Chapter 20
Issuing Securities to the Public

Multiple Choice Questions

1. An equity issue sold directly to the public is called:
A. a rights offer.
B. a general cash offer.
C. a restricted placement.
D. a fully funded sales.
E. a standard call issue.

2. An equity issue sold to the firm's existing stockholders is called:
A. a rights offer.
B. a general cash offer.
C. a private placement.
D. an underpriced issue.
E. an investment banker's issue.

3. Management's first step in any issue of securities to the public is:
A. to file a registration form with the SEC.
B. to distribute copies of the preliminary prospectus.
C. to distribute copies of the final prospectus.
D. to obtain approval from the board of directors.
E. to prepare the tombstone advertisement.

4. A rights offering is:
A. the issuing of options on shares to the general public to acquire stock.
B. the issuing of an option directly to the existing shareholders to acquire stock.
C. the issuing of proxies which are used by shareholders to exercise their voting rights.
D. strictly a public market claim on the company which can be traded on an exchange.
E. the awarding of special perquisites to management.

5. Companies use tombstone advertisements in the financial press to:
A. announce the death of the company.
B. announce the failure of a financial strategy.
C. announce the availability of a new issue of a corporate security.
D. notify the public of foreclosure.
E. None of the above.

6. The first public equity issue made by a company is a(n):
A. initial private offering.
B. initial public offering.
C. secondary offering.
D. seasoned new issue.
E. None of the above.

7. The first public equity issue that is made by a company is referred to as:
A. a rights issue.
B. a general cash offer.
C. an initial public offering.
D. an unseasoned issue.
E. Both C and D.

8. A new public equity issue from a company with equity previously outstanding is called a(n):
A. initial public offering.
B. seasoned equity issue.
C. unseasoned equity issue.
D. private placement.
E. syndicate.

9. The green shoe option is used to:
A. cover oversubscription.
B. cover excess demand.
C. provide additional reward to the investment bankers for a risky issue.
D. provide additional reward to the issuing firm for a risky issue.
E. Both A and B.

10. Dilution refers to:
A. the increase in stock value due to wider ownership of stock.
B. the loss in existing shareholder's equity.
C. the loss in new shareholder's equity.
D. the loss in all shareholder's equity, both existing shareholders and new shareholders.
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11. During the SEC waiting period the potential issuing company can issue a preliminary prospectus which contains:
A. exactly the same information as the final prospectus except an indication of SEC approval.
B. all the information as the final prospectus including red writing stating it is a red herring.
C. very limited financial information and red writing stating it is preliminary.
D. only a description of what the funds are to be used for.
E. information very similar to the final prospectus without a price nor with SEC approval.

12. A company must file a registration statement with the SEC providing various financial and company history information. The registration statement does not need to be filed if:
A. the issue is less than $50 million.
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C. the issue is less than $5.0 million.
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13. Regulation A security issues are exempt from full SEC registration filing and use only a brief offering statement if:
A. the issue is for less than $5,000,000.
B. insiders sell no more than $1,500,000 of stock.
C. insiders sell no more than 100,000,000 shares.
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14. Potential investors learn of the information concerning the firm and its new issue from the:
A. pre-underwriting negotiating meeting.
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16. Investment banks perform which of the following services for corporate issuers:
A. formulating the method used to issue the securities.
B. pricing the new securities.
C. selling the new securities.
D. All of the above.
E. None of the above.

17. A group of investment bankers who pool their efforts to underwrite a security are known as a(n):
A. amalgamate.
B. conglomerate.
C. green shoe group.
D. klatch.
E. syndicate.

18. A firm commitment arrangement with an investment banker occurs when:
A. the syndicate is in place to handle the issue.
B. the spread between the buying and selling price is less than one percent.
C. the issue is solidly accepted in the market evidenced by a large price increase.
D. when the investment banker buys the securities for less than the offering price and accepts the risk of not being able to sell them.
E. when the investment banker sells as much of the security as the market can bear without a price decrease.

19. Which of the following is not normally an example of the services offered by investment bankers?
A. Aiding in the sale of securities
B. Facilitating mergers
C. Acting as brokers to both individuals and institutional clients
D. Offering checking accounts to corporations
E. Both C and D

20. In a best efforts offering the investment banker makes their money primarily by:
A. earning the spread between the buying and offering price.
B. earning a commission on each share sold.
C. earning the discount between the buying and offering price.
D. charging a flat fee for all services.
E. None of the above.

21. Under the _____ method, the underwriter buys the securities for less than the offering price and accepts the risk of not selling the issue, while under the _____ method, the underwriter does not purchase the shares but merely acts as an agent.
A. best efforts; firm commitment
B. firm commitment; best efforts
C. general cash offer; best efforts
D. competitive offer; negotiated offer
E. seasoned; unseasoned

22. Professor Jay Ritter found best-efforts offerings are:
A. reserved for the premier customers because they deserve 'best-efforts'.
B. used most often with seasoned equity issues.
C. used with small IPO issues.
D. attractive because of price stability.
E. None of the above.

23. Empirical evidence suggests that new equity issues are generally:
A. priced efficiently by the market.
B. overpriced by investor excitement concerning a new issue.
C. overpriced resulting from SEC regulation.
D. underpriced, in part, to counteract the winner's curse.
E. underpriced resulting from SEC regulation.

24. The diagonal listing of investment bankers on tombstone advertisements reflects their ____ relative to the other investment bankers listed below.
A. prestige
B. ability to manage selling syndicates
C. role as a firm commitment buyer
D. role as a best efforts seller
E. None of the above

25. The reputational capital of investment bankers is based on their roles as intermediaries with more in-depth knowledge of the issuer. Investment bankers maintain their reputation by:
A. certifying the issue.
B. monitoring the issuing firm's management and performance.
C. pricing issues fairly.
D. All of the above.
E. None of the above.

