INTRODUCTION OF MARKET PLACE Contd…

Circuit Breakers and Trading Curbs:

In listening to market reports, you will sometimes hear that trading curbs are in effect or that a circuit breaker kicked in”. While both trading curbs and circuit breakers are designed to reduce temporary volatility in the market, they are slightly different. At the NYSE, anytime the Dow Jones industrial average moves up or down more than 2%, computerized trading via the SuperDot system is restricted. This happened 366 times on 277 separate trading days in 1998. Non computerized trading continues despite the circuit breaker having been activated.

Trading curbs halt all the trading at the exchange, not just computerized trades. If the Dow Jones industrial average drops 10%, trading stops for an hour or for 30 minutes if the drop was between 2:00 pm and 2:30 pm. After 2:30 pm, trading is not halted. A 20% drop halts trading for two hours if it is before 1:00 pm; for one hour if between 1:00pm and 2:00 pm; and for the rest of the trading day if after 2:00 pm. A 30% drop halts trading for the remainder of the day.

Trading has only been halted once because of there provisions. On October 27, 1997 the DJIA was down 350 points at 2:35 pm and down 550 points by 3:30 pm. This shut down trading for the remainder of the day.

THE NASDAQ STOCK MARKET:

Once a stepchild of the marketplace, the NASDAQ stock market, still sometimes called the over the counter market, is now an important part of the investment arena. Securities trading in this market range from small, unknown firms to some of the largest companies in the world.

The NASDAQ National Market:

Unlike the national and regional stock exchanges, no actual place is called the over the counter market. Rather, it is a worldwide computerized linkup brokerage firms, investment houses, and large commercial banks. The headquarters of the computer system is in Trumbull, Connecticut, with a backup system in Rockville, Maryland. Bids and offers for individual securities are posted to an electronic bulletin board. These prices appear in the financial press under a heading including the term NASDAQ, shorthand for national association of securities dealer’s automated quotations. NASDAQ price quotations first appeared February 5, 1971.

In 1980, NYSE trading outnumbered NASDAQ trading two to one. Today, the numbers of share traded on each of the two systems is approximately equal. Some were very large company’s trade in the NASDAQ market. Including apple computer, sun Microsystems, Microsoft, oracle, MCI communications and Intel. These companies could easily be listed on the NYSE or AMEX of they so close. While many NASDAQ firms are small, start-up companies. In fact, the phrase NASDAQ stock market is increasingly common, emphasizing the growing importance of this part of the marketplace.
Trades of up to 100 shares can be executed in less than 1 minute via the small order execution system. For most stocks, SOES historically executed orders of 1000 shares or less against the best quotes posted in the market. This essentially means that an investor could place an order to buy or sell 1000 shares of an actively traded NASDAQ stock and be confident of getting the order filled at a single price that is the best prevailing price in the market.

After the stock market crash of 1987, member firms were required to participate in the SOES system. There were information and order flow problems during the crash that kept some market makers from honoring quotes maintaining orderly market. Once the SOES system was put in place, a lazy market maker ran the risk of getting hit by SOES bandits who would “pick off” the slow market maker by trading 1000 shares at the untimely price and instantly earn a profit. Perhaps a stock had been trading at $25, and a market maker had posted a bid of $25. Later of stock falls, perhaps to $24¾, but the market maker fails to adjust the bid. An SOES bandit could spot this, buy 1000 at $24¾, and hit the stale bid of $25. Under SOES, the market maker would be obligated to honor a trade of 1000 at $25.

Today the 1000 share rule is no longer absolute. A market maker who posts a bid on 400 shares obliged to honor the bid for an extra 600. For liquid, actively traded stock, however, getting 1000 shares at a single price remains the norm.

**Tiers of the NASDAQ Market:**

The largest and most established firms in the NASDAQ market are called national market issues. These securities, which number about 4000, include firms such as Intel and Microsoft. Information about national market issues is usually readily available and normally covered the popular reference sources found in most public libraries.

Other NASDAQ securities are small-cap issues, meaning they have a low level of capitalization. There are about 1250 of these securities, but detailed information about them is substantially more difficult to gather quickly. These firms receive limited coverage in the financial press. Most pay no dividend; many are too new to have any earning from which to pay the dividend. The newspaper listing for small-cap issues is abbreviated; generally only trading volume and closing price appears.

