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“Securities Offerings - Completing your IPO as
Market Conditions Shift on Pricing Day”
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SECURITIES OFFERINGS – COMPLETING YOUR IPO AS MARKET CONDITIONS SHIFT ON PRICING DAY

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INTRODUCTION

During the first six months of 2007, there were over one hundred initial public offerings filed with the Securities and Exchange Commission with offering proceeds in excess of \$25.7 billion.¹ In recent months, initial public offerings (IPOs), such as that of The Blackstone Group, have found their way onto the front pages of newspapers and into various blogs and chat rooms around the world. While clearly sensitive and subject to conditions of the capital markets and other business considerations in the first instance, IPOs in the U.S. are also subject to a well-developed regulatory regime for the registration, offer and sale of securities to the public. The Securities and Exchange Commission (SEC) has established a number of rules that operate specifically with regard to pricing a securities offering. Understanding those rules can help ensure that the specter of the SEC will not needlessly hamper your efforts to complete your deal, even as conditions in the markets shift and you find yourself needing to resize your offer or price the offering outside of the price range announced on the cover of the preliminary prospectus.

OVERVIEW OF REGULATIONS PERTAINING TO PRICING OF OFFERINGS

Companies intending to offer securities to the public in the United States generally must file a registration statement with the SEC. In the case of an IPO, members of the selling group typically must deliver a copy of the preliminary prospectus that is part of that registration statement to any person who is expected to receive a confirmation of sale. That prospectus delivery must be made at least forty-eight hours in advance of sending the confirmation of sale.² In addition, the registration statement

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1. Equity Capital Markets Review, Second Quarter 2007, Thomson Financial.

2. See Rule 15c2-8(b) under the Securities Exchange Act of 1934 (the Exchange Act). This rule makes it a deceptive act or practice for a broker-dealer to participate in an offering without complying with Rule 15c2-8(b). In addition, the lead managing underwriters will be required to make certain representations to the SEC about the

must be declared “effective” by the SEC before any sales of the registered securities can be made.

Prior to a registration statement being declared effective, an issuer has the ability to change the planned size or price of its proposed offering as long as the changes are reflected in a pre-effective amendment to the registration statement that is filed with the SEC.³ Additionally, in reliance on Rule 430A under the Securities Act, the prospectus in a registration statement at the time it is declared effective may omit the actual, specific price of the shares being offered as well as certain other “pricing-related information”.⁴ The prospectus in the registration statement at effectiveness must, however, include either a total number or an aggregate value of shares that are being registered as well as a per share price range.

The number of shares being offered (or the total intended proceeds) as well as the price range are critical deal terms that must be worked out among the issuer, the selling shareholders, if any, and the underwriters. For the SEC’s part, Item 501(b)(3) of Regulation S-K simply requires that an issuer in an IPO provide a “bona fide estimate of the range of the maximum offering price and the maximum number of securities offered.” The SEC staff typically asserts that a bona fide estimate for the price range used in an IPO should be no more than (1) \$2.00 per share where the maximum offering price is \$20.00 per share or less, and (2) ten percent of the low end of the price range if above that \$20.00 threshold. Notwithstanding these general guidelines, the staff has retained discretion in reviewing and accepting a price range as a “bona fide” estimate. If you are in a situation where a price range is outside the guidelines, it makes sense to discuss it with your SEC examiner as early in the process as is feasible.⁵

The registration statement in an IPO is typically declared effective by the SEC sometime during the day of, but prior to, pricing of the offering. At that point, the issuer has registered a specific number of shares (or amount of proceeds) and established a price range within which it intends to sell the offered shares. It has also paid the registration fee based upon those expected offering parameters. Pricing, of course, does not

distribution of the preliminary prospectus. *See* Rule 460(b) under the Securities Act of 1933 (the Securities Act).

3. An additional filing fee may need to be paid. The issuer may also be required to disseminate the changes to the marketplace. The magnitude of the changes will determine whether recirculation of the preliminary prospectus is necessary.

4. Pricing-related information as contemplated by Rule 430A includes “information with respect to the public offering price, underwriting syndicate (including any material relationships between the registrant and underwriters not named therein), underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date.”

5. The number of shares (or amount of proceeds) registered, along with the price range, will also have an interplay with the registration fee that the issuer must pay to the SEC as we discuss at the end of this article.

happen until market conditions permit, and at that point the issuer and the underwriters may find themselves needing or wanting to change either the number of shares being sold or the offering price. Fortunately, the SEC's rules provide meaningful (but not absolute) flexibility to accomplish these changes if conditions compel them. To understand how these rules operate in practice, it may be useful to consider a hypothetical.

