement or “S1.”

Still with us?

Boy, you must really want your Series 7. Good for you!

Under **Reg A**, an issuer can sell up to \$5,000,000 worth of securities in a year without having to jump through all the usual hoops. Rather than filing a standard registration statement, the issuer files an offering circular, a much more scaled-down document. This is a small offering, so think of a small, Caribbean island where they play lots of Reg-A. But, please save the rest of that fantasy until after passing the test.

The SEC is in charge of interstate commerce, meaning commerce among many states. Therefore, if the issuer wants to sell only to residents of one state, the SEC doesn’t have to get involved—there is already a state securities regulator who can deal with this one. So, if the issuer agrees to sell the stock to residents of only one state, they will qualify for a **Rule 147** exemption. The issuer’s main business is located in this state, and 80% of its assets are located here. Also, the buyers can’t sell the security to a non-resident for nine months. The issuer registers with the state, rather than the SEC, since it’s all taking place in that one state. This is also called an **intrastate offering**, which means it all takes place within (intra) one state.

The SEC is out to protect the average Joe and JoAnne from fast-talking stock operators pushing worthless paper. But, the SEC doesn’t have to provide as much protection to big, sophisticated investors such as mutual funds, pension funds, or high-net-worth individuals. If anybody tries to scam these multimillion-dollar investors, they’ll be in just as much trouble as if they scammed an average investor, but the SEC doesn’t have to put up as much protection for the big, institutional investors, who can usually watch out for themselves to a large extent. Therefore, if the issuer wants to avoid the registration process under the Act of 1933, they can limit the sale to these big institutional, sophisticated investors. These investors are often referred to as **accredited investors**. They include institutions and the officers and board of directors of the company. Also if an individual or married couple meets the net worth or the income requirements, he or she is accredited. So, an issuer can place their securities under a **Reg D** transaction with as many of these folks as they want. This “private placement” is, by definition, not being offered to the general public, so the SEC eases up a bit. As much as the SEC ever eases up, anyway. So, a **Reg D/private placement** transaction is exempt from the Act of 1933’s registration requirements because it is offered to an exclusive group of investors. There is no general advertising or soliciting going on—the underwriters must

have an established relationship with the individual investors. Why? Because, if they're advertising the offering, they're actually doing a *public* offering, which requires registration of the securities. To keep things as clear as mud, the regulators also allow the issuer and underwriters to sell to no more than 35 non-accredited investors. Either way, if the investor is an individual, he has to hold the stock for a certain time frame before selling it. Or, he has to hold it for "investment purposes" as opposed to buying it and immediately flipping it. After the holding period, a **non-affiliated investor** (not on the board, not an officer, doesn't own 10% or more of the company) would have to comply with volume limits on any sales of the stock for only a specified time period, while an **affiliated investor** (10% owner, officer, or director of the issuer) would have to comply with volume limits all the time because they're, you know, affiliated.

See, if you're an affiliate of the company, you always have to file Form 144 with the SEC, announcing that you intend to sell a certain amount of your stock over the next 90 days. We don't want the huge shareholders to dump too much stock at once, which usually drives the price down for everyone else who might want to sell. The volume to be sold over the 90-day period is limited to 1% of the shares outstanding or the average weekly trading volume over the four most recent weeks, whichever is larger. That's surprising, too, because you might think the SEC would stick you with the smaller number.

Go figure.

So you can bet that if it shows up at all the test will give you at least five weeks—only average the four most recent. And then compare that number to 1% of the outstanding shares. Whichever is larger, that's what an insider/affiliate could sell over the next 90 days. Or, that's what a non-affiliated investor could sell while subject to volume limits on his or her sales.

Rule 144 also covers both "restricted stock" and "control stock." Nothing different about control stock *per se*—it's the people who hold the stock that are different. If you're the CEO of a corporation, or the CFO, or the owner of a major chunk (10%) of the stock, you could control the success of the company and even the share price by buying and selling huge chunks of your stock at strategic times. Therefore, you tell the SEC what you're planning to do with your stock every time you think about selling some of it. You do this by filing a Form 144, which also covers **restricted stock**.

What is restricted stock, you may be wondering. Well, stock sold through a private placement (Reg D) is unregistered and therefore restricted. Restricted means its transfer or sale is restricted—investors have to hold it for a specified time period before selling it. Currently, investors not affiliated with the issuing company have to hold the stock for 6 months before selling, and then conform to volume limits until the first year is up, after which they can sell as many shares as they want. Affiliates of the company (officers, directors, 10% shareholders, immediate family of insiders) also have to hold restricted stock for 6 months and—as always—must report their sales, which are subject to the volume limits under Rule 144, always. This is one of those rules that is changed frequently, so see the updates at [www.passthe7.com/updates](http://www.passthe7.com/updates) before taking the exam, assuming the test will go this far into trivial pursuits. When selling restricted shares under Rule 144, investors must file a Form 144 with the SEC no later than concurrently with (at the time of) the sale. The filing is good for 90 days. Also, in case the Series 7 doesn't have enough trivia for you to memorize, you may be expected to know that if the transaction is not larger than 5,000 shares and \$50,000, the sale can be made without reporting. Basically, a transaction that small does not

make the regulators nervous as it won't impact the price of the stock due to the low volume of shares traded.

