APPENDIX: "I.P.O. (Initial Public Offering)"

By Roberto Fazioli

Since capitalism has existed, investing in public companies has been an engine of capitalism that lets individuals invest in large firms that have created vast wealth for shareholders.

A public offering is an organization's sale of equity shares or other financial instruments to the public in order to raise funds for business expansion and further investment. Financial instruments may include equity stakes, such as common or preferred shares, or other assets that can be traded. Packages of tradable capital, such as derivatives, are also financial instruments.

Issuing shares through an IPO is one of the primary reasons that stock markets exist. It lets the company raise capital for a variety of reasons, such as to grow further, let initial and early-stage investors cash out some of their investment, or create a currency (such as common stock) to acquire rivals, or even sell shares at a later date. The entire process is referred to as the primary market and happens when an investor buys stock directly from the company. A secondary market is more common, and it exists when investors trade among themselves with shares that have already been issued by a firm. The term public offering is equally applicable to a company's initial public offering, as well as subsequent offerings.

Initial Public Offering and Secondary Offerings

An IPO is the first time a private company issues corporate stock to the public. Younger companies seeking capital to expand often issue IPOs, along with large, established privately owned companies looking to become publicly traded. In an IPO, a very specific set of events occurs, which the selected IPO underwriters facilitate:

- An external IPO team is formed, including the lead and additional underwriter(s), lawyers, certified public accountants (CPAs) and Securities and Exchange Commission (SEC) experts.
- Information regarding the company is compiled, including its financial performance, details of its operations, management history, risks, and expected future trajectory. This becomes part of the company prospectus, which is circulated for review.
- The financial statements are submitted for official audit.
- The company files its prospectus with the SEC[1] and sets a date for the offering.

A secondary offering is when a company that has already made an IPO issues a new set of corporate shares to the public. Two types of secondary offerings exist: the first is a non-dilutive secondary offering, and the second is a dilutive secondary offering. In a non-dilutive secondary offering, a company commences a sale of securities in which one or more of their major stockholders sells all or a large portion of their holdings. The proceeds from this sale are paid to the selling stockholders. A dilutive secondary offering involves creating new shares and offering them for public sale.

[1] The SEC must approve all registrations for public offerings of corporate securities in the United States. An investment underwriter usually manages and/or facilitates public offerings. Generally, any sale of securities to more than 35 people is deemed to be a public offering, and thus requires the filing of registration statements with the appropriate regulatory authorities. The issuing company and the investment bankers handling the transaction predetermine and establish the offering price.

Initial Offering Date

An initial offering date is the date on which a security is first made available for public purchase and can be advertised for all types of securities, with stocks and managed funds being two of the most common. Such initial offering date is set during the underwriting process. The underwriting and filing process for offering new securities in the market is different for each security. Funds provide examples of the most common types of new offerings.

Historically, new offerings are often underpriced leading up to their initial offering date, which can potentially provide for large capital gains at issuance. This can also create pent-up demand for shares on the first day of trading and provide greater profit potential for those who can subscribe to the issue before the initial offering date. Generally, new offerings will experience high trading volatility in the early phases of their public offering. This can occur more often for stocks since only a small percentage of the outstanding shares (typically less than 25%) is eligible to trade on the first day.

The Process

The process to get a company through to its IPO takes time, is expensive and must pass many regulatory hurdles. The process is complex, and investors need to be aware of IPO timing, but understanding the road to creating an IPO can be lucrative for companies, underwriters and investors alike.

Underwriters on new initial public offerings are generally responsible for leading the initial public offering process, undergoing all due diligence, setting the price of the offering and marketing the offering to investors. Underwriting agreements typically involve support from the underwriters in buying newly offered shares and contingent purchases for shares after trading in the open market for a specified timeframe.

A very important component of going public is opening a firm's books to public scrutiny, as well as the oversight of the SEC. An investment banker, or underwriter, will help a company through this process, and the younger associates at an investment banking firm will bear the brunt of the grunt work. Those associates will spend many sleepless nights preparing a preliminary prospectus for the SEC and investors, which has come to be referred to as a red herring.