**THE OVER THE COUNTER MARKET:**

Some investors view the terms NASDAQ and OTC synonymously. This may have been accurate at one time, but not any more. Today the term OTC equity security refer to an equity security that is not listed or traded on NASDAQ or national securities exchange. On NASDAQ, there are listing standards, automated trade executions, formal corporate relationships with the underlying firms, and substantial market maker obligations. This is not true of over-the-counter securities. These trade two ways, either via the OTC bulletin board or via the pink sheets.

**Over-the-Counter Bulletin Board (OTCBB):**

The OTC bulletin board is a regulated quotation service providing real-time information on OTC equity securities. The OTCBB came about largely because of the penny stock reform act of 1990, which required the SEC to establish a system facilitating widespread
dissemination of piece quotation on OTC equities. Since December 1993 firms have been
required to report trades in these securities within 90 seconds of the transaction.

There are approximately 5500 OTCBB securities and about 400 firms making a market in
them. It is important to note that the OTCBB is only the means of providing price
information; it does not also serve as a listing service as the NASDAQ dose. A firm can
apply for listing on NASDAQ under the prices set of rules. On the OTCBB, the market
makers decide how much to buy and sell of a particular security, so a firm has no assurance
it will be able to sell new shares at an initial price.

**Pink Sheets Stocks:**

The smallest and often most speculative OTC stocks are the pink sheet issues. Information
on these securities comes from the NOB, which begin providing the data in 1913. Roger
Babson, founder of Babson College was largely responsibly for its origination. The name
comes from the fact that historically the pricing informed appeared on narrow strips of pink
paper and hung from a clipboard in brokers’ offices.

The information was often limited to a dealer’s name, telephone number, a bid price, and an
offer price. As technology advanced and investors became accustomed to current price data
on demand, the pink sheets have changed, too. Stale pricing data is not longer acceptable.
Now subscribers can access real time data on pink sheet stocks via the internet at
[www.otcquote.com](http://www.otcquote.com).

Some pink sheet stocks have virtually no assets or than someone with a good idea. The
Corporate headquarters may be a rented office with a mailbox, telephone, desk and nothing
else. Others have assets and real revenue but are closely held and have no interest in
exchange listing. Good ideas can make a great deal of money if they are economically
feasibly. The initial capital investors provide to these firms may be used to provide living
expenses for the person with the good idea who needs time to think and develop a game
plan to exploit idea.

For some people, small OTC issues hold particular intrigue; buried in the list somewhere
lays the next apple computer, AOL, or Netscape. Pink sheet stocks are often very
inexpensive, so the analyst who can correctly spot a few winners may make huge profits if
the idea takes off.

**Third and Fourth Markets:**

Listed securities can be traded in the NASDAQ market. General electric, for instance, trades
on New York stock exchange. A brokerage firm could offer to sell 1000 shares of GE
through the NASDAQ system. In essence, they post a for-sale advertisement on the inter
market trading system (ITS). GE is the widely traded stock and odds are extremely goo that
someone will bid on it. The trading of listed securities in the NASDAQ market is known as
the third market. The third market may offer greater trading flexibility than the exchanges,
particularly with regard to trading rules and fees.

Sometimes large institutions at trade bypass both the exchanges and the NASDAQ system
and trade directly with other. For example, a portfolio manager at a Boston-based mutual
fund might decide to sell 50000 shares of Microsoft. In such a case, some portfolio
managers make it a habit to call portfolio managers at other firms and attempt a direct
attempt rather than going through the changes or NASDAQ. The mutual fund manager
might call a portfolio manager at an insurance company and arrange the sale. Direct trades between large institutional investors comprise the fourth market. Fourth market trading is usually motivated by reduced trading fees. These trades may be done face to face or over the telephone, but more likely they are done via institutional network, known as Instinet. Instinet users receive a proprietary fee and pay commissions at about 25% of the full service broker rate. Only financial institutions and brokers have access to Instinet. Price data on several thousand popular stocks on 16 different exchanges are maintained on Instinet, and like NASDAQ, the system electronically searches for the best price for a particular trade.

**REGULATION:**

Another globally envied characteristic of the US exchanges in their oversight and consequent safety. While nothing can keep market prices from responding to economic and psychological events, effective regulation can reduce the possibilities that investors will be missed by the unscrupulous.

**The Exchanges:**

The exchanges established regarding the financial capacity of members serving as stock specialists. Rule 104.20 of NYSE constitution and rules requires each specialist firm to continually carry sufficient capital to assume a position of 15000 shares in each common stock in which they are registered. At the American stock exchange, rule 171 of AMEX constitution and rules require each specialist to have sufficient capital to assume 6000 shares or $600,000 whichever is greater.

