Unit 3: Equities

Student Workbook

CISI EDUCATION PARTNER 2023-24

Unit 3: Equities – Introduction

Unit Aim: Understand the features of equities and how they are traded.

Relevance of this unit to the course:
This is the first asset class to be explored in the course, and so some terminology and concepts will be in units 4, 5, 6 and 7. An understanding of public and private companies, and the associated role of shares, will also be relevant to units 9 and 11.

Learning Objective	Learning Outcomes	Chapter Section
3.1.1	Know how a company is formed and the differences between private and public companies	2
3.1.2	Know the features and benefits of ordinary and preference shares: • Dividend • Capital gain • Share benefits • Right to subscribe for new shares • Right to vote	3
3.1.3	Be able to calculate the share dividend yield	4
3.1.4	Understand the advantages, disadvantages and risks associated with owning shares: • Price risk • Liquidity risk • Issuer risk • Foreign exchange risk	4 and 5
3.1.5	Know the definition of a corporate action and the difference between mandatory, voluntary and mandatory with options, including takeovers and mergers	6
3.1.6	Understand the following terms: • Bonus / scrip / capitalisation issues / stock splits / reverse stock splits • Rights issued • Dividend payments • Buybacks	6

Unit 3: Equities – Introduction

Learning Objective	Learning Outcomes	Chapter Section
3.1.7	Be able to calculate: • Theoretical ex rights price • Theoretical ex bonus price	6
3.1.8	Know the purpose and format of annual general meetings	2
3.1.9	Know the function of a stock exchange • Primary / secondary market • Listing	7
3.1.10	Know the types and and uses of the main global stock exchange indices	8
3.1.11	Know how shares are traded: • On exchange / over the counter • Multilateral trading facilities • Order driven / quote driven	9
3.1.12	Know the method of holding title and related terminology: registered and bearer; immobilised and dematerialised	10
3.1.13	Understand the role of the central counterparty in clearing and settlement	11
3.1.14	Understand how settlement takes place: • Participants • Process • Settlement cycles	12

How to use this student workbook

Throughout this student workbook, look out for the different icons to support your learning:

Understand and learn – these compulsory sections will help you to develop your knowledge and understanding of the assessed learning objectives. We have also integrated the CISI micromodules into your learning. These give you key explanations of the themes in a short, digestible manner and can be found on the CISI learning platform.

Apply and practise – Practise and test your newly acquired learning by undertaking a range of activities to help you prepare for the multiple-choice assessment at the end of the course.

Further your knowledge – Consolidate your understanding of key concepts by reading and interacting with current, credible CISI resources to help further enhance your learning. These optional resources include the CISI professional refresher modules and webinars from CISI TV, and CISI YouTube videos.

Introduction

Read the Investopedia page and watch the short video defining equity. Summarise the key features of equity below.

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

Learning Outcome 3.1 – Equities

3.1.1: Know how a company is formed and the differences between private and public companies

3.1.8: Know the purpose and format of annual general meetings

3.1.2: Understand the features and benefits of ordinary and preference shares:

- Dividend
- Capital gain
- Share benefits
- Right to subscribe for new shares
- Right to vote

Company formation

GOV.UK provides guidance about how to set up a limited company, appoint directors and shareholders and register for tax. Summarise the stages and identify the key documents required.

1.

2.

3.

4.

5.

6.

7.

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

CISI EDUCATION PARTNER 2023-24
CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

Memorandum and Articles of Association

Look at the example documents on the right and answer the below questions.

1. What is the purpose of each document?

2. More specifically what does it tell you about the business?

PRIVATE COMPANY LIMITED BY SHARES
MEMORANDUM OF ASSOCIATION
OF
LOCAL VEG LTD

1. The company's name is Local Veg Limited.
2. The Company's registered office is:

   Under the Arches, 6 High Street, Newtown, Newtownshire, NE61 5SW.
3. The Company's objects are to carry on the business of a general commercial company, principally this will involve buying vegetables from producers and selling those vegetables on to consumers.
4. The liability of the shareholders/members is limited.
5. The Company's authorised and issued share capital is £1,000 divided into 1,000 Ordinary £1 Shares of £1 each.

   We, the subscribers to this Memorandum of Association, wish to be formed into a Company pursuant to this Memorandum and to take the number of shares shown beneath our respective names.

   Jake Onions, 42A High Street, Newtown, Newtownshire, NE61 5SW.

   Number of shares taken: 400

   Johnny Plant, 36 High Street, Newtown, Newtownshire, NE61 5SW.

   Number of shares taken: 300

   Jenny Plant, 36 High Street, Newtown, Newtownshire, NE61 5SW.

   Number of shares taken: 300

PRIVATE COMPANY LIMITED BY SHARES
ARTICLES OF ASSOCIATION
OF
LOCAL VEG LTD

INDEX TO THE ARTICLES

Ltd or Plc?

Look at the UK companies below and research whether they are private limited or public limited companies.

In your own words, explain the difference between Ltds and Plcs.

Private and Public Limited Companies – True or False?

	True	False
1. All private and public limited companies have limited liability	○	○
2. Private Limited Companies (Ltds) must have a minimum of two shareholders	○	○
3. Public Limited Companies (PLCs) can be listed on a stock exchange	○	○
4. The majority of public limited company shareholders are directors of the company	○	○
5. Shareholders and directors are often the same people in a private limited company	○	○

Annual General Meetings (AGM) – True or False?

	True	False
1. Public Limited Companies must hold an AGM within six months of the financial year end	◯	◯
2. The Companies Act provides shareholders with the right to attend, speak and vote at the AGM or appoint a proxy who can attend, speak and vote on the shareholder's behalf	◯	◯
3. Shareholders are able to vote on matters such as the appointment and removal of directors but are not able to vote on the payment of the final dividend recommendations	◯	◯
4. Matters of major importance, such as proposed changes to the company's consitution, require a special resolution and at least 75% of shareholders to vote in favour	◯	◯
5. Companies may hold other general meetings during the year but must not put important issues on the agenda of such meetings	◯	◯

Further your knowledge – Annual General Meetings (AGM)

Plcs publish information about their AGMs on their websites along with the annual report. Take a look at either NatWest Group or Marks and Spencer's AGM notices and the communications provided to shareholders and summarise the key features of this important meeting.

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

The benefits of owning shares

Using section 4 in chapter 3 of the course workbook, describe the benefits of share ownership.

Benefits of share ownership			
Dividends	**Capital gains**	**Shareholder benefits**	**Shareholder rights**
			• Voting • Subscription

Features of ordinary and preference shares

Using section 3 in chapter 3 of the course workbook, summarise the key features of ordinary and preference shares below:

Ordinary shares	Preference shares

CISI EDUCATION PARTNER 2023-24

Which type of share?

Look at the short scenarios below. Use section 3 in chapter 3 of the course workbook to determine which type of shares each shareholder owns.

Dan Brown receives a fixed dividend on his shares but in 2023 received a larger dividend

Margaret Atwood was entitled to vote at the company AGM after her shares became ordinary shares

James Patterson normally receives a fixed dividend but missed out on dividends for two years in a row

Stephen King lost his investment in a company after it collapsed. Other shareholders received money from the company.

Jane Austen changed her shares to ordinary shares on 31. 01.2023

John Grisham received different dividend amounts each year based on the company's profits

Anne Tyler on 02.02.2022 she received the original value of her shares back from the company and her shares were cancelled

Terry Pratchett was entitled to a vote at the company AGM

Preference Shares

Read the Standard Charter example about preference shares in section 3 of chapter 3 in the course workbook and answer the following questions.

