THE BUSINESS OF INVESTMENT BANKING

K.THOMAS LIAW

John Wiley & Sons, Inc.
New York • Chichester • Weinheim • Brisbane • Singapore • Toronto
Mergers and Acquisitions

Takeover activities, including mergers and acquisitions (M&As) and leveraged buyouts (LBOs), are an important part of investment banking business. The volume of transactions in the 1980s totaled $1,719 trillion, and investment banks took in billions of dollars in fees. The volumes have increased to record highs in the mid-1990s. The M&As in the U.S. set another record at $626 billion in 1996. Volume in 1997 continues the upward trend, with $919 billion in value of deals. The activities in M&As and buyouts will continue to generate significant fee income for Wall Street and help build up merchant banking operations. Successful M&A bankers need to understand client business and objectives and respect the confidence of clients. Bankers should also examine options to overcome the effect of the proposed bill in Congress that would prohibit selling subsidiaries on a tax-free basis under the Morris Trust structure. This chapter discusses the motivations, negotiation process, valuation techniques, M&A banker’s fees, regulatory issues, closing, legal risks, and risk arbitrage.

MARKET OVERVIEW

The M&A market has been a part of the continued evolution of the U.S. business. The forces that drive the market are from the strategic buyers, the financial buyers, and the consolidators. The strategic buyers are seeking to extend their geographic reach, expand their customer base, boost market share, and fill out product lines to be more competitive. The financial buyers play a significant role in increased M&A activity. Financial buyers are formed from various sources including buyout funds, wealthy individuals, and investment arms of financial institutions. Another type of buyer is the consolidator. Consolidators are to roll up or consolidate businesses in industries that were previously characterized by a large number of mom-and-pop type shops.

Investment banks frequently act as a finder and/or a financial advisor. Bankers are knowledgeable in finding a seller or a buyer, terms of recent transactions, financing structure, arranging or providing bridge loans, fairness opinion, negotiations, and conducting divestiture auction.

The M&A transactions totaled $1,719 trillion in the 1980s. Investment bankers took in billions of fee income. Wall Street is obsessed with M&As, because win, lose, or draw, they produce fees: fees for advising, fees for lending money, and fees for divesting unwanted assets. The activities in the early 1990s were below the 1988 peak, but were still significant and generated substantial income for Wall Street. By the mid-1990s, the M&A market revitalized and the dollar volumes in annual deals set record highs.
TABLE 3.1 Value of M&A Deals 1980-1997

<table>
<thead>
<tr>
<th>Year</th>
<th>Deals</th>
<th>Value ( $ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>79</td>
<td>12</td>
</tr>
<tr>
<td>1981</td>
<td>1,030</td>
<td>75</td>
</tr>
<tr>
<td>1982</td>
<td>1,928</td>
<td>56</td>
</tr>
<tr>
<td>1983</td>
<td>3,385</td>
<td>96</td>
</tr>
<tr>
<td>1984</td>
<td>3,618</td>
<td>169</td>
</tr>
<tr>
<td>1985</td>
<td>2,255</td>
<td>204</td>
</tr>
<tr>
<td>1986</td>
<td>3,148</td>
<td>228</td>
</tr>
<tr>
<td>1987</td>
<td>3,317</td>
<td>224</td>
</tr>
<tr>
<td>1988</td>
<td>3,915</td>
<td>352</td>
</tr>
<tr>
<td>1989</td>
<td>5,451</td>
<td>303</td>
</tr>
<tr>
<td>1990</td>
<td>5,650</td>
<td>183</td>
</tr>
<tr>
<td>1991</td>
<td>5,260</td>
<td>138</td>
</tr>
<tr>
<td>1992</td>
<td>5,503</td>
<td>150</td>
</tr>
<tr>
<td>1993</td>
<td>6,309</td>
<td>234</td>
</tr>
<tr>
<td>1994</td>
<td>7,570</td>
<td>340</td>
</tr>
<tr>
<td>1995</td>
<td>9,122</td>
<td>510</td>
</tr>
<tr>
<td>1996</td>
<td>10,330</td>
<td>651</td>
</tr>
<tr>
<td>1997</td>
<td>NA</td>
<td>919</td>
</tr>
</tbody>
</table>

Source: Adapted from Securities Data Co. and The Wall Street Journal, various issues.

M&As in the U.S. announced in 1996 totaled $626 billion, a significant increase from the record $510 billion in 1995. Value of deals in 1997 has swelled to $919 billion. The value of U.S. M&A transactions from 1980 to 1997 is listed in Table 3.1.

The size of the largest mergers and acquisitions keeps increasing. Multibillion-dollar deals are now common. The largest deal so far is the proposed merger of Travelers Insurance and Citicorp, announced in April 1998 ($72 billion). A partial list of other large transactions include the linking of British Petroleum and Amoco in 1998 ($49 billion), KKR’s purchase of RJR Nabisco in 1989 ($25 billion), the merger of Bell Atlantic and Nynex announced in 1996 ($22 billion), AT&T and McCaw Cellular in 1994 ($18.9 billion), SBC Communications and Pacific Telesis in 1997 ($16 billion), Lockheed and Martin Marietta in 1995 ($10 billion), Disney and Capital City/ABC in 1995 ($19 billion), Chase Manhattan and Chemical Bank in 1996 ($10 billion), and Salomon and Smith Barney in 1997 ($9 billion).

During this period, insider trading gained front-page attention. Insider trading is governed by Rule 10b-5, which bars corporate insiders or their affiliates from trading on knowledge of material information before it is made public. A number of prosecutions under Rule 10b-5 stemmed from trading on pending M&As prior to public announcements. Well-known defendants include Dennis Levine of Drexel Burnham Lambert, arbitrageur Ivan Boesky, and Martin Siegel of Kidder Peabody.

MOTIVATIONS

Corporate acquisitions are capital investments. The decision to acquire is determined by whether it makes a net contribution to shareholder wealth. The sources of gains...
include synergies, strategic planning, tax considerations, undervalued shares, agency problems, and diversification. From the seller's perspective, the decision to sell involves reasons such as founder's retirement, estate planning, eliminating personal liabilities, divesture, and venture capital exit strategies.

**Buyers' Motivations**

The most common argument put forth by acquirers in the merger market has been *synergies*. Cost-saving synergy is most frequently mentioned. The merger of Chemical Banking and Manufacturer Hanover, and then with Chase Manhattan, was successful because of overlapping operations and other cost-saving synergies that enhanced shareholder wealth. There are sometimes revenue synergies, which are the additional sales the two would not have made if they were operating independently. Revenue synergies were part of the expected benefits when AT&T purchased Teleport for $11 billion in January 1998. Another related potential benefit is financial synergy. The cost of capital might be lowered as a result of merger. If the streams of cash flows of the two companies are not perfectly correlated, a merger that reduces the instability of revenue streams can reduce the potential costs of financial stress. In addition, there might be economies of scale in flotation and transactions costs.

M&As could be part of corporate *strategic planning* in a changing market environment as well. One aspect is to increase market power so that the firm has the ability to set prices or to compete more aggressively. Furthermore, the combined company could be better positioned to take advantage of further industry consolidation or marketing channels. For example, the 1995 combination of Lockheed Corp. and Martin Marietta Corp. to form Lockheed Martin Corp. positioned itself to take advantage of further consolidation in the defense industry by acquiring Loral's defense operations in 1996 and merging with Northrop Grumman in 1997. As another example, a major plus in Gillette's 1996 merger with Duracell is the potential for Gillette to use its distribution clout to increase Duracell sales abroad, where the battery maker is not as strong as in the United States.

*Unused tax shields* are another benefit. As an example, Penn Central, subsequent to its bankruptcy and reorganization, had billions of unused tax-loss carry forwards. To take advantage of this, Penn Central purchased several taxpaying companies. It should be noted that the IRS might challenge the use of tax-loss carry-forwards if a company acquired another firm and then quickly liquidated its assets.

Another argument for acquisition is *undervalued shares*. This refers to the revaluation of shares because of new information generated during the merger negotiations or the tender offer process. There are three aspects to this argument. One is the kick-in-the-pants explanation, in which management is stimulated to adopt a higher-valued operating strategy. The second is the sitting-on-a-gold-mine hypothesis; the market revalues previously undervalued shares because of the dissemination of new information or the perception that bidders have superior information. The third aspect is related to inflation. The inflation of the 1970s deflated stock prices and increased replacement costs. This resulted in a decline in the *q* ratio, defined as the ratio of a company's market value to its replacement costs of assets. If a firm seeks expansion and if other firms in its target business segment have a *q* ratio of less than one, it is efficient to expand by purchase.

*Agency problems* are a result of the separation of ownership and management. If compensation to management is a function of firm size, then the managers are moti-
vated to expand regardless of returns to shareholders. Alternatively, if a profitable firm is in a mature industry but lacks attractive investment opportunities, the firm should distribute the surplus cash to stockholders by raising dividends or share repurchase. However, managers sometimes prefer to use it for acquisition or to retain the surplus cash; in the latter case, the firm often finds itself a takeover target.

_Diversification_ for shareholders or reducing systematic risk has been regarded as a dubious reason for mergers. However, the perception is not necessarily correct, and it has been proven that it is possible to reduce risk for shareholders through mergers.\(^5\) For horizontal mergers, the risk can be lowered if the market is imperfectly competitive. In the case of conglomerate mergers, the risk will be reduced if economies of scope exist.

**Sellers' Motivations**

Turning to the selling business, owners and managers reach a decision to sell for many reasons. One major motivation is that founders and other individual owners sell as part of their retirement and estate planning, or as a strategy to other business ambitions. Another reason for sale is the recurring need for expansion capital when the public markets are either not desirable or not available. For a private company, another powerful stimulant is the elimination of personal liabilities such as personal guarantees of corporate debt. Such guarantees may risk a family’s entire wealth. Eliminating personal guarantees and liabilities is an appropriate motive.

Large companies sometimes divest businesses that do not fit into their strategic plans. Some business sales are forced by venture capitalists as an exit strategy. Also, some sales are caused by financial distress.

**Personal Issues**

In practice, ego and pride (such as who gets to run the show) affect many merger deals. These social issues are among the most difficult aspects of negotiating multibillion-dollar deals. Often, a big factor in the success of a merger negotiation is an aging chief executive. Many megadeals tend to take place when one chief executive is nearing retirement and looking to go out with a bang. Cases include the union of Bell Atlantic and Nynex, Ciba-Geigy AG and Sandoz AG, and Lockheed and Martin Marietta. Bell Atlantic’s chairman and CEO, Raymond Smith, was 58 and nearing retirement, while Nynex chairman and CEO, Ivan Seidenberg, was 49. In the case of Novartis, Ciba’s chairman Alex Krauer was 65 and Sandoz’s top executive Daniel Vasella was 43. The Lockheed Martin case was helped by the fact that Daniel Tellep was 62 and Martin Marietta’s chief, Norman Augustine, was 58.

Another practical issue involving the sale of private companies is related to nonfinancial concerns. By way of example, a seller entrepreneur’s continuing involvement in the business may be a condition of sale. The nonfinancial factors frequently involve the employees, as well. It is also important for the seller entrepreneur to feel comfortable with the new management and owners.

**STRATEGIC PLANNING AND INTERMEDIARY**

Growth is vital to the well-being of a business. Acquisitions are but one of the many alternatives, and each should be evaluated carefully. The incentive to acquire exists
when acquisition is more beneficial than other alternatives. The alternatives include joint ventures, strategic alliance, minority investment, venture capital, licensing, technology sharing, franchising, and marketing and distribution agreements.

If an acquisition is determined to be the optimal path, a team consisting of internal and external professionals will plan and implement strategies during the acquisition process. The company could rely on in-house analysis or hire investment bankers to complete the acquisition. Lower expenses, reasons of confidentiality, staff transaction experience, and speed frequently motivate completing transactions in house. On the other hand, the advantages of negotiating through third parties are that bankers can tap into information flow in sales and trading and thus can obtain better terms regarding the pricing of securities and company assets. As an example, targets with bankers from 1993 to September 1996 received a median premium of 31.6 percent, while those without bankers received a 26.1 percent premium. For acquirers, those who used bankers paid a median premium of 30.3 percent, compared to a 32.3 percent premium for acquirers without bankers. Additionally, if the deal falls apart, the working relationships would not be jeopardized.

A successful acquisition program must be an integral part of a company's overall strategic plan. The strategic needs and preferences of the management determine the initial selection criterion of targets. One way of finding the candidates is to hire an intermediary, broker, or finder. There are several published sources for finding an M&A intermediary. Two such sources are *Buyouts: Directory of Intermediaries* and *The Corporate Finance Sourcebook*. Another method of discovering acquisition candidates is through networking. *World M&A Network* is a quarterly publication that lists companies for sale, merger candidates, and willing buyers. Other electronic directories can also be used to screen for acquisition candidates.

Each selected candidate should be evaluated. The key to evaluating an acquisition candidate is first to understand the acquirer's business strategy and reactions to the deal among shareholders. Then the evaluation process proceeds to performing a segmentation analysis to determine the segments in which the target operates. The competitive position and operating strategies of the target should be analyzed. In the due diligence process, the following information about the acquiree is often required: market environment, market position, market structure, products, customers, suppliers, operations, financial measures, and legal and regulatory issues.

**Investment Banking Fees and Agreements**

Fees are usually negotiable and contingent upon the success of a deal. The most usual fee scale is the Lehman 5-4-3-2-1 formula. Under this formula, 5 percent is paid on the first $1 million of sale price, 4 percent on the next $1 million, 3 percent on the next $1 million, 2 percent on the next $1 million, and 1 percent on the amount in excess of $4 million. In a small transaction, the fee may range between 5 percent and 10 percent of the sale. For a large transaction, the fees are less than 1 percent of the deal’s value. In yet another turn in the compensation schedule, AT&T's Chairman M. Armstrong instructed his advisers in the Teleport deal that their compensation would be based on how well the company was able to realize the scenario put forward. Many investment bankers seek an up-front retainer before they begin M&A work with a company, especially a private company where owners have been known to change their minds halfway through the process. Regardless of the transaction outcome, out-of-pocket expenses are always billed to the client.
The M&A banker should be paid commission in full at the time of closing if the sale price is payable in a lump sum or in installments. When a portion of the sale price is determined on an *earn-out basis*, in which the payments are contingent on operations after closing, the intermediary is to be paid out of these payments when made to the seller.

Fees in tax-free transactions—such as stock-for-stock exchange—are also paid in cash, despite the fact that the seller has not received cash. There are ways of accomplishing this without affecting the tax-free aspect of the sale. The fee can be paid by the surviving entity. When the transaction is stock-for-assets exchange and the seller must pay the intermediary, two methods can be used. In one approach, the seller pays the fee prior to the exchange and then exchanges only its remaining assets for the buyer's stock. A second technique is to have the purchaser assume the selling company's obligation to pay the fee.

Another important contract is the *confidentiality agreement*. The basic function of the agreement is to protect sellers against the misuse of confidential information provided to potential buyers. The agreement typically contains (1) confidentiality provisions to protect the seller against the business risks of disclosure or misuse of information by competitors, and (2) standstill provisions (corporate peace treaties) to protect the seller against unsolicited takeover attempts by bidders. Other goals of the agreement might include complying with securities law, preventing bidders from forcing unfair offers on the target, governing the sale process, blocking the raiding of target personnel, and timing the announcements.

The types of information that bidders often require include financial, technical, and human resource materials. At times, potential buyers may request that confidential technical information be excluded from the material provided to avoid any possible future claim that it has misused the target's proprietary information. Also, it is a good practice to require that all personnel contacts be made through the target's investment banker and that they are properly briefed.

The agreement may prohibit the disclosure of negotiations by either buyer or seller. The selling company will try to control a bidder's ability to discuss the possible transaction with other potential acquirers. If the target is a public company, the contract typically contains *standstill provisions* setting the terms under which the bidder may acquire, vote, or dispose of target stock. A potential buyer with separate trading and investment functions, such as a securities dealer, may request that some of its units be permitted to continue trading in target stock without violating the standstill, provided that trading and merchant banking divisions are separated by the so-called *Chinese wall*.

The target may, through its investment banker and legal counsel hired by the special committee of the board of directors, provide bidding guidelines governing the substance, timing, and manner of submission of acquisition offers. The restrictions on proposals are most effective when coupled with a provision in which the bidder agrees not to request any waivers or amendments of the standstill. Typically, there is a term to which the bidder is subject to the restrictions of the standstill and non-solicitation provisions. Other provisions—such as technological know-how—may be perpetual or may expire after a stated number of years or a stated event. The acquiree may or may not accept the request of *most favored nation* status by bidders, giving the bidder the right to get the same concessions granted to any other potential buyers.
VALUATION AND FINANCING

The valuation process involves a self-evaluation by the acquiring firm and the valuation of the acquisition candidate. The self-evaluation phase estimates the value of the acquiring firm and examines how it is affected by each of the various scenarios. Self-evaluation takes on special significance in the exchange-of-shares acquisition. Valuing the purchase price at market might induce overpayment if the company’s shares are undervalued, or might obscure the opportunity to offer the seller additional shares while still achieving the acceptable return if the shares are currently overpriced.

The valuation of a merger candidate takes place after a suitable candidate has been identified. This is made to determine what price should be offered to the shareholders of the target company. It is important to recognize that the valuation techniques, as discussed shortly, are used only in determining the price range reference for the target company. Each acquirer should be guided by the technique that fits its objective. Equally important, a risk analysis (such as scenario analysis or sensitivity analysis) should be performed. The valuation is not complete until the impact of the acquisition on the acquirer is also carefully examined.

Estimating the Value of a Business

Several techniques are available to estimate the value of a business. They include discounted cash flow, comparable transactions, comparable company, breakup valuation, target stock price history, M&A multiples, LBO analysis, leveraged recapitalization, gross revenue multiplier, book value, multiple of earnings, and liquidation analysis.

The Discounted Cash Flow (DCF) technique is widely used in evaluating internal growth investments and external acquisitions. The DCF method determines the value by evaluating the cash flow projections of the target and discounting those projections to the present value. The DCF approach is future oriented. It begins with a projection of sales and operating profit, based on the assessment of historical performance as well as certain assumptions regarding the future. Obviously, the usefulness of this technique depends on the accuracy of the assumptions. These assumptions include estimations of how those sales will affect the company’s other areas of business, how much additional working or fixed capital will be required, and what will be the discount rate and residual value. The value of the DCF should be estimated under different scenarios, using projection periods of varying lengths.

Comparable transaction analysis is used to analyze transactions involving companies in the target’s industry or similar industries over the last several years. Acquisition multiples are calculated for the universe of the comparable transactions. These multiples are then applied to the target’s financial results to estimate the value at which the target would likely trade. This technique is most effective when data on truly comparable transactions are available.

The comparable company approach makes assessment of how the value of the potential acquisition candidate compares with the market prices of publicly traded companies with similar characteristics. This method is similar to the comparable transaction approach in that it identifies a pricing relationship and applies it to the candidate’s earnings, cash flow, or book value. A change-of-control premium should be added to the value identified by this method to arrive at the estimated valuation range for the target. One weakness of this technique is that it works well only when there are good
comparable companies for the target. Another weakness is that accounting policies can differ substantially from one company to another, which could result in material differences in reported earnings or balance-sheet amounts.

The *breakup valuation* technique involves analyzing each of the target's business lines and summing these individual values to arrive at a value for the entire company. Breakup analysis is best conducted from the perspective of a raider. The process is first to determine the value of each piece of the target and then compute the total value. Then the acquisition cost is estimated. If value exceeds cost, the raider computes the rate of return. This technique provides the required guidance under a hostile bid.