26. The key difference between a negotiated offer and a competitive offer is that:
A. the underwriters can not set the spread in a negotiated bid but can in a competitive offer.
B. the issuing firm can offer its securities to the highest bidder in a competitive bid but in a negotiated bid only one investment banker is used.
C. the issuing firm works the underwriter for the best spread in a negotiated bid which will be less than that available in a competitive offer.
D. the underwriter will not do a full investigation in a negotiated bid because the company is at their mercy, while in a competitive bid the underwriter must be extra diligent.
E. None of the above.

27. The offering price is set to make an issue attractive to the market and provide a good price to the issuer. Which of the following is/are true?
A. Empirical studies by Ritter have shown that the average firm commitments have had a 17.8% underpricing on the first day of trading.
B. Empirical studies have shown that best efforts sales have underpricing on the first day of trading.
C. Some issues which rose dramatically on the first day of trading were viewed as successfully priced by the underwriter because it helped build a long-term investment base.
D. All of the above.
E. None of the above.

28. Empirical evidence suggests that upon announcement of a new equity issue, current stock prices generally:
A. drop, perhaps because the new issue reflects management's view that common stock is currently overvalued.
B. remain about the same since an efficient market anticipates a new equity issue.
C. increase, perhaps because the issues are associated with positive NPV projects.
D. increase, because the market supply is always less than demand.
E. increase, because underwriters exercise their green shoe option.

29. Underpricing can possibly be explained by:
A. oversubscription of an issue.
B. strong demand by investors.
C. undersubscription of an issue.
D. Both B and C.
E. Both A and B.

30. Debt capacity is often given as a reason for the value of the stock falling when equity is issued. The reason for this is:
A. the high issue costs of a debt offering must be paid by the shareholders.
B. the priority position of the equity is lowered.
C. management has information that the probability of default has risen, limiting the debt capacity and causing the firm to raise equity capital.
D. All of the above.
E. None of the above

31. A study by Lee, Lockhead, Ritter, and Zhao that examined the underwriting discount and other direct costs of going public with a debt or equity offering, found:
A. the direct expenses are higher for equity than debt offerings.
B. substantial economies of scale are prevalent.
C. underpricing, on average, is similar in magnitude to total direct expenses.
D. All of the above.
E. None of the above.

32. The six components that make up the total costs of new issues are:
A. the spread; other direct expenses such as filing fees; indirect expenses such as management time; economies of scale; abnormal returns and the Green Shoe option.
B. the discount; other direct expenses such as filing fees; indirect expenses such as management time; due diligence costs; abnormal returns and the Green Shoe option.
C. the spread; other direct expenses such as filing fees; indirect expenses such as management time; abnormal returns; underpricing and the Green Shoe option.
D. the spread; other direct expenses such as filing fees; economies of scale; due diligence costs; abnormal returns and underpricing.
E. None of the above.

33. In comparison to debt issuance expenses, the total direct costs of equity issues are:
A. considerably less.
B. about the same.
C. meaningless.
D. considerably greater.
E. None of the above.

34. To determine the value of a rights offering, the stockholder needs to know the following two pieces of information in addition to the current stock price:
A. the subscription price and the number of rights needed to acquire a new share.
B. the amount of new equity to be raised and the number of rights needed to acquire a new share.
C. the amount of new equity to be raised and standby fee.
D. the detachment date and the subscription price.
E. None of the above.

35. Assuming everything else is constant, when a stock goes ex-rights its price should:
A. decrease since the stockholder is losing an option.
B. increase since the corporation no longer has the right to force the stockholder to convert.
C. remain the same since an efficient market would anticipate this change.
D. move up or down depending on whether a small investor wanted to exercise his/his rights.
E. None of the above.

36. If a shareholder or investor wants to acquire new stock under a rights plant they must:
A. acquire new stock in the market to get a controlling fraction of shares to be eligible for rights.
B. simply pay a registration fee and turn in the subscription price.
C. acquire the correct rights per share desired, then turn the rights and the total subscription price into the subscription agent.
D. acquire the correct rights and wait for the company to send you the stock.
E. call their broker and sell some CBOE options to make any money.

37. Which of the following statements is true?
A. The subscription price is generally above the old stock price.
B. The subscription price is generally above the ex-rights price.
C. The subscription price is generally below the old stock price.
D. Both A and B.
E. Both B and C.

38. A shareholder who has rights is:
A. always better off to exercise the rights.
B. always better off to sell the rights into the market.
C. able to exercise their rights or sell them.
D. never in the same ownership position again with rights.
E. None of the above.

39. A standby underwriting arrangement provides the:
A. company with methods to cancel the offering.
B. company with an alternate investment banker if there is conflict between the issuer and the agent.
C. investment banker with an oversubscription privilege to ensure profits are earned.
D. company with an alternative avenue of sale to ensure success of the rights offering.
E. investment bankers with an added syndication for the rights offering.

40. Professor Clifford W. Smith, in evaluating issuance costs from underwritten issues, rights issues with standby underwriting, and a pure rights issues, found that 90% of the issues are underwritten, which was the most expensive method. This is done because:
A. investment bankers know more than CFOs and they may buy the issue at an agreed upon price and disburse the funds sooner.
B. investment bankers can increase the price received by increasing confidence in the issue, and they will buy the issue at an agreed upon price and disburse the cash sooner.
C. investment bankers provide other services including price counseling, increasing public confidence, and providing funds to the issuer sooner.
D. investment bankers know how to price the issue, and would not need to set as low as a price as the subscription price and provide price counseling.
E. None of the above.