In addition to the financial and market activity requirements have been established. For some foreign companies, these requirements are much more stringent than in their homeland. Until recently no German firm listed its stock on a US stock exchange. The apparent reason was dislike of these disclosure requirements and US accounting standards. Daimler Benz (manufacturer of Mercedes automobiles) broke ranks in 1993, did the additional work, and became listed on NYSE. It subsequently merged with Chrysler to become Daimler Chrysler.

**The SEC:**

**Background:**

Congress established the Securities and Exchange Commission SEC in 1934. The purpose of the SEC is to promote honest and open securities market. In particular, the SEC is to ensure full and fair disclosure of relevant corporate information to potential and current investors in the firm.

Note, however, that the mere fact that a firm has all its reporting and compliance ducks in order does not mean that its securities are a good instrument. The SEC itself states: “Conformance with federal securities laws and regulations does not imply merit. If information essential to informed investment analysis is properly disclosed, the commission cannot bar the sale of securities which analysis may show to be of questionable value. It is the investor, not the commission, who must take the ultimate judgment of the worth of securities, offered for sale.”
Some people believe congress created the SEC in response to the great crash of 1929. Actually, attempts to regulate the US securities industry date back to the late nineteenth century. As capital markets grew during the industrial revolution, so did the instances of price manipulation and other abuses.

One of the most notable instances of abuse is the infamous Ponzi scheme. In a ponzi scheme someone returns part of the investors’ principal, claiming it as profit.

*The primary purpose of the SEC is to ensure that investors have adequate information to make an informed investment decision.*

**Primary acts:**

Perhaps the two most important security acts as influencing the investment industry today are the securities act 1933 and the securities exchange act of 1934. Both acts were part of President Roosevelt’s new deal legislation.

The securities act of 1933 is specifically designed to protect investors against characters such as Charles Ponzi. It provides for the regulation of the initial sale of virtually all securities. It does not cover the secondary market nor does it apply to the primary market offerings of US government debt securities or to municipal or state security offerings. The act is sometimes called the truth in securities law, and is really about accurate disclosure.

The securities exchange act of 1934 deals with the secondary market. Like its forerunner, it focuses on accurate disclosure surrounding listed securities. In 1964 the act was amended to cover most NASDAQ securities. Its major features include registration of exchanges and brokers, prohibition of misleading trading practices, the establishment of proxy procedures for shareholder votes, and a protocol for handling tender offers.

**The NASD:**

The *National Association of Securities Dealers (NASD)* is a self-regulatory body that licenses brokers and generally oversees trading practices. Congress provided for the creation of such a national securities association in a 1938 amendment to the Securities Exchange Act of 1934. The NASD is the owner and proponent of the NASDAQ price quotation system. The SEC specifically oversees the trading of listed securities, while the NASD oversees all trading. The SEC also oversees the NASD. A central theme of the 1938 amendment is the promotion of a voluntary code of business ethics.

**SIPC:**

In 1970 Congress passed the Securities Investor Protection Act, which established the Securities Investor Protection Corporation SIPC. This organization protects investors from loss due to brokerage firm failure, fraud, natural disaster, or theft. Since its inception, the SIPC has liquidated more than 200 firms and distributed nearly $1 billion in claims to more than 200,000 investors. It does no provide protection against loss due to bad investors, however. Brokerage firms provide a minimum of $500000 protection to each of their customers. For an added insurance premium, firms can increase their protection level. The division of market regulation of the Securities and Exchange Commission supervises the SIPC.
ETHICS:

One characteristic of the marketplace that should be mentioned in the discussion is the growing sensitivity to the importance of ethical behavior of those who can deal with the public’s money. Much of the regulatory history of the markets stems from attempts to curtail questionable or downright corked behavior on the part of unscrupulous characters who seek to take advantage of those who are financially unsophisticated.

Illegal vs. unethical:

A wide range of investment activities may be legal, but these activities carry substantial ethical baggage. Suppose, for instance, someone asks a finance professor about the potential of Gillette common stock. “I think it is a great investment the company’s sales will go up forever” may be the professor’s opinion, which is not illegal to express. From an ethical perspective, however, an important aspect is the basis for the opinion. If the professor knows nothing about the company but is simply stating a preference for the company’s razors, then the opinion is quite different from one formed from careful company’s analysis. It might not be illegal for the professor to like Gillette or to state a personal opinion, but many people would consider it unethical to give the impression that such an opinion is the result of careful analytical study.

