

## 2 Instruments

### 2.1 Learning outcomes

After studying this text the learner should / should be able to:

- Define the instruments of the equity market.
- Distinguish the types of ordinary shares.
- Describe the characteristics of ordinary shares in terms of residual value, voting rights, elastic dividend and limited liability.
- Appreciate the details of preference in respect of similarities with bonds, types, and usefulness.
- Describe the negotiable instruments representing equity.

### 2.2 Introduction

The instruments of the equity market are:

- Ordinary shares.
- Preferences shares.
- Negotiable instruments representing equity.



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## 2.3 Ordinary shares

### 2.3.1 Introduction

This section has to do with the *characteristics* of ordinary shares. Ordinary shares are the “usual” shares issued by companies (in many other countries called *common stock*). When the statute relating to companies refers to *shares* or *stock* it means *ordinary shares* or *common stock*.

The *characteristics* of ordinary shares covered in this section are as follows:

- Shares with par value, shares with no par value, and share premium.
- Residual value.
- Voting rights.
- Elastic dividend payments.
- Limited liability.

### 2.3.2 Shares with par value, shares with no par value, and share premium

Most company statutes allow for the issue of shares that have either:

- A par value.
- No par value.

The statute relating to companies of one particular country determines:

“The share capital of a company may be divided into shares having a par value or may be constituted by shares having no par value: Provided that all the ordinary shares or all the preference shares shall consist of either the one or the other.”

Assets		Share capital and liabilities	
Bank deposits	100	Authorised share capital (3 000 shares of R1 each) Issued (100 shares of LCC1 each)	100
Total	100	Total	100

**Table 1:** Balance sheet of NEWCO (Pty) Limited (LCC<sup>3</sup>)

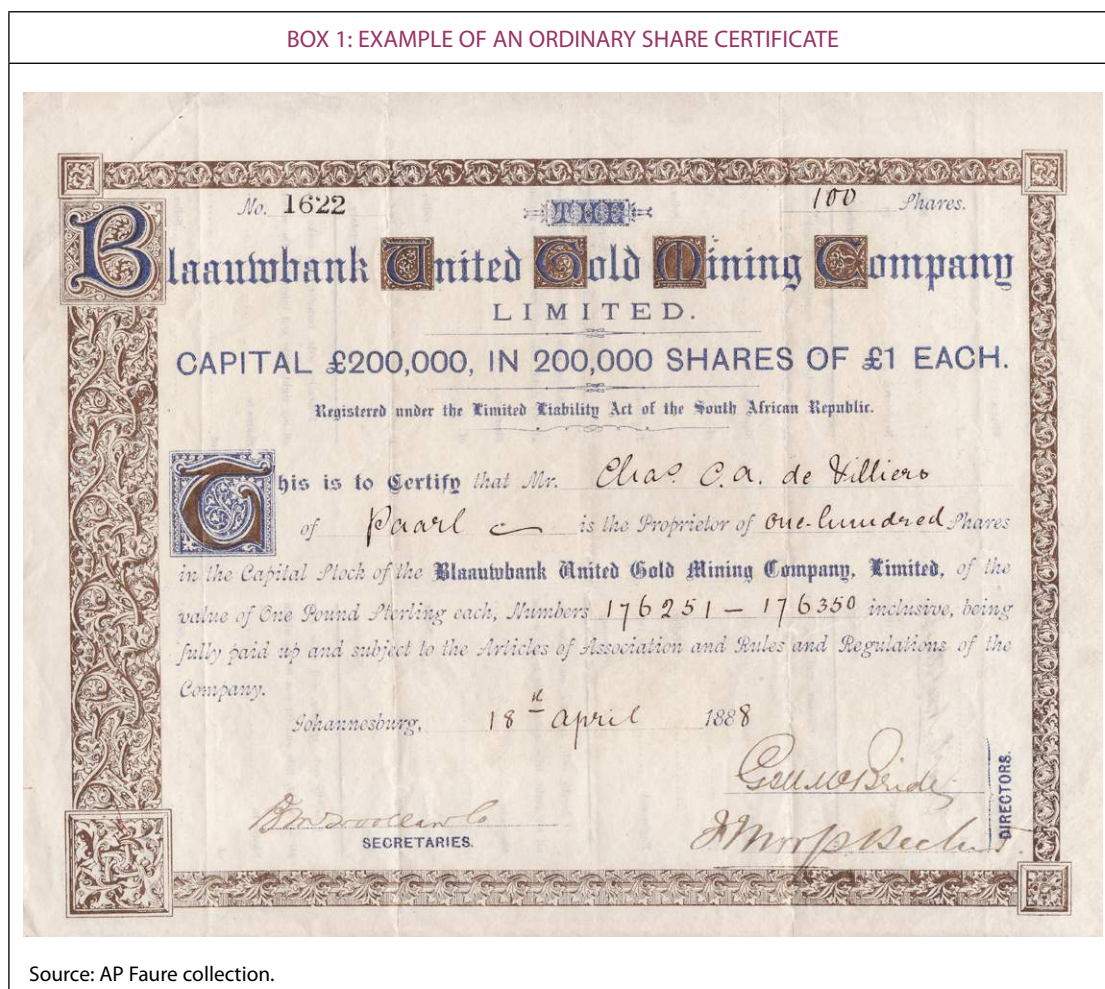
*Par value* means *nominal value* or *face value*, and they all denote that the share has an “original value”, or a value when the company was set up, and this amount is printed on the face of the certificate (or computer-generated statement in the case of a dematerialised market). For example, a person may set up company, say called NEWCO, with a share capital of 100 shares of LCC1 each. The accounting entry for this capital is *share capital* of LCC100 and the counterpart of this, i.e. the asset, is a bank balance of LCC100, as indicated in Table 1.

