

Equities

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Equities

Introduction

In 1934 the U.S. Congress created the Securities and Exchange Commission to regulate the securities markets and to protect the interests of investors. Securities or equities are an important part of the U.S. economy. When new businesses are beginning or when existing businesses need money, the public may be invited to invest in their companies. In order to do this, the businesses may issue stocks and bonds, which are sold to investment banking firms specializing in the underwriting of newly issued securities. These firms in turn sell the securities to the public through licensed brokers.

Stocks and bonds for the largest U.S. corporations are bought and sold on the New York Stock Exchange (NYSE) which is located on Wall Street in New York City. The NYSE lists more than 1600 company's stocks and more than 600 brokerage firms are members of the exchange. The American Stock Exchange (AMEX), which is also in New York City, and the over-the-counter market represent smaller U.S. companies. The over-the-counter market is a nationwide computerized system operated by the National Association of Securities Dealers (NASD). All three exchanges, along with smaller regional exchanges, operate under the regulation of the SEC.

The stock market is by and large a market for corporate securities. There are no requirements by individual states or the NASD mandating that any corporation issue stock. But if a corporation chooses to go public, it may sell stock in the stock market. A corporation is authorized to sell a specific number of shares of stock as part of its original charter. Once the original charter is approved by the state, a stockholder vote is needed to amend the original terms of the charter. This selling of stock or equity securities is one of the two major methods corporations use to finance operations. The other method is debt security and is the topic of another course written by Wexstar.

The two broad categories of equity securities are common stock and preferred stock. Both are considered ownership in the company and both have certain rights attached. The one thing all investors have a right to expect is that the entire securities system is honest and fair.

Common Stock

Common stock can be classified as authorized stock, issued stock, outstanding stock, or treasury stock. Authorized stock refers to the number of shares a corporation can issue as determined by the stipulations in the corporation's state-approved charter. Issued stock refers to the stock that is actually distributed to the public. Outstanding stock is the correct terminology for all issued stock that has not been reacquired. Treasury stock is stock that has been issued and later repurchased from the public. It does not carry the same rights as other common stock and can be held indefinitely by a corporation. Since no one personally owns treasury stock, it does not carry voting rights or the right to receive dividends.

Par value is an arbitrary value the corporation gives its common stock in its original articles of incorporation. Book value is commonly accepted as the difference between the company's total assets and its liabilities, divided by the number of shares outstanding. Market value is the price investors pay to buy or sell the stock at any given time. Par is generally a small amount which is unrelated to the book or market value.

Some of the rights of common stockholders include the right to a certificate as evidence of ownership, the right to share in profits of the corporation and the right to a fair share of dividends if they are declared. Other rights of common stockholders are the right to vote at stockholder's meetings, the right to sell or transfer stock, the right of information concerning the financial affairs of the corporation including the right to inspect corporate books and records, and the pre-emptive right to acquire new stock, if issued, in direct proportion to the amount of stock already owned. Inspection rights include receiving an annual financial statement and a list of stockholders, but do not include examining detailed financial records. Owners of common stock have the right to vote for the members of the board of directors for the corporation. This voting is usually designated as statutory or cumulative.

Statutory voting allows stockholders to cast one vote per share owned for each position on the ballot. Cumulative voting allows stockholders to either cast all their votes for any one candidate or to cast their total number of votes in any combination they choose. With statutory voting, if an individual owns 200 shares of common stock and there are three vacancies on the board of directors, the stockholder may cast up to 200 votes for each of the three vacancies. With

cumulative voting, if there are three vacancies to be filled and the individual owns 200 shares, he may use 600 votes (200 X 3) in any way he chooses: 600 for one candidate, 200 on one and 400 on another, etc. The stockholder has 600 votes to distribute as he pleases. That is, in cumulative voting owners of stock may cast one vote for each share of stock possessed times the number of candidates, and the stockholder may allocate his votes as desired. Cumulative voting is generally considered a benefit to the minority interest shareholders.

If a stockholder is unable to attend the stockholder's meeting, he may vote by proxy. Proxies can be canceled if the stockholder attends the meeting, authorizes a subsequent proxy, or dies. A shareholder may revoke a proxy at any time before the corporation tallies the final vote at its annual meeting.

