Chapter 10: Introduction to Investment Banking

A. Investment Banks and Their Roles

Investment banks market and execute transactions for institutions and certain individuals, including initial public offerings (IPOs), mergers and acquisitions, leveraged buyouts (LBOs), divestitures, securities brokerage, etc. Investment banks provide financial advisory services. The traditional primary function of investment banks is to underwrite and distribute new issues of securities to the general public. We will focus on these underwriting and distribution activities later in this chapter. More generally, investment banks play a variety of roles in the corporate financial and investing industries. Investment banks invest in capital and money markets, as well as trade securities on a proprietary basis (for themselves) and agency basis (for clients). Investment banks play roles advising corporate and other institutional clients on most types of major transactions including mergers and acquisitions, leveraged buyouts, share buybacks, etc. Investment banks can play every banking role except to directly accept deposits, though many investment banks will affiliate with commercial banks, either as parent firms or as subsidiaries.

Top 10 Banks	Fees ($m)	Changes in Fees vs. Prev Period	% of Fees collected by product 2017 M&A	Equity	Bonds	Loans
JP Morgan	6,731.79	+15.59%	27	22	33	18
Goldman Sachs	5,877.94	+13.30%	41	23	24	12
Bank of America Merrill Lynch	5,357.79	+14.50%	27	17	32	24
Citi	5,042.47	+24.71%	24	22	36	18
Morgan Stanley	5,035.45	+11.74%	34	29	27	9
Credit Suisse	3,447.93	+17.58%	26	25	28	21
Barclays	3,421.70	+6.74%	26	15	37	23
Deutsche Bank	2,811.45	+1.78%	20	22	36	21
Wells Fargo	2,139.73	-0.05%	11	15	43	32
RBC Capital Markets	2,129.15	+16.95%	20	19	34	27
Total	**102,226.37**	**+15.20%**	**27**	**22**	**30**	**21**

Source: Financial Times (url: http:// https://markets.ft.com/data/league-tables/tables-and-trends)

Table 1: Major Investment Banks, December 2017

Bulge Bracket and Other Investment Banks

The largest investment banks, such as at least most of those those found in Table 1 (such tables are known as *League Tables*) are colloquially known as bulge bracket banks, so named because their font sizes in tombstone ads (ads announcing security issues) bulge relative to those of other investment banks. Table 1 lists total fees collected by bulge bracket investment banks, change from the prior year and sorted by percentages from M&A advisory, equity issues, bond issues and loans arranged. Bulge bracket investment banks provide the full spectrum of services to large-cap firms (>$10 billion) and often to mid-cap firms ($2 - $10 billion) as well. Small- and micro-cap firms are more likely to be, though not necessarily, serviced by regional or boutique investment banks.

Tier one (major bracket firms), which may include some of the smaller firms in Table 1 as well as, perhaps, Deutschebank, Nomura and UBS also provide a full spectrum of services to large-cap firms as well as mid-cap and sometimes smaller firms. The hundreds or even thousands of tier one, regional, and boutique banks are often difficult to distinguish and categorize because they can be so different from one another. Nevertheless, regional investment banks tend to focus on one or a small number of geographic regions and boutiques tend to be smaller and focus on a particular type of service offerings, industry or sector.

Investment Bank Divisions

Every investment bank has its unique organizational structure. While organizational structures vary widely among investment banks, and within investment banks over time, the following lists the core groups or divisions that are likely to exist in some capacity in practically any major investment bank:

- *Investment Banking Division*: Provides underwriting and other services to help institutional clients raise capital. Sometimes includes M&A Advisory. Typically segmented into industry (e.g., healthcare, utilities), regional or product (e.g., M&A, private equity placement) groups.
- *Sales & Trading* (often called Markets): Facilitates client capital transactions and the bank's proprietary trading. Includes sales teams for relationship building and trading desks organized by asset class (e.g., fixed income, credit).
- *Global Capital Markets*: Provides custom financial services to clients related to consulting, investment management, lending, research, underwriting, syndication formation, conduct road shows (see Table 5.b below), often M&A, etc. May overlap other divisions.
- *Equity Research*: Focuses research on individual corporations and industries. May include credit research for corporate debt.
- *Private Wealth Management*: Assists high net worth individuals and institutional clients on their asset and wealth management needs. Might include securities services (e.g., brokerage products).

Front, Middle and Back Office Functions

Front, middle and back offices refer to teams that provide different categories of functions in an investment bank. Traditionally, front office personnel engage direct interaction with the investment bank's clients (client-facing), middle office personnel directly support front

office staff and back office personnel provide support services behind the scenes.

Front office functions are to produce revenues for the investment bank. Front office services will often include launching, pitching and managing IPOs, issuing commercial paper and other loan instruments, assisting clients with mergers and acquisitions, investment management services for institutions and high net worth individuals, securities brokerage services, private equity investment, investment and capital market research, proprietary securities trading, agency securities trading and a variety of corporate and institutional advisory services. Typical investment banks are likely to include among their front office divisions Investment Banking (such as Mergers & Acquisitions, Equity Capital Markets, which manages offerings of securities, Debt Capital Markets), Sales and Trading (assists in selling offerings and engages in proprietary trading), and Research. An IPO is likely to involve efforts of the Investment Banking Division to structure the IPO and Sales and Trading to bring the issue to the market.

Middle office functions typically include risk management, regulatory compliance and corporate treasury and financial control services such as ensuring the solvency of the bank. Most trading floors will have at least one risk management officer directly on the trading floor; this risk management officer would be considered middle office. Most middle offices will monitor investment bank profits, losses and risks. Many middle offices will inspect, process and track contracts negotiated by front offices along with progress on fulfilling obligations created by these contracts. In some investment banks, middle offices might serve as links between front and back offices.

Back office functions provide indirect support to front office activities. Back office personnel include IT specialists, accountants, operations staff, human resources staff, office managers, customer service representatives and regulatory compliance staff. Back office activities services that we discussed in earlier chapters such as include trade confirmation, clearance and settlement functions. Back office activities also include strategic planning for the bank, records maintenance and software and information technology.

B. Investment Banking Since the Great Depression

Until the 18 to early 19th centuries, the history of investment banking was a part of the history of banking. In Chapter 2, we discussed these histories, with a separate section devoted to the history of investment banking, focusing on history prior to World War I. The growth of the U.S. economy during the 1920s provided an unprecedented expansive environment to investment bankers. Stocks became more popular in securities markets than bonds and new industries grew in importance relative to railroads.

As we discussed earlier, the U.S. banking industry was brought low by the Crash of 1929 and the Great Depression. Based largely on findings of the Pecora Commission of abusive practices on Wall Street and the belief that "securities affiliates of commercial banks had duped investors and converted commercial banks' bad loans into equity shares that they could pawn off on their securities customers," the Bank Act of 1933 (Glass-Steagall) separated commercial from investment banking (Fohlin [2016]). For example, the "House of Morgan" (J.P. Morgan & Co.) was split into three separate institutions, JP Morgan, the commercial bank, Morgan Stanley, the investment bank and Morgan Grenfell, the British merchant bank. Investment banking continued as a sector distinct from commercial banking through much of the remainder of the 20th century. Much of this period, particularly through the 1970s seemed an era of relative calm, still significantly bound by Depression-era regulation.

World War II led to lean times for the U.S. investment banking industry as new total

corporate issues fell to less than $1.1 billion in 1941, in part, to participate in and otherwise avoid interference with government war loans efforts (Carosso [1970]). Investment banks reduced their staffs and many closed. In 1947, the U.S. Justice Department filed anti-trust suits against 17 investment banking houses. Ultimately, the government lost these cases, but did tarnish the image of the industry. Numbers of investment banking houses grew and IPO issues and corporate M&A activity replaced trading and brokerage activities as the primary concerns of investment banks for the next few decades.

