SECTION THREE: FOR MID-CAREER PRACTITIONERS

Doctors, like most people, tend to experience financial losses more intensely than gains, and evaluate investing and other risks in isolation. Much, like they do in clinical practice.

Similarly, risky technology investments, initial public offerings [IPOs], exorbitant portfolio “wrap” account fees and asset management percentages; are often hawked by high priced financial advisors and stock-brokers selling loaded mutual funds, costly hedge and market-neutral funds, alternative investments [AIs]; and even real estate. So, it is not only important to review these modern topics and considerations in *Section Three*, but traditional retirement planning, as well.

In life’s journey, from birth to death, the stage is being set for the emerging medical practitioner to assume the mantle of mature, successful and affluent physician-investor; self-educating, monitoring and perhaps even relying more on self wits or ME Inc, rather than paid advisors.

After all, we believe the analogy of collaborate financial planning and client-centered advice, is akin to the new concept of collaborative medicine and the patient centered care movements.

In other words: *Omnia pro medicus cluentis,* or "all for the doctor client."

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Chapter 13

INVESTMENT BANKING, SECURITIES MARKETS AND MARGIN ACCOUNTS

[Fundamental Trading and Operational Principles]

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There are several different kinds of banks. A general understanding of these concepts is suggested for any medical professional prior to launching a self-directed [ME, Inc], or even a guided investment strategy or wealth building portfolio effort with a financial advisor [FA], stock broker or wealth manager, etc. This operational and trading information is usually not included in a text on financial planning, until now.

Definition of Retail Bank

A retail bank is a typical small mass-market financial institution in which individual customers use local branches; usually of larger commercial banks. Services offered include savings and checking accounts, mortgages, personal loans, debit/credit cards and certificates of deposit (CDs).

Definition of Commercial Bank

A financial institution that provides services, such as accepting deposits, giving business loans and auto loans, mortgage lending, and basic investment products like savings accounts and certificates of deposit. The traditional commercial bank is a brick and mortar institution with tellers, safe deposit boxes, vaults and ATMs. However, some commercial banks do not have any physical branches and require consumers to complete all transactions by phone or Internet. In exchange, they generally pay higher interest rates on investments and deposits, and charge lower fees.

Definition of Investment Bank

Investment banking activities are different than those of retail and commercial banking and include underwriting securities, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and also acting as a broker for institutional clients.

INVESTMENT BANKING AND SECURITIES UNDERWRITING

New economy corporate events of the past several years have provided many financial signs and symptoms that indicate a creeping securitization of the for-profit healthcare industrial complex. Similarly, fixed income medical investors should understand how Federal and State regulations impact upon personal and public debt needs. So, without investment banking firms, it would be almost impossible for private industry, medical corporations and government to raise needed capital; or for doctors to understand the securities business for their own personal investing needs.

Introduction

When a corporation such as a mobile-health company or similar entity needs to raise capital for growth or expansion, there are two methods; debt or equity. If raising equity is used, the corporation can market securities directly to the public by contacting its current stockholders and asking them to purchase the new securities in a rights offering by advertising or by hiring salespeople. Although this last example is somewhat exaggerated, it illustrates that there is a cost to selling new securities, which may be considerable if the firm itself undertakes the task. For this reason, most corporations employ help in marketing new securities by using the services of investment bankers who sell new securities to the general public. Although the investment banking is an exciting and vital industry, the many Securities Exchange Commission [SEC] rules regulating it are not.

Fundamentals of the Investment Banking Industry

Investment bankers are not really bankers at all. The fact that the word banker appears in the name is partially responsible for the false impressions that exist in the medical community regarding the functions they perform. For example, they are not permitted to accept deposit, provide checking accounts, or perform other activities normally construed to be commercial banking activities. An investment bank is simply a firm that specializes in helping other corporations obtain money they need under the most advantageous terms possible.

When it comes to the actual process of having securities issued, the corporation approaches an investment banking firm, either directly, or through a competitive selection process and asks it to act as adviser and distributor. Investment bankers, or under writers, as they are sometimes called, are middlemen in the capital markets for corporate securities.

The corporation requiring the funds discusses the amount, type of security to be issued, price and other features of the security, as well as the cost to issuing the securities. All of these factors are negotiated in a process known as negotiated underwriting. If mutually acceptable terms are reached, the investment banking firm will be the middle man through which the securities are sold to the general public. Since such firms have many customers, they are able to sell new securities, without the costly search that individual corporations may require to sell its own security. Thus, although the firm in need of additional capital must pay for the service, it is usually able to raise the additional capital at less expense through the use of an investment banker, than by selling the securities itself.

The agreement between the investment banker and the corporation may be one of two types. The investment bank may agree to purchase, or underwrite, the entire issue of securities and to re-offer them to the general public. This is known as a *firm commitment*. When an investment banker agrees to underwrite such a sale; it agrees to supply the corporation with a specified amount of money. The firm buys the securities with the intention to resell them. If it fails to sell the securities, the investment banker must still pay the agreed upon sum. Thus, the risk of selling rests with the underwriter and not with the company issuing the securities.

The alternative agreement is a best effort agreement in which the investment banker makes his best effort to sell the securities acting on behalf of the issuer, but does not guarantee a specified amount of money will be raised.

When a corporation raises new capital through a public offering of stock, one might inquire where the stock comes from. The only source the corporation has is authorized, but previously un-issued stock. Anytime authorized, but previously

un-issued stock (new stock) is issued to the public, it is known as a primary offering. If it's the very first time the corporation is making the offering, it's also known as the *Initial Public Offering* (IPO). Anytime there is a primary offering of stock, the issuing corporation is raising additional equity capital.

