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 65 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 stock	Whole life insurance
Preferred stock	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	
ETFs/ETNs	
Real Estate Investment Trusts	
CMOs	

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.

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. 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

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, 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 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, 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, which 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 their percentage interest in the company. This is known as a preemptive right. Should the company wish to sell additional shares to raise new capital, they 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 this example, 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 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 market place.

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 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.
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 will trade 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.

DETERMINING THE VALUE OF A RIGHT CUM RIGHTS

In order to determine the value of one right before the ex-rights date, you must use the cum-rights formula. Subtract the subscription price of the right from the market price of the stock. Once the discount (if any) has been determined, divide the discount by the number of rights required to purchase one share plus one. This will determine the value of one right.

EXAMPLE

XYZ has 10,000,000 shares of common stock outstanding and is issuing 5,000,000 additional common shares through a rights offering. XYZ is trading in the marketplace at $51 per share and the rights have a subscription price of $48 per share. Keep in mind that the stock price reflects the value of the right that is still attached to the stock.

The value of a right is determined as follows:

Stock price
– Subscription price

The number of rights required to purchase one share + 1

$$\begin{array}{r} \$51 \\ -\underline{\$48} \\ \$\ \ 3 \end{array}$$

$3/3 rights = $1

Because each one of the 10,000,000 shares is entitled to receive one right and the company is offering 5,000,000 additional shares, it will require $48, plus two rights, to subscribe to one additional share. The rights agent will handle the name changes when the rights are purchased and sold in the market place.

DETERMINING THE VALUE OF A RIGHT EX RIGHTS

In order to determine the value of one right after the ex-rights date, subtract the subscription price of the right from the market price of the stock. Once the discount (if any) has been determined, divide the discount by the number of rights required to purchase one share. This will determine the value of one right. The price of the stock on the ex-rights date is adjusted down by the value of the right to reflect the fact that purchasers of the stock will no longer receive the rights.

EXAMPLE

XYZ has 10,000,000 shares of common stock outstanding and is issuing 5,000,000 additional common shares through a rights offering. XYZ is trading in the marketplace at \$50 per share and the rights have a subscription price of \$48 per share. The value of a right is determined as follows:

Stock price
– Subscription price

The number of rights required to purchase one share

$$\frac{\$50 - \$48 = \$2}{}$$

\$50
– \$48
\$2

\$2/2 rights = \$1

Because each one of the 10,000,000 shares is entitled to receive one right and the company is ffering 5,000,000 additional shares, it will require \$48, plus two rights, to subscribe to one additional share.

VOTING

As a common stockholder, you have the right to vote on the major issues facing the corporation. You are a part owner of the company and, as a result, you 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:

- 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: statutory and cumulative. 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.

TESTFOCUS!

An investor own 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, 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 cumulative or statutory methods dictate 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 for whom the investor wishes to vote.

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

A stockholder's liability is limited to the amount of money invested in the stock. They 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 their 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 which identifies the:

- Name of the issuing company
- Number of shares owned
- Name of the owner of record
- 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 that 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, 2012. On April 30 of 2013, 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 this 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 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. Although 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 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 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. Although 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 for which the customer failed to pay. 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 then will 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 then may conduct business in the regular way and take 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 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.

TAKENOTE!

While not the norm, some companies issue adjustable rate preferred shares. The dividend rate on these shares will be adjusted based on a benchmark such as Treasury bill rates. Because the dividend rate adjusts with market interest rates the price of the shares tends to be stable.

FEATURES OF ALL PREFERRED STOCK

There are a number of different types of preferred stock but all preferred stock have the same basic features.

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 with 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, they must first pay the dividends in arrears, as well as the stated preferred dividend, before common holders 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 their discretion or after some period of time has expired. Most callable preferred stock may not be called in during the first few years after its 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 their 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

There are a number of ways in which a corporation may pay a dividend to its shareholders. The type of dividend declared for payment may vary between corporation and economic circumstances.

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 investors account. Securities 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 also wants to conserve cash for other business purposes—may elect to pay a stock dividend to their shareholders. Each investor will receive an additional number of shares based on the number of shares that they own. 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, but 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, they may not discriminate as to who receives the dividend. The dividend must be paid to all common stockholders of record. An investor who already owns the stock does not need to notify 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 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 purchases 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 that 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 of this, 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 22. The ex-dividend date will be two business days prior to the record date. In this case, the ex date will be Tuesday, August 20. If TRY closed on Monday, August 19, 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 investors are taxed at a rate of 15% for the year the dividend is received. 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 their 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 they receive the dividend.

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 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 often will 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	**Why**	Offered as a sweetener to make securities more attractive

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

American depositary receipts 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 less in 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 a 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 real estate investment trust 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 as long as:

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

As long as the REIT meet these 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.

