

# Understanding Securities & Stocks: A Comprehensive Guide to *FINRA Exam*

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## Chapter 1: Introduction to Securities

**D**efinition and Overview: A security is a financial instrument that holds value and can be traded in financial markets. It represents an ownership position in a corporation (equity), a creditor relationship with a governmental body or corporation (debt), or rights to ownership as represented by an option. Securities are essential tools for raising capital and providing investors with various opportunities for income and growth.

**Importance of Securities in Financial Markets:** Securities are issued by corporations, governments, and other entities to fund operations, projects, or expansions. They are bought by investors seeking to earn returns on their investments. Understanding what constitutes a security and the different types available is fundamental for making informed investment decisions and achieving financial goals.

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## Chapter 2: Types of Securities

### Equity Securities:

- **Common Stock:** Represents ownership in a corporation. Shareholders have voting rights and a claim on a portion of the company's profits through dividends and capital gains.
- **Preferred Stock:** Represents ownership with higher claim on assets and earnings than common stock. Typically does not include voting rights but offers fixed dividends.

### Debt Securities:

- **Bonds:** Debt instruments where investors loan money to the issuer in exchange for periodic interest payments and the return of the bond's face value at maturity.
  - **Treasury Bills:** Short-term government securities sold at a discount to face value and mature within one year.
  - **Certificates of Deposit (CDs):** Savings certificates issued by banks with a fixed maturity date and specified interest rate, insured by the FDIC.
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## Chapter 3: Equity Securities in Detail

### Common Stock:

- **Categories and Rights:** Authorized, issued, outstanding, and treasury stock. Shareholders have voting rights and a claim on company profits.
- **Common Stock Values:** Market value, par value, and book value. Market value is the current price, par value is nominal, and book value represents net asset value.
- **Stock Splits:** Forward and reverse stock splits. Forward splits increase the number of shares and reduce price; reverse splits consolidate shares and increase price.
- **Benefits and Risks:** Potential for growth and dividends, but comes with market risk, income risk, and residual claim in liquidation.

### Preferred Stock:

- Characteristics: Fixed dividends, higher claim on assets, less volatile than common stock, but no voting rights.
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## Chapter 4: Debt Securities in Detail

### Bonds:

- **Types:** Corporate bonds, government bonds, municipal bonds.
- **Benefits and Risks:** Safer investments compared to stocks, fixed income, higher claim in liquidation, but lower returns.

### Treasury Bills:

- Overview and Benefits: Short-term, low-risk government securities.

### Certificates of Deposit (CDs):

- Features and Benefits: Insured, fixed returns, low risk.
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## Chapter 5: Key Differences Between Equity and Debt Securities

- **Ownership vs. Loan:** Equity represents ownership, debt represents a loan.
  - **Income Potential:** Equity offers dividends and capital gains; debt offers fixed interest payments.
  - **Risk and Return:** Equity is riskier with higher potential returns; debt is safer with lower returns.
  - **Claims on Assets:** Debt has priority over equity in claims on issuer's assets.
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## Chapter 6: Investment Strategies and Considerations

- **Diversification:** Spreading investments across various securities to reduce risk.
  - **Risk Management:** Balancing potential rewards with associated risks.
  - **Understanding Market Conditions:** Keeping informed about economic and market trends.
  - **Long-term vs. Short-term Investments:** Evaluating investment horizons and goals.
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## Chapter 7: Conclusion

**Summary of Key Points:** Recap of the essential information covered in the e-book.

**Final Thoughts on Investment in Securities:** Encouragement to use the knowledge gained to make informed investment decisions.

### What Is a Security?

#### Definition and Overview:

**A** security is a financial instrument that holds value and can be traded in financial markets. It represents an ownership position in a corporation (equity), a creditor relationship with a governmental body or corporation (debt), or rights to ownership as represented by an option. Securities are essential tools for raising capital and providing investors with various opportunities for income and growth. They are issued by corporations, governments, and other entities to fund operations, projects, or expansions, and they are bought by investors seeking to earn returns on their investments. Understanding what constitutes a security and the different types available is fundamental for making informed investment decisions and achieving financial goals.