An example of a share certificate is presented in Box 1 to illustrate this issue. The capital of the company is GBP200 000, made up of 200 000 shares of GBP1 each. GBP1 is the par value of the shares.

Assets		Share capital and liabilities	
Bank deposits	2 000 100	Authorised share capital (3 000 shares of LCC1 each) Issued (2 100 shares of LCC1 each) Share premium	2 100 1 998 000
Total	2 000 100	Total	2 000 100

**Table 2:** Balance sheet of NEWCO (Pty) Limited (LCC)

Assuming that NEWCO is successful and the directors decide to issue new shares (from the balance of 2 900 shares left of the *authorised share capital* of 3 000 shares) to other shareholders, they may issue, say, 2 000 new shares at LCC1 000 each. In this case the shares have an unchanged par value of LCC1, and a *premium* of LCC999. The company receives LCC2 000 000 for the shares (2 000 shares × LCC1 000), and the balance sheet of the company changes as shown in Table 2 (it obviously ignores all the other balance sheet items).





All statutes relating to companies allow for a share premium. An example follows<sup>4</sup>:

“Where a company which is not a banking institution in terms of the Banks Act...issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account to be called the ‘share premium account’, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid-up share capital of the company.”

Shares may be *split into smaller denominations*, and the split value becomes the par value. For example, the LCC1 shares referred to above may be split into denominations such as 50 cents or 1 cent or 0.001 cent and so on.

*Shares of no par value* are shares that do not have a face value. These shares therefore cannot be issued at a premium. In the case of this type of ordinary share the share capital account is styled *stated capital account*. An example of a statute that allows for this share type follows<sup>5</sup>:

“The whole of the proceeds of an issue of shares having no par value shall be paid-up share capital of a company and shall be transferred to an account to be called the ‘stated capital account.’”

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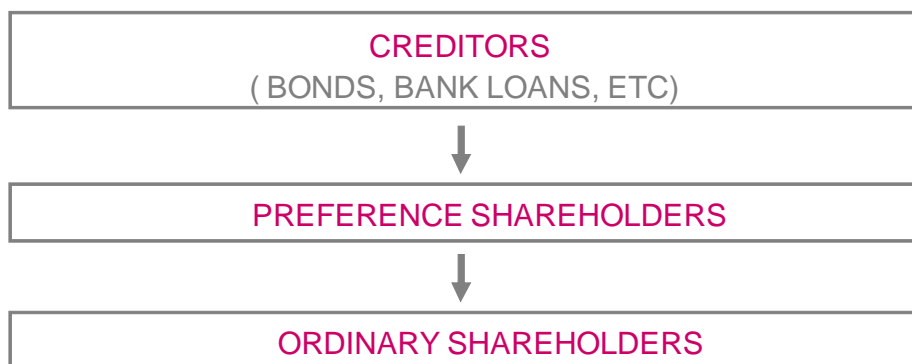


It should be apparent that in the case of a new company issuing 3 000 shares of no par value at LCC150 each, its first balance sheet would appear as shown in Table 3.

