United States General Accounting Office

GAO

Report to the Chairman, Securities and Exchange Commission

June 1996

INITIAL PUBLIC OFFERINGS

Guidance Needed on Disclosure of Underwriters' Disciplinary Histories

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GAO/GGD-96-5

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United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259973

June 6, 1996

The Honorable Arthur Levitt
Chairman, Securities and Exchange Commission

Dear Mr. Levitt:

Initial public offerings (IPO)—the sale of a company's securities to the public for the first time—are a major source of funds for new companies seeking to raise capital from the investment community. According to Securities and Exchange Commission (SEC) data, in 1994, companies registered securities worth $25.9 billion to raise capital through IPOs. Companies typically use underwriters,[1] to assist them in registering the IPO with SEC and raising equity capital from the investment community. We initiated this review because of concerns raised by press reports that some underwriters were giving certain investors preferential access to the IPO market and that some companies were not disclosing material information, such as the criminal and disciplinary histories of their underwriters, to investors. This report discusses (1) the factors that influence underwriters to sell IPO shares to institutional investors or individual investors and (2) disclosure requirements concerning the history of disciplinary actions taken against an underwriter. The report also provides information, analysis, and a recommendation to improve SEC's rules governing the IPO market.

Background

The IPO process generally consists of three phases: (1) developing the information and documents for submission to SEC, (2) processing these documents through SEC, and (3) marketing and selling the newly public shares. Before the initial sale of their stock is permitted, companies are required to register the IPO with SEC. Companies that want the SEC to declare the IPO effective must first complete a registration statement. The registration statement is to contain basic required information about the offering, such as the name of the company, the number of shares to be publicly traded, and the offer price. The company then submits the registration statement and a preliminary prospectus to SEC.

The primary purpose of the prospectus is to inform the investing public of all material information about the company and the security being offered for sale. For this reason, SEC rules require companies to disclose in the prospectus detailed information about the company. Specifically, this

[1]Underwriters are broker-dealers and/or investment bankers who, singly or as a member of an underwriting group or syndicate, may agree to purchase a new issue of securities from an issuer and distribute it to investors or make a "best efforts" attempt to sell the offering.

detailed information is to include a description of the company's business and the identity and experience of its management, the risk factors in the company's operating history and the nature of its business, the names of its current major stockholders, and the company's financial statements. In addition, the company is required to disclose in the prospectus information on its underwriting firm, including the members of the underwriting syndicate,[2] any relationships between the underwriting firm and the company, and whether the underwriting firm has had less than 3 years of broker-dealer[3] experience.

In reviewing the preliminary prospectus, SEC staff are to assess whether the prospectus provides all material information about the issuer, underwriter, and security being offered for sale. SEC has used a working definition, founded on court decisions, that considers information material when there is a substantial likelihood that a reasonable investor would consider it important in determining whether to purchase a security. In their assessment, SEC staff are to use public and nonpublic sources of information to identify areas in the preliminary prospectus that they believe to be incomplete or inaccurate. SEC staff are also to determine whether the financial statements in the preliminary prospectus conform to generally accepted accounting principles. On the basis of its assessment, SEC staff may request that the company revise the preliminary prospectus. When SEC requires no further revisions, the registration process is complete, and IPO securities can be sold to investors. The IPO process is described more fully in appendix I.

Underwriters play an important role throughout the IPO process. Companies typically use underwriters, along with lawyers and accountants, to assist them in registering the IPO with SEC. Companies also rely on underwriters to help market and sell the IPO to the investment community. Underwriters can sell IPO shares by either serving as an agent for the company or as owner of the shares. As an agent, the underwriter assumes no financial risk for the sale of the IPO shares since the company retains ownership of the shares. Alternatively, the underwriter can purchase some or all of the newly issued shares to resell to other investors at a maximum price known as the "offer price." In this case, the underwriter, as the new owner of the IPO shares, assumes financial risk for the issuance of the IPO shares. Underwriters also can be involved in market

[2]A syndicate is a group of underwriting firms that is formed to sell stock to investors.

[3]Broker-dealers combine the functions of brokers and dealers. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell stocks and bonds for their own accounts and at their own risk.

stabilization of the price of the security during the sales period and the period following the cessation of sales efforts in the offering.