1. How much dividend will the investor receive each year?

2. Which is paid first? Dividends to this investor or to ordinary shareholders?

3. What does 'non-cumulative' mean in this context?

4. What does 'irredeemable' mean in this context?

5. Could this investor convert their holding into ordinary shares at any time?

Learning Outcome 3.1 – Equities

3.1.3: Be able to calculate the share dividend yield

3.1.4: Understand the advantages, disadvantages and risks associated with owning shares:

- Price risk
- Liquidity risk
- Issuer risk
- Foreign exchange risk

Calculating the Share Dividend Yield

Potential shareholders will want to compare dividends paid on a company's shares to determine whether an investment will return a healthy yield. The share dividend yield tells investors the percentage of a company's share price that it pays out in dividends each year and is calculated using the following formula.

$$\text{Dividend Yield} = \frac{\text{Dividend}}{\text{Total value of a company's shares (or market capitalisation)}}$$

So if ABC plc has 20 million ordinary shares, each trading at £2.50, and pays out a total of £1 million dividends:

$$\frac{\text{£1 million}}{\text{£20 million} \times \text{£2.50}} \times 100 = \text{Dividend Yield is 2\%}$$

Calculating the Share Dividend Yield

1. XYZ plc has issued 40 million ordinary shares, each trading at £3.20. The company pays out a total of £2m in dividends. What is the dividend yield?

- A. 8.00%
- B. 1.56%
- C. 6.25%
- D. 1.85%

2. ABC plc has issued 25 million ordinary shares, each trading at £2.10. The company pays out a total of £3.5 million in dividends. What is the dividend yield?

- A. 6.67%
- B. 7.00%
- C. 5.57%
- D. 6.38%

Calculating the Share Dividend Yield – scenario

Sam has collated the following data about two companies that he may invest in. Based solely on the dividend yield, which company might Sam invest in and why?

Alpha plc has 38 million ordinary shares trading at £4.50 a share. The company pays out £3 million in dividends.

Zebra plc has issued 27 million ordinary shares, trading at £2.18. The company paid out £4.75 million in dividends.

CISI CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT EDUCATION PARTNER 2023-24

The Share Dividend Yield

Using section 4 of chapter 3 in the course workbook to help, answer the following questions.

1. What could it mean if a company has **higher** than average yields when compared with the rest of the market?

2. What could it mean if a company has **lower** than average yields when compared with the rest of the market?

The risks of owning shares

Describe each of the types of risks of share ownership in the diagram below. Use section 5 in chapter 3 of the course workbook to help.

Risks of Share Ownership			
Market / price risk	**Liquidity risk**	**Issuer risk**	**Foreign exchange risk**

Further your knowledge – Shares

Log onto the professional refresher section of the CISI learning platform and complete the Shares Essential module (30 mins). This module explores the features, risks and benefits of owning shares, the different types available and how they are traded globally.

Learning Outcome 3.1 – Equities

3.1.5: Know the definition of a corporate action and the difference between mandatory, voluntary and mandatory with options, including takeovers and mergers.

3.1.6: Understand the following terms:

- Bonus / scrip / capitalisation issues / stock splits / reverse stock splits
- Rights issues
- Dividend payments
- Buybacks

3.1.7: Be able to calculate:

- Theoretical ex rights price
- Theoretical ex bonus price

CISI CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT EDUCATION PARTNER 2023-24

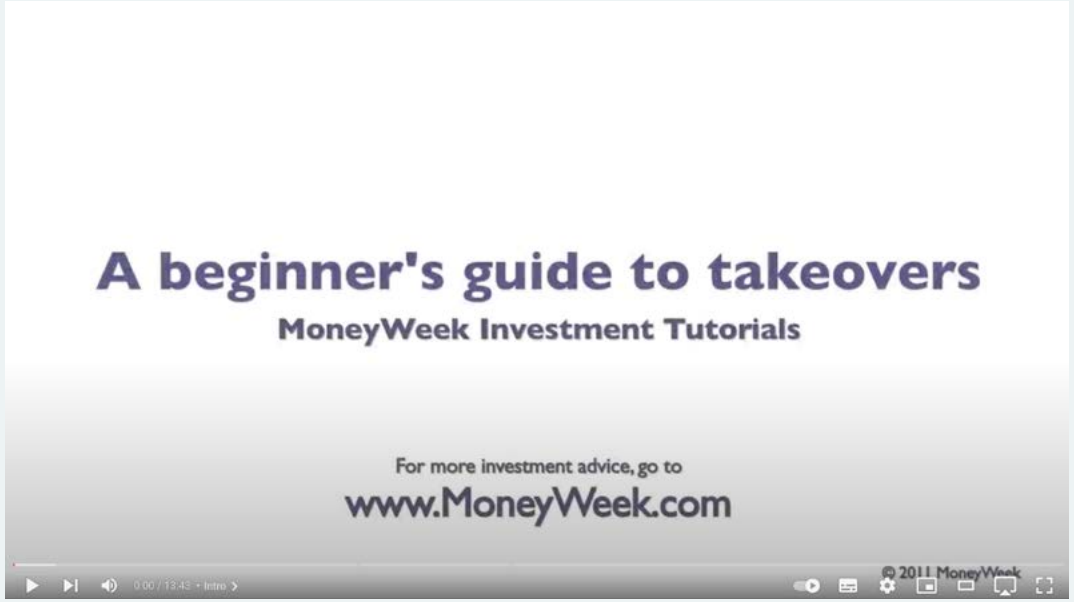
Corporate action

A corporate action occurs when a company does something that affects its shareholders or bondholders. Read section 6 in chapter 3 of the course workbook, summarise the three types of corporate actions below and give an example of each.

Mandatory	Mandatory with options	Voluntary

Takeovers – A beginners guide

Watch the MoneyWeek tutorial about takeovers and explain the process of taking over a company.



*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

Corporate action – takeovers and mergers

Complete the sentences below. Use section 6 in chapter 3 of the course workbook to help

1. Companies seeking to expand can either grow organically or through
2. A takeover can be friendly or hostile. The acquiring company is known as the predator and the other company is known as
3. When the predator acquires shares in the other company, they are obliged to report their share purchases once
4. In a successful takeover, the predator company will buy more than 50% of the shares and is then described as
5. A merger is a similar transaction when the two companies
6. In a merger it is usual for one company to exchange new shares for the shares of the other and as a result the two companies

Example of a corporate action – takeovers and mergers

Watch the video about [Kraft and Heinz] and answer the questions below.

1. Describe what is happening in this deal?

2. What is the impact on Kraft's shareholders?

3. What makes this deal unusual?

4. What category of corporate action is this?

Example of a corporate action – takeovers and mergers

Watch the video about AB Inbev and SABMiller and answer the questions below.

1. How is this deal different to the Kraft/Heinz deal?

2. What is the offer for SABMiller shareholders?

3. How will AB Inbev be benefitting from the deal

4. What are the concerns about this corporate action?

5. What type of corporate action is this deal?

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

Other corporate actions

Read section 6 in chapter 3 of the course workbook and answer the following questions about corporate actions.

1. What is a securities ratio?

2. How does a securities ratio differ between the European and Asian markets and the US markets?

3. What is a 'cash call'?

4. 'Rights issues' are examples of which type of corporate action?

5. How might a company announcing a planned rights issue affect it's share price?

6. What is the agreement that underwriters of a share issue make?

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

Other corporate actions Continued...

7. What happens when a cash call 'flops'?

8. What is a bonus issue also known as?

9. 'Bonus issues' are examples of which type of corporate action? Why?

10. Why would a company make a bonus issue?

11. What does it mean when shares go 'ex-rights'

12. What is a stock split and a reverse stock split?

Teddy's dilemma

Teddy is a shareholder in ABC plc and has come to you for some advice.

- ABC plc has informed Teddy of a 1:4 rights issue.
- Shares in ABC plc are currently trading at £4.00
- The price of the rights is set at a discount to current market price at £2.00
- Teddy currently holds 400 shares in ABC plc

Teddy doesn't really understand what ABC plc has offered and has asked you to give him some information about the rights issue and explain his options to him. He particularly wants to understand what might happen to the share price after the right issue.