Assets		Share capital and liabilities	
Bank deposits	450 000	Stated capital	450 000
Total	450 000	Total	450 000

**Table 3:** Balance sheet of NEWCO (Pty) Limited (LCC)

2.3.3 Residual value



**Figure 1:** waterfall of claims on company in event of liquidation

Ordinary shares only have a *residual value*, or *residual claim status*. This means that in the pecking order (or waterfall) of risk, creditors (providers of credit / loans) are favoured, followed by preference shareholders, in turn followed by ordinary shareholders, and this applies in the cases of *claims on profits* and *claims on the assets* of the company in the event of liquidation (see Figure 1).

It will be evident that *bondholders* are *creditors* of the issuing companies. They are not owners of the issuing companies, but they have a superior claim on the issuing companies’ profits and assets, relative to the ordinary shareholders. This fact is depicted in Figure 2.

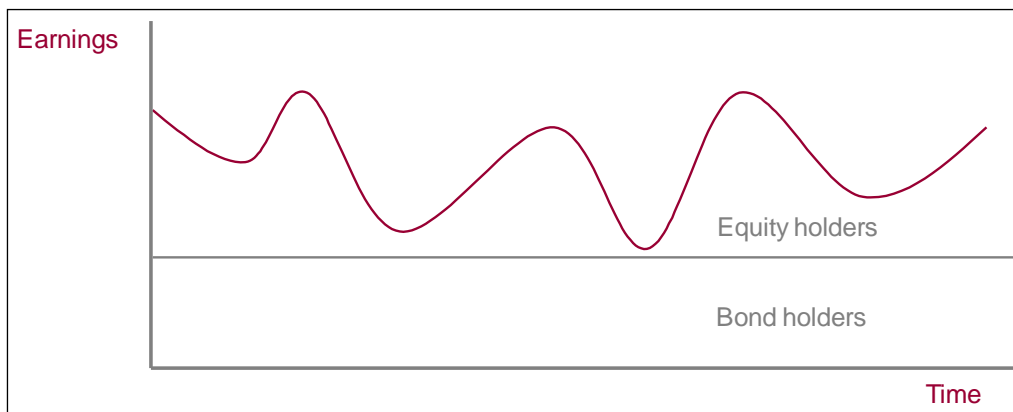


Figure 2: split of earnings between equity and bond owners of a company

### 2.3.4 Voting rights

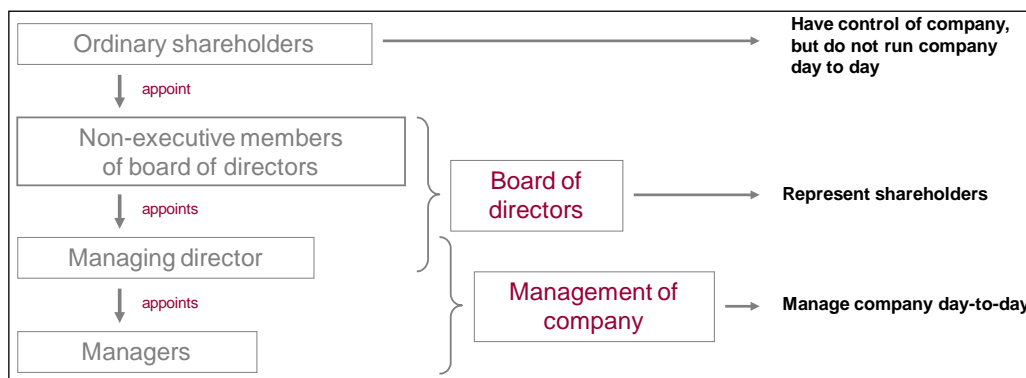


Figure 3: control and management of companies

While *ordinary shareholders* are at the bottom of the waterfall of risk in terms of claims on profits and assets, they have the privilege of *voting rights*. Generally speaking (i.e. in the case of listed companies), ordinary shareholders do not control the daily activities of companies. This is left the managers of companies, who are appointed by the managing director, who in turn is appointed by the board of directors, who in turn are appointed by the ordinary shareholders. This may be depicted as in Figure 3.