A *secondary offering*, or distribution, on the other hand, is defined as an offering of a large block of outstanding stock. Most frequently, a secondary offering is the sale of a large block of stock owned by one or more stockholders. It is stock that has previously been issued and is now being re-sold by investors. Another case would be when a corporation re-sells its treasury stock.

Prior to any further discussions of investment banking, there are several industry terms to be defined. For example, an *agent* buys or sells securities for the account and risk of another party, and charges a commission. In the securities business, the terms *broker* and agent are used synonymously. This is not true of the insurance industry. On the other hand, a *principal* is one who acts as a dealer rather than an agent or broker. A dealer buys and sells for his own account. Finally; the *dealer* makes money by buying at one price and selling at a higher price. Thus, it is easy to understand how an investment banking firm earns money handling a best efforts offering; they make a commission on every share they sell.

The Securities Act of 1933 (Act of Full Disclosure)

When a corporation makes a public offering of its stock, it is bound by the provisions of the Securities Act of 1933, which is also known as the Act of Full Disclosure. The primary requirement of the Act is that the corporation must file a registration statement (full disclosure) with the Securities and Exchange Commission (SEC); containing some of the following items:

- Description of the business entity raising the money.
- Biographical data regarding officers and directors of the issuer.
- Listing of share holdings of officers, directors, and holders of more than 10% of the issuer's securities (insiders).
- Financial statements including a breakdown of existing capitalization (existing debt and equity structure).
- Intended use of offering proceeds.
- Legal proceedings involving the issuer, such as suits, antitrust actions or strikes.

Acting in its capacity as an adviser to the corporation; the investment banking firm fills out the registration statement for the SEC. It then takes the SEC a period of time to review the information in the registration statement. This is the "cooling off period" and the issue is said to be "in registration" during this time. When the Act written in 1933, Congress thought that 20 days would be enough time from the filing date, until the effective date the sale of securities was permitted.

In reality, it frequently takes much longer than 20 days for the SEC to complete its review. But, regardless of how long it lasts, it's known as the *cooling off period*. At the end of the cooling off period, the SEC will either accept the issue or they will send a letter back to the issuer, and the underwriter, explaining that there is incomplete information in the registration statement. This letter is known as a *deficiency letter*. It will postpone the effectiveness of the registration statement until the deficiency is remedied. Even if initially or eventually approved, an effective registration does not mean that the SEC has approved the issue.

For example, the following well known disclaimer statement written in bold red ink, is required to be placed in capital letters on the front cover page of every prospectus:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

During the cooling off period, the investment bank tries to create interest in the market place for the issue. In order to do that, it distributes a *preliminary prospectus*, more commonly known as a *"red herring"*. It is known as a red herring because of the red lettering on the front page. The statement on the very top with the date is printed in red as well as the statements on the left hand margin of the preliminary prospectus.

The cost of printing the red herring is borne by the investment bank, since they are trying to market it. The red herring includes information from the registration statement that will be most helpful for potential medical investors trying to make a decision. It describes the company and the securities to be issued; includes the firm's financial statements; its current activities; the regulatory bodies to which it is subject; the nature of its competition; the management of the corporation, and what the expected proceeds will be used for. Two very important items missing from the red herring are the *public offering price* and the *effective date* of the issue, as neither are known for certain at this point in time.

The public offering price is generally determined on the date that the securities become effective for sale (effective date). Waiting until the last minute enables the investment bankers to price the new issue in line with current market conditions. Since the investment banker uses the red herring to try to create interest in the market place, stock brokers (registered representatives with a Series # 7 general securities license) will send copies of the red herring to their clients for whom they feel the issue is a suitable investment. The SEC is very strict on what can be said about an issue, in registration. In fact, during the *pre-filing period* (the time when the negotiations are going on between the issuer\and underwriter), absolutely nothing can be said about it to anyone.

For example, if the regulators find out that your stock broker discussed with you [the potential investor] the fact that his firm was negotiating with an issuer for a possible public offering, he could be fined, or jailed. During the cooling off period (the time when the red herring is being distributed), nothing may be sent to you; not a research report, nor a recommendation from another firm, or even the sales literature. The only thing you are permitted to receive is the red herring. The red herring is used to acquaint prospects with essential information about the offering. If you are interested in purchasing the security, then you will receive an *"indication of interest"*, but you can still not make a purchase or send money. No sales may be made until the effective date; all that can be used to generate interest is the red herring.

Tombstone Advertising and the Prospectus

Despite the above SEC restriction, some idea of potential demand for a new issue can be gauged and have a bearing on pricing decisions. For example, as CEO of a medical instrument company, or interested investor, would you rather see a great deal of interest in a potential new issue or not very much interest? There is however, one kind of advertisement that the underwriter can publish during the cooling off period. It's known as a *tombstone ad.* The ad makes it clear that it is only an announcement and does not constitute an offer to sell or solicit the issue, and that such an offering can only be made by prospectus. SEC Rule 134 of the 1933 Act itself, refers to a tombstone ad as "communication not deemed a prospectus" because it makes reference to the prospectus in the ad. Tombstones have received their name because of the sparse nature of details found in them. However, the most popular use of the *tombstone ad* is to announce the effectiveness of a new issue, after it has been successfully issued. This promotes the success of both the underwriter, as well as the company.