Assume an issuer sets forth a bona fide price range in its IPO prospectus of \$18.00-\$20.00 per share. At the time the IPO registration statement for this offering is declared effective, the cover of the IPO registration statement included a maximum price of \$20.00 per share for thirty million shares. (The thirty million shares in this hypothetical might reflect 25.5 million primary shares and 4.5 million over-allotment shares.) The maximum price per share of \$20.00 coupled with the number of shares being registered leads to proposed maximum aggregate proceeds from the offering of \$600 million. There are, however, several possibilities for changing the deal size beyond these expected ranges: (1) an increase in the price per share above the price range, (2) an increase in the number of shares being sold (either with or without an increase in the price), or (3) a decrease in the offering proceeds (by reducing one or both of the price per share and the number of shares being sold). If any of the foregoing occurred after effectiveness of the registration statement and constituted a material change in the offering, the issuer would need to file a post-effective amendment and would need to have the SEC in turn declare that amendment effective, which could take up to forty-eight hours or more. Fortunately, the relevant SEC rules provide the flexibility mentioned above for each of these situations and even circumscribe the materiality determination to some extent. Let's look at each of these situations and how they can play out within the SEC's rules.

UPSIZING OR DOWNSIZING YOUR OFFERING AT PRICING: THE "RULE OF 20s"

We mentioned earlier how the designation of a maximum offering price of \$20.00 per share plays into the SEC's guidance about establishing a price range before effectiveness for an IPO. There are several other key ways that the figure "20" comes into play with regard to the SEC's rules and IPO pricing mechanics.

1. *Increasing the price per share.* If market conditions or demand for the offering are good, the issuer and underwriters may be able to sell the offered shares at a higher price than that contemplated by the range shown in the preliminary prospectus circulated to investors. Fortunately there is a zone within which the offering may be upsized in this manner without having to engage in the materiality analysis referenced above. After the registration statement has been declared effective, an issuer may, pursuant to Rule 430A, price its offering up to 20% higher than the high

point of the price range included in the registration statement at the time it was declared effective without needing to file a post-effective amendment⁶ or recirculating a revised prospectus.⁷ In our hypothetical deal, the IPO could be priced at up to \$24.00 (or 20% more than \$20.00) per share without needing a post-effective amendment, yielding gross proceeds of \$720 million.⁸ If the price per share increase were in excess of 20%, the transaction participants would need to assess whether the price increase resulted in a material change in the disclosure. We describe below some techniques for minimizing the disclosure impact of pricing an IPO outside the estimated price range.

If, instead, however, the registration statement registered a maximum dollar amount (i.e., \$600 million), then only twenty-five million shares (representing \$600 million divided by \$24.00) could be sold at \$24.00 per share without filing a post-effective amendment.⁹ Rule 430A does not provide a safe harbor for upsizing the aggregate proceeds of the offering in cases where an issuer had registered a maximum dollar amount rather than a number of shares. Some implications of registering a number of shares as opposed to maximum proceeds are discussed below.

2. *Selling more shares.* If market conditions or demand for the offering are good, the issuer and the underwriters may be able to sell additional shares at a price within the estimated price range or at a price above the range. Additional shares cannot be added to an effective registration statement. Pursuant to Rule 462(b), however, an issuer can file an additional “short form” registration statement to register additional shares in an amount and at a price that together represent no more than 20% of the proposed maximum aggregate offering proceeds set forth in the earlier effective registration statement.¹⁰ In our scenario, Rule

6. As described below, the issuer is also not required to pay an additional filing fee to the SEC under these circumstances.

7. Notwithstanding that an issuer does not have to recirculate a prospectus, because of Rule 159 and its focus on “time of sale” disclosure, an issuer (and its underwriters) still need to be comfortable that the disclosure given to investors at the time of sale is accurate and complete (including with respect to pricing information). As described below, one approach is to include “sensitivity” analyses with respect to price-dependent information.

8. Note also that pursuant to this feature of Rule 430A, an issuer that had registered a set number of shares could also maintain their aggregate proceeds by increasing the price per share while selling fewer shares. This calculation would also be subject to the 20% test for a change in offering price.

9. If following a fairly typical pattern, the twenty-five million shares might consist of 21.25 million primary shares and 3.75 million over-allotment shares based on our original hypothetical. An over-allotment option, or “green shoe”, is generally fifteen percent of the primary offering but could be less based on the negotiations among the parties.

10. A Rule 462(b) filing consists of the cover page, a statement incorporating the contents of the effective registration statement, a signature page and the required consents and opinions.

