

6.1.3. UNDERWRITING PROCESS: PRE-FILING PERIOD

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

Letter of intent and due diligence. With the issuer's selection of an investment bank to underwrite the offering, both parties will sign a non-binding agreement called a **letter of intent (LOI)**. The letter of intent is a tentative agreement between the two parties, setting out the basic terms of their relationship and the terms of the offering. Once a letter of intent has been signed with the lead underwriter, an organizational meeting will kick off the process, in which the parties will discuss the terms and structure of the offering, propose a registration timetable, and assign among themselves certain responsibilities and tasks. The underwriter may invite other investment banks to help with the offering. If other investment banks do join the process, the collection of investment banks is called a **syndicate**. The underwriter will also help the issuer with the preparation of the registration statement for the offering.

The letter of intent also allows the investment bank to conduct due diligence on the issuer before agreeing to take on the financial responsibility of the offering. **Due diligence** typically involves examining the issuer's books and records to evaluate its financial viability and assessing the state of the market for the new issue. The investment bank will look for any evidence that the issuer's securities might not be a good investment. Key elements of the due diligence process include performing background checks on senior officers; examining the company's financial data; analyzing any pending or potential lawsuits; evaluating corporate bylaws; studying relevant contracts, patents, and copyrights; and conducting industry research.

Formation of the underwriting syndicate. In most cases, the underwriter that is selected by the issuer will not want to bear all the financial risk of the offering. For this reason, the underwriter will invite other investment banks during the due diligence period to join in the underwriting. This group of underwriters is called the **syndicate**, and each member of the syndicate will be allotted a certain amount of shares that they will be responsible for selling. The underwriter that manages the underwriting has several different names: it might be called the **lead underwriter**, **managing underwriter**, **deal manager**, **book manager**, or even **book runner**. If there is more than one lead manager, the two lead managers are referred to as co-managers.

All syndicate members sign an **Agreement Among Underwriters (AAU)**. The Agreement Among Underwriters describes the rights and liabilities of the syndicate members with respect to the syndicate manager and among each other. This agreement is also called the **syndicate agreement** or the **purchase group agreement**. Some of the most important characteristics of the syndicate agreement are that it:

- Identifies the lead underwriter and grants authority to the lead underwriter to act on behalf of the syndicate and to execute the final underwriting agreement with the issuer

- Spells out the duties and rights of each member of the syndicate
- States the allocation of shares and the liability of each underwriter
- Sets the management fee to be paid to the lead underwriter, details the compensation for each of the other underwriters, and describes how the delivery and payment for securities will be completed
- Grants the lead underwriter authority to make stabilizing bids, which are bids made for shares of an initial public offering (IPO) by underwriters in an effort to prevent the price of the offering from dropping significantly.
- Authorizes the lead underwriter to qualify the issue in the various states (to meet individual states' blue sky requirements for the issue)

The agreement requires syndicate members to offer securities only at an established price unless they are released from that obligation by the lead underwriter and other conditions hold.

6.1.4. UNDERWRITING PROCESS: COOLING-OFF PERIOD

Once the lead underwriter and the issuer have completed the registration statement, they will file it with the SEC. As soon as the filing takes place, a 20-day **cooling-off period** ensues, in which the public has time to study the information in the registration statement and the accompanying **preliminary prospectus** (also called a **red herring**). The preliminary prospectus contains almost all the same information as the final prospectus, which is issued when the registration takes effect; however, the preliminary prospectus, unlike the final prospectus, does not contain the public offering price because this is typically set the night before the offering.

At this time, the lead underwriter and issuer present the offering to potential investors, usually institutional investors, in a series of “road shows,” in which they both solicit interest in the offering and collect information on its strength in the market. The road show consists of a management presentation and a question-and-answer system. Because the investment banker cannot actually sell the securities, it will collect indications of interest from the investors. During this period, due diligence continues, the underwriting syndicate continues to be formed, and the selling group is assembled.