*Target stock price history analysis* examines the stock trading range of the target over some time frame. The target stock price performance is analyzed against a broad market index and comparable company stock performances. The offering price is based on the price index plus some premium. Similar analysis is performed on the acquiring firm if the transaction is a stock-for-stock exchange. The purpose is to determine the exchange ratio. This approach fails to account for future prospects of the company. Nevertheless, it does provide historical information many find useful in framing valuation thoughts.

The *M&A multiples* technique analyzes the current and past broad acquisition multiples and the change-of-control premium. This technique is used when comparable transactions or comparable companies are not available. The limitation is that a broad market average may be inapplicable to a single transaction.

*Leveraged buyout* (LBO) analysis is performed when the target is a potential candidate for LBO. The objective is to determine the highest price an LBO group would pay. This is often the floor price for the target. On the other hand, it may set the upper value for the target company if a corporate buyer cannot be located. The LBO analysis typically includes cash-flow projections, rates of returns to capital providers, and tax effects. The primary difference between the LBO analysis and DCF technique is that the LBO approach incorporates financing for the LBO. The availability of financing depends on the timing of cash flows, particularly in the first two years after the deal is completed. As is clear, the value derived by the LBO approach can be materially affected by temporary changes in financing conditions.

*Leveraged recapitalization* method is aimed at identifying the maximum value that a public company can deliver to its shareholders today. In general, the analysis is performed in the context of a probable or pending hostile offer for the target. The value in a recapitalization is delivered to the shareholders through stock repurchase, cash dividends, and a continuing equity interest in a highly leveraged company. This technique focuses on the target's capital structure, and is largely affected by the availability of debt financing at a particular time.

*A gross revenue multiplier* is the so-called price-to-sales ratio. The basic concept is that the value is some multiple of the sales the target generates. The method implicitly assumes that there is some relatively consistent relationship between sales and profits for the business. Obviously, the usefulness of the technique depends on the revenue-profit relationship. In practice, this method may be quite useful when acquiring a private company where gross sales are the only reliable data available.

The *book value* approach is an accounting-based concept and may not represent the earnings power. Generally accepted accounting principles permit the use of alternative depreciation and/or inventory methods. Also, the value of intangible assets may not be reflected in the balance sheet. However, it will help provide an initial estimate of goodwill in a transaction.
The *multiple of earnings per share* method involves taking the past or future income per share and multiplying that figure by an earnings multiplier, derived from publicly traded companies in the same industry. One difficulty is that the known multipliers do not reflect control premiums, as evidenced by the rise in the multiplier in the event of an acquisition. Another problem is that income does not necessarily represent cash flow from operations.

*Liquidation* analysis could be used to establish a floor for valuation. This approach is relevant if a business is being acquired for its underlying assets rather than for its going-concern value.

**Financing**

Financing is often left as a final detail in structuring an M&A. In structuring acquisition financing, financial positions and expectations of both parties must be considered simultaneously. The flexibility available through various means of payment (currency) and the ability to balance the requirements of both parties involved are among the key ingredients of the negotiated outcomes. Taxable or tax-free transactions are important considerations in the choice of financing methods as well; buyers are more willing to pay a higher premium in tax-free transactions (pooling-of-interests). For example, buyers between 1993 and September 1996 paid a median premium of 30 percent in tax-free acquisitions, compared to a 21.5 percent premium when pooling was not used.\(^1\)

The forms of payments include cash, common stock, preferred stock or debt, convertible securities, and contingent payments. *Pooling of interests* is the most popular method companies use for big stock mergers. Poolings let companies simply combine their assets, which does not create goodwill charges. Companies currently can write off goodwill for as long as 40 years. A new FASB proposal would force companies to break down goodwill into its component assets, calculate the average useful life for the goodwill, and write it off over that period.

All-cash transactions can be closed faster than those made with any other currency.\(^2\) All-cash deals allow the acquirer the greatest flexibility from a tax standpoint, although the transaction is clearly a taxable event to the selling shareholders. The acquirer has certain tax elections that may produce greater cash flows than the target enjoyed before the acquisition. Much of the tax benefit comes from writing up the tax basis of the assets in order to create larger noncash depreciation or amortization expenses that reduce taxable earnings. Under generally accepted accounting principles (GAAP), all acquired assets and liabilities must be recorded at market values, whether the cash is used to purchase assets or stock.

Common stock transaction is another possibility. The most common appeal is that it substitutes stock for a large outlay of cash or a heavy accumulation of debt. The exchange of shares is a tax-free transaction. The recipients do not pay taxes on the stock received until they sell the stock. There is, however, a potentially negative consequence of dilution. Another factor is that a company cannot intend to repurchase treasury shares and at the same time select to use pooling accounting in an acquisition. For example, the SEC took action forcing U.S. Office Products and Corporate Express to account for their stock financed acquisitions as if they had been cash purchases instead, because both companies announced hefty stock buybacks within six months of closing those deals.

Preferred stock or debt is often issued when the deal is so large that the required acquisition financing is difficult to obtain or the earning power precludes sufficient
financing by alternative modes. The preference of deferring tax liability of the selling entity is another reason. It is possible to structure a note so that the sellers are not taxed until the principal payments are made. This method is easier to structure and is frequently used in the sales of closely held companies. Structuring this type of financing is more difficult with public companies that have large and diverse shareholder groups. Deals with this type of financing will be treated as purchases. The buyers are required to subtract from their future earnings the premium of the takeover price over the book value of the target.

Payment by issuing convertible securities offers a means of issuing common stock in an M&A without immediate dilution. This also effectively allows the acquirer to issue fewer shares than if financed entirely with common stock, because the conversion price is typically set at a level higher than the current market value. It does require payment of interest or preferred dividends for a period of time. In practice, convertible preferred stock is most frequently used because it is possible to structure the transaction so the seller receives new securities tax free, until the securities are sold. The transaction will be accounted for as a purchase for bookkeeping purposes.

Earnout-contingent payments are typically structured so that part of the purchase price is contingent on the target's post-acquisition achievement of certain goals. The contingent formula for additional compensation is often based on financial performance. Experienced M&A bankers representing a private-company seller would typically recommend an operating-based contingency instead of a profit-based one, since the profit picture can be manipulated by the new owner. This approach helps bridge the gap when there is a large difference between the bid price and the asking price in a private transaction. It also provides a means to keep and motivate the former owners of a business subsequent to an acquisition. From an accounting perspective, one of the most difficult aspects is that all contingent payments generally accrue to goodwill. There is no tax benefit. This method of payment precludes the use of pooling of interest accounting.

Securitization has rapidly become a method for generating funds to finance M&A transactions. This type of financing has several benefits, including off-balance-sheet treatment and lower interest costs. The savings in interest payments for non-investment-grade companies could be hundreds of basis points. Typically, the time required is about 8 to 12 weeks. When an acquirer has an existing securitization program in place, the process will go a lot faster.

Bridge loans were common elements in M&As during the 1980s. However, they are rarely used in the 1990s because of the loss experience. The use of a bridge loan is to secure closing a deal. Junk bond issues were commonly used to pay off bridge loans in the 1980s in highly leveraged transactions. Bridge loans are more expensive than other credit products. Structuring and underwriting fees can range from 1 percent to 5 percent. Closing fees and interest rates are higher than the borrower would normally incur. Bridge loans might also involve escalating interest costs, an equity kicker, or a penalty fee if such a loan is not refinanced by a set date.

**CLOSING AND REGULATORY ISSUES**

Most deals begin with preliminary negotiations. The buyer wants to find out as much as possible about the seller. By contrast, the seller walks a thin line between disclosing enough so the buyer won't have future recourse, but not too much negative information.
tion to cause the buyer to walk away. The characteristics of the deal will certainly affect the negotiations. The first significant characteristic is whether the target is privately or publicly owned. The currency or form of payments is another matter subject to heated negotiations. If these preliminary negotiations are successful and both parties agree in principle on the basic points, they sign a letter of intent. A press release may be issued concurrently.

Although the letter of intent generally is not legally binding, it does represent a moral obligation that is normally taken seriously by both parties. The letter of intent can form the basis of filing under the Hart-Scott-Rodino Antitrust Improvement Act. However, there are good reasons not to have a letter of intent. The parties might not wish to make a public announcement that is not required of privately held companies. The selling company might also be negotiating with other potential acquirers and might want to avoid disclosure that could weaken its bargaining position.

The letter of intent is in the form of a letter addressed to the seller or seller's stockholders. It is signed by the acquirer and countersigned by the seller or seller's stockholders. It covers the following areas: form of transaction, currency, protective provisions for purchaser, special arrangements, brokerage or finder's fees, and break fees.

The Acquisition or Merger Agreement

When negotiations reach a point of agreement, the lawyers from both sides face an elaborate process of document drafting to reflect the terms of the transaction. Whether the transaction takes the form of merger, stock purchase, asset purchase, or other variations, the fundamental document is the acquisition or merger agreement. The acquisition agreement is often accompanied or followed by a variety of documents required by federal and state laws regulating acquisitions, and also a variety of documents pertaining to the acquisition agreement itself.

There are four most critical features in the agreement: representations and warranties, covenants, closing conditions, and indemnification.

Representations and warranties serve three important purposes:

1. **Informational.** They provide the means through which the purchaser is able to learn as much as possible about the selling company.
2. **Protective.** They provide a mechanism for the purchaser to be relieved of its obligations if adverse facts are discovered between signing and closing.
3. **Framing.** Representations and warranties provide a framework for the seller's indemnification of the acquirer following the closing.

The seller's representations and warranties normally account for the largest part of the acquisition agreement. They include financial statements, assets, taxes, contracts, employee matters, environmental protection, product liability, litigation and compliance, corporate organizations and capitalization, and existing restrictions. The acquirer typically performs the definite investigation of the seller's business after the execution of the agreement, although an earlier preliminary investigation is usually made. Standard conditions for closing is that the seller's representations be true both at the signing of the agreement, as well as at the time of closing. The information about the seller and its business is frequently generated by the so-called disclosure schedule. The parties can agree on the length of time that certain representations survive the closing. Environmental issues and product liability generally survive longer than other commer-
cial representations and warranties. The seller will raise the issues of materiality and knowledge qualification. That is, the seller will want to limit disclosure to material items and only to items of which it has knowledge.

**Covenants** cover the period between signing and closing, including negative covenants and affirmative covenants. Negative covenants restrict the seller from taking certain actions without purchaser's consent. They are intended to protect the purchaser against the seller's actions that might change the nature of what the purchaser expects to acquire at the closing. For example, the acquirer does not want the seller to take cash out of its business, increase debt, or change accounting methods. Affirmative covenants typically obligate both parties to the transaction to take certain actions prior to the closing. Typical affirmative covenants provide for (1) purchaser's full access to the seller's books and records for the purpose of evaluation and investigation, (2) calling and holding stockholder meetings to obtain approval, and (3) making required filings with government agencies and obtain necessary approvals. Some covenants contain both absolute obligations and reasonable-efforts qualification.

**Conditions of closing** must be met. The first condition in every agreement is that the representations and warranties are true and all of the covenants and agreements required to be performed at or prior to closing have been performed in all material respects. The condition is confirmed by each party's delivering to the other a certificate to this effect. Other common conditions include expiration of the waiting period under the Hart-Scott-Rodino Act, approval of regulatory authorities, receipt of third-party consent, receipt of favorable tax rulings, settlement of litigation, signing of employment and noncompete agreements by key employees, registration of officers and directors, satisfactory results of investigations, and any other conditions deemed important. If the acquisition involves a non-U.S. citizen, the conditions for closing would need to include compliance with the Exon-Florio Amendment relating to national security concerns. Written notification of the proposed transaction must be sent to the Committee on Foreign Investment in the United States (CFIUS). The committee has 30 days to decide whether an investigation is necessary, the investigation must be completed in 45 days, and a final decision must be announced within 15 days thereafter. The final issue is the date of the closing. A good approach is to set a target date and then provide that if a condition is not met, the party unable to meet the condition may postpone the closing, but not later than a specified date.

**Indemnification** provisions are crucial in an acquisition agreement. Indemnification is used to protect the purchaser because of the potentially high costs of certain liabilities such as taxes, environmental matters, and litigation. The provisions normally cover damages incurred by the purchaser resulting from (1) a breach of a covenant or a misrepresentation that is discovered after closing, or (2) an allocation of responsibilities between the buyer and seller in the acquisition agreement. These provisions are the subject of heavy negotiations. The seller may seek a basket provision that provides purchaser indemnification only if the damages exceed a certain amount. The seller may want to include a cutoff date beyond which the purchaser cannot assert claims. Also, it is not uncommon to see an upper limit on liability in the provisions.

**Regulatory Issues**

Legal considerations often affect the timing and structure of an acquisition, especially for a publicly held target. The legal counsel should examine the antitrust concerns, SEC regulation, state laws, IRS rulings, ERISA filings, and other regulatory filings.
An important consideration in any acquisition is the potential constraint posed by federal antitrust laws. The Hart-Scott-Rodino Antitrust Improvements Act requires parties to certain acquisition transactions to provide the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice (DOJ) with a Premerger Form detailing the businesses involved and the proposed deal. The act requires an initial waiting period of 30 days after the Premerger Form is filed before the transaction can be consummated (only 15 days in the case of a cash tender offer). The purpose is to help the government enforce antitrust laws. Responsibility for enforcing federal antitrust laws is shared by the DOJ and the FTC. For vertical mergers, portions of the DOJ 1984 merger guidelines provide a framework for analysis. Few, if any, such deals have been challenged in recent years. For horizontal mergers, the 1992 Horizontal Merger Guidelines, issued jointly by DOJ and FTC, outline the framework that the federal agencies will apply in investigating the proposed transactions. The guidelines employ the Hirndahl-Hirschman Index (HHI) as a measure of market concentration. Proposed transactions are likely to be challenged if the post-merger market is highly concentrated. If a deal is challenged, the new rules (adopted in September 1996) require FTC administrative law judges to file their final decisions within a year. Those decisions could be appealed to the five-member commission. In merger cases, companies could opt for a fast-track program that guarantees a decision by the commission within 13 months. Before the new rules were adopted, it took an average of three to five years for a final approval or rejection. As an example, R.R. Donnelley & Sons Co.’s $536.5 million acquisition of Meredith/Burda Co. was challenged in October 1990. An administrative law judge did not issue a decision until January 1994. Donnelley appealed and won the approval in August 1995.

Another important legal process involves SEC filings. When an acquiring company is issuing securities to finance the purchase, registration must be filed with the SEC (under the Securities Act of 1933) unless the private placement or intrastate offering exemption is available. If the target's securities are registered under the Securities Exchange Act of 1934, it must use a proxy statement or information statement that complies with SEC Regulation 14A. An exception is when the acquisition is via an exchange of securities directly with the target's shareholders. If a target company proxy statement is used, a Form S4 registration statement is generally filed. Within 10 days after purchasing 5% of any class of equity securities, the acquirer must make public disclosure of the purchase by filing with SEC a Schedule 13D and delivering it to the target. In addition, if the method adopted is tender offer, the purchaser must file with the SEC and deliver it to the target a Schedule 14D-1 (Williams Act of 1968). A tender offer commences at the time the offer is first published, sent, or given to stockholders. If the acquirer publicly announces the tender offer, it must file its 14D-1 within 5 days. A tender offer must be open to all holders of a class of securities that the offer is made, and must remain open for at least 20 business days. The offer must remain open for at least 10 days after any amendment.

State securities laws filings can be lengthy and complicated. When an acquisition takes the form of a statutory merger, the agreement of merger must be filed in each state where the company is incorporated. Some states may require tax clearances. A favorable tax ruling by the Internal Revenue Service (IRS) is frequently among the conditions of closing. The most typical request is that the IRS rules the transaction tax free. The request requires an extensive document describing the transaction in detail. It usually takes several months for the IRS ruling. A recent development worth special attention involves the proposed bill in Congress to eliminate the popular
Morris Trust structure used to sell subsidiaries on a tax-free basis. Although stock-for-stock mergers of entire companies are often tax free, division sales are taxable if paid with cash. But under the Morris Trust structure, a buyer can pay with its own stock and assume debt of the seller. If the bill is passed and becomes law, many corporations may choose other options such as straight spinoff, rather than selling the business for cash and paying taxes.

The Employee Retirement Income Security Act of 1974 (ERISA) is intended to protect the interest of employee benefit plan participants and their beneficiaries. A report must be filed with the Pension Benefit Guaranty Corp. Reports are required when the acquisition changes the plan employer, completely or partially terminates the plan, or results in merger of plans. In certain circumstances, filings must be made to the IRS as well.

Legal opinions are standard features of an acquisition agreement. Counsel renders legal opinions for both buyer and seller on behalf of their respective clients. Legal opinions affirm that the acquisition agreement has been duly authorized, executed, and delivered; that the agreement is binding on both parties; and that it does not violate the corporate charter, bylaws, or agreements of which the counsel have knowledge.

When an acquisition is in a regulated business such as banking, transportation, or communications, additional filing with Federal Reserve Board, Interstate Commerce Commission, or Federal Communications Commission is required. Furthermore, several states require their environmental agencies to be notified if there is a change in company ownership and to conduct environmental audits. For example, New Jersey's Environmental Cleanup Responsibility Act requires the target's hazardous wastes be cleaned up when there is a change in corporate control. This may materially increase the costs of acquiring a target with manufacturing facilities in New Jersey.

Closing Summary

Closing is governed by the acquisition contract. The objective is to permit buyers, sellers, lenders, and others to complete the transactions in a coordinated manner. Some of the commonly used closing documents include:

- Certificates of incorporation
- Bylaws
- Letter evidencing the passage of Hart-Scott-Rodino waiting period
- SEC order declaring registration statement effective (if applicable)
- Letter evidencing listing of securities (if applicable)
- Approval or clearance by other government agencies
- Tax rulings from IRS or state tax agencies
- Comfort letters from accountants
- Legal and fairness opinions
- Instructions for securities and/or funds transfer
- Escrow agreements

Before and during the closing, other important activities may be taking place and must be coordinated with closing. These activities include:

- Audit of seller's financial condition
- Registration of securities with the SEC
• Compliance with state securities laws and regulations
• Stock exchange listing and rules
• Tax ruling from IRS
• Antitrust clearance
• Escrow agreements

These important activities are completed before the deal is closed. The closing documents are carefully reviewed and signed. When everyone is satisfied with the documents, they are exchanged and funds or securities (sometimes both) are transferred in payment. The deal is closed.

TAKEOVER DEFENSES

Takeover defenses, or *shark repellents*, generally fall into three classifications. The first involves corporate charter and bylaw amendments, which require shareholder approval. Another involves financial techniques that can be installed by directors without shareholder approval. Also, structural and strategic actions have been occasionally used to fend off unwanted takeover attempts.

*Charter and bylaw amendments* were used frequently in the 1980s, but were rarely tried in the 1990s because of opposition by institutional investors. If used, the menu includes the following. One is the staggered board, in which directors serve a term of three years and only one-third of the board is up for election every year. The aim is to prevent a hostile acquirer from taking control of the board in one blow. The company may set a minimum acceptable price or a supermajority vote in an event of a takeover. Another possibility is to adopt the McDonald's amendment, allowing directors to make decisions on a wide range of issues beyond the purchase price. Anti-greenmail was common practice in the 1980s in fending off raiders. Also, some companies reincorporate in a state with stiff anti-takeover laws.