41. Corporations use the shelf registration method of security sales because:
A. preregistered securities can be quickly brought to market.
B. the main registration process is eliminated for up to two years.
C. their stock is below investment grade.
D. Both A and B.
E. Both B and C.

42. In terms of costs of issuing equity, Professor Clifford W. Smith finds that the ranking of methods, from cheapest to most expensive, is:
A. rights issue with standby underwriting, equity issue with underwriting, pure rights issue.
B. pure rights issue, rights issue with standby underwriting, equity issue with underwriting.
C. pure rights issue, preferred stock and debt issue with underwriting for an IPO, rights issue with standby underwriting.
D. equity issue with underwriting, rights issue with standby underwriting, pure rights issue.
E. equity issue with underwriting, pure rights issue, rights issue with standby underwriting.

43. Arguments to explain why most equity issues are underwritten versus sold through a rights offering are:
A. underwriters buy at an agreed upon price and bear some risk of selling the issue.
B. cash proceeds are available sooner in underwriting and the issue is available to a wider market.
C. investment bankers can provide market advice and certify the issue for potential investors.
D. All of the above.
E. None of the above.

44. Corporations are allowed to use the shelf registration method if they:
A. are rated investment grade and have aggregate market stock value of more than $150 million.
B. have not violated the 1934 Securities Act in the past 12 months.
C. have not defaulted on its debt in the past 3 years.
D. All of the above.
E. None of the above.

45. Arguments against the use of the shelf-registration are:
A. only technology and manufacturing-based firms can use it.
B. less current information available to investors might raise the cost of debt.
C. possible market overhang from future issues depressing price.
D. Both A and C.
E. Both B and C.

46. The market for venture capital refers to the:
A. private financial marketplace for servicing small, young firms.
B. bond markets.
C. market for selling rights to individuals who already own shares.
D. market for selling equity securities for firms with equity already outstanding.
E. None of the above.

47. Rule 144A provides the framework for the issuance of private securities to qualified institutional investors. To buy private securities, institutional investors:
A. must be willing to hold a less liquid security and manage a fund.
B. must be willing to make a market in the security and be a primary market dealer.
C. must be a limited partner in the issue and willing to reduce the illiquidity of the security.
D. must be willing to hold a less liquid security and have $100 million under management.
E. None of the above.

48. Venture capitalists provide financing for new firms from the seed and start-up stage all the way to mezzanine and bridge financing. In exchange for financing, entrepreneurs give:
A. a high interest rate debt instrument and control.
B. an equity position and usually board of director positions.
C. up the right to have an initial public offering.
D. control to a court appointed trustee.
E. the venture capitalists jobs as CEOs and CFOs.

49. An IPO of a firm formerly financed by venture capital is carried out for what primary purposes?
A. Insiders can sell their shares or cash out
B. Generate cash to pay down bank indebtedness
C. To establish a market value for the equity and provide funds for operations
D. All of the above.
E. None of the above.

50. Which of the following is not one of the four main functions that underwriters provide?
A. Risk bearing
B. Marketing
C. Auditing the financial statements
D. Certification
E. Monitoring

51. Types of dilution include:
A. dilution of percentage ownership
B. dilution of market share
C. dilution of book value and earnings per share
D. A and C
E. All of the above

52. The Wordsmith Corporation has 10,000 shares outstanding at $30 each. They expect to raise $150,000 by a rights offering with a subscription price of $25. How many rights must you turn in to get a new share?
A. 0.60
B. 1.20
C. 1.67
D. 2.00
E. Insufficient data to determine

53. Assuming everything else is constant, if a stock's old price is $25 and the ex-rights or new stock price is $19, then the value of the right is:
A. $-6.
B. $6.
C. impossible to determine without the subscription price.
D. impossible to determine without the number of rights needed to buy one share.

54. The LaPorte Corporation has a new rights offering that allows you to buy one share of stock with 3 rights and $20 per share. The stock is now selling ex-rights for $26. The price rights-on is:
A. $22.00
B. $24.00
C. $26.00
D. $28.00
E. impossible to determine without the cum-rights price.

55. Regional Power wants to raise $10 million in new equity. The subscription price is $20. There are currently 3 million shares outstanding, each with 1 right. How many rights are needed to purchase 1 share?
A. 1
B. 3
C. 5
D. 6
E. 8

56. The Overland Corporation intends to issue 50,000 new shares to raise funds for expansion of current plant facilities. The current share price is $40 and there are 500,000 shares outstanding. The number of rights needed to buy a share of stock should be:
A. 1
B. 10
C. 40
D. 400
E. indeterminate without the subscription price.

57. The Schroeder Corporation has 20,000 shares outstanding at $20 each. They expect to raise $200,000 by a rights offering with a subscription price of $25. How many rights must you turn in to get a new share?
A. 1.25
B. 1.50
C. 2.00
D. 2.50
E. Insufficient data to determine

58. Assuming everything else is constant, if a stock's old price is $40 and the ex-rights or new stock price is $32, then the value of the right is:
A. $-8.
B. $8.
C. impossible to determine without the subscription price.
D. impossible to determine without the number of rights needed to buy one share.

59. The Holly Corporation has a new rights offering that allows you to buy one share of stock with 4 rights and $25 per share. The stock is now selling ex-rights for $30. The price rights-on is:
A. $21.00
B. $25.00
C. $30.00
D. $31.25
E. impossible to determine without the cum-rights price.