Through many revisions and discussions between the company and its bankers, the red herring will eventually become the final prospectus, which is the formal legal document filed with the SEC that lets the IPO process go through. One of the more common prospectus documents is referred to as form S-1, the formal registration statement under the Securities Act of 1933. The prospectus may sound dull and can include hundreds of pages of seemingly mundane and redundant information. But it is extremely important for investors to use to understand what the company does, why it is issuing shares through an IPO and what type of ownership structure is being offered. Generally, suc a Process have to plan:

- An external **IPO team** is formed, comprising an underwriter, lawyers, certified public accountants and Securities and Exchange Commission experts.
- **Information Memorandum** regarding the company is compiled, including financial performance and expected future operations. This becomes part of the **Company Prospectus**, which is circulated for review.
- The **financial statements** are submitted for an **official audit**.
- The company files its prospectus with the SEC and sets a date for the offering.

For starters, the underwriters, which generally include a lead underwriter and multiple other underwriters (also referred to as the sell side firm and the lead "book

runner", with "co-managers"), can take a cut of 3% to 7% of the gross IPO proceeds to distribute shares to investors[2].

There will also be legal, accounting, distribution and mailing, and road show expenses that can easily total in the millions of dollars. A road show is just as it sounds, and it occurs when company executives, including the CEO, CFO and investor relations individual (if it already exists) hit the road to build enthusiasm for investing in the IPO and explain their motivations for doing so. A successful road performance can drive demand for the stock and result in more capital raised[3]. In addition to the cost considerations, **a company must make many changes** to survive when public. The prospectus stipulates many of the new financial, regulatory and legal burdens, and PwC estimates that there will be at least $1.5 million in additional ongoing costs to the average firm that goes public. Hiring and paying a board of directors, or at least a higher profile board, can be expensive. Sarbanes Oxley regulation also imposed cumbersome duties on public companies that must still be met by most larger firms. Learning to deal with analysts, holding conference calls and communicating with shareholders may also be a new experience.

Tombstone

A tombstone is **a written advertisement of a public offering** placed by investment bankers who are underwriting the issue. It gives basic details about the issue and lists each of the underwriting groups involved in the deal. The tombstone provides investors with some general information and directs the prospective investors to a link where they can obtain a prospectus.

A tombstone is one component of the disclosure requirements for security offerings required by the Securities and Exchange Commission (SEC). The tombstone is simply an announcement that securities are available for sale[4]. When a security is issued to the public, the SEC requires that each investor receive a prospectus. The prospectus requirement applies to an initial public offering (IPO), which refers to the first time an issuer sells any type of security to the general public. If XYZ company, for example, already has common stock outstanding, however, it can issue a secondary offering to sell more shares to the public. A tombstone for a secondary offering is mailed to all investors who already own the security, and all secondary offerings are sold using a prospectus.

The Role of IPO Underwriters

Through a greenshoe option, **underwriters can have the right to sell additional shares, or an overallotment of shares**. This can occur if an IPO ends up having strong demand and lets the bankers make additional profits, which are earned by selling the shares off at a higher price. It can also let the company earn

[2] For example, Goldman Sachs (NYSE:GS) was Twitter (NYSE:TWTR)'s lead underwriter when Twitter went public in 2013. Together with other underwriters including Morgan Stanley (NYSE:MS) and JPMorgan (NYSE:JPM), they shared about $59.2 million, 3.25% of the $1.82 billion that Twitter raised in its IPO, for managing the sale.

[3] In rarer circumstances a road show can have the opposite effect. Back when Groupon went public, it came under fire from the SEC for an accounting term it referred to as "Adjusted Consolidated Segment Operating Income". The SEC, as well as other investors, questioned the manner in which it adjusted for marketing and advertising expenses, and called into question how fast the company could grow or generate ample profits in the future.

[4] The tombstone describes the types of securities that are offered, the date they are available, the number of shares or bonds to be sold and how the securities can be purchased. If a new debt security receives a credit rating, that rating can be included in the tombstone. A tombstone advertisement gets its name from the black border and heavy black print one typically has in print media. The tombstone lists the syndicate members who are involved in the underwriting of the security, with the primary members listed in larger type at the top of the advertisement. A syndicate member's level of involvement is based on the work the member performs on the security offering and the percentage of the total issue that the member's firm sells to the public. If a syndicate member is listed at the top of a tombstone for a popular issuer of stock, that document helps the syndicate firm market its expertise to other companies.

additional capital. A tombstone refers to a summary advertising document that underwriters issue to prospective investors (and sometimes themselves to commemorate that the IPO process has been completed). It basically summarizes a prospectus and briefly introduces a company.