#### Types of Securities:

##### 1. Equity Securities:

- **Common Stock:** Common stock signifies ownership in a corporation. Shareholders of common stock have voting rights, which allow them to influence corporate decisions, such as electing the board of directors and approving significant corporate policies. Additionally, common stockholders have a claim on a portion of the company's profits through dividends and capital gains. Dividends are periodic payments made to shareholders out of the company's earnings, while capital gains arise from the increase in the stock's market value over time. Common stock is characterized by its potential for high returns but also comes with higher risk, as the value of the stock can fluctuate significantly based on the company's performance and market conditions.
- **Preferred Stock:** Preferred stock also represents ownership in a corporation but comes with different characteristics compared to common stock. Preferred stockholders typically do not have voting rights, meaning they have less influence over corporate governance. However, they have a higher claim on the company's assets and earnings than common stockholders. This higher claim is particularly significant in the event of liquidation, where preferred stockholders are paid before common stockholders but after debt holders. One of the key features of preferred stock is the fixed dividend. Preferred stockholders receive regular, fixed dividends, which provide a more stable income stream compared to the variable dividends of common stock.

Because of this, preferred stock is often considered a hybrid between equity and debt securities.

### Debt Securities:

- **Bonds:** Bonds are debt instruments where investors loan money to the issuer (corporate or government) in exchange for periodic interest payments and the return of the bond's face value at maturity. Bonds are considered safer investments compared to stocks, as they provide fixed income and have a higher claim on the issuer's assets in the event of liquidation. They are commonly used by corporations and governments to raise capital for various projects and operations.
- **Treasury Bills:** Treasury bills (T-bills) are short-term government securities that are sold at a discount to face value and mature within one year. They are considered one of the safest investments as they are backed by the full faith and credit of the government. Investors buy T-bills at a discount and receive the face value upon maturity, earning the difference as interest.
- **Certificates of Deposit (CDs):** Certificates of Deposit are savings certificates issued by banks with a fixed maturity date and specified interest rate. CDs are considered low-risk investments as they are insured by the FDIC (Federal Deposit Insurance Corporation) up to a certain limit. They offer a guaranteed return on investment, making them an attractive option for conservative investors seeking stable income.

### Key Differences Between Equity and Debt Securities:

1. **Ownership vs. Loan:** Equity securities, such as common and preferred stock, represent ownership in a company. Shareholders are considered part-owners and have a claim on the company's assets and earnings. In contrast, debt securities, such as bonds and T-bills, represent a loan from the investor to the issuer. Bondholders are creditors who receive regular interest payments and the return of principal upon maturity.
2. **Income:** Equity securities provide the potential for dividends and capital gains. Dividends are payments made to shareholders from the company's earnings, while capital gains result from an increase in the stock's market value. Debt securities offer fixed interest payments, providing a predictable income stream. The interest rate is determined at the time of issuance and remains constant throughout the life of the bond.
3. **Risk and Return:** Equity securities generally have higher potential for return and risk compared to debt securities. Stock prices can be volatile and are influenced by various factors, including the company's performance and market conditions. In contrast, debt securities are considered safer investments, offering lower returns but with greater stability. Bondholders have a higher claim on the issuer's assets in the event of liquidation, making them less risky than stockholders.
4. **Claims on Assets:** In the event of liquidation, debt securities have priority over equity securities in claims on the issuer's assets. Bondholders are paid first, followed by preferred stockholders, and finally, common stockholders. This priority structure makes debt securities less risky compared to equity securities, as bondholders have a better chance of recovering their investment if the issuer faces financial difficulties.