While underwriters play an important role in a smoothly functioning IPO process, underwriters could adversely affect an investor's investment risk through certain activities, such as fraud and market manipulation, which are illegal, and favoritism, which is not. For example, an underwriter can profit from engaging in prohibited practices, such as "free-riding" or "withholding." An underwriter engaging in free-riding purchases securities with the intent of not paying for them or with the intent of paying for them only if the price goes up by the settlement date. The underwriter can then sell the securities at a price higher than the purchase price and the sales proceeds can be used to cover the purchase obligation. An underwriter engaging in withholding can profit directly or indirectly from a price rise on the sale of IPO shares by withholding a certain number of shares from the market until the market price rises above the offer price. Withholding a sufficiently large number of shares could cause the price to rise quickly in the period following the cessation of the sales offering.

Furthermore, underwriters could give certain investors an economic advantage by favoring those investors over others in sales of IPO shares at the initial offer price. Many academic studies have found that investors can profit from buying IPO shares at the offer price. According to a March 17, 1994, study by Prudential Securities, a significant difference exists between the performance achieved by investors able to buy at the offer price and the performance achieved by investors who buy after the first day of trading.

Both SEC and the National Association of Securities Dealers (NASD), the self-regulatory body for broker-dealers, conduct periodic examinations of broker-dealers' underwriting firms to detect rule violations. When violations are found, the regulators can impose a variety of disciplinary actions. For example, minor violations may result in a letter of caution to the violator; more serious violations can warrant a formal disciplinary action, such as a suspension and/or a monetary fine. Individual brokers and their firms are required to report any formal disciplinary actions taken against them to the Central Registration Depository (CRD).[4] These disciplinary actions for violations related to the securities business may be

[4]The CRD is an automated database operated by NASD and state regulators that contains information regarding the disciplinary history of member firms and individual brokers. Originally established as a centralized broker licensing and SRO registration system, the CRD is now used by regulators and the industry to help oversee brokers' activities.

imposed by SEC, state regulators, self-regulatory organizations (SRO), the courts, or employing firms.

Results in Brief

Most underwriters we contacted primarily target institutional investors in the marketing and sale of IPO shares. According to officials we interviewed at 10 underwriting firms, 9 of the firms market and sell IPOs primarily to institutional investors, rather than individual investors. The nine firms' estimated sales to institutional investors ranged from 60 to 90 percent—at a large underwriting firm with both institutional and individual clients and at a small underwriting firm with few individual clients, respectively. Those firms that marketed primarily to institutional investors did so because of economic factors and their judgment that institutional investors are better able to (1) buy large portions of IPO shares, (2) hold the investment for the long term, and (3) withstand the risk of investing in companies with no history of public trading. Underwriters allocated IPO shares to individual investors when (1) the underwriting firm had a high percentage of individual investor clients, (2) the company or industry related to the IPO had a high level of market recognition among individual investors, and/or (3) there was low demand for the IPO among institutional investors. Except for rules relating to fraud and market manipulation, SEC rules do not address the process used in allocating IPO shares, which allows underwriters to determine how best to allocate IPO shares.

The primary purpose of the prospectus is to inform investors of all material information about a company so investors can assess the risk of purchasing the company's securities. SEC rules require that companies disclose in the prospectus, for the 5-year period preceding the IPO, certain information about the criminal and disciplinary histories of its officers and directors that are material to an evaluation of their ability or integrity. However, SEC does not require companies to disclose similar information about the companies' underwriters, even though underwriters have important roles throughout the IPO process and could affect an investor's investment risk by engaging in prohibited activities, such as manipulating the price of IPO shares. In examining the disciplinary records of 34 underwriting firms, we found that 13 of these firms had a total of 25 formal disciplinary actions imposed by SEC and SROs for securities violations, some of which included cases of free-riding or withholding. While all of the violations we identified may not be considered material or relevant to IPO offerings, information about such violations could have a bearing on an investor's evaluation of the riskiness of the investment. By requiring companies to include in their prospectus material information about their

underwriter's disciplinary history, SEC could provide investors a better means of assessing the risks associated with IPO offerings.

Objectives, Scope, and Methodology

To obtain information on the factors that influence underwriting firms' allocation of IPO shares between institutional and individual investors, we interviewed SEC officials responsible for market regulation to determine what rules, if any, govern the allocation of IPO shares. We also reviewed NASD rules to identify those affecting the IPO allocations process.