The investment banking industry grew considerably during the second half of the 20th century, with employment at the ten largest institutions quadrupling and from CPI-adjusted capitalization levels of $1 billion to $194 billion (Morrison and Wilhelm [2007]).

Deregulation of investment banking and securities firm activities was a major development in the beginning in the late 1970s, extending to the financial crisis of 2008. “May Day,” May 1, 1975 marked the date that fixed brokerage commissions (often as high as 2%) were abolished for securities firms. Revenues from securities brokerage activities collapsed after 1975 as discount brokers such as Charles Schwab and Quick and Reilly grew while institutional trading profits declined. In the U.K., the Financial Services Act of 1986 (whose implementation is colloquially known as the "Big Bang") opened up the London Stock Exchange to international competition and allowed U.K. banks to engage in proprietary trading. Highly successful new financial products such as high-yield bonds and structured products arose during the 1980s, enhancing investment banking profitability.

Late 20th century investment banks went on to enjoy a golden age (subject to some spectacular failures such as Kidder, Peabody) as merger and IPO activity led to major public security offerings and M&A deal-making services. Goldman Sachs and Salomon Brothers eventually reigned at the top of the industry. Junk bonds (speculative grade bonds) were popularized by Michael Milken and Drexel Burnham Lambert, and were issued throughout the industry to become a key source of funding for M&A activity and other corporate deal-making. New computing technologies and the development and trading of a wide array of derivative securities fueled investment bank profits. Proprietary trading (trading on investment banks' own accounts) in a wide range of securities would become the major source of profits for investment banks and producing enormous compensation packages for star traders.

By the mid–1990s, larger commercial banks started returning to their earlier focus on corporate investment banking as Glass-Steagall restrictions waned. Commercial banks began to develop or acquire investment banking arms. By the early 21st century, many larger U.S. commercial banks began to resemble their European universal bank counterparts as the commercial and investment banking industries consolidated. At the same time, there was significant in the banking sector. For example, firms such as Wasserstein Perella focused on advisory functions, particularly in the M&A arena. Such boutique firms could avoid many of the conflict of interest issues (e.g., due diligence valuation) that plague many of their larger competitors. Boutique firms also benefitted from outsourcing of work by their larger competitors.

In 1985, all of the top ten investment banking and brokerage participants were stand-alone entities, without affiliation with a major commercial bank. In fact, most of the investment banks were partnerships. Over the next 20 years, as Glass-Steagall provisions began to relax and investment banks began to reach out to funding from the general public, all of this began to change. The majority of larger U.S. investment banks shifted their organizational structures from private partnerships to publicly-traded stock corporations during the 1990s and after the turn of

the century. These changes opened investment banks to new funding opportunities and afforded them limited shareholder liability. These opportunities enabled the banks to grow and to compete with commercial banks as "shadow banks," and to take on larger risks given their less-regulated environments. Of course, this less regulated shadow banking industry contributed to significant distress during the financial crisis of 2008.

By 1999, the traditional IPO again had found favor, with an all-time record 548 mostly related to the growing Internet technology were brought to the market. In addition, enactment of Gramm-Leach-Bliley repealed most of the remaining restrictions separating insurance, investment and commercial banking. This act sparked an era of financial industry consolidation, with commercial banks merging with investment banks and brokerage institutions, and with investment banks re-organizing as commercial banks. This deregulation is frequently cited as leading to short-term profit focus at the expense of conservatism by investment banks, in turn leading to the financial crisis of 2008 along with the failures or involuntary dissolutions of investment banks such as Lehman Brothers and Bear Stern.

While the "Big Bang" had helped reestablish London as a key investment banking center, investment banks in Switzerland (UBS, Credit Suisse), France (BNP Paribas, Societe Generale) and Germany (Deutschebank) gained in prominence. Substantial economic growth in China and Southeast Asia have led to the emergence of Singapore and Hong Kong (arguably the third largest financial hub in the world) as major investment banking centers in the early 21st century. While as of 2019, Hong Kong may have somewhat easier access to Chinese markets and industry, Singapore has developed a stronger reputation for transparency. Nevertheless, both cities play significant roles in the underwriting markets along with markets in the U.S., Japan, the E.U., London and China.

C. Introduction to IPOs: Going Public

An initial public offering (IPO) refers to the initial sale of its shares by a private firm to the general public, usually with the assistance of one or more investment banks. The issuing firm raises capital through this sale of the issue and the public has an opportunity to invest in the selling firm. Investment banks typically play essential roles in this process. As we will discuss later, most larger IPOs are underwritten by an investment bank, though some are marketed on a best-efforts basis. U.S. Underwritten IPOs can be of any size, but are likely to involve the sale of hundreds of millions or even billions of dollars worth of shares. Shares issued in the IPO will then sell in secondary markets, either on an exchange or in over-the-counter (OTC) markets. Table 2 displays the 25 largest IPOs as of year-end 2018 in terms of raised capital.

	Company	Offer Date	Exchange	Industry	Underwriter	Deal Size (mm)
1	Alibaba	9/18/2014	NYSE	Technology	Credit Suisse	$21,767
2	SoftBank Corp	12/10/2018	Tokyo Stock Exchange	Communication Services	Nomura Sec.	$21,345
3	NTT Mobile	10/22/1998	Tokyo Stock Exchange	Communication Services	Goldman (Asia)	$18,099
4	Visa	3/18/2008	NYSE	Technology	JP Morgan	$17,864
5	AIA(Am. Int'l Assurance)	10/21/2010	Hong Kong Exchange	Financials	Citi	$17,783
6	ENEL SpA	11/1/1999	NYSE	Utilities	Merrill Lynch	$16,452
7	Facebook	5/17/2012	Nasdaq	Technology	Morgan Stanley	$16,007
8	General Motors	11/17/2010	NYSE	Consumer Discretionary	Morgan Stanley	$15,774
9	ICBC - H	10/20/2006	Hong Kong Exchange	Financials	Merrill Lynch	$13,958
10	Deutsche Telekom	11/17/1996	NYSE	Communication Services	Goldman	$13,034
11	Dai-ichi Mutual Life	3/23/2010	Tokyo Stock Exchange	Financials	BofA ML	$10,986
12	AT&T Wireless Group	4/26/2000	NYSE	Communication Services	Goldman	$10,620
13	Rosneft Oil Company	7/13/2006	Russian Trading System	Energy	ABN AMRO	$10,421
14	Agricultural Bank - H	7/7/2010	Hong Kong Exchange	Financials	Goldman (Asia)	$10,419
15	Glencore	5/19/2011	LSE	Materials	Citi	$10,049
16	Japan Tobacco Inc.	10/27/1994	Tokyo Stock Exchange	Consumer Staples	Nomura Sec.	$9,576
17	Hengshi Mining	11/26/2013	Hong Kong Exchange	Materials	BofA ML	$9,300
18	Bank of China - H	5/24/2006	Hong Kong Exchange	Financials	Bank of China	$9,190
19	Agricultural Bank - A	7/7/2010	Shanghai Stock Exchange	Financials	Goldman (Asia)	$8,894
20	Kraft Foods	6/12/2001	NYSE	Consumer Staples	Credit Suisse	$8,680
21	Japan Airlines	9/10/2012	Tokyo Stock Exchange	Industrials	Daiwa Sec.	$8,461
22	Electricite De France	11/18/2005	Euronext/Paris	Utilities	ABN AMRO	$8,328
23	China Construction - H	10/20/2005	Hong Kong Exchange	Financials	Morgan Stanley	$8,023
24	VTB Bank	5/10/2007	LSE	Financials	Citi	$7,988
25	Banader Hotels Co	11/20/2005	Bahrain Stock Exchange	Consumer Discretionary	KPMG Cor. Fin.	$7,958

Source: Renaissance Capital

Table 2: All Time Largest Global IPOs as of December 31, 2018

D. Benefits and Costs of Going Public

Privately held firms sell stock to the general public for a number of reasons. Because an IPO is likely to be the most costly organizational action a firm is likely to undertake, and because of the informational asymmetries inherent to the IPO, it is important for investors in IPOs to discern exactly why a particular firm is being taken public. Such rationale might include:

1. To raise capital: A wide distribution of securities to the general public represents a crucial opportunity for the firm to raise large sums of money for potentially profitable projects.
2. To create a liquidity event, enabling entrepreneurs to "cash out." Besides enabling entrepreneurs an opportunity to claim investment and profits in the offering firm, cashing out enables the entrepreneur to unload his investment when profit potential is weak.