60. Bradley Power wants to raise $40 million in new equity. The subscription price is $25. There are currently 5 million shares outstanding, each with 1 right. How many rights are needed to purchase 1 share?
A. 1.000
B. 3.000
C. 3.125
D. 4.525
E. 6.525

61. The Shields Corporation intends to issue 100,000 new shares to raise funds for expansion of current plant facilities. The current share price is $20 and there are 500,000 shares outstanding. The number of rights needed to buy a share of stock should be:
A. 1
B. 5
C. 20
D. 50
E. indeterminate without the subscription price.

62. For a particular stock the old stock price is $20, the ex-rights price is $15, and the number of rights needed to buy a new share is 2. Assuming everything else constant, the subscription price is ______ .
A. $5
B. $13
C. $17
D. $18
E. $20

Essay Questions

The Holyoke Corporation has 120,000 shares outstanding with a current market price of $8.10 per share. The company needs to raise an additional $36,000 to finance new expenditures, and has decided on a rights issue. The issue will allow current stockholders to purchase one additional share for 20 rights at a subscription price of $6 per share.

63. Calculate the ex-rights price that would make a new stockholder indifferent between buying shares at the old stock price and exercising the rights or buying the shares ex-rights.

64. If the ex-rights price were set at $7.90, would you as a potential new stockholder choose to buy shares ex-rights or buy shares at the old price and exercise your rights?

65. Suppose that the company was also considering structuring the rights issue to allow for an additional share to be purchased for 10 rights at a subscription price of $3. Prove that a stockholder with 100 shares would be indifferent between purchasing a new share for 10 rights at $3 or purchasing a new share for 20 rights at $6.

66. Explain the advantages of a shelf-registration to an issuer. How can timeliness of disclosure and a potential market overhang work against a shelf-registration?

67. The evidence on IPO sales is varied from issue to issue, but there are three common themes; underpricing, underperformance, and the reasons for going public. Explain these three themes.

68. The Direct Interactive Publishing Company is planning to raise $200 million dollars in new capital. There are currently 50 million shares outstanding with an estimated market price of $60 each. The corporate officers are debating whether to use a rights offering (with or without a standby underwriting) or have the issue fully underwritten. The company is currently listed on a regional exchange and plans to list on a national exchange after the security issue. List and explain three advantages/disadvantages of each method.

69. Discuss what a Dutch auction is and how it works.

70. Lamar Inc. is attempting to raise $5,000,000 in new equity with a rights offering. The subscription price will be $40 per share. The stock currently sells for $50 per share and there are 250,000 shares outstanding. How many rights are needed to buy a new share?

71. Lamar Inc. is attempting to raise $5,000,000 in new equity with a rights offering. The subscription price for the 125,000 new shares will be $40 per share. The stock currently sells for $50 per share and there are 250,000 shares outstanding. What will the price per share be if all rights are exercised?

Chapter 20 Issuing Securities to the Public Answer Key

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Topic: EQUITY ISSUE
Type: DEFINITIONS

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Topic: SEASONED EQUITY OFFERING
Type: DEFINITIONS

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Topic: GREEN SHOE PROVISION
Type: DEFINITIONS

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Topic: PROSPECTUS
Type: CONCEPTS

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Type: CONCEPTS

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Type: CONCEPTS

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Topic: INVESTMENT BANKER SERVICES
Type: CONCEPTS

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Topic: INVESTMENT BANKER SYNDICATE
Type: CONCEPTS

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Type: CONCEPTS

20. In a best efforts offering the investment banker makes their money primarily by:
A. earning the spread between the buying and offering price.
B. earning a commission on each share sold.
C. earning the discount between the buying and offering price.
D. charging a flat fee for all services.
E. None of the above.

Difficulty level: Medium
Topic: BEST EFFORTS
Type: CONCEPTS

21. Under the _____ method, the underwriter buys the securities for less than the offering price and accepts the risk of not selling the issue, while under the _____ method, the underwriter does not purchase the shares but merely acts as an agent.
A. best efforts; firm commitment
B. firm commitment; best efforts
C. general cash offer; best efforts
D. competitive offer; negotiated offer
E. seasoned; unseasoned

Difficulty level: Easy
Topic: FIRM COMMITMENT AND BEST EFFORTS
Type: CONCEPTS

22. Professor Jay Ritter found best-efforts offerings are:
A. reserved for the premier customers because they deserve 'best-efforts'.
B. used most often with seasoned equity issues.
C. used with small IPO issues.
D. attractive because of price stability.
E. None of the above.

Difficulty level: Medium
Topic: EMPIRICAL EVIDENCE - SMALL IPOS
Type: CONCEPTS

23. Empirical evidence suggests that new equity issues are generally:
A. priced efficiently by the market.
B. overpriced by investor excitement concerning a new issue.
C. overpriced resulting from SEC regulation.
D. underpriced, in part, to counteract the winner's curse.
E. underpriced resulting from SEC regulation.