We also randomly sampled 50 of the 952 IPOs that SEC processed from January 1, 1993, to June 30, 1994. For each of these offerings, we identified the underwriting firm from an SEC listing of IPOs. Thirty-four[5] underwriting firms were associated with these 50 IPOs. Of these 34 firms, we judgmentally selected 10 firms to obtain a better understanding of the IPO process and the factors that influence the distribution of IPO shares. Of the 10 firms selected, 6 were large underwriting firms that were each responsible for over $1 billion in IPOs, and 4 were smaller underwriting firms that were each responsible for under $1 billion in IPOs between January 1993 and June 1994.

To obtain a perspective on underwriting practices from other than New York firms, 2 of the 10 firms were located outside of New York. One of the two underwriting firms was located in Atlanta, and the other was located in Baltimore. For each of the underwriting firms, we interviewed senior officials responsible for selling IPO shares to investors. We visited officials at the New York and Baltimore underwriting firms; however, we interviewed officials at the Atlanta firm over the telephone. During these interviews, we discussed the IPO allocation process, the pricing of IPOs, and the disclosure of information about underwriters' disciplinary histories.

To determine disclosure requirements for underwriting firms' disciplinary histories, we first identified existing disclosure requirements that could pertain to underwriting firms. We discussed these requirements with SEC officials responsible for processing IPO registrations in Washington, D.C., and New York. We also discussed these requirements with officials from the underwriting firms during our conversations on the IPO allocation process.

We obtained the disciplinary histories of the 34 underwriting firms in our sample from the CRD. Specifically, we obtained information on (1) formal

[5]Nine of the 34 underwriting firms were responsible for 2 or more offerings.

disciplinary actions taken against the 34 underwriting firms for the 5-year period preceding the issuance of the IPO and (2) specific securities violation(s) that gave rise to such actions.[6] We obtained and reviewed the prospectus for each of the 50 IPOs in our sample to determine what types of information were disclosed. In reviewing the prospectus, we determined that information concerning the underwriter's disciplinary history was not disclosed. We discussed the disciplinary actions and related violations with SEC officials and the 10 underwriting firms' officials to obtain their views about the benefits from and any concerns about disclosure of such information in the prospectus.

Our work was performed in New York, Baltimore, and Washington, D.C., between May 1994 and August 1995 in accordance with generally accepted government auditing standards.

We obtained written comments from SEC on a draft of this report, and we have reprinted their letter in appendix II. SEC's comments are summarized and evaluated at the end of this report.

Institutional Investors Obtained Largest Portion of IPO Shares for Sampled Firms

In marketing and selling IPO shares, underwriting firms primarily target institutional investors rather than individual investors. According to officials we interviewed at 10 underwriting firms, 9 of the firms sold the largest portion of IPO shares to institutional investors, such as pension funds, mutual funds, and money managers. Estimates of sales to institutional investors by officials of the nine underwriting firms ranged from 60 to 90 percent—at a large underwriting firm with both institutional and individual clients and at a small underwriting firm with few individual clients, respectively. An official at the 10th underwriting firm said his firm sold primarily to individual investors. This underwriting firm was unlike the other nine in that it had few institutional clients.

Underwriters said they allocated their IPO shares predominantly to institutional investors because of economic factors and their business judgment that institutional investors are better suited for IPOs than individual investors. According to the underwriters we interviewed, they preferred to allocate IPO shares to institutional investors because they believed that these investors are better able than individual investors to buy large blocks of IPO shares, assume financial risk, and hold the

[6]We used a 5-year period because SEC uses the same time frame for requiring companies to disclose in the prospectus the criminal and disciplinary actions taken against the company's officers and directors. Our CRD search was limited to information about the lead underwriting firm. We did not obtain the history of brokers employed by the lead firm or by other syndicate members.

investment for the long term. Officials at nine underwriting firms said they sold largely to institutional investors because these investors had the financial resources to purchase large blocks of stock. This practice was important to these officials because they were concerned that unsold shares could be a source of financial losses should the market price fall below the offer price.