3. To reduce debt: IPOs enable the firm to raise capital to pay off debt.
4. Some companies might wish to use the IPO to enhance its visibility, transparency and credit ratings to borrow additional money.
5. To enter the market for mergers and acquisitions
6. To affect the distribution of control of the firm: For example, a wide distribution of stock can dilute the voting power of venture capital firms and other investors, especially if they use the offering as an opportunity to cash out.
7. To enhance the visibility and prestige of the firm: A successful public offering signals strength and stability of the firm to customers, high-level managers, suppliers, investors and the general public. A second motivation for increasing the visibility of the firm with an IPO is to make the firm's stock more attractive in a secondary offering of shares.

Direct and Indirect Costs of Going Public

However, these many benefits of the IPO are obtained at a substantial cost, both direct and indirect:

1. IPOs generate substantial fees: The offering firm incurs significant legal, accounting and investment banking fees that frequently exceed 10% of the capital raised by the offering. We will detail these fees further.
2. Tax and legal entity restructuring costs in anticipation of the IPO: The issuing company faces significant restructuring costs (e.g., articles of incorporation) to prepare for the IPO.
3. Public firms subject themselves to increased disclosure, scrutiny and regulation by the media, competitors, the general public, the S.E.C. and other regulators. In addition to potentially drawing unwanted attention, this regulation and accompanying media coverage may restrict the firm's operating activities and reveal corporate secrets.
4. Increased auditing, legal and other fees incurred on an ongoing basis after the IPO, in addition to associated distractions to managers.
5. Fluctuating share prices in secondary markets might serve to distract managers and employees from essential operations.
6. IPO underpricing: IPO investors enjoy substantial short-term returns on their investments, presumably at the expense of entrepreneurs.

Tables 3 and 4 provide insights into the direct and indirect costs associated with going public, grouping IPOs by their proceeds. Table 3 is specific with respect to the types of direct costs. While costs do generally increase with the size of the IPO, proportional costs decline, implying that there can be strong economies of scale in investment banking. Loughran and Ritter (2002) estimate that the total cost of the typical IPO averages approximately 21% of the IPO proceeds. In Table 3, the column heading titled "Average Initial Return (in %)" refers to IPO underpricing or "money left on the table, a costly problem that is a focus of the next chapter. These underpricing effects are often actually higher than the direct or administrative costs associated with many IPOs.

Proceeds (in millions of dollars)	Gross Spreads (in %)	Other Expenses (in %)	Total Direct Costs (in %)	Average Initial Return (in %)	Average Direct & Indirect Costs (in %)	Number of IPOs	Interquartile Range of Spread (in %)
2-9.99	9.05	7.91	16.96	16.36	25.16	337	8.00-10.00
10-19.99	7.24	4.39	11.63	9.65	18.15	389	7.00-7.14
20-39.99	7.01	2.69	9.70	12.48	18.18	533	7.00-7.00
40-59.99	6.96	1.76	8.72	13.65	17.95	215	7.00-7.00
60-79.99	6.74	1.46	8.20	11.31	16.35	79	6.55-7.00
80-99.99	6.47	1.44	7.91	8.91	14.14	51	6.21-6.85
100-199.99	6.03	1.03	7.06	7.16	12.78	106	5.72-6.47
200-499.99	5.67	0.86	6.53	5.70	11.10	47	5.29-5.86
500-up	5.21	0.51	5.72	7.53	10.36	10	5.00-5.37
Totals:	7.31	3.69	11.00	12.05	18.69	1767	7.00-7.05

Direct and Indirect Costs (in %) of Equity IPOs from 1990 to 1994. Taken from Schoar [2006] and based on: Lee, Lochhead, Ritter, and Zhao (1996)

Table 3: Direct and Indirect Costs of IPOs

(Numbers in millions, except number of IPOs)		External auditor		Legal		Printing		Registration/ filing		Miscellaneous				Underwriter discount	
Gross proceeds	Number of IPOs	Range	Avg.	Range	Avg.	Range	Avg.	Range	Avg.	Range	Avg.	Range	Avg.	Avg. % of gross proceeds	Avg. total
$0-50	41	$0.0-$2.5	$0.6	$0.1-$4.2	$1.0	$0.0-$0.7	$0.2	$0.0-$0.3	$0.1	$0.0-$0.9	$0.2	$0.2-$3.9	$2.0	6.9%	$4.1
51-100	115	0.- 4.4	1.0	0.3-7.3	1.5	0.1-0.9	0.3	0.0-0.5	0.2	0.0-2.8	0.4	1.2-6.7	5.1	6.8%	8.5
101-200	115	0.1-5.6	1.0	0.2-4.9	1.6	0.1-1.2	0.3	0.0-1.9	0.2	0.0-4.0	0.5	2.5-12.2	9.4	6.6%	13.0
201-300	45	0.1-4.2	0.9	0.6-4.8	2.1	0.0-1.0	0.4	0.1-0.5	0.3	0.0-6.7	0.7	8.0-16.4	15.2	6.3%	19.6
301+	73	0.0-5.0	1.2	0.0-17.0	2.3	0.1-9.8	0.5	0.1-2.4	0.3	0.0-4.5	0.5	7.9-237.9	23.3	5.5%	28.1

Taken from Price, Waterhouse Coopers (2012), based on 380 IPOs issued between January 1, 2009, and June 30, 2012

Table 4: Offering costs incurred, based on gross proceeds of offerings

Uses for IPO Proceeds

IPO issuers are required to detail their uses of IPO proceeds on their SEC Form *S-1* registration filing, and most other countries require similar filings. Kim and Weisbach [2005] examine 16,958 IPOs from 38 countries between 1990 and 2003 to determine how issuing firms use the proceeds of their IPOs. First, they distinguish between "primary offerings," IPOs whose proceeds are used for investment purposes or to pay down debt and "secondary offerings," whose proceeds are used to enable managers and private shareholders to "cash out" and

diversify.[1] Kim and Weisbach find that most IPOs offer at least some primary shares and primary shares represent 79% of the value of the shares sold to the public. Thus, they argue, raising capital is an important motive for going public. They find that for every dollar raised in an IPO, cash holdings rise by 68.8 cents during one subsequent year. R&D and capital expenditures increase by 17.1 cents and 8.3 cents respectively per IPO dollar raised. Inventory levels rise by 2.3 cents and long-term debt is reduced by 4.2 cents. All of these changes occur in the year subsequent to the IPO. By four years after the IPO, each dollar raised in the IPO is associated with a 50 cent increase in cash relative to the pre-IPO-level. Thus, the firm does not instantly spend its IPO proceeds. This 19.9 percent reduction from the first-year increase in cash is a companied by 88.2 cent and 38.7 cent increases in R&D and capital expenditures four years subsequent to the IPO. By four years after the IPO, inventory levels rise by 5.3 cents and long-term debt is reduced by 10.4 cents.

