CHAPTER 1

# Equity Securities



## INTRODUCTION

This first chapter will build the foundation upon which the rest of this text is built. A thorough understanding of equity securities will be necessary in order to successfully complete the Series 6 exam. Equity securities are divided into two types: common and preferred stock. We will examine the features of common stock and preferred stock, as well as the benefits and risks associated with their ownership. But first we must define exactly what meets the definition of a security.

## WHAT IS A SECURITY?

A security is any investment product that can be exchanged for value and involves risk. In order for an investment to be considered a security, it must be readily transferable between two parties and the owner must be subject to the loss of some, or all, of the invested principal. If the product is not transferable or does not contain risk, it is not a security.

| Types of securities | Types of nonsecurities |
|---|---|
| Common stocks | Whole life insurance |
| Preferred stocks | Term life insurance |
| Bonds | IRAs |
| Mutual funds | Retirement plans |

*(Continued)*

| Types of securities | Types of nonsecurities |
|---|---|
| Variable annuities | Fixed annuities |
| Variable life insurance | Prospectus |
| Options | Confirmations |
| Rights | |
| Warrants | |
| Exchange-traded funds/Exchange-traded notes | |
| Real estate investment trusts | |
| Collateralized mortgage obligations | |

## EQUITY = STOCK

The term *equity* is synonymous with the term *stock*. Throughout your preparation for this exam, and on the exam itself, you will find many terms that are used interchangeably. Equity or stock creates an ownership relationship with the issuing company. Once an investor has purchased stock in a corporation, he or she becomes an owner of that corporation. The corporation sells off pieces of itself to investors in the form of shares in an effort to raise working capital. Equity is perpetual, meaning that there is no maturity date for the shares and the investor may own the shares until he or she decides to sell them. Most corporations use the sale of equity as their main source of business capital.



## COMMON STOCK

There are thousands of companies whose stock trades publicly and who have used the sale of equity as a source of raising business capital. All publicly traded companies must issue common stock before they may issue any other type of equity security. The two types of equity securities are common stock and preferred stock. Although all publicly traded companies must have sold or issued common stock, not all companies may want to issue or sell preferred stock. Let's take a look at the formation of a company and how common stock is created.

### CORPORATE TIME LINE

The following is a representation of the steps that corporations must take in order to sell their common stock to the public, as well as what may happen to that stock once it has been sold to the public.

## AUTHORIZED STOCK

Authorized stock is the maximum number of shares that a company may sell to the investing public in an effort to raise cash to meet the organization's goals. The number of authorized shares is arbitrarily determined and is set at the time of incorporation. A corporation may sell all or part of its authorized stock. If the corporation wants to sell more shares than it's authorized to sell, the shareholders must approve an increase in the number of authorized shares.

## ISSUED STOCK

Issued stock is stock that has been authorized for sale and that has actually been sold to the investing public. The total number of authorized shares typically exceeds the total number of issued shares so that the corporation may sell additional shares in the future to meet its needs. Once shares have been sold to the investing public, they will always be counted as issued shares, regardless of their ownership or subsequent repurchase by the corporation. It's important to note that the total number of issued shares may never exceed the total number of authorized shares.

Additional authorized shares may be issued in the future for any of the following reasons:

- Pay a stock dividend.
- Expand current operations.
- Exchange common shares for convertible preferred or convertible bonds.
- To satisfy obligations under employee stock options or purchase plans.



## OUTSTANDING STOCK

Outstanding stock is stock that has been sold or issued to the investing public and that actually remains in the hands of the investing public.

**EXAMPLE**

XYZ corporation has 10,000,000 shares authorized and has sold 5,000,000 shares to the public during its initial public offering. In this case, there would be 5,000,000 shares of stock issued and 5,000,000 shares outstanding.

## TREASURY STOCK

Treasury stock is stock that has been sold to the investing public and then subsequently repurchased by the corporation. The corporation may elect to reissue the shares or it may retire the shares that it holds in treasury stock. Treasury stock does not receive dividends nor does it vote.

A corporation may elect to repurchase its own shares for any of the following reasons:

- To maintain control of the company.
- To increase earnings per share.
- To fund employee stock purchase plans.
- To use shares to pay for a merger or acquisition.

To determine the amount of treasury stock, use the following formula:

issued stock – outstanding stock = treasury stock

**EXAMPLE** If in the case of XYZ above, the company decides to repurchase 3,000,000 of its own shares, then XYZ would have 5,000,000 shares issued—2,000,000 shares and 3,000,000 shares of treasury stock.



It's important to note that once the shares have been issued, they will always be counted as issued shares. The only thing that changes is the number of outstanding shares and the number of treasury shares.

### VALUES OF COMMON STOCK

A common stock's market value is determined by supply and demand and may or may not have any real relationship to what the shares are actually worth. The market value of common stock is affected by the current and future expectations for the company.

### BOOK VALUE

A corporation's book value is the theoretical liquidation value of the company. The book value is found by taking all of the company's tangible assets and subtracting all of its liabilities. This will give you the total book value. To determine the book values per share, divide the total book value by the total number of outstanding common shares.

### PAR VALUE

Par value, in a discussion regarding common stock, is only important if you are an accountant looking at the balance sheet. An accountant uses the par value as a way to credit the money received by the corporation from the initial sale of the stock to the balance sheet. For investors, it has no relationship to any measure of value that may otherwise be employed.

## RIGHTS OF COMMON STOCKHOLDERS

As an owner of common stock, investors are owners of the corporation. As such, investors have certain rights that are granted to all common stock holders.

## PREEMPTIVE RIGHTS

As a stockholder, an investor has the right to maintain a percentage interest in the company. This is known as a preemptive right. Should the company wish to sell additional shares to raise new capital, it must first offer the new shares to existing shareholders. If the existing shareholders decide not to purchase the new shares, then the shares may be offered to the general public. When a corporation decides to conduct a rights offering, the board of directors must approve the issuance of the additional shares. If the number of shares that are to be issued under the rights offering would cause the total number of outstanding shares to exceed the total number of authorized shares, then shareholder approval will be required. Existing shareholders will have to approve an increase in the number of authorized shares before the rights offering can proceed.



