A Guide to the Initial Public Offering Process

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A milestone for any company is the issuance of publicly traded stock. While the motivations for an initial public offering are straightforward, the mechanism for doing so is complex. In this paper, we outline the process by which companies are brought to market in an initial public offering. Our goals here are to delineate the specific steps that are required in an IPO, to demonstrate the complex inter-relationships between the advising, marketing, pricing, and trading functions of the IPO process, and to highlight the role played by the underwriter in a public offering.

When a company wishes to make a public offering, its first step is to select an investment bank to advise it and to perform underwriting functions in connection with the issue. The selection process relies on the investment banker's general reputation and expertise as well as on the quality of its research coverage in the company's specific industry. The selection also depends on whether the issuer would like to see its securities held more by individuals or by institutional investors (i.e., the investment bank's distribution expertise). Prior banking relationships the issuer and members of its board (especially the venture capitalists) have with specific firms in the investment banking community also influence the selection outcome. Often, the selection process is a two-way affair, with the reputable investment banker choosing its clients at least as carefully as the company should choose the investment banker.

The most common type of underwriting arrangement involved with large issues is the "firm commitment" underwriting. In a firm commitment underwriting, the underwriter purchases the entire issue of securities from the issuer and then attempts to resell the

securities to the public. The difference between the price at which the underwriter buys and subsequently sells the issue is called the gross spread.

Public offerings can be managed by one underwriter (sole managed) or by multiple mangers. When there are multiple managers, one investment bank is selected as the lead or book-running manager. The lead manager almost always appears on the left of the cover of the prospectus, and it plays the major role throughout the transaction. The managing underwriter makes all the arrangements with the issuer, establishes the schedule of the issue, and has the primary responsibility for the due diligence process, pricing and distribution of the stock. The lead manager is also responsible for assembling a group of underwriters (the syndicate) to assist in the sale of the shares to the public. Members of the syndicate are paid a portion of the gross spread for their participation.

The lead underwriter, the co-managers and the syndicate members all receive compensation from the company for being involved in the IPO process. This compensation comes from the gross spread—the difference between the price the securities are bought from the issuer, and the price for which they are delivered to the public. The lead underwriter receives a fee for its efforts that is typically 20% of the gross spread. The second portion of the spread is called the “selling concession”, and it is the amount paid to the underwriter and other syndicate members for actually selling the securities. This is typically equal to 60% of the gross spread. Each syndicate member receives a selling concession based on the amount of the issue it sells to its customers. Institutions occasionally directly designate the selling concession credit associated with their stock purchase to a specific syndicate member regardless of who actually sold the stock. These

designated orders usually arise as compensation for research services performed by investment houses. The remaining portion of the gross spread (approximately 20%) is used to cover underwriting expenses (underwriter counsel, road show expenses, etc.). If anything remains after deducting all expenses, it is divided proportionately among the underwriter and syndicate members depending on the amount of securities each underwrote.

One of the lead underwriter's first-agenda items (usually before any significant expenses have been incurred) is to draft a letter of intent. Indeed, an important aspect of the letter of intent is to protect the underwriter against any uncovered expenses in the event the offer is withdrawn either during the due diligence and registration stage, or during the marketing stage. Thus, the letter of intent contains a clause requiring the company to reimburse the underwriter for any out-of-pocket expenses incurred during the process. Another important aspect of the letter is the gross spread or the underwriting discount. In most cases, the gross spread is 7% of the proceeds (see Chen and Ritter, 1998 for an excellent discussion of the uniform size of the gross spread). The letter also typically includes: a commitment by the underwriter to enter into a firm commitment agreement (or other underwriting agreements, as the case may be); an agreement by the company to cooperate in all due diligence efforts, and to make available all relevant information to the underwriter and its counsel; and a commitment by the company to grant a 15% overallotment option to the underwriter.

It is important to note that there is no guarantee of the final offering price (and, in most cases, no mention of any valuation) in the letter of intent. The letter of intent remains

in force until the Underwriting Agreement is executed at pricing. Only then is the underwriter firmly committed to buy the securities at a specific price from the issuer. By that point, the underwriter has good indications on how successful the deal is and at what price the market will be willing to buy the deal. This knowledge allows the underwriter to determine a price for the issue.

The Securities Act of 1933 mandates that the company and its counsel draft a registration statement for filing with the SEC, based upon an outline frequently provided by the lead underwriter. It usually takes several weeks and many meetings of the working group (the company management, its counsel and auditors, the underwriters, the underwriters' counsel and accountants) before the registration statement is ready to file. The registration statement is circumscribed by Section 5 of the Act, which gives specific requirements for the registration statement.[1] The registration statement consists of two parts: the prospectus, which must be furnished to every purchaser of the securities, and "Part II" which contains information that need not be furnished to the public but is made available for public inspection by the SEC.