Furthermore, these officials believed that IPOs are more suitable for large institutional investors than for individual investors because institutional investors are more able to assume the risk of declining share values than individual investors who may not have the financial resources to hold shares in an IPO when share values decline. Some underwriting firm officials expressed concern that individual investors may be more likely to take a quick profit by selling their stock within the first days or weeks of the offering when the price of the IPO shares may be at its highest.

Underwriting firm officials cited the following factors as affecting their decision to allocate IPO shares to individual investors.

- The underwriter has a high percentage of individual clients. Underwriting firms with a high percentage of individual investor clients were more likely to allocate a portion of the IPO shares to these investors. An official at one underwriting firm we interviewed estimated that his firm sold 80 percent of its IPO shares primarily to individual investors because its client base primarily included individual investors. Officials of another underwriting firm told us that even if there were sufficient demand to sell an entire IPO to institutional investors, it was company practice to allocate a portion to its individual investor clients. The officials explained that they had adopted this practice to satisfy the demands of their individual investors.
- Investor recognition of company and industry may stimulate interest in an IPO. Pressure from individual investors can cause underwriters to allocate IPO shares to these investors. Officials at all of the underwriting firms with whom we spoke told us that they expect greater individual investor interest in an IPO when the company or the company's product or industry is widely recognized and little individual investor interest when the company is not well known. For example, at one underwriting firm an official told us that the IPO of a popular retail gourmet coffee establishment generated significant individual investor demand. Although the entire IPO could have been sold to institutional investors, the underwriting firm designated a portion of the offering to individual investors to maintain their goodwill and ensure they remain as clients. The same official told us of another IPO issued by a company with limited individual investor

recognition. This IPO involved a freight consolidator company that was known only to a small number of institutional investors. Rather than educate individual investors and improve their knowledge of the company, the underwriting firm sold the entire IPO to the few institutional investors.

- There is insufficient demand for the IPO from institutional investors. Underwriters may target individual investors when there is insufficient institutional demand for the IPO. An official of an underwriting firm, who usually sold IPOs exclusively to institutional investors, told us of a situation that forced the firm to sell shares to individual investors. In marketing the IPO, officials at the underwriting firm determined that institutional investor interest was insufficient to sell the entire issue. (According to the officials, the issue's profit potential was too low.) To locate purchasers for the remaining shares, the underwriting firm extended its marketing efforts to individual investors. These efforts were successful and enabled the underwriting firm to sell the entire IPO to a combination of institutional and individual investors.

Under existing SEC and NASD rules, underwriters generally have wide latitude in deciding how best to market and allocate IPO shares. Except for rules governing fraud and manipulation of securities offerings,[7] SEC rules do not address the allocation of IPO shares. NASD has an interpretive rule prohibiting free-riding, withholding, and sales to certain insiders under certain market conditions. Officials from underwriting firms told us that they discouraged these practices, but enforcing such policies, especially among syndication partners, can be difficult.

According to an SEC official, SEC has received a number of complaints from individual investors about their lack of access to the IPO market. In response to these complaints and press articles about sales of IPO shares to insiders by underwriters, SEC conducted a limited study of the IPO allocation process in 1994. The purpose of the study, according to SEC officials, was to study whether firms had a reasonable basis for allocating shares. SEC officials told us they interviewed underwriters as part of their study and discussed the allocation process. On the basis of these interviews, SEC officials observed that underwriters' allocation practices generally reflected the companies' clientele; therefore, if the company dealt primarily with institutional investors, most of its IPOs were generally

[7]SEC's principal antimanipulation rules that apply to securities offerings are Rules 10b-6, 10b-7, and 10b-8. These rules are designed to prevent the offering's price from being influenced improperly by persons who have a significant interest in the offering. In 1994, SEC solicited public comment on a broad range of issues dealing with antimanipulation regulation in light of significant changes in the securities markets and distribution practices in recent years. On April 11, 1996, SEC proposed new rules and announced a 60-day comment period.

made available to institutional investors. However, if underwriters had a substantial retail client base, they were more likely to make IPOs available to individual investors. Thus, in the SEC's officials' views, these practices appeared to be based on reasonable business judgment.

