EQUITIES CHAPTER (1)

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SECTION 1: COMMON STOCK

1a. ISSUANCE OF COMMON STOCK

Common is equity issued by regular corporations and investment companies

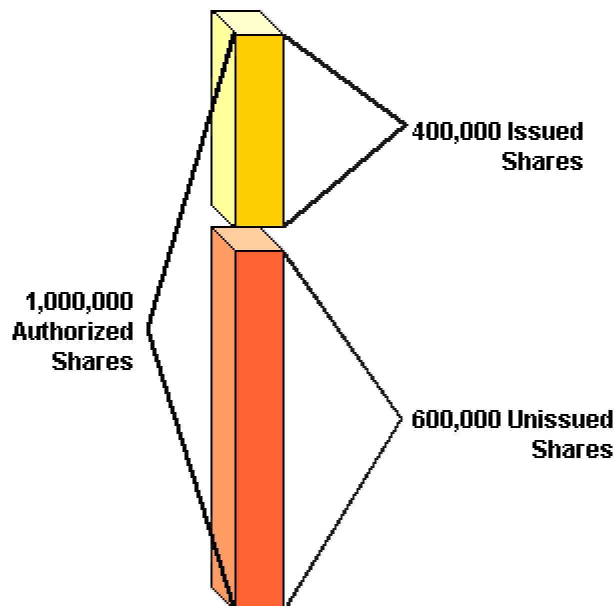
A common stockholder is an "owner" of a corporation. Owners are considered to have an equity position in the corporate structure. Therefore, common stock is an "equity" security. Aside from regular corporations, issuers of common stock include investment companies, such as mutual funds and real estate investment trusts.

Authorized stock / Arbitrary low par value

When a corporation is formed, its corporate charter authorizes that a fixed number of common shares may be issued. This is called "authorized" stock. The stock is assigned an arbitrary par value, which is typically set quite low. For example, common stock might be assigned a par value of 10 cents a share or $1 per share. Sometimes, par value is even set at zero, which is termed no par common stock. Par value for common has no bearing on the market price of the stock. Market value is based on investor expectations about the future of the company. The reason why par value is set so low is that many states tax corporations based on the par value of their shares.

Issued stock

Assume that a corporation is authorized under its charter to sell 1,000,000 common shares with a $1 par value. The corporation does not "issue" all of its authorized shares. It sells only part of the authorized amount to the public so that it has the ability to sell more shares at a later date without having to amend its corporate charter. If this corporation issues 400,000 shares, it still has 600,000 shares available for issuance at a later date. This looks as follows:



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Outstanding shares / Treasury stock - repurchased shares

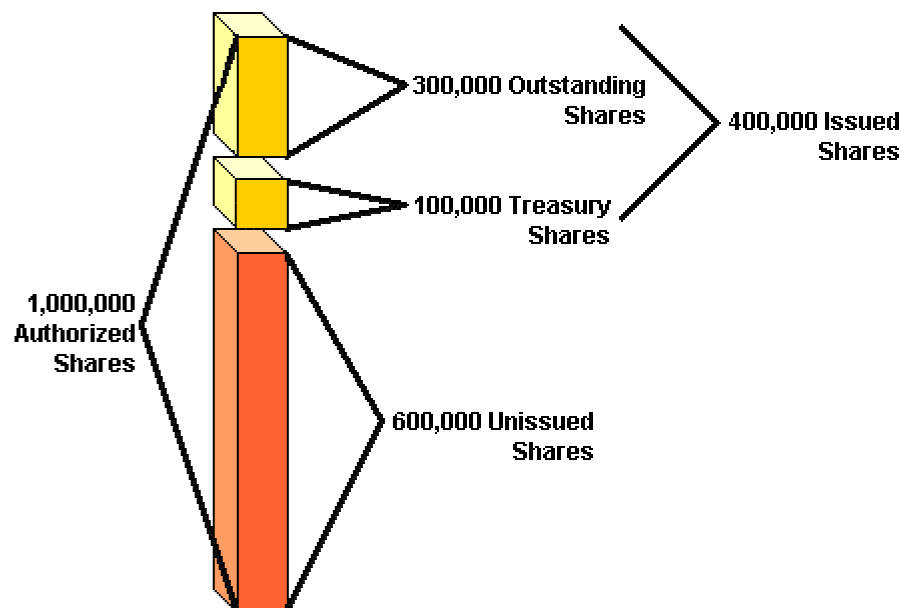
This corporation now has 400,000 shares outstanding in the hands of the public. These are the shares that trade in the market. After issuance, the corporation may "buy back" shares that are trading in the market. Repurchased shares are called "Treasury Stock" and are no longer outstanding in the hands of the public. Corporations will repurchase shares because:

- The market price is low and the corporation feels that the stock is a "good buy" at that price.
- As Treasury stock is repurchased, the number of outstanding shares is reduced. Because earnings per share is based on outstanding shares, with fewer shares outstanding, earnings per share will rise.
- The shares can be used to fund pension plan and stock option plan obligations.
- The shares can be used at a later date as "payment" for an acquisition or merger.

Treasury stock does not vote or receive dividends

Treasury shares do not have the usual privileges accorded to outstanding common shares. For example, Treasury shares cannot vote and do not receive dividends. (These rights of a common shareholder are covered later.)

Assume that our sample corporation has repurchased 100,000 common shares for its Treasury. The common stock structure of the corporation is:



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1b. SHAREHOLDER RECORDKEEPING

Registered in owner's name

The corporation must keep detailed records of the number of shares outstanding and the names and addresses of the owners of the shares. These shares are "registered" in the name of the owner. All equity securities are registered, so that the corporation can send dividends and other mail to the proper owners.

Registrar

The corporation hires an outside firm (usually a bank or trust company) to act as registrar. The registrar ensures the integrity of the list of all shareholder names and addresses and is given the responsibility to make sure that the company does not issue more shares than authorized under its charter.

Transfer agent / Record book of shareholders

The corporation also hires an outside firm, a bank or trust company, to act as transfer agent. Every day, as trades of the stock settle (meaning payment takes place), a report is made to the transfer agent. The transfer agent then cancels old shares which have been sold and issues new shares in the name of new buyers of the stock. The transfer agent keeps an accurate record of the shareholders updated daily. Because it maintains the shareholders' names and addresses, the transfer agent usually handles the mailings to shareholders (e.g. dividends, corporate reports and voting materials).

The registrar acts as a watchdog over the transfer agent. Transfer agents can, and have, made mistakes, such as canceling 100 shares and transferring those shares to the new owner as 1000 shares. The registrar is supposed to catch these mistakes and assure correction.

Book entry certificate

Instead of physically issuing and canceling certificates, a newer method of recording owners is through "book-entry" certificates. When securities are issued "book-entry," no certificates are issued. Instead, the ownership record is simply kept by the transfer agent and by the clearing corporation that settles trades.

1c. RIGHTS OF A COMMON SHAREHOLDER

Common shareholders enjoy limited liability as owners of the company (the most they can lose is their investment) and have a number of rights. These rights are:

- right to vote
- right to inspect books and records
- right to transfer ownership
- preemptive right
- right to corporate distributions
- right to corporate assets upon dissolution

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Right to vote

Common stockholders vote at the company's annual meeting. They vote for the Board of Directors (most corporate charters have half the Board come up for election each year) and on matters that affect the shareholder's "ownership interest." For example, the common shareholders must approve the issuance of convertible bonds, since these securities can be converted into more common shares. If conversion occurs, with more shares outstanding, each existing shareholder's "ownership interest" will be diluted. Shareholders do not vote on management or dividend decisions - these are made by the Board.

Voting rules may vary, to some degree, from state to state. However, the New York Stock Exchange has very specific voting rules for companies that wish to list their shares.

Items That Require A Shareholder Vote

Voting rules may vary to some degree, from state to state. Generally, the shareholder approval is required if the corporation wishes to:

- Declare a stock split
- Declare a reverse stock split
- Issue convertible bonds or preferred stock
- Issue stock options to officers on a preferential basis

The logic for shareholder approval of a stock split or reverse stock split is that these change the par value of the company's stock. Since the original par value was legally established in the corporate charter, any change to this par value must be approved by the shareholders.