Since distributing securities involves potential liability to the investment bank, it will do everything possible to protect itself. So, near the end of the cooling off period, a meeting is held between the underwriter and the corporation. It is known as a *due diligence meeting.* At this meeting they both discuss amendments that are going to be necessary to make the registration statement complete and accurate. The corporate officers *and* the underwriters sign the final registration statement. They have civil liability for damages that result from omissions of material facts or misstatements of fact. They also have criminal liability if the distribution is done by use of fraudulent, manipulative, or deceptive means. Due diligence takes on a whole new meaning when incarceration from a half-hearted underwriting effort; can occur. The investment bank strives to ensure that there have been no material changes to the issuer or the terms of the issue since the registration statement was filed.

Again, as a physician, how would you feel if you were an investment banker raising capital for a new pharmaceutical company that had developed a drug product that was highly marketable. But, on the day after the issue was effective, there was a major news story indicating that the company was being sued for patent infringement? What effect do you think that would have on the market price of this new issue? It would probably plunge. How could this situation have been prevented? The due diligence meeting is more than a cocktail party or a gathering in a smoke filled room. Otherwise, the company would require specially trained people, to do a patent search lessening the likelihood of this scenario. At the due diligence meeting, work is done on the preparation of the final prospectus, but the investment bank does not set the

public offering price or the effective date at this meeting. The SEC will eventually set the effective date for the registration and it is on that date that the final offering price will be determined.

Once the SEC sets the effective date, sales may be executed and money can be accepted by the investment bank. It is at this time that the *final prospectus*, similar to the red herring but *without* the red ink and *with* the missing numbers, is issued. A prospectus is an abbreviated form of the registration statement, distributed to purchasers, on and after the effective date of the registration. It is *not* the same as the registration statement. A typical registration statement consists of papers that stand more than a foot high; rarely does a prospectus go beyond 40 or 50 pages. All purchasers will receive a final prospectus and then it becomes permissible for the underwriter to provide sales literature.

In addition to the requirement that a prospectus must be delivered to a purchaser of new issues no later than with confirmation of the trade, there are two other requirements which physicians, medical professionals and healthcare executive investors should know.

90-day: When an issuer has an *initial* public offering *(IPO),* there is generally a lack of publicly available material relating to the operations of that issuer. Because of this, the SEC requires that all members of the underwriting group make available a prospectus on an IPO for a period of 90 *days* after the effective date.

40-day: Once an issuer has gone public, there are a number of routine filings that must be made with the SEC so there is publicly available information regarding the financial condition of that issuer. Since additional information is now available, the SEC requires that, on all issues other than IPOs, any member of the underwriting group must make available a prospectus for a period of *40 days* after the effective date.

In the event that the investment bankers misgauged the marketplace, and the issue moves quite slowly, it is possible that information contained in the prospectus would be rendered obsolete by the SEC. Specifically, the SEC requires that any prospectus used more than 9 months after the effective date, may not have any financial information more than 16 months old. It can however, be amended or stickered, with updated information, as needed.

Syndication Among Underwriters

Because the investment banking firm may be underwriting (distributing) a rather large dollar amount of securities, to spread its risk exposure, it may form a group made up of other investment bankers or underwriters, known as a *syndicate.* The syndicate is headed by a *syndicate manager,* or *lead underwriter,* and it is his job to decide whether to participate in the offering. If so; the managing underwriter will sign a non-binding agreement called a *letter of intent.* .

If all has gone well and the market place is sufficiently interested in the security, and the SEC has been satisfied with respect to the registration statement, it is time for all parties to the offering to formalize their relationships with a contract including the basic understandings reflected in the letter of intent. Three principal underwriting contracts are involved in the usual public offering, each serving a distinct purpose. These are the: Agreement among Underwriters, Underwriting Agreement, and the Dealer Agreement.

In the *Agreement Among Underwriters (AAU),* the underwriters committing to a portion of the issue, enter into an agreement establishing the nature and terms of their relationship with each other. It designates the syndicate manager to act on their behalf, particularly to enter into an Underwriting Agreement with the issuer, and to conduct the offering on behalf of each of them. The AAU will designate the managing underwriter's compensation *(management fee)* for managing the offering.

The authority to manage the offering includes the authority to: agree with the issuer as to the public offering price; decide when to commence the offering; modify the offering price and selling commission; control all advertising; and, control the timing and effectiveness of the registration statement by quickly responding to deficiency letters. Each underwriter agrees to purchase a portion of the underwritten securities, which is known as each under-writer's *allotment* (allocation). It is normally signed severally, but not jointly, meaning each underwriter is obligated to sell his allocation but bears no financial obligation for any unsold allotment of another underwriter. This is referred to as a divided account or a *Western*

account. Much less frequently, an undivided or *Eastern account;* will be used. Each underwriter is responsible for unsold allotments of others, based upon a proportionate share of the offering.

The above comments referred to firm commitment underwriting. Another type of underwriting commitment however, is known as best efforts underwriting. Under the terms of *best-efforts* underwriting, the underwriters make no commitment to buy or sell the issue, they simply do the best they can, acting as an agent for the issuer, and having no liability to the issuer if none of the securities are sold. There is no syndicate formed with a best efforts underwriting. The investment bankers form a selling group, with each member doing his best to sell his allotment. Two variations of a best efforts underwriting are: the all-or-none, and the mini-max (part-or-none) underwriting. Under the provisions of an all-or-none offering, unless all of the shares can be distributed within a specified period of time, the offering will terminate and no subscriptions or orders will be accepted or filled. Under mini-max, unless a set minimum amount is sold, the offering will be terminated.

SEC Rule 15c2-4 requires the underwriter to set up an escrow account for any money received before the closing date, in the event that it is necessary to return the money to prospective purchasers. If the "minimum" or "all" the contingencies are met, the monies in escrow go to the issuer with the underwriters retaining their appropriate compensation. In order to make sure that investors are properly protected, the escrow account must be maintained at a bank for the benefit of the investors until every appropriate event or contingency has occurred. Then, the funds are properly returned to the investors. If the money is to be placed into an interest bearing account, it must have a maturity date no later than the closing date of the offering, or the account must be redeemable at face with no prepayment penalty as regards principal.