The purpose of the registration and disclosure requirements is to ensure that the public has adequate and reliable information regarding securities that are offered for sale.

[1] The power of Congress to enact legislation regulating securities transactions is based in the Commerce Clause of the constitution. The Commerce Clause which is contained in Article I, Section 8 of the constitution gives Congress the power "to regulate commerce … among the several states …" So long as a transaction makes use of "any means or instruments of transportation or communication in interstate commerce", it will fall within the reach of the federal securities laws. This includes the use of telephones and the mails. It is rare that a transaction will not use some instrumentality of interstate commerce and will thus fall outside the reach of the law. In addition, Congress has given the Securities and Exchange Commission the authority to administer the securities laws and to promulgate rules and regulations to supplement its enforcement powers. These additional rules are necessary to clarify statutes that are vague or ambiguous or to make substantive additions to the statutes so long as they are not inconsistent with the legislatively enacted statutes. In addition to the federal laws, the states all have their own securities laws,

To achieve this, the underwriter has a "due diligence" requirement to investigate the company and verify the information it provides about the company to investors. The Securities Act also makes it illegal to offer or sell securities to the public unless they have first been registered. It is important to note, however, that the SEC has no authority to prevent a public offering based on the quality of the securities involved. It only has the power to require that the issuer disclose all material facts. As a safeguard, the Securities Act requires that the registration statement be signed by the directors and principal officers of the issuer as well as the underwriters, accountants, appraisers and other experts who assisted in the preparation of the registration statement. Any purchaser of the securities who is damaged as a result of a misstatement or omission of a material fact in the registration statement may sue these signatories.[2] Such disclosure-based lawsuits have become commonplace in recent years.

Once the registration statement is filed with the SEC, it is transformed into the preliminary prospectus (or "Red Herring".) The preliminary prospectus is one of the primary tools in marketing the issue. Within 20 days, the SEC responds to the initial filing and declares the issue effective.[3] At this stage, the red herring is amended and transformed into a prospectus, which is the official offering document. During the period after the filing, the SEC examines the registration statement and engages in a series of communications with issuer's counsel regarding any changes necessary to bring about

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which are known as "blue sky" laws. The federal securities laws have permitted states to retain their right to regulate intrastate securities transactions so long as their regulation does not conflict with federal law.

[2] Sections 11 of the Securities Act of 1933 imposes civil monetary liability against persons who fail to establish "due diligence". Section 12 of the Act provides that a purchaser may recover damages against any person who offers or sells a security in violation of Section 5 (the registration requirements).

[3] Section 8 of the Securities Act of 1933 details the process by which the registration statement becomes effective.

SEC approval. If the changes are minor, they are included in the "price amendment"; if the changes are extensive, a new prospectus is prepared and distributed.

Once the registration statement is approved by the SEC, the marketing of the offering begins. Often the Red Herring is sent to sales people as well as to institutional investors around the country. At the same time, the company and the underwriter promote the IPO through the road show, in which the company officers make numerous presentations to (mainly) institutional investors. A typical road show lasts 3-4 weeks and includes two or more meetings a day with both retail salespeople and institutional investors.

As the road show progresses, the underwriter receives indications of interest from investors. The indications of interest by individual investors and by institutions differ along several dimensions. First, retail investors typically submit a "market order" in which only the quantity desired is stated. Institutions, on the other hand, typically submit limit orders where the quantity demanded is subject to a maximum price. Second, retail orders are received earlier than institutional orders since institutions prefer to wait to a later stage of the process before submitting their orders. Third, in some cases, institutions submit an order with a commitment to purchase more shares in the open market if their order is fulfilled. These differences in turn may affect the investment bank marketing strategy. However, regardless of the source of the indication of interest, at this stage, prior to the effective day, no shares can be officially sold, so any orders submitted are only indications of interest and are not legally binding.

The registration and marketing process can take several months, and it is therefore impossible for the underwriter to include certain information (such as the final IPO price, the precise discount to the dealers, and the names of all the syndicate members) in its initial filing with the SEC. Once the registration statement has been approved and deemed effective, the underwriter files with the SEC an acceleration request, asking the SEC to accelerate the effective date of the registration statement.[4] Usually the issuer assesses market conditions and chooses what it considers to be the optimal effective date.