E. Investment Banking and the Underwriting Process

Corporations and other institutions raise money by selling securities to investors. An *investment bank* is an institution whose traditional role is to assist corporations and other institutions in the issue and sale of securities to the general public. This issue of new securities can be referred to as a *primary offering* or primary distribution. The market in which the primary distribution occurs is referred to as the *primary market* as opposed to the *secondary market* where previously issued securities are sold. The secondary market's function can be described as "providing liquidity for the primary market" and includes transactions on the exchanges and in the so-called "over the counter markets." If new corporate stock is being sold to the public for the first time, it is said that the corporation is making an *initial public offering* (IPO) of its stock. If the firm is raising money from an institution specialized in working with firms seeking to start or continue early-stage operations, it is said to be raising *venture capital*.

The firm seeking capital can also issue securities via a private placement, selling share directly to a small group of institutional and high net worth investors. For example, SEC Rule 144A enables firms to forgo high placement costs by permitting private placements to small groups of qualified private investors (usually large institutions with significant capital). These 144A markets also provide for trading of these private placements to qualified investors. While not publicly available, the securities from these firms can be traded among the firms qualified to trade in 144A markets. Similarly, a firm can sell its securities to a variety of other types of institutions, including private equity firms, venture capital firms, etc., but these securities are normally not marketable until they go through an IPO process.

Firm Commitment and Best Efforts Offerings

The investment bank assists the corporation in making the primary offering by first providing advice and counsel and then acting as a "middleman" in the sale of the new securities. This "middleman" function is served by the investment banker acting either as a broker selling the securities on a "*best efforts*" basis or by *underwriting* the new issue. If the investment banker acts as an underwriter in a *firm commitment*, it purchases the new securities from the issuing corporation and attempts to resell them at a profit, called the *underwriting spread*, in a sense, acting as a wholesaler or dealer. This underwriting operation, through negotiation with the investment banking institution, in effect, insures the issuing corporation against the risk of being

[1] This reference to primary and secondary offerings is unrelated to the usual definitions of primary and secondary markets for stock.

unable to make its primary distribution at a satisfactory price.

The investment bank can also act as a broker, selling the new securities for the corporation or other investment banks on a commission or best efforts basis, also sometimes called "soft commitment" or "reasonable endeavors" basis. Investment bankers specialize in the selling of newly issued securities; they are better equipped to handle a primary offering than is the issuing corporation. Often, an underwriting institution engages other investment banks and brokers to assist in the sale of the new securities. Thus, typically, an investment banker does not underwrite a primary offering alone; it forms with other investment banking institutions an *underwriting syndicate*. This enables the *managing underwriter* (originating investment banker dealing directly with the issuing corporation) to decrease its risk by engaging other members of the syndicate to purchase and resell securities. The underwriting syndicate also allows the managing underwriter to improve its selling or marketing ability and to more easily raise the funds necessary to underwrite the issue. Often, the underwriting syndicate employs a *selling group* to distribute the new issues. This selling syndicate brokers shares of the new issue for the underwriting syndicate on a best efforts basis.

A study of 1028 IPOs from 1977-1982 found that approximately 35% were brought to market on a best efforts basis. Almost half of these best efforts IPOs failed; that is, the issuer was not able to sell a sufficient number of shares of the issue to make the new issue viable. However, average returns for best efforts offerings were 48%, compared to 15% for underwritten (also called firm commitment) offerings over this period (Ritter (1987)). This "IPO underpricing" phenomena will be discussed in detail later.

Issuing firms often select an underwriter based on its experience taking similar firms public. Having a well-known analyst in the same industry is usually a strong selling point for the investment bank as is a willingness to make a market for the new issue. Many industrial corporations maintain an ongoing relationship with an investment bank, though such ongoing relationships are not as strong as a few decades ago. In some instances, there will be a sharing of directors of the investment bank and its client. This investment bank may be in a particularly good position to provide competent advice and counsel given its close working relationship with its client. Contractual arrangements in these cases are usually negotiated between the investment bank and the issuing corporation. In most instances, publicly regulated utilities and municipalities are required to submit their primary offerings for competitive bidding among prospective underwriters.

The Typical Firm Commitment Offering Process

Tables 5a, b and c characterize the general process of a typical common stock underwriting operation, starting with the issuing firm preparing for the IPO. The underwriter then leads the process of administering the IPO, from dealing with the registration and syndicate formation processes and dealing with price setting and marketing the new issue. After the new issue reaches the market, fees are distributed and after-market matters are dealt with.

Investment banks also tend to be active in secondary markets for stocks they underwrite. In addition to the price stabilization role discussed above, investment banks also develop and maintain closer relationships with clients by participating in secondary markets. These improved relationships make it easier for underwriters to place their new offerings. Furthermore, their participation in secondary markets improves liquidity for securities they underwrite. In addition, secondary markets participation provides opportunities to realize profits.

Preparing for the IPO

1. *Preparation*: The issuing firm prepares a business plan that details its operations, discusses its profitability, past and future, its prospects and its plans. This business plan will be useful to secure an investment bank's services and to complete regulatory registration statements. The plan should also clearly detail how the firm plans to use the IPO proceeds. The firm will undertake efforts to begin auditing, legal, restructuring, governance, risk management, public relations and other operations to conduct itself as a public corporation.
2. *Underwriter Selection*: Issuing firms consider the practices and reputations of prospective underwriters, with *bulge bracket* underwriters (the largest and best-known) often being preferred. Alternatively, certain underwriters such as boutique banks may have developed reputations or demonstrated success for certain types of offerings. Sometimes, analyst coverage in the firm's industry will play a role in underwriter selection.
3. *Advice and Counsel*: The issuing firm and prospective investment bank discuss the issuing firm's need for funds, the amounts needed and various means of raising them. A specific issue or group of issues is decided upon and the investment banker helps determine the legal (e.g., the underwriting agreement and lock-up arrangements) and other technical implications (e.g., exchange compliance) of the flotation. The function of the investment bank at this stage is to provide advice and counsel. In addition, the investment bank will conduct a due diligence investigation of the issuer. The investment bank will ultimately stake its reputation on the viability and success of the IPO, and needs to acquire and evaluate information to ensure that no harm is done to its reputation.
4. *Underwriting Agreement*: Terms of the underwriting agreement are negotiated between the issuing firm and the underwriter. Fees are negotiated. A kick-off meeting is organized in which members of the transaction team are introduced. Early-look meetings might be held with certain key potential investors. Generally as noted above, railroad and utility firms and states and municipalities are required to accept competitive bids for underwriting.