Certain financial techniques or changes in capitalization are measures costly to the raiders. A *poison pill* is a shareholder right that allows them to buy additional shares when triggered by certain events. Similarly, poison securities take on a deterring character when the company is under siege. Poison shares are preferred stock with supervoting right, triggered by an unwanted takeover attack. Poison puts are attachments to debt securities, puttable if the control of the company changes hands—which effectively increases the amount of debt, making it less attractive for a takeover. Capitalization changes include multiple classes of common stocks, with one class superior to the other in voting rights. Also, financial engineering techniques may produce temporary changes in capital structure. The techniques include leveraged recapitalization, self tenders (large-scale repurchase), employee stock ownership plans (ESOP), pension parachutes, and severance parachutes (golden parachutes).

Strategic and structural defenses involve a wide range of initiatives. One common technique is to seek a *white knight*, a more compatible buyer that will pay a higher price than the hostile bidder. A management buyout, in which management becomes its own white knight, is another tactic. Another defense is for the target to sell its "crown jewel" to keep a hostile acquirer away. At the other end of the spectrum, the besieged company can use acquisitions as defensive tactics, either by purchasing a poor-performing company to make itself look worse or by buying a business that competes with the acquirer to set up a possible antitrust conflict. The most extreme of this
type of defense is the Pacman strategy, the counterattack by the target to tender the acquirer's shares.

LEGAL CONSIDERATION IN BUYING PUBLIC TARGETS

The important legal issues facing acquirers and investment bankers are break fees and lock-up options, deal poaching, the role of controlling shareholders at a target, just-say-no defense, and conflicts of interests.

Break fees are paid by the target to the first accepted bidder if it is beaten out. Lock-up options for target stock or selected assets are triggered by a successful competing bid. These two are at times combined, and sometimes given mutually by the acquirer and the seller. Break fees and lock-up options are among the most intensely negotiated items in public deals. The acquirer almost always asks for a large break fee or lock-up option for the risk of providing a floor value for the target. The target usually argues for lower fees or smaller options in order to retain flexibility to consider better offers. The break fees are currently in the 1% to 3% range, while the lock-up options to buy shares usually involve between 10% to 20% of target stock. For example, the break fees for the proposed merger between British Telecom and MCI were $450 million—if either company canceled the deal, it would have had to pay that much to the other. A target's board may grant break fees and lock-up options without breaching fiduciary duty, provided that the terms are reasonable.

Another issue is deal poaching. There are several examples. One is Medtronic's acquisition of Electromedics in 1994 for $95.1 million in stock, beating out a previously accepted bid of $92 million by St Jude Medical. Another is Moorco's $150 million bid accepted by Fisher & Porter and later upset by Elsag Bailey Process NV's bid of $156.5 million in 1994. Also, NBC acquired Outlet Communications in 1996 for $395.9 million. Outlet Communications originally had agreed to sell to Renaissance Communications for $350.5 million. The bidders were willing to absorb the break fees and lock-up options because the amounts were not high enough to deter them.

A controlling shareholder has the right, with certain exceptions, to decide whether, when, and on what terms to sell its shares. However, it is also a fundamental legal principle that a company's board of directors owes a fiduciary duty to all shareholders, not just some subgroup, even if that group has a controlling position. If the controlling shareholder wants to sell its entire position and the buyer wants to buy the whole company, the deal gets done only if the price offered to the minority is the best available. The legal outcome becomes uncertain if the target's financial advisor determines that terms of the offer are inadequate. Under Delaware case law, dissenter's rights are normally the exclusive remedies for minority shareholders cashed out by the controlling party. Additional remedies are available if there has been fraud or unfair dealing.

A target board can decide not to sell the company—just say no, even in the face of a premium or fair bid. The 1989 Time Warner case reaffirmed the target board's flexibility in dealing with hostile bids. The court permitted Time Inc. and Warner Communications Inc. to proceed with a strategic alliance in the face of a hostile bid for Time by Paramount Communications. This ruling is in contrast to a corporate principle in which a target board cannot take unilateral steps to absolutely preclude a takeover proposal or proxy contest. Therefore, what can or cannot be done in this area will continue to be a battleground.
Next, a transaction is most legally vulnerable if one or more parties has an actual or potential conflict of interest. When there is a suspicion of conflict, many jurisdictions shift the burden of proof to the contracting parties to demonstrate fairness if challenged. Companies often set up special committees of independent directors to deal with conflict situations. Another area for conflict of interest involves fairness opinion fee arrangements. It is a common practice that the target of public deals receives a fairness opinion from a reputable financial advisor. Fairness opinion fees typically range between $75,000 and $200,000. Usually the financial advisor also provides advice and assistance in deal structure and negotiations, receiving a fee based on the deal value and contingent on closing. The overall transaction fees to a financial advisor often are in the range of 0.5% to 1%. The size of the deal fee and its dependence on closing certainly create pressures on a financial advisor to give fairness opinions in close calls. To date, courts generally have not barred reliance on fairness opinions, despite the potential conflict of interest imbedded in the fee structure. An increasing number of boards have either insisted on receiving a second fairness opinion from another advisor or assigned deal advice and fairness opinion to different advisors.

**POSTACQUISITION INTEGRATION**

The period shortly after closing is the time when critical steps are taken to integrate the acquired business with the buyer organization. During the same period, a variety of steps—legal, accounting, tax, insurance, employee benefits, and others—should be taken to ensure a successful transition.

Many acquirers form transition teams composed of executives of both companies to coordinate the postmerger integration process. This includes developing recommendations for combining a wide range of functions and proposing the configuration of the new organization. It is better to organize a small team of results-oriented experts around postmerger projects, in order to stabilize the organization and build early momentum. The poor transition in the 1989 merger of SmithKline Beekman Inc. and Beecham PLC illustrates the importance of a small, efficient transition team. The company saw its operating costs and interest expenses rise and its R & D synergy falter while it stumbled through a hierarchy of 250 transition teams.

Early management placement is a critical factor in stabilizing the company and positioning it for quick gains. The crucial task is in deciding whom to retain, whom to redeploy, whom to dismiss, and at what price. A striking point frequently is that the compensation schedule at the acquired company is out of line with acquirer's policies. Also, competing organizations often attempt to lure away the best and brightest managers and technical stuff immediately after the acquisition. The acquiring company often has to offer "stay bonuses" to retain these employees.

The changes in benefits, particularly changes in pensions, have highly complex ramifications. Important items in benefits are pensions, health insurance, life insurance and disability plans, and labor agreements. The administration of qualified retirement plans is guided by many tax and labor laws, as well as by numerous accounting guidelines. Health insurance costs are among the major cost items for a company. The buyer must analyze current life insurance and disability plans to determine whether they match the buyer's objectives.

Collectively bargained labor agreements present a unique set of issues. In addition, postacquisition discrimination tests must be applied to ensure continued compliance
with applicable legislation. When acquiring a target's stock, the acquirer assumes all of the target's obligations.

Manufacturing units and back-office operations are to be integrated after the merger. This might take several months, at least. Another related issue is that every attempt should be made to prevent the rise of such feelings as "us versus them" or "winners versus losers."

In addition to these important areas of integration, there are several other crucial steps. A partial checklist of important items is as follows:

- File Form 8-K with the SEC.
- File affidavit with the IRS.
- File Forms BE-13 with the DOC.
- Obtain issuance of formal title insurance policies.
- Record assets at stepped-up values for tax and accounting purposes.
- Arrange for seller's employees to read and sign corporate code of conduct.
- Obtain recorded originals of deeds.
- Monitor sales of shares covered by any shelf registration.
- Comply with Rule 10-b.
- Change corporate name and signatories on seller's bank accounts.

Another post-closing project is to identify and obtain evidence of the seller's historical insurance coverage. Many courts interpret statutory time limits on the right to sue as running from the date the claimant allegedly discovered the damage or injury, and the claims might be covered by policies written years ago. A determined effort should be made before or right after closing to obtain old liability policies and related records.

**RISK ARBITRAGE**

Risk arbitrage is an important part of the M&A market. The arbitrageurs (arbs) help make the M&A market liquid and provide shareholders a way to sell stock at a price near the tender price right after the announcement. The arbs are, in essence, taking over shareholder risk and hence, they expect a high return.

A transaction can involve a cash exchange, an exchange of securities, or a combination of both. First consider the case of a cash offer. Suppose an acquirer is offering to buy the target's stock at a price of $50 per share at a time when it is traded at $40 per share, a 25% premium. The target's stock can be expected to rise to about $50. There is a chance that the acquirer might withdraw or change the offer, however, so the target's stock might rise to, say, $46 rather than $50. An arbitrageur purchasing the target at $46 will realize a profit of $4 per share if the acquisition takes place at $50. The arb will lose $6 or more per share if the deal does not go through and the target's share falls back to $40 or lower. As the deal becomes more of a certainty, the stock price will be bid up to almost $50. Late-entering arbs will face less risk—and lower possible returns.

A classic example of the risk associated with this type of risk arbitrage is the various buyout attempts of UAL Corp. in 1989 and 1990. In September 1989, a group consisting of pilots and management of United Airlines proposed a $300-per-share bid for UAL's stock. The board approved the transaction and the stock reached $296. However, the group could not obtain financing to close the deal, and subsequently the stock fell by almost 50% in just a few days. In January 1990, the union proposed a bid of $201 per
share. The stock plunged again because of financing problems. It has been estimated that the arbs lost more than $1 billion resulting from these failed takeover attempts.

When the transaction involves an exchange of securities, the arb would long the securities of the target, expecting them to rise in price, and short the securities of the acquiring company, expecting them to decline. There are two risks involved: Either the acquisition would not be consummated, or the length of time would be longer than anticipated. As an example, assume that the stock of an acquirer is trading at $50 per share. The company offers to exchange one share of its stock for one share of the target, which is traded at $40. The transaction is expected to be complete in three months. Suppose that the arb offers the target stock $46 per share. The target's shareholders can immediately take a $6 profit from the proposed deal by selling now to the arb. Or these shareholders can wait three months and receive one share of the acquirer's stock. This gives an extra $4 per share profit, but only if the acquisition is completed and only if the shares of the acquirer are still traded at $50 per share.

Suppose the target's shareholder decides to sell to the arb and take a profit of $6 per share. The arb will have a profit of $4 per share if the deal is closed as proposed. The same outcome remains even if the shares of the acquirer are traded at a level lower than $50. For example, the acquirer's shares are traded at $48, instead of $50. The arb has a $2 profit from the short position (acquirer) and another $2 profit from the long position (target).

As an example of such profitable risk-arbitrage business, consider the 1988 Hoffman-LaRoche's hostile bid of $72 per share for Sterling Drug. Sterling rejected the offer and Hoffman-LaRoche sweetened the offer to $76 and again to $81. The bidding war ended when Sterling agreed to be bought by Eastman Kodak for $89.50 per share. The arbs had hit the jackpot.

The primary risk is that the deal will not go through and the prices of both companies will go back to their levels before the announcement. The arb will lose $6 per share. The secondary risk is that the time horizon involved might be longer than anticipated.

The level of complexity in risk arbitrage varies depending on the structure of the transaction. A more complicated transaction is the two-tiered offer, in which cash is offered for an initial given percentage of stock, while securities are offered for the remainder. Another still more complex transaction offers cash and combination of securities for stock. To reduce risk, the arbs must perform comprehensive research to examine the likelihood of the proposed transaction and the structure of the deal.

The relentless pursuit of information by the arbs in M&A markets is vital to their success. However, occasionally arbs have violated insider-trading regulations. Several prosecutions were cited earlier in this chapter. Among them, Ivan Boesky reportedly made $50 million on the acquisition of Getty by Texaco, $65 million on the marriage of Chevron and Gulf, and $150 million in the failed Ted Turner's CBS takeover attempt. On the other hand, he reportedly lost $40 to $70 million when Phillips Petroleum bought off T Boone Pickens.

**SUMMARY**

Mergers and acquisitions are one of the major areas of investment banking business. Investment banks provide important services to this market, including intermediary, negotiation, pricing, advisory, and financing. An understanding of the dynamics in
M & A s and buyouts provides the foundation for playing a successful role as an M & A banker.

SELECT BIBLIOGRAPHY


*Mergers and Acquisitions.* Various issues.


Stock Underwriting

The investment bank that wins the mandate to run an issue of new securities is referred to as the lead manager or the bookrunner. Other houses could participate as members of the underwriting syndicate or the selling group. Investment banks earn billions of dollars each year through underwriting initial public offerings and secondary offerings. Increased competition certainly pressures underwriters for lower fees. Successful investment bankers must have a keen awareness of market condition and a strong perception of client capabilities and financial position. This chapter covers the major aspects in underwriting equities, including the mechanics and process, pricing, underwriter risks and compensation, aftermarket trading, and equity takedowns. The chapter also covers expenses associated with an offering, alternative types of offerings, and the new SEC "aircraft carrier" proposals.

MARKET OVERVIEW

The market includes initial public offerings (IPOs) and secondary offerings. The IPO underwriting spreads in the 1990s average slightly above 6%, compared with about 4% for the secondary offerings. The underwriting fees for IPOs each year from 1991 to 1997 are $1.6 billion, $2.4 billion, $3.5 billion, $2.1 billion, $1.9 billion, $3.0 billion, and $2.6 billion, respectively. Over the same period, Wall Street earned between $1 billion and $2 billion each year in underwriting secondary offerings. Major houses engaged in equities underwriting include the Big Three (Morgan Stanley Dean Witter, Merrill Lynch, and Goldman Sachs), Credit Suisse First Boston, Lehman Brothers, J.P. Morgan, Salomon Smith Barney, Chase Securities, Donaldson Lufkin Jenrette, BT Alex. Brown, SBC Warburg Dillon Read, NationsBank Montgomery, and BancAmerica Robertson Stephens. There are also many boutique houses such as Hambrecht & Quist (technology) and Friedman Billings (financial-services firms and mortgage REITs). It should be noted that commercial banks are permitted to engage in investment banking activities through their Section 20 subsidiaries, but revenues from such ineligible activities are capped at 25% of total revenue of the securities affiliate.

In a public offering, the Securities Act of 1933 requires the lead manager to conduct due-diligence research. The lead manager must prepare a registration statement to begin the SEC registration process. This is done in close coordination with the company, accountant, and counsel. Supporting documents such as the underwriting agree-
ment, legal documents, and financial data are made available to the public at SEC offices. The day the investment bank turns in the registration statement with the SEC is known as the filing date. The amendments to the registration statement, if so required, are submitted to the SEC again. If there are no further changes, registration becomes effective. In addition, if certain conditions are met, the issuer may file for Shelf Registration (Rule 415). Rule 415 permits issuers—with as little as 24-hour notice to the SEC—to register securities they expect to sell within two years.

There are two types of agreements between the issuing company and the investment bank. The first type is the firm commitment, in which the investment bank agrees to purchase the entire issue and reoffer to the general public. The second type is known as a best efforts agreement. With this type of agreement, the investment bank agrees to sell the securities but does not guarantee the price.

Other steps also take place during the registration process. The red herring is printed and distributed. The stock certificates are printed, and the listing exchange and the transfer agent are selected. The lead manager forms the underwriting group and promotes the issue in a roadshow. These terms will be explained later in this chapter.

After the issue goes public, the lead manager assures sufficient liquidity in the aftermarket by making market after the underwriting period. A public company is subject to the SEC disclosure requirements, including regular filings of financial data and timely disclosure of material information. The company is also required to send quarterly and annual financial statements to shareholders.

The basic process just described is applicable to both IPOs and secondary offerings. Therefore, the following discussion focuses on IPOs. There are, however, some basic differences between IPOs and secondary offerings. First of all, the motivations are often quite different. Second, IPOs are typically smaller but more lucrative for underwriters. The stock market responses are more dramatic for IPOs. Share price in an IPO generally surges, while in a secondary offering the price remains flat or declines. In addition, the process for a secondary offering is faster because the management team, listing exchange, and transfer agent are already in place.

The SEC is drafting proposals to simplify and modernize securities offerings. The SEC is considering whether to allow public companies to sell securities without having to file a registration statement for each transaction, other than a short written notification, for all small and mid-sized transactions. Companies selling big blocks of securities or selling stock in IPOs are still subject to the registration process. Thus, many small and mid-sized public companies could bypass underwriters and sell securities directly to investors or in private-placement transactions. Because of their significance, these proposals are known as the aircraft carrier.

MOTIVATIONS OF ISSUERS

Financing needs by an emerging firm are often the results of the firm’s success. Alternatives for satisfying the needs include a public offering, private placement, venture capital, and debt financing. The entrepreneur must evaluate each alternative carefully when searching for new capital. Theoretically, successful business people consider sharing their businesses with others because the firm is unable to obtain enough financing through other alternatives. In practice, there are many reasons motivating the decision to go public.
Advantages of an Initial Public Offering

An important reason for issuing an IPO is to raise capital as a source for ongoing financing, which will enhance the company's chance for successful growth and thereby increase stock value. If needed, a public company with a broader equity base has more access to the capital markets for future financing. Another advantage is greater public exposure and the improvement of corporate image. There is also a higher degree of public confidence because of disclosures required of public companies. This allows for a greater borrowing capability.

Beyond the gain to the company coffers, the greatest financial advantage of going public falls to the founders of the company. The benefits are distributed to the founder-manager, passive founding investors, and members of the management team who have received shares. An IPO provides founding insiders with opportunity to diversify their wealth and facilitates the exit of founding entrepreneurs from the business. With shares traded in the market by way of an IPO, it provides for liquidity as well as better estate planning flexibility for insiders. In addition, if the founding stockholder wishes to take a personal loan from a financial institution, the marketable shares offer a more acceptable form of collateral.

There are also added benefits for management and employees working for a public company. In a public company, stock options plans provide an attractive employment inducement. The plans make it easier to recruit quality employees, and often lead to improvement in productivity and long-term loyalty by the employee-shareholders. These enhancements in company value certainly result in a higher share price.

Disadvantages of Going Public

Prospective issuers should carefully examine the costs, risks, restrictions, and duties associated with going public. First of all, there is a lack of operating confidentiality resulting from the filing of the registration statement and meeting the subsequent reporting requirements. Some particularly sensitive areas of disclosure are remuneration packages (for the top five employees) and extensive company financial information.

Once the company becomes publicly owned, the management is under constant pressure to enhance short-term performance. The requirement that the board of directors or shareholders approve certain management decisions could cause delays or missed opportunities. As a public company, shareholders may demand that the company establish a dividend policy. Furthermore, if a substantial portion of shares is sold to the public, the original owners could lose control of the company.

Another area of concern is the possible change in accounting practices and reduction in management perquisites. Owner-managers are typically more concerned with tax savings than with earnings per share. Further, the company's financial statements may not have been audited. Certain compensation packages and related-party transactions that might be acceptable for a private company might appear imprudent in a public company. A company considering an IPO must be prepared to meet these additional burdens.

One important but frequently ignored negative effect is the possible damage to the thriving entrepreneurial culture as a result of tighter legal constraints or public exposure. Furthermore, the diffusion of corporate ownership could increase the possibility of a hostile takeover.
Finally, the process of going public is expensive and time consuming. The expenses include underwriting discount, counsel fees, printing costs, and other incidental costs. Preparation of the registration document and financial statements is a complicated process that demands a substantial amount of time from management. After going public, the company is subject to the SEC's reporting requirements and the disclosure of material information. These add significantly to the cost of operations.

ASSEMBLING THE IPO TEAM

Once the decision to go public is made, the next step is to assemble the IPO team. The team consists of the management and company's legal counsel, underwriter and its legal counsel, independent accountants, and financial consultants and advisors, and in some cases a financial public relations firm.