And, those people can never sell the company's stock short. They can't profit from their company's poor stock performance, in other words. And, if they make a profit on their company's stock held less than 6 months, they'll wish they hadn't. This is called a short-swing profit, and it has to be turned back over to the company with the gain still being taxed by the IRS, which, as always, is here to help.

FINRA is very concerned that agents and their firms sometimes help clients sell unregistered restricted securities, which violates federal securities law. In other words, if the customer does not conform to all the stipulations we just went over, but wants to just take his unregistered restricted shares and sell them, firms need to be sure they don't help him skirt securities law in this manner. FINRA alerts its member broker-dealer firms that some customers are really companies trying to sell their shares illegally. If the customer deposits certificates representing a large block of thinly traded or low-priced securities, that's a red flag. If the share certificates refer to a company or customer name that has been changed or that does not match the name on the account, that's another red flag. If a customer with limited or no other assets under management at the firm receives an electronic transfer or journal transactions of large amounts of low-priced, unlisted securities, that's another red flag. Broker-dealer firms need to do a reasonable inquiry to make sure that they are not helping people get around securities law. The SEC has said that "a dealer who offers to sell, or is asked to sell a substantial amount of securities must take whatever steps are necessary to be sure that this is a transaction not involving an issuer, person in a control relationship with an issuer, or an underwriter." For this purpose, it is not enough for him to accept "self-serving statements of his sellers and their counsel (attorneys) without reasonably exploring the possibility of contrary facts."

**Rule 144a** allows the restricted securities that we just discussed to be re-sold to institutional investors including banks, insurance companies, broker-dealers, investment advisers, pension plans, and investment companies without meeting the usual registration requirements under the Securities Act of 1933. So, if an investor acquires restricted securities through a private placement, he/they can actually re-sell them to **qualified institutional buyers** such as those mentioned without messing up the exemption the issuer is claiming from the registration requirements. As usual, the regulators want to prevent the shares from being distributed in a general public offering without registration requirements being met. When the buyers are all sophisticated (allegedly) institutions, the regulators can ease up and let the professionals play hardball.

This SEC rule also states that the seller needs to be reasonably certain that the buyers are qualified institutional buyers, which generally means that the institution invests on a discretionary basis at least \$100 million, or is a registered broker-dealer, an investment company, a bank, or a federal covered investment adviser. To check that the buyers are qualified institutional buyers, the SEC says that the seller can rely on the buyer's most recent publicly available financial statements, or a certification from the CFO or other officer of the institution.

**Rule 145** has to do with disclosure requirements to investors involved with a merger or a reclassification of securities. When Procter & Gamble acquired Gillette, for example, they gave the Gillette shareholders a certain number of PG shares for each share of Gillette currently held. Those PG shares have to be registered on a special form (S-4), and the Gillette shareholders have to receive all types of disclosure of material information. Or, if an issuer has decided to give all

current warrant holders shares of convertible preferred stock instead, this is a reclassification subject to Rule 145. Remember that stock splits, stock dividends, and changes to the par value of a security are not subject to Rule 145.

To review, the Act of 1933 says that non-exempt issuers (corporations) have to register their securities with the SEC. Exempt issuers, exempt securities, and exempt transactions all find a way around the arduous process set forth by the Act of 1933.

## UNDERWRITING SECURITIES

We already looked at the underwriting process for municipal securities. Many of those same firms also underwrite securities for corporations. When they do, issuers receive different levels of commitment from the underwriters. Under a **best efforts** commitment, the underwriters act as agents. In other words, no money at risk. They try to sell, and whatever they can't sell goes back to the issuer. Two similar types of underwritings are **All or None** and **Mini-Max**. In either case, the underwriters have no money at risk. They just have to sell a minimum amount, or cancel the whole underwriting and return all the money to investors. Only difference between the two is that mini-max has both a minimum and a maximum number. So, if the underwriters reach the minimum level, they can continue to sell more shares, up to the maximum.

Underwriters only have money/capital at risk when they give **firm commitments**. Now, they're agreeing to buy the securities outright, then turn around and sell them to the public. The difference between where they buy from the issuer and sell to the public is known as the **spread**. The managing underwriter takes a management fee, the underwriters split up the underwriting fee, and whoever makes the sale gets the selling concession. If the total spread is 80 cents, only the managing underwriter can make that amount, and they'd have to make the sale; otherwise, they'd have to concede the selling concession to the party who made the sale. A typical spread might be made up of 10 cents for the management fee, 20 cents for the underwriting fee, and 50 cents for the selling concession. For a total spread of 80 cents per share.

If you see a reference to a **green shoe clause**, just remember that this would allow the syndicate to increase the number of shares sold by 15% over the original number of shares in the offering. People must really want the security in that case, right? They're all "green with envy," so this "green shoe" clause would take care of them.

Sorry to resort to such cheesy memory joggers, but many people swear by them.

How does the issuer decide how to price the security being offered to the public? The underwriters are the experts, so they advise the issuer as to how to structure the offering, and they determine the final public offering price (POP) based on the following:

- Current market conditions for securities offerings
- Current market value of competitors' securities
- Current climate for the industry in which the issuer competes
- Level of interest from indications of interest

We mentioned that the preliminary prospectus/red herring does not contain the final public offering price. It may, however, contain a range of likely offering prices. The level of enthusiasm for the shares during the cooling-off period will help determine whether the final POP ends up