Online Study Guide

Investment Banking

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Investment Banking

Introduction

Investment bankers are securities firms that specialize in helping corporations raise funds by selling new securities to the general public. If hired by a corporation, an investment banking firm acts as adviser and distributor. Investment bankers are also known as underwriters and are essentially the traditional middle men in the actual process of having securities listed.

Negotiated underwriting is a process of discussion between the corporation and the investment banker in which agreements are made concerning the amount of funds the corporation needs, the type of security to be issued, the price, any particular features of the security, and the cost to the firm of issuing the securities. Investment banking firms have many customers and are generally able to market securities for a corporation more economically than the individual corporation could on its own. Most corporations use negotiated underwriting to choose an investment banker to represent them, but competitive bidding is another method. This is generally used by public utility issues and involves a choice by the issuer from competing underwriting syndicates as to which firm offers the best deal for the issuer.

If the investment bankers choose to buy the entire issue of securities from the issuer and re-offer them to the general public, the agreement is known as a firm commitment. In this case, the risk of selling the securities belongs to the underwriter, not the issuing corporation and the corporation is supplied with a specific amount of money.
If the investment bankers simply agree to make the best possible effort to sell the securities for a corporation, a best effort agreement is used. No guarantees are made and the issuer is not given a specific amount of money.

The securities offered to the public for sale in a primary offering are authorized, previously unissued stocks. If it's the first time the corporation has made a public offering, it is called their Initial Public Offering (IPO). A secondary offering uses a large block of outstanding stock usually owned by one or more investors. It is securities that have been previously sold and is now being re-sold by stockholders or when a corporation re-sells treasury securities. A combined or split offering represents the offerings of both the primary and secondary shares.

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Corporations must follow the guidelines set forth in the Securities Act of 1933 (also known as the Act of Full Disclosure) when making a public offering of stock. The corporation must file a registration statement with the Securities and Exchange Commission (SEC), which enforces national laws and regulations. A registration statement includes a description of the business raising the capital, biographical information of the officers and directors of the issuer, and a list of share holdings of the officers and directors and anyone who holds more than 10% of the corporation's issues. The registration statement also includes complete financial statements with a breakdown of current debt and equity securities, an explanation of how the new capital will be used and any legal proceedings in which the issuer is involved. Once an investment banking firm files a registration statement with the SEC on behalf of a company, there is a "cooling off period" of twenty days from the date of filing to the effective date. This time lapse allows the SEC enough time to review the information and decide if full disclosure has been made. This process usually takes more than twenty days in actual practice. The SEC will postpone the effective date if the issuer has not made full disclosure by sending a deficiency letter. Even if no deficiency letter is sent, the SEC does not endorse issues. The following disclaimer must be included inside the front cover of every prospectus:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

During the twenty day cooling off period, the investment banker may issue a preliminary prospectus known as a "red herring" in order to improve the marketability of the upcoming issue. Red herrings are paid for by the investment banking firm and include information such as the firm's financial statements, its current activities, the regulatory bodies which oversee it, the type of competition, the management of the company, and how the capital being raised will be used. The public offering price and the effective date are not included in the red herring, since neither of those has yet been determined. Most public offering prices are set on the effective date in order to consider current market conditions.

During the pre-filing period, nothing can be said to anyone about the negotiations between the issuer and the underwriter. Such discussions are

criminal in nature and are taken very seriously by authorities. No research reports, no recommendations from others, and no sales literature may be sent to clients during the cooling off period. Two things legally allowable during this time period are the red herring which simply solicits indications of interest (but no orders) from clients and the tombstone ad which simply announces the upcoming issue. Tombstone ads are often used to advertise the effectiveness of new issues and include the date of the new issue, the number of shares and price per share, and the names of the syndicate members as well as a statement that the issues may only be sold by use of the prospectus.