The quality of the management team is one of the most important factors in a successful offering. A quality management team should be able to foster growth and establish a leadership position in the market. Underwriters are especially pleased if some members in the management have experience in an IPO. It adds credibility to the management's role. A good board of directors with highly regarded business people who could be objective is a big plus in an offering.

The selection of an underwriter is important because the investment bankers are responsible for selling the securities. Management should begin building an underwriter relationship long before the offering. Usually a company selects one investment bank as the lead underwriter or syndicate manager. The underwriter will typically form a syndicate to underwrite and distribute the issue. When selecting an underwriter, consideration is paid to reputation, experience, market-making capabilities, fees, and after offering services. The underwriter will perform a preliminary investigation of the company to decide whether to undertake the offering. If satisfied, the investment banker and the company will discuss the type of security to be offered, firm commitment or best-efforts underwriting, the range of offering price, and the number of shares to be offered. Then the investment bank issues the letter of intent to formalize the arrangement, which will later lead to the underwriting agreement. One important note here is that the letter of intent signals the beginning of the quiet period (or silence period), during which the company is subject to SEC guidelines on publication of information outside of the prospectus.

Accountants are a key figure in this process. Much of the financial information contained in the registration statement is obtained from the audited financial statements. SEC regulations require the independent public accountant to certify the financial statements and examine other information included in the registration statement. The accountants also assist in responding to SEC comments on accounting issues and are required to sign the comfort letter stating that the financial statements conform to GAAP.

A consultant or advisor is sometimes retained on a dedicated basis for a specific task. A knowledgeable consultant can be very helpful in starting a company off on the right foot in the offering process. A knowledgeable consultant or advisor can also help in finding a suitable underwriter, making timely proper filings to the SEC, and several steps in between. The best advisors are those who have had years of experience in the area.
Attorneys are retained to advise on compliance with the securities laws during and after the registration process. In addition, attorneys usually conduct due-diligence matters, such as reviewing minutes of the board and shareholder meetings, articles of incorporation, contracts and leases, and the ownership status of major assets. They also coordinate the efforts of other members, resolve any question arising from SEC comments, and file necessary amendments. The attorney's competence and experience with the registration process are critical to the timely and effective coordination of the complex process. Top IPO legal counsels include Wilson, Sonsini & Goodrich; Brobeck, Phleger & Harrison; Testa, Hurwitz & Thibeault; Hale & Dorr; Fenwick & West; Skadden, Arps, Slate, Meagher & Flom; Latham & Watkins; Cravath, Swaine & Moore; Davis, Polk & Wardwell; Sullivan & Cromwell; and Shearman & Sterling; among others.

Another important member is the financial printer, who is responsible for printing the registration statement according to the SEC format and guidelines. Bankers, attorneys, or accountants are able to recommend financial printers. For example, Manhattan-based Browne & Co. is a leading financial printer.

Sometimes an IPO company might use the services of a financial public relations firm. A PR firm experienced in SEC registrations can often guide the company through the restrictions of the quiet (silence) period and help prepare materials for roadshows. A good PR firm can also help in developing the list of analysts and business press editors who follow the industry and providing them with news releases and information about the company. Furthermore, a transfer agent should be selected. The transfer agent provides services beyond simply transferring stock and recording the transaction. The transfer agent must report to IRS when dividends are paid. The transfer agent also provides a complete mailing service for sending out reports, proxy statements, and meeting notice to shareholders.

**MECHANICS AND PROCESS**

It usually takes at least several months to complete the offering process. The length of time needed depends on the readiness of the company, the availability of information required in the registration statement, and market conditions. The silence period typically begins once the company reaches a preliminary understanding with the underwriter and ends 25 days after the offering becomes effective if the security is listed on an exchange or is quoted on Nasdaq, otherwise it ends 90 days after the effective date. The steps in the process include filing registration statement, SEC letter of comments, preparing the amended registration statement, preparing the red herring or preliminary prospectus, conducting roadshows, performing due-diligence research, negotiating price amendment and signing the underwriting agreement, and closing.

**Registration Statement**

The commonly used forms for SEC registration are Form S-1 and Form SB-2. There is no limitation on the amount of offering using SEC Form S-1 or SB-2. In general, the same things must be disclosed in SB-2 as in S-1, but the required degree of detail is substantially reduced in SB-2.

Form S-1 requires the most extensive disclosure, and hence it will be illustrated here. Major items required in Part I and Part II of Form S-1 are as follows:
Part I
1. Forepart of the Registration Statement and Outside Front Cover Page of Prospectus
2. Inside Front and Outside Back Cover Pages of Prospectus
3. Summary Information, Risk Factors, and Ratio of Earnings to Fixed Charges
4. Use of Proceeds
5. Determination of Offering Price
6. Dilution
7. Selling Security Holders
8. Plan of Distribution
9. Description of Securities to Be Registered
10. Interest of Named Experts and Counsel
11. Information with Respect to the Registrant

Part II
1. Other Expense of Issuance of Distribution
2. Indemnification of Directors and Officers
3. Recent Sales of Unregistered Securities
4. Exhibits and Financial Statement Schedules
5. Undertakings

Part I is usually distributed as a separate booklet to prospective investors. The prospectus also must contain any additional data to make it meaningful and not misleading. Part II contains additional information such as the signatures of company officers, directors, consent of counsel and experts, and the financial schedules called for by Section 12 of Regulation S-X Part II is made available for public inspection at SEC headquarters in Washington or can be accessed online through Electronic Data Gathering, Analysis, and Retrieval (EDGAR).

In general, disclosed in the registration statement are various kinds of important information for investors when making investment decisions. Not all the items just listed will appear in every registration statement. Some information may be incorporated by reference to another statement filed with the SEC and need not be duplicated in the Form S-1 filing.

Part of the data includes information about the company's business, officers, directors, and principal shareholders and their compensation. The company must also disclose the size of the offering, the price range, the intended use of the funds, the audited financial statements, and the risk factors. Additional disclosures include the selling shareholders (if any), underwriting syndicate, type of underwriting, dividend policy, dilution, capitalization, related party transactions, and certain legal opinions. A key portion in Form S-1 filing is the management's discussion that examines the company's financial condition and results of its operations and the business plan.

Before a filing, there are often prefiling conferences with the SEC staff. The purpose is to discuss and make certain adequate disclosure and compliance with relevant regulations. The SEC staff is adept at pinpointing potential problem areas that may arise during the process of assembling information for the registration statement. For example, the company may wish to know how to handle a legal or accounting problem or how to deal with questionable regulation compliance in a filing.
Once the registration statement has been filed with the SEC, the waiting period (cooling off) begins. During the cooling-off period, the issue is considered in registration, and there are restrictions on the activities the company or the underwriter may undertake. During the waiting period, the underwriting syndicate begins soliciting indications of interest from potential purchasers, but no actual sales can be made until after the registration statement becomes effective. The effective date is usually the date when the issue is offered to the public for a firm commitment, or the date when selling begins for a best-efforts underwriting.

SEC Review and Comments

SEC staff specialists, consisting of an attorney, an accountant, and a financial analyst, review the IPO registration statement. The review group may also include other staff experts familiar with a particular industry. The staff reviews the documents to determine full and fair disclosure, particularly any misstatements or omissions of material facts that might prevent investors from making a fully informed investment decision. The SEC does not pass judgment on or evaluate the quality of a proposed offering, which is made by the marketplace.

After reviewing the registration statement, the SEC typically sends the company's legal counsel a letter of comments concerning deficiencies and suggestions. There are four basic types of SEC reviews, all aimed at the accuracy and adequacy of disclosure in the registration statement. A deferred review is when the initial registration statement is poorly put together, and is notified by a "bedbug letter" advising the registrant to withdraw. A cursory review, not often used, indicates that the staff has not found any glowing deficiencies. Similar to cursory review, the summary review is not often used. It includes a few comments based on limited review. The most preferred review is the customary review, which is a full review by the SEC staff accompanied by a detailed comment letter.

Amended Registration Statement

Each comment in the SEC letter of comments must be addressed and resolved. Common amendments include delaying amendment, substantive amendment, and price amendment.

A delaying amendment is used to request a new effective date if the company has not been able to reply or to make up the deficiencies. Failure to do so can result in a defective registration or SEC's stop order against the company.

A substantive amendment is typically used to correct the deficiencies in a registration statement. It could be either a reply to the SEC comment or an update of significant interim developments subsequent to the filing. The registration statement must be correct and current when it becomes effective.

A price amendment is commonly used when the price and the size of the offering are not determined until the day of or the day prior to the offering. This amendment supplies the last-minute information.

The Preliminary Prospectus or Red Herring

After the filing, a preliminary prospectus is distributed to brokers and prospective purchasers. The purpose is to gather an indication of interest from investors. This is the
main document the underwriting syndicate uses to sell the stock. However, as required by the SEC, the cover page must bear the caption "Preliminary Prospectus" in red ink (hence the term red herring) and the following statement:

Information contained herein is subject to completion or amendment. A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective.

Under SEC rules, the offering price, underwriting discounts, or other matters dependent on the offering price may be omitted in the preliminary prospectus. Once the effective date arrives, the offering price and the effective date will be added to the prospectus. Then the final prospectus is issued. A sample of the prospectus cover page and summary is provided in the appendix. The company in the sample prospectus, Friedman Billings Ramsey, is an investment bank that recently went public. Friedman Billings Ramsey itself was the lead underwriter. The issuing price was $20 per share and the underwriting discount was $1.40 per share.

Each state has its own securities laws, called blue-sky laws. However, as part of the efforts to reduce regulatory burdens on issuers, the National Securities Markets Improvement Act of 1996 exempts listed securities or securities sold to qualified purchasers from state registration requirements. It preserves state antifraud authority.

The Roadshow

The roadshow is the key marketing event that precedes the IPO by several weeks. It is arranged to meet with financial analysts and brokers in order for potential purchasers to learn more about the company, which hopefully will improve price performance in the aftermarket. The management team has to explain what their market position is, describe how the company will execute its business plan, and show off the quality of the management team. Many analysts consider top management to be among the most important aspects of any company. Investors frequently base their purchasing decision on their perception of the management. The roadshow is also a kind of public opinion trial for the issuer's business plan. By the end of the roadshow, the lead manager should have a good idea of the investor's interest, which assists in determining the final price and size of the IPO. An effective roadshow is crucial to the success of the offering.

Due Diligence

Before the registration statement becomes effective, the underwriter will hold a due-diligence meeting attended by members of the IPO team. The purpose is to list, gather, and authenticate matters such as articles of incorporation, bylaws, patents, completeness and correctness of minutes, and verification of corporate existence.

Due-diligence meetings are held to reduce the risk of liability associated with filing by ensuring that all material matters have been fully and fairly disclosed in the registration statement. This is an important safeguard. Part of the due diligence activity of legal counsel is to make formal visits to the company's offices and plant sites. Legal counsel typically maintains a due-diligence file.
Price Amendment and Underwriting Agreement

The negotiation and final determination of offering size and price are influenced by a number of factors, including financial performance of the company, stock market conditions, prices of comparable companies, market perceptions of the company, and anticipated aftermarket share value. The underwriting agreement is signed when the registration statement is about to become effective. Also at this time the final amendment to the registration statement is filed. The price amendment includes the agreed price, underwriter discount, and the net proceeds to the company. The underwriter will typically request that the offering be declared effective immediately (requesting acceleration) if the staff of the SEC Division of Corporate Finance has no important reservations. The underwriter may then proceed with the sales of the securities if the acceleration is granted.

There are three primary underwriting contracts: Agreement Among Underwriters, Dealer Agreement, and the Underwriting Agreement. The agreement among underwriters establishes the relationship among the underwriters. It designates the syndicate manager to act on their behalf. The dealer agreement or selling agreement is the agreement in which securities dealers who are not part of the syndicate are contracted to distribute the securities. These other dealers help move the issue to the marketplace. The dealer agreement will allow these dealers to purchase the securities at a discount from the offering price. The underwriting agreement establishes the contractual relationship between the corporate issuer and the syndicate.

The underwriting agreement generally contains introductions, warranties, terms of offering, conditions, covenants, indemnification, and cancellation. The Introduction section identifies the parties to the underwriting syndicate, the size and security type to be offered. The Representations and Warranties provisions cover the guarantee by the company. It also includes the warranty that the company is properly incorporated and accredited. Additionally, the Terms of the Offering include the underwriter's pledge to buy and pay for the securities, the timing, and any green shoe provisions. Covenants spell out the rights and obligations of all parties. Conditions in the underwriting agreement include the completeness and accuracy of company's representations, and that neither party can sell shares until the effective date. The Indemnification provisions excuse the underwriter's liability for material misstatements or omissions in the registration statement on the part of the issuer. Finally, the Cancellation section contains a clause that allows the underwriter to cancel the offering after the effective date but prior to the closing date, provided that the underwriter can show cause and justification.

Closing

The closing date is sometime after the effective date but the actual date depends on the type of underwriting. The closing meeting includes all key players and is usually held in the conference room of the escrow institution. At the closing date, various documents as well as the updated comfort letter are exchanged. The company delivers the registered securities to the underwriter and receives payment for the issue. Closing differs considerably between small offerings on a best-efforts basis and larger offerings on firm commitments.

For small, best-efforts offering, the closing takes place after the selling period has been completed. The selling period is usually 60 to 120 days after the effective date,
with extension allowance of 60 to 90 days by mutual consent. For a firm commitment, closing is usually a week or two after the effective date.

**Tombstones**

Tombstone ad is considered an essential ingredient of the process. This is more in the nature of announcement than advertisement. A *tombstone* is a boxed-in ad that appears in financial sections of newspapers and magazines that announces the particulars of the issue. It contains the name of the company, the issuing price and size, the lead underwriter, and other members of the underwriting group. A disclaimer also appears at the top:

> This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these securities. The offering is made only by the Prospectus.

The tombstone ads are a good means to introduce the company to the public and to pique the public’s interest. But management must make every effort to put together effective due-diligence meetings and roadshows, using all the help it can get from its PR firm and the underwriter. These meetings are presented to a largely critical audience of brokers and analysts who need convincing. The outcomes of these shows often spell the difference between the success and failure of an offering.

**TIMETABLE SUMMARY**

The share-issuing process is complex and requires team efforts. The following illustration serves to initiate the reader to the registration details and mechanics. Included in the illustration is a listing of some of the major events that must take place, an indication of the individuals involved, and the illustrative timetable.

1. (Day 1) The management selects counsel, underwriter, printer and signs the letter of intent. The quiet period begins.
2. (Day 3) Board of directors authorizes issuing shares, preparing registration statement, and negotiating underwriting agreement.
3. (Day 6) The IPO team in the initial organization meeting determines the type and structure of the offering, and selects the form of the registration statement.
5. (Day 10) The management, counsel, and independent accountant begin gathering necessary information and financial statements for the registration statement.
6. (Day 15) The management, underwriter, and respective counsels meet to prepare a draft of the underwriting agreement, agreement among underwriters, and power of attorney.
7. (Day 20) The management, its counsel, and underwriter’s counsel distribute questionnaires to directors, officers, and selling shareholders related to the registration statement.
9. (Day 30) All members of the IPO team meet to review the first draft of textual portion of the registration statement.
10. (Day 35) The management and independent accountant complete a draft of financial statements for inclusion in the registration statement.

11. (Day 45) Members of the IPO team hold a prefiling conference with SEC staff. All members meet again to review and comment on the draft registration statement, including financial statements.

12. (Day 50) The management sends first draft of registration statement to the financial printer. The management at this stage also needs to appoint a stock transfer agent and registrar and arrange for preparation of stock certificates. Separately, the management, underwriter, and independent accountant discuss comfort letter requirements and procedures.

13- (Day 70) The board of directors approves and signs the registration statement and prospectus.

14. (Day 71) The company files the registration statement. The underwriter distributes the preliminary prospectus.

15. (Day 80) The management, PR firm, and underwriter begin the roadshows.

16. (Day 100) The SEC comment letter arrives.

17. (Day 101) The IPO team prepares amendments to the registration statement and sends draft to the printer.

18. (Day 105) The team reviews printer's proof of amendments. The company files amendments to the registration statement covering SEC comments and updating any material development. Notification is also sent to SEC that a final price amendment will be held on Day 110 and that the company requests acceleration, so that the registration may become effective on Day 110.

19. (Day 106) The management, its counsel, and independent accountants resolve any final comments and changes with SEC by telephone.

20. (Day 107) In the due-diligence meeting, the team determines whether any additional events should be disclosed in the registration statement and if all parties are satisfied that the registration statement is not misleading.

21. (Day 108) The management and underwriter finalize the offering price.

22. (Day 110) This is the offering date. The independent accountant delivers the first comfort letter to underwriter. Management, underwriter, and respective counsel sign underwriting agreement. The company files price amendment to registration statement, and notifies stock exchange and NASD of effectiveness.

23. (Day 111) The tombstone advertisement appears in newspapers.

24. (Day 112) Managing underwriter provides registrar with names in which the certificates are to be registered, and packages certificates for delivery.

25. (Day 120) This is the closing date. The independent accountant delivers a second comfort letter to the underwriter. The company completes settlement with the underwriter, issue stock, and collect proceeds from offering. The management and underwriter sign all final documents.

VALUATION AND PRICING

The issuer often believes the stock is worth much more than the suggested price. But the underwriter wants to create demand for the new issue, and to sell it quickly. The best way to do that is to offer the stock at a price attractive enough to encourage prospective purchasers to buy it. In this area, investment bankers need to make the entrepreneur realize that his or her interests are not in conflict with the investors.
When the share does well, the entrepreneur also realizes a huge profit. This is the big difference between being acquired and going public. When a company is acquired, the entrepreneur is giving up a claim to the stream of future profits that the company will bring. In a public issue, the entrepreneur retains a big portion of ownership. What has been sold to the public is just a fraction of the entrepreneur's potential wealth.

Valuation and pricing are related, but they deal with different issues. Valuation is estimating the value of the company. The underwriter typically conducts a survey of comparable public companies, which will help provide a preliminary valuation. The underwriter also looks into the following factors: efficiency, leverage, profit margins, use of proceeds, operating history, operating base, management, and product differentiation. Furthermore, it is important for the underwriter to take into account whether this is a single-product or a multiple-product company. The use of proceeds is a key variable to the underwriter and to the investors. Many underwriters would be deterred or would only engage in best efforts if they perceive that the prime purpose of the issue is for the selling shareholders to bailout.

Pricing refers to setting the offering price. The main concern is how much the market will bear. Most underwriters follow historical traditions in pricing a new issue. The price should not be too high or too low in order to appeal to potential investors. For example, a price of $5 or less might be considered too risky, and a price of $20 or more might be considered too high unless for a prestigious company. It is common to see an IPO priced from $10 to $20 per share.

One formula underwriters often use is the method of discounting. Underwriters like to price a new issue a certain percentage below what they consider a fair value. This creates an incentive for investors to put money into the new issue. This discounting practice is clearly evidenced by the observations that a new issue typically traded at a much higher price in the aftermarket, averaged at 16%.

Timing is also critical. The offering price is adjusted upward when the underwriter has received a higher over-subscription in indications of interest. The offering price needs to be lowered or the issue may be postponed if indications of interest are weak. Certainly the overall market environment in part influences investor's interest.

Another pricing reference is the price/earnings ratio, especially for the secondary offerings. In an IPO, this yardstick is not as crucial. The size of the offering also plays a role. Underwriters typically want to see broad distribution and provide liquidity in the aftermarket. The SEC rules require disclosure for owners of 5% or more of shares. Institutional investors usually purchase blocks of securities. The SEC rules might prevent institutional investors that want to avoid disclosure from participating in an IPO if the offering size is small. This could negatively affect the demand and the price of the security.