Suppose the professor likes Gillette after reading a research report in which an analyst recommended the stock. Does this make the opinion more reasoned, and therefore give the response more ethical credibility? Take for instance, another consideration with ethical overtones. Suppose the professor has researched Gillette and does believe it as a common stock with above average potential. Can the professor now comfortably recommend Gillette when someone asks about it? Even now the answer is not clear cut. Who is asking? 30 years old professional earning $75000 per year or a 75 years old widow was living on a fixed income? It is not possible to discuss the merits of a particular investment without knowing the context in which the potential investor is asking the question.

The capital markets serve three primary functions. The economic function brings buyers and sellers together. The continuous pricing function enables traders to get market prices quickly. The fair pricing function is related to the continuous pricing function and assures both buyers and sellers of getting a market-determined price when they trade.

The two national exchanges in the United States are the New York Stock Exchange and the American Stock Exchange. The AMEX recently merged with the NASDAQ stock market, the latter having historically been called over-the-counter market. Thirteen other smaller exchanges are known as regional exchanges. Worldwide, approximately 150 exchanges exist in more than 50 countries.

Many securities trade in the over-the-counter market via the NASDAQ system. In this electronic linkup of brokerage firms, orders are placed by computer. Some very large companies are National Market Issues, with smaller firms listed as small-cap stocks. The over-the-counter market is distinct from the NASDAQ Stock Market. OTC securities trade as either OTC Bulletin Board stocks or as Pink Sheet issues.

Shares are initially sold in the primary market. The sales of listed securities via the Nasdaq system is called the third market, while direct institutional trading via the Internet system is the fourth market.
Numerous organizations regulate the securities industry. The most important pieces of legislation are probably the Securities Act of 1933 and the Securities exchange Act of 1934, which significantly improved the required level of financial disclosure for public securities. The Securities Investor Protection Corporation provides protection against fraud or brokerage firm failure.

The Chartered Financial Analyst (CFA) designation is a prestigious credential for those involved in the money management business. In many businesses, enrollment in the CFA program is a prerequisite for employment.

Of all securities, common stock is probably the most familiar. Still, many people know comparatively little about stock, why it exists, how Company A’s shares differ from Company B’s, and how the potential investor decides among them.

**CORPORATIONS, SHARES, AND SHAREHOLDER RIGHTS**

Common stock is the hallmark of the capitalist systems. Millions of people directly own a portion of U.S. business through their investment in common stock; millions more have an indirect ownership interest through their investments in mutual funds, insurance contracts and retirement annuities. People own stock have an equity interest in the organization.

**Corporations:**

If a business has shares of stock, it is organized as a corporation rather than a proprietorship or a partnership. Corporations vary widely in their complexity and size General Motors (GM NYSE) and Intel (INTC, NASDAQ) are corporations, but so are many doctors professional athletes and inventors.

All corporations issue common stock, but it is not always possible for the general public to buy the shares. The stock of some corporations is closely held, meaning the people who own the stock do not routinely offer it for sale. The stock of outdoor sporting gear Giant L.L. Bean is closely held and not available to the public. The professional golfer Jack Nicklaus operates as “Golden Bear Golf.” Until recently an individual investor could not buy shares in Golden Bear. (These shares now trade with the ticker symbol JACK) Investors can however buy shares in the Boston Celtics; they trade on the New York Stock Exchange. People who own stock in the Boston Celtics (BOS, NYSE) are part owners of the basketball organization and share in its success. You can also buy shares in the Cleveland Indians (GLEV, NASDAQ). These shares are publicly held because any investor can acquire them with a simple phone call to a stockbroker.

**Shares:**

In the United States, those two types of stock are common stock and preferred stock. Both are equity securities and both represent a partial ownership interest in the firm. Don’t be misled by the term common. It does not mean the stock is average or routine. Common stock is really a single term rather than an adjective and a noun. In formal terms, common shareholders have a residual claim on the assets of the firm after the bondholders and other creditors.

Preferred stock (also called preference stock) has priority over common stock in the event the firm goes bankrupt and the courts direct the distribution of the remaining firm assets. To
an individual investor, this is probably preferred stock only advantage. Most preferred stock pays a perpetual fixed dividend stream; it is more like a consol bond than a share of common stock. If market interest rates change the value of existing preferred stock, moves significantly. Preferred shares actually have more interest rate risk than bonds, because they have no maturity date at which their price will return to par.