Difficulty level: Easy
Topic: EMPIRICAL EVIDENCE - UNDERPRICING
Type: CONCEPTS

24. The diagonal listing of investment bankers on tombstone advertisements reflects their ____ relative to the other investment bankers listed below.
A. prestige
B. ability to manage selling syndicates
C. role as a firm commitment buyer
D. role as a best efforts seller
E. None of the above

Difficulty level: Medium
Topic: UNDERWRITER REPUTATION
Type: CONCEPTS

25. The reputational capital of investment bankers is based on their roles as intermediaries with more in-depth knowledge of the issuer. Investment bankers maintain their reputation by:
A. certifying the issue.
B. monitoring the issuing firm's management and performance.
C. pricing issues fairly.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: UNDERWRITER REPUTATION
Type: CONCEPTS

26. The key difference between a negotiated offer and a competitive offer is that:
A. the underwriters can not set the spread in a negotiated bid but can in a competitive offer.
B. the issuing firm can offer its securities to the highest bidder in a competitive bid but in a negotiated bid only one investment banker is used.
C. the issuing firm works the underwriter for the best spread in a negotiated bid which will be less than that available in a competitive offer.
D. the underwriter will not do a full investigation in a negotiated bid because the company is at their mercy, while in a competitive bid the underwriter must be extra diligent.
E. None of the above.

Difficulty level: Easy
Topic: TYPES OF OFFERINGS
Type: CONCEPTS

27. The offering price is set to make an issue attractive to the market and provide a good price to the issuer. Which of the following is/are true?
A. Empirical studies by Ritter have shown that the average firm commitments have had a 17.8% underpricing on the first day of trading.
B. Empirical studies have shown that best efforts sales have underpricing on the first day of trading.
C. Some issues which rose dramatically on the first day of trading were viewed as successfully priced by the underwriter because it helped build a long-term investment base.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: EMPIRICAL EVIDENCE - INITIAL PUBLIC OFFERINGS
Type: CONCEPTS

28. Empirical evidence suggests that upon announcement of a new equity issue, current stock prices generally:
A. drop, perhaps because the new issue reflects management's view that common stock is currently overvalued.
B. remain about the same since an efficient market anticipates a new equity issue.
C. increase, perhaps because the issues are associated with positive NPV projects.
D. increase, because the market supply is always less than demand.
E. increase, because underwriters exercise their green shoe option.

Difficulty level: Easy
Topic: EMPIRICAL EVIDENCE - NEW EQUITY ISSUES
Type: CONCEPTS

29. Underpricing can possibly be explained by:
A. oversubscription of an issue.
B. strong demand by investors.
C. undersubscription of an issue.
D. Both B and C.
E. Both A and B.

Difficulty level: Easy
Topic: UNDERPRICING
Type: CONCEPTS

30. Debt capacity is often given as a reason for the value of the stock falling when equity is issued. The reason for this is:
A. the high issue costs of a debt offering must be paid by the shareholders.
B. the priority position of the equity is lowered.
C. management has information that the probability of default has risen, limiting the debt capacity and causing the firm to raise equity capital.
D. All of the above.
E. None of the above

Difficulty level: Medium
Topic: EMPIRICAL EVIDENCE - INFORMATION
Type: CONCEPTS

31. A study by Lee, Lockhead, Ritter, and Zhao that examined the underwriting discount and other direct costs of going public with a debt or equity offering, found:
A. the direct expenses are higher for equity than debt offerings.
B. substantial economies of scale are prevalent.
C. underpricing, on average, is similar in magnitude to total direct expenses.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: EMPIRICAL EVIDENCE - COSTS OF GOING PUBLIC
Type: CONCEPTS

32. The six components that make up the total costs of new issues are:
A. the spread; other direct expenses such as filing fees; indirect expenses such as management time; economies of scale; abnormal returns and the Green Shoe option.
B. the discount; other direct expenses such as filing fees; indirect expenses such as management time; due diligence costs; abnormal returns and the Green Shoe option.
C. the spread; other direct expenses such as filing fees; indirect expenses such as management time; abnormal returns; underpricing and the Green Shoe option.
D. the spread; other direct expenses such as filing fees; economies of scale; due diligence costs; abnormal returns and underpricing.
E. None of the above.

Difficulty level: Medium
Topic: TOTAL COSTS OF A NEW ISSUE
Type: CONCEPTS

33. In comparison to debt issuance expenses, the total direct costs of equity issues are:
A. considerably less.
B. about the same.
C. meaningless.
D. considerably greater.
E. None of the above.

Difficulty level: Medium
Topic: DIRECT COSTS OF EQUITY OFFERING
Type: CONCEPTS

34. To determine the value of a rights offering, the stockholder needs to know the following two pieces of information in addition to the current stock price:
A. the subscription price and the number of rights needed to acquire a new share.
B. the amount of new equity to be raised and the number of rights needed to acquire a new share.
C. the amount of new equity to be raised and standby fee.
D. the detachment date and the subscription price.
E. None of the above.

Difficulty level: Medium
Topic: VALUATION OF A RIGHTS OFFERING
Type: CONCEPTS

35. Assuming everything else is constant, when a stock goes ex-rights its price should:
A. decrease since the stockholder is losing an option.
B. increase since the corporation no longer has the right to force the stockholder to convert.
C. remain the same since an efficient market would anticipate this change.
D. move up or down depending on whether a small investor wanted to exercise his/his rights.
E. None of the above.

Difficulty level: Easy
Topic: EX-RIGHTS PRICE
Type: CONCEPTS

36. If a shareholder or investor wants to acquire new stock under a rights plant they must:
A. acquire new stock in the market to get a controlling fraction of shares to be eligible for rights.
B. simply pay a registration fee and turn in the subscription price.
C. acquire the correct rights per share desired, then turn the rights and the total subscription price into the subscription agent.
D. acquire the correct rights and wait for the company to send you the stock.
E. call their broker and sell some CBOE options to make any money.

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: CONCEPTS

37. Which of the following statements is true?
A. The subscription price is generally above the old stock price.
B. The subscription price is generally above the ex-rights price.
C. The subscription price is generally below the old stock price.
D. Both A and B.
E. Both B and C.