The logic for shareholder approval of convertible securities is that such an action is highly "dilutive," resulting in the issuance of many more common shares, reducing each existing shareholder's ownership interest. Issuing "preferential" stock options to officers benefits a select group of individuals, and could be viewed as "self-dealing" by these persons - hence shareholder approval is required.

Items That Do Not Require A Shareholder Vote

Generally, shareholder approval is **not** required if the corporation wishes to:

- Declare a cash dividend
- Declare a stock dividend
- Declare a rights distribution (discussed later in this section)
- Repurchase shares for its Treasury

Dividend decisions are made at the sole discretion of the Board of Directors - no shareholder vote is required. This is true for both cash dividends and stock dividends (defined as any stock distribution that is less than 25% of the outstanding shares). Any dividend distribution, even a stock dividend, had no effect on the stock's par value, so there is no requirement for a shareholder vote. Rights distributions preserve a shareholder's ownership interest, so no voting is required. Finally, repurchase of Treasury shares results in fewer common shares outstanding, increasing each shareholder's percentage ownership, so no voting is required.

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1 vote per share

Each shareholder gets 1 vote per share. An owner with 100 shares gets 100 votes on each item being voted on that year. The corporation will use one of two voting methods - either statutory voting or cumulative voting. Assume that 6 directorships are open (6 voting items), with a choice of one of three persons for each directorship. Voting for a 100 share owner works as follows:

- Statutory Voting: 100 votes maximum are allowed for **each** directorship. In total, 600 votes are cast
- Cumulative Voting: 6 directorships x 100 votes = 600 votes which may be cast in **any manner**. For example, 300 could be cast for one director, 200 for a second, 100 for a third, with no votes for the remaining three directors.

Most corporations use statutory voting. Cumulative voting is considered to be an advantage for the "small investor" since he or she can vote disproportionately and can achieve more influence in the election of "selected" directors.

If a shareholder does not attend the annual meeting, he or she cannot vote. For this reason, many companies are infamous for having the meetings in places like East Gulch, Texas. If the only people who show up at the meeting are management (who usually hold large positions) and only they vote, they get to do whatever they want with the company.

Proxies - completed by shareholders who do not attend annual meeting

To stop this, shareholders not attending the meeting are required to receive voting cards from the company. By filling out these cards and mailing them to the company, at the annual meeting these votes will be counted. These cards are called "proxies" since a person at the annual meeting is acting as the shareholder's "proxy" (stand-in) and voting for them. Many shareholders receiving proxies do not respond. If this happens, management controls the voting at the annual meeting.

Common stock with different classes

Some companies issue different classes of stock with different voting rights. For example, a family-owned company may go public by issuing Class A stock for family members and Class B stock for the public. Class A stock will have all voting privileges or "concentrated" privileges. Class B stock does not vote or has limited voting ability.

Right to inspect books and records

Common shareholders may inspect the books and records of a company. In practice, this doesn't happen since audited financial statements are required to be sent to shareholders annually by the Securities and Exchange Commission under the Securities Act of 1934.

Right To Transfer Ownership / Negotiable / Non-negotiable

Common shareholders have the right to sell their shares to anyone else without restriction. The shares are "negotiable" securities. They can be traded. Certain securities are "non-negotiable." They cannot be traded. As an example, mutual fund shares are non-negotiable. Savings bonds are non-negotiable. These securities are redeemed with the issuer at a calculated value.

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Preemptive right

If the corporation wishes to issue more shares, common stockholders have the right to buy these shares before anyone else. Thus, they can maintain their proportionate ownership interest in the company. The offer of these shares to existing shareholders is called a "rights offering" and is discussed below in the **RIGHTS DISTRIBUTIONS** section.

Right to corporate distributions

The Board of Directors decides if the corporation will pay a cash dividend, a stock dividend, or if it will "split" its stock (usually done when the market price of the stock rises too high for an average investor to buy the shares; by splitting the stock, the number of shares is increased and the price reduced, making the issue more accessible to investors). The common shareholder has the right to his pro-rata share of these distributions. Most corporations declare and pay common dividends quarterly.

Right to corporate assets upon dissolution

If the corporation goes bankrupt or is dissolved, the common stockholder is paid (if any assets remain).