### TESTFOCUS!

| Number of Existing Shares | Number of New Shares | Total Shares After Offering |
|---|---|---|
| 100,000 | 100,000 | 200,000 |
| 10,000 | 10,000 | 20,000 |
| 10% ownership | 10% of offering | 10% ownership |

In the example above, the company has 100,000 shares of stock outstanding and an investor has purchased 10,000 of those original shares. As a result, the investor owns 10% of the corporation. The company wishing to sell 100,000 new shares to raise new capital must first offer 10% of the new shares to the current investor (10,000 shares) before the shares may be offered to the general public. So if the investor decides to purchase the additional shares, as is the case in the example, the investor will have maintained a 10% interest in the company.

A shareholder's preemptive right is ensured through a rights offering. The existing shareholders will have the right to purchase the new shares at a discount to the current market value for up to 45 days. This is known as the subscription price. Once the subscription price is set, it remains constant for the 45 days, while the price of the stock is moving up and down in the marketplace.

There are three possible outcomes for a right. They are:

1. **Exercised.** The investor decides to purchase the additional shares and sends in the money, along with the rights to receive the additional shares.
2. **Sold.** The rights have value. If the investor does not want to purchase the additional shares, they may be sold to another investor who would like to purchase the shares.
3. **Expire.** The rights will expire when no one wants to purchase the stock. This will only occur when the market price of the share has fallen below the subscription price of the right and the 45 days has elapsed.



## CHARACTERISTICS OF A RIGHTS OFFERING

Once a rights offering has been declared, the company's common stock will trade with the rights attached. The stock in this situation is said to be trading "cum rights." The company's stock, which is the subject of the rights offering, will trade cum rights between the declaration date and the ex date. After the ex date, the stock will trade without the rights attached, or "ex rights." The value of the common stock will be adjusted down by the value of the right on the ex rights date. During a rights offering, each share will be issued one right. The subscription price and the number of rights required to purchase one additional share will be detailed in the terms of the offering on the rights certificate. During a rights offering, the issuer will retain an investment bank to act as a standby underwriter, and the investment bank will stand by, ready to purchase any shares that are not purchased by the rights holders.

## STOCK SPLITS

There are times when a corporation will find it advantageous to split its stock. A corporation that has done well and seen its stock appreciate significantly may declare a forward stock split to make its shares more attractive to retail investors. Most retail investors would be more comfortable purchasing shares of a \$25 stock rather than purchasing shares of a \$100 stock. When a corporation declares a forward stock split the share price declines and the number of outstanding shares increase. Alternatively if a corporation has seen its share price decline significantly, it may declare a reverse stock split. A corporation would declare a reverse stock split to increase the price of its shares to make its shares more attractive to institutional investors. Many institutions have investment policies that don't allow the institution to purchase shares of low price stocks. With a reverse stock split the price of the stock increases and the number of outstanding shares decrease. With any split the overall market capitalization (the total value of all of the outstanding shares) and the value of an investor's holdings are not affected by the decision to split the stock. The following table details the effect of various types of splits on an investor's holdings, notice how the value has not changed, only the number of shares and price have changed.

| Type of Split | Old | New | Value |
|---|---|---|---|
| 2:1 | Long 100 shares at 50 | Long 200 shares at 25 | $5,000 |
| 4:1 | Long 100 at 100 | Long 400 at 25 | $10,000 |
| 3:2 | Long 100 shares at 100 | Long 150 shares at 66.67 | $10,000 |
| 1:4 | Long 1000 shares at 5 | Long 250 at 20 | $5,000 |



## VOTING

Common stockholders have the right to vote on the major issues facing the corporation. Common stockholders are part owners of the company and, as a result, have a right to say how the company is run. The biggest emphasis is placed on the election of the board of directors.

Common stockholders may also vote on:

- The issuance of bonds or additional common shares.
- Stock splits.
- Mergers and acquisitions.
- Major changes in corporate policy.

## METHODS OF VOTING

There are two methods by which the voting process may be conducted: the statutory method and the cumulative method. A stockholder may cast one vote for each share of stock owned, and the method used will determine how those votes are cast. The test focuses on the election of the board of directors, so we will use that in our example.

**TESTFOCUS!**

An investor own 200 shares of XYZ. Two board members are to be elected, and there are four people running in the election. Under both the statutory and cumulative methods of voting, you take the number of shares owned and multiply them by the number of people to be elected to determine how many votes the shareholder has.

In this case, 200 shares × 2 = 400 votes. The method used dictates how those votes may be cast.

| Candidate | Statutory | Cumulative |
|---|---|---|
| 1 | 200 votes | 400 votes |
| 2 | | |
| 3 | | |
| 4 | 200 votes | |



The **statutory method** requires that the votes be distributed evenly among the candidates that the investor wishes to vote for.

The **cumulative method** allows shareholders to cast all of their votes in favor of one candidate, if they so choose. The cumulative method is said to favor smaller investors for this reason.

## LIMITED LIABILITY

A stockholder's liability is limited to the amount of money that has been invested in the stock. Stockholders cannot be held liable for any amount past their invested capital.

## FREELY TRANSFERABLE

Common stock and most other securities are freely transferable. That is to say that one investor may sell shares to another investor without limitation and without requiring the approval of the issuer. The transfer of a security's ownership, in most cases, is facilitated through a broker dealer. The transfer of ownership is executed in the secondary market on either an exchange or in the over-the-counter market. Ownership of common stock is evidenced by a stock certificate that identifies:

- The name of the issuing company.
- The number of shares owned.

- The name of the owner of record.
- The CUSIP number.

In order to transfer or sell the shares the owner must endorse the stock certificate or sign a power of substitution known as a stock or bond power. Signing the certificate or a stock or bond power makes the securities transferable into the new buyer's name.

## THE TRANSFER AGENT

The transfer agent is the company that is in charge of transferring the record of ownership from one party to another. The transfer agent:

- Cancels old certificates registered to the seller.
- Issues new certificates to the buyer.
- Maintains and records a list of stockholders.
- Ensures that shares are issued to the correct owner.
- Locates lost or stolen certificates.
- Issues new certificates in the event of destruction.
- May authenticate a mutilated certificate.