Difficulty level: Easy
Topic: SUBSCRIPTION PRICE
Type: CONCEPTS

38. A shareholder who has rights is:
A. always better off to exercise the rights.
B. always better off to sell the rights into the market.
C. able to exercise their rights or sell them.
D. never in the same ownership position again with rights.
E. None of the above.

Difficulty level: Easy
Topic: RIGHTS
Type: CONCEPTS

39. A standby underwriting arrangement provides the:
A. company with methods to cancel the offering.
B. company with an alternate investment banker if there is conflict between the issuer and the agent.
C. investment banker with an oversubscription privilege to ensure profits are earned.
D. company with an alternative avenue of sale to ensure success of the rights offering.
E. investment bankers with an added syndication for the rights offering.

Difficulty level: Medium
Topic: STANDBY UNDERWRITING AGREEMENT
Type: CONCEPTS

40. Professor Clifford W. Smith, in evaluating issuance costs from underwritten issues, rights issues with standby underwriting, and a pure rights issues, found that 90% of the issues are underwritten, which was the most expensive method. This is done because:
A. investment bankers know more than CFOs and they may buy the issue at an agreed upon price and disburse the funds sooner.
B. investment bankers can increase the price received by increasing confidence in the issue, and they will buy the issue at an agreed upon price and disburse the cash sooner.
C. investment bankers provide other services including price counseling, increasing public confidence, and providing funds to the issuer sooner.
D. investment bankers know how to price the issue, and would not need to set as low as a price as the subscription price and provide price counseling.
E. None of the above.

Difficulty level: Medium
Topic: EMPIRICAL EVIDENCE - UNDERWRITTEN ISSUES
Type: CONCEPTS

41. Corporations use the shelf registration method of security sales because:
A. preregistered securities can be quickly brought to market.
B. the main registration process is eliminated for up to two years.
C. their stock is below investment grade.
D. Both A and B.
E. Both B and C.

Difficulty level: Medium
Topic: SHELF REGISTRATION
Type: CONCEPTS

42. In terms of costs of issuing equity, Professor Clifford W. Smith finds that the ranking of methods, from cheapest to most expensive, is:
A. rights issue with standby underwriting, equity issue with underwriting, pure rights issue.
B. pure rights issue, rights issue with standby underwriting, equity issue with underwriting.
C. pure rights issue, preferred stock and debt issue with underwriting for an IPO, rights issue with standby underwriting.
D. equity issue with underwriting, rights issue with standby underwriting, pure rights issue.
E. equity issue with underwriting, pure rights issue, rights issue with standby underwriting.

Difficulty level: Challenge
Topic: EMPIRICAL EVIDENCE - EQUITY ISSUANCE
Type: CONCEPTS

43. Arguments to explain why most equity issues are underwritten versus sold through a rights offering are:
A. underwriters buy at an agreed upon price and bear some risk of selling the issue.
B. cash proceeds are available sooner in underwriting and the issue is available to a wider market.
C. investment bankers can provide market advice and certify the issue for potential investors.
D. All of the above.
E. None of the above.

Difficulty level: Challenge
Topic: UNDERWRITTEN ISSUES
Type: CONCEPTS

44. Corporations are allowed to use the shelf registration method if they:
A. are rated investment grade and have aggregate market stock value of more than $150 million.
B. have not violated the 1934 Securities Act in the past 12 months.
C. have not defaulted on its debt in the past 3 years.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: SHELF REGISTRATION
Type: CONCEPTS

45. Arguments against the use of the shelf-registration are:
A. only technology and manufacturing-based firms can use it.
B. less current information available to investors might raise the cost of debt.
C. possible market overhang from future issues depressing price.
D. Both A and C.
E. Both B and C.

Difficulty level: Easy
Topic: SHELF REGISTRATION
Type: CONCEPTS

46. The market for venture capital refers to the:
A. private financial marketplace for servicing small, young firms.
B. bond markets.
C. market for selling rights to individuals who already own shares.
D. market for selling equity securities for firms with equity already outstanding.
E. None of the above.

Difficulty level: Easy
Topic: VENTURE CAPITAL
Type: CONCEPTS

47. Rule 144A provides the framework for the issuance of private securities to qualified institutional investors. To buy private securities, institutional investors:
A. must be willing to hold a less liquid security and manage a fund.
B. must be willing to make a market in the security and be a primary market dealer.
C. must be a limited partner in the issue and willing to reduce the illiquidity of the security.
D. must be willing to hold a less liquid security and have $100 million under management.
E. None of the above.

Difficulty level: Challenge
Topic: RULE 144A
Type: CONCEPTS

48. Venture capitalists provide financing for new firms from the seed and start-up stage all the way to mezzanine and bridge financing. In exchange for financing, entrepreneurs give:
A. a high interest rate debt instrument and control.
B. an equity position and usually board of director positions.
C. up the right to have an initial public offering.
D. control to a court appointed trustee.
E. the venture capitalists jobs as CEOs and CFOs.

Difficulty level: Challenge
Topic: VENTURE CAPITAL
Type: CONCEPTS

49. An IPO of a firm formerly financed by venture capital is carried out for what primary purposes?
A. Insiders can sell their shares or cash out
B. Generate cash to pay down bank indebtedness
C. To establish a market value for the equity and provide funds for operations
D. All of the above.
E. None of the above.