Underwriter Compensation Hierarchy

As we have seen, in a firm commitment the underwriter buys the entire issue from the issuer and then attempts to resell it to the public. The price at which the syndicate offers the securities to the public is known as the public offering price. It is the price printed on the front page of the prospectus. However, the managing underwriter pays the issuer a lower price than this for the securities. The difference between that lower price and the public offering price is known as the spread or underwriting discount. Everyone involved in the sale of a new issue is compensated by receiving part of the spread. The amount of the spread is the subject of negotiations between the issuer and the managing underwriter, but usually is within a range established by similar transactions between comparable issuers and underwriters. The spread is also subject to NASD review and approval before sales may commence. The spread is broken down by the underwriters so that a portion of it is paid to the managing underwriter for finding and packaging the issue and managing the offering (usually called the manager's fee); and a portion is retained by each underwriter (called the underwriting or syndicate allowance) to compensate the syndicate members for their expenses, use of money, and assuming the risk of the underwriting. The remaining portion is allocated to the selling group and is called selling concession. It is often useful to remember the compensation hierarchy pecking order in the following way:

- Spread {syndicate manager).
- Underwriters allowance {syndicate members)
- Selling concession {selling group members)
- Re-allowance {any other firm)

While the above deal with corporate equity, the only other significant item with respect to corporate debt is the Trust Indenture Act of 1939. This Federal law applies to public issues of debt securities in excess of $5,000,000. The thrust of this act is to require an indenture with an independent trustee (usually a bank or trust company) who will report to the holders of the debt securities on a regular basis.

Successful marketing of a new issue is a marriage between somewhat alien factors: compliance and numerous Federal, state, and self-regulatory rules and statutes; along with finely honed and profit-motivated sales techniques. It's not too hard to see that there could be a real, or apparent, conflict of interest here. Most successful investment bankers have built their excellent reputations upon their ability to properly balance these two objectives consistently, year after year.

New Issue Stabilization

Some issues move very well, like traditional blue chips stocks (ie.,Walgreens). Some are dogs, like smaller dot.com companies (iixl.com). Then, there are issues that were former darling, but are now ice cold; like PPMCs (i.e., Phycor) and internet stocks (i.e., Dr. Koop). How far can an underwriting manager go in nudging along an issue that's not selling well? SEC rules do permit a certain amount of help by the manager, even if this takes on the appearance of price-fixing. This help is called stabilizing the issue. Simply put, if shortly after a new offering begins, supply exceeds demand, there will be downward pressure on the price. But the law requires that all purchasers of the new issue pay the official offering price on the prospectus. If public holders of the stock become willing to bail out and accept a low selling price, the investor looking to buy will find he is able to buy stock of the issuer cheaper in the open market than buying it new from the syndicate members.

To prevent such a decline in the price of a security during a public offering, SEC rules permit the manager to offer to buy shares in the open market at a bid price at, or just below, the official offering price of the new issue. This is referred to as stabilizing and his bid price is called the stabilizing bid. There is always the risk, in a firm commitment underwriting, that the underwriters will have difficulty selling the new issue. What they can't sell, they're "stuck" with. That's where the term "sticky issue" comes from. As a potential investor in a new issue, be aware that the best way to get an issue to sell is to increase the compensation to the sales force (i.e., your stock broker *aka* “financial advisor”).

Another choice is through *stabilization.* Stabilizing is a permitted form of market manipulation which tends to protect underwriters against loss. It allows the underwriting syndicate (usually through the efforts of the syndicate manager) to stabilize (peg or fix) the secondary market trading price in a new issue at the published public offering price. It works something like this.

When a new issue is selling slowly, some of the investors who initially purchased, may be dissatisfied with the performance of the stock (if it is selling slowly and the underwriters have plenty to sell at the public offering price, this is anything but a hot issue and the security price will not have risen). This dissatisfaction with performance leads to these investors desiring to sell the securities they have just purchased. If the underwriters are unable to sell at the public offering price, certainly an individual investor will have to take less when bailing out. As market makers begin to trade the stock in the secondary market, they would only be able to compete with the underwriters by offering the stock at a lower price than the public offering price. This would make it difficult (if not impossible) for the underwriters to distribute the remaining new shares.

In order to prevent this from happening, the managing underwriter (who is usually the one to assume the role of stabilizing underwriter), agrees to purchase back any of the new shares at or just slightly below the public offering price. That is a higher price than any market maker could, in all practicality, bid for the shares. When the shares are repurchased by the stabilizing underwriter, it is as if the initial trade was annulled and never took place so that these new shares are now placed back into the distribution and are sold as new shares at the public offering price. SEC rules do, however, require disclosure of this practice. Therefore, no syndicate manager may engage in stabilizing unless the following phrase appears in bold print on the inside front cover page of the prospectus:

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF (XYZ COMPANY) AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH TRANSACTIONS MAY BE EFFECTED ON (NYSE) STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

Of course, it would be manipulation and, therefore, a violation of law, if this "price-pegging" activity continued after the entire new issue was sold out. This activity costs the syndicate manager money which is recouped by levying a syndicate penalty bid against those members of the syndicate whose clients turn shares in on a stabilizing bid.