## THE REGISTRAR

The registrar is the company responsible for auditing the transfer agent to ensure that the transfer agent does not erroneously issue more shares than are authorized by the company. In the case of a bond issue, the registrar will certify that the bond is a legally binding debt of the company. The function of the transfer agent and the registrar may not be performed by a single department of any one company. A bank or a trust company usually performs the functions of the transfer agent and the registrar.

## CUSIP NUMBERS

The Committee on Uniform Securities Identification Procedures issues CUSIP numbers, which are printed on the stock or bond certificates to help identify the security. CUSIP numbers must also appear on trade confirmations.

## INSPECTION OF BOOKS AND RECORDS

All stockholders have the right to inspect the company's books and records. For most shareholders, this right is ensured through the company's filing of quarterly and annual reports. Stockholders also have the right to obtain a list of shareholders, but they do not have the right to review other corporate financial data that the corporation may deem confidential.

### RESIDUAL CLAIM TO ASSETS

In the event of a company's bankruptcy or liquidation, common stockholders have the right to receive their proportional interest in residual assets. After all the other security holders have been paid, along with all creditors of the corporation, common stockholders may claim the residual assets. For this reason common stock is the most junior security.

### WHY DO PEOPLE BUY COMMON STOCK?

The main reason people invest in common stock is for capital appreciation. They want their money to grow in value over time. An investor in common stock hopes to buy the stock at a low price and sell it at a higher price at some point in the future.



**EXAMPLE** An investor purchases 100 shares of XYZ at $20 per share on March 15, 2013. On April 30th of 2015, the investor sells 100 shares of XYZ for $30 per share, realizing a profit of $10 per share, or $1,000 on the 100 shares.

### INCOME

Many corporations distribute a portion of their earnings to their investors in the form of dividends. This distribution of earnings creates income for the investor, and investors in common stock generally receive dividends quarterly. The amount of income that an investor receives each year is measured relative to what the investor has paid, or will pay, for the stock and is known as the dividend yield or the current yield.

**EXAMPLE** ABC pays a $.50 quarterly dividend to its shareholders. The stock is currently trading at $20 per share. What is its current yield (also known as dividend yield)?

current yield = annual income/current market price

$.50 × 4 = $ 2.00 $2/$20 = 10%

The investor in the above example is receiving 10% of the purchase price of the stock each year in the form of dividends, which, by itself, would be a nice return for the investor.

## WHAT ARE THE RISKS OF OWNING COMMON STOCK?

The major risk in owning common stock is that the stock may fall in value. There are no sure things in the stock market and, even if you own stock in a great company, you may end up losing money.

## DIVIDENDS MAY BE STOPPED OR REDUCED

Common stockholders are not entitled to receive dividends just because they own part of the company. It is up to the company to elect to pay a dividend. The corporation is in no way obligated to pay a dividend to common shareholders.

## JUNIOR CLAIM ON CORPORATE ASSETS

A common stockholder is the last person to get paid if the company is liquidated. It is very possible that after all creditors and other investors are paid there will be little or nothing left for the common stockholders.



## HOW DOES SOMEONE BECOME A STOCKHOLDER?

We have reviewed some of the reasons why an investor would want to become a stockholder. Now we need to review how someone becomes a stockholder. While some people purchase the shares directly from the corporation when the stock is offered to the public, most investors purchase the shares from other investors. These investor-to-investor transactions take place in the secondary market on the exchange or in the over-the-counter market. Although the transaction in many cases only take seconds to execute, trades actually take several days to fully complete. Let's review the important dates regarding transactions, which are done for a "regular-way" settlement.

### TRADE DATE

The trade date is the day when your order is actually executed. Although an order has been placed with a broker, it may not be executed on the same day. There are certain types of orders that may take several days or even longer to execute, depending on the type of order. A market order will be executed immediately, as soon as it is presented to the market, making the trade date the same day the order was entered.

### SETTLEMENT DATE

The buyer of a security actually becomes the owner of record on the settlement date. When an investor buys a security from another investor, the selling investor's name is removed from the security and the buyer's name is recorded as the new owner. Settlement date is three business days after the trade date. This is known as T + 3 for all regular-way transactions in common stock, preferred stock, corporate bonds, and municipal bonds. Government bonds and options all settle the next business day following the trade date.

### PAYMENT DATE

The payment date is the day when the buyer of the security has to have the money in to the brokerage firm to pay for the purchase. Under the industry rules, the payment date for common and preferred stock, and corporate and municipal bonds is five business days after the trade date or T + 5. Payment dates are regulated by the Federal Reserve Board under regulation T of the Securities Exchange Act of 1934. While many brokerage firms require their customers to have their money in to pay for their purchases sooner than the rules state, the customer has up to five business days to pay for the trade.

### VIOLATION

If the customer fails to pay for the purchase within the five business days allowed, the customer is in violation of Regulation T. As a result, the brokerage firm will "sell out" and freeze the customer's account. On the sixth business day following the trade date, the brokerage firm will sell out the securities that the customer failed to pay for. The customer is responsible for any loss that may occur as a result of the sell out, and the brokerage firm may sell out shares of another security in the investor's account in order to cover the loss. The brokerage firm will then freeze the customer's account, which means that the customer must deposit money up front for any purchases for the next 90 days. After the 90 days have expired, the customer is considered to have reestablished good credit and may then conduct business in the regular way and take up to five business days to pay for the trades.

## PREFERRED STOCK

Preferred stock is an equity security with a fixed-income component. Like a common stockholder, the preferred stockholder is an owner of the company. However, the preferred stockholder is investing in the stock for the fixed income that the preferred shares generate through their semiannual dividends. Preferred stock has a stated dividend rate or a fixed rate that the corporation must pay to its preferred shareholders. Growth is generally not achieved through investing in preferred shares.

## FEATURES OF ALL PREFERRED STOCK

### PAR VALUE

Par value on preferred stock is very important because that's what the dividend is based on. Par value for all preferred shares is $100 unless otherwise stated. Companies generally express the dividend as a percentage of par value for preferred stock.

