

So, here's the big picture: in order for a company to expand, it needs capital. It accesses this capital in the "primary market," where investment bankers raise money for corporations by selling the company's securities to investors, keeping a "spread" for their trouble. The issuing corporation takes the capital and buys equipment, technology, or whatever it needs for expansion. Investors can now trade their stocks and bonds with other investors on the secondary market. Securities firms like yours might work both the primary market and the secondary market. Whether offering new stock to a customer in the primary market or helping her trade securities in the secondary market, your firm's actions are regulated by their **self-regulatory organization**, FINRA, as well as the government body called the SEC. The SEC insists on truthfulness and full disclosure. Because of the SEC, companies who access the public markets have to disclose all kinds of negative information about things that have happened and things that could happen in the future to impair the value of the investor's stock or bond before issuing their securities. Then, they have to disclose all kinds of negative information through quarterly and annual reports filed with the SEC and posted all over the Internet. This way investors have a fair shot at discerning a good investment opportunity from a poor one. There is always risk, but through full disclosure, truthfulness, and fair dealings, investors can manage this risk, using a highly regulated professional such as yourself to help choose suitable investments.

Now that you have a grasp of the big picture, let's start looking at all the details your exam will expect you to know. But, no matter how detailed the material may get, please remember one thing: this is not rocket science. It isn't even close. Just learn the big concepts, and boost your score at the exam center with good test-taking skills.

Ready?

## CHAPTER 1

# Equity Securities

Some investors want to receive a predictable stream of income on their investment. For example, maybe they like to loan a corporation \$100,000 and receive \$5,000 a year in interest payments. That 5% yield is nice, but at the end of the term, the investor will only get back \$100,000. Other investors will give up that steady stream of income in order to reach for growth or "capital appreciation." Rather than lending money to a corporation, these **equity** investors prefer to buy **common stock** in the company. This way, if the company becomes more profitable, so do the shares of common stock that the investor purchased.

## COMMON STOCK

The most basic form of "equity" is known as **common stock**. Common stock is easily transferable, which means it can be sold without breaking a sweat. If investors get tired of looking at the stock certificates, they can sell them to other investors. That's how common stock works. You get tired of it, you sell it. You start to miss it, you buy it back.

A corporation hires a firm (usually a bank) to keep track of all of those transfers of ownership, by the way, and guess what we call them? The **transfer agent**. The transfer agent keeps the ownership records of the company's stock. Equate the word "certificates" with "transfer agent." The transfer agent deals with issuing and validating certificates, recording all the name changes when investors sell their certificates, that sort of thing. Lost, stolen, mutilated...if there's a problem with the certificates, contact the transfer agent. They can validate them or re-issue them, as the case may be. And, usually for a fee. They're a business. They like fees.

Just to make sure the transfer agent does a good job, the corporation also hires another outside firm—typically a bank—and we refer to this bank as the **registrar**. The registrar audits/oversees the transfer agent, just to make sure there aren't more shares outstanding than the company is authorized to sell.

## AUTHORIZED, ISSUED, TREASURY, OUTSTANDING

Which brings us to four important terms: **authorized, issued, treasury, and outstanding**. To answer most test questions successfully, all you really have to do is take the number of "issued" shares and subtract the number of "treasury" shares to get the number of shares "outstanding." But, if you want to grasp the concept of the four terms, you'll need to read the next few paragraphs.

Sorry about that.

Authorized shares represent the number of shares a company has authorized itself to issue to the public, a number disclosed in the corporate charter. Let's say a company is authorized to issue 1,000,000 shares of common stock, according to the charter. When they first sell shares to the public during their IPO, they probably won't issue all of them the first time out. The number they actually issue would be known, surprisingly enough, as issued shares. This corporation could issue 1 million, but they only issue 500,000. Therefore, there are 500,000 issued.

For various reasons, the corporation might decide to buy back some of those shares that are out in the secondary market. These shares, which were issued but repurchased, are called **treasury stock**. Since it's sort of locked up in a vault, it has no voting rights and pays no dividends. But, it can be used in many ways by the issuing corporation. For the test, you just have to take the number of shares actually issued and subtract the number repurchased and held in the treasury. If this corporation had issued 500,000 shares and then purchased 100,000 for the treasury, they would have how many shares left outstanding?