One way to avoid stabilization is to over allot to each of the syndicate members. This is the same concept as "over booking" that's done by the airlines. Most airlines typically sell 5% to 10% more seats than the airplane has knowing that there will be last minute cancellations and no shows. This tends to ensure that the plan will fly full. In the same manner, managing underwriters frequently over allot an additional 10% to each of their syndicate members so that last minute

cancellations should still leave the syndicate with sell orders for 100% of the issue. If there are no "drop outs", one of two things may happen:

1. The issuer will issue the additional shares (which results in it raising more money).
2. The issuer will not issue the additional shares and the syndicate will have to go short. Any losses suffered by the syndicate through taking of this short position are shared proportionately by the syndicate members.

Now, what if market conditions and the fervor surrounding a new issue like e-commerce company Ariba in 1999, remain so that the issue doesn't cool down during the cooling off period? Such hot issues are a mixed blessing to be sure. On the one hand, the issue is a sure sell-out. On the other hand, just how many healthcare investors are going to be told by brokers that additional shares cannot be obtained? Furthermore, the SEC and the FINRA/NASD are vigorous in their scrutiny of proper distribution channels for hot issues. Just what is a "proper" distribution? It can be summed up in one sentence. Member firms have an obligation to make a "bona fide" public distribution of all the shares at the public offering price. The key to this rule lies within the definition of bona fide public distribution.

Municipal Underwriting

While the underwriting procedures for corporate bonds are almost identical to corporate stock, there are significant differences in the underwriting of municipal securities. Municipal securities are exempt from the registration filing requirements or the Securities Act of 1933. A state or local government, in the issuance of municipal securities, is not required to register the offering with the SEC, so there is no filing of a registration statement and there is no prospectus which would otherwise have to be given to investors.

There are two main methods of financing when it comes to municipal securities. One method is known as *negotiated.* In the case of a negotiated sale, the municipality looking to borrow money would approach an investment bank and negotiate the terms of the offering directly with the firm. This is really not very different from the above equity discussions.

The other type of municipal underwriting is known as *competitive bidding*. Under the terms of competitive bidding, an issuer announces that it wishes to borrow money and is looking for syndicates to submit competitive bids. The issue will then be sold to the syndicate which submits the best bid, resulting in the municipality having the lowest net interest cost (lowest expense to the issuer).

If the issue is to be done by a competitive bid, the municipality will use a Notice of Sale to announce that fact. The notice of sale will generally include most or all of the following information.

- Date, time, and place. This does not mean when the bonds will be sold to the public, but when the issue will be awarded (sold) to the syndicate issuing the bid.
- Description of the issue and the manner in which the bid is to be made (sealed bid or oral).
- Type of bond (general obligation, revenue, etc.)
- Semi-annual interest payment dates and the denominations in which the bonds will be printed.

- Amount of good faith deposit required, if any.
- Name of the law firm providing the legal opinion and where to acquire a bid form.
- The basis upon which the bid will be awarded, generally the lowest net interest cost.

Since municipal securities are not registered with the SEC, the municipality must hire a law firm in order to make sure that they are issuing the securities in compliance with all state, local and federal laws. This is known as the bond attorney, or independent bond counsel. Some functions are included below:

1. Establishes the exemption from federal income tax by verifying requirements for the exemption.
2. Determines proper authority for the bond issuance.
3. Identifies and monitors proper issuance procedures.
4. Examines the physical bond certificates to make sure that they are proper

5. Issues the debt and a legal opinion, since municipal bonds are the only securities that require an opinion.
6. Does not prepare the official statement.

When medical or other investors purchase new issue municipal securities from syndicate or selling group members, there is no prospectus to be delivered to investors, but there is a document which is provided to purchasers very similar in nature to a prospectus. It is known as an *Official Statement.* The Official Statement contains all of the information an investor needs to make a prudent decision regarding a proposed municipal bond purchase.

The formation of a municipal underwriting syndicate is very similar to that for a corporate issue. When there is a negotiated underwriting, an *Agreement Among Underwriters* (AAU) is used. When the issue is competitive bid, the agreement is known as a Syndicate Letter. In the syndicate letter, the managing underwriter details all of the underwriting agreements among members of the syndicate. *Eastern* (undivided) and *Western* (divided) accounts are also used, but there are several different types of orders in a municipal underwriting. The traditional types of orders, in priority order, are:

Pre-Sale Order: Made before the syndicate actually offers the bonds. They have first priority over any other orders.
Syndicate (group net) Order: Made once the offering is under way at the public offering price. The purchase is credited to each syndicate member in proportion to its allotment. An institutional buyer will frequently purchase" group net", since many of the firms in the syndicate may consider this buyer to be their client and he wishes to please all of them.

*Designated Order***:** Sales made to medical investors (usually healthcare institutions) at the public offering price where the investor designates which member or members of the syndicate are to be given credit.

Member Orders: Purchased by members of the syndicate at the take-down price (spread). The syndicate member keeps the full take-down if the bonds are sold to investors, or earns the take-down less the concession if the sale is made to a member of the selling group. Should the offering be over-subscribed, and the demand for the new bonds exceeds the supply, the first orders to be filled are the pre-sale orders. Those are followed by the syndicate (sometimes called group net) orders, the designated orders, and the last orders filled are the member's.

Finally, be aware that the term *bond scale*, which is a listing of coupon rates, maturity dates, and yield or price at which the syndicate is re-offering the bonds to the public. The scale is usually found in the center of a tombstone ad and on the front cover of the official statement. One of the reasons why the word "scale" is used is, that like the scale on a piano, it normally goes up. A regular or positive scale is one in which the yield to maturity is lowest on the near term maturities and highest on the long term maturities. This is also known as a positive yield curve, since the longer the maturity, the higher the yield. In times of very tight money, such as in 1980-81, one might find a bond offering with a negative scale. A negative (sometimes called inverted) scale is just the opposite of a positive one, with, yields on the short term maturities are higher than those on the long term maturities.