Difficulty level: Easy
Topic: RATIONALE FOR IPO
Type: CONCEPTS

50. Which of the following is not one of the four main functions that underwriters provide?
A. Risk bearing
B. Marketing
C. Auditing the financial statements
D. Certification
E. Monitoring

Difficulty level: Medium
Topic: UNDERWRITER RISK BEARING
Type: CONCEPTS

51. Types of dilution include:
A. dilution of percentage ownership
B. dilution of market share
C. dilution of book value and earnings per share
D. A and C
E. All of the above

Difficulty level: Medium
Topic: DILUTION
Type: CONCEPTS

52. The Wordsmith Corporation has 10,000 shares outstanding at $30 each. They expect to raise $150,000 by a rights offering with a subscription price of $25. How many rights must you turn in to get a new share?
A. 0.60
B. 1.20
C. 1.67
D. 2.00
E. Insufficient data to determine

New shares = $150,000/25 = 6,000
Number of rights needed/share = 10,000/6,000 = 1.67

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

53. Assuming everything else is constant, if a stock's old price is $25 and the ex-rights or new stock price is $19, then the value of the right is:
A. $-6.
B. $6.
C. impossible to determine without the subscription price.
D. impossible to determine without the number of rights needed to buy one share.

$R = P_O - P_X = \$25 - \$19 = \$6$.

Difficulty level: Easy
Topic: VALUE OF A RIGHT
Type: PROBLEMS

54. The LaPorte Corporation has a new rights offering that allows you to buy one share of stock with 3 rights and $20 per share. The stock is now selling ex-rights for $26. The price rights-on is:
A. $22.00
B. $24.00
C. $26.00
D. $28.00
E. impossible to determine without the cum-rights price.

$R_X = (P_X - S)/N = (\$26 - \$20)/3 = \$6/3 = \$2$; Price = $26 + $2 = $28

Difficulty level: Medium
Topic: PRICE RIGHTS-ON
Type: PROBLEMS

55. Regional Power wants to raise $10 million in new equity. The subscription price is $20. There are currently 3 million shares outstanding, each with 1 right. How many rights are needed to purchase 1 share?
A. 1
B. 3
C. 5
D. 6
E. 8

Number of new shares = Funds to be raised/subscription price = $10,000,000/$20 = 500,000
Number of rights needed to buy 1 share = old shares/new shares = 3,000,000/500,000 = 6

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

56. The Overland Corporation intends to issue 50,000 new shares to raise funds for expansion of current plant facilities. The current share price is $40 and there are 500,000 shares outstanding. The number of rights needed to buy a share of stock should be:
A. 1
B. 10
C. 40
D. 400
E. indeterminate without the subscription price.

N = Old Shares/New Shares = 500,000/50,000 = 10

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

57. The Schroeder Corporation has 20,000 shares outstanding at $20 each. They expect to raise $200,000 by a rights offering with a subscription price of $25. How many rights must you turn in to get a new share?
A. 1.25
B. 1.50
C. 2.00
D. 2.50
E. Insufficient data to determine

New shares = $200,000/25 = 8,000
Number of rights needed/share = 20,000/8,000 = 2.5

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

58. Assuming everything else is constant, if a stock's old price is $40 and the ex-rights or new stock price is $32, then the value of the right is:
A. $-8.
B. $8.
C. impossible to determine without the subscription price.
D. impossible to determine without the number of rights needed to buy one share.

$R = P_O - P_X = \$40 - \$32 = \$8.$

Difficulty level: Easy
Topic: VALUE OF A RIGHT
Type: PROBLEMS

59. The Holly Corporation has a new rights offering that allows you to buy one share of stock with 4 rights and $25 per share. The stock is now selling ex-rights for $30. The price rights-on is:
A. $21.00
B. $25.00
C. $30.00
D. $31.25
E. impossible to determine without the cum-rights price.

$R_X = (P_X - S)/N = (\$30 - \$25)/4 = \$1.25$; Price = $30 + $1.25 = $31.25

Difficulty level: Medium
Topic: PRICE RIGHTS-ON
Type: PROBLEMS

60. Bradley Power wants to raise $40 million in new equity. The subscription price is $25. There are currently 5 million shares outstanding, each with 1 right. How many rights are needed to purchase 1 share?
A. 1.000
B. 3.000
C. 3.125
D. 4.525
E. 6.525

Number of new shares = Funds to be raised/subscription price = $40,000,000/$25 = 1,600,000
Number of rights needed to buy 1 share = old shares/new shares = 5,000,000/1,600,000 = 3.125

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

61. The Shields Corporation intends to issue 100,000 new shares to raise funds for expansion of current plant facilities. The current share price is $20 and there are 500,000 shares outstanding. The number of rights needed to buy a share of stock should be:
A. 1
B. 5
C. 20
D. 50
E. indeterminate without the subscription price.

N = Old Shares/New Shares = 500,000/100,000 = 5

Difficulty level: Medium
Topic: RIGHTS OFFERING
Type: PROBLEMS

62. For a particular stock the old stock price is $20, the ex-rights price is $15, and the number of rights needed to buy a new share is 2. Assuming everything else constant, the subscription price is ______ .

A. $5
B. $13
C. $17
D. $18
E. $20

$(P_O - S)/(N + 1) = (P_X - S)/N$
$(\$20 - S)/3 = (\$15 - S)/2$
$\$15/3 = \$10/2 = \$5$

Difficulty level: Medium
Topic: SUBSCRIPTION PRICE
Type: PROBLEMS

Essay Questions

The Holyoke Corporation has 120,000 shares outstanding with a current market price of $8.10 per share. The company needs to raise an additional $36,000 to finance new expenditures, and has decided on a rights issue. The issue will allow current stockholders to purchase one additional share for 20 rights at a subscription price of $6 per share.