SEC officials also observed that institutional investors have the financial resources to buy more shares and handle more risk, which is important because IPOs involve companies with no previous history as publicly traded firms. In addition, institutional investors are often better able to hold investments for the long term. Furthermore, the underwriters SEC interviewed pointed out that traditional distinctions between individual investors and institutional investors have become blurred in today's market environment. Individual investors have invested substantial amounts in institutional investment entities, such as pension and mutual funds, and can gain access indirectly to the IPO market by investing money in these entities.

According to an SEC official, SEC has chosen, thus far, not to address the IPO allocation process in rulemaking. Among the reasons SEC cited for not addressing this issue were the complexity of the issues involved and the difficulty of crafting rules that would be reasonable and enforceable.

Disclosure of Material Information About Underwriters' Disciplinary Histories Could Benefit Investors

Securities regulation is based on the concept of full and fair disclosure. The assumption is that investors will be able to make a more rational and informed evaluation of the relative risk and reward of a particular investment if they have free and equal access to information about that investment. Rules under the Securities Act of 1933 and the Securities Exchange Act of 1934 require the issuer and the underwriter to take reasonable steps to make a preliminary prospectus available to investors who have expressed an interest in purchasing the security. The prospectus is to contain material information about the company issuing the security. The prospectus is also to contain material information concerning the offering and firms that participate in the offering. SEC rules specifically require a company registering an IPO to report, for the 5 years preceding the issuance of the IPO, information on the criminal and disciplinary histories of its officers and directors that is material to an evaluation of the individuals' ability and integrity. However, SEC rules currently do not specifically require that companies report similar information about firms underwriting the offering, even though underwriters have important roles throughout the IPO process and could affect an investor's investment risk by engaging in prohibited activities, such as manipulating the price of IPO

shares. SEC has used its more general authority under the Securities Act of 1933 to require additional disclosure from certain underwriters who had Commission enforcement proceedings against them. These proceedings generally involved cases in which the companies were either in financial trouble or had been involved in pervasive fraud.

Item 401 of SEC Regulation S-K provides companies specific guidance on what information the prospectus must contain about the criminal and disciplinary histories of the companies' officers and directors. Information that companies are to report includes bankruptcy filings, criminal convictions, pending criminal actions, civil judgments, and SEC disciplinary actions. While federal securities laws generally require companies issuing securities to disclose all material information about the underwriter participating in the issuance, Regulation S-K does not provide any specific guidance on what aspects of an underwriter's disciplinary history are material.

The disclosure in the prospectus of information about an underwriter's disciplinary history could help investors more fully assess the underwriter's ability and integrity as well as the riskiness of investing in the IPO. Our search of the CRD found that 13 of the 34 underwriting firms we sampled had 25 formal disciplinary actions, collectively, that related to past underwriting activities for the 5-year period before the issuance of the IPO. None of these actions was disclosed in the prospectuses we reviewed. Of the 13 underwriting firms, 1 had 5 violations, 2 had 4 violations, 2 had 2 violations, and 8 had 1 violation.

A frequent violation was of the NASD rule that prohibits underwriting firms from withholding IPO shares from public distribution if the market price rises above the offer price. This rule was designed to prevent underwriting firms, and others associated with the offering, from directly or indirectly profiting from the price rise. Four of the 13 underwriting firms were cited for violating this rule.

Another frequent violation concerned underwriting firms that improperly overstated the orders for and the sales of new debt issues of government-sponsored enterprises.[8] By manipulating these statistics, the underwriting firms attempted to maintain or increase their share of future offerings. Nine of the 13 underwriting firms were among the 98 brokers

[8]Government-sponsored enterprises are congressionally chartered enterprises that help capital raising for certain economic sectors, such as agriculture and housing.

that SEC, jointly with other federal regulatory organizations, fined in 1992 for violating these rules.

Other violations in our sample for which formal actions were taken included the following:

- Three underwriting firms were cited for failing to finalize trades with other syndicate members within specified time periods.
- Two underwriting firms were cited for performing an inadequate search of the company's finances and business activities.
- One underwriting firm attempted to improperly influence the pricing of an impending public offering.
- One underwriting firm was cited for selling unregistered securities.