Thus, ultimately, the *ordinary shareholders are in control of the fortunes of the company*. They appoint the board of directors to *direct* the company and they are selected for their skills and abilities that are fitting for the company. The board elects the managing director on behalf of the shareholders for his skills in the type of business the company is involved in.

Typically one share has one voting right. However, many company statutes allow for the existence of different classes of ordinary shares in terms of voting rights. There are different names for these shares such as:

- “N” shares and ordinary shares.
- Class A and Class B shares.

For example, Class A shares may carry one vote, while Class B shares may have one-tenth of a vote. An alternative to this arrangement is limiting the extent to which the “inferior” shares may elect the board of directors. For example, Class A shareholders may elect 90% of the board members, leaving only 10% to be elected by the Class B shareholders.<sup>6</sup>

Ordinary shareholders exercise their voting rights at the *Annual General Meetings* (AGMs) that companies are required to hold in terms of statute or *General Meetings* that may be called by the company or the shareholders. It is notable that ordinary shareholders may only call a *General Meeting* if they collectively hold 10% or more of the voting rights (this varies from country to country).

In the case of most listed companies, ordinary shareholders do not attend the AGM. They usually *exercise their voting power by proxy voting*. This is given effect by the company attaching a proxy form to the *Notice of Annual General Meeting* that is sent to each shareholder. Most shareholders do not even bother to complete the proxy. Clearly, in the case of a badly performing company, shareholders will either attend the AGM or appoint a proxy to represent them.

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Sources: Keuzegids Master ranking 2013; Elsevier 'Beste Studies' ranking 2012; Financial Times Global Masters in Management ranking 2012

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### 2.3.5 Elastic dividend payments

Although ordinary shareholders are the lowest head on the totem pole in terms of claims on the company’s assets, they share in the net worth of the company, which may be substantial. The ordinary shareholders are the owners of this net worth, i.e. the assets of the company after allowing for all other claims (preference shareholders, creditors, tax owed). Clearly thus, while bondholders have a prior right in relation to ordinary shareholders, they only are entitled to a fixed interest payment (usually), while the latter share in the financial success of the company.

The profits of companies are paid to shareholders in the form of dividends (after tax), and the dividends received may, of course, be substantial if the company is highly profitable. However, there is no guarantee of a dividend. Thus, unlike bondholders, ordinary shareholders have no legal claim if a dividend is not paid.

The *decision on whether a dividend should be paid* and the magnitude of the dividend to be paid rests with the *board of directors* of the company. The decision is influenced by a number of factors, including:

- Whether the company will be more profitable in future by investing its profits in new equipment or new projects.
- The tax rate on dividends paid by the company (if this exists<sup>7</sup>).
- The tax rate on dividends paid by the shareholder (if this exists).
- The tax rate on capital gains (applicable in many countries).