Underwriting Government Issues

The underwriting of US Government securities is the largest underwriting market in the world, but issues a bit differently. For example, there is no such thing as a negotiated underwriting on a US Government security. All offerings of the Treasury are sold by auction. The auction is conducted by the Federal Reserve Bank of New York in accordance with a published schedule. Unfortunately, they are not open to the public, just primary dealers. A bank or investment dealer is appointed by the president of the Federal Reserve Bank of New York and are the only entities authorized to buy and sell government securities in direct dealings with the FED. One becomes a primary dealer through qualifications of reputation, underwriting capacity, and adequacy of staff and facilities.

Currently, 13 and 26-week treasury bills are offered every week on Mondays, while 52- week bills are auctioned once a month. Treasury notes and bonds are auctioned much less frequently. Those dealers wishing to acquire a particular Treasury security enter bids on a yield basis rather than at a specific price. This method is sometimes called a Dutch auction. As a practical matter, about a week or so before the proposed auction, the Treasury announces the following four items: amount, maturity date, nominal or coupon rate anticipated, and the minimum denominations available (except for T bills which don't have interest coupons and always carry a minimum denomination of $10,000).

Can the individual medical professional purchase newly issued Treasuries? Yes! Rather than turning in a competitive bid, as the primary dealer does, the individual will turn in a non-competitive bid. Competitive bidding with governments is similar to the other competitive bidding discussed above. The underwriter turning in the lowest bid; wins. Due to the enormous size of Treasury offerings, it is extremely rare that the lowest bidder is able to take the entire issue. That being the case, the Treasury moves to the next best and the next best bidders, until most of the issue is taken. There is always a small portion left over for the non-competitive bidders. Non-competitive bids may only be made in amounts of $1 million or less. All non-competitive bids are automatically filled at the average yield of the competitive bids which have been accepted.

Underwriting State Issues (Blue Sky Registration)

Unlike Federal issues, there are three types of State registration that are important for the medical professional to know: *Notification:* This is the simplest form of registration and is used by an issuer who has been in continuous operation for at least the previous three years. Most, but not all, states permit registration by notification.

Coordination: This occurs when an issuer wishes to coordinate a Federal registration under the Securities Act of 1933 with Blue Sky registration in one or more states. Under most circumstances, the Blue Sky registration automatically becomes effective when the Federal registration statement becomes effective.

Qualification: Any security may be registered in a state by qualification, but is most commonly used by those issuers who are unable to use notification or coordination. Registration by Qualification becomes effective when so ordered by the State Administrator.

Exempt Securities

There are many securities which are exempt from the Act of '33 registration and prospectus requirements. They include:

- US Government and Federal Agency issues.
- Municipal, State issues and commercial paper with a maturity not in excess of 270 days.
- Intra-state offerings (Rule 147) because they are blue-sky chartered within the state.
- Small Public offerings (Regulation A) if the value of the securities issued does not exceed $5,000,000 in any 12 month period. An issuer using the Regulation A exemption does not make the normal filings with the SEC in Washington. Instead, they file a simplified disclosure document with their SEC Regional Office, known as an Offering Statement. It must be file at least 10 business days prior to the initial offering of the securities. No securities may be sold unless issuer has furnished an offering circular (full disclosure document) to the purchaser at least 48 hours prior to the mailing of confirmation of the sale, and, if not completed within 9 months from the date of the offering circular , a revised circular must be filed. Every 6 months, issuers must file a report with the SEC of sales made under the Regulation A exemption until offering is completed.
- Traditional insurance policies are considered to be securities and are exempt, as are fixed annuities. However, some of the newer forms of life insurance, like variable life, as well as variable annuities, have investment characteristics and, therefore are not exempt from registration.
- Commercial paper and banker's acceptances (9 month or shorter maturity) since they are money market instruments.

The Private Placement (Regulation D) Securities Exemption

Since the Securities Act of 1933 requires disclosure of all public offerings (other than the exemptions just described), it should make sense that any securities offering not offered to the public would also be exempt. The Act provides a registration exemption for private placements, know as Regulation D.

Since one of the stated purposes of the Act of 1933 is to prevent fraud on the sale of new public issues, an issue which has only a limited possibility of injuring the public may be granted an exemption from registration. The SEC just doesn't have the time to look at everything so they exempt offerings which do not constitute a "public offering". Strict adherence to the

provisions of the law, however, is expected and is scrutinized by the SEC. This exemption provision of the Act of '33 lies within Regulation D.

Regulation D describes the type and number of investors who may purchase the issue, the dollar limitations on the issue, the manner of sale, and the limited disclosure requirements. Bear in mind at all times that from the issuer's viewpoint, the principal justification for doing a private, rather than public offering, is to save time and money, not to evade the law. Remember, it is just as illegal to use fraud to sell a Regulation D issue as it is in a public issue. However, if done correctly, a Regulation D can save time and money, and six separate rules (501-506).

Rule 501: Accredited investors are defined as: corporations and partnerships with net worth of $5,000,000 not formed for the purpose of making the investment; corporate or partnership "insiders"; individuals and medical professionals with a net worth (individual or joint) in excess of $1,000,000; individuals with income in excess of $200,000 (or joint income of $300,000) in each of the last two years, with a reasonable expectation of having income in excess of $200,000 (joint income of $300,000) in the year of purchase; and any entity 100% owned by accredited investors.

Rule 502: The violations of aggregation and integration are defined:
Aggregation: Sales of securities in violation of the dollar limitations imposed under Rules 504 and 505 (506 has no dollar limitations).