Table 5.a: Preparing for the IPO

Administering the IPO

5. *Registration*: A registration statement (Normally Form *S-1*or *F-1* for foreign issuers) containing a *prospectus* with audited financial statements detailing relevant business and financial information regarding the issuing firm's condition and prospects is drafted and filed for initial comments from the SEC (the Securities and Exchange Commission), as required by law. The types and quantity of information to be included in this registration statement will depend on the size and age of the firm along with the amount of money being raised. IPOs from certain regulated industries such as banking will be required to fulfill additional disclosure requirements as will firms from industries with histories of securities markets abuses (such as and oil, gas and mining). The SEC will require a minimum of approximately 20 days (more likely 3-6 months given several rounds of submissions) to analyze the revised statement for omissions and clarifications. The underwriter assists in this registration process and may not offer the securities for sale during this period; however, they may print a *preliminary prospectus* (sometimes referred to as a *red herring*) with all relevant information except for the price of the securities. As of year-end 2014, SEC filing fees were $128.80 per $1,000,000 of security issuance.
6. *Syndicate Formation*: The originating underwriter may invite other investment banking institutions to join the operation, forming an *underwriting syndicate*. In most cases, it will invite other investment banks and brokers to form a selling group to assist in selling shares. The syndicate members share in the risk of the underwriting, publicize and combine their efforts in the sale of the IPO and share information needed to price and market the IPO. All members sign an Agreement among Underwriters (AAU), which states, in part, the management fees and the percentage of the IPO each syndicate member will be allocated. There may be an overallotment provision (sometimes called *green shoe* because overallotment provision was first used in an underwriting for the Green Shoe Company). This agreement is signed when the registration of the new securities becomes effective. Other brokers might be invited to join a given underwriting syndicate member to form a selling group or syndicate.
7. *Price Setting*: For a *seasoned issue* (an issue which is substantially the same as a previous issue which is publicly traded) of stock, price setting is fairly straightforward. The market price of currently traded securities will provide useful information for pricing the seasoned issue. However, the price setting process is most difficult for an initial public offering. The investment bank is likely to perform an appraisal based on the issuing firm's accounting statements and other relevant information. Institutional interest in the bookbuilding process draws limit orders from customers; the quantity-weighted limited orders will influence the offer price of the IPO.
8. *Road Shows and Bookbuilding*: The investment bank (along with issuing firm representatives, frequently the CEO and CFO) will present the new issue to prospective purchasers in a 1-3 week series of *"dog and pony shows"* or *"road shows"* in its efforts to create interest in the issue. The underwriter will canvas its clientele to solicit bids from "cornerstone investors" to purchase shares in the new issue within a price range (the *bookbuilding* process). Although these preliminary bids are not binding, they do indicate the strength of the interest in the new issue. If the new issue is *oversubscribed*, the offer price may be set at a level that exceeds the high end of the preliminary range. If interest in the new issue seems week, the offer price may be reduced below the range or the offering may be withdrawn altogether. A few online road shows can be accessed through Retail Road Shows at https://www.retailroadshow.com.

Table 5.b: Administering the IPO

After-market Matters

9. *Fee Distribution*: The price of the securities is often determined just before the IPO's *effective date* (offer date). The IPO is said to be effective and the shares are then offered for sale to the public, a process known as *opening the books* on the new issue. In a *firm commitment offering*, the lead underwriter will purchase shares from the issuing firm and set the offer price. Consider a typical offering whose offer price might be set at $15 per share such that the issuing firm receives $13.95 per share. The 7% difference is taken by the underwriting syndicate. The lead underwriter might take a manager's fee of $.20 for each share that is offered. Each share that the managing underwriter sells itself produces the full fee of $1.05, all for itself. Each underwriting syndicate member might receive $.85 ($1.05 minus the $.20 managing underwriter's fee) for each share that it sells. Underwriting syndicate members arrange selling group syndicates that might receive $.50 for each share that it sells. This $.50 concession would be paid from the relevant underwriting syndicate member's $.85. Any broker or dealer who is not part of the syndicate or any selling group might receive $.30 for each share that it sells, again, out of the relevant underwriting syndicate member's payment.
10. *Price Stabilization*: The managing underwriter may attempt to stabilize, manipulate or control the security price through a price-pegging operation. Price stabilization processes may be implemented in the aftermarket to provide protection to participants in the market for the security, improving the market's acceptance of the new issue. Securities Exchange Commission Rule 104 under Regulation M, Part 4 permits underwriter price supports because it *reduces* underwriter *losses* due to temporary downward price pressure during IPO selling periods. This operation typically has the managing underwriter placing a buy order in secondary markets at a specified price to support the new issue should its market price drop. The typical price pegging operation lasts for approximately two to four days and the underwriting syndicate shares its costs. The prospectus must state that there will be a price-pegging operation if one is planned. The price stabilization program may also contribute to the IPO underpricing phenomena discussed below. Price supports and stabilization also seem to enhance underwriters' reputations with issuers and clients. In addition, lead underwriters may revoke selling concessions to syndicate members if shares they are assigned are *flipped* (immediately sold) by their clients.
11. *Greenshoe Option*: Many underwriter agreements include an *overallotment option* (*Greenshoe*) whereby the underwriter retains an option from the issuing firm to purchase additional shares, up to 15% of the original issue. This greenshoe option normally supports the price stabilization process described above. The underwriter then oversells the issue by up to 15% (shortselling). If interest in the issue appears to weaken, the underwriter supports its price by purchasing oversold shares. If sales are strong, the underwriter covers its short position by exercising its greenshoe option.

Table 5.c: After-market Matters

(Continued). After-market Matters

12. *Quiet and Lock-up Periods*: A 25-day *quiet period* (40 days for lead underwriters) is instituted when the issue is brought to the market, to avoid having the underwriter and issuing firm engage in activities to "hype" the firm's share price. During this quiet period, the issuing firm and underwriters remain silent about the issuing firm's prospects. The IPO price typically rises at the end of this period after renewed marketing efforts commence. In addition, many IPOs will have a "*lock-up*" period where existing IPO shareholders are discouraged or prohibited from selling their shares. These lock-up periods typically extend for 180 days, after which, share prices typically drop significantly for anomalous reasons.

Table 5.c (Continued): After-market Matters

Taking a firm public is a costly activity for a firm. As we saw in Table 3, auditing, legal and auditing fees along with substantial management time are among the costs of taking the firm public. Several studies (e.g., Chen and Ritter [2000]) have observed a remarkable similarity among underwriting fees, which seem to be concentrated around 7% of the issue amount, though several more recent very large IPOs were taken public in the 1-3% range. Furthermore, most IPOs are underpriced (This will be discussed in detail later). IPOs occur with the expectation that the issued securities will develop liquid markets. This enhanced liquidity may reduce the firm's cost of capital and bring added attention to the firm's products. Also, firms tend to cluster by industry when they bring their IPOs to the market. This clustering may reduce the information costs associated with IPOs, enabling firms to learn from each other's IPOs (Colaco, Ghosh, Knopf and Teall [2008]). Firms going public in the same industry have an opportunity to "piggy-back" of the success and learning of their peers.

<u>On-Ramp Legislation for Emerging Growth Companies</u>

The Securities Act of 1933 and subsequent regulation imposes substantial costs on firms seeking to raise capital from the general public. In an effort to ease these regulatory burdens on smaller firms with fewer resources while facilitating their abilities to raise funds, President Obama enacted the Jumpstart Our Business Startups (JOBS) Act in 2012. The JOBS Act was intended to facilitate so-called emerging-growth companies (EGC's, with capitalizations less than $1 billion) by creating a "mini-registration" process, allowing for crowdfunding offerings (for EGC's less than $1 million) and easing certain reporting requirements..

F. Alternatives to Traditional Underwriting

Prior to the U.S. Civil War, most IPOs were brought to the market by issuing firms themselves, in what we might call today self-underwritings or direct listings (see below). Settling on market clearing prices for IPOs was a problem as were the issuing complications and potential litigations brought on by the Securities Act of 1933. These problems enhanced the importance of investment banks, which are expert at dealing with the requirements of various

securities legislation and the S.E.C. There are a number of alternatives to using traditional investment banks as underwriters in the IPO process. For example, we earlier discussed the best efforts process. The following lists other alternatives to traditional firm commitment offerings.

IPO Auctions

Google, in its widely publicized IPO 2004 offering, structured a Dutch auction process intending to sell 25.8 million shares of its stock, suggesting bids in the range of $108 to $135 per share. This Dutch auction searched bids for a clearing price that enabled it to finally sell 19.6 million shares at the IPO price of $85, thereby raising $1.67 billion. The first trade price was $100.01, rising to over $300 within a year and over $1,000 by 2013. While Google originally seemed to intend to "democratize" its IPO process by directly offering shares directly to the public, it did receive substantial assistance from the investment banking industry. Lead underwriters, Morgan Stanley and CS First Boston collected a 3% commission on the offering rather than the standard 7% fee. Some observers opined that, if successful, the Google IPO could lead to a transfer of power and fees away from underwriters in favor if issuing firms. However, it is not clear just how successful the IPO was. The IPO price was not as high as anticipated or nearly as high as subsequent trading prices. A later follow-on offering was priced at $295 per share, raising $4.18 billion. On the other hand, the IPO created substantial favorable publicity for the firm and raised fortunes for its owners.