Dividends

Dividends are an example of a mandatory corporate action. Summarise the key features of dividents in the table below using section 6 in chapter 3 of the course workbook to help.

When are dividends paid?	
What factors determine the amount to be paid?	
How are dividends paid?	
What is the role of the London Stock Exchange?	
What is the standard settlement period for dividends?	

Identify the type and category of the following corporate actions.

	Type	Category
1. A company offer new shares to existing shareholders at a discounted price		
2. A company issues new shares to existing shareholders for free		
3. Ordinary shareholders receive interim and final payment based on company profits		
4. A company looks to buy 55% of the shares in another company		
5. Two similar companies join together to become one large entity		
6. A company wants to raise finance to expand		

CHOOSE FROM:

TYPES:

A - Bonus/Scrip/Capitalisation Issue

B - Rights issue

C - Dividends

D - Takeover

E - Merger

CATEGORY:

A - Mandatory corporate action

B - Mandatory with options

C - Voluntary Corporate Action

Buybacks

'Buyback' or 'share repurchase' is a corporate action in which a company buys back its shares from their shareholders. Generally, companies buyback shares at a price higher than the current market price.

Read the report and watch the short video about [Apple's buyback corporate action] and answer the following questions:

1. In your opinion, do you think Apple were right to buyback their shares? Give reasons for your answers.
2. Can this type of corporate action also benefit the shareholders? Again, give reasons for your answers.

*CISI is not responsible for the accuracy, legality or content of any external sources referenced in this workbook

Further your knowledge – corporate actions

Log onto the professional refresher section of the CISI learning platform and complete the Corporate Actions module (45 mins). This module provides an understanding of the mandatory and voluntary events.

Calculating the theoretical ex rights price (TERP)

Using the example from section 6.2 in chapter 3 of the course workbook, answer the following questions.

1. What is another term for the TERP?

2. Why is it a theoretical price?

3. The formula for calculating the TERP is:

$$\text{TERP} = \frac{(\text{Number of Existing Shares x Price per Share}) + (\text{Number of New Shares x Rights Issue Price})}{\text{Total Number of Shares After the Rights Issue}}$$

4. Using this formula above, show why the TERP is £3.60 in this example.

Example

ABC plc has 100 million shares in issue, currently trading at £4.00 each.

To raise finance for expansion, it decides to offer its existing shareholders the right to buy one new share for every four previously held. This would be described as a 1 for 4 rights issue (see section 6.1).

The price of the rights would be set at a discount to the prevailing market price at, say, £2.00.

Each shareholder is given choices as to how to proceed following a rights issue. For an individual holding four shares in ABC plc, they could do the following:

- **Take up the rights**, by paying the £2.00 and increasing their holding in ABC plc to five shares.
- **Sell the rights on to another investor.** The rights entitlement is transferable (often described as renounceable) and will have a value because it enables the purchase of a share at the discounted price of £2.00.
- **Do nothing.** If the investor chooses this option, the company's advisers will sell the rights at the best available price and pass on the proceeds (after charges) to the shareholder.
- Alternatively, the investor could sell sufficient rights to raise cash and use this to take up the rest. As an example, if an investor had a holding of, say, 4,000 shares then they would have the right to buy 1,000. They could sell sufficient of the rights to raise cash and use this cash to take up the rest.

The share price of the investor's existing shares will also adjust to reflect the additional shares that are being issued. So, if the investor originally had four shares priced at £4 each, worth £16, and they can acquire one new share at £2.00, on taking the rights up, the investor will have five shares worth £18 or £3.60 each.

The share price will, therefore, change to reflect the effect of the rights issue once the shares go ex-rights (this is the point at which the shares and the rights are traded as two separate instruments). The adjusted share price of £3.60 is known as the theoretical ex-rights price (TERP) – theoretical because the actual price will also be determined by demand and supply.

The rights can be sold, and the price is known as the premium. In the example above, if the theoretical ex-rights price is £3.60 and a new share can be acquired for £2.00, then the right to acquire one has a value. That value is the premium and would be £1.60, although again the actual price would depend upon demand and supply.

Calculating the theoretical ex bonus price

The new price of the stock (the theoretical ex-bonus price) after a bonus issue, is determined by dividing the total market value of the company by the new number of shares outstanding. So if XYZ plc's shares trade at £15 each and the company decide to make a 1:2 bonus issue, each shareholder who held two shares worth £30, now has three shares worth £30 and the share price has decreased to £10.

Example

XYZ plc's shares currently trade at £15.00 each.

The company decided to make a 1 for 2 (1:2) bonus issue, giving each shareholder an additional share for every two shares they currently hold.

The result is that a single shareholder who held two shares worth £30.00 now has three shares worth the same amount in total. As the number of shares has increased, the share price decreases to £10.00.

The example taken from section 6.3 of the course workbook explains how the theoretical ex bonus price is calculated.

In your own words, explain the reasons for making a bonus issue.

Learning Outcome 3.1 – Equities

3.1.9: Know the function of a stock exchange
- Primary / secondary market
- Listing

3.1.10: Know the types and uses of the main global stock exchange indices

Going public

Identify whether the following features describe the primary or secondary market for shares. Tick the box that applies.

	Primary	Secondary
The marketing of new shares in a company to investors for the first time	○	○
Disposal of shares via a stock exchange	○	○
Surplus funds to be matched with investment opportunities	○	○
Two way trade in issued securities	○	○
A way to raise capital	○	○

Advantages and disadvantages of listing on a stock exchange

Advantages	Disadvantages

Listing on the London Stock Exchange (LSE)

Read section 7.2.1 – requirements for listing on the LSE in chapter 3 of the course workbook, and summarise the six key requirements for a company wishing to list on either the premium or standard segments of the LSE.

1.

2.

3.

4.

5.

6.

Listing on the LSE

Read the three scenarios below and decide which companies are eligible for listing on the London Stock Exchange.

Kelsey Market Research ltd

- Established 10 years ago.
- Company has been trading profitably since 2nd year of operation.
- 85% of revenues from market research.
- Has sufficient working capital for 14 months of operations.

Eden Park IT Services plc

- Established four years ago.
- 75% of revenues from IT services.
- Been trading profitably from company's inception.
- Directors, associates and significant shareholders own 25% of the shares.
- Expected market cap £1 million.

Langley Property Rentals plc

- Established five years ago.
- First rental properties acquired two years ago.
- 100% of revenues from property rentals.
- Directors, associates and significant share-holders own 70% of the shares.
- Expected market cap £2 million.

Eligible	Ineligible
○	○
○	○
○	○

AIM – case study

Heena has come to you for some further information about investing in the AIM market. She is particularly interested in understanding more about the requirements that a company must meet to be listed on AIM and how that differs from companies who list on the LSE.

What would you tell Heena to aid her understanding?

The types and uses of the main global stock exchange indices

Markets worldwide compute one or more indices of of the shares of their country's large companies. These indices provide a of how share prices are progressing across the whole group of constituent companies. They also provide a for investors, allowing them to assess whether their portfolio of shares are or underperforming the market in general.

Additionally, in recent decades, many indices have provided the basis for contracts, such as the FTSE, Futures and FTSE Options. Indices also proved the basis for many products such as ETFs (Exchange Traded Funds)

Generally, the constituents of these indices are the largest companies, by their market value or market However, there are also indices which track all constituents of a market, or which focus specifically on a , eg the smaller companies listed on that market.

What are the features of the following index calculation methods?