The registrar for a company has the responsibility of maintaining independence from the issuing corporation, certifying that a bond represents a legal debt of the issuer, and ensuring that the company does not have more shares outstanding than have been authorized. The corporation's transfer agent has the responsibility of canceling old and issuing new certificates, maintaining records of ownership, ensuring that securities are issued in the correct owner's name, and handling issues relating to lost, stolen, or destroyed certificates.

In the event that a corporation declares a stock split, the transfer agent distributes additional shares. If a company declared a two for one split, the company's outstanding stock doubles in number and the par value of each share is half the previous value. Each stockholder has twice as many shares as he had before the split, but the value of his holdings is the same as before the split. The corporation expects the market value of each share to drop to a level relative to the increased number of outstanding shares. An additional expectation is that more people will buy the stock at the lower price and the end result will be that the stock increases in value. In a three for one, five for four, or any other ratio, the numbers are simply adjusted accordingly.

In the event of a reverse split, the transfer agent issues new certificates. The total market value is the same immediately before and after the reverse split. After a reverse split, an investor owns fewer shares worth more per share. For example: After a 1-for-2 reverse split, a shareholder who had 300 shares with a market value of \$10 per share, now owns 150 shares worth \$20 per share. The total market value remains \$3,000 immediately before and after the split.

Another decision a corporation may choose to exercise is to issue more of its authorized but previously unissued shares. The company sends letters to each stockholder explaining the terms of the new offering and informing him of his pre-emptive rights. Current stockholders have the right to maintain a proportionate share of the company's holdings. A company will always issue one right per existing share, no matter how many new shares are being offered or how many rights are needed to buy each new share. If the holder of a right does not sell it, he may either buy the stock specified in the right or let it expire. The number of rights needed to buy one new share is based on the number of shares outstanding and the number of new shares offered. If a corporation has 15 million outstanding shares and chooses to issue 3 million new shares, each shareholder will need five rights to buy one new share.

If a common stock is trading with rights, the correct terminology is "cum rights" and without rights, the correct terminology is "ex-rights." The formula for "cum rights" is market price less subscription price divided by one more than the number of rights needed to subscribe to one share. If a stock is trading "cum rights" at a price of \$71 per share and it takes 6 rights plus \$50 to buy an additional share, the value of a right is computed as follows: $\$71 - \50 divided by $6+1$ or $\$21/7$ which equals \$3. The value of each right in this case is \$3. The formula for "ex-rights" is market price less subscription price divided by the number of rights needed to subscribe to one share. If a stock is trading "ex-rights" at a price of \$71 per share and it takes 6 rights plus \$50 to buy an additional share, the value of a right is computed as follows: $\$71 - \50 divided by 6 or $\$21/6$ which equals \$3.50. The value of each right in this case is \$3.50.

Preferred Stock

Preferred stock is issued with a specified dividend which must be paid prior to paying common stockholders. This fixed dividend is normally stated as a percentage of par value. If the preferred stock does not have a par value, its dividend will be specified as a fixed dollar amount per year. Preferred stock is normally nonvoting which is considered a disadvantage since most investors desire input into decisions that affect the corporation as a whole. Preferred stock prices usually fluctuate with changes in interest rates.

For the most part, common stock has the highest potential for appreciation, but preferred stockholders have a priority claim over common stockholders. The highest claim on assets belongs to the bondholders, with general creditors next in line, then comes the claims of preferred stockholders and common stockholders follow.

Some preferred stock carries a cumulative dividend feature. If a company's earnings drop dramatically, it may not be able to pay the dividends that it owes its preferred stockholders, so to protect investors, cumulative preferred stock may be offered. This means that the preferred dividends will be paid in arrears before any common stock dividends are paid. The cumulative feature may run for an indefinite time period and all dividends which are past due must be paid in full before any payment is made to common stockholders. If the company goes into liquidation, the past due dividend payments to the preferred stockholders take precedent over the claims of common stockholders. If preferred stock is non-cumulative and a corporation misses a dividend payment due to financial hardship, neither the preferred stockholder nor the common stockholder receives any payment for that pay period and neither has any further claim on the company's earnings.