Exactly. 400,000 shares outstanding.

So, just take "issued" and subtract "treasury" to get the number of shares "outstanding."

|          |             |
|----------|-------------|
| 500,000  | Issued      |
| -100,000 | Treasury =  |
| 400,000  | Outstanding |

No big deal, really. When we talk about a company's **earnings per share**, or **EPS**, we're only talking about the **outstanding shares**, which are also the only shares that get to vote. That's why the company can boost its earnings per share (EPS) by repurchasing their outstanding stock on the secondary market. Even if the company's total profit/earnings stayed the same, the earnings *per share* would rise if the company were reducing the number of outstanding shares. For example, if the company earned \$1 million, that would be an earnings per share of \$2 when there were 500,000 shares outstanding. However, after the company buys back 100,000 shares for the treasury, that same \$1 million profit would be \$2.50 of earnings per share. Right?

### RIGHTS, PRIVILEGES OF COMMON STOCK OWNERSHIP

Owners of common stock enjoy several important rights the exam wants you to know about. The first right is the right of common stockholders to vote for any major issue that could affect their status as a proportional owner of the corporation. Things like stock splits, mergers and acquisitions, board of director elections, and changes of business objectives all

require shareholder approval. But, one thing shareholders never get to vote on is whether a dividend is paid and, if so, how much it should be. Letting shareholders propose and vote on dividends would be like letting your kids propose and approve their own allowance.

Not at this time, thank you.

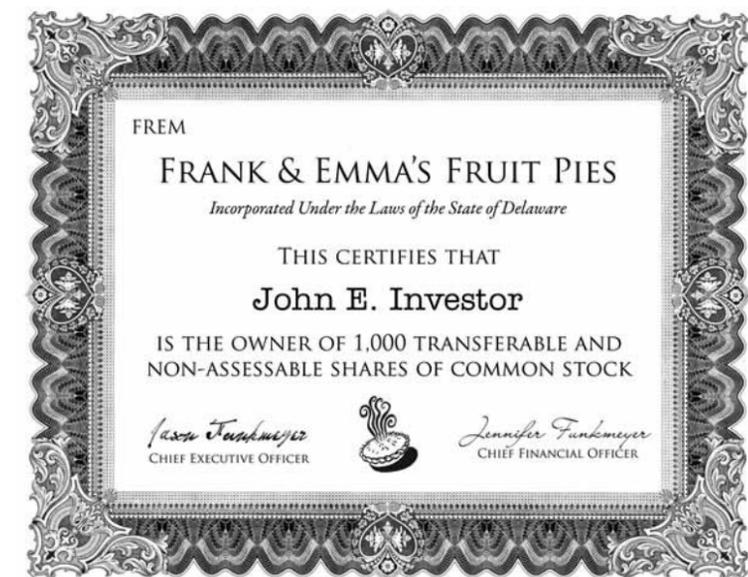
Shareholders vote their shares. If you own 100 shares of common stock, you have 100 votes to cast. Let's say there are three seats up for election on the Board of Directors. There are two ways that your votes could be cast for the election. Under **statutory**



**voting**, you can only cast the number of shares you own for any one seat. So, you could cast up to 100 votes for any one seat, representing a total of 300 votes for three seats. Under cumulative, you could take those 300 votes and split them up any way you wanted among the three candidates. You could even cast all 300 votes for one candidate and give nothing to the others. That's why the exam might want you to say that **cumulative voting** gives a benefit to the small/minority shareholders. In other words, if we can manage to get a candidate on the slate who will look out for us small shareholders, we can all cast all of our votes for her. The big guys will still get their way with the other candidates, but this gives us a fighting chance every once in a while. And remember that "the big guys," including pension funds and mutual funds, may have millions of shares (votes) versus our couple of hundred votes. Oh well. That's how it works—one vote per share, not per shareholder.

Beyond voting, common stockholders also have the right to inspect the corporation's financials through quarterly (10-Q) and annual (10-K) reports, just to see how the corporation is spending the shareholders' money and running the show up there at headquarters. Shareholders may also see the list of stockholders and the minutes of shareholder meetings.