Most preferred stock is owned by other corporation because of tax advantage. A corporation avoids taxation on most of its dividend income, and preferred stock tends to pay more in dividends than common stock. The appendix to Chapter Nineteen elaborates on this point.

Shareholder Rights:

Investors in the shares of U.S. corporations are entitled to standard bills of rights unless otherwise provided in the corporate charter. A few of these are especially important to stock investors.

The Right to Receive Declared Dividends on a Pro Rata Basis:

A corporation is not required to issue any kind of dividend to its shareholders. Shareholders do not have a right to dividends; but if a dividend is declared the dividend each shareholder receives must be in proportion to the shareholder’s ownership interest in the firm. A person owning 500 shares receives five times the dividends received by a person owning 100 shares.

The Right to Vote:

Shareholders are entitled to vote on matters of interest to the corporation, such as the election of the board of directors, the selection of an auditor, and amendments to the corporation charter. The usual rule is the shareholders gets one vote for each share held.

Some companies have more than one class of stock, such as Class A and Class B. Tele-Communication, Inc is the largest operator of cable television systems in the United States. It has both Class A and Class B stock. Class A stock gets one vote per share, while Class B gets 10 votes per share. There are nearly 9,000 Class A shareholders, but fewer then 700 Class B shareholders; 69 percent of the Class B shares are closely held. Still a potential investor can buy either class.

Until recently General Motors had Class A, Class E, and Class H common stock, the automobile share are Class A. Class E shares came about as a consequence of GM’s acquisition of Ross Perot’s computer company EDS (hence the letter E). The income of the EDS subsidiary was the basis for any dividend declared on the Class E stock. These securities had 1/8 of a vote per share. These share no trade as Electronic Data System (EDS; NYSE). The Class H stock arose form GM’s acquisition of Hughes Electronics. These shares have ½ vote each, and like the E share receive dividends based on the separate income of the associated GM, subsidiary.

Corporations hold an annual meeting at which time shareholders may exercise their right to vote. Most shareholders however, are unable to attend the meeting. These people may still exercise their right to vote by completing a proxy statement in advance of the annual meeting. This form automatically comes in the mail with the annual meeting announcement. It is really an absentee ballot the shareholder sends to a neutral party (usually an accounting
or law firm) that will vote in the shareholder’s absence in accordance with the shareholders wishes.

In additional to the process of voting shareholders, also have the right to propose matters to be voted upon. Any shareholder even a person with a single share, may submit a proposal for consideration at the company’s next annual meeting. In general any such proposal must be included in the proxy statement the firm sends out.

It is unusual for a shareholder proposal to get enough votes to pass, but it does occasionally happen. In 1993, a person holding 100 shares of Chemical Banking Corporation (CML, NYSE) proposed that the corporate board of director be elected all at once rather than serve staggered terms. (Staggered director terms are a common defense against hostile takeovers). The bank agreed with this idea and it was incorporated into the corporate charter.)

**The Right to Maintain Ownership Percentage:**

Sometimes a firm chooses to raise new capital by selling additional shares of stock. The preemptive right gives existing shareholders the right to maintain the same ownership percentage before and after the new stock sale. Suppose for instance a corporation has 10 million shares of stock outstanding and a pension fund owns one percent of them. If the corporation decides to issue an additional 1 million shares, the pension fund will be entitled to purchase 10,000 (one percent) of these new shares. If it does so after the stock issue the fund would own 110,000 of the 11 million total shares still one percent of the total.

The mechanics of the preemptive right are accomplished by a right offering; giving existing shareholders first crack at any new shares offered by the company. These rights function like store coupons. They allow their owner to buy the new stock at a below market price.

Rights are actual securities that can be bought and sold. They have a limited life usually expiring within a few weeks after they are issued. People who hold their own stock certificates will receive the rights in the mail, people who leave their securities with their brokerage firm find them listed on their next account statement.

The investor can do one of three things with these rights, (1) sell them to some one else, (2) use them to buy share, (3) let them expire. The last option is inappropriate because it amounts to throwing money away. Rights are valuable and should be exercised if you want more stock. Otherwise sell them.

Describes the terms of a right offering for the Emerging Mexico Fund (EMF, NYSE); dated February 14, 1994, the notice indicates the offering expires on March 3, 1994 As with most right offerings, shareholders have only a few weeks between the initial announcement and the expiration of the rights.