**EXAMPLE**

How much would the following investor receive in annual income from the investment in the following preferred stock?

**An investor buys 100 shares of TWT 9% preferred**

**$100 × 9% = $9 per share × 100 = $900**



### PAYMENT OF DIVIDENDS

The dividend on preferred shares must be paid before any dividends are paid to common shareholders. This gives the preferred shareholder a priority claim on the corporation's distribution of earnings.

### DISTRIBUTION OF ASSETS

If a corporation liquidates or declares bankruptcy, the preferred shareholders are paid prior to any common shareholder, giving the preferred shareholder a higher claim on the corporation's assets.

### PERPETUAL

Preferred stock, unlike bonds, is perpetual, having no maturity date. Investors may hold shares for as long as they wish or until the shares are called in by the company under a call feature.

### NONVOTING

Most preferred stock is nonvoting. Occasionally the holder of a cumulative preferred stock may receive voting rights in the event the corporation misses several dividend payments.

## INTEREST RATE SENSITIVE

Because of the fixed income generated by preferred shares, their price will be more sensitive to changes in interest rates than the price of their common stock counterparts. As interest rates decline, the value of preferred shares tends to increase, and when interest rates rise, the value of the preferred shares tends to fall. This is known as an inverse relationship.

## TYPES OF PREFERRED STOCK

Preferred stock, unlike common stock, may have different features associated with it. Most of the features are designed to make the issue more attractive to investors and, therefore, benefit the owners of preferred stock.

### STRAIGHT/NONCUMULATIVE

The straight preferred stock has no additional features. The holder is entitled to the stated dividend rate and nothing else. If the corporation is unable to pay the dividend, it is not owed to the investor.

### CUMULATIVE PREFERRED

A cumulative feature protects the investor in cases when a corporation is having financial difficulties and cannot pay the dividend. Dividends on cumulative preferred stock accumulate in arrears until the corporation is able to pay them. If the dividend on a cumulative preferred stock is missed, it is still owed to the holder. Dividends in arrears on cumulative issues are always the first dividends to be paid. If the company wants to pay a dividend to common shareholders, it must first pay the dividends in arrears, as well as the stated preferred dividend, before common shareholders receive anything.

**TESTFOCUS!**

GNR has an 8% cumulative preferred stock outstanding. It has not paid the dividend this year or for the prior three years. How much must the holders of GNR cumulative preferred be paid per share before the common stockholders are paid a dividend?

The dividend has not been paid this year nor for the previous three years, so the holders are owed four years' worth of dividends, or:

**4 × $8 = $32 per share**

#### PARTICIPATING PREFERRED

Holders of participating preferred stock are entitled to receive the stated preferred rate, as well as additional common dividends. The holder of participating preferred receives the dividend payable to the common stockholders over and above the stated preferred dividend.

#### CONVERTIBLE PREFERRED

A convertible feature allows the preferred stockholder to convert or exchange their preferred shares for common shares at a fixed price known as the conversion price.

**EXAMPLE**

TRW has issued a 4% convertible preferred stock, which may be converted into TRW common stock at $20 per share. How many shares may the preferred stockholder receive upon conversion?

**number of shares = par/conversion price (CVP)**

**$100/$20 = 5**

The investor may receive five common shares for every preferred share.



These are some additional concepts regarding convertible securities that will be addressed in the convertible bond section that follows.

#### CALLABLE PREFERRED

A call feature is the only feature that benefits the company and not the investor. A call feature allows the corporation to call in or redeem the preferred shares at its discretion or after some period of time has expired. Most callable preferred stock may not be called in during the first few years after their issuance. This feature, which does not allow the stock to be called in its early years, is known as call protection. Many callable preferred shares will be called at a premium price above par. For example a $100 par preferred stock may be called at $103. The main reasons a company would call in its preferred shares would be to eliminate the fixed dividend payment or to sell a new preferred stock with a lower dividend rate when interest rates decline. Preferred stock is more likely to be called by the corporation when interest rates decline.

### TYPES OF DIVIDENDS

#### CASH

A cash dividend is the most common form of dividend, and it is one that the test focuses on. A corporation will send out a cash payment in the form of a check, directly to the stockholders. For those stockholders who have their stock held in the name of the brokerage firm, a check will be sent to the brokerage firm and the money will be credited to the investor's account. Securities that are held in the name of the brokerage firm are said to be held in "street name." To determine the amount that an investor will receive, simply multiply the amount of the dividend to be paid by the number of shares.

**EXAMPLE** JPF pays a \$.10 dividend to shareholders. An investor who owns 1,000 shares of JPF will receive \$100: 1,000 shares × \$.10 = \$100.

### STOCK

A corporation that wants to reward its shareholders but that also wants to conserve cash for other business purposes may elect to pay a stock dividend to its shareholders. Each investor will receive an additional number of shares based on the number of shares the investor owns. The market price of the stock will decline after the stock dividend has been distributed to reflect the fact that there are now more shares outstanding; however, the total market value of the company will remain the same.

**EXAMPLE** If HRT pays a 5% stock dividend to its shareholders, an investor with 500 shares will receive an additional 25 shares. This is determined by multiplying the number of shares owned by the amount of the stock dividend to be paid.

**500 × 5% = 25**

### PROPERTY/PRODUCT

This is the least likely way in which a corporation would pay a dividend, but it is a permissible dividend distribution. A corporation may send out to its shareholders samples of its products or portions of its property.

### DIVIDEND DISTRIBUTION

If a corporation decides to pay a dividend to its common stockholders, it may not discriminate as to who receives the dividend. The dividend must be paid to all common stockholders of record. Investors who already own the stock do not need to be notified by the company that they are entitled to receive the pending dividend, because it will be sent to them automatically. However, new purchasers of the stock may or may not be entitled to receive the dividend, depending on when they purchased the stock relative to when the dividend is going to be distributed. We will now examine the dividend distribution process.

### DECLARATION DATE

The declaration date is the day that the board of directors decides to pay a dividend to common stockholders of record. The declaration date is the starting point for the entire dividend process. The company must notify the regulators at the exchange or FINRA, depending on where the stock trades, at least 10 business days prior to the record date.