462(b) could be used to register up to an additional \$120 million of securities (20% of \$600 million), which would translate into an additional (a) six million shares at \$20.00 per share or (b) five million shares at \$24.00 per share (assuming the deal was priced at 20% above the maximum end of the price range).¹¹ Unlike a “post-effective” amendment to a registration statement, a Rule 462(b) registration statement is immediately effective upon filing with the SEC (assuming filing fee arrangements have been made). Therefore, if the Rule 462(b) filing is made the evening of pricing, trading of those additional shares can also commence at the stock market opening the following morning.

3. *Decreasing the size of the offering.* An issuer is not obligated to sell a particular number of shares simply because it has registered that number in an effective registration statement. A size decrease for an IPO (whether in terms of number of shares sold or aggregate proceeds from the offering), where no other changes are made, would not require a post-effective amendment or recirculation unless the decrease would materially change the disclosure in the registration statement at the time of effectiveness. And once again, Rule 430A and its Rule of 20s operates to provide a buffer zone within which that analysis need not be undertaken (assuming no other changes are made). Pursuant to the Rule of 20s, a post-effective amendment is not required if the downsizing of a deal results in no more than a 20% reduction in the aggregate proceeds to the issuer. So an issuer could sell 20% less shares if it was still pricing within its estimated price range. Reducing proceeds may also be accomplished by selling shares at a lower price, which we’ll turn to next.

As with a decrease in the volume of securities being sold (or aggregate proceeds), a decrease in the price per share would only require a post-effective amendment and perhaps recirculation if the effect of such decrease would be to materially change the disclosure that was in the registration statement at the time of effectiveness. And again, Rule 430A is available to soften the edges of that standard. According to longstanding SEC staff guidance, for these purposes the 20% reduction is calculated using the *low* point of the filing range for the number of shares registered. Pursuant to this application of the Rule of 20s then, a post-effective amendment would not be required, assuming no other changes are made, when the price per share is reduced by no more than 20% from the low end of the published range. In our hypothetical, the low end of the range was \$18.00 per share and

11. In either scenario, any additional shares offered would likely be split between the primary offering and the over-allotment option.

since 20% of that is \$3.00, we can calculate that the price at which the issuer will be able to sell the securities turns out to be \$15.00 per share.

Note that while an offering's size may be decreased by reducing the price per share, the number of shares sold, or a combination of those two techniques, in order to avail such an offering of the Rule of 20s, the aggregate decrease must fall within the 20% safe harbor. Its reach cannot be expanded by applying the 20% first to the price per share and then again to the number of shares sold.

A REMINDER ON THE KEY POINT OF RULE 430A.

Although the 20% safe harbor provided by Rule 430A is useful and can accommodate much needed flexibility on pricing day, it is important to keep in mind that it is not *exclusive*. Should the issuer and the underwriters desire to price a deal outside its range by more than 20% after effectiveness, that still may be possible without the need to file and have declared effective a post-effective amendment. In that case, however, the deal participants will need to be comfortable that the change is not a material change to the disclosure that was in the registration statement and included prospectus at the time of effectiveness.

To maximize flexibility on pricing day, issuers often include a sensitivity analysis with respect to price-dependent information included in the registration statement.¹² Remember, in an IPO, most of the price-related disclosure in the preliminary prospectus delivered to investors is based on the midpoint of the price range. Given that the price range represents a bona fide estimate, there is naturally uncertainty about the actual IPO price come pricing day. To address the disclosure implications of this uncertainty, market practice is to include in the preliminary prospectus a sensitivity analysis with respect to price-related information. A typical approach, for example, in a primary offering is to include in the use of proceeds section disclosure about the impact on the use of proceeds of pricing below the midpoint of the price range, assuming the number of primary shares offered remains the same. Often, an issuer will describe the impact on the use of proceeds of each \$1.00 per share decrease in the estimated offering price. So, to return to our hypothetical, assuming the number of shares offered remains the same, a \$1.00 per share decrease in the estimated offering price would result in \$25.5 million less of gross proceeds (or \$30 million if the over-allotment option is exercised in full). In our hypothetical, if the issuer were using the proceeds to repay debt, that decrease in offering proceeds may result in an additional use of cash to complete the issuer's desired refinancing. To prepare for the desirable problem of pricing above the estimated price

12. Price-dependent information includes the use of proceeds, capitalization, share data and any pro forma information.

range, the issuer will often indicate its plans for the additional proceeds based on \$1.00 per share increments.

THE INTERACTION OF THE PROCEEDS YOU’RE GOING TO RECEIVE
AND THE FEES YOU’RE PAYING THE SEC

Although SEC fees paid in advance of the first filing may seem far removed from pricing day decisions about how many shares, and for how much, to sell in a particular offering, if deal participants do not keep their eyes on this ball when filing the registration statement they may find their hands unexpectedly tied when they get to pricing the offering weeks or months later. This is particularly true if the issuer and underwriters wish to upsize the IPO by increasing the price beyond the range.¹³ Some careful forethought, however, can help avoid that unwanted situation.