It is important to note that REITs do not pass through losses or expenses to shareholders, only income. REIT investors own an undivided share of the underlying real estate portfolio. An investor may elect to invest in a REIT rather than directly in real estate ownership because of the greater liquidity provided by the REIT and the quality of the property manager.

DIRECT PARTICIPATION PROGRAMS AND LIMITED PARTNERSHIPS

Direct participation programs and limited partnerships are entities that allow income, expenses, gains, losses, and tax benefits to be passed through to the investors. There is generally no active secondary market for these investments, so it's important that investors understand the risks and can afford the risks associated with direct participation programs and limited partnerships. Series 65 candidates can expect to see several questions on this material on their exam.

LIMITED PARTNERSHIPS

A limited partnership is an entity that allows all of the economic events of the partnership to flow through to the partners. These economic events are:

- Income
- Gains
- Losses
- Tax credits
- Deductions

There are two types of partners in a limited partnership. They are the limited partners and the general partner. The limited partners:

- Put up the investment capital
- Losses are limited to their investment
- Receive the benefits from the operation
- May not exercise management over the operation
- May vote to change the objective of the partnership
- May vote to switch or remove the general partner
- May sue the general partner, if the general partner does not act in the best interest of the partnership

A limited partner may never exercise any management or control over the limited partnership. Doing so would jeopardize their limited status and they may be considered a general partner.

The general partner is the person or corporation that manages the business and has unlimited liability for the obligations of the partnership business. The general partner may also:

- Buy and sell property for the partnership
- Receive compensation for managing the partnership
- Enter into legally binding contracts for the partnership

The general partner also must maintain a financial interest in the partnership of at least 1%. The general partner may not:

- Commingle funds of the general partner with the funds of the partnership
- Compete against the partnership
- Borrow from the partnership

It is important to note that there are no tax consequences at the partnership level. In order to qualify for the preferential tax treatment, a DPP or LP must avoid at least two of the six characteristics of a corporation. These characteristics are:

- Continuity of life
- Profit motive
- Central management
- Limited liability
- Associates
- Freely transferable interest

Several of the characteristics cannot be avoided, such as associates and a profit motive. The easiest two characteristics of a corporation to avoid are continuity of life and freely transferable interest. The LP can put a termination date on the partnership and substitute limited partners may not be accepted or may only be accepted once the general partner has agreed.

STRUCTURING AND OFFERING LIMITED PARTNERSHIPS

The foundation of every limited partnership is the partnership agreement. All limited partners must be given a copy of the partnership agreement. The partnership agreement will spell out all of the terms and conditions, as well as the business purpose for the partnership. The powers and limitations of the general partner's authority will be one of the main points detailed in the partnership agreement. Prior to forming a limited partnership, the general partner will have to file a certificate of limited partnership in the state in which the partnership is formed. The certificate will include:

- Name and address of the partnership
- A description of the partnership's business

- The life of the partnership
- Size of limited partner's investments (if any)
- Conditions for assignment of interest by limited partners
- Conditions for dissolving the partnership
- Conditions for admitting new limited partners
- The projected date for the return of capital if one is set

A material change to any of these conditions must be updated on the certificate within 30 days.

Most limited partnerships will be offered to investors through a private placement. All investors who purchase a limited partnership through a private placement must receive a private placement memorandum. Private placements, with very limited exceptions, may only be offered to accredited investors. However, a few limited partnerships will be offered to the public through a standard public offering. All investors who purchase a limited partnership though a public offering must receive a prospectus. If the partnership is sold through a syndicator, the syndicator is responsible for filing the partnership documents. The maximum fee that may be received by the syndicator is limited to 10% of the offering. If a secondary market develops for a partnership, the partnership will be known as a master limited partnership or MLP. All investors wishing to become a limited partner must complete the partnership's subscription agreement. The subscription agreement will include:

- A power of attorney appointing the general partner
- A statement of the prospective limited partner's net worth
- A statement regarding the prospective limited partner's income
- A statement from the prospective limited partner that they understand and can afford the risks related to the partnership

TYPES OF LIMITED PARTNERSHIPS

A limited partnership may be organized for any lawful purpose. The limited partnerships that are most common are set up to:

- Invest in real estate
- Invest in oil and gas wells
- Engage in equipment leasing

There are several types of real estate partnerships. They are:

- Existing property
- New construction
- Raw land
- Government-assisted housing
- Historic rehabilitation

Type of LP	Risk	Advantages	Disadvantages	Tax Benefits
Existing property Purchase income property	Low	Immediate predictable cash flow	Rental problems and repairs	Deductions for mortgage interest and depreciation
New construction Build units for appreciation or rental	Higher	Potential capital gains low maintenance	No deduction for current expenses and no promise of rental or sale	Deduction of expenses and depreciation only after completion
Raw land Purchase land for appreciation	Highest	Only appreciation potential	No tax deductions or income	No tax benefits
Government-assisted housing Low-income housing	Low	Government rent subsidies and tax credits	High maintenance costs risk of a change in government programs	Tax credits and any losses on the property
Historic Rehabilitation Restore sites for use	Higher	Tax credits	Financing trouble, no rental history	Tax credits deductions and depreciation