### 2.3.6 Limited liability

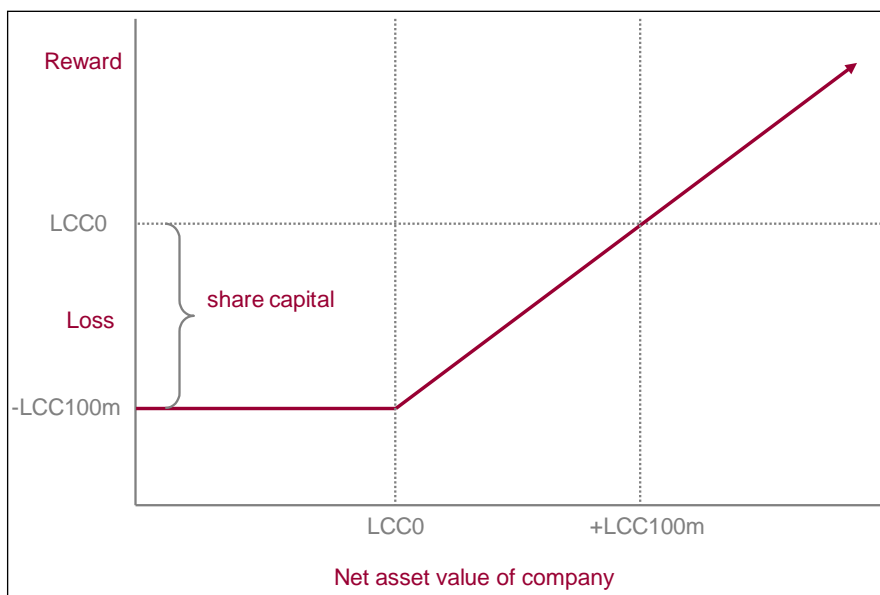


Figure 4: risk-reward profile of ordinary shareholders



A pertinent characteristic of ordinary shares is that shareholders have *limited liability in terms of the debt of the company*. Legally, ordinary shareholders are not responsible for the debt of the company; their liability ends with the loss of the share capital of the company, i.e. their investment in the ordinary shares of the company. But the potential for gain for ordinary shareholders is unlimited. The limit of their loss and their unlimited potential for gain may be depicted as in Figure 4 (it will be noted that this risk-reward profile is similar to that of a call option).

If the ordinary share capital of a company is equal to LCC100 million, this is the amount that the ordinary shareholders stand to lose if the debt of the company exceeds LCC100 million. It will be clear that if the debt is LCC50 million, then the net asset value (NAV) is LCC50 million, i.e. the ordinary shareholders lose LCC50 million in the event of liquidation. It will also be apparent that if the NAV increases to LCC200 million, the shareholders have gained LCC100 million in value (this assumes that the share price equals the NAV per share).

## 2.4 Preference shares

### 2.4.1 Introduction

It was seen earlier that there are only *two types of shares* that companies may issue, i.e. ordinary shares and *preference shares* (termed *preferred stock* in some other markets such as the US). Preference shares are covered by the company statutes of countries. In terms of redeemability (maturity) there are three types of preference shares:

- Compulsory maturity.
- Maturity at the option of the issuer company.
- No maturity (the perpetual preference share).

Characteristic	Ordinary shares	Bonds	Preference shares
Represents ownership of company	Yes	No	Yes
Fixed periodic payment	No	Yes	Yes (usually)
Dividend payment	Yes	No	Yes
Senior risk status	No	Senior to all	Senior to ordinary shares
Voting rights	Yes	No	No*
Fixed maturity date	No	Yes	Yes & No
Can force liquidation	No	Yes	No
Convertibility option	No	Yes	Yes
*Usually not, but there are exceptions			

**Table 4:** Preference shares: similarities to ordinary shares and bonds

One country's<sup>8</sup> Companies Act, for example, provides that a:

“...company may determine that any preference shares shall be issued on the condition that they are, or are at the option of the company, liable to be redeemed.”

Preference shares have characteristics of bonds and shares, and can thus be termed *hybrid securities*. Their similarities / differences to shares and bonds are shown in Table 4.

The three types of preference shares in terms of maturity can have one or more characteristics which are outlined below after we describe the common preference share. The following are the sections:

- The “normal” or “common” preference share.
- The non-cumulative preference share.
- The participating preference share.
- The convertible preference share.
- Preference share hybrids.

We then conclude with a discussion of the advantages of preference shares.



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## BOX 2: EXAMPLE OF A PREFERENCE SHARE CERTIFICATE



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#### 2.4.2 The “normal” or “common” preference share

The typical preference share is the one that carries a fixed rate of interest, called a *fixed dividend*. The dividend is paid either annually or six-monthly. These preference shares are thus *non-participating*, and are *cumulative*.