Price weighted	Market-cap weighted	Equal weighted

Refer to the table on the main indices in section 8 of chapter 3 of the course workbook and complete the table below:

Region	Country	Index Name and Description	Index Type
America	US		
Europe	UK		
	France		
	Germany		
Asia Pacific	China		
	Hong Kong		
	Japan		

Multiple choice questions

1. Which of the following is NOT a function of a stock market index?

- A. Calculates the daily aggregate price movements of its targeted stocks
- B. Provides a snapshot of how share prices are performing in a particular market
- C. Provides a single figure for ease of comparison
- D. Provides a very accurate indicator of future share prices

2. Which UK stock market is used as a benchmark against which diversified share portfolios are assessed?

- A. FTSE All Share
- B. FTSE 100
- C. FTSE All Star
- D. FTSE 350

3. How many stocks does the Xetra DAX track?

- A. 100
- B. 225
- C. 40
- D. 30

Further Your Knowledge – Stock Exchange and Trading

Log onto the professional refresher section of the CISI learning platform and complete the Stock Exchange and Trading module (1hr 30 mins). This module explores what stock exchanges are, how they work, their participants and potential future developments.

Learning Outcome 3.1 – Equities

3.1.11: Know how shares are traded:
- On exchange / over the counter
- Multilateral trading facilities
- Order driven / quote driven

3.1.12: Know the method of holding title and related terminology: registered and bearer; immobilised and dematerialised

3.1.13: Understand the role of the central counterparty in clearing and settlement

3.1.14: Understand how settlement takes place:
- Participants
- Process
- Settlement cycles

Use the boxes below to describe the key features of the different ways shares can be traded:

Share Trading

On-Exchange
(through recognised stock exchange)

Off-Exchange
(direct trading between market counterparties)

Quote Driven

Features:

Examples:

Order Driven

Features:

Examples:

Over the Counter (OTC)

RSPs:

MTFs:

Systematic Internaliser:

Holding titles, clearing and central counterparties and settlement

Read sections 10, 11 and 12 in chapter 3 of the course workbook and answer the following questions.

1. Explain the difference between holding shares in registered or bearer form

2. Who might 'immobilise' bearer shares and why?

3. What is a share register?

4. What is settlement?

Holding titles, clearing and central counterparties and settlement Continued...

5. Why do most markets now use a single central securities depository?

6. Which system does the UK use for settlement?

7. What is another term for dematerialised settlement?

8. What is the settlement cycle/ period for those investors who still hold physical share certificates?

Clearing and Central Counterparties

Clearing is the process through which the obligations held by the buyer and the seller to a trade are defined and legally formalised.

It:

- establishes what each of the counterparties expects to receive when the trade is settled
- defines the obligations each counterparty must fulfil
- for the trade to settle successfully

List 4 of the features of the clearing process

1.

2.

3.

4.

Central Counterparties (CCPs)

1. Explain bi-lateral settlement?

2. Who is liable for losses in bi-lateral settlement?

3. Explain the process of novation?

4. Why are regulators keen on the use of CCPs across a wide range of financial products?

Settlement

CREST is the term commonly used to refer to the system operated by Euroclear UK & International which is the central securities depository for UK and Irish equities. Which **TWO** of the following features are **NOT** a key feature of CREST:

- ☐ A. holdings are uncertified; that is share certificates are not required to evidence transfer of ownership
- ☐ B. trades are matched at T+2
- ☐ C. settlement of transactions takes place in sterling only
- ☐ D. electronic transfer of title (ETT) takes place on settlement
- ☐ E. settlement generates guaranteed obligations to pay cash outside CREST
- ☐ F. coverage includes shares, corporate and government bonds and other securities held in registered form
- ☐ G. a range of corporate actions is processed, including dividend distributions and rights issues
- ☐ H. it also provides a mechanism to facilitate the settlement of trades when the investor holds paper share certificates

The Settlement Process in CREST

List the key features in each stage of the settlement process below:

Stage 1
Trade Matching

→

Stage 2
Stock Settlement

↓

Stage 3
Cash Settlement

←

Stage 4
Register Update

Further Your Knowledge – Central Clearing

Log onto the professional refresher section of the CISI learning platform and complete the Central Clearing module (45 mins). This module explores the background of central clearing , the risks that central counterparties mitigate, recent events and legislation.

End of Unit 3
Multiple Choice Assessment

Test your knowledge

1. When a shareholder appoints somebody to vote on their behalf at an AGM, it is known as:

   - A. A closed ballot
   - B. A secret ballot
   - C. Ad-hoc voting
   - D. Proxy voting

2. If shares are sold for a capital gain, the profit is referred to as having been:

   - A. Taken
   - B. Banked
   - C. Gained
   - D. Unrealised

Test your knowledge

3. A company with 30 million ordinary shares, trading at £5.00 per share pays out a total of £2.5m in dividends. What is the dividend yield?

- A. 1.5%
- B. 1.8%
- C. 1.7%
- D. 7.1%

4. A 'cash call' is also known as:

- A. A bonus issue
- B. A rights issue
- C. The premium
- D. A dividend

Test your knowledge

5. Which of the following is a possible reason for a company having a higher than average dividend yield?
   - A. It is mature and continues to generate healthy levels of cash, but has limited growth potential
   - B. The company is viewed by investors strong growth prospects
   - C. A large proportion of the profit is being ploughed back into the business
   - D. It is a new company

6. A shareholder receives a fixed dividend but in a particular year receives a higher level of dividend as company profits were higher than anticipated. What types of shares does he/she hold?
   - A. Non cumulative preference shares
   - B. Redeemable preference shares
   - C. Ordinary shares
   - D. Participating preference shares

Test your knowledge

7. Which index is often used as a benchmark against which diversified share portfolios are assessed in the UK?

- A. FTSE 100
- B. FTSE All Star
- C. FTSE All Share
- D. FTSE 350

8. In order for a special resolution to be passed, what percentage of shareholders need to vote in favour?

- A. 51%
- B. 75%
- C. 100%
- D. 57%

Test your knowledge

9. Which of the following is NOT true about preference shares:

- A. They are non-voting except in special circumstances
- B. They pay a fixed dividend each year (the amount being set when they are first issued)
- C. They rank ahead of ordinary shares in terms of being paid back if the company is wound up
- D. They carry the full risk and reward of investing in a company

Test your knowledge

10. Which of the following would require a special resolution?

- A. Election of a director
- B. Company dissolution
- C. Appointment of auditors
- D. Payment of dividends

11. When currency price movements have a negative impact on the value of an investment, it is known as:

- A. Issuer risk
- B. Liquidity risk
- C. Foreign exchange risk
- D. Transaction risk

Test your knowledge

12. When a company has to use its undistributed profits from previous years to cover dividend payments, the dividend payment is referred to as:

- A. unrealised
- B. bare
- C. naked
- D. covered

13. Which of the following terms reflects a company marketing new shares to investors for the first time?

- A. The secondary market
- B. The tertiary market
- C. The primary market
- D. The gearing process

CISI CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT EDUCATION PARTNER 2023-24

Test your knowledge

14. An investor choses to buy shares in a 'thinly traded' company. Which of the following is the most likely risk they face?

- A. Price risk
- B. Liquidity risk
- C. Issuer risk
- D. Foreign exchange risk

15. Which of the following is NOT true about plcs?

- A. They must be listed
- B. They must have a minimum of 2 shareholders
- C. Company accounts must be submitted to HMRC within 6 months of the end of the financial year
- D. They are permitted to issue shares to the public

Test your knowledge

16. The rights of shareholders to subscribe for new shares if the company wants to issue more are referred to as:

- A. Voting rights
- B. Pre-emptive rights
- C. Shareholder rights
- D. Pre-issue rights

17. The price risk associated with owning shares is best described as:

- A. A fall in share prices where investors can lose capital even when dividends are paid
- B. When shares become worthless due to the collapse of the issuing company
- C. When shares cannot be sold quickly enough to prevent a loss for the investor
- D. A fall in dividend paid out by the issuing company

Test your knowledge

18. An IPO is also referred to as:

- A. Listing
- B. Trading
- C. Speculating
- D. Dealing

19. Which of the following documents details the relationship between a company and its shareholders when it is being established?