Near the end of the cooling off period, a meeting known as the due diligence meeting is held between the underwriter and the issuer. If necessary, the registration statement is edited so that it is complete and accurate. Since they have civil liability for omissions or misstatements and criminal liability for fraudulent, manipulative, or deceptive means, both corporate officers and underwriters must sign the final registration statement. The final prospectus may also be written and/or finalized at the due diligence meeting.

Once the effective date is set by the SEC, sales may begin and the underwriter may accept money from clients. The final prospectus, a shortened form of the registration statement, must be delivered to the client no later than the confirmation of his trade. The SEC also requires that the prospectus for any IPO must be available for 90 days after the effective date. On all issues other than IPOs, the SEC requires that the prospectus must be available for 40 days. Any prospectus in use nine months after the effective date must not contain any financial information more than sixteen months old. The prospectus must be updated to reflect current data.

If an underwriter wishes to share its exposure to risk, a syndicate of other investment bankers may be formed. The syndicate will be led by a syndicate manager or managing underwriter. A non-binding agreement known as a letter of intent is used to indicate that all parties have prepared for the upcoming offering. When plans progress and all parties agree to formalize the agreement, binding contracts are used. Generally, most public offerings make use of the Agreement among Underwriters, the Underwriting Agreement and the Dealer Agreement.

The Agreement among Underwriters (AAU) establishes the specifics of the relationship among the underwriters and states that the syndicate manager will act on behalf of the group but is not part of the prospectus. Each

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underwriter of the syndicate promises to buy a portion (his allotment) of the total issue. The syndicate manager agrees to establish the offering price with the issuer, decide when to begin the offering, amend the offering price and selling commission as needed, oversee all advertising, and respond to deficiency letters. The managing underwriter will also file required federal securities paperwork and have the issue “Blue Skied” (meet appropriate state securities laws and requirements).

The Underwriting Agreement (AU) establishes the relationship between the issuers and the underwriters. It is legally binding as to the purchase and sale of the securities. When each underwriter agrees to sell his allocation but is not responsible for any unsold allotment of another underwriter, the AU is referred to as a divided or Western account. When each underwriter is responsible for unsold allotments of other underwriters, the AU is an undivided or Eastern account.

The Dealer or Selling Agreement is used when underwriters allow selected dealers who are not participating underwriters to purchase securities for distribution. These dealers do not assume the same risks as the underwriters. They simply buy the issues from the underwriters at a discount from the public price so they can fill orders they received after the effective date.

If any part of the issue does not sell, the risk belongs to the syndicate (not the dealers and not the issuer) **unless** the contract specifies that the agreement is best efforts underwriting. With best efforts underwriting, the underwriters make no promise to buy or sell the issue; they just do their best. They act as an agent for the issue and have no liability to the issuer. In this situation, the investment bankers form a selling group, but not a syndicate. Each member only agrees to do his best. The all-or-none and the mini-max are variations of the best efforts underwriting. With an all-or-none offering, unless all the shares can be distributed within a certain period of time, none will be filled. With the mini-max offering, a specified minimum must be sold or the offering will be eliminated. For all-or-none and mini-max offerings, an escrow account must be set up to hold all monies until the closing date in case it is necessary to return money to clients. Such escrow accounts must be kept at banks to protect prospective purchasers.

In the case of a pre-emptive rights offering, a stand-by underwriting commitment may be used. It requires the underwriter to “stand by” to purchase

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any part of the issue not claimed by the existing stockholders. This would happen if current stockholders choose not to exercise their pre-emptive rights. After the underwriter buys any unclaimed issues, he would then re-offer them to the public for purchase.