Shareholders have the right to receive a certificate that serves as their proof of ownership. The certificate states the name of the issuing corporation, the shareholder's name, and the number of shares represented by the certificate. The certificate must be signed by an officer of the corporation. If you were to purchase 1,000 shares of Frank & Emma's Fruit Pies, your certificate would look something like this:



The certificate above would also include the name of the transfer agent, because shareholders have the right to freely transfer their shares to other parties, whether by selling them, donating them to a charity, giving them as a gift, or "bequeathing" them to their heirs when they pass away. The transfer agent is usually a division of a bank that keeps shareholder records for an issuer such as Frank & Emma's or Microsoft.

Common stockholders have what the test may call a "pre-emptive right" to maintain their

percentage of ownership. In other words, if Frank & Emma's wants to raise more money in the future by selling more common stock, existing shareholders would get a chance to buy their percentage of the upcoming issue. If not, their ownership would be diluted.

Should a corporation go belly-up and have to be liquidated, common stockholders get in line for their piece of the proceeds. Unfortunately, they are last in line. They are behind all the creditors, including bondholders, and also behind preferred stockholders.

But, at least they are in line, and if there are any residuals left, they get to make their claim on those assets. That's known as a **residual claim** on assets, by the way, because they like to get real creative with the language in this industry. The test could also refer to common stock as the most "junior" security, since all other securities represent senior claims.

The exam might also point out that shareholders, who are owners of the corporation, have **limited liability**, which means they are shielded from the debts of the company and lawsuits filed against it. I'm not sure why they bring this up—it's not like the bondholders *are* liable, just something the exam might mention. Limited liability is a good news–bad news thing. The bad news is when you buy common stock, you can lose all your money. The good news is that when you buy common stock, you can only lose all your money.

Finally, the exam might say that common stock owners have a "claim on earnings and dividends." That's true—as owners, they have a share of the profits. Some of the profits/earnings are reinvested into the business, which tends to make the share price rise. Some of the profits might be paid out as dividends, so let's take a look at that.

## DIVIDENDS

Did you know that a cash dividend is only paid if the Board of Directors decides to pay it?

That's right, if a corporation doesn't declare a dividend, the dividend doesn't get paid. End of story.

But, if they do declare a dividend, the board gets to decide three dates. FINRA/NYSE (depending on where the stock trades) decides the fourth one. Here's how it works. The day that the Board declares the dividend is known as the **declaration date**. The board decides when they'll pay the dividend, too, and we call that the **payable date**. Notice how creative the language is there—we call the day the dividend is d-e-c-l-a-r-e-d the *declaration date*, and the day the dividend is p-a-y-a-b-l-e the *payable date*. Remember, if you get yourself in a jam on the exam, break down the words and ask yourself what they probably mean, because most terms probably mean exactly what their names imply. The party in charge of transfers is the "transfer agent." The company that issues securities is called the **issuer**, and so on.

Anyway, the board of directors wonders who should receive this dividend—how about investors who actually own the stock as of a certain date? We call that the **record date** because an investor has to be the "owner of record" as of that date if she wants to receive the dividend. Now, since an investor has to be the owner of record as of the Record Date to receive the dividend, there will come a day when it's too late for investors to buy the stock and also get the dividend.

Why?

### Regular Way Settlement

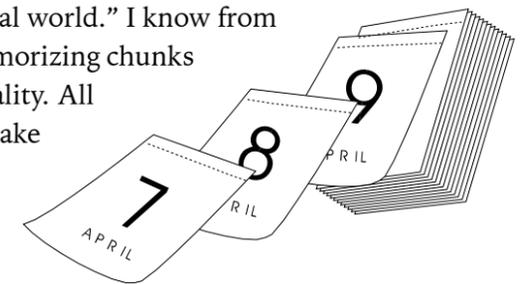
Because stock transactions don't "settle" until the third business day following the **trade date**,