- A. Memorandum of Understanding
- B. Memorandum of Association
- C. Articles of Association
- D. Articles of Understanding

Test your knowledge

20. Which of the following is NOT true about stock splits

- A. They do not raise extra cash
- B. It involves the division of existing shares into smaller denominations
- C. It makes share capital more marketable
- D. It raises the market value of a company share

21. An ordinary shareholder is not entitled to:

- A. A vote on resolutions at company meetings
- B. Receive dividends declared by the company
- C. Dispose of some or all of their shares
- D. Seniority if the company was to be 'wound up'

Test your knowledge

22. In which country will you find the CAC 40 index?

- A. France
- B. Belgium
- C. Germany
- D. Italy

23. A merger is what type of corporate action?

- A. Mandatory with options
- B. Voluntary
- C. Mandatory
- D. A rights issue

Test your knowledge

24. When bearer shares are transferred over to electronic records of ownership, the physical certificate is no longer used and they are said to have been:

- A. Immobilised
- B. Dematerialised
- C. Diminished
- D. Destroyed

25. A capitalisation issue is an example of:

- A. A mandatory corporate action
- B. A mandatory with options corporate action
- C. A voluntary corporate action
- D. A rights issue

Test your knowledge

26. When shares go ex-rights, the share price will change to reflect the effect of the rights issue. What is the new price known as?

- A. Ex-dividend price
- B. Premium price
- C. Theoretical ex-rights price
- D. Bid offer spread

27. Which of the following is NOT true about a share register?

- A. It must be maintained by an employee of the company
- B. It is a record of all current shareholders and how many shares they hold
- C. All companies (apart from a very few exceptions) must maintain a share register
- D. It is kept and maintained by the registrar

Test your knowledge

28. Which of the following is NOT true about ordinary shares:

- A. They are a hybrid security with elements of both debt and equity
- B. Some ordinary shares may be referred to as contributing shares where only part of their nominal value has been paid up
- C. They carry the full risk and reward of investing in a company
- D. Holders are paid last if a company is 'wound up'

Test your knowledge

29. Which of the following is NOT another term for a bonus issue

- A. A capitalisation issue
- B. A scrip issue
- C. A rights issue
- D. A mandatory corporate action

30. A company wanting to list on AIM must have:

- A. A minimum market capitalisation of £700,000
- B. At least 3 years' trading history
- C. At least 25% of shares held by outside investors
- D. An appointed NOMAD

Monitoring my progress – Unit 3

My multiple choice assessment mark is / 30

I am happy with the progress that I made on the multiple choice assessment

○ Yes ○ No

To improve my knowledge and understanding, I now need to….

1.

2.

3.

Need more help?

If you feel that your multiple choice score can be improved further, complete the end of unit 3 multiple choice questions in the course workbook.

Answers

Page 8
Memorandum of Association
- Purpose - Sets out the details of the companies existence
- Tells you – registered address, statement of liability, amount of share capital, purpose of the business, the initial shareholders or guarantors (i.e. the subscribers)

Articles of Association
- Purpose – This document acts as a contract between the company and its members. It includes who governs the company
- Tells you –
  - o Details of how and when directors are appointed and the powers and operation of the Board of Directors.
  - o Details of how the share capital will be structured and divided into different types of shares which have different rights. It also states how dividends will be distributed amongst shareholders.
  - o Details of how shares can be transferred - directors of private companies usually want to restrict the transfer of shares to maintain control.
  - o Details of the rights of shareholders in terms of attendance and voting at company meetings

Page 9
Ltds
- Home Bargains
- River Island
- Clarks
- Deloitte
- Guardian Media Group

Plcs
- Vodafone
- Easyjet
- Barclays
- Tesco
- Rolls Royce

Page 10
1. All companies have limited liability - TRUE
2. Private Limited Companies (Ltds) must have a minimum of 2 shareholders – FALSE can have 1
3. Public Limited Companies (PLCs) can be listed on a stock exchange - TRUE
4. The majority of public limited company shareholders are Directors of the company - FALSE
5. Shareholders and Directors are often the same people in a private limited company - TRUE

Page 11
- Public Limited Companies must hold an AGM within 6 months of the financial year end TRUE
- The Companies Act provides shareholders with the right to attend, speak and vote at the AGM or appoint a proxy who can attend, speak and vote on the shareholder's behalf FALSE: Shareholders can appoint a proxy who can vote but not speak on their behalf at the meeting
- Shareholders are able to vote on matters such as the appointment and removal of directors but are not able to vote on the payment of the final dividend recommendations FALSE - shareholders can vote on matters such as the appointment and removal of directors as well as on the payment of the final dividend recommended by the directors
- Matters of major importance, eg proposed changes to the company's constitution require a special resolution and at least 75% of shareholders to vote in favour TRUE

Answers

- Companies may hold other general meetings during the year but must not put important issues on the agenda of such meetings FALSE - important issues such as a takeover or raising capital can be dealt with at general meetings

Page 13
Dividends:

- The return that an investor gets for providing the risk capital for a business
- Companies pay dividends out of their profits which form part of their distributable reserves (post tax profits over the life of a company, in excess of dividends paid)
- Dividends can be paid using undistributed profits from previous years - naked or uncovered as current year's profits were insufficient to fully cover the dividend
- Typically paid annually or semi-annually
- Companies seek to pay steadily growing dividends where possible - falls in dividend payments can lead to a loss in shareholders' willingness to hold company shares or provide additional capital

Capital Gains:

- Made on shares if their prices increase over time
- Shares need to be sold in order to realise any capital gain ('unrealised' gain if not sold)
- When shares are sold and the gain is 'realised' the profits are said to have been 'banked'

Shareholder Benefits:

- Some companies offer perks to shareholders eg discounted prices
- Often a pleasant bonus for small investors, but not normally a bit factor in investment decisions

Shareholder Rights:

- Rights are one method by which a company can raise additional capital where existing shareholders have the right to subscribe for new shares.
- 'Pre-emptive' rights mean existing shareholders do not lose control or have their ownership diluted.
- A rights issue is a method by which a company can raise additional capital, complying with pre-emptive rights, with existing shareholders having the right to subscribe for new shares. In many cases, existing shareholders will receive some capital if they decide not to subscribe for new shares as part of a rights issue.
- Ordinary shareholders have the right to vote on matters presented to them at company meetings, including the right to vote on proposed dividends and other matters. Usually allocated on the basis of one share = one vote. Can vote person or appoint a proxy.
- Some companies issue different share classes where for some voting rights are restricted or absent. This allows some shareholders to control the company whilst only holding a small proportion of the shares.
- In practice, most shares are held in electronic form and held by nominee companies. If the shareholder wishes to vote, they need to arrange for the operator of the nominee account to vote on their behalf.

Answers

Page 14

Ordinary shares

Ordinary shares carry the full risk and reward of investing in a company. If a company does well, its ordinary shareholders should do well. As the shareholders of the company, it is the ordinary shareholders who vote 'yes' or 'no' to each resolution put forward by the company directors at company meetings. For example, an offer to take over a company may be made and the directors may propose that it is accepted but this will be subject to a vote by shareholders. If the shareholders vote 'no', then the resolution will not be passed.

Ordinary shareholders share in the profits of the company by receiving dividends declared by the company, which tend to be paid half-yearly or even quarterly. With the final dividend for the financial year, the company directors will propose a dividend which will need to be ratified by the ordinary shareholders before it is formally declared as payable. The amount of dividend paid will depend on how well the company is doing. However, some companies pay large dividends and others none as they plough all profits made back into their future growth.