Understanding the distinctions between equity and debt securities is crucial for making informed investment decisions. Equity securities offer the potential for higher returns but come with greater risk, while debt securities provide more stable income with lower risk. By

diversifying their portfolios with a mix of both equity and debt securities, investors can balance potential rewards with associated risks and achieve their financial goals.

## Common Stock

**C**ommon stock represents ownership in a corporation and is the most prevalent type of equity security. Shareholders of common stock are considered part-owners of the company and have certain rights and privileges, including voting rights, which allow them to influence corporate decisions such as electing the board of directors and approving major corporate policies. Common stockholders are also entitled to a share of the company's profits through dividends and capital gains. Dividends are periodic payments made from the company's earnings, while capital gains result from the increase in the stock's market value over time.

Common stock is classified into categories based on its status: authorized, issued, outstanding, and treasury stock. Authorized stock is the maximum number of shares a company can issue, as specified in its corporate charter. Issued stock includes all shares that have been sold to investors. Outstanding stock consists of shares currently held by investors, excluding treasury stock, which are shares repurchased by the company.

One of the primary benefits of owning common stock is the potential for growth through capital appreciation. As the company grows and performs well, the value of its stock can increase, providing substantial returns for shareholders. Additionally, common stockholders may receive dividends, offering a source of income. However, common stock also carries risks. Stock prices can be volatile, and there is no guarantee of returns. In the event of liquidation, common stockholders are last in line to receive any remaining assets after all debts and other obligations have been satisfied. Despite these risks, common stock remains a popular investment choice due to its potential for high returns and the ownership stake it provides in a company.

## Difference Between Current Shares Outstanding and Equity Float

### Current Shares Outstanding:

Current shares outstanding refer to the total number of shares of a company's stock that are currently held by all its shareholders, including shares held by institutional investors and insiders, as well as restricted shares. This figure represents the total ownership in the company and is used in calculating key metrics such as market capitalization and earnings per share (EPS). The number of shares outstanding can change over time due to corporate actions such as stock splits, share repurchases, and the issuance of new shares.

### Equity Float:

Equity float, also known simply as "float," refers to the number of shares of a company's stock that are available for trading by the public. This excludes shares that are held by insiders, employees, or major shareholders who have restrictions on trading these shares. The float is an important measure of a stock's liquidity, as it represents the shares that can be freely bought and sold in the market. A larger float generally indicates higher liquidity, making it easier for investors to trade the stock without significantly impacting its price.

### Key Differences:

### 1. Inclusion of Restricted Shares:

- **Current Shares Outstanding:** Includes all shares held by shareholders, including restricted shares and those held by insiders and institutional investors.
- **Equity Float:** Excludes restricted shares and those held by insiders, focusing only on shares available for public trading.

### 2. Impact on Liquidity:

- **Current Shares Outstanding:** Does not directly measure the stock's liquidity as it includes all shares, regardless of their trading status.
- **Equity Float:** Directly measures the stock's liquidity, indicating the number of shares available for trading in the market.

### 3. Use in Financial Metrics:

- **Current Shares Outstanding:** Used in calculating market capitalization and EPS, providing a comprehensive view of the company's total equity.
- **Equity Float:** Important for assessing the stock's liquidity and trading volume, influencing how easily shares can be bought and sold.

Understanding the difference between current shares outstanding and equity float is crucial for investors. While the total number of shares outstanding provides a picture of the company's total equity, the float offers insight into the stock's liquidity and trading dynamics, helping investors make more informed decisions.

## Common Stock Values

The value of common stock is determined by various factors, including market perception, the company's financial health, and overall economic conditions. Understanding these values is crucial for investors. The primary measures of a stock's value include market value, par value, and book value.

**Market Value:** Market value, often referred to as market price, is the current price at which a share of common stock can be bought or sold in the stock market. This value fluctuates continuously based on supply and demand dynamics, investor sentiment, and overall market conditions. The market value is the most meaningful measure of a stock's worth because it reflects what investors are willing to pay for it at a given time. Factors influencing market value include the company's earnings, growth potential, industry performance, and broader economic indicators.