If preferred stock carries a conversion feature, it may be exchanged for a fixed number of common stock shares of the issuing corporation at the investor's discretion. Common stock usually fluctuates more than preferred stock, but it has more growth potential because it is not tied to a fixed dividend rate. Preferred stock is more for consistent income. The conversion feature of preferred stock allows the investor the option of converting to benefit from the growth potential as well as having the fixed income of the preferred. Some preferred stock carries a callable provision. The corporation is given the right to call back its stock if it is in its best interest to do so. Some preferred stock is

also participating. This allows the investor to share in the common stock's dividends (if any are declared) and to receive the fixed dividend of the preferred stock.

Other Equities

Real estate investment trusts (REITs) are companies that manage real estate investments in order to earn profits for shareholders. REITs are generally traded publicly and are usually used to provide long term financing of real estate projects.

Similar to an investment company, a REIT pools money from different investors. These shareholders receive dividends from investment income or through capital gains distributions.

It may buy shares or certificates on stock exchanges or from the over-the-counter market. Subchapter M of the Internal Revenue Code allows a REIT to avoid being taxed as a corporation by receiving 75% or more of its income from real estate and distributing 95% or more of its taxable income to its stockholders.

American depositary receipts (ADRs) facilitate the trading of foreign stocks in U.S. markets. An ADR represents a receipt for shares (usually 1 to 10) of stock in a non-U.S. company and is a negotiable security. ADRs are bought and sold in the U.S. securities markets like stock and are registered on the books of the U.S. banks that are responsible for them. Owners of ADRs have most of the same rights as owners of common stock.

Equities Trading

Because approximately 40 to 50 million people own securities estimated to be worth \$2 trillion, the means of trading is elaborate and complicated. The term secondary market, which includes the stock exchanges and the over-the-counter market, refers to trading in outstanding issues. The term primary market refers to issuing new securities. A stock exchange is simply a private association of brokers organized to provide a location or floor for its member-brokers to meet. The price of securities exchanged on the floor is based on a free and open trading market and the supply and demand of any specific equity at any given time. Stocks that are traded on an exchange are known as listed stocks.

An order to buy is considered a market order which means it is to be bought at the lowest possible price at the time the order reaches the floor of the exchange. Market orders (with the great advantage of speed) are the most common of all orders and are valid until the exchange closes on the day the order is entered. Limit orders (with the definite advantage of minimum selling price and maximum buying price) are used when the investor is willing to wait to do business until his price is reached at the risk that the order may not be executed soon or at all. Day limit orders expire at the end of the day entered and GTC or open orders remain in force until the client orders that they be canceled or until they are filled. Limit orders to buy are always placed below the current market price and limit orders to sell are always placed above the current market price.

Whichever type order is chosen, it is telephoned by direct wire to a member firm, which then telephones it to its clerk on the floor. Each member firm has at least one member of the exchange who represents them, makes their trades on the floor, and acts as a commission broker. The commission broker consults the specialist who is responsible for conducting the auction at his post. When a broker who represents a buyer and a broker who represents a seller agree on a price, a sale is made. The specialist himself may buy the stock from the commission broker or sell it from his own inventory if it's a buy order. When the specialist is buying or selling for his own account, he is acting as a dealer and when he is executing limit orders left with him by a commission broker, he is acting as a broker. If he sells from the specialist's book, he earns a commission.

The broker may place the order with another exchange if he sees a better price posted on a monitor screen. The Intermarket Trading System (ITS) connects the seven major stock markets and makes the quotes of all securities available to all the markets where those securities are traded.

Most buy and sell orders on the NYSE are for 100 shares or multiples of 100 and are called round lots. A few stocks are traded in 10 share round lots, but those are generally the inactive stocks. Any trade for less than a round lot is called an odd lot. Odd lots are more trouble for a specialist to handle since he must match it to a round lot order of the same security. The price of the odd lot is determined by price of the next round lot and the specialist normally adds $1/8^{\text{th}}$ of a point to the price per share of every odd lot buy order and subtracts $1/8^{\text{th}}$ per share from the proceeds of an odd lot sale order. This becomes his compensation for the trouble of breaking round lots to fill odd lot orders.