Underwriters also help companies determine price, or how to best balance the supply of shares being offered with investor demand. Of course, most companies will happily increase supply (such as through a greenshoe option) to meet higher demand, but a difficult balance must be reached. A stock exchange, such as the New York Stock Exchange (NYSE), can help the process and indicate what an opening price on the IPO day is likely to be. Market makers and floor brokers help in this process, as does the syndicate of underwriters, to gauge the overall level of investor interest. Deciding which exchange to use is also of the utmost importance. Most firms would prefer the NYSE or Nasdaq markets given their ability to transact billions of dollars of daily trading activity and a solid guarantee of market liquidity, trading execution and follow-up reporting.

Funds

For Funds, the process leading to an IPO is different than for public stocks, since Funds are subject to different regulations and regulatory filing requirements. In a mutual fund offering, the company partners with a distributor who is also the principal underwriter on the fund. The distributor partners with the company’s legal and compliance teams to file a registration statement with the Securities and Exchange Commission, which must include full details on the fund in a prospectus and statement of additional information. Distributors serve as the underwriter, buy shares of the Fund and are responsible for marketing the Fund for its initial offering date. Distributors seek to list the Fund with discount brokerages and financial advisor platforms across the industry. These are the primary channels of distribution for a Fund and are important for its launch.

Factoring in Underwriters

An underwriter is responsible for managing the legal and accounting process of creating a prospectus. The prospectus includes the issuer's most recent set of audited financial statements, as well as a legal opinion regarding the existence of any pending legal matters. A prospectus goes into great detail about a firm's marketing, production and sales process, and it explains why the company is raising more capital. In addition to the underwriters, there may be many other members of the syndicate who are brought in to sell the securities to their customers. The underwriter's sales force also sells the newly issued securities.

Greenshoe Option

In security issues, a **greenshoe option is an over-allotment option**[5]. In the context of an IPO, it is a provision in an underwriting agreement that grants the underwriter the right to sell investors more shares than originally planned by the issuer if the demand for a security issue proves higher than expected.

A greenshoe option can provide additional price stability to a security issue because the underwriter has the ability to increase supply and smooth out price fluctuations. It is the only type of price stabilization measure permitted by the SEC, such options typically allow underwriters to sell up to 15% more shares than the original amount set by the issuer if demand conditions warrant such action. Since underwriters are paid a percentage of the IPO, they are interested in making it as large as possible. The prospectus, which is filed with the SEC prior to the IPO, details the actual percentage and conditions related to the option.

---

[5] Over-allotment options are known as greenshoe options because in 1919, Green Shoe Manufacturing Company (now part of Wolverine Worldwide Inc.) was the first to issue this type of option.

Underwriters use greenshoe options in one of two ways. First, if the IPO is a success and stock prices surge, the underwriters exercise the option, buy the extra stock from the company at the predetermined price, and send those extra shares, at a profit, to whoever bought them. Contrastingly, if the price starts to fall, they buy back the shares from the market instead of the company to cover their short position, supporting the price of the stock. Some issuers prefer not to include greenshoe options in their underwriting agreements under certain circumstances, such as if the issuer wants to fund a specific project with a fixed amount of cost and does not want more capital than it originally sought.

Offering Price

An **offering price is the per share value at which publicly issued securities are made available for purchase** by the investment bank underwriting the issue. A security's offering price includes the underwriter's fee and any management fees applicable to the issue. The term offering price is almost exclusively used in reference to the initial public offering (IPO) process, although it could apply to other securities such as bonds, structured investments and so on.

Setting the offering price is more Hollywood script writing than high finance, especially when high profile private companies go public. The syndicate handling the IPO wants to set the offering price high enough that the company going public is happy with the amount of money raised, but just low enough that the opening price and the trading on the first few days of listing provide a nice IPO pop as the public finally gets a chance at shares. This IPO pop makes for good news and also helps to mask any unloading if early stage investors choose to cash out from the company. While this IPO pop makes for good headlines, it can be frustrating for some venture capitalist as it represents a discount they've taken on their investment if they sold their holdings at the offering price pre-IPO.