Web-based IPOs

Perhaps the first web-based IPO was the 1996 offering of the Manhattan microbrewery Spring Street Brewing Company. The company raised $2mm of its $5mm goal. Spring Street used web-based documents, prospectuses and solicitations to offer its IPO. Spring Street, as other web-based IPO offerings Annie's Homegrown and Logos Research Systems, solicited their customer base to draw in investors. When stock purchasers are customers, employees, suppliers, etc., such offerings can be referred to as *direct public offerings*, or *DPO*s. Some firms that issue shares directly to such purchasers later go through direct listings on exchanges. While all prospective U.S. public companies can file Form *S-1* (in some cases, alternative forms such as *F-1* for certain foreign listings) with the S.E.C., smaller IPOs can qualify for more simple filing alternatives, including the *SB-1* (up to $10mm) and the *SB-2* (up to $25mm), though these limits can be as high as $50mm due to the 2012 Jobs Act, facilitating offerings for a much large number of firms.

WitCapital was formed by Spring Street founder Andrew Klein for the purpose of providing web-based IPOs. Among WitCapital's earlier transactions were the Israeli firm Radcom, Ltd. and transportation services firm C.H. Robinson Worldwide. WitCapital went public in 1999 and merged with the Old Greenwich CT-based Soundview Technology Group, which was acquired by Charles Schwab in 2003. Klein argued that "invariably, IPO shares wind up in the hands of the big brokers and are given as rewards to favored customers," and that his web-based IPO market would provide for more market fairness. The firm generally charged its clients 4% to 10% of the capital it raised.

W.R. Hambrecht & Co. is a smaller investment bank founded in 1998 (later affiliated with J.P. Morgan Chase) that markets primarily to individual investors. Hambrecht uses a web-based auction process called *OpenIPO* to offer securities for its clients. For example, Hambrecht brought the 2002 CSFB offering of Instinet and July 2001 offering of Ravenswood Winery to the market. In addition, Hambrecht advised Google on its IPO. Some observers believe that these

nontraditional approaches to offering IPOs will improve prices received by issuing firms and allow smaller retail investors to participate in IPO markets that they are generally shut out of. Nevertheless, it appears that even Hambrecht's and similar offerings experienced IPO price run-ups.

The Reverse Takeover

The reverse takeover is the acquisition of a public company by a private company in an effort to take itself public. The private company places itself in the shell of the public company, but replaces the management of with its own. The best known of reverse takeovers was the 2006 acquisition of the New York Stock Exchange by the Archipelago Group, a public firm trading on its own exchange. In this takeover, the NYSE, a private concern was merged into a public firm, replaced Archipelago's management with its own, thereby becoming a public firm without an IPO. This technique had been used earlier in 1989 by Long Distance Discounting Services, which was taken over by Advantage Companies, which was listed on NASDAQ. This firm ultimately became WorldCom, which melted down a decade later.

SPACs

A *Special Purpose Acquisition Company* (*SPAC*) is a temporary-lived (typically two years) shell company created by a sponsor for the sole purpose of raising money through an IPO to acquire a non-public company at a later date. The SPAC is sometimes referred to as a "blank check company" because it initially has no commercial operations and investors normally do not know what firm will actually be acquired by the SPAC. The SPAC is usually intended to serve as a sort of "back door" approach to taking a private firm public by first creating a "blank check company" to take over the target private firm. Examples of SPAC acquisitions include 23andMe, Opendoor, Pershing Square Tontine Holdings, DraftKings and Virgin Galactic.

Prior to the IPO of a SPAC, its investors typically include private equity firms, hedge funds, former corporate CEOs and other institutional and high-profile wealthy investors. Such investors frequently serve as SPAC officers and directors. The reputations of these investors and their perceived acquisition and managerial abilities are key to developing public interest in the SPAC and its acquisition process. On the other hand, celebrities such as Alex Rodriguez, Serena Williams, Shaquille O'Neal and Jay-Z also serve on SPAC boards or otherwise fund and lead or represent them.

Once public, typically at $10 per share, the IPO is listed on an exchange and IPO proceeds are normally held in debt instruments until the acquisition (technically, merger target) is actually identified and completed. Should the SPAC fail to consummate an acquisition, typically within two years, the SPAC is liquidated and money is returned to the IPO investors. Thus, SPACs can be potentially lucrative and reasonably safe investments for their sponsors.

The process of taking a company public by merging it with a SPAC is typically faster and less costly than the traditional IPO. However, sponsors tend to take back stock, typically 20% in order to promote the SPAC, which often covers much more than the sponsors' up-front cash start-up expenses. It appears that SPACs provide for regulatory loopholes speeding up the IPO process because, technically, the SPAC is publicly traded prior to the merger. The speed of consummating a merger relative to having the target company go through a traditional underwriting process subjects the target to less market volatility and uncertainty during the going-public process. SPACs might avoid typical IPO underpricing, further reducing their costs. If the management team and directors of the SPAC are reputable and outstanding managers, the

target firm will have access to their talents. Furthermore, shareholders generally have rights to redeem their shares should they disapprove of the acquisition proposal, again, enhancing the safety of their investments.

On the other hand, the SPAC has been criticized as an alternative to the traditional IPO for failing to provide the level of due diligence and disclosure typically associated with the traditional underwriting process. SPACS have been criticized for failing to provide disclosures concerning sponsor potential conflicts of interest, and financial compensation. SPAC sponsors and initial investors, sometimes including celebrity sports and media stars often receive guaranteed returns on their investments, so that they face less risk than later IPO investors from the general public. Klausner, Ohlrogge and Ruan [2020] found that SPACs experience returns of roughly -30% during the first year after their mergers, suggesting that early SPAC investors and sponsors benefit at the expense of shareholders who acquire when mergers are consummated.

Self-Underwritten IPOs

Self-underwritten IPOs are typically motivated by the costs associated with traditional underwritten IPOs, both the direct costs of administering the IPO and the indirect costs associated with the IPO price run-up (underwriter discount or "pop"). Typically, self-underwritten (or do-it-yourself) IPOs seek to allow existing shareholders of the private firm cash-out their holdings when the firm goes public, and involve no lock-up period. However, self-underwritten IPOs lack some of the benefits associated with traditional underwritings, including the certification brought to the IPO by investment banks. This certification decreases uncertainty in setting the IPO price and should mitigate price volatility on the first day of trading. Self-underwritten IPOs have included a number of investment banks that took their own issues (e.g., Goldman Sachs) to the market.

One example of a self-underwritten IPO is Spotify, which, in 2018, listed its own shares directly on the NYSE. Spotify was not seeking to raise capital in its $9.2 billion (theoretical) offering, the largest in the U.S. for 2018; it was seeking to allow its employees, managers and other shareholders to cash out their shares in a liquid market. Thirty million shares of Spotify changed hands on its first day of trading, which closed at $149.01 after trading as high as $165.90, a relatively low trading price volatility for the first day of an IPO. Other U.S. examples of self-underwritten IPOs include Ben & Jerry's (ice cream) and Annie Homegrown (packaged pasta dishes).

Self-underwritten IPOs provides a natural control group as to the costs associated with investment banking. Essentially, if underwriters exploit companies undergoing an IPO process, one might expect that self-underwritten IPOs would fare better with lower “IPO pops.” Muscarella and Vetsuypens (1989) in their tests find that self-underwritten IPOs tend to receive abnormal returns comparable to those of traditional underwritten IPOs. This suggests that abnormal IPO returns, or IPO underpricing is not the result of underwriter exploitation; underwriters don’t exploit themselves.