If the company does badly, it is the ordinary shareholders that will suffer. If the company closes down, often described as the company being 'wound up', the ordinary shareholders are paid last, after everybody else. If there is nothing left, then the ordinary shareholders get nothing. If there is money left after all creditors and preference shareholders have been paid, it all belongs to the ordinary shareholders.

Some ordinary shares may be referred to as partly paid or contributing shares. This means that only part of their nominal value has been paid up. For example, if a new company is established with an initial capital of £100, this capital may be made up of 100 ordinary £1 shares. If the shareholders to whom these shares are allocated have paid £1 per share in full, then the shares are termed fully paid. Alternatively, the shareholders may contribute only half of the initial capital, say £50 in total, which would require a payment of 50p per share, ie, one-half of the amount due. The shares would then be termed partly paid, but the shareholder has an obligation to pay the remaining amount when called upon to do so by the company.

Preference Shares

Some companies have preference shares as well as ordinary shares. The company's internal rules (its Articles of Association) set out the specific ways in which the preference shares differ from the ordinary shares.

Preference shares are a hybrid security with elements of both debt and equity. Although they are technically a form of equity investment, they also have characteristics of debt, particularly in that they pay a fixed income. Preference shareholders have legal priority (known as seniority) over ordinary shareholders in respect of earnings and, in the event of bankruptcy, in respect of assets.

Normally, preference shares:

- are non-voting, except in certain special circumstances, such as when their dividends have not been paid
- pay a fixed dividend each year, the amount being set when they are first issued and which has to be paid before dividends on ordinary shares can be paid, and rank ahead of ordinary shares in terms of being paid back if the company is wound up.

Preference shares may be cumulative, non-cumulative, and/or participating.

Answers

If dividends cannot be paid in a particular year, perhaps because the company has insufficient profits, preference shareholders would receive no dividend. However, if they are cumulative preference shareholders, then the dividend entitlement accumulates. Assuming sufficient profits, the cumulative preference shareholders will have the arrears of dividend paid in the subsequent year. If the shares were non-cumulative, the dividend from the first year would be lost.

Participating preference shares entitle the holder to a basic dividend of, say, 3p a year, but the directors can award a bigger dividend in a year when the profits exceed a certain level. In other words, the preference shareholder can 'participate' in bumper profits.

Preference shares may also be convertible or redeemable.

Convertible preference shares carry an option to convert into the ordinary shares of the company at set intervals and on pre-set terms.

Redeemable shares, as the name implies, have a date on which they may be redeemed; that is, the nominal value of the shares will be paid back to the preference shareholder and the shares cancelled.

Page 15

Dan Brown: Participating Preference Shares
Margaret Atwood: Convertible Preference Shares
James Patterson: Non cumulative Preference Shares
Stephen King: Ordinary Shares
Jane Austen: Convertible Preference Shares
John Grisham: Ordinary Shares
Anne Tyler: Redeemable Preference Shares
Terry Pratchett: Ordinary Shares

Page 16

1) The investor will receive a fixed dividend of 7 $^3/8$ % each year (payable in two equal half yearly instalments on 1st of April and 1st November). The amount of the dividend is calculated by multiplying the nominal value of shares held (£1,000 which is 1,000 £1 preference shares) by the interest rate (7 $^3/8$ %) giving an annual dividend of £73.75 gross)
2) The dividend will be paid to this investor first
3) If the company does not make sufficient profits to pay the dividend, then it is lost and the arrears and not carried forward
4) There is no fixed date for the shares to be repaid and capital would only be repaid in the event of the company being wound up.
5) The preference share is not convertible and so does not carry an option to convert into the ordinary shares of the company.

Page 19

XYZ
B) 1.56%
ABC
A) 6.67%

Page 20

Alpha plc
1.75%
Zebra
8.07%
Zebra has the higher yield

Answers

Page 21
Higher than average

1. The company is mature and continues to generate healthy levels of cash, but has limited growth potential, perhaps because the government regulates its selling prices, and so surplus profits are paid to shareholders in the form of higher dividends. Examples are utilities such as water or electricity companies.
2. The company has a low share price for some other reason, perhaps because it is, or is expected to be, relatively unsuccessful; its comparatively high current dividend is, therefore, not expected to be sustained and its share price is not expected to rise.

Lower than average

1. the share price is high, because the company is viewed by investors as having high growth prospects, and
2. a large proportion of the profit being generated by the company is being ploughed back into the business, rather than being paid out as dividends.

Page 22
Market or Price Risk:
The risk that share prices in general may fall - market wide falls in equity prices occur fairly frequently

Investors could face a loss of capital even if the company might maintain dividend payments

egs. 'dot-com' bubble/ Black Monday / sub-prime crisis/ covid

As well as market wide movements, any single company can experience dramatic falls in its share price when it discloses bad news such as the loss of a major contract

Price risk varies between companies: volatile shares tend to exhibit more price risk than more 'defensive' shares such as utility companies and general retailers

Liquidity Risk:
The risk that shares may be difficult to sell at a reasonable price or be traded quickly enough in the market to prevent a loss

Essentially occurs when there is difficulty in finding a counterparty who is willing to to trade in a share

Typically occurs with shares in 'thinly traded' companies - private companies where there is not much trading activity.

It can also happen (to a lesser degree) if shares prices in general are falling in which case the spread between the bid and offer prices may widen.

Shares in smaller companies tend to have a greater liquidity risk than shares in larger companies and tend to have a wider price spread than larger, more actively traded companies

Issuer Risk:
The risk here is that the issuing company collapses and the ordinary shares become worthless

In general, it is very unlikely that larger, well established companies would collapse.

But some egs include Northern Rock, Bradford & Bingley, Woolworths, Debenhams

Shares in new companies, which have not yet managed tor report profits, may have substantial issuer risk

Answers

Foreign Exchange Risk:
Can be indirect or direct

Indirect relates to investing in a company that has earnings and operations overseas where investors are exposed to the risks associated with changes in earnings as a result of this

The company itself may engage in hedging their exposure to foreign currency risk

Direct foreign exchange risk relates to investing in shares denominated in foreign currency and where the relative value of currencies fluctuate and the sterling value of an equity investment fluctuates.

Forward and Futures contracts are examples of strategies used to manage this risk.

Page 25
Mandatory:
Mandated by the company and not requiring any intervention from shareholders or bondholders e.g. payment of a dividend

Mandatory with options:
Action that has some sort of default option that will occur if the shareholder does not intervene.

Until the date at which the default option occurs, the individual shareholders are given the choice to select another option e.g. right issue

Voluntary:
Action that requires the shareholder to make a decision e.g. a takeover bid where each individual shareholder needs to chose whether to accept the offer or not

Page 27

- Companies seeking to expand can either grow organically or through buying other companies
- A takeover can be friendly or hostile. The acquiring company is known as the predator and the other company is known as the target
- When the predator acquires shares in the other company, they are obliged to report their share purchases once they reach a certain percentage
- In a successful takeover, the predator company will buy more than 50% of the shares and is then described as having gained control of the target company
- A merger is a similar transaction when the two companies are of a similar size and agree to merge their interests
- In a merger it is usual for one company to exchange new shares for the shares of the other and as a result the two companies effectively merge together to form a bigger entity

Page 28

1) Heinz (a private company) is merging with Kraft (a public company) and receiving $10 billion dollars in capital from 3G and Warren Buffet. This is creating a public company with an estimated worth of $100 billion.
2) The share holders will get a 49% stake in the company, 1 share in the new company for each Kraft share they own, $16.50 cash payment per share owned and access to the expertise of two investors who are considered the best
3) The deal is considered unusual as more commonly private equity firms take over public companies, borrow capital and then take them public. This is the reverse of that process.
4) This is a merger