63. Calculate the ex-rights price that would make a new stockholder indifferent between buying shares at the old stock price and exercising the rights or buying the shares ex-rights.

Set up the indifference equation as follows:
N(Old Stock Price) + Subscription Price = (N + 1) (Ex-Rights Price)
20($8.10) + $6 = 21(X) = > X = $8.00

Topic: EX-RIGHTS VALUE
Type: ESSAYS

64. If the ex-rights price were set at $7.90, would you as a potential new stockholder choose to buy shares ex-rights or buy shares at the old price and exercise your rights?

If you purchase 20 shares at the old price and exercise, your cost will be 20($8.10) + $6 = $168.00.
If you purchase 21 shares ex-rights, your cost is 21($7.90) = $165.90. This is the cheaper alternative.

Topic: EX-RIGHTS VALUE
Type: ESSAYS

65. Suppose that the company was also considering structuring the rights issue to allow for an additional share to be purchased for 10 rights at a subscription price of $3. Prove that a stockholder with 100 shares would be indifferent between purchasing a new share for 10 rights at $3 or purchasing a new share for 20 rights at $6.

***Alternative 1:** 20 rights at $6 a share; Ex-Rights Price is $8.*	
Originally owned 100 shares at $8.10	***= $810.00***
Now own 105 shares at $8.00	***= $840.00***
Net Investment is $30.	
***Alternative 2:** 10 rights at $3 a share; Ex-Rights price is $7.64.*	
Originally owned 100 shares at $8.10	***= $810.00***
Now own 110 shares at $7.64	***= $840.00***
Net Investment is $30.	

Topic: RIGHTS AND NET INVESTMENT
Type: ESSAYS

66. Explain the advantages of a shelf-registration to an issuer. How can timeliness of disclosure and a potential market overhang work against a shelf-registration?

Several advantages of a shelf registration are:
- *Issue on short notice with a short term statement.*
- *A master registration statement need only be filed for a two year issuing window.*
- *Timeliness is reduced with shelf registration.*
- *Timeliness and overhang come into play because:*
- *Information may be stale; registration can be up to two years prior.*
- *Market overhand may depress market price.*
- *There is no evidence to suggest market overhang by Bhagat, Marr & Thompson.*

Topic: SHELF REGISTRATION
Type: ESSAYS

67. The evidence on IPO sales is varied from issue to issue, but there are three common themes; underpricing, underperformance, and the reasons for going public. Explain these three themes.

Underpricing:
--at issuance most IPOs underpriced
excess returns are earned over the initial market price.
risk of IPO is great and issuance market reaction reflects future expectations.
Underperformance:
--typically 3 years after IPO the price has fallen below the initial price.
issuers are optimistic about future at issuance but uncertainty is revealed over time and the firm may be less promising.
Reasons for going public
--establish market value.
raise cash to pay down debt and fund operations.
allow insiders to sell some of their stock.

Topic: UNDERPRICING AND UNDERPERFORMANCE
Type: ESSAYS

68. The Direct Interactive Publishing Company is planning to raise $200 million dollars in new capital. There are currently 50 million shares outstanding with an estimated market price of $60 each. The corporate officers are debating whether to use a rights offering (with or without a standby underwriting) or have the issue fully underwritten. The company is currently listed on a regional exchange and plans to list on a national exchange after the security issue. List and explain three advantages/disadvantages of each method.

Rights
Advantages: lowest cost method, maintains ownership percentage, shareholders can fully participate and maintain wealth.
Disadvantages: shareholders may not have capital, may not be fully subscribed, use of standby and oversubscription.
Underwriting
Advantages: advice on issue characteristics and pricing from investment bankers, access to broader market, acts to "certify" issuer and issue, acts to guarantee price in firm commitment.
Disadvantages: most costly--both direct and other expenses, if best efforts--may be withdrawn, current shareholders may not be able to maintain ownership percentage.

Topic: RIGHTS AND UNDERWRITING
Type: ESSAYS

69. Discuss what a Dutch auction is and how it works.

In a Dutch auction, the underwriter does not set a fixed price, but rather conducts an auction in which investors bid for the shares. Also known as a uniform price auction, it has recently been used in the IPO market, notably with the Google IPO in 2004. It is an attempt to determine a fair market price for an unmarketed security. Investors bid for a security and the top bids all pay a uniform price as discussed in Section 20.3. In essence they all pay the lowest acceptable price for the total number of shares offered.

Topic: DUTCH AUCTION
Type: ESSAYS

70. Lamar Inc. is attempting to raise $5,000,000 in new equity with a rights offering. The subscription price will be $40 per share. The stock currently sells for $50 per share and there are 250,000 shares outstanding. How many rights are needed to buy a new share?

Number of new shares = $5,000,000/40 = 125,000
Number of rights needed = 250,000/125,000 = 2 rights per share.

Topic: RIGHTS OFFERING
Type: ESSAYS

71. Lamar Inc. is attempting to raise $5,000,000 in new equity with a rights offering. The subscription price for the 125,000 new shares will be $40 per share. The stock currently sells for $50 per share and there are 250,000 shares outstanding. What will the price per share be if all rights are exercised?

Total Equity Value = (250,000 ×50) + (125,000 ×40) = 12,500,000 + 5,000,000 = 17,500,000
Price per share = $17,500,000/375,000 = $46.67
Or $R_o = (P_o - S)/(N + 1) = (50 - 40)/3 = 3.33$ (see above for # of rights needed)
$P_x = P_o - Ro = 50 - 3.33 = 46.67$.

Topic: RIGHTS OFFERING
Type: ESSAYS