SEC officials and officials at all of the firms with whom we met agreed that the prospectus should disclose all of the information investors need to assess the risk of the offering. However, the officials did not believe that all information about an underwriter's disciplinary history should be disclosed in the prospectus. Instead, they believed that if there were to be requirements on disclosing information about the underwriter, that information should be material to an investor's decision on investing in the IPO and to an assessment of risk. While agreeing that investors have a right to know about an underwriter's disciplinary history, officials associated with two underwriting firms expressed reservations about disclosing such information in the prospectus. Officials at the two firms said that SEC's Broker-Dealer Form already requires the reporting of extensive information about an underwriter's criminal and disciplinary history and that this information is available to the public. An official at another underwriting firm suggested that the prospectus, instead of disclosing information on an underwriter's disciplinary history, should inform investors that they could obtain this information by contacting NASD or state securities regulators.

To help investors more fully assess their IPO investment risk, we believe it is important for companies to disclose in the prospectus material information on the criminal and disciplinary histories of their underwriter. A requirement that companies disclose information on underwriters is similar to information already required to be reported on officers and directors of the issuing companies and should not be a difficult or costly task. Underwriting firms should have ready access to detailed knowledge of all formal disciplinary actions that regulatory organizations have imposed against them. In addition, they could access the CRD through

on-site computer terminals or telephone NASD to ensure the completeness of their information.

We believe the suggestion that SEC's Broker-Dealer Form could serve as the disclosure vehicle to investors is not the preferred option, because the information reported on the Broker-Dealer Form is not as readily accessible to investors as the prospectus. The other suggestion was to use the prospectus as a vehicle to inform investors about the availability of information from NASD or state regulators. While this could serve as an additional source of information to investors, adding this information to the prospectus would mean that investors would have to contact NASD, request information about the underwriter, and scan the information to determine which violations and disciplinary actions are material to their investment decision. In some cases, the information about the underwriter could be quite lengthy and difficult to interpret.

Differences of opinion exist as to the types of disciplinary actions and violations that are material to an investor's decisionmaking on the IPO. While the violations we identified were serious enough to warrant reporting to the CRD, some may not have been relevant and others may not have been serious enough to be considered material to an investor's decisionmaking about an IPO. In the absence of specific guidance, many underwriting firms may conclude that their disciplinary history does not warrant disclosure to investors. For example, officials at the 10 underwriting firms we interviewed believed that some of the actions we identified were not serious enough to be considered material and ought not be reported.[9] SEC could provide guidance clarifying what information relating to an underwriting firm's disciplinary history is material and, therefore, required to be reported.

Conclusions

Investors require material information on an IPO to make an informed investment decision. SEC rules require companies to disclose in the prospectus material information on their businesses, finances, operations, and officers and directors. SEC provides specific guidance on what information about the criminal and disciplinary histories of a company's officers and directors must be disclosed. In contrast, SEC does not specifically require disclosure of material information about the underwriter's disciplinary history in the prospectus. Because of the important role underwriters play in the IPO process, material information

[9]Each of the previously mentioned violations was identified by one or more of the underwriters as not serious.

about an underwriter's disciplinary history would be useful to investors. Having certain information, including formal disciplinary actions taken by SEC, state regulators, and SROs for securities violations arising from past underwriting activities, would enable investors to use these factors in their investment decisions and allow them to better assess the risks of the IPO. In the absence of a specific disclosure requirement, investors may not receive information that may be critical to their investment decisions.

Recommendations to the SEC Chairman

To improve disclosure to investors who purchase IPOs, we recommend that the SEC Chairman amend SEC Regulation S-K and IPO registration forms to require that companies disclose in the prospectus information about the underwriter's disciplinary history that is material to assessing the risk of an IPO investment, and provide guidance on the type of information that is material. SEC should also incorporate a statement in the prospectus that tells investors how to obtain additional information from NASD on the underwriter's disciplinary history.

Agency Comments and Our Evaluation

SEC staff provided written comments on a draft of this report, and these comments are included in appendix II. SEC agreed that investors need adequate information to make an informed investment decision and that among the necessary items of disclosure would be information relating to any material disciplinary actions taken against the principal underwriters. However, SEC does not believe there is a need for a specific requirement for material disclosures, similar to that involving directors and officers of the offering company. SEC believes more detailed information is necessary for company officers and directors because, unlike the underwriter, they have an ongoing role to play with the offering company. SEC also believes it provides for sufficient disclosure requirements for those underwriters with a history of disciplinary problems through its more general authority under the Securities Act of 1933. SEC officials showed us recent examples of prospectuses with extensive disclosures SEC had required from underwriters who had Commission enforcement proceedings against them. The staff did agree that, for those investors who desired more information, it may be appropriate to recommend a rule requiring prominent disclosure in prospectuses on how to obtain information from the CRD.

