

Chapter One

Securities Markets, Investment Risks, and Policies

Introduction

The first chapter will lay the foundation on which the rest of the text is built. A thorough understanding of this material will be necessary in order to successfully complete the Series 6 exam. While a Series 6 Registered Representative may not directly sell the securities detailed in this first section, most mutual funds and variable annuities invest in these securities, so it is an important starting point.

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 their invested principal. If the product is not transferable or does not contain risk it is not a security.

Types of Securities

Common & Preferred stock
Bonds
Mutual funds
Variable annuities
Variable life insurance

Types of Non-Securities

Whole life insurance
Term life insurance
Retirement plans
Fixed annuities
Prospectus

Securities are broken up into two major categories for the Series 6: equity and debt. Let's begin by comparing the two different types of securities:

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, they become 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 there is no maturity date for the shares and the investor may own the shares until they decide to sell them. Most corporations use the sale of equity as their main source of business capital.

Debt = Bonds

A bond, or any other debt instrument, is actually a loan to the issuer. By purchasing a bond, the investor has made a loan to the corporation and become a creditor of the issuing company.

Debt instruments, unlike their equity counterparts, have a time frame or maturity date associated with them. Whether it is one year, five years, or 30 years, at some point the issue will mature and the investor will receive their principal back and will cease to be a creditor of the corporation. We will examine how investors may purchase stocks and bonds, but first we must look at how the corporation uses the sale of these securities to meet their organizational goals.

Capitalization

The term capitalization refers to the sources and makeup of the company's financial picture. To determine a company's capital composition, an investor must look at the corporation's balance sheet. The balance sheet is like a snapshot of the corporation's finances at the time it was produced. It shows a list of the company's assets and liabilities as well as the company's net worth or stockholders' equity. Most publicly traded companies have to disclose or report their performance at least quarterly.

The Balance Sheet Equation

$$\text{assets} - \text{liabilities} = \text{net worth}$$

Assets

Assets are everything that a company owns, including cash, securities, investments, inventory, property, and accounts receivable.

Liabilities

Liabilities are everything that a company owes, including accounts payable and both long- and short-term debt as well as any other obligations.

Net Worth

The company's net worth is equal to the value of all assets after all liabilities have been paid. This corporation's net worth is the stockholders' equity. Remember that the stockholders own the company.

Common Stock

There are thousands of companies whose stock trades publicly and that 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. There are two

types of equity securities, common stock and preferred stock. While 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 creation of a company and how common stock is created.

Corporate Time Line

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 is 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 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 is 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 to:

- ✓ Pay a stock dividend
- ✓ Expand current operations
- ✓ Exchange common shares for convertible preferred or convertible bonds
- ✓ 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.

Treasury Stock

Treasury stock is stock that has been sold to the investing public, which has subsequently been 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 to:

- ✓ Maintain control of the company
- ✓ Increase earnings per share
- ✓ Fund employee stock purchase plans
- ✓ Use shares to pay for a merger or acquisition

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

$$\text{issued stock} - \text{outstanding stock} = \text{treasury stock}$$

Values of Common Stock

The market value of a common stock 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

The book value of a corporation is the theoretical liquidation value of the company. It is calculated by taking all of the company's tangible assets and subtracting all of its liabilities. To determine the book value 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. 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 stockholders.

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, they may be offered to the general public.

Test Focus!

<u>Number of Existing Shares</u>	<u>Number of New Shares</u>	<u>Total Shares After Offering</u>
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, they own 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 their 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 45 days. This is known as the subscription price. Once the subscription price is set, it remains constant for 45 days, while the price of the stock is moving up and down in the market place. There are three possible outcomes for a right. They are:

Exercised

The investor decides to purchase the additional shares and sends in the money as well as the rights to receive the additional shares.

Sold

The rights have value and 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.

Expire

The rights will expire if 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 have elapsed.

Voting

A common stockholder has the right to vote on major issues facing the corporation. They are part owners of the company, and as a result, have the 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 and cumulative methods. A stockholder may cast one vote for each share of stock owned and the statutory or cumulative methods 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.

Test Focus!

An investor owns 200 shares of XYZ. There are two board members to be elected and there are four people running in the election. Under both the statutory and cumulative methods of voting, the number of votes the shareholder has is decided by multiplying the number of shares owned by the number of people to be elected. In this case, $200 \text{ shares} \times 2 = 400 \text{ votes}$. The cumulative or statutory methods dictate how those votes may be cast.

<u>Candidate</u>	<u>Statutory</u>	<u>Cumulative</u>
1	200 votes	400 votes
2		
3		
4	200 votes	

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

The cumulative method allows the shareholder 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

Stockholders' liability is limited to the amount of money they have invested in the stock. They cannot be held liable for any amount that exceeds their invested capital.

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 other security holders as well as all creditors of the corporation have been paid, common stockholders may claim the residual assets. For this reason, common stock is the most junior security.

Why Do People Buy Common Stock?

Capital Appreciation/Growth

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, 2008. On April 30, 2009, 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. Investors in common stock generally receive dividends quarterly.

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)?

$$\text{annual income} / \text{current market price} = \text{current yield}$$

$$$.50 \times 4 \text{ quarters} = \$2.00 \quad \$2 / \$20 = 10\%$$

The investor in the above example is receiving 10% of the purchase price of the stock each year in the form of dividends.

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 a company seems great, an investor 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 common shareholders a dividend.

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, that there will be little or no money left for the common stockholder.

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 directly, 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 takes 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 an 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. A market order, however, will be executed 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 all settle the next business day following the trade date and a trade done on a cash basis settles on the same day regardless of the security involved in the transaction.

Payment Date

The payment date is the day when the buyer of the security has to have the money to the brokerage firm to pay for the purchase. Payment date for securities under the industry rules 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 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 they want to make in the next 90 days. After the 90 days have expired, the customer is considered to have reestablished good credit and may then conduct business the “regular way” and will again be given up to five business days to pay for their 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 semi-annual 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 Preferred Stock

Par Value

Par value on preferred stock is very important because it is what the dividend is based on. Par value for preferred shares is \$100. 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

$$\mathbf{\$100 \times .09 = \$9 \text{ per share} \times 100 = \$900}$$

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, with no maturity date. Investors may hold shares for as long as they wish or until they are called in by the company under a call feature.

Non-Voting

Most preferred stock is non-voting.

Interest Rate Sensitive

Because of the fixed income generated by preferred shares, their price will be more sensitive to change in interest rates than the price of their common stock counterparts. As interest rates decline, the value of preferred shares tends to increase. 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 has different features associated with it than common stock. Most of the features are designed to make the issue more attractive to investors and therefore benefit the owners of preferred stock.

Straight/Non-Cumulative Preferred

Straight, or non-cumulative, 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, they must first pay the dividends in arrears as well as the stated preferred dividend before common shareholders receive anything.

Test Focus!

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

$$4 \times \$8 = \$32 \text{ per share}$$

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 stock 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?

$$\text{par value} / \text{conversion price (CVP)} = \text{number of shares}$$

$$\$100 / \$20 = 5$$

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

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