**Par Value:** Par value is a nominal or face value assigned to a share of stock in the company's articles of incorporation. For common stock, par value is typically set at a minimal amount and is largely symbolic, having little to no impact on the stock's market price. Par value is primarily used for accounting purposes and legal considerations. It represents the minimum price at which shares can be issued to shareholders, although in practice, shares are often issued at prices significantly higher than their par value.

**Book Value:** Book value per share is an accounting measure calculated by dividing the company's total tangible assets minus its liabilities by the number of outstanding shares. It represents the net asset value of the company based on its balance sheet. Book value provides a baseline for determining whether a stock is overvalued or undervalued in the market. If a company's stock is trading below its book value, it might indicate that the stock is undervalued, assuming the company's assets are accurately valued on its balance sheet.



Conversely, if the stock is trading above its book value, it may be considered overvalued, depending on the company's growth prospects and future earnings potential.

**Comparison Example:** To illustrate these concepts, let's compare two companies: IBM and Apple.

- **IBM:**
  - **Market Value:** Reflects current investor sentiment and the perceived future earnings of IBM.
  - **Par Value:** A nominal amount set by IBM's articles of incorporation, likely very low and not indicative of actual stock value.
  - **Book Value:** Calculated from IBM's balance sheet, giving an idea of the net asset value per share.
- **Apple:**
  - **Market Value:** Driven by high demand, reflecting strong investor confidence in Apple's continued growth and profitability.
  - **Par Value:** A minimal, symbolic value set during incorporation.
  - **Book Value:** Reflects Apple's net asset value per share, providing a baseline for evaluating its market price.

**Conclusion:** Understanding the different measures of common stock values—market value, par value, and book value—is essential for investors. Market value is the most relevant measure for making buy or sell decisions, while par value and book value provide additional context for assessing a stock's worth. By considering these values, investors can make more informed decisions and better manage their investment portfolios.

## Rights of Common Stock Ownership

**O**wning common stock in a corporation grants shareholders several important rights that protect their ownership interests and allow them to participate in the company's growth and governance. These rights include voting rights, preemptive rights, the right to inspect corporate books, the right to dividends, and residual claims to assets.

### Voting Rights:

One of the primary rights of common stockholders is the ability to vote on important corporate matters. This includes electing the board of directors, approving major corporate policies, and voting on significant changes such as mergers or acquisitions. Shareholders typically get one vote per share owned, giving them a proportional influence based on their ownership stake. Voting can be conducted in two main ways:

- **Statutory Voting:** Shareholders cast one vote per share for each item on the ballot. For example, if three directors are being elected, a shareholder with 100 shares can cast 100 votes for each director.
- **Cumulative Voting:** Shareholders can allocate their total votes in any manner they choose, which can help minority shareholders have a greater impact. For instance, with 100 shares and three directors to be elected, a shareholder could cast all 300 votes for a single candidate.

### Preemptive Rights:

Preemptive rights allow existing shareholders to maintain their proportional ownership in the company when new shares are issued. This right is crucial in preventing dilution of ownership. If a company plans to issue additional stock, current shareholders have the first opportunity to purchase these shares before they are offered to the public. This ensures that their ownership percentage remains unchanged.

### **Right to Inspect Corporate Books:**

Common stockholders have the right to inspect the company's books and records. This includes reviewing annual financial statements and obtaining lists of shareholders. While this right allows shareholders to stay informed about the company's financial health and operations, it does not extend to examining detailed financial records or the minutes of board meetings.

### **Right to Dividends:**

Shareholders have a right to receive dividends if and when the company declares them. Dividends are a portion of the company's earnings distributed to shareholders. They can be paid in cash, additional shares of stock, or other property. While dividends are not guaranteed and can fluctuate based on the company's profitability and management decisions, they represent a significant source of income for investors.