UNDERWRITING RISK AND COMPENSATION

It is customary for the lead underwriter to form a distribution syndicate consisting of the underwriting syndicate and a selling group. Each member in the underwriting syndicate is committed to buying a portion of the IPO shares, while members of the selling group accept no risk. The lead underwriter's decision to distribute shares outside of its own organization has its positives and negatives. The lead underwriter benefits because each underwriter shares a portion of the underwriting risk. Second, the syndicate manager has the responsibility to ensure liquidity in the aftermarket. A broad
participation by the street provides incentives for other firms to make a market in the stock and regularly research it. On the other hand, the lead manager has to make some economic concessions in sharing the underwriting spread. Another risk is that one of the syndicate members might outshine the lead manager and hence gain an edge in competing for future offerings. In general, the selection of underwriting syndicate and the selling group should be based on a solid distribution of shares and the ability of market making.

**Underwriting Risks**

In underwriting, investment bankers "sell" risk services to the issuers by assuming at least part of the floating risk when they underwrite an offering by firm commitment. A firm commitment becomes absolutely firm only on the offering day or the night before, when the underwriting agreement is signed. The signing typically occurs just before the issue goes effective. By then, all the marketing has been done, the roadshows have been conducted, and the underwriter knows the "indication of interests." The risk or uncertainty can occur when the market shifts after a firm commitment on price has been made.

Floating risk consists of waiting risk, pricing risk, and marketing risk. During the period after the filing of the registration statement, but before it is declared effective by the SEC, changes in market environment often affect the offering price. Such waiting risk is mainly borne by the issuer, and has been minimized by the introduction of Rule 415 Shelf Registration. However, the pricing risk and marketing risk are exclusively borne by the underwriters. The pricing risk occurs when the market conditions worsen after the underwriting agreement is signed. Marketing reduces flotation risk by building a "book of interest" before the effective date and by aftermarket trading. Forming a syndicate in which each member is taking only a portion of the total risk also lessens the risk. Institutional sales help bankers place large pieces of new issues.

The risks cannot be underestimated. Underwriters for even the highest quality issues have suffered big losses. In October 1979 IBM's $1 billion issue was priced just prior to the weekend in which the Fed shifted policy (known as the Saturday night massacre). The underwriters took heavy losses. Another example is the 1987 British Petroleum stock issue on Thursday, October 15, 1987 (days before the October 19 market crash). The four underwriters of that issue took a total loss of $283 million.

**Compensation**

The underwriting spread is the difference between the price to the public printed on the prospectus and the price the corporate issuer receives. The amount of the spread is determined through negotiation between the managing underwriter and the corporate issuer. All members of the syndicate are paid out of the spread. The varying amount of risk accepted by the members of the distribution syndicate is reflected in the compensation schedule. The *manager's fee* is compensation to the managing underwriter for preparing the offering. Participating in a thorough due-diligence review and putting the deal together are the primary basis for the compensation.

The *underwriting or syndicate allowance* covers expenses incurred by the underwriting syndicate, including advertising, legal expenses, and other out-of-pocket expenses. Finally, the selling concession is allocated among all firms based on the amount of securities they accept to sell. Therefore, the syndicate manager will have all
three, the manager's fee, the underwriting allowance, and the selling concession. The underwriting dealers will get the underwriting allowance and the selling commission. The selling group is allocated a portion of the total selling concession.

THE PRICE OF GOING PUBLIC

The costs of a public offering are substantial. There are no hard and fast numbers. Total costs vary, depending on the size of the offering and the company's ability to market the offering smoothly and efficiently. As an example, for an issue around $150 million, the total costs can be as high as 10%. It also demands a great deal of time from top management, resulting in internal costs that may be difficult to quantify. Furthermore, there are costs of "underpricing."

Direct Costs

Direct costs include direct expenses plus the underwriting spread. The company pays the direct expenses whether or not the offering is completed. The underwriter's commission is contingent on the completion. The first big item is the gross spread. This is generally negotiable, and depends on factors such as the size of the offering, the type of underwriting commitment, and the type of security offered. There is also reimbursement for some of the banker's direct expenses. Additional compensation is in the form of warrants, stock issued to the underwriter before the public offering at a price below the offering, or a right of first refusal for future offerings.

Legal fees are usually the second largest item of expenses. They vary depending on the complexity of the company, the orderliness of its records, and the amount of time necessary to draft and file the registration statement.

Accounting fees are substantial as well. The accountant reviews and verifies the data in the registration statement and issues the comfort letter. These fees do not include audits of the financial statements, which vary depending on the size of the company and the number of years audited.

Printing costs are determined by the length, number of changes made to the registration statement, and the number of photographs. Registration fees, registrar and transfer agent fees, and miscellaneous fees are not insignificant. The SEC registration fee is 0.0278% of the dollar amount of the securities being registered (gradually reduced to 0.0067% by year 2007). The NASD filing fee is $100 plus 0.01% of the maximum dollar amount. Additionally, there are exchange listing fees.

Underpricing Costs

A public offering is costly in yet another way. Since the offering price is typically less than the aftermarket value, investors who bought the issue get a bargain at the expense of the firm's original shareholders, to a certain degree. The original shareholders typically retain a large portion of the company's shares on which they make enormous profits. Furthermore, the public would be eager to subscribe to subsequent offerings.

When a company goes public, it is very difficult for the underwriter to judge how much investors will be willing to pay for the stock. Hence, underpricing is a means of soliciting investor interest. According to a study by Ibbotson, Sindelar, and Ritter
(1994), the average underpricing is about 16%. IPOs in 1996 and 1997 showed an average first day gain of 17% and 15%, respectively.

Underpricing helps the underwriter. It reduces the risk of underwriting and gains them the gratitude of investors who buy the IPO issues. The true cost of underpricing is difficult to judge. If the business is sufficiently competitive, underwriters will probably take all these hidden benefits into account when negotiating the spread.

Hidden and Future Costs

During the lengthy process of preparing the first listing of the company, unanticipated costs will crop up. These include extra transportation costs to and from consultants, counsels, accountants, and underwriter; meals and entertainment; postage; phone calls, faxes, and messenger deliveries. Another important item is promotions. Thousands of dollars may be required to make the brokerage community and investors aware of the company. Another cost worth mentioning is directors' and officers' liability insurance, which is not only difficult to obtain for small companies, but also costly.

Although management has considerable control over the amount and extent of some of these hidden costs, the costs invariably exceed what is anticipated. In addition, the one cost that is difficult to put a dollar value on is the management time it takes to complete the offering.

A further consequence is the expense of being a public company. First, the SEC requires the company to file periodic reports, including annual Form 10-K, quarterly Form 10-Q, Form 8-K for report of significant events, and proxy and information statements. Significant costs and executive time are incurred in preparing and filing these reports. The financial printing business is about $800 million per year. The SEC required that all corporate documents be filed with it electronically by May 1996 through the introduction of Electronic Data Gathering, Analysis, and Retrieval (EDGAR). However, filing expenses have not declined as expected initially.

SEC REGULATIONS AND EXCHANGE LISTING

The SEC requires that a company planning an IPO follow the communications guidelines concerning the quiet period, preliminary prospectus, trading practices rules, offering, and postoffering communications.

Rule 134 of the Securities Act of 1933 sets forth the specific information that can be released to the public during the quiet period. During this period, the prospectus is the most important marketing document for the offering. The investment bank may not provide any other information to its clients other than what is contained in the red herring. They cannot provide research reports, recommendations, sales literature, or anything from any other firm about the company. Usual ongoing disclosures of factual information are permitted. The SEC also requires that communications only proceed at the level that was in effect before the preparations for the offering began. Therefore, it is in the company's interest to establish a fairly high level of public awareness well in advance of the offering.

After the registration statement is filed, SEC regulations prohibit distribution of any written sales literature about the offering other than the preliminary prospectus and the tombstone ads. Until the quiet period is over, cooperation by the company or its underwriter in the preparation of news stories on the pending offering is not permitted.
The trading practices rules (Regulation M) are aimed at preventing manipulative trading in securities during an offering. The rules govern the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities. The rules prohibit persons subject to the regulation from bidding, purchasing, or inducing others to bid for or purchase a covered security during the applicable restricted period. A covered security is any security that is the subject of a distribution or any security into which or for which such a distribution may be converted. For any security with an average daily trading volume (ADTV) of $100,000 or more and having a public float of $25 million or more, the restricted period begins on the latter of (a) the business day prior to the determination of the offering price or (b) the time a person becomes a distribution participant, and it ends when the participation of distribution is completed. For all other securities, the restricted period begins on the latter of five business days prior to pricing or the time that person becomes a distribution participant, and it ends upon completion of such person's participation of distribution. Certain transactions and securities are exempt from the trading restrictions. The exempt transactions cover stabilizing, exercises of securities, basket transactions, transactions among distribution participants, and transactions in Rule 144A. Exempt securities include actively traded securities (ADTV of $1 million and $150 million public float), investment grade nonconvertibles, asset-backed securities, and securities exempted from registration requirements.

Once the registration statement is declared effective, the pricing information is added to the prospectus. The SEC also permits news releases, press conferences, tombstone ads, and one-on-one meetings. However, the quiet period will remain in effect for another 25 days, unless the security is not listed on an exchange or quoted on Nasdaq, in which case the period is 90 days. The content of these communications must conform to information contained in the prospectus.

After the closing of the offering, the issuer becomes a public company and is subject to the disclosure requirements. The company must file quarterly and annual reports. The company must also provide timely disclosure of material information.

The choice of exchange listing is part of the IPO process. The main securities trading markets are the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), the regional markets, and the over-the-counter markets (OTC). What follows is a brief description of the listing requirements.

The listing requirements on the NYSE are extensive. The form for listing is similar to a full S-1 registration statement. The minimum listing requirements are: 2,000 shareholders, 1 million publicly held shares, market value of public shares of $40 million, and net tangible assets of $40 million. Detailed listing requirements are documented in Table 4.1.

The AMEX is the second largest exchange. The minimum requirements are as follows. There are at least 800 shareholders. Publicly held shares should be at least 300,000 shares and these shares have a market value of $3 million. Income before taxes must be $750,000 annually for the latest fiscal year or for two of the last three years. The stockholder's equity is at $4 million or more. The bid of the stock is at least $3. Table 4.2 lists the details.

The National Association of Securities Dealers Automated Quotations (Nasdaq) is a computer-based quotation/trading system with terminals in broker/dealer offices all over the country. Table 4.3 lists the requirements for national market. The minimum listing requirements for smallcaps (companies with small market capitalizations) are: 300 shareholders, 1 million shares of public float valued at $5 million, a bid price of $4, and three market makers (see Table 4.4).
TABLE 4.1 NYSE Listing Requirements

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Round-lot holders</td>
<td>2,000 U.S.</td>
</tr>
<tr>
<td>OR,</td>
<td>2,200 U.S.</td>
</tr>
<tr>
<td>Total shareholders AND</td>
<td>100,000 shares</td>
</tr>
<tr>
<td>Average monthly trading volume for most recent 6 months</td>
<td></td>
</tr>
<tr>
<td>OR,</td>
<td>500</td>
</tr>
<tr>
<td>Total shareholders AND</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Average monthly trading volume for the most recent 12 months</td>
<td></td>
</tr>
<tr>
<td>Public shares</td>
<td>1,100,000 U.S.</td>
</tr>
<tr>
<td>Market value of public shares</td>
<td>$40,000,000</td>
</tr>
<tr>
<td>Net tangible assets</td>
<td>$40,000,000</td>
</tr>
<tr>
<td>Pretax income</td>
<td></td>
</tr>
<tr>
<td>Most recent year</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Each of 2 preceding years</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>OR,</td>
<td></td>
</tr>
<tr>
<td>Aggregate for the 3 years</td>
<td>$6,500,000</td>
</tr>
<tr>
<td>Minimum in most recent year</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Or,</td>
<td></td>
</tr>
<tr>
<td>For companies with not less than $500 million market capitalization</td>
<td></td>
</tr>
<tr>
<td>and $200 million in revenues in the most recent year</td>
<td></td>
</tr>
<tr>
<td>Aggregate for the 3 years</td>
<td>$25,000,000</td>
</tr>
</tbody>
</table>

Source: Adapted from New York Stock Exchange, Domestic Listing Standards and Procedures, current as of July 7, 1997.

AFTERMARKET TRADING

Aftermarket trading begins after the new issue has been sold to the original buyers, who purchased the shares at the issuing price. Aftermarket trading is handled differently in a small, best-efforts IPO and in a larger firm commitment underwriting.

In a large firm commitment issue, the underwriters typically want to stabilize the stock if its price does not perform as anticipated. The underwriter will support the

TABLE 4.2 AMEX Listing Requirements

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income, latest year or 2 of the most recent 3 years</td>
<td>$750,000</td>
</tr>
<tr>
<td>Market value of public float</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Price</td>
<td>$3</td>
</tr>
<tr>
<td>Stockholder's equity</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Alternative Financial Guidelines:</td>
<td></td>
</tr>
<tr>
<td>Market value of public float</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Price</td>
<td>$3</td>
</tr>
<tr>
<td>Operating history</td>
<td>3 years</td>
</tr>
<tr>
<td>Stockholder's equity</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

market price of a new issue in order to keep it from becoming a broken deal or falling below the initial offering price when trading of the stock goes into the aftermarket. If the new issue price goes down on the first aftermarket trading, the underwriters could be negatively branded for months. Underwriters want to avoid that. Furthermore, declining new issue prices point to poor judgment on the part of the lead underwriter and the analysts of the selling group.

The SEC requires detailed reports if stabilization is used. The stock purchased for stabilization cannot be resold at a higher price. It must be resold at or below the purchase price. Losses are shared pro rata by the selling syndicate. If price continues to

<table>
<thead>
<tr>
<th>TABLE 4.3 Nasdaq National Market Listing Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net tangible assets</strong></td>
</tr>
<tr>
<td><strong>Market capitalization</strong></td>
</tr>
<tr>
<td><strong>OR,</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
</tr>
<tr>
<td><strong>OR,</strong></td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
</tr>
<tr>
<td><strong>Pretax income in latest year or 2 of recent 3 years</strong></td>
</tr>
<tr>
<td><strong>Public float</strong></td>
</tr>
<tr>
<td><strong>Operating history</strong></td>
</tr>
<tr>
<td><strong>Market value of public float</strong></td>
</tr>
<tr>
<td><strong>Minimum bid price</strong></td>
</tr>
<tr>
<td><strong>Round lot shareholders</strong></td>
</tr>
<tr>
<td><strong>Market makers</strong></td>
</tr>
<tr>
<td><strong>Corporate governance</strong></td>
</tr>
</tbody>
</table>

*Source: Adapted from Nasdaq Stock Market, August 25, 1997.*

<table>
<thead>
<tr>
<th>TABLE 4.4 Nasdaq Smallcap Market Initial Listing Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net tangible assets</strong></td>
</tr>
<tr>
<td><strong>OR,</strong></td>
</tr>
<tr>
<td><strong>Market capitalization</strong></td>
</tr>
<tr>
<td><strong>OR,</strong></td>
</tr>
<tr>
<td><strong>Net income in latest fiscal year or 2 of the last 3 years</strong></td>
</tr>
<tr>
<td><strong>Public float</strong></td>
</tr>
<tr>
<td><strong>Market value of public float</strong></td>
</tr>
<tr>
<td><strong>Minimum bid price</strong></td>
</tr>
<tr>
<td><strong>Market makers</strong></td>
</tr>
<tr>
<td><strong>Shareholders (round lot holders)</strong></td>
</tr>
<tr>
<td><strong>Operating history</strong></td>
</tr>
<tr>
<td><strong>OR,</strong></td>
</tr>
<tr>
<td><strong>Market capitalization</strong></td>
</tr>
<tr>
<td><strong>Corporate governance</strong></td>
</tr>
</tbody>
</table>

*Source: Adapted from Nasdaq Stock Market, August 25, 1997.*
fall, the underwriters may withdraw support at their discretion without notice. Underwriters will make every attempt to place stock in strong hands among the syndicate members to avoid the necessity for stabilization. Weak members might have reduced participation in future offerings or might even be eliminated as a player in the syndicate.

On the other hand, a hot new issue will require underwriters to exercise the over-allotment or green shoe option. The name comes from the first company to ever use it, Green Shoe Company. The purpose of over-allotment, like stabilization, is to ensure an orderly aftermarket. It allows underwriters to sell up to 15% more of the stock. The additional funds raised by the green shoe go to the company, less commissions.

When the underwriter anticipates either over-allotment or a possibility of stabilization, the fact must be disclosed on the front cover of the prospectus as follows:

*In connection with this offering, the underwriters may over-allot or effect transactions which stabilize or maintain the market price of the common stock of the company at a level above that which might otherwise prevail in the open market. Such stabilizing, if commenced, may be disconnected at any time.*

For smaller best-efforts offerings, stabilization is not used. The best that can be hoped for is that the primary market makers purchase the stock for their own inventory. If the market goes down, it is often that a weak syndicate member is cutting losses rather than an indication of the market reception of the issue. Typically, a minimum/maximum offering is used. The underwriter may get an indication of the range of interest from syndicate members to determine the minimum and maximum of the offering size.

Generally, during the first several weeks or so, a high degree of volatility in the trading price and volume can be seen. The issuing company is still subject to the 25-day quiet period during which the company cannot begin any publicity efforts. The company can only depend on the support of the underwriters and the selling group to maintain its stock at a reasonable trading level. Hence, it is important for the company to maintain a strong relationship with brokers during the selling period.

**DIRECT OFFERINGS, SHELLS, AND EQUITY TAKEDOWNS**

The conventional process of issuing equities is quite complex and expensive. Some entrepreneurs are looking for ways to avoid the complexities and expenses. On the other hand, for investment banking firms lacking strong client relationship, it is difficult to compete. Direct Internet offerings, shells, and equity takedowns are the possible alternatives.

**Direct Offerings**

The expenses associated with raising capital in the equity market are very high. Now Internet offering (or direct offering) is available, through which the issuing company bypasses the underwriters and brokerages. The 1996 IPOs of Spring Street Brewery and Logos Research Systems are the first of the so-called do-it-yourself initial public offerings. On November 14, 1997, The Green Bay Packers, Inc. offered the sale of 400,000 shares of its common stock at a price of $200 per share online. On the fixed-
income side, General Motors Acceptance Corp. started marketing $500 million medium-term notes through Chicago Corp. on September 27, 1996.

Entrepreneurs plan to launch virtual stock exchanges and online investment banks that they believe will reach retail and institutional investors more efficiently and cheaply. Ben Ezra, Weinstein & Co. developed software to help companies draft their own prospectuses. Hambrecht & Quist set up a new brokerless electronic division that uses the Internet to sell stocks, mutual funds, and IPOs at the same rates given to its institutional clients. ETrade, Direct Stock Market, and Wit Capital are all working to build an Internet stock exchange. However, the Web's uses will be limited until the legal and regulatory issues are resolved.

Major Wall Street firms think that most corporations still need investment banks to do the bulk of their financing. They have the ability to provide liquidity by market making in the secondary market.

Shells

A public shell is the other alternative that entrepreneurs can consider in their quest for going public. A shell is an inactive public company with securities traded in the marketplace. It can be used as a backdoor way of becoming a public company.

