INTEGER WEALTH CAPITAL

SECURITIES – AN OVERVIEW

Defining Securities in Investment Terms

What Is a Security.?

The term "security" refers to a fungible, negotiable financial instrument that holds some type of monetary value. It represents an ownership position in a publicly traded corporation via stocks (also known as shares), a creditor relationship with a governmental body or a corporation represented by owning that entity's bond; or rights to ownership as represented by an option.

Key Takeaways

- Securities are fungible and tradable financial instruments used to raise capital in public and private markets.
- There are primarily three types of securities: equity—which provides ownership rights to holders; debt—essentially loans repaid with periodic payments; and hybrids—which combine aspects of debt and equity.
- Public sales of securities are regulated by the SEC.
- Self-regulatory organizations such as NASD, NFA, and FINRA also play an important role in regulating derivative securities.

Understanding Securities

Securities can be broadly categorized into two distinct types: equities and debts. However, some hybrid securities combine elements of both equities and debts.

Equity Securities

An equity security represents ownership interest held by shareholders in an entity (a company, partnership, or trust), realized in the form of shares of capital stock, which includes shares of both common and preferred stock.

Holders of equity securities are typically not entitled to regular payments—although equity securities often do pay out dividends—but they are able to profit from capital gains when they sell the securities (assuming they've increased in value).

Equity securities do entitle the holder to some control of the company on a pro rata basis, via voting rights. In the case of bankruptcy, they share only in residual interest after all obligations have been paid out to creditors. They are sometimes offered as payment-in-kind.

Debt Securities

A debt security represents borrowed money that must be repaid, with terms that stipulate the size of the loan, interest rate, and maturity or renewal date.

Debt securities, which include government and corporate bonds, certificates of deposit (CDs), and collateralized securities (such as CDOs and CMOs), generally entitle their holder to the regular payment of interest and repayment of principal (regardless of the issuer's performance), along with any other stipulated contractual rights (which do not include voting rights).

They are typically issued for a fixed term, at the end of which they can be redeemed by the issuer. Debt securities can be secured (backed by collateral) or unsecured, and, if secured, may be contractually prioritized over other unsecured, subordinated debt in the case of a bankruptcy.

Hybrid Securities

Hybrid securities, as the name suggests, combine some of the characteristics of both debt and equity securities. Examples of hybrid securities include equity warrants (options issued by the company itself that give shareholders the right to purchase stock within a certain timeframe and at a specific price), convertible bonds (bonds that can be converted into shares of common stock in the issuing company), and preference shares (company stocks whose payments of interest, dividends, or other returns of capital can be prioritized over those of other stockholders).

> **Note:** Although the preferred stock is technically classified as equity security, it is often treated as debt security because it "behaves like a bond." Preferred shares offer a fixed dividend rate and are a popular instrument for income-seeking investors. It is essentially fixed-income security.

How Securities Trade

Publicly traded securities are listed on stock exchanges, where issuers can seek security listings and attract investors by ensuring a liquid and regulated market in which to trade. Informal electronic trading systems have become more common in recent years, and securities are now often traded "over-the-counter," or directly among investors either online or over the phone.

An initial public offering (IPO) represents a company's first major sale of equity securities to the public. Following an IPO, any newly issued stock, while still sold in the primary market, is referred to as a secondary offering. Alternatively, securities may be offered privately to a restricted and qualified group in what is known as a private placement—an important distinction in terms of both company law and securities regulation. Sometimes companies sell stock in a combination of a public and private placement.

In the secondary market, also known as the aftermarket, securities are simply transferred as assets from one investor to another: shareholders can sell their securities to other investors for cash and/or capital gain. The secondary market thus supplements the primary. The secondary market is less liquid for privately placed securities since they are not publicly tradable and can only be transferred among qualified investors.

Investing in Securities

The entity that creates the securities for sale is known as the issuer, and those who buy them are, of course, investors. Generally, securities represent an investment and a means by which municipalities, companies, and other commercial enterprises can raise new capital. Companies can generate a lot of money when they go public, selling stock in an initial public offering (IPO), for example.

City, state, or county governments can raise funds for a particular project by floating a municipal bond issue. Depending on an institution's market demand or pricing structure, raising capital through securities can be a preferred alternative to financing through a bank loan.

On the other hand, purchasing securities with borrowed money, an act known as buying on a margin is a popular investment technique. In essence, a company may deliver property rights, in the form of cash or other securities, either at inception or in default, to pay its debt or other obligation to another entity. These collateral arrangements have been growing of late, especially among institutional investors.

