



Sample content from Solomon Exam Prep *Series 79* *Online Exam Simulator and Supplementary Guide*

Pipe transactions

PIPE (Private Investment in Public Equity) transactions are when public companies raise funds by selling shares in a private offering. Because a PIPE transaction is a private offering, the company does not need to file a registration statement before the deal closes. Most companies typically register the offering after the deal closes, however, so that investors will not be subject to resale restrictions. After the PIPE transaction, a company typically files an 8-K form to alert their shareholders, the public, and the SEC of the transaction. Because a PIPE transaction can have a dilutive effect on the earnings per share, NASDAQ requires issuers to file a notification form within 10 days of the closing if the transaction resulted in an increase of 5% or more of the shares outstanding. There is no limit on how many shares can be sold in a PIPE transaction. NASDAQ and the exchanges require that if a company sells more than 20% of its outstanding common stock in a PIPE transaction, the shares must be sold at or above the fair market price unless the company obtains shareholder approval. If a company is not selling more than 20% of its outstanding common stock, the shares can be sold at either above or below the market price.

Issuer and shareholder lock-up agreements

At the time of a public offering, underwriters typically require insiders and early investors to sign a so-called **lock-up agreement** that prohibits them from selling shares for a specific period of time, often 180 days. The underwriter requires such lock-up agreements in order to prevent insiders from quickly profiting from a public offering before the market has had time to value the shares. Lock-up provisions are not required by federal law and underwriters may waive lock-up provisions. Upon lock-up expiration share prices typically drop, often dramatically, as the supply of available shares expands.

SEC Forms for Registration Statements

The SEC offers standard forms for companies to use to file their Registration Statement. These forms can be filed electronically for submission on the SEC's Electronic Data-Gathering Analysis Retrieval (EDGAR) system. Form S-1 is the general registration form, Form S-3 is the simplified form, Form S-4 is used with exchange offers. Form S-8 is used to register securities being offered to a company's employees. Foreign companies use either an F-1 or an F-3 form.



Form S-1 is a registration statement that must be filed with the SEC prior to the registration and offering of new equity securities. S-1 forms are used for all initial public offerings or new small, unseasoned reporting companies that are issuing new securities. The S-1 form requires a full prospectus which includes extensive information about the corporation. The SEC does allow small, reporting companies to reference other SEC documents in their S-1 form, but the information must be available on the issuer's website. An underwriting discount is included in an S-1 form.

An **S-3 form** is the most simplified registration form. Issuers must be a US domestic issuer, and must have made all their other required filings in a timely manner. The S-3 form is commonly used for shelf registrations. Issuers must have a history with the SEC to use the S-3 form. The S-3 form is briefer, and therefore much more desirable than the S-1 form. The S-3 form is used for large, seasoned companies that already report to the SEC. These companies must have a public float of at least \$75 million. The public float is the total market value of a company's stock not held by insiders or affiliates. The S-3 form allows a briefer prospectus that only describes the particular offering, and issuers simply refer to annual reports and other reporting documents that have already been filed.

Form S-4 is used to register securities with the SEC in connection with a business combination or exchange offer. The S-4 is filed by the acquirer when the acquirer issues securities to pay for the acquisition. The S-4 form is used to file the registration statement/prospectus for these new securities. The securities could be equity or debt. An S-4 form contains loads of information including the amount an investor will receive in stock of the combined companies and/or cash for their shares. It also includes instructions and deadlines for voting, and whether the transaction will be taxable to the investor. The S-4 also contains executive compensation details, text of the merger agreement, risk factors of the deal, a question and answer section, and financial information on the merger. The S-4 is signed by the registrant, its principal executive officer or officers, its principal financial officer, and its controller or principal accounting officer, and by at least a majority of the board of directors or persons performing similar functions.

The **S-8 form** is used for employee stock purchase plans.

Shelf Registrations

An issuer may file a **shelf registration** when the market conditions are not favorable for an initial public offering to occur. Using a shelf registration, an issuer may carry out all the necessary registration procedures ahead of time, and put them on a "shelf" until the market conditions become more favorable. A shelf registration is permitted under SEC Rule 415 in certain situations. There is an advantage to filing in advance; the issuer may be able to time the public offering for when market conditions are most favorable, getting a better price for securities offered. The public offering must be made within three years of filing a shelf registration depending (two years for securities issued through a business combination). S-3 filers can check a box on the form to file an **automatic shelf registration**, allowing an automatic three-year shelf registration. A shelf registration can be used for both equity and debt securities.