On the day prior to the effective date, after the market closes, the firm and the lead underwriter meet to discuss two final (and very important) details: the offer price and the exact number of shares to be sold. Particular attention during the pricing decision is given to the order books (where institutions and other investors' indications are recorded). Discussions with investment bankers indicate that they perceive that an offer should be two to three times oversubscribed to create a "good IPO".[5] There is extensive evidence (see, for example, Ritter (1991)) that IPOs tend to be "under-priced". This means that investors in an IPO can expect the price to rise on the offer day, a characteristic that enhances demand for the issue. From the company's perspective, such under-pricing "leaves money on the table" in the sense that the company is not getting the full value for its shares, but it may be preferable for the company if it guarantees that the issue succeeds.

[4] It is at this point that the issuer needs the cooperation of the SEC. Since the law provides that the filing of an amendment (in this case the price amendment) starts the 20-day waiting period running again, the issuer must make a "request for acceleration" which asks the SEC to exercise its discretion and waive the 20-day period. Ordinarily, an issuer does not want to wait for 20 days because during this time market conditions could change dramatically. Thus, the threat of denial of acceleration usually leads the issuer to cooperate with the SEC and it enables the SEC to get the issuer to make changes to the registration statement, which it might not be able to force under the law.

After those final terms are negotiated, the underwriter and the issuer execute the Underwriting Agreement, the final prospectus is printed, and the underwriter files a "price amendment" on the morning of the chosen effective date. Once approved, the distribution of the stock begins. On this morning, the company stock opens for trade for the first time. The closing of the transaction occurs three days later, when the company delivers its stock, and the underwriter deposits the net proceeds from the IPO into the firm's account.

But the IPO is far from being completed. Once the issue is brought to market, the underwriter has several additional activities to complete. These include the after-market stabilization, the provision of analyst recommendations, and making a market in the stock. The stabilization activities essentially require the underwriter to support the stock by buying shares if order imbalances arise. This price support can be done only at or below the offering price, and it is limited to a relatively short period of time after the stock has began trading. Interestingly, during this period, the standard prohibitions against price manipulation do not apply to the underwriter, and he is free to trade so as to influence the price of stock. (See Ellis Michaely and O'Hara, 1999a, 1999b for an in-depth analysis of the underwriters activities in the post-IPO period). In general, the underwriter will continue to actively trade the stock in the months and years following the offering. By "making a market in the stock", the underwriter essentially guarantees liquidity to the investors, and thus again enhances demand for the shares.

The final stage of the IPO begins 25 calendar days after the IPO when the so-called "quiet period" ends. This "quiet period" is mandated by the SEC, and it marks a

[5] This "pricing meeting" will never be held on Friday since the underwriter does not want to take the risk of pricing a firm on Friday and being able to sell the firm only on Monday. Indeed, there are practically

transition from investor reliance solely on the prospectus and disclosures mandated under security laws to a more open, market environment. It is only after this point that underwriters (and other syndicate members) can comment on the valuation and provide earnings estimates on the new company. The underwriter's role thus evolves in this after-market period into an advisory and evaluatory function (see Michaely and Womack (1998) for an evaluation of the role of the underwriters' post-issuance recommendations).

The initial public offering process thus involves a complex combination of tasks by the company, the underwriter, and the syndicate members. Throughout the process, the company relies on the underwriter's expertise to market, price, distribute, stabilize, and support the issue, while the underwriter relies on the information and integrity of the company. The completion of the process provides new capital for the firm, and a new investment opportunity for the public.

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no firm commitments IPOs on Mondays.

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Biographical summaries:

1. Katrina Ellis is completing her doctorate degree in Finance at the Johnson Graduate school of Business at Cornell University. Her research interest are in the area of Corporate Finance and Market Micro-structure

2. Professor Michaely's research interests are in the areas of corporate finance, capital markets and market microstructure. His current research focuses on the pricing of IPOs, their long term performance and firms' financial policies. His research has appeared in Journals like the *Journal of Finance*, the *Review of Financial Studies* and *Financial Management*. His research has been frequently featured in *the Wall Street Journal*, the *New York Times*, the *Economist, Forbes* and others.

3. Professor Maureen O'Hara specialties are in the area of the structure of the securities market. Recent work includes an examination of the optimal regulation of exchanges and alternative trading systems. Professor O'Hara has recently been named the Executive Editor of the *Review of Financial Studies*, and she is the past president of the Western Finance Association and a member of the Economic Advisory Board of the NASDAQ. Her research has appeared in a wide range of Journals including the *American Economic Review*, the *Journal of Finance*, the *Review of Financial Studies*, *the Journal of Financial Economics*, and the *Brookings Papers on Financial Markets*.