Stocks: Frequently Asked Questions

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How are Stocks Traded?

Generally, stocks are traded in blocks or multiples of 100 shares, which are called round lots. An amount of stock consisting of fewer than 100 shares is said to be an odd lot.

On an exchange, an order that involves both a round lot and an odd lot-say 175 shares-will be treated as two different trades and may be executed at different prices.

In the financial world, a trade is jargon for buy and sell. Your broker will charge you a different commission on each trade, and will confirm each of them separately.

These distinctions do not generally apply to trades executed in the OTC (Over-the-Counter) market. OTC stocks are not traded on a formal exchange such as New York Stock Exchange (NYSE) or the American Stock Exchange (AMEX).

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What are the Differences between Stock Exchange Trades and Over-the-Counter Trades?

To be traded on an exchange such as the NYSE or AMEX, the issuing company must meet the exchange's listing standards; these may include requirements on the company's assets, number of shares publicly held, and number of stockholders. Organized markets for other instruments, including standardized options, impose similar restrictions.

The National Association of Securities Dealers' Automated Quotation System (NASDAQ), operated by the National Association of Securities Dealers (NASD), is considered a stock exchange. Like the exchanges, NASDAQ has certain listing standards which must be met for securities to be traded in that market.

Many securities are not traded on an exchange because the issuing companies are too small to meet exchange requirements. Instead, they are traded Over-the-Counter or OTC by broker-dealers negotiating directly with each other via computer and phone.

Investors who buy or sell securities on an exchange or over the counter usually will do so with the aid of a broker-dealer firm. The registered representative is the link between the investor and the traders and dealers who actually buy and sell securities on the floor of the exchange or elsewhere.

Market prices for stocks traded over the counter and for those traded on exchanges are established in somewhat different ways. The exchanges centralize trading in each security at one location-the floor of the exchange. There, auction principles of trading establish the market price of a security according to the current buying and selling interests. If such interests do not balance, designated floor members known as specialists are expected to step in to buy or sell for their own account, to a reasonable degree, as necessary to maintain an orderly market.

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Are My Mutual Fund Investments Protected by Insurance?

There are no guarantees for investors. No matter how you buy a fund-through a brokerage firm, a bank, an insurance agency, a financial planning firm, or directly through the mail, bond funds, unlike bank deposits, are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Nor are they guaranteed by the bank or other financial institution through which you make your investment. Mutual funds involve investment risk, including the possible loss of principal. Conversely, investment risk always includes the potential for greater reward.

Even though mutual funds are not insured, there are some protections. Mutual funds are highly regulated by both the federal government-primarily through the Securities and Exchange Commission-and each of the state governments.

For example, all funds must meet certain operating standards, observe strict anti-fraud rules, and disclose specific information to potential investors. After you invest, funds must provide you with reports at least twice a year that describe how the fund fared during the period covered.

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How are Securities Held?

Today, debt securities are held in electronic book-entry form, but in the past were issued as paper certificates. Ownership is transferred via computer rather than via actual transfer of paper certificates, reducing the possibility of loss, theft, or mutilation of the certificates.

There are still, however, many securities that are in certificate form. For example, you may have inherited stock certificates in paper form from a grandparent or other older relatives. Certificates representing your ownership of stocks or bonds are valuable documents and should be kept in a safe place. If a certificate is lost or destroyed, it may prove time-consuming and costly to obtain a replacement. Furthermore, some securities certificates may not be replaceable at all.

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What are the Differences between Preferred Stock and Common Stock?

Stocks may be designated as common stock, which is the most widely known form, or as preferred stock. Preferred shareholders have more of a stake in the company's assets and earnings and when dividends are issued, they are paid before shareholders of common stock. in addition, when you hold preferred stock you receive dividend payouts at a regular interval and generally have a stated dividend, while common stock dividend are based on company performance. Shareholders with common stock may or may not receive a dividend and are last in line to be paid when a company goes belly up and is liquidated or reorganized in bankruptcy.

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What are Restricted Securities?

Some stocks are designated as "restricted" or "unregistered" because they were originally issued in a private sale or other transaction where they were not registered with the SEC. Restricted or unregistered securities may not be freely resold unless a registration statement is filed with the SEC or unless an exemption under the law permits resale.

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How Can Foreign Stocks Be Bought?

Foreign corporations that sell securities in the United States must register those securities with the SEC. They are generally subject to the same rules and regulations that apply to securities of U.S. companies, although the nature of information foreign companies make available to investors may be somewhat different.

U.S. investors who are interested in foreign securities may also purchase American Depositary Receipts (ADRs). These are negotiable receipts, registered in the name of a U.S. citizen, which represent a specific number of shares of a foreign corporation. Denominations are in U.S. dollars and the security is held by a U.S. financial institution overseas. Listed on either the NYSE, AMEX or NASDAQ, ADRs are an excellent way to buy shares in a foreign company, but keep in mind that there are still risks associated with doing so.

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What are Dividend Reinvestment Plans (DRIPs)?

Dividend reinvestment plans, often referred to as DRIPs or DRPs, are associated with company sponsored plans, but may also be purchased through a broker, and offer opportunities to make small, regular cash investments in participating companies without paying prohibitive transaction fees. Further, all or a part of your dividends can be reinvested and used to purchase more shares, although some plans offer the option to receiving dividends by check.

Tip: Treat your decision to enroll in a DRIP just as seriously as you would a decision to invest in a company. Before investing, subject the company to your usual research and analysis.

Many U.S. companies have direct stock purchase programs that allow investors to buy a company's shares directly from the company instead of using a broker. To enroll in the DRIP, contact the transfer agent or the company's shareholder relations department, and ask for an enrollment form. Then return the form, usually along with your first optional cash investment, to the company.

Once you are enrolled, you can invest more money directly through the company's transfer agent. Many companies offer an automatic investment service, that is, they will automatically withdraw a pre-set amount from your bank account to make optional cash investments. There may be a fee for this service.

Direct stock purchase plans cost an investor less, since there is no broker commission to pay, and often no fee. Some programs have automatic-investment options, which will debit a set amount each month from an investor's bank account.

Dividend reinvestment isn't mandatory. Investors can receive dividend payments, and they can be automatically deposited in a bank account. Some companies that offer direct-purchase programs do not pay dividends.

As with anything else, there are positives and negatives. The main drawback associated with DRIPs is that calculation of capital-gains taxes becomes complex when dividends have been reinvested over the years, and lots have been bought at varying prices. This can be remedied by carefully keeping track of the cost basis of shares when dividends are reinvested. Further, investors who invest through an IRA need not deal with the problem of calculating capital gains taxes at all. In addition, the dividends are taxable income even though you reinvest them.

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