Integration: Sales of securities to a large number of non-accredited investors, in violation of the "purchaser limitations" set forth in Rules 505 and 506 (504 has no "purchaser limitations").

Rule 503: Sets forth notification requirements. An issuer will be considered in violation of Regulation D, and therefore subject to Federal penalties, if a Form D is not filed within 15 days after the Regulation D offering commences.

Rule 504: Enables a non-reporting company to raise up to $1,000,000 in a 12-month period without undergoing the time land expense of an SEC registration. Any number of accredited and non-accredited investors may purchase a 504 issue.

Rule 505: Enables corporations to raise up to $5,000,000 in a 12-month period without a registration. The "purchaser limitation" rule does apply here. It states that the number of non-accredited investors cannot exceed 35. Obviously, we would have few problems if only medical investors in private placements were accredited investors, but that is not always the case. Since we are limited to a maximum of 35 non-accredited investors, how we count the purchasers becomes an important consideration. The SEC states that if a husband and wife each purchase securities in a private placement for their own accounts, they count as one non- accredited investor, not two. It would also be true that if these securities were purchased in UGMA accounts for their dependent children, we would still be counting only one non- accredited investor. In the case of a partnership, it depends upon the purpose of the partnership. If the partnership was formed solely to make this investment, then each of the partners counts as an individual accredited or non-accredited investor based upon their own personal status, but if the partnership served some other purpose, such as a law firm, then it would only count as one purchaser.

Rule 506: Differs from 505 in two significant ways. The dollar limit is waived and the issuer must take steps to assure itself that, if sales are to be made to non-accredited investors, those investors meet tests of investment "sophistication".

Generally speaking, this means that either the individual non-accredited investor has investment savvy and experience with this kind of offering, or he is represented by someone who has the requisite sophistication. This representative, normally a financial professional, such as an investment advisor, accountant, or attorney, is referred to in the securities business as a *Purchaser Representative.*

Regulation D further states that no public advertising or solicitation of any kind is permitted. A tombstone ad may be used to advertise the completion of a private placement, not to announce the availability of the issue. As a practical matter, however, whether required by the SEC or not, a Private Offering Memorandum for a limited partnership, for example, is normally prepared and furnished so that all investors receive disclosure upon which to base an investment judgment.

If any of the provisions of the Securities Act of 1933 are violated by an issuer, underwriter, or investor, this is known as "statutory underwriting" of underwriting securities in violation of statute. One who violates the '33 Act is known as a statutory underwriter. One all too common example of this occurs when a purchaser of a Regulation D offering offers his unregistered securities for re-sale in violation of SEC Rule 144, an explanation of which is given below:

In simple English, SEC Rule 144 was created so that certain re-sales of already-existing securities could be made without having to file a complete registration statement with the SEC. The time and money involved in having to file such a registration is usually so prohibitive as to make it uneconomical for the individual seller. What kinds of re-sales are covered by Rule 144 and are important to the medical investor? Let's first define a few terms.

Restricted Securities: Are unregistered Securities purchased by an investor in a private placement. It is also called Letter Securities or Legend Securities referring to the fact that purchasers must sign an "Investment Letter" attesting to their understanding of the restrictions upon re-sale and to the "Legend" placed upon the certificates indicating restriction upon resale.

Control Person: A corporate director, officer, greater than 10% voting Stockholder, or the spouse of any of the preceding, are loosely referred to as Insiders or Affiliates due to their unique status within the issuer.

Control Stock: Stock held by a control person. What makes it control stock is who owns it, not so much how they acquired it.

Non-Affiliate: An investor who is not a control person and has no other affiliation with the issuer other than as an owner of securities.

Rule 144 says that restricted securities cannot be offered for re-sale by any owner without first filing a registration statement with the SEC:

1. unless the securities have been held in a fully paid-for status for at least two years;
2. unless a notice of Sale is filed with the SEC at the time of sale and demonstrating compliance with Rule 144
3. unless small certain quantity apply:

Shelf Registration

A relatively new method of registration under the Act of '33 is known as shelf registration. Under this rule, an issuer may register any amount of securities that, at the time the registration statement becomes effective, is reasonably expected to be offered and sold within two years of the initial effective date of the registration. Once registered, the securities may be sold continuously or periodically within 2 years without any waiting period for a registration to clear issuers generally like shelf registration because of the flexibility it gives them to take advantage of changing market conditions. In addition, the legal, accounting, and printing costs involved in issuance are reduced, since a single registration statement suffices for multiple offerings within the 2 year period. In effect, what the issuer does is register securities that will meet its financing needs for the next 2 years. It issues what it needs at the current time, and puts the balance on the shelf" to be taken off the shelf as needed.

SECURITIES MARKETS

The purchase of common stock in an IPO (initial public offering) is facilitated through the use of members an investment bank underwriting syndicate or selling group. This is known as the *primary market* and the proceeds of sale go directly to the issuing company. Six months later however, if a doctor wants to sell his shares, this would be accomplished in the *secondary market*. The term secondary market refers to trading in outstanding issues as the proceeds do not go to the issuer, but to the current owner of the securities, such as the physician investor.

Therefore, the secondary market provides liquidity to doctors who acquired securities in the primary market. After a doctor has acquired securities in the primary market, he wants to be able to sell the securities at some point in the future in order to acquire other securities, buy a house, or go on a vacation. Such a sale takes place in the secondary market. The

medical investor's ability to convert the asset (securities) into cash is heavily dependent upon the secondary market. All investors would be hesitant to acquire new securities if they felt they would not subsequently have the ability to sell the securities quickly at a fair price in the secondary market.