you might put in your purchase order to buy 1,000 shares of Frank & Emma's on a Monday, but you aren't the official owner until that transaction clears or settles on Thursday. Your broker-dealer has to send payment to the seller's broker-dealer, who has to deliver the 1,000 shares. Both sides have to agree that the terms of the transaction have been met, and the whole thing has cleared or settled between the buyer and seller. This process takes three business days and is known as **regular way settlement**, or "T + 3," where the "T" stands for Trade Date. Assuming there are no holidays, a trade taking place on Monday, would settle on Thursday, while a trade on Tuesday would settle on Friday. So, if an investor has to be the owner of record on the record date, and it takes three business days for the buyer to become the new owner, wouldn't she have to buy the stock at least three business days prior to the record date? Yes. If she buys it just two business days before the record date, her trade won't settle in time. We call that day the **ex-date** or "ex-dividend" date, because starting on that day investors who buy the stock will not receive the dividend. On the ex-date, it's too late. Why? Because the trades won't settle in time, and the purchasers won't be the owners of record (with the transfer agent) as of the record date. The answer to your exam question might be that "if the trade takes place on or after the ex-date, the seller is entitled to the dividend." Of course, if the trade takes place before the ex-date, the buyer will get the dividend.

FINRA sets the ex-date, as a function of "regular way" or "T + 3" settlement. The ex-date is two business days before the record date.

So, remember DERP. Declaration, Ex-Date, Record Date, Payable Date. The board sets all of them except the Ex-Date, which is set by FINRA/NYSE. If investors don't qualify for the dividend starting with the ex-date, guess what? The amount of the dividend is taken right out of the stock price when trading begins on the ex-date. If the dividend to be paid is 70 cents, and the stock closed at \$20 the day before, it would open at 19.30 (the dividend comes out) on the ex-date.

One of the problems people have while studying for the Series 7 is that too much information seems to be "test world" and not "real world." I know from teaching live classes that candidates get tired of just memorizing chunks of information that seem completely divorced from reality. All this "XYZ" and "ABC" stuff gets a little tiring, so let's take a look at how the DERP thing would play out in the so-called "real world." Also, we *know* the date below is 2005—this is a *historical* example. The date will *always* be 2005 for this *one example*, even in the year 2018, okay?.



### Equity Office declares first quarter common dividend

Mar 16, 2005-- Equity Office Properties Trust (EOP), a publicly held office building owner and manager, has announced that its Board of Trustees has declared a first quarter cash dividend in the amount of \$.50 per common share. The dividend will be paid on Friday 15 April 2005, to common shareholders of record at the close of business on Thursday 31 March 2005.

So, March 16 is the Declaration Date. The Payable Date is April 15. The Record Date is Thursday, March 31st. The article doesn't mention the Ex-Date (because that's not established by

the company), but we can figure that it must be...right, Tuesday, March 29th. If you bought the stock on Tuesday, your trade wouldn't settle until Friday, April 1st, which means the seller's name would be on the list of shareholders at the close of business on Thursday, March 31st.

Quick note: EOP is a REIT, and the "T" in "REIT" stands for "trust." That's why the press release refers to the board as the "Board of Trustees." EOP is a Real Estate Investment Trust, but the stock works like any other stock. It simply pays a nice dividend. As we'll see later, REITs are just shares of stock that tend to pay nice dividend yields. If you owned 1,000 shares of EOP as of the record date, what would you receive?

A check for \$500. So, if the dividend stays the same or increases in Q2, Q3, and Q4, you'll collect at least \$2,000 just for sitting on your shares of EOP this year. Ever heard that the rich get richer? This is partly why.

It also brings up a testable point as to how a dividend can be paid. A dividend can be paid in the following ways:

- Cash (which means they cut you a check)
- Stock (more shares of stock)
- Shares of a subsidiary
- Product (extremely rare)

Cash dividends are taxable. Stock dividends are not taxable.