1d. CORPORATE DISTRIBUTION PROCEDURES

When a corporation decides to make a distribution (for example, a cash dividend) or if the corporation is going to issue "preemptive rights" to its existing shareholders, it makes an announcement which is published in such newspapers as The Wall Street Journal. Below is a sample announcement:

> **Monday, March 31, 20XX**
>
> The Board of Directors of Acme Manufacturing Company today declares a dividend of 50 cents per share to stockholders of record on April 15, 20XX. The dividend will be paid on April 30th, 20XX.

The Board of Directors has set the:

- Declaration Date: The date the dividend is declared;
- Record Date: The date on the which the corporation takes the shareholder names and addresses from the transfer agent records for mailing the dividend;
- Payable Date: The date the dividend checks will be mailed by the corporation's transfer agent.

These dates show on the calendar as:

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April 200X

S	M	T	W	T	F	S
	31	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			

Declaration Date

Record date

Payable date

Regular way settlement - 3 business days / Must settle by record date to receive dividend

Once the distribution is announced, the exchange where the stock trades has some work to do. To be an owner of record for the distribution, a customer must have paid for the stock by the close of business on the 15th (the record date). If the trade settles on the record date or before, the buyer will be on record as of the evening of the 15th and will be mailed the dividend.

If trade settles after record date, do not receive dividend

Regular way settlement occurs 3 business days after trade date, so that the last day to buy and get the dividend is 3 business days prior to the record date. If the stock is bought after this date, the trade will settle after the record date and no dividend is received.

April 200X

S	M	T	W	T	F	S
	31	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			

Last day to buy stock regular way and receive dividend

Record date

Cum-dividend

If a customer buys on the 10th or before in a regular way trade, he or she will get the dividend. The stock is trading with the dividend - "cum dividend."

Ex-dividend

If the customer buys on the 11th or later, he does not get the dividend - the stock is now trading "ex-dividend."

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April 200X

S	M	T	W	T	F	S
	31	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			

Last day to buy stock regular way and receive dividend

Record date

First day stock trades without dividend

If a customer buys on the 9th, the trade will settle on the 14th, regular way, and the customer will get the dividend. If the customer buys on the 10th, the trade will settle on the 15th, and since the record book list is taken that night, the customer will get the dividend. If the customer buys on the 11th, the trade will settle on the 16th, and the customer will not be on the record book for the dividend, since the list was taken the previous night.

On ex-date the exchange reduces price of stock

As of April 11th, any purchaser in a regular way trade does not get the dividend. The exchange sets this date as the "ex dividend" date and reduces the price of the stock by the amount of the distribution when the stock opens for trading, since purchasers no longer qualify for the payment.

April 200X

S	M	T	W	T	F	S
	31	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			

Last day stock trades cum dividend

Record date

Ex date

Ex-date for cash dividends is 2 business days prior to record date

The "ex-date" is set by the exchange as 2 business days prior to the record date. (Remember, if one buys the stock 3 business days prior to the record date, the trade will settle on the record date and that person will get the distribution.)

Assume that Acme stock was trading at $20 on the 10th. As of the 11th (the "ex"-date), the stock will open for trading at a price reduced by the $.50 dividend, so it opens at $19.50. Reduction on ex-date is done for a very simple reason. It stops traders from making windfall profits. If there was no reduction, a day trader could buy the stock on the 10th (getting on the record book for the 15th) and then sell on the 11th (going off the record book on the 16th) and be on the record book for the one day necessary to get a $.50 dividend check. If there is no reduction, he could buy at $20 and then sell at $20 the next day and get a $.50 check for 1 day's investment.

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With the reduction, he buys at $20 and sells at $19.50, but receives the $.50 dividend, so the end result is a "wash."

Ex-dates for cash dividends, stock dividends and splits, and rights offerings

Ex-dates (adjustment dates) are set not only for cash dividends, but also for stock dividends, stock splits, and rights offerings (discussed in the next section). For example, a corporation is splitting its stock 2 for 1. Just prior to the ex-date, the stock is trading at 44. As of the morning of the ex-date, the exchange will open the stock at 22 ($44 / 2).

As another example, a corporation declares a 20% stock dividend. Just prior to the ex-date, the stock is trading at $48. As of the ex-date, the exchange will open the stock at $40 ($48 / 1.20).