*Non-participating* means that the preference shareholder does not receive any payments in addition to the contracted fixed dividend or participate in the profits of the company, as do ordinary shareholders.

*Cumulative* means that if the company does not pay the dividend, it is in arrears in this respect, i.e. it remains liable for the dividend. Clearly this dividend must be honoured before payments of dividends are made to ordinary shareholders.

It is notable that some preference shares are also issued with an obligation to pay a *floating dividend*. In this case, the dividend is linked to some benchmark rate such as prime rate, the treasury bill rate and the call money rate (the average of a number of banks’ rates).

The price / value of the fixed rate, fixed redemption date preference share is calculated according the bond pricing formula.

#### 2.4.3 The non-cumulative preference share

Preference shares can also be non-cumulative. This simply means that passed-up dividends are not cumulated, i.e. are never paid.

#### 2.4.4 The participating preference share

The common preference share is non-participating. *Participating* preference shares are where the holder participates in the profits of the company in ways other than the fixed dividend. There are essentially two types of *participating* preference shares:

- The shareholder receives a bonus dividend payment in the good years. The basis for this may or may not be predetermined.
- The shareholder shares in the profits as do the ordinary shareholders.

It will be apparent that participating preference shares are more expensive than the common preference shares.

#### 2.4.5 The convertible preference share

Preference shares may also be issued with an option for conversion into other securities, but usually the shares of the company. The basis of conversion, i.e. the terms, is usually predetermined.<sup>9</sup>

#### 2.4.6 Preference share hybrids

Hybrids of the above also exist. For example, a company may decide to issue preference shares that are participating, non-cumulative and convertible.

#### 2.4.7 Advantages of preference shares

There are a number of advantages and disadvantages pertaining to preference shares for both companies and the holders:

- Preference shares are a convenient borrowing tool in the case where companies wish to borrow for short periods (a few years) as opposed to their seeking permanent capital (ordinary shares). Obviously this only applies in the case of non-convertible preference shares.
- Companies can accumulate dividends. In difficult years, when it is not financially propitious to pay dividends, companies can miss the dividend, and have no concern of being put into liquidation (this may only be brought about by creditors). However, a passed-over dividend detracts from the image of the company; the company that misses a preference share dividend may have difficulty in raising capital thereafter.
- In many countries preference share dividends are not taxed in the hands of the holder. However, in this case companies cannot deduct preference dividends from income for tax purposes, as they may in the case of the payment of interest on bonds.
- Preference share funding is cheaper than bond issues. Because preference share dividends are not taxed in the hands of the holder the dividends (rates) payable on these instruments are lower than the rates payable on equivalent term bonds.

## 2.5 Negotiable instruments representing equity

### 2.5.1 Introduction

Negotiable instruments representing equity are not derivatives of equities, but *instruments that represent the right to equities*, and they are tradable instruments in their own right. They are as follows:

- Letters of allocation.
- Certified transfer deeds.
- Share transfer receipts.
- Balance receipts.
- Warrants.

### 2.5.2 Letters of allocation

Letters of allocation (also called *letter of rights* and *nil-paid letters*) are a form of option on specific equities. In terms of the company statute, when a company requires further capital in the form of the issue of ordinary shares, it is obliged to offer the additional equity to *existing ordinary shareholders in proportion to their existing holding*. The company is said to be making a *rights offer* or a *rights issue* of additional equity.



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The company makes the offer by the issue of a *letter of allocation*. The letter specifies the subscription price and the expiration time of the offer (which is usually short – a few weeks – from the issue date of the letter). Thus the shareholder has the right to buy the shares offered, but is not obliged to take up the offer. The shareholder does not pay for the letter (option), but the letter has a value, depending on the price specified in the letter relative to the market price, as well as expectations of the future price of the share. These letters are listed by, and traded on, the share exchange.

The take-up of the offer is a function of the price of the offer relative to the market price of the share. If the rights offer price is below the market price, the offer is usually taken up and the shares held or sold.

### 2.5.3 Certified transfer deeds

A *securities transfer deed* (STD) is the instrument prescribed by the statute relating to companies for the transfer of securities from one name to another. In many countries there are two types, distinguished by colour; here we assume white and blue.