TAX REPORTING FOR DIRECT PARTICIPATION PROGRAMS

Direct participation programs are organized as either limited partnerships or as Subchapter S corporations. These entities allow for the flow-through of income and losses and the DPP has no tax consequences. The DPP will only report the results of its operation to the IRS. The responsibility for paying any taxes due rests with the partners or shareholders. DPPs allow the losses to flow through to the investors. Losses from DPPs can only be used to offset the investor's passive income. Investors may not use the losses to shelter or offset the ordinary income. Investors should not purchase DPPs simply for the tax benefits; they should purchase them to earn a return. Any DPP that is found to have been formed simply to create tax benefits may subject the investors to strict penalties. Investors could owe back taxes, fines, or be prosecuted for fraud.

LIMITED PARTNERSHIP ANALYSIS

Before investing in a limited partnership, the investor should analyze the key features of the partnership to ensure that the partnership's objectives meet their investment objectives. The investor should review:

- Economic viability of the program
- Tax considerations
- Management's ability
- Lack of liquidity
- Time horizon
- Whether it is a blind pool or a specified program
- Internal rate of return

A blind pool is a partnership in which less than 75% of the assets that the partnership is going to acquire have been identified. In a specified program, more than 75% of the assets that the partnership is going to acquire have been identified.

A partnership's internal rate of return is the discounted present value of its projected future cash flow.

TAX DEDUCTIONS VS. TAX CREDITS

Tax deductions that are generated by partnerships are used to lower the investor's taxable income. A tax credit results in a dollar-for-dollar reduction in the amount of taxes due from the investor.

OTHER TAX CONSIDERATIONS

If a limited partnership has used up all of its deductions and has a gain on the sale of a depreciated asset, the sale above the asset's depreciated cost basis may subject the limited partners to a taxable recapture. There are two types of loans that a partnership may take out: a nonrecourse loan and a recourse loan. With a nonrecourse loan, if the partnership defaults, the lender has no recourse to the limited partners. With a recourse loan, in the event of the partnership's default, the lender can go after the limited partners for payment. A recourse loan can increase the investor's cost base. Partners must monitor their cost base and adjust it for:

- Cash or property contributions to the partnership
- Recourse loans
- Any cash or property received from the partnership

Investors are responsible for any gain on the sale of their partnership interest in excess of their cost basis.

DISSOLVING A PARTNERSHIP

A partnership will terminate on the date set forth in partnership agreement, unless earlier terminated. A partnership may dissolve if a majority of the limited partners vote for its dissolution. If the partnership terminates its activities, the general partner must cancel the certificate of limited partnership and liquidate the partnership assets. The priority of payment will be as follows:

- Secured lenders
- General creditors
- Limited partners' profits first, then return of investment
- General partner for fees first, then profits, then return of capital

TAKENOTE!

An investor in a limited partnership is subject to both liquidity risk and legislative risk. The investor may not be able to liquidate their interest when they need to and the government may change tax laws relating to their investment. As a result, an investor should not have more than 10% of their portfolio in limited partnerships.

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. All qualified dividends 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%

5. All of the following are rights of common stockholders, except:
   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

6. 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 to receive dividends that the foreign corporation declares for shareholders.
   d. The foreign country may issue restrictions on the foreign ownership of stock.

7. An investor buys a 10% preferred stock at 110. What is their current yield?
   a. 10.4%
   b. 9.1%
   c. 10%
   d. 9.5%

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

9. 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.

10. 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

11. 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

12. 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. Right to receive past dividends not paid by the corporation
    c. Right to exchange the preferred for the underlying common shares
    d. The right to receive the past dividends before common holders receive a dividend

13. Authorized stock is all of the following, except:
    a. The maximum number of shares a company may sell
    b. Arbitrarily determined at the time of incorporation and may not be changed
    c. May be sold in total or in part when the company goes public
    d. Sold to investors to raise operating capital for the company

14. 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

15. Common dividends are all of the following except:
    - **a.** A portion of the earnings of the company
    - **b.** A source of income for the investor
    - **c.** Generally paid quarterly
    - **d.** A figure determined by subtracting the current yield from the current market price

16. If a 5% stock dividend is paid to an investor who owns 800 shares of stock already, the investor will receive how many shares?
    - **a.** 4 shares
    - **b.** 8 shares
    - **c.** 40 shares
    - **d.** 80 shares

17. It may be necessary for a company to repurchase some of its stock, to increase its treasury stock, for which one of the following reasons:
    - **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