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Public Offerings And Secondary Trading Markets

The purpose of this memorandum is to explain the steps and processes of making a public offering of shares and listing shares on the new stock exchange in order to create a secondary trading market. When an active secondary trading market exists for a company's shares, the company has a greater chance of raising capital and attracting foreign investors. Also, shareholders can use the trading market to sell their shares and achieve "liquidity". Some Armenian companies may not be able to list their shares on the Top Listing Board of the new exchange unless they first make a public offering in order to increase the number of their shareholders and the number of their issued shares. However, almost all companies that are being required to register with the Armenian Securities Commission pursuant to the Armenian securities law will be able to list on the proposed second Listing Board of the new exchange.

The listing rules of the exchange must be established to the satisfaction of the Securities Commission. Typically, listing rules for the top listing boards of exchanges will include minimum requirements related to net worth, profits, financial statements, number of shares and number of shareholders. Another typical requirement is for a minimum "free float". This refers to the total number of shares not owned by either (i) shareholders who own directly and indirectly 10% or more of the class of shares being listed, or (ii) any director or management officer of the company. The reason for a free float requirement is that shares owned by large shareholders and by directors and management officers are not freely tradable in secondary market brokerage transactions, except in very small quantities that can be easily handled in an ordinary brokerage transaction. For this reason, the number of shares available for trading in the secondary market is for all practical purposes not the entire number of issued shares.

When a company wishes to sell new shares to raise capital and to expand its base of shareholders, it can do so by making an initial (i.e., first) public offering ("IPO"). The process requires the use of a Prospectus that must pass through a review process at the Securities Commission and the company will probably use a broker or other financial intermediary to distribute the shares to the public. The Prospectus must comply with the requirements of the Armenian securities law and the additional requirements set forth in regulations of the Securities Commission. The company's financial statements must meet International Accounting Standards.

Financial intermediaries should have a client base that is likely to show interest in the proposed share offering. They should also have skilled staff people who can be helpful to the company in preparing a proper Prospectus. The financial intermediary must meet the

licensing requirements of the Securities Commission.

A financial intermediary may organize a partnership of other intermediaries and brokers to assist in finding buyers for the shares that will be offered. The partnership, called a "syndicate", will have only one purpose and that is to distribute the shares of the company covered by a specified Prospectus. Then the syndicate will terminate.

Companies can negotiate with the intermediary to sell the shares on a "firm commitment" basis or a "best efforts" basis. These transactions are sometimes called "underwritings". A firm commitment underwriting means that the syndicate will buy all of the shares offered by the company and takes the risk of reselling the shares to the public. The underwriting contract will guarantee an agreed price to be paid to the company and an agreed fee or commission to be paid to the syndicate. In a best efforts transaction, the syndicate does not take the risk of selling the shares to the public. The risk remains with the company. The word "underwriting" has historically been used in the insurance industry. When it is used in connection with a public offering, it means that the syndicate, through its agreement with the company, "insures" that all of the shares will be sold by the company.

There are some other slang terms connected with public offerings. When a company makes a public offering, this is a "primary" offering of new shares. If a public offering is made by large shareholders or by directors and management officers, the transaction is called a "secondary" offering. In a primary offering, the company raises new capital. In a secondary offering, it does not. The shareholders receive the money paid for the shares that are sold. A primary and a secondary offering can be combined into one Prospectus and this is called a "combination" offering. As mentioned above, the first or "initial" public offering by a company is an IPO.

When a company makes an IPO it will usually at the same time list all of its shares of common stock, including the new shares that are being sold, on a stock exchange so that secondary market trading will be available to the shareholders after the IPO is completed. Of course, listing is also a possibility without first making an IPO if the company can already meet the exchange listing requirements.

The existence of an active secondary trading market creates a new method for valuing a company. A company will be able to compute its "market capitalization" by multiplying the total number of it shares of issued common stock by the market price per share. Obviously, market capitalization will rise and it will fall, and in a falling market, shareholders will not feel happy and a company will not want to sell new shares. In fact, it may not even be able to sell any new shares.

Shareholders may not always sell their shares in the secondary trading market. In addition to the limitation described above applicable to large shareholders and directors and management officers, no person may buy or sell shares on the basis on "inside information". In simple terms, this is any material information about the company that has not been made public and is not yet generally known to the investing public. Some persons believe that the only safe time for a director or management officer to buy or sell shares in the market is within a short period of time after each public announcement of

quarterly or annual financial information about the company. There can even be situations when these buying and selling "windows" are not safe.

The following sections of this primer describe the typical components of an IPO.

<u>Duties of the Board of Directors:</u> The Board of Directors of a company has many important responsibilities. One of these is the duty to determine the correct capital structure for the company and to take steps to raise additional capital.

If the Board of Directors decides to make a public offering in order to raise additional capital, the chief financial officer should interview several possible financial intermediaries for the job of being the chief underwriter and syndicate manager for the offering. The CFO will make a recommendation to the Board and it will be the Board that makes the final decision on selecting the intermediary. The decision will be entered in the minutes of the Board meeting. The Board will need to meet later to approve specific actions once the details of the financing are known and the Prospectus and underwriting contract have been completed. Among the specific actions on which Board decisions will be needed, with appropriate minutes to be kept, are the calling of a shareholders' meeting to increase the charter capital and the approval of the information statement to be given to shareholders for the meeting, the approval of the registration statement and Prospectus for the public offering before it is submitted to the Securities Commission, the price at which the new shares will be sold in the public offering and the fees and commissions of the financial intermediary and the approval of the listing application to the stock exchange.