Some orders are stop orders. A stop order to sell is called a sell stop and a stop order to buy is called a buy stop. Both become market orders when the market price reaches or goes through the specified stop price and will be executed at the best possible price thereafter. One use for stop orders is protective and the other is preventive. The protective can protect an investor from losing his profit and the preventive can prevent further losses. A sell stop is entered at a price below the market price and a buy stop is entered at a price above the market. A stop limit order is a stop order that becomes a limit order once it is activated.

Equities which are not listed on an exchange are called unlisted and must be traded over-the-counter (OTC). Since the over-the-counter market is a negotiated market, its buyers and sellers bargain to arrive at an agreeable price. The over-the-counter market does not have a trading floor or a central market place. It is made up of a network of thousands of brokers and dealers who make transactions for themselves and their customers. The process of negotiating agreeable prices takes place electronically and by telephone. The over-the-counter market has more than 30,000 issues with regular quotations. These include all government bonds, all municipal bonds, all mutual funds, all new issues, all variable annuities, all tax shelter programs, and all equipment trust certificates. Principals or dealers in the OTC market buy at one price and sell at a higher price. That is, they make a profit from marking up the price of the security.

Pink sheets are alphabetical listings of over-the-counter stocks and the name of one or more firms willing to trade that security. These lists are compiled daily by the National Quotation Bureau and contain wholesale quotations between dealers. The ask and bid prices on pink sheets are approximate, not actual, prices.

A firm quote indicates a bid and an offer at which an OTC dealer has committed to buy or sell at least one round lot of a particular security immediately. As market conditions change, OTC firms change their firm quotes. Spread is the difference between the bid and offer for OTC securities.

Third market trades refer to listed securities which are traded over-the-counter. Most trading of listed securities takes place on the NYSE, but it is possible for an OTC market making firm to secure an inventory of one or more listed securities and to begin making a market in it. These trades must be reported through the Consolidated Quotation System (CQS) within ninety seconds of the trade.

Fourth market trades are generally private transactions between institutions such as banks or insurance companies. These institutions swap securities without involvement from brokers or dealers and the trades are reported on a system referred to as Instinet.

Position means that a client, dealer or broker is either long or short in a security. If anyone owns a security, he has a long position. If anyone does not own a security but has sold a security and borrowed to make delivery, he has a short position. A short seller's losses are potentially unlimited since there is no limit to how high a stock's price may climb, but a long investor can only lose the amount of his total investment. Market makers have long positions when clients and other firms want to sell securities and the market makers have short positions when clients and other firms want to purchase securities in quantities larger than their current inventory. Whenever an equity can be bought and sold at firm prices very quickly and easily, the equity has a high degree of liquidity or marketability.

Trade Reporting

The NYSE reports its trading through the exchange's transaction reporting system known as the stock ticker. All information is handled electronically and is readily available throughout the world. Whenever a sale is made on the floor, a trade reporter gives the information to a page who sends it over an optical scanning machine so the information is sent to the exchange reporting system. Sales are reported by flashing symbols on the electronic board followed by the number of shares traded and the execution price. Three things are reported on the ticker tape: the name of the issue traded, the volume of the trade, and the price of the trade.

Nasdaq (not to be confused with NASD) stands for National Association of Securities Dealers Automated Quotation. It is a computerized system that provides automated quotations on the most active over-the-counter stocks and bonds. NASD stands for the National Association of Securities Dealers and is the organization of brokers which regulates trading on the over-the-counter market.

Common stock, preferred stock, municipal bonds and corporate bonds all use CUSIP numbers in trade confirmations.

Newspaper reports of NYSE transactions include valuable information for the security's customers, brokers, and dealers. To the left of the corporation's name is found the highest and the lowest price it has traded during the previous 52 weeks. After the abbreviation of the company's name, the current annual dividend per share is listed. The next column is the yield. Then comes the price earnings ratio (PE) followed by the sales in hundreds and then the high, low, and the last trade of the day. The last column is the net change. There are no listings for PE ratio for preferred stock because preferred stockholders only have a fixed claim against earnings.

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Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.