An agent (or broker) buys or sells issues for the account and risk of another party and charges a commission for his services. A principal is someone who acts as a dealer which means he buys and sells for his own account and risk. He makes money by selling at a higher price than he buys. In a firm commitment, the underwriter acts as a principal. The price an issue is offered to the public is known as the public offering price, but the underwriter actually pays the issuer a lower price when he purchases it. The spread or underwriting discount is the difference between the lower price and the public offering price. The issuer and the underwriter actually negotiate the amount of the spread and it may be reviewed by NASD before sales begin. A portion of the spread is used to pay the managing underwriter and is called the manager's fee. A portion of the spread is kept by each underwriter and is called the underwriting or syndicate allowance. The other portion of the spread is used to pay the selling group and is called the selling concession.

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Stabilization

The best way to get a "sticky issue" to sell better is by increasing the selling concession. But stabilization may also be effective. The SEC permits an underwriting manager to stabilize an issue by buying shares in the open market at a bid price at, or just below, the official offering price of the new issue. The underwriter's bid price is called the stabilizing bid. If shares are repurchased by the stabilizing underwriter, they may be placed back into the distribution and sold as new shares at the public offering price. This practice may be used only if specified in the prospectus with this statement:

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF ______________________ AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH TRANSACTIONS MAY BE EFFECTED ON __________________. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

This activity must cease after the entire new issue is sold in order to avoid manipulation and violation of the law. Since this activity is costly, the syndicate manager charges a syndicate penalty bid to any member of the syndicate who has clients turn in shares on a stabilizing bid.

To avoid the need to stabilize, an underwriting manager may overallot to each member of the syndicate. This helps the syndicate sell orders for 100% of the issue even if some potential clients cancel or change their minds. In the case where a manager overallots and no one cancels, the issuer may issue additional shares or the syndicate may go short. Member firms must make a proper distribution of all the shares at the public offering price. The SEC and the NASD are diligently watching member firms to see that their practices protect the clients' best interests.

Municipal securities do not have to adhere to the filing requirements of the Securities Act of 1933. When a state or local government issues a municipal security, there is no requirement for registering with the SEC, so no registration statement or prospectus is needed.

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Municipal Underwriting

One way of financing municipal securities is known as negotiated in which the issuer negotiates directly with an investment banker the terms of the offering. With competitive bidding, an issuer announces that it wants to borrow money and is seeking syndicates to submit competitive bids. So that the issuer has the lowest net interest cost, an agreement is made with the underwriter who submits the best bid. Net interest cost is the lowest expense to the issuer; true interest cost also considers the time value of the money involved. A Notice of Sale is used by the issuer to solicit competitive bids. The notice usually includes the date, time, place, a description of the issue, the way in which the bid is to be made, the type of bond, the semi-annual interest payment dates, the denominations to be used in printing the bonds, the deposit amount required, the name of the law firm involved, where to acquire the bid form, and how the bid decision will be made (usually the lowest net interest cost).

A bond attorney or independent bond counsel is hired by the municipality to ensure that all state, local and federal requirements are met. The bond attorney establishes the eligibility from federal income tax and determines that there is proper authority from the state's constitution, a legislative decision, or judicial ruling for the bond issuance. The bond attorney also oversees the procedures of the issuance, makes sure the bond certificates are proper and then completes a legal opinion. The only securities that require a legal opinion are municipal bonds. The bond attorney is not responsible for preparing the official statement which gives investors all the information needed to make decisions about a possible municipal bond purchase.

If negotiated underwriting is used to form a municipal underwriting syndicate, an AAU is prepared. If competitive bidding is used, the managing underwriter specifies all the agreements among syndicate members in a Syndicate Letter.

There are four basic types of orders used in municipal underwriting: pre-sale orders, syndicate or group net orders, designated orders, and member orders. A pre-sale order is taken before the syndicate offers the bonds and has priority over all other orders. A syndicate order is made at the public offering price after the offering has begun and is credited to the appropriate syndicate member in proportion to his allotment. A designated order is made at the public offering price, but the investor is given the right to credit the syndicate member

of his choice. A member order is an order by a syndicate member at the "take-down" price (spread minus the manager's fee) for the member's own account or for sale to another dealer or investor.