<u>Organizing a "Project Group":</u> In consultation with the financial intermediary, the company's chief executive and financial officers and the company's regular lawyer will establish a "project group" and a timetable for implementing the IPO and the stock market listing transaction. Project groups usually include the CFO, the regular company lawyer, sometimes a specialist lawyer from outside the company who is an expert in IPO's, a representative from the company's external auditor and several representatives of the financial intermediary. [If the IPO is will be a combination offering, there will also be a representative of the "selling shareholders" in the project group.]

The project group will conduct its business at "All Hands Meetings". Board members usually do not participate in All Hands Meetings except for limited periods of time in order to answer questions from project group members [usually the members who are not employees of the company]. This question/answer process is part of the "due diligence" for which the project group is responsible.

<u>Restructuring</u>: As part of an IPO project, it would not be unusual for the Board of Directors to consider restructuring the company in order to make it more attractive to potential investors and in this way to make it possible to receive a higher price for the new shares to be sold. Restructuring might, for example, include a plan to close down an unprofitable category of business activity. The Prospectus would describe the plan to close the unprofitable operations and this would naturally be more positive than describing the fact that an unprofitable operation is being continued.

Another type of restructuring that should be considered is the termination of relationships between the company and "interested parties" because of the possibility that potential investors might be uneasy about investing in a company with conflict of interest situations that involve the management. Sometimes it is said that even if these types of relationships are "fair" or priced at "fair value", investors may still be unwilling to take the risk or else they will be unwilling to pay a top price for the IPO shares.

It may also be necessary to eliminate "defensive" arrangements that restrict shareholders' voting rights. For example, the minimum number of shares that is required in order for shareholders to call for a special meeting or to add an item of business to the agenda for a shareholders' meeting should not be too high. Also, it is a good idea to eliminate any arrangements whereby management has taken long-term control of shareholders' voting rights, such as through discretionary voting authorizations for any period extending beyond the next annual shareholders' meeting. [Any share subject to such a long-term authorization would not be part of the "free float" for listing purposes.]

The financial intermediary [or a separate consultant] should be requested to suggest what restructuring steps it believes will make the company and the proposed IPO more attractive.

One technical type of restructuring is required in almost every IPO and that is the adjustment of the capital structure [often by share split up] so that the correct relationship will exist between the number of existing shares and the number of new shares that are going to be offered and sold. The Board of Directors must take action to recommend this type of restructuring to the shareholders because the company's charter may need to be amended in order to complete the capital structure change.

The questions of existing shareholders' preemptive or priority rights to purchase new shares in the IPO must be analyzed as a restructuring step. If a primary purpose of the IPO is to create more "free float" shares, preemptive rights will hinder that purpose. The shareholders may need to vote to give up their preemptive rights, at least in connection with the IPO.

<u>Securities Law:</u> In accordance with the securities law, the Securities Commission may permit the proposed Prospectus to become "effective" after a review process, and the Commission and the securities exchange may also approve any listing application process. These steps require coordination because the timing of bringing an IPO to market may be of critical importance. The financial intermediary will provide advice to the company on this particular point.

The project group must be made aware of all applicable disclosure requirements of the securities law and the Securities Commission regulations. Based on this knowledge, its task is to prepare a Prospectus that is compliant with these requirements and that also is easy to read and interesting to prospective investors. Serious effort must be made to use "plain talk" rather than legal jargon. A most important writing principle is to discuss everything that is important, whether there is a specific disclosure requirement or not. If this principle is ignored, the Prospectus may be considered false and misleading, and the

directors and executive officers, the financial intermediary and controlling shareholders can have personal liability for any damage caused to investors.

Contract with Financial Intermediary: In a firm-commitment underwriting, the underwriting agreement or contract will be signed by the company and the financial intermediary. Signing will be after the parties reach agreement on the share price for the shares being offered and on the compensation and expenses of the syndicate. The intermediary will sign for itself and on behalf of the syndicate. The negotiation on "pricing" will usually occur at or near the time that the Prospectus becomes effective after the regulatory review process. The listing application process will be coordinated to be completed at about the same time.

Market Price: The negotiated price for newly issued shares being sold in an IPO is thought of as a "fair market price". This price is almost never "par" or "face" or "nominal" or "book" value. If it is one of these values, then it should be purely a coincidence that the fair market price happens to be that amount. The goal of the Board, and indeed its duty, is to set the IPO price at fair market value negotiated with an independent financial intermediary (i.e., not affiliated with the company).

Closing: The final event of the IPO and listing process is the "closing" of the transaction. In the case of an IPO, this is a meeting between the representatives of the company and the representatives of the financial intermediary for the purpose of confirming that [i] the shares that have been sold have actually been registered in the name of the financial intermediary or its nominee, and [ii] the agreed purchase price has actually been transferred to the company's bank account. Other legal details to be completed as part of the closing will be included in the Purchase or Underwriting Agreement. When all these details have taken place and been confirmed to the satisfaction of both parties, then the Closing of the IPO is said to occur and the contract is considered to have been performed by the parties. Board members often attend the final stages of the Closing process, as well as any formal listing ceremony at the stock exchange. Later the same day there is often a gathering where these events are celebrated with speeches, toasts and a good meal. Indeed, an IPO and a stock exchange listing are very important events for a company and its management.