In this case, shareholders received one right for each share owned. Buying one new share required 3 rights, and each new share could be purchased at a discount of about five percent from the current market price. The EMF right had a market price of about 7/3nds of a dollar apiece. While this is not a lot of money, customers are not happy about losing out because they were uninformed. Just before, expiration brokerage firms may sell customers’ right on their behalf if they do not receive instruction to the contrary.

Many investors keep their stock certificates at home or in a safe deposit box at the bank. When stock rights are issued they are sent to the registered owners. Because stock rights are confusing securities to almost everyone too often they go onto, a stack on a desk and are
temporarily forgotten. After a few weeks, they expire and their value is lost and can not be recovered. If instead an investor stock is held by the brokerage firm, the rights will be sent to the brokerage house, and the broker should make sure that they are not wasted.

To avoid unhappy clients, brokerage firms carefully monitor rights offerings and advise their clients appropriately.

The preemptive right is sometimes waived in the corporate charter. The face of the stock certificate might specifically say without preemptive rights.

**Type of dividends:**

The three types of dividends that corporations may pay to their shareholders include cash dividends stock dividends, and property dividends.

1. **Cash Dividends:**

A cash dividend not surprisingly, is paid in cash and is the most common type of dividend. Most firms have an established dividend payment schedule through which a portion of the firm’s profits are returned to the shareholders. These dividends may be received as cash (via a check form the company) or they can sometimes be reinvested in additional shares of stock in the firm. This latter option is accomplished via a dividend reinvestment plan, often called a DRIP. Such a plan virtually always provides for the purchase of fractional shares with the reinvested check. If the current share price is $25, $30 dividend check would buy 1.2 shares.

More than, 1,000 firms have a dividend reinvestment plan. Reinvested dividends can make a significant difference in the growth of an investment, particularly if the additional shares are acquired at a discount form the prevailing market price. About 100 firms, especially bank and utilities encourage dividend reinvestment by offering such a discount.

To see the potential impact of dividend reinvestment over the long run supposes two firms are identical in every respect except that one reinvests dividends at a 5 percent discount while the other has no dividend reinvestment plan. Assume cash earns 4 percent the two firms have a constant 5 percent dividend yield both shares initially sell for $25 and the share price rises by $1 per year for ten years. At the end of the period the account value with reinvestment would be $61.38 compared to $38.52 without reinvestment.

If an investor securities with a broker for safekeeping rather than taking them home, they are said to be held in a street name. In this case the company paying dividends pays them to the brokerage firm. The firm’s subsidiary accounting then allocates the large dividend check appropriately among the clients owning this stock. Most brokerage firms have arrangements whereby any excess cash in an account is automatically transferred into an interest earning fund of some type.

One of the minor inconveniences with dividend reinvestment is that the shares usually must be registered in the individual investor name they cannot be held in a street name. Also dividend re-investment results in the holding of odd lots. An odd lot is a quantity of shares not divisible by 100. holding are either odd lots or round lots (quantities that are divisible by 100.) the opportunity to be able to buy shares at a discount from the prevailing market price through makes up for any odd lot in convenience. There is really nothing wrong with holding an odd lot anyway.
At the 1995 annual meeting of the Walt Disney Company (DIS, NYSE) shareholders voted on a stockholder proposal to reinstate the dividend reinvestment plan the firm terminated in 1990. A husband and wife owning 108 shares made the proposal in accordance with their rights as shareholders and the proposal appeared in the meeting announcement.

The company recommended voting against the proposal on cost-effectiveness grounds. The company had more than 470,000 stockholders and incredibly 69 percent owned 25 shares or less 78 percent owned 50 shares or less and 83 percent owned 100 or less. The clerical task and associated expenses of the dividend reinvestment plan would be significant. The proposal failed.

2. **Stock Dividends:**

Stock dividends are paid in additional shares of stock rather than in cash. Firms announce these as a percentage such as a 10 percent stock dividend, which means the holder of 1000 shares would receive an additional stock certificate for 100 shares. The person who holds 100 shares would get 10 more.

If you hold an odd lot you will receive a check for the value of any fractional shares that cannot be distributed. Suppose you hold 221 shares worth $25 each. A 10 percent stock dividend means you are entitled to 22.1 shares. In practice you would receive an additional 22 shares plus a check for 10 percent of $25 or $2.50.

It is unclear why firms issue stock dividends but we do know several things about them. First, they are often used when firms lack the funds to pay a cash dividend. They are especially common in the infancy or adolescent stages of a firm's life cycle. Second, many shareholders seem to like them. A young firm may establish a pattern of paying a cash dividend and a stock dividend on a regular basis.