The easiest way to become a public company is to merge into the public shell. One big advantage is the time and money saved. There is no need to obtain the SEC approval of the registration statement. The entrepreneurs pay little to "acquire" the shell. The entrepreneurs essentially purchase control of the shell by buying stocks from the existing controlling shareholders. The price of acquiring a shell ranges from $20,000 to $100,000 or more, depending on factors such as the amount of control, board seats, and reporting status. After completing the acquisition, the company could meet the objective of raising money in the capital markets by issuing stock.

Shells have been around for a long time. Many of the new shells were first set up in Utah, which has been a continuing source of supply. Shell brokers have negotiable fees and often retain some of the stock. This approach is legal. However, there have been abuses. In the late 1950s, the SEC prosecuted Alexander Guterman and Lowell Burrell, who manipulated stocks by spreading rumors to push up share prices and then unloaded their stock. Such operators are still around today. These con artists target small private company with alluring line of business, and promise its founders financial assistance. They convince the entrepreneurs to merge that private company with the public shell, getting public listing with minimum disclosure. The next step is to dress up the company by pumping in money and in some cases also acquiring other ventures. Meanwhile, the scheme operators take control of the board. The purpose is to authorize issuing millions of shares and to register them through SEC loopholes, such as Form S-8 and Regulation S. Form S-8 allows company to register shares with a short filing with minimum disclosure. It pertains mainly to employees and consultants. Another loophole involves SEC Regulation S. It permits companies to sell shares to foreign investors without detailed registration statement, and the shares need to be held for only 40 days before the foreigners can trade them back to the U.S. market. The SEC has proposed to lengthen the holding period requirement for such securities.

This type of fraud is difficult to detect and prosecute. In contrast, another type of fraud is about dubious initial public offerings. Investors are lured into a penny stock (usually, stock at less than $5 per share, in a company without a track record) by hard-sell tactics, bait tactics (which wins investor confidence with opener stock), and
wooden tickets (unauthorized trades). In October 1996, the NASD accused Sterling Foster and 15 of its officers and brokers of making $51 million of illicit profits in nine months by using manipulative trading, high-pressure sales tactics, and wooden tickets. This is the largest disciplinary case alleging stock manipulation ever brought by the NASD.

Equity Takedowns
Equity takedowns, or super block trades, are aggressive tactics taken by investment banking firms in which the investment banker commits to buy stock at a discount from the issuing company after the market closes, and then seeks to redistribute these shares to clients before the market opens the next day. Until the stock is resold, the investment banking firm has its own capital at risk. These are used primarily in the secondary offerings, known as spot secondary offerings. As long as the markets remain robust, spot secondaries are likely to grow in frequency.

The approach is unlike a typical stock underwriting. There is no roadshow nor a lengthy premarketing period during which underwriters seek to build a book of interest from prospective purchasers. This method could undercut the old-line investment banking relationships the Wall Street firms have cultivated with corporate clients. There are significant advantages for the issuing corporation. The stock price is not hurt in the days preceding the offering, as is common in underwritten deals. Speed is another benefit. There is no marketing process, and within a few hours the transaction is completed.

EXEMPT OFFERINGS
The market environment and the company’s ability to accept the responsibilities and pressures of being a public company are among the determining factors of going public or using exempt offerings (private placement). There are several basic types of exempt offerings: Regulation D offerings, Regulation A offerings, intrastate offerings, and blank check offerings.

Regulation D Offerings
Regulation D establishes the parameters of limited offering exemptions, which allow companies in need of capital to sell securities under an exempt offering and avoid the complexity and expenses of going public.

Rule 504 allows the sale of securities up to $1 million over a 12-month period. The number of investors is not limited and the offering circular is not required. Rule 504 permits unregistered offering by a nonreporting company without an offering statement if the issuer supplies material information to the purchaser at a reasonable time prior to the sale. Related to Rule 504, there is a Small Corporate Offering Registration (SCOR). SCOR offers small businesses a low-cost alternative. SCOR allows businesses to raise up to $1 million in equity capital annually for business startup, development, or growth. Companies who wish to take advantage of the SCOR program are required to file two forms: Form D and SCOR Form U-7. The Form U-7 is filed with states. It is uniform for all states. A Form D is filed with the SEC under Rule 504. This simplified process reduces a company's legal and accounting fees by up to 75%.
Rule 505 allows sale of securities up to $5 million over a 12-month period. Except for a maximum of 35 nonaccredited investors, all other investors must meet the SEC's definition of accredited investor. An accredited investor is an individual or institution that is knowledgeable and has a net worth adequate to make such investments.

Rule 506 permits sale of unlimited amount of securities. The requirement is that all nonaccredited investors (maximum of 35) must qualify as sophisticated investors, who are capable of evaluating the merit of the investments.

Regulation A Offerings

The second type of exempt offering is under Regulation A. It allows a company to raise capital through public offering of up to $5 million per year, including no more than $1.5 million in secondary offerings. Unless the offering is less than $100,000, Regulation A requires the use of an offering circular, similar to a prospectus, which contains financial and other information. Companies are required to notify the SEC and file other information. Audited financial statements are generally not required. The procedures are similar to a regular registration, but the disclosures are not as extensive. The filings are made to and reviewed by the regional offices of the SEC. A notice of no further comments from a regional office indicates the Regulation A offering is effective.

Intrastate Offerings

This is the third type of exempt offerings. There are no limits on the amount of capital to be raised or the number of individuals to whom securities are offered. The qualifications are as follows:

- Be incorporated in the state of offering
- Maintain the principal offices in the state
- Hold 80% of assets in the state
- Derive 80% of revenues from sources in the state
- Offer only to investors with principal residence in the state

It should be noted that securities purchased via this exemption may not be resold to a nonresident of the state within nine months after the offering.

Blank Check Offerings

A blank check offering is the sale of penny stock by a blank check company. A blank check company is defined as a company that is devoting all its efforts to establishing a new business, that is issuing penny stock, and has no business plan or has indicated its business plan is to engage in a merger or acquisition with an unspecified business entity. Rule 419 requires funds received from a blank check offering to be placed in an escrow account and must be held for the sole benefit of the purchasers. Once a blank check company agrees to an acquisition or acquisitions that meet certain criteria (one of the criteria is that the acquisition represents at least 80% of the offering), a post-effective amendment must be filed. Notification of the acquisition must be sent to the purchasers. A purchaser would have no less than 20 and no more than 45 business days to either confirm an intent to invest or request a refund.
SUMMARY

Underwriting is a key business for investment banking firms. Investment banks raise a significant amount of capital for companies through IPOs and secondary offerings. Compared with secondary offerings, IPO underwriting spreads are higher, but they involve a higher risk. This chapter covers all major areas in stock underwriting. The coverage includes the investment banker's role as an advisor as well as an underwriter. The mechanics and process of a public offering are discussed in detail. Special focus has been on pricing, SEC regulations, and several capital-raising alternatives. The next chapter will cover fixed-income underwriting.

SELECT BIBLIOGRAPHY

Of the 11,000,000 shares of Class A Common Stock, par value $0.01 per share ("Class A Common Stock"), of Friedman, Billings, Ramsey Group, Inc., a Virginia corporation ("FBR" or the "Company"), offered hereby (the "Offering"), 10,000,000 are being issued and sold by the Company and 1,000,000 are being sold by certain shareholders (the "Selling Shareholders") of the Company. The Company will not receive any of the proceeds of the sale of shares by the Selling Shareholders. Prior to the Offering, there has been no public market for the Class A Common Stock. The initial public offering price is $20.00 per share. The initial public offering price was determined by agreement among the Company, the Selling Shareholders and the Underwriters (as defined herein) in accordance with the recommendation of a "qualified independent underwriter" as required by Rule 2720 of the Conduct Rules of the National Association of Securities Dealers, Inc. (the "NASDAQ"). See "Underwriting" for a discussion of the factors considered in determining the initial public offering price. In addition to the shares of Common Stock (as defined herein) offered hereby, PNC Bank Corp. has agreed to acquire a number of shares of Class A Common Stock equal to 4.9% of the outstanding Common Stock upon the losing of the Offering (which, without giving effect to the exercise of the Over-allotment Option (as defined herein) will total 2,451,421 shares of Class A Common Stock) at a price equal to the initial public offering price less a 4% discount. The Company has been approved for the listing of the Class A Common Stock on the New York Stock Exchange, Inc. ("NYSE") under the symbol "FBG."

The Company has two classes of stock outstanding: Class A Common Stock and Class B Common Stock, par value $0.01 per share ("Class B Common Stock" and together with Class A Common Stock, "Common Stock"). Class A Common Stock and Class B Common Stock have identical dividend and other rights, except that Class A Common Stock has one vote per share and Class B Common Stock has three votes per share. Class B Common Stock is converted into Class A Common Stock at the option of the Company in certain circumstances, including (i) upon a sale or other transfer, (ii) at the time the holder of such shares of Class B Common Stock ceases to be affiliated with the Company, and (iii) upon the sale of such shares in a registered public offering. See "Description of Capital Stock—Common Stock."

Up to 1,000,000 shares of Class A Common Stock are being reserved for sale to certain Existing Shareholders (as defined herein), other employees and directors of the Company, and their family members at the initial public offering price less underwriting discount. See "Direct Offering." On December 15, 1997, the Company declared a dividend of $54 million to Existing Shareholders (the "S Corporation Distribution"). The Company intends to make the S Corporation Distribution on or before February 2, 1998. See "Certain Transactions Occurring Prior to the Offering—S Corporation Distribution and Termination of S Corporation Status." A portion of the proceeds of the Offering may be used to fund the S Corporation Distribution.

The Shares offered hereby involve a high degree of risk. See "Risk Factors" at page 9.

These securities have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

<table>
<thead>
<tr>
<th></th>
<th>Price to Public</th>
<th>Underwriting Discount(1)</th>
<th>Proceeds to Company(2)</th>
<th>Proceeds to Selling Shareholders(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Share</td>
<td>$20.00</td>
<td>$1.40</td>
<td>$18.60</td>
<td>$18.60</td>
</tr>
<tr>
<td>Total (3)</td>
<td>$220,000,000</td>
<td>$15,400,000</td>
<td>$186,000,000</td>
<td>$186,000,000</td>
</tr>
</tbody>
</table>

(1) See "Underwriting" for indemnification arrangements with the several Underwriters (as defined herein).
(2) Not including expenses payable by the Company, estimated at $1,853,000.
(3) The Company and the Selling Shareholders have granted the Underwriters a 30-day option to purchase up to 1,650,000 additional shares of Class A Common Stock solely to cover over-allotments, if any (the "Over-allotment Option"). If such option is exercised in full, the total Price to Public, Underwriting Discount, Proceeds to the Company and Proceeds to the Selling Shareholders will be $253,000,000, $17,710,000, $213,900,000 and $21,390,000, respectively. See "Underwriting."

The shares of Class A Common Stock are offered by the several Underwriters subject to prior sale, receipt and acceptance by them and subject to the right of the Underwriters to reject any order in
whole or in part and certain other conditions. It is expected that certificates for such shares will be available for delivery on or about December 29, 1997 at the office of Friedman, Billings, Ramsey & Co., Inc. in Arlington, Virginia.

FRIEDMAN, BILLINGS, RAMSEY & CO., INC.
BEAR, STEARNS & CO., INC.
CREDIT SUISSE FIRST BOSTON
LAZARD FRERES & CO., LLC
SALOMON SMITH BARNEY

December 22, 1997

No dealer, salesperson or other person has been authorized to give any information or to make any representations other than those contained in this Prospectus and, if given or made, such information or representations must not be relied upon as having been authorized by the Company or the Underwriters. This Prospectus does not constitute an offer to sell or a solicitation of an offer to buy to any person in any jurisdiction in which such offer or solicitation would be unlawful or to any person to whom it is unlawful to make such offer or solicitation. Neither the delivery of this prospectus nor any offer or sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Company or that the information contained herein is correct as of any time subsequent to the date hereof.

TABLE OF CONTENTS

Prospectus Summary
Risk Factors
Certain Transactions Occurring Prior to the Offering
Use of Proceeds
Dividend Policy
Capitalization
Dilution
Selected Consolidated Financial Data
Management's Discussion and Analysis of Financial Condition and Results of Operations
Business
Management
Principal and Selling Shareholders
Description of Capital Stock
Shares Eligible for Future Sale
Underwriting
Direct Offering
Legal Matters
Experts
Additional Information
Index to Consolidated Financial Statements

Until January 16, 1998 (25 days after the date of this Prospectus), all dealers effecting transactions in Class A Common Stock, whether or not participating in this distribution, may be required to deliver a Prospectus. This is in addition to the obligation of dealers to deliver a Prospectus when acting as Underwriters and with respect to their unsold allotments or subscriptions.

11,000,000 Shares

FBR
FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

Class A Common Stock

PROSPECTUS

BEAR, STEARNS & CO., INC.
CREDIT SUISSE FIRST BOSTON
LAZARD FRERES & CO.
SALOMON SMITH BARNEY

December 22, 1997
The main objectives of securities regulation are facilitating capital formation and protecting the interest of the investing public. Registration of new securities ensures full and accurate disclosure of material information. Exemptions of registration are available when the securities are sold to certain qualified institutional investors or the amount of issuance is limited. Active secondary-market trading is key to successful primary market capital raising activities. Hence, regulating sales and trading in the secondary markets is to ensure fairness and maintain public trust. Professional investment management has become an essential part of the capital markets. Regulation of investment companies and investment advisers is in the public interest and for the protection of investors. Furthermore, integrity and professionalism are basic to success on Wall Street. This chapter provides a brief coverage on the full spectrum of these issues.

INTRODUCTION

Securities regulation provides protection for investors and ensures that the securities markets are transparent and fair. The Securities and Exchange Commission (SEC) is the regulatory agency with responsibility for administering the federal securities laws. The SEC enforces the following securities acts:

- **Securities Act of 1933**: requires registration of a new security issue unless an exemption is available, also known as "truth in securities" law
- **Securities Exchange Act of 1934**: requires timely and accurate disclosure of material information, prohibits sales practice abuses and insider trading
- **Investment Company Act of 1940**: activities of "investment companies" are subject to SEC regulation
- **Investment Advisers Act of 1940**: requires registration of investment advisers and compliance with statutory standards
- **Trust Indenture Act of 1939**: the trust indenture of a debt security must conform to the statutory standards of the act
The SEC delegates significant regulatory authority to a number of securities industry self-regulatory organizations (SROs). These SROs include National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), the Chicago Board Options Exchange (CBOE), regional exchanges, and the Municipal Securities Rulemaking Board (MSRB). These SROs are responsible for establishing rules governing securities practices and markets, reviewing fair dealing by members, examining securities firms for compliance with financial requirements, surveilling the markets, taking enforcement action for proven violations, and arbitrating disputes. The SEC must approve all SRO rules and regulations before they can take effect.

The next two sections cover securities regulation in the issuance of new securities and in sales and trading in the secondary markets. Subsequent sections describe regulation of broker-dealers, investment companies, and investment advisers. The discussion naturally flows to ethics and professionalism.

**ISSUANCE OF SECURITIES**

The Securities Act of 1933 (Securities Act) governs the issuance of new securities. At the same time, the Securities Act exempts private placements and certain transactions that involve either a limited dollar amount, certain qualified investors, or are offered only on an intrastate basis. The National Securities Markets Improvement Act of 1996 (NSMIA) exempts state regulation of securities listed on the NYSE, the AMEX, the National Market System of the Nasdaq, securities sold in certain exempt offerings, and mutual funds.

**Registration of Securities Offerings**

The Securities Act requires issuers to register their securities offerings and supply financial and other material information that will enable investors to make informed decisions. As such, the objectives are to ensure that investors are provided with material information of the offerings and to prevent misrepresentation, deceit, and other fraud in the sale of securities. The standard that must be met when registering securities is adequate and accurate disclosure of material facts concerning the issuer and the securities.

A security is registered with the SEC by filing a registration statement in triplicate (forms for registration are listed in Appendix A). Issuer's principal executive officer or officers, its financial officer, its comptroller or principal accounting officer, and the majority of its board of directors shall sign at least one copy. For a foreign issuer, its duly-authorized representative in the United States has to sign the registration statement. In the case when a foreign government issues the security, the underwriter has to sign it. At the time of filing a registration statement, the applicant must pay to the SEC a registration fee equal to 0.0278% of the aggregate offering amount (gradually reduced to 0.0067% by year 2007). The information contained or filed with any registration statement shall be made available to the public.

Information and documents required in registration statements are specified in Schedule A, unless the security is issued by a foreign government or political subdivision, in which case Schedule B applies. Specifically, information required in Schedule A includes:
1. The name of the issuer
2. The name of the State or other sovereign power under which the issuer is organized
3. The location of the issuer's principal business office, and if the issuer is a foreign or territorial person, the name and address of its agent in the U.S. authorized to receive notice
4. The names and addresses of the directors, the chief executive, and financial and accounting officers
5. The names and addresses of the underwriters
6. The names and addresses of all persons owning of record or beneficially more than 10% of any class of stock of the issuer, or more than 10% in the aggregate of the outstanding stock of the issuer as of a date within 20 days prior to the filing of the registration statement
7. The amount of securities of the issuer held by any person specified in (4), (5), and (6), as of a date within 20 days prior to the filing of the registration statement
8. The general character of the business
9. A statement of the capitalization of the issuer
10. A statement of the securities covered by options outstanding or to be created in connection with the security to be offered
11. The amount of capital stock of each class issued or included in the shares of stock to be offered
12. The amount of the funded debt outstanding and to be created by the security to be offered, with a brief description of such security
13. The specific purposes in detail
14. Remuneration paid, or estimated to be paid, to directors and officers
15. The estimated net proceeds from the security to be offered
16. The proposed offering price or the method by which such price is computed
17. All commissions or discounts paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered
18. The estimated amounts of other expenses
19. The net proceeds derived from any security sold by the issuer during the past two years, the offering price, and the names of the principal underwriters of such security
20. Any amount paid within two years preceding the filing of the registration statement or intended to be paid to any promoter and the consideration for any such payment
21. The names and addresses of the vendors and the purchase price of any property, or good will, acquired or to be acquired, which is to be defrayed in whole or in part from the proceeds of the security to be offered
22. Full particulars of the nature and extent of the interest, if any, of every director, principal executive officer, and of every stockholder holding more than 10% of any class of stock
23. The names and addresses of counsel who have passed on the legality of the issue
24. Dates of and parties to, and the general effect concisely stated of, every material contract made, not in the ordinary course of business, which contract is to be executed in whole or in part at or after the filing of the registration statement or which contract has been made within two years before such filing
25. A balance sheet as of a date not more than 90 days prior to the filing date of the registration statement showing all of the assets and liabilities of the issuer in detail
26. A profit and loss statement of the issuer showing earnings and income, the nature and source thereof, and the expenses and fixed charges in detail
27. If the proceeds or any part of the proceeds of the security are to be applied to the purchase of any business, a profit and loss statement of such business certified by an independent public or certified accountant
28. A copy of any agreement or agreements made with any underwriter, including all contracts and agreements referred to in (17) of this schedule
29. A copy of the opinion or opinions of counsel in respect to the legality of the issue
30. A copy of all material contracts referred to in (24) of this schedule
31. Unless previously filed and registered under the provisions of this title, and brought up to date, a copy of its articles of incorporation
32. A copy of the underlying agreements or indentures affecting any stock, bonds, or debentures offered or to be offered

For a security issued by a foreign government or political subdivision, the requirements are (Schedule B):

1. Name of borrowing government or subdivision
2. Specific purposes in detail and the approximate amounts to be devoted to such purpose
3. The amount of the funded debt and the estimated amount of the floating debt outstanding and to be created by the security to be offered, excluding intergovernmental debt, and a brief description of such debt
4. Whether or not the issuer or its predecessor has, within a period of 20 years prior to the filing of the registration statement, defaulted on the principal or interest of any external security
5. The receipts and the expenditures in detail for the latest fiscal year for which such information is available and the two preceding fiscal years, year by year
6. The names and addresses of the underwriters
7. The name and address of its authorized agent, if any, in the United States
8. The estimated net proceeds to be derived from the sale in the United States of the security to be offered
9. The proposed offering price in the United States to the public or the method by which such price is computed
10. All commissions paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered
11. The amount or estimated amounts of other expenses
12. The names and addresses of counsel who have passed upon the legality of the issue
13. A copy of any agreement or agreements made with any underwriter governing the sale of the security within the United States
14. An agreement of the issuer to furnish a copy of the opinion or opinions of counsel in respect to the legality of the issue

After the registration statement is filed with the SEC, the waiting period begins. During this waiting period, the SEC's Division of Corporate Finance reviews it to ensure full
and accurate disclosure. The waiting period was originally 20 days. Now it is much longer. If it appears to the SEC staff that the registration statement is incomplete or inaccurate in any material respect, the Commission may issue an order refusing such statement to become effective until it has been amended in accordance with such order. Concurrent with the SEC's review, the NASD Regulation's Corporate Financing Department also reviews the offering to ensure that the amount of underwriting compensation to be paid to the NASD members underwriting the issue is fair and within NASD's guidelines. After the SEC has determined that the amendments satisfy its comments and has been informed that NASD Regulation has no objections to the underwriting compensation, terms, and arrangements, the SEC issues an order allowing the registration statement to become effective (declared effective). At that point, sales to the public can take place.