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## PRACTICE

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**1. An investor purchases common stock on a Thursday. Under regular way settlement, the transaction will settle**

- A. Friday
- B. Monday
- C. Tuesday
- D. Wednesday

**2. The Board of Directors declared a dividend on Monday, March 1st. If the record date is Tuesday, March 16th, the ex-dividend date is**

- A. Monday, March 15th
- B. Friday, March 12th
- C. Thursday, March 18th
- D. Tuesday, March 23rd

**3. Which of the following is/are true concerning Treasury stock?**

- A. has been issued and repurchased by the company
- B. reduces the number of outstanding shares
- C. tends to raise EPS
- D. all of the above

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## ANSWERS

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1. **C**, Thursday is the trade date or the "T" in "T + 3." T + 1 is Friday, T + 2 is Monday, and T + 3 is Tuesday.
2. **B**, go back two business days.
3. **D**, they buy it back to leave fewer shares outstanding; therefore, the same total earnings/profits of the company are divided among fewer shares for a higher EPS.

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## STOCK SPLITS, STOCK DIVIDENDS

The big idea behind stock splits and stock dividends is that when the investor ends up with more shares, the total value of his investment is unchanged. If he had 100 shares at \$10 before, that was worth \$1,000. No matter how many shares he has after the split or the stock dividend, the total value is still just \$1,000. So, when a corporation does a 2:1 stock split, the investor would have twice as many shares. What would the price per share be?

Half as much. The investor has \$1,000 worth of stock both before and after the split. He used to have 100 shares worth \$10 each. Now he has 200 shares worth \$5 each. A thousand bucks,

either way. The test might want you to work with an uneven split, like a 5:4 ratio. This is where the company gives investors five shares for every four that they own.

A possible exam question might read:

**Joe Tidewater owns 100 shares of XYZ Corp. common stock currently trading at \$50. XYZ Corp. declares a 5:4 stock split. What will Mr. Tidewater's stock position be after the 5:4 split?**

- I. 500 shares
  - II. 125 shares
  - III. @\$50 each
  - IV. @ \$40 each
- A. I, III
  - B. I, IV
  - C. II, III
  - D. II, IV

Okay, if Joe Tidewater had 100 shares worth \$50, what was the total value? \$5,000. Well, that's what his investment will be worth after the split, too, so let's see how the numbers work out.

Just multiply Joe's 100 shares by the first number, and divide that by the second number.

$$100 \times 5 \text{ divided by } 4 = 125 \text{ shares}$$

Joe will have 125 shares.

What will each share be worth?

Well, he still has \$5,000 worth of XYZ Corp. stock; he just has to divide that total amount over more shares. \$5,000 divided by 125 shares, gives us a share price of \$40.

The answer, then, is "D."

Why do companies do this? For one reason: to push the share price *down*. Companies have concluded that when their stock price goes up "too high," many investors, especially the Average Joe and JoAnne, get scared off. Since stock prices are determined purely through supply and demand, if we scare off the little guy, there won't be as much demand for our stock, and the stock price will drop. So, if our share price goes up to \$100, let's knock it back to \$50 with a 2:1 split and hope that demand for the shares will increase. At this point, it might seem shocking that a company worried about a sagging stock price will solve the problem by pushing their share price . . . down. But, trust me, you'll get used to these things the farther you go into Series Sevenland.

In any case, a stock *dividend* would work the same way in terms of more shares/lower price. If an investor receives a 20% stock dividend, that's 20% more shares of stock, but the total value of the investment is the same. It's just divided among more shares. So an investor with 200 shares of XYZ common stock @\$40 would have \$8,000 of XYZ stock. If XYZ sent her a 20% stock dividend, she would then have 240 shares. Her \$8,000 would then be divided among 240 shares, yielding a per-share price of \$33.33. Companies like Frank & Emma's, which are still in a growth phase, are more likely to pay stock dividends (vs. cash dividends) than more established companies, who are more likely to pay cash dividends compared to small, growing companies.

Either way, nothing really changes after a stock dividend or a stock split. The investor simply has more shares at a lower price, which means her **cost basis** in the stock changes. 100 shares @\$50 might become 125 shares @\$40. Just keep track of your cost basis so that when you sell someday you can tell the IRS how much of a **capital gain** or loss you realized on the stock. But whether you have 100 shares @\$50 or 125 shares @\$40, you've paid \$5,000 for a certain percentage of ownership. And, we'll deal with concerns such as "cost basis" and "capital gains" in more detail in the Taxation chapter later in the book.