ADRs and GDRs

ADR is an acronym for **American Depositary Receipt**. ADRs represent ownership in shares of foreign stock that trade in US markets. ADRs allow investors to purchase foreign investments without having to transact business in another country. Investors benefit from the simplicity of purchasing ADRs because ADRs trade in the US market in US dollars, with all dividends being converted to US dollars. ADRs are subject to currency risk because dividends are converted to US dollars. Dividends from ADRs are subject to US income tax. Some disadvantages of ADRs include fees and expenses that can be charged by depository banks, as well as the longer time that investors have to wait to get information.

ADRs allow United States stock exchanges to trade foreign stocks. The underlying shares represented by the ADR are the American Depositary Shares (ADSs). Global Depositary Receipts (GDRs) and Global Depositary Share (GDSs) involve the trading of stocks on foreign exchanges.

Un-sponsored ADRs are often issued by more than one depository bank with each depository bank responsible for only the shares that it issues. The depository bank has no formal agreement with the foreign company that has issued the underlying foreign stock. Un-sponsored shares trade on the OTC market, and recently have become more popular. In contrast, **sponsored ADRs** are issued by one US depository bank that has a formal agreement with the foreign company to act as the depository bank for foreign stock. The bank receives the dividends for the stock and converts them to US dollars, and distributes them to the holders in the US. The US bank acts as transfer agent for the ADRs, by recording trades among US investors. Sponsored ADRs typically have voting rights associated with them, but un-sponsored ADRs typically do not.



Practice Questions and Rationales

1. **Switching accounting methods from straight-line depreciation to accelerated depreciation in the first year of an asset's life will have which of the following effects?**

- I. it will increase earnings
 - II. it will decrease earnings
 - III. it will have no effect on EBITDA
 - IV. it will increase EBITDA
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- A. II and III
 - B. I and IV
 - C. II and IV
 - D. I and III

Correct Answer: A

Rationale: Switching accounting methods from straight line depreciation to accelerated depreciation in the first year of an asset's life will decrease earnings because more depreciation expenses will be taken out of earnings. It will have no effect on EBITDA because depreciation expenses are included in EBITDA so it does not matter if the size of the depreciation expenses changes.

2. **Imagine that you are an investor and you want to calculate the WACC of a particular stock to compare it to other investments. Given the S&P 500 returns 10.5%, the stock's beta is 1.25, and the rate on Treasury bills is 4.0%, what is the stock's WACC.**

- A. 8.13%
- B. 12.13%
- C. 13.13%
- D. 17.13%

Correct Answer: B

Rationale: The WACC is the Weighted Average Cost of Capital and it measures the opportunity cost of capital of an investment. Generally, the WACC includes the cost of debt and the cost of equity, but in this question no



debt is mentioned so WACC is assumed to be equal to the cost of equity. The Cost of Equity can be calculated using the Capital Asset Pricing Model.

Cost of Equity Capital = Risk-Free Rate + (Beta x Market Risk Premium).

In this case, the Risk-Free Rate = Treasury Bills at 4.0%. The Market Risk Premium = Market Rate - Risk-free Rate. In this case, the Market Risk Premium = S & P 500 - Treasury Bills Rate = 10.5 - 4 = 6.5.

Putting it all together, The Cost of Equity = $4.0 + (1.25 \times 6.5) = 12.13\%$

3. **When acting in the capacity of Manager or Co-Manager of an offering, a research analyst may not make a public appearance or publish a research report in all of the following instances EXCEPT:**
- A. For 25 calendar days following an Initial Public Offering (IPO)
 - B. All of the following choices are true
 - C. For ten calendar days following a secondary offering
 - D. Within 15 days of the expiration of a lock-up agreement

Correct Answer: A

Rationale: NASD Rule 2711(f) and NYSE Rule 472(f) state that a member may not distribute a research report and a research analyst that has acted as manager or co-manager may not make a public appearance for 40 days after an IPO or ten days after a secondary offering. For underwriters and dealers that are not managers or co-managers, they must wait 25 days before making a public appearance or distributing a research report. If a member terminates research coverage of a company, they must give notice and complete a final research report of the same scope if possible.

In addition to everything else, Rule 2711(f) holds that "No member that has acted as a manager or co-manager of a securities offering may publish or otherwise distribute a research report or make a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering. This paragraph will not prevent a member from publishing or otherwise distributing a research report concerning the effects of significant news or a significant event on the subject company within such period, provided legal or compliance personnel authorize publication of that research report before it is issued. In addition, this paragraph shall not apply to the publication or distribution of a research report pursuant to SEC Rule 139 regarding a subject company with 'actively traded securities,' as defined in Regulation M, 17 CFR 242.101(c)(1), or to a public appearance concerning such a subject company."