Direct Listings

A *direct listing* is a type of *direct public offering* (DPO, mentioned above), which, after appropriate regulatory and market/exchange approval, the listing firm essentially declares its existing shares to be publicly traded, at which time, shares are listed on the exchange that has accepted them for trading. Direct listings do not involve underwriters, but may involve investment banks serving as advisers. Direct listings over many decades have included spin-offs

of publicly traded firms, foreign companies with shares listed on foreign exchanges, companies re-emerging from Chapter 11 bankruptcy reorganizations and private firms seeking to take their share public for the first time.

Prior to 2018, a number of somewhat smaller firms have brought their shares to the market via direct listings, including Ovascience (NASDAQ), Nexeon MedSystems, Coronado Biosciences, and BioLine Rx (Tel Aviv Stock Exchange). In early 2018, the streaming service Spotify (also self-underwritten and listed on the NYSE) was the first high-profile firm to announce its intention of pursuing this option. Spotify benefitted from the following advantages of a typical direct listing:

1. The firm forgoes many of the high expenses (e.g., underwriter fees, road shows) associated with a traditional IPO.
2. IPO underwriters do not have the ability to allocate IPO shares to their favored or most profitable clients.
3. Since shares held by existing investors are being listed, the issuing firm need not issue new shares or otherwise dilute existing shareholder ownership proportions.
4. The direct listing provides an opportunity for the listing firm shareholders including existing managers and investors to flexibly "cash out" their shares on schedules that meet their personal needs and at prices that are determined by the market rather than interactions between underwriters and institutional investors.
5. The firm and its managers do not need to subject themselves or enforce the post-IPO lock-up and quiet periods prohibiting share sales by managers and public commentary on the firm's business and operations.
6. The direct listing and subsequent exchange trading facilitates price discovery for the listed stock, which betters enable existing investors and owners to sell their shares at a fair price.

In many respects, Spotify was an ideal candidate for a direct listing. Its officers and directors were interested in cashing out of their firm's stock. The company was already well-capitalized and did not need to issue and sell new shares of stock to support its operations. The company, through its prior offerings to employees, managers and other investors had a large and diverse shareholder group to supply shares to secondary markets.

The April 2021 offering of Coinbase was also through a DPO. Coinbase listed its shares on Nasdaq. Coinbase was an interesting candidate to conduct its DPO because of the volatile history of its primary business lines, bitcoin and other cryptocurrencies, making it difficult to value this cryptocurrency exchange. Many analysts valued the company as high as $100 billion, higher than the values of any other major U.S. securities exchange.

The traditional IPO process described above is designed to attract long-term investors (for example, consider the price stabilization procedures and lock-up requirements), which is generally the preferred investor for most firms. Thus, a direct listing imposes certain costs and risks on the listing firm:

1. Since no new shares are issued or sold, firms do not raise additional funding for business operations as with a traditional IPO. Only existing shares owned by existing investors and managers are sold in a DPO.
2. The firm does not benefit from significant underwriting and price-setting efforts of an

investment bank (e.g., such as through road shows), thereby subjecting itself to substantial price uncertainty in setting the share price, both when the "books are opened" and afterwards.
3. Many of the direct costs and disruptions associated with the traditional IPO can remain with the direct listing. These include the business, legal and administrative preparations, due diligence, prospectus drafting and issuance, SEC filings and requirements, after-market reporting, regulations and management.
4. While the listing firms do avoid IPO road shows and associated costs, they also forgo the often long-term investor relationships that are established by the road shows.
5. The listing firm typically forgoes the association with a high-reputation underwriter and the publicity and branding associated with a high-profile IPO, settling instead with advisory relationships with associated investment banks.

G. Regulation of IPOs and Securities Issuance

The United States

Beginning in the 1930s, a series of regulatory acts were proposed to prevent or mitigate market failures such as the Great Crash of 1929. The U.S. and much of the world financial systems were in shambles due to devastated economies, and there was a clear need to restore integrity to financial markets to rebuild economies. Government involvement was clearly needed to develop a much-needed regulatory system and to promote fairness and transparency in the securities markets. Such sweeping legislation was made possible, in part, due to overwhelming Democrat majorities elected to both houses of U.S. Congress and the election of President Roosevelt in 1932. Twenty-five days after his inauguration in 1933, President Roosevelt asked Congress for a new law that would "put the burden of telling the whole truth on the seller" of securities, and, referring to the caveat emptor rule generally preferred in business circles, added: "Let the seller also beware." The financial community was in a poor position to effectively protest this imposition of regulation at the height of the Great Depression, though many members did argue that the Act would be burdensome, stifle entrepreneurship, drive business offshore and make independent directors reluctant to sit on corporate boards. Some institutions even threatened to protest the Act by refusing to bring new issues of stock to the market in a "Wall Street strike."

The single most important piece of legislation affecting investment banking and the issue of new securities in the U.S. was the Securities Act of 1933, sometimes called the "Truth in Securities Law." The Act requires that issuers and underwriters provide financial and other significant information concerning securities offered for public sale. In addition, the Act prohibits deceit, misrepresentations, and other fraud in the sale of securities. Unlike most of the "blue skies laws" (early securities laws enacted by individual states in the U.S.) that focused on the merits of securities, the Securities Act focused on making full, accurate and timely information available to prospective investors in securities. Its major provisions are as follows:

1. All primary issues must be registered with an appropriate government agency (later to be the Securities Exchange Commission or SEC). The registration will include proper statements and documentation.
2. A prospectus must accompany each new issue. This prospectus must contain a complete and accurate accounting of the firm's condition, risks, and prospects, and state how the proceeds of the new issue will be used.

3. Small and private issues are exempt from the registration provisions. In addition, SEC Rule 415 (shelf registration) of 1982 allows up two years for securities to actually be issued after completing the SEC registration process.
4. Firms, officers of firms, and underwriters are prohibited from making false statements regarding their new issues, and may be criminally liable for doing so.

The Securities and Exchange Commission (SEC) was created as an independent agency by the Securities and Exchange Act of 1934 to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation, particularly in the business sectors. The SEC seeks to ensure that firms and organizations raising money by selling securities to investors disclose certain essential facts about these securities prior to their sale and while they are held. The SEC also seeks to ensure that those who trade securities are dealt with fairly and honestly.

As we discussed in Table 5.b above, a registration statement (Normally Form S-1) containing a prospectus with audited financial statements detailing relevant business and financial information regarding the issuing firm's condition and prospects is drafted and filed for initial comments from the SEC (the Securities and Exchange Commission), as required by law. The types and quantity of information to be included in this registration statement will depend on the size and age of the firm along with the amount of money being raised. IPOs from certain regulated industries such as banking will be required to fulfill additional disclosure requirements as will firms from industries with histories of securities markets abuses (such as and oil, gas and mining). The SEC will require a minimum of approximately 20 days to analyze the revised statement for omissions and clarifications. The underwriter assists in this registration process and may not offer the securities for sale during this period; however, they may print a preliminary prospectus (sometimes referred to as a red herring) with all relevant information except for the price of the securities.

<u>Europe</u>

In many respects, European IPO regulation mirrors its counterpart in the U.S. For example, Directive 2003/71/EC and its Prospectus Amendment Directive 2010/73/EU provides the requirements for securities offered to the general public in the EEA, particularly with respect to the prospectus (Analogous to the Securities and Securities Acts of 1933 and 34). The prospectus must be approved by the "competent authority" of the "home member state" of the issuer, such as the Financial Conduct Authority in the U.K. (this particular situation is presently in flux due to Brexit) or the Commission Nazionale per le Societa' a la Borsa (CONSOB) in Italy. The following lists a few of the European regulatory agencies responsible for EEA IPOs.