If an offering has higher demands than supplies, it is referred to as over-subscribed and the priority for filling orders is: pre-sale, syndicate, designated and members. The underwriting manager has responsibility for handling group net and designated orders after the pre-sale orders are filled. That is, he must decide on the retention percentage or how much of the member's allotment he will actually have available for sale. If a member had an allotment of 1,000,000 bonds and an 80% retention rate, he could actually sell 800,000 bonds.

A scale for a municipal bond is a listing of coupon rates and maturity dates. It also includes yield or price the syndicate is re-offering the bonds to the public. A regular or positive scale shows that the yield to maturity is lowest on near term maturities and highest on long term maturities. The longer the maturity, the higher the yield. This is also called a positive yield curve. If a bond has a negative scale, the short term maturities are higher than the long term maturities.

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Underwriting Governments

The largest underwriting market in the world is the underwriting of U.S. Government securities. Since the government is in control, there is no negotiated underwriting on these securities. All offerings are sold in an auction conducted by the Federal Reserve Bank of New York. A schedule is published and only primary dealers are invited to attend. Reputation, underwriting capacity, and adequacy of staff and facilities are considered by the president of the Federal Reserve Bank of New York in choosing primary dealers. Primary dealers are the only firms authorized to buy and sell government securities in direct dealings with the FED.

Every Monday, 13 and 26-week treasury bills are offered; 52-week bills are offered once a month. Treasury notes and bonds are offered less frequently. Bids are entered on a yield basis, using the "Dutch" auction method. About a week before an offering, the Treasury announces the amount they want to borrow, the maturity date, the expected nominal or coupon rate, and the minimum denominations to be issued. T-bills do not have a nominal or coupon rate and are only offered in $10,000 denominations.

Individuals who want to buy newly issued Treasuries may submit a non-competitive bid in amounts of $1 million or less. All non-competitive bids are automatically filled at the average yield of the accepted competitive bids. Because Treasuring offerings are so large, it would be very rare for the lowest competitive bidder to receive the entire issue. Therefore, the Treasury begins with the best bid and progressively moves to the next best, then the next best, etc. until most of the issue is taken. A small portion is always left for the non-competitive bids.

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Blue Sky Registration

The three main types of state registrations are notification, coordination and qualification. Most, but not all, states allow the issue to register by notification. This is a very simple form that may be used by issuers who have been in business for at least the last three years and have met certain earning requirements during those three years. An offering document with certain disclosures must be filed, but usually the Administrator declares the registration effective concurrently with the Federal registration. Coordination registration is used when an issuer wants to coordinate a Federal registration under the Securities Act of 1933 with the Blue Sky registration of one or more states. Usually the state registration becomes effective with the Federal registration. In most cases, qualification registration (which is ordered by the State Administrator) is used only by those issuers who cannot use notification or coordination.

Fiduciaries handle money on behalf of others and are regulated by state laws. A custodian for a minor, an executor or administrator of an estate, a trustee of a trust, and a guardian appointed by a court are all examples of fiduciaries. Some states maintain a list of investments which are considered legal investments for fiduciaries. The list is known as the legal list, but most states follow the "Prudent Man" Rule instead of publishing a legal list. The "Prudent Man" Rule gives the fiduciary more leeway and requires that "prudence, discretion and intelligence" be practiced when making investment decisions.

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Exempt Securities

The following offerings are exempt from the Act of '33 registration and prospectus requirements: U.S. Government and Federal Agency issues, municipal and state issues, intrastate offerings, small public offerings, insurance policies, fixed annuity contracts, commercial paper and banker's acceptances of nine months or shorter maturity, and private placements. Intrastate offerings must meet the requirements of SEC Rule 147 to keep their SEC registration exemption. That is, the issuer must be incorporated within the state, at least 80% of its revenues must come from business within the state, 80% of its assets are located within the state, and 80% of the proceeds of this offering must be used to do business within the state. Additionally, those who purchase the offering must be state residents. Re-sales are permitted only to other state residents unless at least nine months have passed since termination of the Rule 147 offering. The certificates must have a legend stating these restrictions and the restrictions must be delineated in the offering document.