The prospectuses with extensive disclosure SEC staff provided us generally involved cases in which the companies were either in deep financial trouble or had been involved in pervasive fraud. In those cases, SEC's

actions to require additional disclosure were probably appropriate. However, our concern is that this disclosure threshold may be too high. Many of the cases we cite in our report did not involve allegations of fraud, but we believe there are investors who would find the disciplinary information pertinent in making an informed investment decision. Thus, we still believe there should be an affirmative disclosure requirement for underwriters with disciplinary histories and that SEC should provide guidance on this disclosure. For the reasons cited by SEC, the disclosure requirements probably do not have to be as elaborate as those for officers and directors, so we modified our recommendation accordingly.

As you know, the head of a federal agency is required by 31 U.S.C. 720 to submit a written statement of actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight not later than 60 days after the date of this letter and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this letter.

We will provide copies of this report to the Senate Committee on Banking, Housing and Urban Affairs and its Subcommittee on Securities; the House Committee on Commerce and its Subcommittee on Telecommunications and Finance; and other interested parties and Members of Congress. Copies will be available to others upon request.

This report was prepared under the direction of Helen H. Hsing, formerly Associate Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix III. If you have any questions about this report, please contact me on (202) 512-8678.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Letter 1

Appendix I Description of the Initial Public Offering Process 18

Appendix II Comments From the Securities and Exchange Commission 21

Appendix III Major Contributors to This Report 23

Abbreviations

CRD	Central Registration Depository
IPO	initial public offering
NASD	National Association of Securities Dealers
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

Description of the Initial Public Offering Process

The initial public offering (IPO) process consists of three phases: (1) developing the information and documents for submission to the Securities and Exchange Commission (SEC), (2) processing these documents through SEC, and (3) marketing and selling the newly public shares. Various alternative requirements apply under certain conditions; for example, different requirement apply for companies that meet SEC small business criteria.

Corporations may have several motivations for offering their securities to the general public. For example, they may view the IPO process as a means to raise capital for expansion or special projects or to replace debt with equity. Another motivation may stem from the desire of existing shareholders to sell their holdings to the general investment community.

Corporations usually use an underwriting firm to assist in preparing the documents and getting the IPO statement declared effective. Underwriting firms may also assume some of the financial risks involved in selling the IPO. For example, in what is known as "firm commitment offerings," the underwriting firm agrees to purchase all of the IPO shares from the company. Purchasing all of the IPO shares subjects the underwriting firm to the risk that it may be unable to sell some or all of these shares. If the underwriting firm believes that it will be difficult to sell the new issue, it can reduce its risks by agreeing to a "best efforts offering." Under the best efforts offering, the underwriting firm does not commit itself to the purchase of the entire offering.

In addition to the underwriting firm, lawyers and certified public accountants assist in preparing sections of the registration statement and prospectus. Each of these parties has special responsibilities for ensuring the accuracy and completeness of these documents.

The registration statement contains basic information about the offering, such as the name of the company, the number of shares to be publicly offered, and the offering price. The prospectus contains detailed information about the company, including a description of its business, the identity and experience of its management, the factors in the company's operating history and the nature of its business, and the current major stockholders. The prospectus also contains the company's financial statements.

After their completion, the prospectus and registration statement are submitted to SEC for review. SEC neither approves or disapproves the

securities, nor does it verify the accuracy or adequacy of the information in these documents.[10] However, SEC does identify areas for amplification, clarification, or supplementation on the basis of information from the prospectus, newspapers, and periodicals and on the basis of SEC staff knowledge of accounting rules and practices, industry trends, and regulatory requirements. SEC asks the company to respond to each of its areas of concern.

After addressing these comments and making any appropriate revisions, the company resubmits the prospectus and registration statement to SEC. At this point, SEC may have a second set of comments that may require a second revision of the documents. This submission, review, and revision process is repeated until SEC has no further comments.