Offering Price and Opening Price

The offering price was, and sometimes still is, referred to as the public offering price. This is a bit misleading as almost no individual investors are able to purchase an IPO at the offering price. The syndicate generally sells all the shares at the offering price to institutional and accredited investors. The opening price, therefore, is the first opportunity for the public to purchase shares and it is set purely by supply and demand as buy and sell orders queue up for the first day of trading. Individual investors shouldn't be too upset about missing out on the offering price, however, as many IPOs hit a patch of post-IPO blues where they can be snapped up below the offering price as initial market expectations and a company's performance in reality finally collide.

Subscription Price

A subscription price is a static price at which existing shareholders can participate in a rights offering that a public company conducts. Shareholders participate so they are able to retain their proportional ownership of the business. The subscription price will be the same for all shareholders and typically less than the current market price of the underlying stock.

The term may also refer to **the exercise price for warrant holders** in a particular stock. A company may issue warrants at different times, along with debt offerings. Subscription prices may vary slightly from one owner to another. Rights and warrants offerings are specific ways to raise capital although they are less common than a secondary offering or even an IPO may signal a lack of demand for shares in the open market. Issuing rights encourages more long-term ownership of the company as existing shareholders are increasing their investment in the company. A rights offering may also come with an oversubscription privilege that

allows existing shareholders to pick up any extra rights to shares that other shareholders have not claimed. Rights offerings tend to happen quickly as the subscription price is static and needs to be relevant to the current market price for shareholders to be interested in the deal.

Subscription Price and Public Offerings

Companies offer shares to the public in several ways. Rights and warrants are ways investors can take stakes in companies at certain exercise or subscription prices. In addition, companies can offer shares IPO on a public exchange, as well as issue secondaries. Smaller companies generally IPO as they look to expand their reach and capital base; however, larger, more established companies also go public for similar reasons to take the next step in their development. A specific set of protocol occur when gearing up for an IPO, including:

- Selected underwriters forming an external IPO team that consists of the underwriter(s) themselves, lawyers, certified public accountants (CPAs) and SEC experts.
- From here, the team compiles all relevant information on the company, including financial performance, projections of expected future operations, management backgrounds, risks, and competitive landscape. This all becomes part of the company prospectus that the team subsequently circulates for review.
- Finally, the team submits financial statements for official audit, and the company files its prospectus with the SEC.
- A date and price for the offering are set.

Secondary offerings have similar protocol; however, since the company already trades on a public exchange after the IPO, the secondary process includes less information collection and is a more streamlined issuing process.

Strike Price in derivatives trading

Strike price is the price at which a derivative contract can be exercised. The term is mostly used to describe stock and index options. For call options, the strike price is where the security can be bought by the option buyer up till the expiration date. For put options, the strike price is the price at which shares can be sold by the option buyer. **Strike prices are used in derivatives trading**. Derivatives are financial products that derive value from other financial products. Two derivative products that use strike price are call and put options. Calls give the buyer of the option the right, but not the obligation, to buy a stock in the future at a certain price (strike price). Puts give the holder the right, but not the obligation, to sell a stock in the future at the strike price.

The strike price, also known as the exercise price, is the most important determinant of option value. Strike prices are established when a contract is first written. It tells the investor what price the underlying asset must reach before the option is in-the-money (ITM). Strike prices are standardized, meaning they are at fixed dollar amounts, such as $31, $32, $33, $102.50, $105 and so on.

The price difference between the underlying stock price and the strike price is a key determinant in how valuable the option is. For a call option, if the strike price is above the underlying stock price, the option is out of the money (OTM). In this case, the option doesn't have intrinsic value, but it may still have value based on volatility and time until expiration as either of these two factors could put the option in the money in the future. If the underlying stock is above the strike price, the option will have intrinsic value and be in the money. If a put option has a strike price below the price of the underlying stock, then the option is out of the money. It doesn't have intrinsic value, but it may still have value based on the volatility of the underlying

asset and the time left until option expiration. If a underlying stock price is below the strike price of the put option, then the option is in the money.

Strike Price Example

Assume there are two option contracts. One is a call option with a $100 strike price. The other is a call option with a $150 strike price. The current price of the underlying stock is $145. Assume both call options are the same, the only difference is the strike price. At expiration, the first contract is worth $45. That is, it is in the money by $45. This is because the stock is trading $45 higher than the strike price. The second contract is out of the money by $5. If the price of the underlying asset is below the call's strike price at expiration, the option expires worthless. If we have two put options, both about to expire, and one has a strike price of $40 and the other has a strike price of $50, we can look to the current stock price to see which option has value. If the underlying stock is trading at $45, the $50 put option has a $5 value. This is because the underlying stock is below the strike price of the put. The $40 put option has no value, because the underlying stock is above the strike price. Recall that put options allow the option buyer to sell at the strike price. There is no point using the option to sell at $40 when they can sell at $45 in the stock market. Therefore, the $40 strike price put is worthless at expiration.