When the issue is in registration, the investment bank may not provide any other information to its clients other than what is contained in the preliminary prospectus (red herring). During the waiting period, the issuing company or underwriter may not instigate publicity to promote the security. Using the red herring, the underwriters may offer the security and accept indications of interest. However, no sales may be made.

Once an issue has been declared effective, the security is placed and trading begins. If this is an IPO and the issue is traded on Nasdaq or an exchange, then, for 25 days after the effective date, a buyer is entitled to a prospectus. The requirement extends 90 days after the effective date if the security is not traded on Nasdaq or listed on an exchange. The final prospectus is similar to the red herring. Except it will have the missing numbers for the offering price and the effective date filled in.

In order for the stock to begin trading on Nasdaq or an exchange, an issuer must sign a listing agreement and meet certain quantitative and often qualitative standards set by Nasdaq or the exchange. These include a minimum per-share bid, public float, market value of public float, company assets, and capital. In addition, a minimum number of market makers is required for trading on the Nasdaq.

The states also regulate the registration of new securities through state blue-sky laws. The National Securities Markets Improvement Act of 1996 (NSMIA) exempts from state registration securities that are listed on the Nasdaq National Market, the NYSE, or the AMEX Unlike the SEC regulation that ensures full and accurate disclosure, some state laws deal with the merits of a security.

In addition, debt securities can be offered for public sale only under a trust indenture approved by the SEC. The Trust Indenture Act of 1939 applies to debt securities offered for public sale and issued under trust indentures with more than $7.5 million of securities outstanding at any one time. Such securities, even though they may be registered, may not be offered for public sale unless the trust indenture conforms to the statutory standards of this act. The act is aimed at safeguarding the rights and interests of the purchasers. To meet this objective, the act prohibits the indenture trustee from conflicting interests, requires the trustee to be a corporation with required capital and surplus, and requires the trustee to provide reports and notices to security holders.

**EXEMPT OFFERINGS**

The Securities Act provides for certain exemptions of registration; that is, under certain conditions, a company can sell its securities as a private placement. A private placement of securities is intended to be limited in frequency and scope. The principal
exemptions available are the traditional private placements, Rule 144A, and Regulation S safe harbors.

Private Placements
A private placement under Rule 505 and Rule 506 of Regulation D is generally limited to 35 nonaccredited investors, but there is no limit on the number of accredited investors. Accredited investors must have a net worth of $1 million, or an annual income of $200,000, or an annual family income of $300,000. A private placement memorandum must be prepared. The securities acquired are considered restricted securities, and they may not be freely traded until registered with the SEC.

Rule 504 of Regulation D provides exemption from SEC registration for an amount up to $1 million. However, these offerings must comply with state blue-sky laws. Under Rule 504, there are "test the waters" and SCOR offering. Massachusetts has a "test the waters" exemption, which permits a public solicitation for indications of interest, but the security must be registered with the state Securities Division before sale. A SCOR (small corporate offering registration) offering is exempt from SEC registration, but must be registered or qualified under state law. Many states allow registration on a Form U-7.

An exemption from SEC registration is also available for an intrastate offering, where the securities are sold only to residents of a single state and the issuer is both a resident and doing business within that state. Another type of exempt offering is under Regulation A. It allows a company to raise capital through public offering of up to $5 million per year, including no more than $1.5 million in secondary offerings.

Rule 144 governs the sale of restricted securities and control securities. Restricted securities are purchased in unregistered nonpublic offerings, and control securities are held by affiliates of the issuer. Generally, a one-year holding period applies when the volume of securities sold is limited to the greater of 1% of all outstanding shares or the average weekly trading volume for the preceding four weeks. If the shares have been owned for two years or more, no volume restrictions apply to nonaffiliates. Affiliates are always subject to volume restrictions. The term affiliate includes the chief executive officer, inside directors, holders of at least 20% of the company voting power, and holders of at least 10% of the company's voting power with at least one director on the company's board of directors.

Rule 144A
Rule 144A addresses private sales of restricted securities among qualified institutional buyers (QIBs). Rule 144A states four conditions that the securities and the transaction must satisfy. First, the securities must be sold to QIBs. Second, the seller or any other person acting on behalf of the seller must take reasonable steps to ensure that the purchaser is aware that the seller may rely on the exemption of registration and associated requirements. Third, the current holder of the securities and the prospective purchaser have the right to obtain certain basic information from the issuer if the issuer is not subject to reporting requirements. Finally, the securities, when issued, are not of the same class as securities listed on a national exchange or quoted in a U.S. automated interdealer quotation system, and the issuer is not an open-end investment company or a unit investment trust.

A QIB sometimes is called a sophisticated investor and is an entity acting for its own account or the accounts of other QIBs that in aggregate owns and invests on a dis-
cretionary basis at least $100 million in securities of issuers not affiliated with the entity. For a registered dealer, the qualification is at least $10 million of securities. A QIB also includes:

- A registered dealer acting in a riskless principal transaction on behalf of a QIB
- Any investment company registered under the Investment Company Act that is part of investment companies that together own at least $100 million of such securities
- Any entity, all of whose equity owners are QIBs
- Any bank or S&L or similar institution that in aggregate with other QIBs owns and invests at least $100 million in such securities and that has a net worth of at least $25 million

**Regulation S**

Regulation S under the Securities Act was adopted in 1990 in order to provide companies with clear guidelines as to the circumstances under which Regulation S securities sold overseas are not subject to the SEC registration. The provisions of Regulation S require that such securities not be advertised in the United States, and there is a restricted period during which Regulation S securities cannot be resold in the United States.

Regulation S establishes **issuer safe harbor** and **resale safe harbor**. Issuer safe harbor deals with offers and sales by issuers, underwriters, and other persons involved in the distribution process pursuant to a contract. The resale safe harbor applies to resales by persons other than the issuer, distributors and their respective affiliates. Two general conditions must be satisfied to take advantage of the issuer and resale safe harbors. The first condition is that any offer or sale must be made in an offshore transaction. The second general condition is that no direct selling efforts may be made in the United States.

To qualify for the issuer safe harbor, the issuer's offer or sales must be made in an offshore transaction and the offer must not be made to a person in the United States. In accordance, compliance must be made with regard to (1) reasonable belief that the buyer is outside the United States at the time of the transaction and (2) submission of evidence that the sale is made through an established exchange or through a designated offshore securities market. For resale safe harbor, Regulation S permits resale in an offshore transaction without any directed sales effort into the United States. Also, after the expiration of the restricted period, the securities can be resold into the United States provided that such sales are made in compliance with the U.S. securities laws.

Since its adoption in 1990, the SEC has identified abusive practices in offshore Regulation S securities transactions. In an effort to address these abuses, the SEC has adopted a rule requiring U.S. reporting companies to disclose on Form 8-K offshore sales of equity securities in reliance upon Regulation S within 15 days of sale. A new SEC proposal would require Regulation S sales to be reported by the issuer on Form 10-Q instead of Form 8-K as currently required. The SEC has also proposed to amend Rule 903 of Regulation S. The amendments will lengthen to two years the restricted period. This represents an increase from the current 40-day holding period applicable to reporting issuers and the one-year holding period applicable to nonreporting issuers. The SEC has also proposed to add a new Rule 905 that would classify as restricted securities covered equity securities placed offshore under the issuer safe
SECONDARY TRADING

The Securities Exchange Act of 1934 (Exchange Act) governs the secondary market trading. The Exchange Act seeks to ensure fair and orderly securities markets by requiring timely and accurate disclosure of material information, by prohibiting certain types of activities, and by requiring compliance with rules regarding the operation of the markets and participants. The following discussion covers corporate reporting, insider trading, and Regulation M (trading practices in connection with securities offerings).

Corporate Reporting

Following the registration of their securities, companies must file annual and other periodic reports with the SEC. These filings are available through EDGAR as well as on the SEC's Web site. Appendix B lists forms prescribed under the Exchange Act.

The first reporting requirement is the Form 10-K, which is an annual report to stockholders. It discloses in detail information about the company's activities and results of operations. It contains the company's annual financial reports. The report is due within 90 days of the year end. Also, a quarterly report on Form 10-Q is required for each of the first three quarters of the fiscal year. It includes condensed financial data and information on significant events. The report must be filed within 45 days of quarter-end. In addition, a Form 8-K that reports any significant events is due within 15 days of the event. The types of information generally considered material include financial results, new products, acquisitions or dispositions of assets, and changes in dividends, management, or corporate control.

Under the SEC rules, all proposed proxy material must be filed in advance for examination to ensure compliance with disclosure requirements. Proxy solicitations must make public all material facts concerning matters on which security holders are asked to vote. Plus, the Williams Act requires reporting and disclosure when control of a company is sought through a tender offer or other planned stock acquisition of more than 5%. This disclosure is also required of anyone soliciting shareholders to accept or reject a tender offer.

Insider Trading

There are two types of insider trading. One is the legal trading by insiders, corporate officers and directors, and beneficial owners of more than 10% of registered equity shares. Such insiders must file an initial report on their holdings with the SEC. Thereafter, they must file reports during the month when there are changes in their holdings.

The illegal insider trading is trading on material nonpublic information. State law plays a limited role in regulating insider trading. The one limited way is through rules against fraud and deceit. Many states have adopted what is known as special facts doctrine and some states have expended the doctrine into the Kansas rule. Both are very limited in regulating insider trading. Both theories apply only where there is an existing shareholder trading with an insider. Also, both rules require privity or face-to-face
transactions. Therefore, state law mostly comes into play with stock transactions in closely held companies.

Primarily, Rule 10b-5 of the Exchange Act governs such insider trading. Under Rule 10b-5,

\textit{It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.}

Five elements must be proved to impose criminal or civil liability under Rule 10b-5:

1. \textit{Misinformation:} The defendant must misrepresent a fact or not disclose a fact.
2. \textit{Material and nonpublic:} The fact must be material and nonpublic.
3. \textit{Knowledge:} The defendant must know that he or she made a misrepresentation and intended for the plaintiff to rely on it.
4. \textit{Reliance:} The plaintiff must rely on the information in the transactions.
5. \textit{Causation and injury:} The plaintiff must show that his or her trades relied on such information, such misinformation caused losses, and the plaintiff suffered damages.

However, Rule 10b-5 liability cannot be imposed on everyone who trades on the basis of material nonpublic information. As an example, a person with no fiduciary responsibility to the shareholders of the company in whose stock he or she trades does not violate Rule 10b-5 so long as the person is not a "tippee" or "misappropriator." Rule 10b-5 liability can generally be imposed on four types of groups:

1. \textit{Insiders and constructive insiders:} Corporate insiders and constructive insiders (attorneys, investment bankers and accountants hired by the company) have an abstain-or-disclose duty while in possession of material nonpublic information. It is a violation of regulation if they trade on such information.
2. \textit{Tippers:} An insider or constructive insider who never trades may be in violation for tipping the material nonpublic information to someone who trades based on such information.
3. \textit{Tippees and subtippees:} A tippee or a tippee of the tippee can be liable for trading on such nonpublic material information.
4. \textit{Misappropriators:} Under the misappropriation theory, an outsider can be criminally liable if he or she breaches a duty arising from a relationship of trust and confidence and uses that information in securities transactions, regardless of whether that person owed any fiduciary responsibility to the shareholders of the traded stock.

The misappropriation theory is an important weapon in SEC's fight against insider trading. As in the case \textit{United States v. O'Hagan}, an attorney hired by an acquirer is crimi-
nally liable if the attorney trades on the target’s stocks while in possession of confidential information that the firm’s client was planning to launch a tender offer for another company. The attorney would not have been liable without the misappropriation theory. In the case of O’Hagan, he was not an insider or constructive insider of the target company, and he was not a tippee of an insider or constructive insider of the target. He learned of the tender offer from the acquirer, the company to which he was a constructive insider. The misappropriation theory extends Rule 10b-5 to cover this situation. The misappropriation theory also extends liability to the tippers and tippees of the person who misappropriated the information.

In addition, Rule 14e-3 prohibits trading during the course of a tender offer by anyone, other than the bidder, who has material nonpublic information about the offer that was knowingly obtained either from the bidder or the target. Thus, Rule 14e-3 provides that the misappropriation theory may be used to hold a person liable for securities fraud involving tender offers.

**Regulation M**

Regulation M became effective on March 4, 1997. It governs trading practices during securities distributions. The new Regulation M replaces the former "anti-manipulation" rules. Regulation M significantly reduces the trading restrictions during a distribution by narrowing the basic coverage of the restrictions, expanding old exemptions, and adding new exemptions. Significant changes from the previous trading practices rules are outlined in the following paragraphs.

The first significant change is the deregulation of brokerage firm trading in actively traded securities. Underwriters, prospective underwriters, and their affiliated purchasers are generally no longer subject to any trading restrictions during the distribution of actively traded securities. Actively traded securities are securities with a public float of $150 million and an average daily trading volume (ADTV) value of at least $1 million. Another exemption is called the De Minimis exemption. Inadvertent purchases by an underwriter, prospective underwriter or affiliated purchaser of less than 2% of the ADTV of the security being distributed are exempt from the trading restrictions. Basket transactions are also exempt. The exemption applies to basket securities containing a covered security where the basket contains at least 20 securities and the covered security is no more than 5% of the basket value.

Second, Regulation M provides several new exemptions or exclusions from the trading restrictions. Restrictions on trading in derivatives such as options, warrants and convertible securities are eliminated when the offering involves only a distribution of the underlying securities. New exemptions are provided for trading in investment-grade asset-backed securities, Rule 144As, odd-lot transactions, and distribution pursuant to dividend reinvestment plans and employee plans.

Third, the restricted periods are shortened. Regulation M limits buying and soliciting of purchases by issuers, selling shareholders, and their affiliated purchasers during the restricted period. The restricted period starts either one business day or five business days prior to the day of pricing and runs through the end of the distribution. The one-business-day restricted period applies to offered securities with ADTV of $100,000 or more and a public float of $25 million. Offered securities that do not meet these qualifications are subject to a restricted period of five business days.

In addition, Regulation M permits broker-dealers to engage in passive market-making transactions in all Nasdaq securities. Passive market making is disallowed only when
Nasdaq securities are distributed in an "at the market" or best-efforts offering. Regulation M also provides that a stabilizing bid can be maintained, reduced, or raised to follow the independent market as long as the bid does not exceed the lower of the offering price or the stabilizing bid for the security in the principal market. Finally, Regulation M reduces the period during which short sales that are covered by securities purchased in an offering are prohibited. Short sales are prohibited during the period starting five business days prior to pricing. This is in contrast to the former rule, which prohibited such short sales starting at the filing date of the registration statement.

**BROKER-DEALER REGISTRATION AND REGULATION**

The registration of brokers and dealers engaged in soliciting and executing securities transactions is an important part of the regulatory plan of the Exchange Act. Under the Exchange Act, there is a high degree of industry self-regulation as well. Each exchange is responsible for setting standards of qualification and monitoring the conduct of its members. The NASD performs this function with respect to broker-dealers in the OTC market. Every registered broker-dealer must be a member of the NASD, except for certain exchange members who carry no customer accounts and conduct all of their business on the exchange. Thus, all U.S. broker-dealer registrants file one application for registration on Form BD with the NASD, which in turn passes over the application to the SEC for review. Foreign applicants are required to forward certain application materials such as Forms 9M and 10M directly to the SEC, as well as to the NASD.

Form BD requires detailed information regarding the broker-dealer applicant, its principals, and controlling persons. Form BD must be amended whenever there is any material change in the information included in the form. In addition to Form BD, the NASD requires additional materials before it will grant membership approval. These additional documents generally include a statement of financial condition, a copy of the applicant's written supervisory procedures, evidence of fidelity bonding, fingerprint cards and Form F-4 registration applications, a membership fee, and a clearing agreement.

A fidelity bond is to cover the loss, theft, forgery, and misplacement of securities by its personnel. The bond must be 120% of the applicable minimum net capital requirement, subject to an overriding minimum of $25,000. A Form U-4 must be submitted for each candidate who applies for registration as a principal or a representative. For purposes of the NASD registration, a principal is any person actively engaged in the management and supervision of the business. Any employee engaged in the member's investment banking or securities business must qualify and register as a representative. Furthermore, all registered broker-dealers are required to become members of the Securities Investor Protection Corporation (SIPC) and pay annual assessments. The SIPC insurance fund provides each customer with coverage up to $100,000 for cash owed and $500,000 for securities owed by a financially distressed broker-dealer.

All registered broker-dealers are subject to rules of the SEC and the NASD. Major procedural rules include recordkeeping, net capital rule, periodic financial reporting, and continuing education. First, recordkeeping covers basic record creation, maintenance, and preservation. The SEC and the NASD periodically conduct inspections to monitor compliance with the recordkeeping and other internal operating procedures. Second, the net capital rule specifies that the "aggregate indebtedness" may not exceed 800% of "net capital" in the first year of operation and 1,500% thereafter. Aggregate
indebtedness includes all liabilities, except for certain subordinated collateralized debt. The net capital requirements are determined by the broker-dealer's activities; the less contact it has with customer funds and securities, the lower the requirements. For example, the minimum net capital requirement is $5,000 for an introducing broker-dealer that does not hold customer securities and funds. Broker-dealers who are engaged only in riskless principal transactions would be subject to the same minimum requirements. In contrast, introducing broker-dealer that receives funds and securities are subject to a $50,000 minimum requirement. A broker-dealer that provides clearing services to customer transactions but does not hold funds and securities beyond settlement is required to maintain $250,000 in net capital. The maximum requirement of net capital is $1,000,000 for broker-dealers engaged in substantial market-making activities.

Third, all broker-dealers are required to file with the SEC annual financial statements, and copies of these statements must be furnished to the NASD. Finally, the NASD and the SEC introduced continuing education program requirements in 1995. The *Regulatory Element* of continuing education requires individual registered persons to complete NASD administered continuing education sessions within 120 days of the anniversary of the second, fifth, and tenth years of registration. The *Firm Element* requires NASD member broker-dealers to implement, maintain, and administer internal continuing training programs for all covered registered persons.