ESMA

The *European Securities and Markets Authority* (ESMA) is the *European Supervisory Authorities* (ESA) body that regulates EU securities markets. The ESMA is the only supranational securities regulatory body that has the authority to draft legally binding technical standards and ban securities market activities likely to increase systemic risks, and has the ability to launch fast-track country-specific procedures to ensure consistent application of EU law. The ESMA can initiate investigations and request that EU member countries launch investigations, and can impose fines and issue recommendations based on the results of those investigations. The ESMA also has binding mediation powers to resolve securities market conflicts among member countries.

MiFID

The *Markets in Financial Instruments Directive* (MiFID) was approved in 2004 and took effect in 2007 as the cornerstone of the E.U.'s regulation of financial instruments and markets. It was intended to create a single market based on competing trading venues. In some respects, MiFID is analogous to the National Market System in the U.S. MiFID provides for standardized rules on the issue of securities, transparency and reporting requirements, prevention of market abuse, client order handling (including best execution), and conduct of securities firms. In order to provide for client protection rights, MiFID categorizes securities firms' clients as follows:

- Retail Clients: Clients not categorized as Professional Clients or Eligible Counterparties
- Professional Clients: Other than Eligible Counterparties—"large undertakings" with 2 or 3 of the following: balance sheet totaling at least EUR 20 million, net turnover of at least €40 million or capital of at least €2 million; or has requested and been granted Professional Client status
- Eligible Counterparties (ECP): Investment firms, credit institutions, insurance companies, other financial institutions, central banks, and national governments

These client groups are granted, in descending order, levels of protection, as professional clients and ECPs are considered to be more experienced and sophisticated. Protections concern the delivery of investment advice, investment suitability assessment, and provision of details on fees and commissions received by the securities firm.

MiFID II and Markets in Financial Instruments Regulation (MiFIR) were adopted by the E.U. in 2014 to take effect in 2018. MiFID II seeks to force more trading into regulated trading venues such as exchanges or other eligible platforms. In addition, it enhances rules for algorithmic trading and HFT conduct (e.g., algo testing), provides for non-E.U. firm access to E.U. markets, facilitates small- and medium-sized firms' access to capital, and increases supervisory powers for regulators. MiFIR, seeking to enhance transparency, sets forth improved reporting requirements for pre- and post-trade data to the general public.

The United Kingdom

The U.K. maintains two primary financial regulators over financial service firms, known as the *Financial Conduct Authority* (FCA) and the *Prudential Regulation Authority* (PRA). Funded by the institutions that it regulates, the FCA seeks to proactively ensure that consumers are protected in the marketplace and that markets maintain integrity and function well. The FCA is an independent regulator, supervised by the Treasury, which oversees the U.K. financial system. The PRA, an arm of the Bank of England, seeks to proactively ensure the safety and soundness of financial institutions. Both regulators regulate and supervise commercial banks, securities firms, and insurance companies, and, since 2012, have served to replace the failed Financial Services Authority (FSA).

Japan

Securities markets are regulated in Japan by its *Securities and Exchange Surveillance Commission* (SESC), established in 1992 as a commission operating under the authority of the Japanese Financial Services Agency. As is the case with the SEC in the United States, the SESC attempts to ensure that investors receive full disclosure with respect to security issues. Unlike in

the United States, the SESC imposes eligibility standards on Japanese firms wishing to make public bond issues. The SESC does not have the authority to prosecute violations. The commission files its findings and recommendations with prosecutors and the Financial Services Agency.

Canada

Whereas the U.S. abandoned its emphasis on blue skies regulation in the 1930s, Canada relies on provincial securities regulations. As of July 2017, with Canada currently lacking a primary governmental regulatory body at the national level, each of Canada's 10 provinces and three territories has its own securities legislation and its own securities commission. With the exception of Ontario, provinces recognize securities professionals' registration status under any of the other provincial authorities. This mutual recognition is known as the "passport system." In addition, these provincial commissions appoint representatives that comprise the Canadian Securities Administrators (CSA), a national organization that supports and monitors the brokerage industry. The CSA and provincial regulatory authorities have conferred self-regulatory organization (SRO) status on the Investment Industry Regulatory Organization of Canada (IIROC), the Chambre de la Sécurité Financière (CSF—Quebec only), and the Mutual Funds Dealer Association (MFDA). These SROs have the power to regulate the conduct of securities dealers, including mutual fund dealers, all under the ultimate supervision of the CSA. There has been pressure to create national securities legislation and governmental regulatory bodies, but these efforts are still underway.

IOSCO

The most significant nonbanking global organization engaged in financial regulatory policy is the *International Organization of Securities Commission*s (IOSCO). This organization cooperates in "developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks" (Quoted from the IOSCO website, http://www.iosco.org/about/.) Thus, the organization seeks to improve financial efficiency and transparency, protect investors, and reduce systemic risks, an obvious need for the markets that investment banks serve. The Organization works closely with the G20 and the Financial Stability Board, and is comprised of representatives from over 100 national securities regulatory commissions around the world.

Exercises

1. Some observers comment that the distinction between front, middle and back offices is becoming increasingly meaningless as computerized technology dominates more roles. Create an argument to support this comment.

2. Numerous observers of securities markets (e.g., Surowiecki (2004)) have argued that diverse crowds, such as those that would trade in an unimpeded securities market provide for better information flow (such as price and value information) than experts. What impact might this belief, if held by managers of a private firm seeking to sell shares to the general public play in the market for its initial public offering? That is, how might a financial manager seeking to take her firm public manage the IPO if the manager strongly believes in the "wisdom of the crowds?"

3.a. Is it likely that a direct listing of shares will raise more capital for the listing firm than a traditional IPO? Why or why not?

b. Why is it unlikely that a direct listing will be tied to a lock-up arrangement?

c. What is the role of bookbuilding in a direct listing?

4. Some observers have commented that the Securities Act of 1933 was based on the “sunlight theory of regulation,” which is analogous to others saying that “those who are forced to undress in public will presumably pay some attention to their figures.” What do these commentators mean by such expressions?

Exercise Responses

1. Computer and information technology is increasingly taking on the roles played by humans. For example, many investment banks employ far fewer front office traders as computer algorithms and electronic trading take over trading roles. Sales roles and customer interactions are increasingly assumed by web pages and automated systems. For example, few people call their registered representatives at investment banks to execute trades.

2. One of the primary benefits of a traditional IPO is the expertise of the underwriter in valuing the IPO and setting its offer price. Self-underwritten IPOs are priced directly by the market, with supply and demand for the securities replacing the expert's role in price setting. Hence, confidence in the market's ability to set prices is likely to enhance the preference of a self-underwritten IPO relative to a traditional underwriting.

3.a. No. Since no new shares are issued or sold in a direct listing, firms do not raise additional funding for business operations as with a traditional IPO. Only existing shares owned by existing investors and managers are sold in a DPO. Investors and managers raise money in a DPO, not the listing firm itself.

b. Lock-up agreements are not likely to be associated with a direct listing because the purpose of the direct listing is to enable and facilitate managers and other inside investors who wish to sell their shares.

c. None: there is no need for bookbuilding in a direct listing since there is no underwriter or need to sell shares to institutional investors at the listing. Sometimes, firms going through a direct listing will host an "Investor Day" to explain the listing to prospective investors. In some respects, the "Investor Day" is similar to a roadshow.

4. The Securities Act of 1933 does not contain merit tests (e.g., tests as to whether the securities are valuable) as did earlier “blue skies” legislation, but instead provides for full disclosure of all material facts. This “sunlight theory of regulation” is based on the assumption that if investors are provided with all necessary and relevant information, they will make wise investment decisions. Presumably, firms that are forced to provide this information will pay attention to the merits of the securities that they sell.

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