Answers

Page 29

1) This is a takeover (rather than a merger)
2) 59% of shares will be paid back at £44 per share (a 50% premium) and 41% of shares will receive a combined stock and cash at £39 per share
3) Providing AB Inbev with a major presence across most continents/ access to African markets and enables the company to acquire Kraft beer brands
4) Concerns are that the company could take advantage of its size to control markets and raise prices, that scrutiny from anti trust groups could delay the deal by a year and that the deal may face regulatory issues from the US, China and some Latin American companies
5) A mandatory corporate action

Page 30

1) A securities ratio specifies the terms of a corporate action.
2) In the European and Asian markets the securities ratio is expressed in terms of the investor receiving 'x new shares for each y existing share', eg terms or a securities ratio expressed as 1:4 whereby a company is issues 1 new share for every existing 4 shares held. In the US market, the first number in the securities ratio indicates the final holding after the event and the second number is the original number of shares held. So the above example would be expressed as 5:4 in the US.
3) Where a company may wish to raise additional finance by issuing new shares, they may approach it's existing shareholders with a 'cash call' asking if they would like to buy more shares.
4) Since it is an offer and shareholders have a choice, a rights issue is an example of a 'mandatory with options' type of corporate action
5) The initial response to the announcement of a planned rights issue will reflect the market's view of the scheme - if it is to finance expansion and the strategy makes sense to investors, the share price may rise. If investors have a negative view of the reasons for the rights issue the share price may fall.
6) Underwriters of a share issue agree, for a fee, to buy any portion of the issue not taken up by shareholders at the issue price. They then sell these shares when market conditions seem opportune to them and may make a gain or a loss on this sale.
7) A cash call flops when the price at which new shares are offered is too high and the price of shares on the open market fall to below the discounted rights issue price. This is when underwriters end up having to take the new shares
8) A bonus issue is also known as a scrip or capitalisation issue
9) A bonus issue is a mandatory corporate action. Shareholders do not have a choice but receive extra shares without having to subscribe any further funds.
10) A company will make a bonus issue to increase liquidity of the company shares in the market and to bring about a lower share price to be more attractive to investors.
11) This is the point at which shares and the rights are traded as two separate instruments.
12) A stock split is similar to a bonus/scrip/capitalisation issue in that it does not raise extra cash. Instead it involves the division of existing shares into smaller denominations, making the share capital more marketable eg a company whose shares have a nominal value of £1 but are trading at £5 each could split each £1 share into 5 shares of 20p each so that the market value of each share becomes £1. A reverse stock split is simply the opposite - where the market value of a company's share is very low and shares are consolidated.

Answers

Page 33

1. Twice a year
2. Overall profitability, future plans
3. Cheque, BACS, CREST
4. LSE has procedures to minimise the extent that people receive dividends they are not entitled to, or fail to receive the dividend to which they are entitled.
5. The standard settlement period across Europe for equity trades changed to T+2; this means that a trade is settled two business days after it is executed so, for example, a trade executed on Monday would settle on Wednesday

Page 34

1. A company offer new shares to existing shareholders at a discounted price –
   TYPE – Rights issue – CATEGORY Mandatory with options
2. A company issues new shares to existing shareholders for free –
   TYPE – Bonus/ Scrip/Capitalisation Issue – CATEGORY – Mandatory Corporate Action
3. Ordinary shareholders receive interim and final payment based on company profits –
   TYPE – Dividends – CATEGORY - Mandatory Corporate Action
4. A company looks to buy 55% of the shares in another company –
   TYPE – Takeover – CATEGORY – Voluntary Corporate Action
5. Two similar companies join together to become one large entity –
   TYPE – Merger - CATEGORY - Voluntary Corporate Action
6. A company wants to raise finance to expand –
   TYPE – Rights issue – CATEGORY - Mandatory with options

Page 37

1. Adjusted share price
2. Because the actual price will also be determined by demand and supply
3. TERP = [(Number of existing shares x Price per share) + (Number of new shares x Rights issue price)] / Total number of shares after the rights issue. It provides a theoretical prediction of the post-issue share price based on the prices of existing shares and the new rights shares. So as per the example in your workbook - if ABC plc has 100 million shares in issue currently trading at £4 each. The company decides on a rights issue of 1:4 with the price of the rights set at £2. If an investor had 4 shares prices worth £16 and they acquire one extra share, they now have 5 shares worth £18. Each share is worth £3.60 each. This is the TERP.

Page 38

The reason for making a bonus issue is to increase the liquidity of the company's shares in the market and to bring about a lower share price. The logic is that, if a company's share price becomes too high, it may be unattractive to investors.

Page 39

Primary Market:

- Marketing of new shares in a company to investors for the first time
- Enables surplus funds to be matched with investment opportunities
- A way to raise capital

Secondary Market:

- Disposal of shares via a stock exchange
- Facilitates two-way trade in issued securities

Answers

Page 41

Advantages:

- Capital - provides the possibility of raising capital and, once listed, further offers of shares are much easier to make. If the shares being offered to the public are those of the company's original founders, then the IPO offers them an exit route and a means to convert their holdings into cash
- Takeovers - a listed company could use its shares as payment to acquire the shares of other companies as part of a takeover or merger
- Status- being a listed company should help the business in marketing itself to customers, suppliers and potential employees
- Employees - stock options to key staff are a way of providing incentives and retaining employees, and options to buy listed company shares that are easily sold in the market are even more attractive

Disadvantages:

- Regulation - listed companies must govern themselves in a more open way than private ones and provide detailed and timely information on their financial situation and progress
- Takeovers - listed companies are at risk of being taken over themselves
- Short-termism - shareholders of listed companies tend to exert pressure on the company to reach short term goals, rather than be more patient and look for longer-term investment and growth

Page 42

1) The company must be a plc
2) The company's expected market capitalisation must be at least £30m
3) For listing on the premium main market, the company should have been trading for at least 3 years and at least 75% of its business must be supported by a historic revenue-earning record for that period
4) At least 10% of the company's shares should be in public hands or available for purchase by the public (excludes directors of the company and their associates and significant shareholders who hold 5% or more of the company's shares)
5) A trading company must demonstrate that it has sufficient working capital for the next 12 months
6) Once listed, companies are expected to fulfil rules known as the continuing obligations, eg, they are obliged to issue a half yearly report and to notify the market of any new price-sensitive information

Page 43

- Kelsey – Ineligible – it is a Ltd
- Eden Park – Eligible
- Langley – Ineligible – only generated revenue for 2 years. Companies need a revenue of at least 3 years

Answers

Page 45

Markets worldwide compute one or more indices of **prices** of the shares of their country's large companies. These indices provide a **snapshot** of how share prices are progressing across the whole group of constituent companies. They also provide a **benchmark** for investors, allowing them to assess whether their portfolio of shares are **outperforming** or underperforming the market in general.

Additionally, in recent decades, many indices have provided the basis for **derivatives** contracts, such as the FTSE, Futures and FTSE Options. Indices also proved the basis for many **tracker** products such as ETFs (Exchange Traded Funds)

Generally, the constituents of these indices are the **largest** companies, **ranked** by their market value or market **capitalisation**. However, there are also indices which track all constituents of a market, or which focus specifically on a **segment**, eg the smaller companies listed on that market.

Page 46

Price Weighted - only the price of each stock within the index is considered when calculating the index. This means no account is taken of the relative size of a company contained within an index and the share price movement of one can have a disproportionate effect on on the index

Market-capitalisation Weighted - greater range of shares which takes into account the relative market capitalisation of each stock in the index to give a more accurate indication of how the market moves. Development ongoing and most market cap weighted indices have a further refinement in that they now take account of the free-float capitalisation of their constituents. The float adjusted calculation looks to exclude shareholdings held by large investors and governments that are not available for trading.