You can think of a stock split or stock dividend like this: let's say you and a friend are on a diet. You decide to splurge and order pizza for lunch, but since you're on this diet you're not going to cut the thing in half and eat half a pizza, for crying out loud. Since you're on a diet, you can only have small pieces, so you decide to cut the pie into 20 slices, and you each eat only 10 small pieces. Or, maybe your friend is overzealous and talks you into cutting the pie into 50 slices, whereby you each consume only 25 teeny, tiny, little pieces.

Umm, you're eating half the pie either way, right?

Same thing for a stock dividend or a forward stock split. No matter how they slice the earnings pie, you own the same percentage before and after this non-event. They've made the shares smaller and "cheaper," but you have more of them. A "forward split," by the way, just means you end up with more shares. A 2:1, 3:2, or 5:4 split would be a forward split that pushes the share price down.

Well, sometimes companies have the opposite problem—their share price is so low that the big, institutional investors (pension funds, mutual funds, insurance companies) won't touch it. These entities usually won't touch a stock trading below \$5, so if our company's stock is trading for \$1, we might need to increase that price. One way to do it would be to become a more competitive, profitable company and let the increased profits take the share price up.

Nahhhhhh, too much work. Let's do a reverse stock split instead.

If the test question says that JoAnne is long 100 shares of LMNO @\$1, we might find LMNO doing a reverse split of 1:10. That means for every 10 shares she owns now, she'll end up with only one really big share. She'll have 10 shares when it's all over, in other words. If the shares were trading for \$1 before the split and everybody now has shares that are 10 times bigger, the share price magically becomes...yes, \$10 a share. JoAnne is now long 10 LMNO @\$10.

Awesome—LMNO is a \$10 stock, just like that! Doesn't the stock represent the same % ownership, though? Sure, but human beings are funny creatures—many of them will just think the stock has gone up due to, like, profits and stuff. Just remember that whether the exam is talking about a stock dividend, a forward split, or a reverse split, the investor's cost basis changes because the share price changes. But no change in *value* actually occurs. See, there's a big difference between a change in *price* and a change in *value*. It's not how many dollars you paid for the stock. It's, "How much did you pay for the *earnings*?" Remember, a share of stock represents a slice of the earnings/profits pie, so how much are you paying for these earnings/profits? A \$100 stock with \$10 of earnings associated with it is much *cheaper* than a \$1 stock with 1 penny of earnings. The first one trades at a "multiple" or P/E of only 10, while the second one will cost you 100 times the earnings, or a P/E of 100. Looks cheaper, but the \$1 stock is really 10 times more expensive than the \$100 stock. P/E means "Price to Earnings." Just compare how much larger the stock price is compared to the *earnings* associated with each share. Guess what we call "earnings per share"?

Earnings per share. Except we prefer to be hip and abbreviate it as "EPS."

Finally, remember that shareholders vote on stock splits, whether forward (5:4, 2:1, 3:2) or reverse (1:7, 1:10, etc.). Shareholders do not vote on dividends, period.

## WHAT IS A SHARE OF COMMON STOCK?

Before we move on, let's make sure we understand exactly what a share of stock is. When you buy a company's common stock, you simply own a percentage of the company. What are all owners interested in? Profits, called *earnings*. The bottom line, baby. You start your own business for one main reason—to earn a profit. You buy a share of somebody else's business for the same reason—to share in the profits. So, you only buy a share of common stock if you think the company will earn a profit, increase that profit, and, eventually, pay some of that profit out to you as a dividend. That's all there is to it—if you want to share in the earnings/profits of the company, buy some *shares* of common stock.

What if there aren't any earnings?

Hope for better days or sell the stock to a greater fool than the current owner.