### EX-DIVIDEND DATE

The ex-dividend date, or the ex date, is the first day when purchasers of the security are no longer entitled to receive the dividend that the company has declared for payment. Stated another way, the ex date is the first day when the stock trades without (ex) the dividend attached. The exchange or FINRA set the ex date for the stock, based on the record date determined and announced by the corporation's board of directors. Because it takes three business days for a trade to settle, the ex date is always two business days prior to the record date.

### RECORD DATE

This is the day when investors must have their name recorded on the stock certificate in order to be entitled to receive the dividend that was declared by the board of directors. All stockholders whose name is on the stock certificate (owners of record) will be entitled to receive the dividend. The investor would have had to have purchased the stock before the ex dividend date in order to be an owner of record on the record date. The record date is determined by the corporation's board of directors and is used to determine the shareholders who will receive the dividend.

### PAYMENT DATE

This is the day when the corporation actually distributes the dividend to shareholders and it completes the dividend process. The payment date is controlled and set by the board of directors of the corporation and is usually four weeks following the record date.

### STOCK PRICE AND THE EX DIVIDEND DATE

It is important to note that the value of the stock prior to the ex-dividend date reflects the value of the stock with the dividend. On the ex-dividend date, the stock is now trading without the dividend attached, and new purchasers will not receive the dividend that had been declared for payment. As a result, the stock price will be adjusted down on the ex-dividend date in an amount equal to the dividend.

**TESTFOCUS!**

TRY declares a $.20 dividend payable to shareholders of record as of Thursday, August 22nd. The ex-dividend date will be two business days prior to the record date. In this case the ex date will be Tuesday, August 20th. If TRY closed on Monday, August 19th at $24 per share, the stock would open at $23.80 on Tuesday.

| Sunday | Monday | Tuesday | Wednesday | Thursday | Friday | Saturday |
|---|---|---|---|---|---|---|
| | | | | 1 | 2 | 3 |
| 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| 11 | 12 | 13 | 14 | 15 | 16 | 17 |
| 18 | 19 | 20 | 21 | 22 | 23 | 24 |
| 25 | 26 | 27 | 28 | 29 | 30 | 31 |



## TAXATION OF DIVIDENDS

All qualified dividends received by ordinary income earners are taxed at a rate of 15% for the year the dividend is received. (High income earners will pay a set rate of 20%.) The tax rate for dividends is a hotly debated topic and may be subject to change.

## SELLING DIVIDENDS

Selling dividends is a violation! A registered representative may not use the pending dividend payment as the sole basis of his or her recommendation to purchase the stock. Additionally, using the pending dividend as a means to create urgency on the part of the investor to purchase the stock is a prime example of this type of violation. If the investor were to purchase the shares just prior to the ex-dividend date simply to receive the dividend, the investor in many cases would end up worse off. The dividend in this case would actually be a return of the money that the investor used to purchase the stock and then the investor would have a tax liability when the dividend is received.

## DIVIDEND DISBURSEMENT PROCESS

The corporation's dividend disbursement agent is responsible for the distribution of dividends and will send the dividends to the shareholders of record on the record date. For convenience, most investors have their securities held in the name of the broker dealer, also known as the "street name." As a result, the dividend disbursement agent will send the dividends directly to the broker dealer. The broker dealer's dividend department will collect the dividends and distribute them to the beneficial owners.

## WARRANTS

A warrant is a security that gives the holder the opportunity to purchase common stock. Like a right, the warrant has a subscription price. However, the subscription price on a warrant is always above the current market value of the common stock when the warrant is originally issued. A warrant has a much longer life than a right, and the holder of a warrant may have up to 10 years to purchase the stock at the subscription price. The long life is what makes the warrant valuable, even though the subscription price is higher than the market price of the common stock when the warrant is issued.

## HOW DO PEOPLE GET WARRANTS?

### UNITS

Many times, companies will issue warrants to people who have purchased their common stock when it was originally sold to the public during its initial public offering (IPO). A common share that comes with a warrant attached to purchase an additional common share is known as a unit.

### ATTACHED TO BONDS

Many times, companies will attach warrants to their bond offerings as a sweetener to help market the bond offering. The warrant to purchase the common stock makes the bond more attractive to the investor and may allow the company to issue the bonds with a lower coupon rate.

### SECONDARY MARKET

Warrants will often trade in the secondary market just like the common stock. An investor who wishes to participate in the potential price appreciation of the common stock may elect to purchase the corporation's warrant instead of its common shares.

### POSSIBLE OUTCOMES OF A WARRANT

A warrant, like a right, may be exercised or sold by the investor. A warrant may also expire if the stock price is below the warrant's subscription price at its expiration.

**Rights vs. Warrants**

| Rights | | Warrants |
|---|---|---|
| Up to 45 days | **Term** | Up to 10 years |
| Below the market | **Subscription Price** | Above the market |
| May trade with or without common stock | **Trading** | May trade with or without common stock or bonds |
| Issued to existing shareholders to ensure preemptive rights | **Who** | Offered as a sweetener to make securities more attractive |



## OPTIONS

An option is a contract between two parties, the buyer and the seller, that determines the time and price at which a security may be bought or sold. The buyer of the option pays money, known as the option's premium, to the seller. For this premium, the buyer obtains a right to buy or sell the security, depending on what type of option is involved in the transaction. The seller, because it received the premium from the buyer, now has an obligation to perform under that contract. Depending on the type of option involved, the seller may have an obligation to buy or sell the security.

## CALLS

A call option gives the buyer the right to buy, or to "call," the security from the option seller at a specific price for a certain period of time. The sale of a call option obligates the seller to deliver or sell that security to the buyer at that specific price for a certain period of time.

## PUTS

A put option gives the buyer the right to sell, or to "put," the security to the seller at a specific price for a certain period of time. The sale of a put option obligates the seller to buy the security from the buyer at that specific price for a certain period of time.

## BULLISH VS. BEARISH

### BULLISH

Investors who believe that a security's price will increase over time are said to be bullish. Investors who buy calls are bullish on the underlying security. That is, they believe that the security's price will rise, and they have paid for the right to purchase the security at a specific price, known as the exercise price. An investor who has sold puts is also considered to be bullish on the security. The seller of a put has an obligation to buy the security, and therefore believes that the security's price will rise.