Two things are permitted during the cooling-off period:

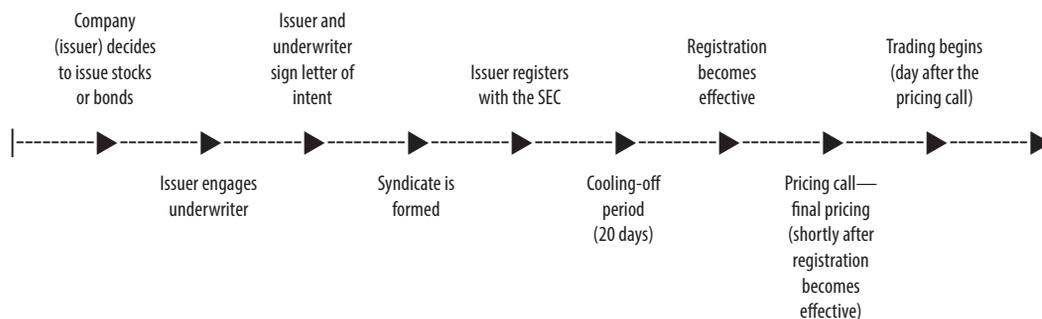
- The first is the publication of a **tombstone ad**, which announces the basic details of the offering without discussing the investment merits of it or offering it for sale.
- Secondly, the underwriter or issuer may accept indications of interest.

An **indication of interest** is nothing more than that—an investor saying he might be interested in purchasing the security, without the investor actually committing to it, depositing any type of money, and so forth. Financial professionals need to be careful they don't promise their customers the ability to obtain a security before it is issued,

much less take a deposit for the purchase of the security. Doing so could lead to a violation of the Securities Act of 1933. Anyone providing an indication of interest must be given a copy of the preliminary prospectus.

If there are no material omissions or misleading statements, the registration statement will become effective after 20 calendar days. If the SEC does find issues with the prospectus, it will give a **qualified decision** and the issuer will have to file an amendment to the prospectus. Once an amendment has been filed, the company must wait an additional 20 days. Although an issuer may ask the SEC for an accelerated effective date after the amendment has been filed, there is no guarantee that this will be granted.

Near the end of the cooling-off period, the lead underwriter will conduct a due diligence meeting with the corporate officers of the issuing company and the other underwriters. This is sometimes called the “bring-down” due diligence meeting. Its purpose is to review the information in the registration statement, prepare the final prospectus, and negotiate terms to be reflected in the final underwriting contract. Underwriters who do not wish to remain part of the syndicate are free to withdraw at this stage without incurring any liability to the corporation. The Agreement Among Underwriters is signed after the due diligence meeting and shortly before the cooling-off period ends.



Note: The SEC does not “approve” a registration statement for a securities issue. Instead, if it finds no material omissions or misleading statements, it simply allows the registration statement to become effective at the end of the 20-day waiting period.

6.1.4.1. Selected Dealers Agreement (Selling Group Agreement)

As just mentioned, prior to the public offering, the lead underwriter will usually collect indications of interest from institutional investors. The collection of indications of interest typically leads to the sale of most of the lead manager’s allocated shares to institutional investors. The other underwriters in the syndicate, in contrast, will often engage broker-dealers to help them sell shares of the offering to retail investors. These dealers are referred to as **selected dealers** or **selling group dealers**.

The selling group has no relationship with the issuer. It is only involved in selling its allotted shares to the public. Nor is it financially liable for unsold shares. Financial risks are borne by the syndicate.



The selected dealers will enter into an agreement with the syndicate called the **Selected Dealers Agreement**, also called the **Selling Group Agreement**.

The Selected Dealers Agreement includes the:

- Specifics of the dealers' compensation for shares sold
- Provision that compels dealers to follow self-regulatory organization (SRO) requirements and to sell securities at the public offering price
- Price of the securities or a formula to derive it (required under FINRA Rule 5160)

6.1.4.2. **Underwriting Agreement**

The **underwriting agreement (UA)** is typically signed the evening before or the morning of the effective date of the security's issue. Unlike the letter of intent, it is a binding agreement. The agreement sets the terms and conditions between the issuer and the lead underwriter. Recall that the Agreement Among Underwriters grants authority to the lead underwriter to enter into the UA with the issuer on its behalf. The agreement is filed with the SEC and becomes part of the registration statement.

The UA includes:

- The public offering price or a formula with which to derive it
- The **per-share underwriting spread**
- A settlement date on which the issuer will receive payment and deliver the securities to the syndicate
- The net proceeds to be received by the issuer and which costs will be borne by which parties
- An **over-allotment (greenshoe) option**, if granted, allowing underwriters to issue up to 15% more shares than originally planned
- Legal provisions allowing the underwriter to terminate the contract under certain conditions