

CHAPTER ONE

EQUITY AND DEBT SECURITIES

Introduction:

This first chapter will build the foundation upon which the rest of this text is built. A thorough understanding of this material will be necessary in order to successfully complete the series six exam. While a series six-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's 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 stock
Preferred stock
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 six equity and debt. Let's begin by comparing the two differed 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 in fact made a loan to the corporation and has become a creditor of the company that issued the instrument.

Debt instruments, unlike their equity counterparts, have a time frame or maturity date associated with them. Whether it is one year, five years, or thirty years, at some point the issue is going to 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 make up 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 snap shot of the corporation's finances at the time it was taken. It shows a list of all 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, both long and short term debt along with 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 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

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:

- ✓ To pay a stock dividend
- ✓ To expand current operations
- ✓ To 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.

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:

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

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. It 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. 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 which 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. Should 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 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:

Exercised:

The investor decides to purchase the additional shares and sends in the money along with 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 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.

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:

- ✓ 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, they are known as the statutory and cumulative methods of voting. 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 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, you take the number of shares owned and multiply them by the number of people to be elected to determine how many votes the shareholder has. In this case, $200 \text{ shares} \times 2 = 400 \text{ votes}$. 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 that 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 invested in the stock. They can not be held liable for any amount past 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, which 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 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?

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, 1999. On April 30th of 2001, 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.

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

$$\$.50 \times 4 = \$ 2.00 \quad \$ 2 / \$ 20 = 10\%$$

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

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 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 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. 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 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 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 in 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 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. The brokerage firm on the sixth business day following the trade date 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 ninety days. After the ninety days have expired, the customer is considered to have reestablished good credit and may then conduct business on 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 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 all preferred stock

Par Value

Par value on preferred stock is very important because that’s what the dividend is based on. Par value for all preferred shares is \$100. 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

$$\text{\$ 100 x 9\% = \$9 per share x 100 = \$900}$$

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 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 / Non-Cumulative

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.

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 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 stock holder receive upon conversion?

Number of shares = par / conversion price (CVP)

$$\text{\$ 100} / \text{\$ 20} = 5$$

The investor may receive 5 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.

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 preferred which is callable may not be called in the first few years after its issuance. This feature that 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

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 x \$.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 dividend to be paid.

$$500 \times 5\% = 25$$

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 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 the NASD depending where the stock trades at least ten 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 the NASD set the ex date for the stock based on the record date determined and announced by the corporation's Board of Directors. Because it takes three business days for a trade to settle, the ex date is always two business days prior to the record date.

Record Date

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

Test Focus!

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

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

Taxation of Dividends

All dividends received by investors are taxed as ordinary income for the year in which the dividend is received.

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 was to purchase the shares just prior to the ex dividend date simply to receive the dividend, the investor in many cases will end up worse off. The dividend in this case will actually be a return of the money that the investor used to purchase the stock and the investor will have a tax liability when they receive the dividend.

Rights and Warrants

Rights

A right is issued to existing shareholders by a corporation that wants to sell additional common shares to raise new capital. All common stockholders have a preemptive right to maintain the proportional ownership in the company. If the corporation were allowed to sell additional shares to the general public, the existing shareholders interest in the company would be diluted. As a result, any new offering of additional common shares must first be made to the existing shareholders. Common shareholders will receive a notice of their right to purchase the new shares. They will be offered the opportunity to purchase the new shares at a price that is below the current market value of the stock. This is known as the subscription price. The shareholder will have the right to purchase the new shares for 45 days.

Possible Outcomes for a Right

Exercised

The shareholder may elect to purchase the additional shares. This is known as exercising the right. The investor sends in the rights along with a check for the total purchase price to the rights agent and the additional shares are issued to the investor.

Sold

The investor may not want to purchase the additional shares and may elect to sell the rights to another investor. The investor who purchases the right will then have the opportunity to purchase the stock at the subscription price for the duration of the original 45-day period.

Expire

The right to purchase the additional shares will expire at the end of the 45-day period if no one has elected to purchase the shares. A right will only expire if the stock's market price has fallen below the subscription price of the right. While market price of the stock is fluctuating during the 45-day period, the subscription price of the right remains fixed.

Terms

The particular terms of the rights will be printed on the right certificate and each share of outstanding stock will be issued one right. The terms will include: the subscription price, the final date for exercising the rights, the number of rights required to purchase additional shares, and the date that the new shares will be issued.

Standby Underwriting

A corporation may retain a brokerage firm to purchase any shares which existing shareholders do not purchase. This is known as a standby underwriter. The brokerage firm will purchase the shares that were not bought by the existing shareholders and resell them to the investing public.

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 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 ten 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, which comes with a warrant attached to purchase, an additional common share is known as a unit.

Attached to Bonds

Many times companies will attach warrants to their bond offerings as a "sweetener" to help market the bond offering. The warrant to purchase the common stock makes the

bond more attractive to the investor and may allow the company to issue the bonds with a lower coupon rate.

Secondary Market

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

Possible Outcomes of a Warrant

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

Rights vs. Warrants

Rights		Warrants
Up to 45 days	Term	Up to 10 years
Below the Market	Subscription price	Above the market
May trade with or Without common Stock	Trading	May trade with or without common stock or bonds
Issued to existing Shareholders to ensure preemptive rights	Who	Offered as a sweetener to make securities more attractive

Options

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

Types of Options

Calls

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

Puts

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

Bullish vs. Bearish

Bullish

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

Bearish

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

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

Characteristics of All Options

All option contracts are issued and their performance is guaranteed by the Options Clearing Corporation (The OCC) Standardized options trade on the exchanges such as the Chicago Board Options Exchange and the American Stock Exchange.

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

Exercise Price

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

Buyer vs. Seller

<u>Buyer</u>		<u>Seller</u>
Owner	Known as	Writer
Long	Known as	Short
Rights	Has	Obligations
Maximum	Objective	Premium
Speculative		Income
Profit	Wants the option	
	To	
Exercise		Expire

Possible Outcomes For an Option

Exercised

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

Sold

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

Expire

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

American Depository Receipts (ADR's) / American Depository Shares (ADS's)

American Depository Receipts facilitate the trading of foreign securities in the US markets. An ADR is a receipt, which represents the ownership of the foreign shares that are being held abroad in a branch of a United States bank. Each ADR represents ownership of between one to ten shares of the foreign stock and the holder of the ADR may request the delivery of the foreign shares. Holders of ADR's 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 US dollar, the holder of the ADR will receive less US dollars when a dividend is paid and less in US dollars when the security is sold. It's important to note that the dividend on the ADR's paid by the corporation in the foreign currency and is converted so that the dividend is received by the holder of the ADR in US dollars.

Securities Markets

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

The Exchanges

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

see on the news and financial reports when they show the floor of the exchange. All securities that trade on an exchange are known as listed securities.

Over the Counter / NASDAQ

Securities that are not listed on any of the exchanges trade over the counter or on the NASDAQ. NASDAQ stands for National Association of Securities Dealers Automated Quotation System. It is the inter-dealer network of computers and phone lines that allows securities to be traded between broker dealers. NASDAQ is not an auction market or an exchange. It is a negotiated market. One broker dealer negotiates a price directly with another broker dealer. None of the other interested parties for that particular security have any idea of what terms are being proposed. The broker dealers may communicate over their NASDAQ workstations or can speak directly to one another over the phone.

Market Makers

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

Third Market

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

Fourth Market

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