The first version of the prospectus contains the approximate number of shares to be publicly offered. This version also contains the range of possible offering prices. The final prospectus, with the final offering price, is completed either the day before or the day of the start of public trading.

When SEC no longer has any comments on the registration statement and prospectus, it notifies the company of the effective date of the offering. On the effective date, the underwriting firm purchases the shares from the company and resells the shares to institutional and individual investors at the offering price. After the effective date, the investors are free to sell the shares at the market-determined price.

Underwriting firms use a variety of techniques to help them set the offer price. For example, they compare new companies' financial history and prospects to those of similar companies whose stock is already publicly traded. Underwriting firms also meet with investors to assess the extent of their interest in the offering. These meetings, often called "road shows," also give investors the opportunity to question management about the company's finances, products, and operations.

The underwriting firms frequently set the offer price at a level somewhat below their estimate of the market price. The variance is intended to provide investors with an incentive for purchasing the IPO shares. Officials at underwriting firms told us that this variance may range from near 0 percent, when they expect the IPO to have high investor interest, to 25 percent, when less interest is expected.

[10]SEC requires that a notice to this effect be placed on the first page of the prospectus.

Although federal law prohibits any sales of securities before the effective date, investors may furnish underwriting firms with "expressions of interest" in the offering. On the effective date, investors are asked to convert their expressions of interest into commitments to purchase. Investors who purchase securities may resell their securities after the registration is effective.

Comments From the Securities and Exchange Commission

DIVISION OF
CORPORATION FINANCE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

April 22, 1996

James L. Bothwell, Director
Financial Institutions and Market Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for your letter of March 22, 1996 providing copies of the General Accounting Office's ("GAO") draft report entitled Initial Public Offerings: Guidance Needed on Disclosure of Underwriters' Disciplinary Histories. I am pleased to take this opportunity to provide comments on the recommendations set forth in the report.

The staff agrees with the GAO's conclusion that investors in IPOs, like investors in any securities offerings, need adequate information to make an informed investment decision. We also agree that among the items of disclosure necessary to make such a decision is information relating to any material disciplinary actions taken against the principal underwriters for an offering that may bear on such matters as the likelihood that the underwriter will conduct the offering in a lawful manner, or the liquidity of the securities in the secondary market.

While we appreciate the GAO's interest in providing disclosure requirements for disciplinary actions against the underwriters involved in public offerings, it is not clear that a provision similar to existing Item 401(f) of Regulation S-K (governing disclosure of legal proceedings involving directors, nominees for director or executive officers of a registrant) is the appropriate way to address this issue. In this regard the staff notes that the amount of detailed information about the criminal and disciplinary histories of an issuer's officers and directors is supported by the fact that those individuals are the persons who will be responsible for the success or failure of the company on an on-going basis. Investor's have less need for comparable information about the underwriter because the underwriter typically does not have a similar on-going role in the operations of the company.

Moreover, disclosure of material actions brought against broker-dealer firms underwriting a public offering that have a bearing on the ability of that firm to complete the offering in a lawful manner and to carry out any other obligations it has

James L. Bothwell, Director
Page 2

undertaken is provided through the application of more general disclosure requirements under the Securities Act of 1933. 1/ For example, registration statements, including IPOs, filed by issuers whose securities were being underwritten by firms such as Stratton Oakmont, Inc., Biltmore Securities, Inc. 2/ Blinder Robinson, Drexel Burhnam and Lambert Inc. and First Jersey Securities have contained extensive disclosures about major Commission enforcement proceedings involving such firms.

The staff does agree, however, that for the purposes of those investors who desire additional information about the underwriter of a particular offering it may be appropriate to recommend to the Commission a rule requiring prominent disclosure in prospectuses providing investors with information on how to obtain information from the NASD's Central Registration Depository on an underwriter's disciplinary history.

Sincerely,

Brian J. Lane
Director

1/ Usually, this information is disclosed pursuant to Rule 408 under the Securities Act of 1933 which provides that "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

2/ The disclosures in recent cases involving Stratton Oakmont and Biltmore Securities indicated in both cases that the Commission had entered Administrative Orders against the firms for willful violations of the securities laws. The violations included fraudulent sales practices, unauthorized trading, market manipulation, improper price predictions and misrepresentations regarding the firms experience in the securities industry.

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