1e. RIGHTS DISTRIBUTIONS

We know that shareholders have the "preemptive" right to maintain proportionate ownership in the company. If a company wants to issue new shares, it gives its existing shareholders "first chance" on the issue.

Existing owners can subscribe at a lower price

The existing shareholders are able to buy these shares for less than the current market price. The discount reflects the amount that would have to be paid to an underwriter to handle the offering if the issue were being sold to the general public. By selling directly to its existing shareholders, the company avoids using an underwriter and can pass the savings on to the existing shareholders.

Rights agent

To handle the mechanics of the offering, the corporation hires a "rights agent." This is usually the existing transfer agent of the issuer. The rights agent issues the additional shares upon presentation of the rights certificates with the appropriate dollar subscription amount.

Rights offering performed with a stand-by underwriter

If all of the issue is not subscribed to by existing shareholders, the issuer will have an underwriter "stand-by" to pick up the unsubscribed shares. The underwriter then resells these shares to the public. This is known as a "stand-by" underwriting and ensures that the issuer sells the entire issue and gets the needed funding.

Rights expire in 30 - 60 days

Since the existing shareholders can buy the stock for less than the current market price, their subscription rights have value. Shareholders are free to exercise their subscription rights or they can sell them to someone else. Since these rights typically last for 30 to 60 days and then expire, shareholders must decide quickly. Below is a sample rights announcement:

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Monday, March 31, 20XX

The Board of Directors of Acme Manufacturing Corporation today declares a rights distribution to stockholders of record on April 15th, 20XX. The rights will be distributed on April 30, 20XX.

Under the terms of the offer, 5 rights are necessary to subscribe to one new share at a price of $14 per share. Any residual rights totaling less than 5 can be rounded to 5 rights to purchase 1 additional share. The offer expires Midnight May 31, 20XX.

The current market price of Acme stock is $20.

1 right per share

Assume that a customer owns 100 shares of Acme stock. He will receive 100 rights from Acme on April 30th. These come as a physical certificate which can be sent to Acme with money to buy ("subscribe") more shares or they can be traded in the open market until expiration.

Cum rights

Assume that it is March 31st and the customer wants to know how much the rights will be worth in the market. The stock is still trading "cum rights," since any purchaser will settle before the record date of April 15th and will receive the rights.

Value of right (cum rights)

In theory the value of the right is included in the current market price of the stock. The formula for the value of the right is:

$$\text{Value "Cum Rights"} = \frac{\text{Market Price - Subscription Price}}{\text{Number of Rights Per Share To Subscribe + 1}}$$

$$= \frac{\$20 - \$14}{5 + 1} = \frac{\$6}{6} = \$1 \text{ Value Per Right}$$

The right is worth $1 and theoretically can be sold for this amount.

Value of right (ex-rights)

When the stock trades "ex-rights," any purchaser will no longer get the distribution. The market price will be reduced by $1 ($20 - $1 = $19 new market price). As of the ex-date, the formula to calculate the value of a right is:

$$\text{Value "Ex Rights"} = \frac{\text{Adjusted Market Price - Subscription Price}}{\text{Number of Rights Per Share To Subscribe}}$$

$$= \frac{\$19 - \$14}{5} = \frac{\$5}{5} = \$1 \text{ Value Per Right}$$

Please notice that the theoretical value did not change. This is not an accident - the values must always be the same.

This shareholder receives 100 rights which are worth $100. He can send his certificate for 100 rights to Acme with a check for $280 and receive 20 shares of stock (remember, it takes 5 rights to buy 1 share, so 100 rights buys 20 shares at $14

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subscription price = $280). Or the rights can be traded in the market and the customer should get about $100 for them. The shareholder must act fast though, since the rights expire in 2 months.

Fractional shares rounded to whole shares

If the customer had 104 shares, he would get 104 rights. Under the terms of the offer, he can "round up" to 105 rights and buy 21 shares at $14.

Topical Index

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Book Entry

C
Cum-Dividend

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O
On Ex-Date
Outstanding Shares

P
Preemptive Right

R
Registrar
Rights Agent

T
Transfer Agent
Treasury Stock