In addition to the requirements by the SEC and the NASD, practically every state has its own securities law requiring registration of broker-dealers before a broker-dealer conducts its business in the state. Generally, state broker-dealer requirements are no more onerous than the SEC and the NASD requirements. However, associated persons of a broker-dealer may have to take a Series 63 examination in order to qualify in certain states, such as New York.

**INVESTMENT COMPANY AND INVESTMENT ADVISERS**

The Investment Company Act of 1940 (ICA) governs the regulation of investment companies, while the Investment Advisers Act of 1940 (IAA) regulates the activities of investment advisers including advisers to registered investment companies, private money managers, and most financial planners.

Activities of companies engaged primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public, are subject to the regulation of ICA. There are three classifications for such investment companies. face-amount certificate company, unit investment trust, and management company. A *face-amount certificate company* is an investment company that is engaged in the business of face-amount certificates of the installment type. A *unit investment trust* is an investment company that is organized under a trust indenture, does not have a board of directors, and issues only redeemable securities. A *management company* is any investment company other than a face-amount certificate company or a unit investment trust.

Every registered investment company is subject to SEC registration requirements. The registration statement must include the following information and documents:

- The policy in respect of types of activities that the registrant proposes to operate, lending and borrowing money, engaging in the business of underwriting securities, concentrating investment in a particular industry or industries, trading of real estate or commodities, and portfolio turnover
• Investment and other important fundamental policies, which are changeable only if authorized by a shareholder vote
• The name and address of each affiliated person of the registrant, and a brief statement of the business experience for the preceding five years of each officer and director of the registrant
• The information and documents that would be required to be filed in order to register under the Securities Act and Exchange Act, and all securities that the registrant has outstanding or proposes to issue

In addition to the registration requirement, the ICA bars persons guilty of securities fraud from serving as officers or directors and requires that management contracts and any other material changes are submitted to shareholders for their approval. Under the ICA, it is unlawful for any registered investment company to purchase any security on margin or to effect a short sale of any security. The ICA also prevents underwriters, investment bankers, or brokers from constituting more than a minority of the directors of an investment company. In addition, the ICA forbids investment companies to issue senior securities except under specified conditions and upon specified terms.

Other provisions of the ICA involve advisory fees, sales and repurchases of securities issued by the investment companies, exchange offers, and other activities of the investment companies.

**Investment Advisers Act of 1940**

The IAA regulates the activities of investment advisers, including advisers to investment companies, private money managers, and most financial planners. Registration is required of any person, absent an exclusion or an exemption, engaging in the business of providing advise or issuing reports about securities to clients for compensation. The persons excluded from the definition of investment adviser are:

• U.S. banks and bank holding companies
• Instrumentalities of the United States or any state
• Government securities advisers
• Publishers of bona fide newspapers and magazines of general and regular circulation
• Lawyers, accountants, teachers, and engineers, provided that the advise is solely incidental

There are five statutory exemptions available as well: instrastate advisers, insurance company advisers, private investment advisers, charitable organization advisers, and church employee pension plans. The private adviser exemption is the one most often used by advisers to avoid registration. Private investment advisers are investment advisers who had fewer than 15 clients during the past 12 months, do not hold themselves out to the public as investment advisers, and do not advise any registered investment company. In addition, under the 1996 NSMIA, an adviser that has less than $25 million of assets under management and is not an adviser to a registered investment company may register with the state, and need not register with the SEC.

An investment adviser registers with the SEC by filing a Form ADV. The information required to be disclosed on Form ADV consists of two parts. Part I requires information on
the adviser's jurisdiction of incorporation and principal place of business, the ownership and control of the adviser, how the operations are financed, detailed employment histories and educational backgrounds of key personnel, and whether an adviser or an affiliate has been involved in any material civil or criminal or administrative legal proceedings. Part II requires detailed disclosures on the operations and business practices of the investment adviser, and is usually provided to clients. Generally, an adviser's registration becomes effective 45 days after Form ADV is filed with the SEC. After registration, information contained in Form ADV must be kept current through the filing of amendments.

The LAA also establishes requirements governing the operation of a registered adviser and the relationship between the adviser and its clients. The most important requirements include recordkeeping, brochure rule, advisory contacts and performance fees, conflicts and anti-fraud provisions, and duty to supervise. Each of these requirements is briefly explained as follows:

- The IAA requires investment advisers to maintain books and records. Registered investment advisers are required to keep business and financial records and proprietary trading records. All these records are subject to inspection by the SEC at any time.
- The brochure rule requires an adviser to provide each client with a written statement concerning the adviser, its operations, and its principals.
- The IAA requires that any contract for advisory services contain a provision prohibiting the adviser from assigning the contract without the consent of the client (assignment of contracts). The IAA prohibits, with certain exceptions, performance-based compensation (performance fees). There are three exceptions, First, an adviser may charge a fulcrum fee, based on the total value of client funds under management over a specified period. Second, a registered investment adviser may charge a performance fee if the client meets an eligibility requirement and the fee formula includes realized losses as well. The third exemption is provided under the NSMIA that an investment adviser is permitted to charge performance fees to persons who are not U.S. residents and to private investment funds that are restricted to qualified purchasers.6
- The IAA requires investment advisers to conform to the statutory requirements that prohibit violation of the fiduciary duties on an investment adviser to its clients. The IAA requires an adviser to disclose to clients material facts concerning any conflict of interest.
- Under the IAA, an investment adviser is required to use reasonable efforts to supervise the activities of its employees, agents, and associated persons to prevent violations of related statutes.

If an investment adviser is not registered under the IAA because it has less than $25 million in assets under management and does not advise a registered investment company, then it may be required to register under state law. The NSMIA provides that state registration and other requirements will not apply to any person registered under the IAA or is a supervised person of a registered adviser.

ETHICS

On Wall Street, your word is your bond. Integrity and high ethical standards are basic to success. Without strict regulatory compliance and high ethical standards, any success
will eventually fade away. To abide by the highest professional standards is an obligation to all securities industry professionals. Anything less would be a betrayal of the professional obligation.

The SEC enforces securities regulation. There are, however, gray areas in which integrity and ethics is the guiding principle. Successful capital market professionals use reasonable care and practice in a professional and ethical manner. The basics of professional conduct are to maintain knowledge of and comply with all applicable laws and rules. Furthermore, anyone in the securities business shall not knowingly participate in or assist any violation of such laws or rules. Members of the markets shall not engage in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation.

Securities firms should emphasize the high value of their reputation and interest in contributing to enhanced investor protection and the integrity of the securities industry. Firms should insist on compliance and professionalism throughout the firm with senior management leading by example. Special emphasis is that compliance with laws, rules and ethical standards is expected of every employee. Compliance record is made part of performance evaluations. To achieve this, firms should provide vehicles and resources for the transmission of compliance and regulatory information to all employees. In addition, input by compliance professionals is an integral component of decisions relating to hiring and training.

As an employee, there are certain responsibilities to your employer. An employee shall not undertake any independent practice that could result in compensation or other benefit in competition with the employer unless written consent is obtained from both employer and client. When called for, the employee should disclose to the employer all matters, including beneficial ownership of securities or other investments, that could be expected to interfere with his duty or ability to make unbiased and objective recommendations.

When dealing with clients, securities markets professionals should put the customer first and use particular care in determining applicable fiduciary duty and shall comply with such duty. Customers expect fair dealing, preservation of confidentiality, and trust. Misrepresentation of any kind, including qualifications, credentials, and capabilities, is a violation of integrity.

The code of ethics and standards of professional conduct have been put into practice at most investment banks. For example, the business principles of Goldman Sachs are:

1. Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow.
2. Our assets are our people, capital and reputation. If any of these is ever diminished, the last is the most difficult to restore. We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard.
3. We take great pride in the professional quality of our work. We have an uncompromising determination to achieve excellence in everything we undertake. Though we may be involved in a wide variety and heavy volume of activity, we would, if it came to a choice, rather be best than biggest.
4. We stress creativity and imagination in everything we do. While recognizing that the old way may still be the best way, we constantly strive to find a better solution to a client's problems. We pride ourselves on having pioneered many of the practices and techniques that have become standard in the industry.
5. We make an unusual effort to identify and recruit the very best person for every job. Although our activities are measured in billions of dollars, we select our people one by one. In a service business, we know that without the best people, we cannot be the best firm.

6. We offer our people the opportunity to move ahead more rapidly than is possible at most other places. We have yet to find the limits to the responsibility that our best people are able to assume. Advancement depends solely on ability, performance and contribution to the firm's success, without regard to race, color, religion, sex, age, national origin, disability, sexual orientation, or any other impermissible criterion or circumstance.

7. We stress teamwork in everything we do. While individual creativity is always encouraged, we have found that team effort often produces the best results. We have no room for those who put their personal interests ahead of the interests of the firm and its clients.

8. The dedication of our people to the firm and the intense effort they give their jobs are greater than one finds in most other organizations. We think that this is an important part of our success.

9. Our profits are a key to our success. They replenish our capital and attract and keep our best people. It is our practice to share our profits generously with all who helped create them. Profitability is crucial to our future.

10. We consider our size an asset that we try hard to preserve. We want to be big enough to undertake the largest project that any of our clients could contemplate, yet small enough to maintain the loyalty, the intimacy and the esprit de corps that we all treasure and that contribute greatly to our success.

11. We constantly strive to anticipate the rapidly changing needs of our clients and to develop new services to meet those needs. We know that the world of finance will not stand still and that complacency can lead to extinction.

12. We regularly receive confidential information as part of our normal client relationships. To breach a confidence or to use confidential information improperly or carelessly would be unthinkable.

13. Our business is highly competitive, and we aggressively seek to expand our client relationships. However, we must always be fair competitors and must never denigrate other firms.

14. Integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives.

**SUMMARY**

This chapter provides an overview of major regulatory issues and ethics in the securities markets. The coverage starts with the process of bringing new securities to the marketplace, and then to the trading practices in the exchanges or the OTC markets. Subsequent sections cover exempt offerings and restrictions of trading on these restricted securities. Another subject is regulation of the money management operations. Finally, maintaining the highest professional standards is an obligation for all market professionals.
SELECT BIBLIOGRAPHY

APPENDIX A  Selected Forms Prescribed Under the 1933 Act

A. Forms for Registration Statements

Form SB-1 - Optional Form for the Registration of Securities to Be Sold to the Public by Certain Small Business Issuers

Form SB-2 - Optional Form for the Registration of Securities to Be Sold to the Public by Small Business Issuers

Form S1 - Registration Statement under the Securities Act of 1933

Form S2 - for Registration under the Securities Act of 1933 of Securities of Certain Issuers

Form S3 - for Registration under the Securities Act of 1933 of Securities of Certain Issuers Offered pursuant to Certain Types of Transactions

Form S4 - for the Registration of Securities Issued in Business Combination Transactions

Form S6 - for Unit Investment Trusts Registered on Form N-8B-2

Form S8 - for Registration under the Securities Act of 1933 of Securities to Be Offered to Employees pursuant to Employee Benefit Plans

Form S11 - for Registration under the Securities Act of 1933 of Securities of Certain Real Estate Companies

Form S20 - for Standardized Options

B. Forms for the Use of Foreign Issuers

Form F1 - Registration Statement under the Securities Act of 1933 for Securities of Certain Foreign Private Issuers

Form F2 - for Registration under the Securities Act of 1933 for Securities of Certain Foreign Private Issuers

Form F3 - for Registration under the Securities Act of 1933 of Securities of Certain Foreign Private Issuers Offered pursuant to Certain Types of Transactions

Form F4 - for Registration of Securities of Foreign Private Issuers Issued in Certain Business Combination Transactions

Form F6 - for Registration under the Securities Act of 1933 of Depositary Shares Evidenced by American Depositary Receipts

Form F7 - for Registration under the Securities Act of 1933 of Securities of Certain Canadian Issuers Offered for Cash Upon the Exercise of Rights Granted to Existing Securityholders

Form F8 - for Registration under the Securities Act of 1933 of Securities of Certain Canadian Issuers to Be Issued in Exchange Offers or a Business Combination

Form F9 - for Registration under the Securities Act of 1933 of Certain Investment Grade Debt or Investment Grade Preferred Securities of Certain Canadian Issuers

Form F10 - for Registration under the Securities Act of 1933 of Securities of Certain Canadian Issuers

Form F80 - for Registration under the Securities Act of 1933 of Securities of Certain Canadian Issuers to Be Issued in Exchange Offers or a Business Combination

C. Forms Pertaining to Exemptions

Form 1-A - Offering Statement under Regulation A

Form 2-A - Report pursuant to Rule 257 of Regulation A

Form 144 - for Notice of Proposed Sale of Securities pursuant to Rule 144

(continues)
APPENDIX A  (continued)

C. Forms Pertaining to Exemptions
Form 1-E - Notification under Regulation E
Form 2-E - Report of Sales pursuant to Rule 609 of Regulation E
Form 1-F - Notification under Regulation F
Form D - Notice of Sales of Securities under Regulation D and Section 4(<S>) of the Securities Act of 1933
Form 701 - Report of Sales Securities pursuant to a Compensatory Benefit Plan or Contract Relating to Compensation

APPENDIX B  Forms Prescribed Under the Securities Exchange Act of 1934

A. Forms for Registration or Exemption of, and Notification of Action Taken by, National Securities Exchanges
Form 1, for Application for, or Exemption from, Registration as a National Securities Exchange
Form 1-A, for Amendments to Form 1
Form 25, for Notification of Removal from Listing and Registration of Matured, Redeemed or Retired Securities
Form 26, for Notification of the Admission to Trading of a Substituted or Additional Class of Security under Rule 12a-5

B. Forms for Reports to Be Filed by Officers, Directors, and Securityholders
Form 3, Initial Statement of Beneficial Ownership of Securities
Form 4, Statement of Changes in Beneficial Ownership of Securities
Form 5, Annual Statement of Beneficial Ownership of Securities

C. Forms for Applications for Registration of Securities on National Securities Exchanges and Similar Matters
Form 8-A, for Registration of Certain Classes of Securities pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934
Form 8-B, for Registration of Securities of Certain Successor Issuers pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934
Form 10 and Form 10-SB, General Form for Registration of Securities pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934
Form 10-SB, Optional Form for the Registration of Securities of a Small Business Issuer
Form 18, for Foreign Governments and Political Subdivisions Thereof
Form 20-F, Registration of Securities of Foreign Private Issuers pursuant to Section 12(b) or (g) and Annual and Transition Reports pursuant to Sections 13 and 15(d)

(continues)
E. Forms for Registration of Brokers and Dealers Transacting Business on Over-the-Counter Markets
Form BD, for Application for Registration as a Broker and Dealer or to Amend or Supplement Such an Application
Form B D W , Notice of Withdrawal from Registration as Broker-Dealer pursuant to Rules 15b6-l, 15Bc3-l, or 15Cci-l
Form 7-M, Consent to Service of Process by an Individual Nonresident Broker-Dealer
Form 8-M, Consent to Service of Process by a Corporation Which Is a Nonresident Broker-Dealer
Form 9-M, Consent to Service of Process by a Partnership Nonresident Broker-Dealer
Form 10-M, Consent to Service of Process by a Nonresident General Partner of a Broker-Dealer Firm

F. Forms for Reports to Be Made by Certain Exchange Members, Brokers, and Dealers
Form X-17A-5, Information Required of Certain Brokers and Dealers pursuant to Section 17 of the Securities Exchange Act of 1934 and Rules 17a-5,17a-10 and 17a-ll
Form X-17A-19, Report by National Securities Exchanges and Registered National Securities Associations of Changes in the Membership Status of Any of Their Members
Form 17A-23, Information Required of Certain Broker and Dealer Sponsors of Broker-Dealer Trading Systems pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-23

G. Forms for Self-Regulatory Organization Rule Changes and Forms for Registration of and Reporting by National Securities Associations and Affiliated Securities Associations
Form X-15AA-1, for Application for Registration as a National Securities Association or Affiliated Securities Association
Form X-15AJ-1, for Amendatory and/or Supplementary Statements to Registration Statement of a National Securities Association or an Affiliated Securities Association
Form X-15AJ-2, for Annual Consolidated Supplement of a National Securities Association or an Affiliated Securities Association
Form 19b-4, for Filings with Respect to Proposed Rule Changes by All Self-Regulatory Organizations

H. Forms for Registration of, and Reporting by, Securities Information Processors
Form SIP, for Application for Registration as a Securities Information Processor or to Amend Such an Application or Registration

I. Forms for Registration of Municipal Securities Dealers
Form MSD, Application for Registration as a Municipal Securities Dealer pursuant to Rule 15Ba-2-l under the Securities Exchange Act of 1934 or Amendment to Such Application
Form M S D W , Notice of Withdrawal from Registration as a Municipal Securities Dealer pursuant to Rule 15Bc3-l

J. Forms for Reporting and Inquiry with Respect to Missing, Lost, Stolen, or Counterfeit Securities
Form X-17F-la, Report for Missing, Lost, Stolen or Counterfeit Securities
APPENDIX B  (continued)

E. Forms for Registration of Brokers and Dealers Transacting Business on Over-the-Counter Markets
Form BD, for Application for Registration as a Broker and Dealer or to Amend or Supplement Such an Application
Form BD W, Notice of Withdrawal from Registration as Broker-Dealer pursuant to Rules 15b6-1, 15b3-1, or 15Cc1-1
Form 7-M, Consent to Service of Process by an Individual Nonresident Broker-Dealer
Form 8-M, Consent to Service of Process by a Corporation Which Is a Nonresident Broker-Dealer
Form 9-M, Consent to Service of Process by a Partnership Nonresident Broker-Dealer
Form 10-M, Consent to Service of Process by a Nonresident General Partner of a Broker-Dealer Firm

F. Forms for Reports to Be Made by Certain Exchange Members, Brokers, and Dealers
Form X-17A-5, Information Required of Certain Brokers and Dealers pursuant to Section 17 of the Securities Exchange Act of 1934 and Rules 17a-5,17a-10 and 17a-11
Form X-17A-19, Report by National Securities Exchanges and Registered National Securities Associations of Changes in the Membership Status of Any of Their Members
Form 17A-23, Information Required of Certain Broker and Dealer Sponsors of Broker-Dealer Trading Systems pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-23

G. Forms for Self-Regulatory Organization Rule Changes and Forms for Registration of and Reporting by National Securities Associations and Affiliated Securities Associations
Form X-15AA-1, for Application for Registration as a National Securities Association or Affiliated Securities Association
Form X-15AJ-1, for Amendatory and/or Supplementary Statements to Registration Statement of a National Securities Association or an Affiliated Securities Association
Form X-15AJ-2, for Annual Consolidated Supplement of a National Securities Association or an Affiliated Securities Association
Form 19b-4, for Filings with Respect to Proposed Rule Changes by All Self-Regulatory Organizations

H. Forms for Registration of, and Reporting by, Securities Information Processors
Form SIP, for Application for Registration as a Securities Information Processor or to Amend Such an Application or Registration

I. Forms for Registration of Municipal Securities Dealers
Form MSD, Application for Registration as a Municipal Securities Dealer pursuant to Rule 15Ba-2-1 under the Securities Exchange Act of 1934 or Amendment to Such Application
Form MSD W, Notice of Withdrawal from Registration as a Municipal Securities Dealer pursuant to Rule 15Bc3-1

J. Forms for Reporting and Inquiry with Respect to Missing, Lost, Stolen, or Counterfeit Securities
Form X-17F-la, Report for Missing, Lost, Stolen or Counterfeit Securities