Regulation of Securities

In the United States, the U.S. Securities and Exchange Commission (SEC) regulates the public offer and sale of securities. In the UK the Financial Conducts Authority and in Europe each country has its own regulator however these all follow union rules and regulations from the European Union.
In Luxembourg the CSSF (Commission de Surveillance du Secteur Financier) is the regulator for the securities and financial services industry.

The definition of a security offering was established by the United States Supreme Court in a 1946 case. In its judgment, the court derives the definition of a security based on four criteria—the existence of an investment contract, the formation of a common enterprise, a promise of profits by the issuer, and use of a third party to promote the offering.

Residual Securities

Residual securities are a type of convertible security—that is, they can be changed into another form, usually that of common stock. A convertible bond, for example, is a residual security because it allows the bondholder to convert the security into common shares. Preferred stock may also have a convertible feature. Corporations may offer residual securities to attract investment capital when competition for funds is intense.

When residual security is converted or exercised, it increases the number of current outstanding common shares. This can dilute the total share pool and their price also. Dilution also affects financial analysis metrics, such as earnings per share, because a company's earnings have to be divided by a greater number of shares.

In contrast, if a publicly traded company takes measures to reduce the total number of its outstanding shares, the company is said to have consolidated them. The net effect of this action is to increase the value of each individual share. This is often done to attract more or larger investors, such as mutual funds.

Other Types of Securities

Certificated securities are those represented in physical, paper form. Securities may also be held in the direct registration system, which records shares of stock in book-entry form. In other words, a transfer agent maintains the shares on the company's behalf without the need for physical certificates.

Modern technologies and policies have, in most cases, eliminated the need for certificates and for the issuer to maintain a complete security register. A system has developed wherein issuers can deposit a single global certificate representing all outstanding securities into a universal depository known as the Depository Trust Company (DTC). All securities traded through DTC are held in electronic form. It is important to note that certificated and un-certificated securities do not differ in terms of the rights or privileges of the shareholder or issuer.

Bearer securities are those that are negotiable and entitle the shareholder to the rights under the security. They are transferred from investor to investor, in certain cases by endorsement and delivery. In terms of proprietary nature, pre-electronic bearer securities were always divided, meaning each security constituted a separate asset, legally distinct from others in the same issue.

Depending on market practice, divided security assets can be fungible* or (less commonly) non-fungible, meaning that upon lending, the borrower can return assets equivalent either to the original asset or to a specific identical asset at the end of the loan. In some cases, bearer securities may be used to aid tax evasion, and thus can sometimes be viewed negatively by issuers, shareholders, and fiscal regulatory bodies alike.

Registered securities bear the name of the holder and other necessary details maintained in a register by the issuer. Transfers of registered securities occur through amendments to the register. Registered debt securities are always undivided, meaning the entire issue makes up one single asset, with each security being a part of the whole. Undivided securities are fungible by nature. Secondary market shares are also always undivided.

Letter securities are not registered with the SEC and cannot be sold publicly in the marketplace. Letter security—also known as restricted security, letter stock, or letter bond—is sold directly by the issuer to the investor. The term is derived from the SEC requirement for an "investment letter" from the purchaser, stating that the purchase is for investment purposes and is not intended for resale. When changing hands, these letters often require form 4.

Cabinet securities are listed under a major financial exchange, such as the NYSE, but are not actively traded. Held by an inactive investment crowd, they are more likely to be a bond than a stock. The "cabinet" refers to the physical place where bond orders were historically stored off of the trading floor. The cabinets would typically hold limit orders, and the orders were kept on hand until they expired or were executed.

** replaceable by another identical item; mutually interchangeable*

Issuing Securities: Examples
Consider the case of XYZ, a successful startup interested in raising capital to spur its next stage of growth. Up until now, the startup's ownership has been divided between its two founders. It has a couple of options to access capital. It can tap public markets by conducting an IPO or it can raise money by offering its shares to investors in a private placement.

The former method enables the company to generate more capital, but it comes saddled with hefty fees and disclosure requirements. In the latter method, shares are traded on secondary markets and not subject to public scrutiny. Both cases, however, involve the distribution of shares that dilute the stake of founders and confer ownership rights on investors. This is an example of equity security.

Next, consider a government interested in raising money to revive its economy. It uses bonds or debt security to raise that amount, promising regular payments to holders of the coupon.
Such bonds usually referred to as 'sovereign bonds' are usually graded by risk analysts such as Moody's, Standard & Poor and Fitch.

Finally, look at the case of startup ABC. It raises money from private investors, including family and friends. The startup's founders offer their investors a convertible note that converts into shares of the startup at a later event. Most such events are funding events. The note is essentially debt security because it is a loan made by investors to the startup's founders.

At a later stage, the note turns into equity in the form of a predefined number of shares that give a slice of the company to investors. This is an example of a hybrid security.