An issuer may be exempt from full registration under Regulation A of the 1933 Act if the securities issued do not exceed $5,000,000 in any twelve month period. Instead of filing with the SEC in Washington, the issuer may file a simplified disclosure document known as an Offering Statement with the Regional SEC Office at least ten days prior to the initial offering. An offering circular (instead of a prospectus) is given to prospective investors at least 48 hours before the confirmation of a sale is mailed. If the offering is not over within nine months from the date of the offering circular, a revised circular must be prepared and a report must be filed with the SEC of sales made under the Regulation A exemption every six months until the offering is completed.

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Life Insurance and Commercial Paper

Traditional life insurance and fixed annuities are exempt from the SEC registration requirement, but variable life insurance and variable annuities are not
exempt. If commercial paper and banker's acceptances mature within 270 days or less, they are also exempt. Private placements are exempt because the '33 Act applies to public offerings.

Regulation D of the Act of 1933 allows issuers of private offerings to save time and money by exemption from the SEC registration requirements if certain stipulations are met. Rule 501 of Regulation D clearly defines accredited investors. Certainly, banks, savings & loans, credit unions, insurance companies, and investment companies are included. Corporations and partnerships with net worth of $5 million qualify if they were not formed for the purpose of making this investment. Colleges or university endowment funds and other nonprofit organizations with assets of $5 million also qualify. Corporate or partnership "insiders" are accredited investors. Individuals with a net worth (individual or joint) of more than one million dollars or individuals with incomes of more than $200,000 (or joint incomes of $300,000) in each of the last two years who have a reasonable expectation of the same income during the current year also qualify as accredited investors as well as any entity 100% owned by accredited investors.

Non-accredited investors are eligible to purchase Regulation D offerings if certain guidelines are met. Rule 505 of Reg D allows corporations to raise up to $5 million in a 12-month period without filing a registration if the number of non-accredited investors does not surpass 35. Rule 506 waives the dollar limit for non-accredited investors if they have ample investment experience or if they are represented by a Purchase Representative such as an attorney, accountant or investment advisor.

Regulation D prohibits any public advertising or solicitation. Tombstone ads may announce the completion of a private offering, but cannot announce the availability of the offering. Even if not required by the SEC, in most cases a Private Offering Memorandum is prepared and distributed so that all investors receive disclosure.

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SEC Rule 144 allows issuers to save the time and money of filing a complete registration statement with the SEC and still re-sell unregistered securities only if certain conditions are met. One situation which allows this is if the securities have been held in a fully paid-for status for at least one full year. Another situation is if a Notice of Sale (specifying the details and proving compliance with Rule 144) is filed with the SEC at the time of sale. Another situation is when the quantity limitations of Rule 144 are met. That is, if the intended re-sale exceeds 500 shares or a value of $10,000, the investor must limit his re-sale to the larger of the following two share amounts: 1% of the outstanding shares or the average weekly volume in the four weeks before the receipt of the order.

Rule 144A allows private resales of unregistered issues to institutions known as "qualified institutional buyers." These include insurance companies, banks, employee benefit plans, non-profit organizations or investment adviser (if they own and invest on a discretionary basis at least $100 million in issues not affiliated with said issue).

Rule 145 allows stockholders to resell issues acquired by reclassifications other than a stock split or reverse split, mergers or consolidations, or transfers of assets after a holding period of at least one year if the other conditions of Rule 144 are met. No restrictions apply to resale of issues that have been held at least two years if the person is not an affiliate.

With shelf registration an issuer is allowed to register all issues that can reasonably be offered and sold within two years. The issuer offers what meets its financing needs at the current time and puts the rest on a "shelf" to be offered at later times as needed.

Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.

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