### **Residual Claims to Assets:**

In the event of a company's liquidation, common stockholders have a residual claim to the company's assets. This means they are entitled to any remaining assets after all debts, bonds, and preferred stockholders have been paid. While common stockholders are last in line, this right ensures they receive their proportional share of any remaining value. However, in most liquidation scenarios, there may be little to no assets left for common stockholders.

### **Limited Liability:**

Common stockholders enjoy limited liability, meaning they cannot lose more than the amount they invested in the company's stock. This protection ensures that shareholders are not personally liable for the company's debts and obligations, safeguarding their personal assets.

### **Proxies:**

When shareholders cannot attend the annual meetings, they can vote by proxy. A proxy is an absentee ballot that allows another individual, often the company's management, to vote on behalf of the shareholder. Proxies must be solicited according to SEC regulations, ensuring that shareholders are provided with detailed information about the issues being voted on.

Understanding these rights helps investors make informed decisions about buying, holding, or selling common stock. By exercising these rights, shareholders can actively participate in the governance and success of the companies they invest in, thereby enhancing their potential returns and protecting their interests.

## Stock Splits

**S**tock splits are corporate actions taken by companies to increase or decrease the number of outstanding shares of their stock without changing the overall value of shareholders' holdings. These splits are typically executed to make the stock more affordable and attractive to investors, thereby increasing liquidity. There are two main types of stock splits: forward stock splits and reverse stock splits.

### Forward Stock Split:

In a forward stock split, a company increases the number of its outstanding shares by issuing additional shares to current shareholders. The total value of the shares remains the same, but each share's price is reduced proportionally. This makes the stock more affordable for investors and can increase market participation and liquidity.

**Example of Forward Stock Split:** Consider NVIDIA (ticker symbol: NVDA), which implemented a 10-for-1 stock split. If you owned 100 shares of NVIDIA before the split, you would own 1,000 shares after the split. If the pre-split price was \$1,000 per share, the post-split price would be approximately \$100 per share. The total value of your holdings remains the same at \$100,000, but you now own more shares at a lower price.

### Benefits of Forward Stock Split:

- **Increased Liquidity:** More shares at a lower price make it easier for investors to buy and sell the stock, increasing trading activity.
- **Accessibility:** Lower-priced shares are more accessible to a broader range of investors, including retail investors.
- **Positive Market Perception:** Announcing a stock split can create a positive perception of the company's growth prospects, potentially boosting investor confidence and demand.

### Reverse Stock Split:

In a reverse stock split, a company decreases the number of its outstanding shares by consolidating multiple shares into one. This increases the share price proportionally, without changing the total value of shareholders' holdings. Reverse stock splits are often undertaken to meet stock exchange listing requirements or to make the stock more attractive to institutional investors.

**Example of Reverse Stock Split:** Consider a company executing a 1-for-15 reverse stock split, like PEGY. If you owned 1,500 shares of PEGY before the split, you would own 100 shares after the split. If the pre-split price was \$1 per share, the post-split price would be approximately \$15 per share. The total value of your holdings remains the same at \$1,500, but you now own fewer shares at a higher price.

### Benefits of Reverse Stock Split:

- **Meeting Listing Requirements:** Increasing the share price can help the company meet minimum price requirements for stock exchange listings.
- **Attracting Institutional Investors:** Higher-priced shares can be more attractive to institutional investors, who may have policies against buying low-priced stocks.

- **Improving Market Perception:** A higher share price can improve the stock's image and reduce the stigma associated with being a "penny stock."

#### Implications for Investors:

- **No Change in Value:** Both forward and reverse stock splits do not change the overall value of an investor's holdings. The total market capitalization of the company remains the same.
- **Psychological Impact:** Stock splits can influence investor psychology. Forward splits may be perceived as a sign of growth, while reverse splits might be seen as a strategy to combat declining stock prices.
- **Tax Considerations:** Stock splits are generally not taxable events. However, investors should adjust their cost basis to reflect the new number of shares owned post-split.