The white STD is used for the normal transferring of shareholding from one beneficial owner to another. The blue STD is issued by companies (or their Transfer Secretaries – TS) under certain circumstances. For example, if a broker requests a TS to split a LCC10 million par value Company ABC share certificate, and this cannot be effected immediately, the TS will complete 10 blue STDs for say LCC1 million each and stamp them with an official stamp. The STD is now (usually) called a *certified securities transfer deed* (CSTD) and may be traded as bearer equity.

It will be evident that under a *dematerialised system*, where an electronic entry in a register/s represents evidence of ownership, this instrument will become extinct.

### 2.5.4 Share transfer receipts

Another alternative to the share certificate is the *share transfer receipt* (STR). When shares are lodged for transfer and this cannot be immediately given effect, the TS may issue STRs in the denominations required. When accompanied by a STD the STRs are negotiable.

As in the case of the certified transfer deed, under a dematerialised system, where an electronic entry represents evidence of ownership, this instrument will disappear.

### 2.5.5 Balance receipts

A balance receipt, as the wording depicts, is a receipt showing the balance of shares. For example, if an equity deal for LCC1 million is transacted, and the seller only has a LCC10 million denomination certificate, this will be lodged with the TS together with a STD for LCC1 million.

If the transfer cannot be given effect immediately, and the seller wishes to trade the balance of LCC9 million, the TS will issue a *balance receipt* for LCC9 million. This receipt is tradable when accompanied by a STD.

It will be apparent (as in the above cases) that this instrument will die out under a dematerialised system.

### 2.5.6 Warrants

The warrant, being similar to an option, should perhaps be discussed under derivatives. However, because it is only a *call* option (in most cases) and represents a call on *new equity* (also in most cases), we regard it a negotiable instrument representing equity.

Warrants are call options issued by a company to purchase a specified number of shares in the company at a specified price before a specified date in the future. The main differences of warrants compared with traded options are:

- They are written by the issuing company.
- They have a longer lifespan than traded options (usually two to three years).
- They involve new equity issues by the company upon exercise.

The above describes the standard warrant, i.e. single equity warrant, which is a call warrant on new shares. Internationally, there are deviations from the standard warrant. Examples are:

- Covered warrant – where a banker (that operates in this market) acquires the underlying shares for the express purpose of issuing the warrant.
- Low exercise price warrants.
- Capped warrants – low exercise price warrants where the upside gain is capped.
- Instalment warrants – where the shares are purchased in instalments.
- Endowment warrants.
- Capital plus warrants.

South Africa boasts a substantial warrant market.<sup>10</sup> However, the warrants in this market are *not standard warrants*, but *retail options*. Thus they belong under the heading of *derivatives*. The South African call “warrants” are not tied in with new issues of shares. Both call and put warrants (options) are available on specific shares and indices, and all are settled in cash. There are also basket warrants (options) available, which are warrants (options) written on the shares of a group of different companies that are involved in a similar sector.

To confuse the matter further, there exists (internationally) a *discount warrant*, which is a hybrid of the *common / real warrant* and the South African *retail option*. With this hybrid the holder receives *either cash or the underlying share upon exercise*, and this depends on the market / closing price of the underlying share on expiry:

- Closing price  $\geq$  is pre-specified target level: the holder obtains a cash settlement.
- Closing price  $<$  the target level: the holder receives the underlying share.

In summary, there are three types of warrants:

- Common warrants (tied to the issue of new shares).
- Warrants which are retail options (not tied to the issue of new shares).
- Discount warrants (tied to the issue of new shares under certain circumstances).

## 2.6 Summary

Ordinary shares are the essence of the equity market. The majority have a par value (and most a share premium if listed). They stand last in the waterfall of claims on the company, but have voting rights and share in profits to an unlimited extent.

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Preference shares have preference to dividends over ordinary shares, but profit sharing (in most cases) is limited to the coupon. There are many different types of preference shares, which include characteristics such as *participating*, *cumulative* and *convertible*.

There are a number of negotiable instruments representing equity, the best known of which is the letter of allocation (rights issue).

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