### BEARISH

Investors who believe that a security's price will decline are said to be bearish. The seller of a call has an obligation to sell the security to the purchaser at a specified price and believes that the security's price will fall and is therefore bearish. The buyer of a put wants the price to drop so that the security can be sold at a higher price to the seller of the put contract. The buyer is also considered to be bearish on the security.

| | Calls | Puts |
|---|---|---|
| **Buyers** | Bullish | Bearish |
| | Have right to buy stock, want stock price to rise | Have right to sell stock, want stock price to fall |
| **Sellers** | Bearish | Bullish |
| | Have obligation to sell stock, want stock price to fall | Have obligation to buy stock, want stock price to rise |

## CHARACTERISTICS OF ALL OPTIONS

The Options Clearing Corporation (OCC) issues all option contracts and guarantees their performance. Standardized options trade on the exchanges, such as the Chicago Board Options Exchange and the American Stock Exchange.

All option contracts are for one round lot of the underlying security, or 100 shares. To determine the amount that an investor either paid or received for the contract, take the premium and multiply it by 100. If an investor paid $4 for 1 KLM August 70 call, then the investor paid $400 for the right to buy 100 shares of KLM at $70 per share until August.

## EXERCISE PRICE

The exercise price is the price at which an option buyer may buy or sell the underlying security, depending on the type of option involved in the transaction.

## BUYER VS. SELLER

| Buyer | | Seller |
|---|---|---|
| Owner | **Known as** | Writer |
| Long | **Known as** | Short |
| Rights | **Has** | Obligations |
| Maximum speculative profit | **Objective** | Premium income |
| Exercise | **Wants the option to** | Expire |



## POSSIBLE OUTCOMES FOR AN OPTION

### EXERCISED

If the option is exercised, the buyer has elected to exercise its rights to buy or sell the security depending on the type of option involved. Exercising an option obligates the seller to perform under the contract.

### SOLD

Most individual investors will elect to sell their rights to another investor rather than exercise their rights. The investor who buys the option from them will acquire all the rights of the original purchaser.

### EXPIRE

If the option expires, the buyer has elected not to exercise its right, and the seller of the option is not required to perform.

### AMERICAN DEPOSITARY RECEIPTS (ADRs)/ AMERICAN DEPOSITARY SHARES (ADSs)

American depositary receipts (ADRs) facilitate the trading of foreign securities in the U.S. markets. An ADR is a receipt that represents the ownership of the foreign shares that are being held abroad in a branch of a U.S. bank. Each ADR represents ownership of between one to 10 shares of the foreign stock, and the holder of the ADR may request the delivery of the foreign shares. Holders of ADRs also have the right to vote and the right to receive dividends that the foreign corporation declares for payment to shareholders.

## CURRENCY RISKS

The owner of an ADR has currency risk along with the normal risks associated with the ownership of the stock. Should the currency of the country decline relative to the U.S. dollar, the holder of the ADR will receive fewer U.S. dollars when a dividend is paid and fewer U.S. dollars when the security is sold. It's important to note that the dividend on the ADR is paid by the corporation to the custodian bank in the foreign currency. The custodian bank will convert the dividend to U.S. dollars for distribution to the holders of the ADRs.



## FUNCTIONS OF THE CUSTODIAN BANK ISSUING ADRs

ADRs are actually issued and guaranteed by the bank that holds the foreign securities on deposit. The custodian bank is the registered owner of the foreign shares and must guarantee that the foreign shares remain in the bank as long as the ADRs remain outstanding. Foreign corporations will often use ADRs as a way of generating U.S. interest in their company. The issuance of the ADR allows them to avoid the long and costly registration process for their securities.

## REAL ESTATE INVESTMENT TRUSTS (REITs)

A real estate investment trust, or REIT, is a special type of equity security. REITs are organized for the specific purpose of buying, developing, or managing a portfolio of real estate. REITs are organized as a corporation or as a trust, and publicly traded REITs will trade on the exchanges or in the over-the-counter market just like other stocks. A REIT is organized as a conduit for the investment income generated by the portfolio of real estate. REITs are entitled to special tax treatment under Internal Revenue Code subchapter M. A REIT will not pay taxes at the corporate level so long as:

- It receives 75% of its income from real estate.
- It distributes at least 90% of its taxable income to shareholders.

So long as the REIT meet the above requirements, the income will be allowed to flow through to the shareholders and will be taxed at their rate. Dividends received by REIT shareholders will continue to be taxed as ordinary income.

## ISSUING CORPORATE SECURITIES

Once a business has decided that it needs to raise capital to meet its organizational objectives, it must determine how to raise the needed capital. Most corporations will hire an investment banker, also known as an underwriter, to advise them. The underwriter works for the issuer, and it is the underwriter's job to advise the client about what type of securities to offer. The issuer and the underwriter together determine whether stocks or bonds should be issued and what the terms will be. The underwriter is responsible for trying to obtain the financing at the best possible terms for the issuer. The underwriter will:

- Market the issue to investors.
- Assist in the determination of the terms of the offering.
- Purchase the securities directly from the issuer to resell to investors.

The issuer is responsible for:

- Filing a registration statement with the SEC.
- Registering the securities in the states in which it will be sold, also known as blue-skying the issue
- Negotiating the underwriter's compensation and obligations to the issuer.

## TYPES OF UNDERWRITING COMMITMENTS

### FIRM COMMITMENT

In a firm commitment underwriting, the underwriter guarantees to purchase all of the securities being offered for sale by the issuer regardless of whether they can be sold to investors. A firm commitment underwriting agreement is the most desirable for issuers, because it guarantees them all of their money right away. The more in demand the offering is, the more likely it is that it will be issued on a firm commitment basis. In a firm commitment, the underwriter puts its own money at risk if it cannot sell the securities to investors.

### BEST EFFORTS

In a best efforts underwriting, the underwriter will attempt to sell all of the securities that are being offered by the issuer, but in no way is the underwriter obligated to purchase the securities for the underwriter's own account. The lower the demand for an issue, the greater likelihood that it will be done on a best efforts basis. Any shares or bonds in a best efforts underwriting that have not been sold will be returned to the issuer.