#### Conclusion:

Stock splits are strategic moves by companies to adjust the number of shares outstanding and the share price. Forward stock splits increase the number of shares and reduce the price, enhancing liquidity and accessibility. Reverse stock splits reduce the number of shares and increase the price, often to meet listing requirements and attract institutional investors. While the total value of an investor's holdings remains unchanged, these actions can impact market perception and investor behavior. Understanding stock splits helps investors navigate these changes and make informed decisions about their investments.

## Benefits and Risks of Owning Common Stock

#### Benefits:

**Growth Potential:** One of the primary benefits of owning common stock is the potential for capital appreciation. When a company's performance is strong, its stock price can increase, providing substantial returns to investors. This growth potential makes common stock an attractive investment for those looking to build wealth over time. Historically, common stocks have provided higher returns than other types of investments, such as bonds or savings accounts.

**Dividend Income:** Many companies distribute a portion of their earnings to shareholders in the form of dividends. These payments can provide a steady source of income, which can be particularly appealing to investors seeking regular income streams. Dividends can be reinvested to purchase more shares, compounding growth over time. Even if the stock price does not appreciate significantly, dividends can still offer a return on investment.

**Ownership and Voting Rights:** Common stockholders have ownership in the company and voting rights, which allow them to influence corporate decisions. This includes electing the board of directors and voting on significant corporate policies and actions, such as mergers and acquisitions. These rights give shareholders a voice in the direction and management of the company, aligning their interests with the company's success.

**Liquidity:** Common stocks are typically highly liquid, meaning they can be easily bought and sold on the stock market. This liquidity allows investors to enter and exit positions quickly, providing flexibility in managing their investment portfolios. The ability to trade shares easily

can help investors take advantage of market opportunities and respond to changes in their financial needs or market conditions.

**Diversification:**Including common stocks in an investment portfolio can enhance diversification. Diversification reduces risk by spreading investments across different asset classes, industries, and geographic regions. By holding a variety of stocks, investors can mitigate the impact of poor performance by any single investment, leading to a more balanced and stable portfolio.

### **Risks:**

**Market Risk:**Stock prices can be highly volatile and subject to significant fluctuations due to various factors, including economic conditions, market sentiment, and company performance. Market risk is the potential for investors to lose money due to these price changes. Unlike fixed-income securities, common stocks do not offer guaranteed returns, and investors must be prepared for the possibility of losing part or all of their investment.

**Income Risk:**While dividends can provide a source of income, they are not guaranteed. Companies may reduce or eliminate dividend payments if they experience financial difficulties or need to conserve cash for other purposes. This income risk means that investors relying on dividend income may face uncertainty regarding the consistency and amount of their returns.

**Residual Claim:**In the event of a company's liquidation, common stockholders have the last claim on the company's assets. This means they are paid after all debts, bonds, and preferred stockholders have been satisfied. As a result, common stockholders may receive little to no compensation if the company goes bankrupt or is liquidated. This residual claim status makes common stock inherently riskier than debt securities and preferred stock.

**Psychological Impact:**The volatility of stock prices can have a psychological impact on investors. Significant market swings can lead to emotional decision-making, such as panic selling during market downturns or irrational exuberance during bull markets. This behavior can result in poor investment decisions and potential financial losses. Successful investing in common stocks often requires a long-term perspective and the ability to withstand short-term market volatility.

**Dilution:**Issuing additional shares can dilute the ownership percentage of existing shareholders. Dilution occurs when a company issues more shares, reducing the value of existing shares and potentially lowering earnings per share (EPS). While issuing new shares can raise capital for the company, it can also impact the ownership and voting power of existing shareholders.

By understanding the benefits and risks associated with owning common stock, investors can make more informed decisions and better manage their investment portfolios. Balancing the potential for high returns with the inherent risks of market volatility, income uncertainty, and residual claims is key to successful stock investing.