3. **Property dividends:**

A property dividend is the prorate distribution of a physical asset. The asset is usually something the firm produces. Property dividends were popular in the early days of the capital markets when the number of shareholders in a particular company was small and the company produced something that could conveniently be distributed.

The London East Indies Company is an example. In 1928 the company distributed a dividend in pepper and calico interesting shareholder discussions followed regarding the merits of commodity dividends versus traditional cash dividends.

Discussions frequently occurred whether the distribution should be in commodities or money. The former was preferred by the merchant shareholders as they could realize additional profits by selling the commodities the gentry on the other hand preferred money. Subsequently there was a kind of alternation; in 1647 there was a dividend in indigo in 1649 in money, in 1650 in both pepper and money, in 1651 and 1652 in money, in 1653 in paper and money. As late as 1678, the East India Company paid a dividend in damaged calico for which it could find no market.

Early U.S. railroad companies occasionally distributed parcels of land from their land grants to their shareholders. During World War II the government rationed consumer goods. Distillers and the manufacturers of women’s nylon stockings got around the ration laws by issuing these products as property dividends. Each November Swissair issues a voucher for...
15 Swiss francs per shares. These can be accumulated and used as credit toward ticket prices (up to a maximum reduction of 50 percent).

**Why Dividends Do Not Matter:**

The company’s decision to pay or not to pay dividends is a complex issue. As we will see, dividends play a role in security valuation, especially with mature Industries. Public utilities, Insurance companies, and banking still, widespread understanding exists about economic value of dividends to shareholders. In many distances, a strong case can be made for the notion that dividend do not matter at all.

When people are first told that dividends do not matter they are often skeptical; how can a check that can be cashed and spent not matter? Suppose a professor appears before a group of finance students and claims to be able to prove that dividends so not matter. The professor produces a shoe box and sets it on to the table in the front of the room but does not show the contents (if any); however a neutral party is chosen to verify that box contains nothing bad. The neutral party essentially fulfils the role of an outside audition.

As students watch, the professor counts out 100$ and place them into the shoe box. After replacing the lid on the box, the professor announces an intention to ownership interest in the show box by going public and issuing 100 shares. Anyone who buys all 100share will own the entire company. Naturally the professor wants to sell the company for as much as possible, but the marketplace will determine how much the box is worth. Each share must be worth at least one dollar. If it were worth less, a risk less profit would exist because any purchaser could be certain of receiving the $100(at least) contents of the box for less than this amount.

In practical, the share will probably sell at a sight premium over $1 exactly. Some students buy one share, other buy more, some won’t buy any. Collectively though, they acquire all 100 shares. The professor takes the $100 they paid, issued the shares. And then no longer owns the shoe box or its contents.

Now the board of directors of the shoe box decides to pay a 10-cent per-share cash dividend. The outside audition reaches into the box, take out ten one dollar bills exchange them for two rolls of dimes, and proceeds to distribute the dimes to the students according to the number of shares they own. Folks who bought one share get one dime, those who bought five get dimes, the 100 dimes are distributed this way.

How will the marketplace view this activity? Will the shares in the shoe box still command a price of $1? They will not of course, because there may only be $90 left in the box, without knowing precisely what is in the box, investors/students know that its value is less now than it was before the payment of dividend. What will happen is that the market price of the shoebox shares will fall by the amount of the dividend. Shares that previously sold for $1 will now sell for 90 cents.

This scenario is generally what happens in the real world. Dividends do not fall from the sky; they are real money paid from the firm’s checking account. If the firm gives the money away in this fashion, the firm is simply not worth as much after writing the checks.

A person once said, “I don’t understand it; every time this stupid stock pays a dividend its price goes down. You would think it would go up.” That person obviously had not heard the shoe box story.
As stated previously, the ex-dividend date determines whether a stockholder receive the dividends; consequently, on the ex-dividend date the price of a share of stock lends to fall by about the amount of dividend to be paid. Stock is normally priced in sixteenths of a dollar, so the share price may not be fall by exactly the right amount. Research into this question is also confounded by a variety of other factors that affect the price of the stock, making it difficult to isolate a pure dividend effect.

There is some evidence that the stock price drop lends to be less than full amount of the dividends especially with “low dividend” stock. One study find that while high dividend stock fall by 98% of the dividend amount, low dividend stocks fall by only 16%. See Frank Murrey, and Ravi Jagannathan, “Why Do Stock Price Drop by Less than the Value of the Dividend? Evidence from a Country without Taxes,” Journal and Financial Economics (February 1998), 161-188.