Issuers have a couple of choices about how to register shares and pay the corresponding fees. Rule 457(a) permits an issuer to register a particular number of shares and then pay a filing fee to the SEC based on the estimate of the maximum offering price when the registration statement is filed. If this route is chosen, then the issuer does not need to pay any additional filing fees if it increases the offering by increasing the price per share beyond the maximum price in the stated range. If additional shares are registered, however, an additional filing fee must be paid. This is true even if the maximum offering price per share is less than it was originally by this point in the registration process.

Standing in almost the reverse position to Rule 457(a), Rule 457(o) allows an issuer to calculate and pay the fee to register its securities based on the maximum offering proceeds, without regard to number of shares. If the number of shares changes as well as the maximum offering price during the registration process, no additional fees will be required as long as the maximum possible aggregate proceeds does not increase. Should the maximum proceeds increase, then additional fees must be paid before effectiveness. SEC staff interpretation also allows the additional required fees in this circumstance to be paid via a Rule 462(b) automatically effective registration statement, subject to the Rule of 20 limits described above.

When considering how these fee filing rules intersect with the ability to price outside the range or otherwise change your offering size under Rule 430A, the SEC staff has taken the position that when fees are paid based on a number of shares pursuant to Rule 457(a) then when the registrant wishes to upsize pursuant to Rule 430A the 20% safe harbor is calculated on the basis of the price range for which the filing fee was

13. As discussed above, there are not any limits on the issuer’s ability to change the size or price of the offering prior to a registration statement being declared effective. Any changes in the size or price of the offering, however, will need to be incorporated into a pre-effective amendment that reflects the size of the deal being registered. In addition, an additional filing fee may need to be paid.

calculated (even though the price range may have been increased in a subsequent pre-effective amendment for which fees were not required or paid). This could seriously curtail the flexibility otherwise available on the date of pricing. Rule 457(o) does not have this limitation as it requires fees calculated based on the aggregate offering proceeds, and an issuer can also avoid this potential pitfall by voluntarily paying additional fees at any pre-effective point when it is increasing the maximum offering price.

LIABILITY FOR INFORMATION CONVEYED AT TIME OF SALE
VERSUS WHAT'S IN THE REGISTRATION STATEMENT

Rule 430A provides a much needed mechanism for issuers and underwriters to comply with their obligations pursuant to Section 11 of the Securities Act which stipulates that all material information must be in the registration statement at the time of effectiveness. Because the pricing information covered by Rule 430A is allowed to be filed by prospectus after the registration statement is declared effective by the SEC but is then deemed to relate back to the time of effectiveness, the issuer and the underwriters have fully complied with Section 11 in this respect when they comply with Rule 430A.

The SEC made clear with its offering reform package in 2005, however, that liability under Section 12(a)(2) of the Securities Act attaches pursuant to its own terms and particularly to the information conveyed to investors before or at the time the securities are sold. The contents of the effective registration statement may or may not overlap with the information disclosed to investors for Section 12 purposes but the retroactive effect that later-filed prospectuses can have for Section 11 purposes does not carry over for Section 12 liability determinations. The sensitivity analysis discussed above can provide issuers with the disclosure necessary to conclude that a change in the offering price and all the follow-on changes in price-related items don't represent a material change requiring recirculation or other disclosure to the market. Accordingly, disclosure about the uncertainty of pricing in an IPO is an important part of being able to take advantage of the flexibility offered by the Rule of 20s and beyond. By providing investors with information about the potential for pricing-related changes, the issuer can minimize the chance it will have to recirculate a preliminary prospectus and file a post-effective amendment that the SEC would then have to declare effective, which could take up to forty-eight hours or more.¹⁴ The final pricing information, however, must be included in the final prospectus filed with the SEC pursuant to Rule 424(b) under the Securities Act.

14. Although it is beyond the scope of this article, in adopting offering reform, the SEC also allowed a new communication tool called a "free writing prospectus" which meaningfully contributes to an issuer's ability, outside the registration statement, to convey material information prior to the time its securities are sold.

CONCLUSION

The SEC's rules with regard to pricing a securities offering provide important flexibility for an issuer that for market or other reasons needs to make last minute changes in the size and price of its initial public offering. Prior planning coupled with an understanding of those rules can help ensure a smooth pricing day free from unnecessary limitations imposed by the SEC's rules or as a result of inadequate (or missing) disclosure about the impact of a change in estimated price.