## RIGHTS, WARRANTS

As we mentioned, one of the **rights** common stockholders enjoy is the right to maintain their proportionate ownership in the corporation. We call this a “preemptive right” because the existing shareholders get to say yes or no to their proportion of the new shares before (pre-) the new shareholders get a chance to buy any. Otherwise, if you owned 5% of the company, you'd end up owning less than 5% of it after they sold the new shares to everyone *but* you, which could be called “dilution of equity” to make us sound smarter than we really are. Sort of a “first dibs for current investors” thing happening here, but the exam will probably call it “preemptive rights.” For every share owned, an investor receives what's known as a right. It's an equity security with a very short life span. It works like a coupon, allowing the current shareholders the chance to purchase the stock below the market price over the course of a few weeks—called the **subscription price**. If a stock is trading at \$20, maybe the existing shareholders can take two rights plus \$18 to buy a new share. Those rights act as coupons that give the current shareholders two dollars off the market price. So, the investors can use the rights, sell them, or let them expire in a drawer somewhere, like most coupons. The exam might bring up a rather challenging question or two on calculating the value of a right. We will explain the two formulas required to make the calculation at the end of this chapter in order to avoid getting bogged down with numbers at this point.

Warrants have absolutely nothing to do with rights, and vice versa, but it's convenient to talk about them in the same section, so here goes. Unlike a right, a **warrant** is a long-term equity security. There are no dividends attached to a warrant. If you own a warrant, all you own is the opportunity to purchase a company's stock at a pre-determined price. If you have a warrant that lets you buy XYZ for \$30 per share, then you can buy a certain number of shares at that price whenever you feel it makes sense to do so, like when XYZ is trading for a lot more than \$30 per share. When issued, the price stated on the warrant is above the current market price of the stock. It usually takes a long time for a stock's price to go above the price stated on the warrant. But, they're good for a long time, typically somewhere between two and ten years.

Warrants are often attached to a bond offering. Corporations pay interest to borrow money through bonds. If they attach warrants, they can “sweeten” the deal a little and maybe offer investors

a lower interest payment. Why would you take 4% when your buddy gets 6% on his bond? Doesn't he make \$60 a year, while you only make \$40? Yes. But if the company's common stock rises, he'll still be making \$60 a year, while you could make a huge profit on the common. If you have a warrant to buy 1,000 shares @30 and those shares rise to \$50, are you going to cry about that \$20 a year your buddy made? Not when you just made about \$20,000, right? In fact, why not give your buddy a call right after you cash in your profits and offer to buy him lunch, especially if he was ever talking trash about your decision to take 4% when he got 6%.

## PREFERRED STOCK

A common stock investor might receive dividends, but the dividend is not stated by the company on the stock certificate—in fact, the company may never get around to paying a dividend on their common stock. Common stock investors are generally interested in growth or capital appreciation more than income. That means they want to buy the stock low and watch it increase in market price over time. On the other hand, income investors who want to buy a corporation's stock would likely want to buy the company's **preferred stock** instead. Preferred stock gets preferential treatment if the company has to be forcibly liquidated to pay creditors, and always receives dividends before owners of common stock can be paid. And, unlike common stock, the preferred stock dividend is printed right on the stock certificate. The par value for a preferred stock is assumed to be \$100. The stated dividend is a percentage of that par value. Six-percent preferred stock would pay 6% of \$100 per share, or \$6 per share per year. Three percent preferred stock would pay a dividend of 3% of the par value each year.

We hope.

See, dividends still have to be declared by the Board of Directors. Preferred stockholders aren't creditors. They're just proportional owners who like to receive dividends. If the board doesn't declare a dividend, do you know how much an owner of a 6% preferred stock would receive?

Nothing.

However, if the investor owned **cumulative preferred stock**, that might be different. They wouldn't necessarily get the dividend now, but the company would have to make up the missed dividend in future years before it could pay dividends to any other preferred or common stockholders. If the company missed the six bucks this year and wanted to pay the full six bucks next year, cumulative preferred stockholders would have to get their \$12 before anybody else saw a dime.

This 6% works more like a maximum than a minimum. If an investor wants the chance to earn more than the stated 6%, he'd have to buy **participating preferred stock**, which would allow him to share in dividends above that rate, if the company has the money and feels like distributing it. Generally, if the issuer increases the dividend paid to common stockholders, they will also raise the dividend paid to participating preferred stockholders.

Another type of preferred stock has a rate of return that is tied to another rate, typically the T-bill rate. If T-bill rates are up, so is the rate on the **adjustable preferred stock**, and vice versa. Because the rate adjusts, the price remains stable.

## Convertible Preferred Stock

A highly testable type of preferred stock is **convertible preferred stock**. This type lets an