Equal Weighted - an equal investment in each stock in the index is assumed - this means that a percentage rise in the share price of any constituent company will have an equal impact on the index as that in any other Page 47

Page 47

Region	Country	Index Name and Description	Index Type
America	US	Dow Jones Industrial Average (DJIA) – provides a narrow view of the US stock market	Price-weighted
		NASDAQ Composite – focuses on the shares traded on NASDAQ, including many technology companies	Market Cap
		S&P 500 (Standard & Poor's) – provides a wider view of the US stock market	Market Cap
Europe	UK	FTSE 100 – an index of the largest 100 companies	Market Cap
	France	CAC 40 – represents the 40 most significant stocks among the 100 largest market caps on Euronext Paris	Market Cap
	Germany	Xetra DAX – consisting of 30 major German companies trading on the Frankfurt Stock Exchange until 2021. The index now includes 40 companies	Market Cap
Asia Pacific	China	Shanghai Stock Exchange (SSE) Composite Index – reflects overall market performance of companies listed on the SSE including stocks listed on China's NASDAQ- style sci-tech innovation board	Market Cap
		Shanghai Shenzhen CSI 300 Index – replicates the performance of the top 300 A-share stocks quoted on the Shanghai and Shenzhen stock exchanges	Market Cap
	Hong Kong	Hang Seng – largest companies that trade on the Hong Kong Exchange, covering approximately 65% of its total market capitalisation	Market Cap
	Japan	Nikkei 225 – contains the 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange	Price-weighted

Answers

Page 48

1. Which of the following is NOT a function of a stock market index? D
2. Which UK stock market is used as a benchmark against which diversified share portfolios are assessed? A
3. How many stocks does the Xetra DAX track? C

Page 51

Quote Driven:

Features:

- Employ market makers to provide continuous two way (or bid and offer) prices during the trading day in particular securities, regardless of market conditions
- Market makers make a profit, or turn, through this price spread
- Compared to electronic order-driven systems many practitioners argue that quote driven systems provide liquidity to the market when trading would otherwise dry up

Example: NASDAQ and LSE's Stock Exchange Automated Quotation (SEAQ) trading systems

Order Driven:

Features:

- Employs either a electronic order book or an auction process to match buyers with sellers
- In both cases, buyers and sellers are matched in strict chronological order by price and the quantity of shares being traded
- Does not require market makers

Example: LSE's Stock Exchange Electronic Trading Service (SETS) or NYSE floor auction process

OTC

RSPs:

Brokers providing services to retail clients use trading approach known as Retail Service Provider (RSP) system

Firms provide RSP gateways that on demand, harvest prices fro a broker defined range of RSPs and respond to the broker with the best price available

The systems primary role is to provide electronic quotation and dealing facilities for retail stockbrokers

It s a quote driven system

Example: FIDESSA

MTFs:

An alternative to trading on a stock exchange - trades can be conducted through multilateral trading facilities (also known as alternative trading systems' which are non exchange trading venues which bring together buyers and sellers of securities.

Examples: Cboe Europe Equities, Turquoise

Systematic Internaliser:

Firms execute client trades against their own account. Instead of sending orders to a stock exchange, it matches them with other orders on its own book

Able to compete directly with stock exchanges and automated dealing systems but has to make such dealings transparent - i.e. show a price before a trade is made, and has to give information about the transaction just like conventional trading exchanges, after a trade is made.

Answers

Page 52

1) Holding shares in registered form involves the investor's name being recorded on the share register and often the investor being issued with a share certificate to reflect their ownership. Many companies who issue registered shares now do so on a non-certified basis.
With bearer shares, the person who holds the shares is the owner and ownership passes by transfer of the share certificate.
2) Bearer shares are usually immobilised in depositories such as Euroclear or by their local country registries. This is because there is a risk inherent in holding bearer shares (as they can be lost) and they are viewed unfavourably by regulatory authorities as they offer opportunities for money laundering.
3) A share register is a record of all current shareholders in that company and how many shares they each hold. It is kept by the company registrar who might be a specialist firm or might be an employee of the company itself
4) Settlement is the process through which legal title (ownership) of a security is transferred from seller to buyer in exchange for the equivalent value in cash. Settlement requires a mechanism for updating the share register to reflect the buyer and effect the change of ownership and for transferring the money to the settler.
5) Previously the process of certified settlement involved the issue of new share certificates which was cumbersome and inefficient. A single central securities depository holds records of transfer and ownership electronically.
6) In the UK, settlement has moved the CREST system for settlement
7) Uncertified
8) Settlement of physical share certificates takes place at T + 10 to allow all the paperwork to be completed

Page 54

Answers could include:

- Recording the key trade information so counterparties can agree on trade terms
- Formalising the legal obligation between counterparties
- Matching and confirming trade details
- Agreeing procedures for settling the transaction
- Calculating settlement obligations and sending out settlement instructions to the brokers, custodians and central securities depository (CSD)
- Managing margin and making margin calls

Page 55

1) Bi-lateral settlement is when trades are cleared and settled directly between the trading counterparties.
2) Each trading party bears a direct credit risk against each counterparty that it trades with and bears direct liability for any losses incurred through counterparty default
3) This is when trades are cleared using a CCP who interposes itself between the counterparties to a trade - essentially becoming the buyer to every seller and the seller to every buyer. As result the buyer and seller interact with the CCP and remain anonymous to one another
4) CCPs spread the risk across all participants and as a result makes these risks progressively easier to monitor and regulate. The risk controls extended by a CP effectively provide an early warning system to financial regulators of impending risk and are an important tool in efforts to contain these risks within manageable limits.

Answers

Page 56
B) there is a real time matching of trades in CREST
C) settlement of transactions takes place in sterling, euros or dollars

Page 57
Stage 1 – Trade Matching
- The buying and selling members input instructions in CREST detailing the terms of the agreed trade.
- CREST authenticates these instructions to check that they conform to the authentication procedures stipulated by CREST. If the input data from both members matches, CREST creates a matching transaction.

Stage 2 – Stock Settlement
- On the intended settlement date, CREST checks that the buying member has the funds, the selling member has sufficient stock in its stock account and the buyer's CREST settlement bank has sufficient liquidity at the Bank of England to proceed to settlement of the transaction.
- If so, CREST moves the stock from the selling member's account to the buying member's account.

Stage 3 – Cash Settlement
- CREST also credits the cash memo account (CMA) of the selling member and debits the CMA of the buying member, which simultaneously generates a settlement bank payment obligation of the buying member's settlement bank in favour of the Bank of England.
- The selling member's settlement bank receives that payment in Bank of England funds immediately upon the debit of the purchase price from the buying member's CMA.

Stage 4 – Register Update
- CREST then automatically updates its operator register of securities to effect the transfer of shares to the buying member.
- Legal title to the shares passes at this point – ETT, as described earlier.

This prompts the simultaneous generation by the CREST system of a registrar update request (RUR), requiring the issuer to amend its record of uncertificated shares.

In practice, stages 2, 3 and 4 occur simultaneously.

Answers

Test your knowledge

1D: Proxy voting
2B: Banked
3C: 1.7%
4A: A rights issue
5A: It is mature and continues to generate healthy levels of cash, but has limited growth potential
6D: participating preference shares
7C: FTSE All Share
8B: 75%
9D: They carry the full risk and reward of investing in a company
10B: Company dissolution
11C: Foreign exchange risk
12C: Naked
13The primary market
14B: Liquidity risk
15A: They must be listed
16B: pre-emptive rights
17A: A fall in share prices
18A: Listing
19C: Articles of Association
20D: it raises the market value of a company share
21D: Seniority if the company was to be 'wound up'
22A: France
23B: Voluntary
24B: Dematerialised
25A: A mandatory corporate action
26C: Theoretical ex-rights price (TERF)
27A: it must be maintained by an employee of the company
28A: they are a hybrid security with elements of both debt and equity
29C: A rights issue
30D: An appointed NOMAD