Portion of Stock or Bond

The portion of a stock (pot) or bond issue that investment bankers return to the managing or lead underwriter. This is done so that the portion can be sold to institutional investors. Depending upon the issue and the size of the pot, it may be very lucrative for the underwriter to sell inventory to institutional investors. An institutional investor is a non-bank person or organization who trades securities in large enough share quantities and/or has a net worth high enough to qualify for preferential treatment and lower commissions. Examples of institutional investors include hedge funds, high net worth individuals, pension funds, and endowments.

Preceding the division of the pot, underwriters will facilitate an issue. A common type of issue is an IPO. Underwriters follow specific steps when undertaking an IPO. First, an external IPO team is formed, next, information regarding the company is amassed, these records become part of the company prospectus to be circulated for review among many potential investors and are submitted for official audit. Finally, the issuing company files its prospectus with the SEC and sets a date for the offering. As potential institutional investors look through the company prospectus, book building occurs. This is the process by which an underwriter attempts to determine at what price to offer new shares, based on demand. An underwriter may build her book by accepting orders from fund managers, who will indicate the number of shares they'd like to purchase and the price they will pay. Once investment bankers or IPO underwriters determine the price, the company markets the IPO before its first day of trading. As stated above, the pot is the portion of a the issue that investment banks return to the lead underwriter following the deal.

The lead underwriter will generally assemble and collaborate with other investment banks to establish an underwriting syndicate or group of investment banks, which will create an initial public offering or secondary offering. The lead underwriter will take charge in assessing company financials and current market conditions to arrive at the initial value and quantity of shares to be sold. Being the lead underwriter can be highly lucrative – if a deal is a success.

Block Trade

A block trade, also known as a block order, is an order or trade submitted for the sale or purchase of a large number of securities. A block trade involves a significantly large number of equities or bonds being traded at an arranged price between two parties, sometimes outside of the open markets, to lessen the impact on the security price. In general, 10,000 shares of stock, not including penny stocks, or $200,000 worth of bonds are considered a block trade. Due to the size of block trades, both on the debt and equities markets, individual investors rarely, if ever, make block trades. In practice, these trades typically occur when significant hedge funds and

institutional investors buy and sell large sums of bonds and shares in block trades via investment banks and other intermediaries.

If a block trade is conducted on the open market, traders must be careful with the trade, because it can cause large fluctuations in volume, and can impact the market value of the shares or bonds being purchased. Therefore, block trades are usually conducted through an intermediary, rather than the hedge fund or investment bank purchasing the securities normally, as they would for smaller amounts.

Block trades are usually conducted through an intermediary known as a blockhouse. These firms specialize in large trades and know how to initiate such trades carefully, so as to not trigger a volatile rise or fall in the price of the security. Blockhouses keep traders on staff who are well versed in managing trades of this size. Staffers provide a block house with special relationships with other traders and other firms that allow the company to trade these large amounts more easily.

So, when a large institution decides to initiate a block trade, it will reach out to the staff of a blockhouse, trusting they will collectively help get the best deal. Once an order is placed, brokers at a blockhouse contact other brokers who specialize in the specific type of security being traded, and the expert securities traders fill the large order through several sellers[6].

Block trades can be more difficult than others because they expose the broker-dealer to more risk. Because the broker-dealer is committing to one price for a large amount of securities, it opens him up to more risk if there is any adverse activity in the market should the position not be sold. This means that block trades can tie up any of his capital. But it also means that it can be a predictor of future market movements since a money manager (especially someone who is well informed) may want to sell or buy particular shares in such a large volume.

[6] If, for example, JP Morgan wants to initiate a block trade of 10,000 shares at $10 a share, it will contact a blockhouse for help. The staffers at the blockhouse break up the large trade into manageable chunks, in this case, five smaller blocks of 2,000 shares, at $10 a share. Each one of the blocks will be initiated with a separate broker, thus keeping market volatility low.