### STANDBY

A standby underwriting agreement will be used in conjunction with a preemptive rights offering. All standby underwritings are done on a firm commitment basis. The standby underwriter agrees to purchase any shares that current shareholders do not purchase. The standby underwriter will then resell the securities to the public.



## TYPES OF OFFERINGS

### INITIAL PUBLIC OFFERING (IPO)/NEW ISSUE

An initial public offering (IPO) is the first time that a company has sold its stock to the public. The issuing company receives the proceeds from the sale minus the underwriter's compensation.

### SUBSEQUENT PRIMARY/ ADDITIONAL ISSUES

In a subsequent primary offering, the corporation is already publicly owned, and the company is selling additional shares to raise new financing.

### PRIMARY OFFERING VS. SECONDARY OFFERING

In a primary offering, the issuing company receives the proceeds from the sale minus the underwriter's compensation. In a secondary offering, a group of selling shareholders receives the proceeds from the sale minus the underwriter's compensation. A combined offering has elements of both the primary offering and the secondary offering. Part of the proceeds goes to the company and part of the proceeds goes to the group of selling shareholders.

## AWARDING THE ISSUE

There are two ways in which the corporation may select an underwriter. A corporation may elect to have multiple underwriters submit bids and then choose the underwriter with the best bid. This is known as a competitive bid underwriting. Or, a company may elect to select one firm to sell the issue and negotiate the terms of the offering with it. This is known as a negotiated underwriting. Most corporate offerings are awarded on a negotiated basis, whereas municipal bonds offerings are usually awarded through competitive bidding.



## THE UNDERWRITING SYNDICATE

Because most corporate offerings involve a large number of shares and a very large dollar amount, they will be offered through several underwriters, known as the underwriting syndicate. The syndicate is a group of investment banks that have agreed to share the responsibility of marketing the issue. The managing underwriter, also known as the lead underwriter, leads the syndicate.

## SELLING GROUP

The syndicate may form a selling group in an effort to help market the issue. Members of the selling group have no underwriting responsibility and may only sell the shares to investors for a fee, known as the selling concession.

### UNDERWRITER'S COMPENSATION

The group of broker dealers that make up the underwriting syndicate will be compensated based on their role as a syndicate member. The only syndicate member that may earn the entire spread is the lead or managing underwriter.

### MANAGEMENT FEE

The lead or managing underwriter will receive a fee, known as a management fee, for every share that is sold. In most cases, the managing underwriter is the firm that negotiated the terms of the offering with the issuer and formed the syndicate.

### UNDERWRITER'S FEE

The underwriter's fee is the cost of bringing the issue to market and is a fee assessed for each share that is sold by the syndicate. If there is any money remaining after all expenses are paid, the syndicate members will split it based on their commitment level in the underwriting.

### SELLING CONCESSION

The selling concession will be paid to any syndicate member or selling group member who sells the shares to the investors. The selling concession is the only fee that the selling group members may earn.

### UNDERWRITING SPREAD

The total amount of the management fee, the underwriting fee, and the selling concession make up the total underwriting spread. This is the difference between the gross proceeds of the offering and the net proceeds to the issuer.

**EXAMPLE**

| |
|---|
| **SELLING CONCESSION**<br>**$1.50** |
| **UNDERWRITING FEE**<br>**$.75** |
| **MANAGEMENT FEE**<br>**$.25** |

**PROCEEDS TO ISSUER $9.50 PER SHARE**

In this example, the underwriting spread is $2.50 per share.

## SECURITIES MARKETS

Investors who do not purchase their stocks and bonds directly from the issuer must purchase them from another investor. Investor-to-investor transactions are known as secondary market transactions, where the selling security owner receives the proceeds from the sale. Secondary market transactions may take place on an exchange or in the over-the-counter market known as the National Association of Securities Dealers Automated Quotations (Nasdaq). Although both facilitate the trading of securities, they operate in a very different manner.

## THE EXCHANGES

The most recognized stock exchange in the world is the New York Stock Exchange (NYSE). There are, however, many exchanges throughout the United States, and they all operate in a similar manner. Exchanges are dual-auction markets, a central marketplace where buyers and sellers come together in one centralized location to compete with one another. Buyers compete with other buyers to be the highest price anyone is willing to pay for the security, and sellers compete with other sellers to be the lowest price anyone is willing to sell a security. All transactions in an exchange-listed security have to take place in front of the specialist or designated market maker (DMM) for that security. The specialist/DMM is an exchange member who is responsible for maintaining a fair and orderly market for the stock in which he or she specializes. The specialist/DMM stands at the trading "post" where all the buyers and sellers must go to conduct business in the security. This is responsible for the crowd that you see on the news and financial reports when they show the floor of the exchange. All securities that trade on an exchange are known as listed securities.



## OVER THE COUNTER/NASDAQ

Securities that are not listed on any of the traditional exchanges trade over the counter or on the Nasdaq system. Nasdaq is the interdealer network of computers and phone lines that allows securities to be traded between broker dealers. Nasdaq is not a traditional auction market, but it has been granted exchange status by the Securities and Exchange Commission (SEC). It is a negotiated market. One broker dealer negotiates a price directly with another broker dealer. None of the other interested parties for that particular security have any idea of what terms are being proposed. The broker dealers may communicate over their Nasdaq workstations or can speak directly to one another over the phone.

## MARKET MAKERS

Because there are no specialists for the over-the-counter markets, bids and offers are displayed by broker dealers known as market makers. A market maker is a firm that is required to display a two-sided market (both a bid and an offer) for the security through the Nasdaq workstation. The market maker must be willing to buy the security at the bid price, which is displayed, as well as be willing to sell the security at the offering price, which is also displayed. These are known as firm quotes. There is no centralized location for the Nasdaq market; it is simply a network of computers that connects broker dealers throughout the world. Market makers purchase the security at the bid price and sell the security at the offering price. Their profit is the difference between the bid and the offer, which is known as the spread.