An extreme example provides further intuition into why the share falls after the payment of a dividend. In late 1987, UAL Corp. (UAL, NYSE) the parent of United Airlines, decided to sell its three non airline subsidiaries. Hertz Car Rental, Hilton International Hotel, and Westin Hotels. This “extraordinary” transaction board of directors subsequently announced its intent to pay a $50 special dividend to the shareholders. Why nearly 22 million shares outstanding, payment of such a dividend would be sizable reduction in the firm’s assets, and the value of the firm would be expected to fall.

To reduce the tax ability shareholders would face on the receipt of such a large dividend, the firm ultimately decided to buy back some of its own share at a premium price rather than pay the dividend. This action enabled many shareholders to take advantage of the capital gains tax break in effect at the time.

**Stock splits:**

Even though stock splits are common in the marketplace, the typical investor may misunderstand them. And because stock splits are generally a natural occurrence, they clearly are not a windfall for the recipient.

**Why Stock Splits Do Not Matter:**

Like cash dividends, a stock split neither increases nor decreases an investor’s wealth as shown in the following analogy. Imagine a perfect pie make from Maine blueberries. Mom cuts the pie into fourths, and intends to dish out a piece to each of her four children. Would it make any difference if the pie were cut into eight pieces and each child receive two? In either case the amount of pie is the precisely the same. No matter how many pieces are cut the total amount available for consumption cannot be increase by increasing the number of slices.

The same is true with the value of the firm. Its ownership is represented by all the shares of stock. Simple doubling the number of shares will not change the value of the company. As a consequence, after the split the share price adjusts to reflect the stock split ratio. With a two-for-one split, the share price will fall approximately in half. The person who previously held 500 shares valued at $ 40 each will now own 1,000 worth $ 20 each. In each case the total value is $ 20,000.
Why Firms Split Their Stock:

The primary motivation for stock split is usually to reduce the price of the shares and to increase share liquidity. This notion is largely based on survey research of corporate managers. A study by Baker and Gallagher found that, according to the chief financial officers of a number of U.S. firms, a principal reason for splitting shares is to “broaden the ownership base.” Although some evidence points to an opinion ….. Trading range for the value of common stock, the jury is still out on the subject. Theoretically, the price of the stock is unimportant; the wealth represented by the stock is the issued. One hundred shares of a $100 stock should be worth just as much as one thousand shares of a $10 stock.

One fact remains, however; many investors shy away from high-period stocks. People seem to prefer to buy in found lots and higher pre-share prices make the purchase of 100-share lots more difficult for individual investors. If a firm’s stock sell for $100 and management decides this price is too high, the firm can split the stock, perhaps four-for-one, and reduce the share price to about $25. The lower price may attract investor who previously passed over the security because of its sleep price. At the same time, many people also have preconceptions about a stock selling for $1 per share. Such a low price “must” mean that the shares are risky. Financial managers will do what is prudent into order to maximize their shareholder’s investment, which could mean rising or lowering the share price into the best range, as determined for that particular stock.

One of the truly classic investments books is Security Analysis by Graham and Dodd. Even though this book appeared before the development of the modern finance theory, it still occupies a place on many analysts and investors bookshelves. In the book, the author assert, “It is a commonplace of the market that an issue will rise more steadily from 10 to 40 than from 100 to 400.” Many people, whether consciously or subconsciously, probably like low-priced stock for this very reason.

Management sometimes uses a reverse split for the express purpose of reducing the number of outstanding shareholders. A large reverse split, like one for two hundred, will climate the ownership interests of everyone who owns fewer than 200 shares, because after the split they would be left with less than a full share and would receive cash for this fractional holding. Management usually does this when a large shareholder wants to consolidate control of the company or perhaps take it private.

Stock Split vs. Stock Dividends:

The financial page….. Sometimes reports that a firm announced a “100% stock dividend,” which means that for every share investor own, they will receive another one. How is the arrangement different from a two-for-one stock split? Similarly how is a five-for-four stock split different from a 25 percent stock dividend?

In practical terms, they are not different at all. From the investor’s perspective, the impact is exactly the same. The difference between a stock split and a stock dividend is purely an accounting phenomenon. With a stock split the par value of the stock as carried on the firm’s book changes by the split factor. With a stock dividend the par value is not affected, new shares are issued. Stock par value is not a meaningful statistics from an investment point of view, it is an accounting curiosity.