## THIRD MARKET

The third market consists of transactions in exchange-listed securities executed over the counter in the Nasdaq environment. A broker dealer may wish to simply purchase or sell an exchange-listed security directly with another brokerage firm instead of executing the order on the floor of the exchange. These transactions are known as third-market transactions. All third-market transactions are reported to the consolidated tape for display.



## FOURTH MARKET

A fourth-market transaction is a transaction between two large institutions without the use of a broker dealer. The computer network that facilitates these transactions is known as INSTINET. Large blocks of stock, both listed and unlisted, trade between large institutional investors in the fourth market.

## BROKER VS. DEALER

The term *broker dealer* actually refers to the two capacities in which a firm may act when executing a transaction. When a firm is acting as a broker, it is acting as the customer's agent and is merely executing the customer's order for a fee, known as a commission. The role of the broker is simply to find someone willing to buy the investor's securities if the customer is selling or to find someone willing to sell the securities if the customer is buying. The firm acts as a dealer when it participates in the transaction by taking the opposite side of the trade. For example, the firm may fill a customer's buy order by selling the securities to the customer from the firm's own account or the dealer may fill the customer's sell order by buying the securities for its own account. A brokerage firm is always acting in a dealer or principal capacity when it is making markets over the counter.

| Broker | Dealer |
|---|---|
| Executes customers' orders. | Participates in the trade as a principal. |
| Charges a commission. Must disclose the amount of the commission. | Charges a markup or markdown. Makes a market in the security. Must disclose the fact that it is a market maker, but not the amount of the markup or markdown. |

CHAPTER 1

# Pretest

## EQUITY SECURITIES



1. A company you own common stock in has just filed for bankruptcy. As a shareholder, you will have the right to receive:
   - **a.** the par value of the common shares.
   - **b.** new common shares in the reorganized company.
   - **c.** a percentage of your original investment.
   - **d.** your proportional percentage of residual assets.

2. A corporation may pay a dividend in which of the following ways?
   - **a.** Stock
   - **b.** Cash
   - **c.** Stock of another company
   - **d.** All of the above

3. ABC common stock has declined dramatically in value over the last quarter but the dividend it has declared for payment this quarter has remained the same. The dividend yield on the stock has:
   - **a.** not changed because the board has to declare the dividend amount.
   - **b.** gone down because the yield is a stated rate.
   - **c.** gone up as the price of ABC has fallen.
   - **d.** been fixed at the time of issuance.

4. The transfer agent does which of the following?
   I. Maintains and records a list of stockholders.
   II. Authorizes shares.
   III. Adjusts the number of authorized shares.
   IV. Locates lost shares.

   a. II and III
   b. I and III
   c. I and IV
   d. I and II

5. All qualified dividends for ordinary income earners are:
   a. taxed as ordinary income each year.
   b. tax-free income.
   c. taxed as special interest-free income.
   d. taxed at a set rate of 15%.

6. Which of the following is NOT a right of common stockholders?
   a. Right to elect the board of directors.
   b. Right to vote for executive compensation.
   c. Right to vote for a stock split.
   d. Right to maintain their percentage of ownership in the company.

7. Which of the following is NOT true regarding American depositary receipts (ADRs)?
   a. They are receipts of ownership of foreign shares being held abroad in a U.S. bank.
   b. Each ADR represents 100 shares of foreign stock, and the ADR holder may request delivery of the foreign shares.
   c. ADR holders have the right to vote and receive dividends that the foreign corporation declares for shareholders.
   d. The foreign country may issue restrictions on the foreign ownership of stock.

8. An investor buys a 10% preferred stock at 110, what is its current yield?
   a. 10.4%
   b. 9.1%
   c. 10%
   d. 9.5%

9. An investor buys 100 shares of XYZ 7% convertible preferred stock, which is convertible into XYZ common at $20 per share. How many common shares of XYZ common stock will the investor receive upon conversion?
   a. 5
   b. 400
   c. 500
   d. 5,000

10. An investor has purchased shares of a foreign company through an ADR. Which of the following is NOT true?
    a. The ADR may represent one or more shares of the company's common stock.
    b. The dividend will be paid in U.S. dollars.
    c. The investor may elect to exchange the ADR for the underlying common shares.
    d. The investor is subject to currency risk.



11. An investor owns 100 shares of XYZ 8% participating preferred stock. XYZ's common stock pays a quarterly dividend of $.25. How much will the investor earn each year in dividends?
    a. $825
    b. $90
    c. $180
    d. $900

12. An investor who buys a 7% cumulative preferred stock will receive semi-annual dividends of:
    a. $7 per share.
    b. 7% of the corporate profits.
    c. $3.50 per share.
    d. 3.5% of the corporate profits.

13. As the owner of a cumulative preferred stock, an investor would have all of the following rights, EXCEPT:
    a. voting if dividends are missed for a significant period of time.
    b. the right to receive past dividends not paid by the corporation.
    c. the right to exchange the preferred for the underlying common shares.
    d. the right to receive the past dividends before common holders receive a dividend.

**14.** Which of the following is NOT true of authorized stock?

**a.** It is the maximum number of shares a company may sell.

**b.** It is arbitrarily determined at the time of incorporation and may not be changed.

**c.** It may be sold in total or in part when the company goes public.

**d.** It may be sold to investors to raise operating capital for the company.

**15.** Common stockholders do not have the right to vote on which of the following issues?

**a.** Election of the board of directors

**b.** Stock splits

**c.** Issuance of additional common shares

**d.** Bankruptcy

**16.** Which of the following is NOT true of common dividends?

**a.** They are a portion of the company's earnings.

**b.** They are a source of income for the investor.

**c.** They are generally paid quarterly.

**d.** Their value is determined by subtracting the current yield from the current market price.

**17.** If a 5% stock dividend is paid to an investor who owns 800 shares of stock, the investor will receive how many shares?

**a.** 4

**b.** 8

**c.** 40

**d.** 80

**18.** Why might a company repurchase some of its stock to increase its treasury stock?

**a.** To maintain control of the company

**b.** To allow the company to pay out smaller dividends

**c.** To increase the funding in the company's treasury

**d.** To reassure its investors that all is well