Securities Act of 1934

Every trade of stocks and bonds that is not a purchase of a new issue is a trade that takes place in the secondary market. The market place for secondary trading is the stock exchanges and the over-the-counter (OTC) market, and is governed by the *Securities Act of 1934,* which actually created the *Securities and Exchange Commission (SEC)* and outlines the powers of the SEC to interpret, supervise, and enforce the securities laws of the United States. The Act of 34 is very broad and governs the sales of securities, including the regulation of securities markets exchanges, OTC markets, broker/dealers, their employees, the conduct of secondary markets, the extension of credit in the purchase and sale of securities, and the conduct of corporate insiders (officers and directors and holders of more than 10% of the outstanding stock). The Act also prohibits fraud and manipulative and deceptive activities in securities transactions

The Stock Exchanges

A stock exchange is a private association of brokers. The main purpose of an exchange is to provide a central meeting place for its member-brokers. This central meeting place is called the floor. It is on the floor that the members trade in securities. It is important to remember that a stock exchange itself does not own any of the securities that are traded on its floor. Nor does it buy or sell any of the securities traded on the exchange. Instead, the securities are owned by member firms, customers, or perhaps, by the exchange member firm itself.

It is also important to remember that a stock exchange does not establish or fix the price at which any security is traded on the exchange. The price is determined in a free and open auction type of trading. It depends on the supply and demand relationship of that security at a particular time. In other words, if sellers of a stock are offering to sell more shares of that stock than buyers want to buy, the price of that stock will tend to go down. On the other hand, if buyers want to buy more shares of a stock than the sellers are offering to sell, the price of that stock will tend to go higher because of the strong demand.

Any discussion of stock exchanges has to focus on the New York Stock Exchange [NYSE] which is by far the largest and most important of the exchanges. There are two exchanges referred to as national stock exchanges, the NYSE and the American Stock Exchange (AMEX). In addition to these two national exchanges, there are several regional stock exchanges including the Philadelphia Exchange, the Chicago Exchange (formerly Midwest), the Pacific Exchange, the Boston Exchange, and the Cincinnati Exchange. Stocks that are traded on an exchange are referred to as *listed stocks*. The term "listed on an exchange" means that the issue is eligible for trading on the floor of the exchange.

How does a stock become listed? The issuing company, having decided that they wish the prestige and broad visibility of being listed on the NYSE, applies to the exchange for listing. A critical condition for listing is that the issuer agrees to solicit proxies from those common stock shareholders unable to attend shareholder meetings. Once the securities have been accepted for listing (trading) on an exchange, the issuer must continue to meet certain requirements which are not quite as stringent as the original listing requirements, and may be de-listed if the firm ceases to solicit proxies on its existing voting stock, or meet other minimal requirements.

Physically, the exchange brings together buyers and sellers on a trading floor. The NYSE floor is larger than several football fields and is divided into 19 trading posts. Eighteen of the posts are horseshoe or U-shaped stations 100 square feet in area. The nineteenth post (post number 30) is in the northwest corner and really isn't a post at all; it's just an area where the inactive stocks trade.

The Specialist

Specialists are experts in trading one or more specific stocks at their particular post on the exchange floor. Their activity is vital to the maintenance of a free and continuous market in the specific issues they represent. They are responsible for conducting the auction at the post. Everyone interested in buying the stock calls out a price and the shares go to the

highest bidder. The buyers compete, but there is only one seller. Unlike the usual auction market, the auction on the floor of the exchange is a two way auction with some brokers seeking to buy at the lowest possible price for their doctor clients and other brokers trying to sell at the highest possible price for their doctor clients. When two brokers, one representing a buyer and one a seller, agree on a price, a sale is made. The specialist functions in a dual capacity as a dealer and as a broker. As a dealer or principal, he buys and sells for his own account with risk to maintain a fair and orderly market in the stocks in which he specializes.

For example, if a commission broker approaches the specialist at the post with a buy or sell order, and there are no other brokers in the crowd, that is currently interested in buying or selling the stock, the specialist will buy the stock from that commission broker (if it's a sell order) for his own account or sell the stock from his inventory (if it's a buy order). Perhaps, he may even be able to fill the order from his specialist's book.

Specialist's Book

This is done by using the specialist's book of buy orders (bids), marked on the left hand page, or sell orders (offers) on the right. There is a book for each stock in which the specialist specializes. The pages are ruled and are usually printed with fractional stock points at regular intervals to permit easy insertion of orders. The orders are entered in the book by the specialist according to price and in the sequence in which they are received at the post. He notes the number of shares, putting down 1 for 100 shares, 2 for 200 shares, etc. He also notes the name of the member firm placing the order and if the order is *Good Till Cancelled* (GTC), or not. When orders are executed, they are executed in the same order recorded in the book at that particular price.

The specialist's book also keeps track of all orders "away from the market " (limit orders and stop orders) in his book. The book is organized with all buy orders on the left hand side of the page and all sell orders on the right hand side. In the absence of bids and offers from the "trading crowd" on the floor, the specialist can quote the best available market for the security by announcing the highest bid and the lowest offer (ask). The best bid is always the highest buy limit order on his book and the best offer (ask) is always the lowest sell limit on his book. In addition to quoting the best price, he will also give the "size of the market" which is determined by the number of shares being bid for and offered at the respective best bid and best ask prices. The quote is price and size. When asked to quote the market for a security, the specialist disregards any stop orders on his book since those orders do not become activated until triggered by another trade. One thing to remember is that since most doctors place stop orders to hedge (protect) against a price movement adverse to their interests, most stop orders are entered with the fervent wish that they never be executed.

On stop and limit orders placed below the market, the specialist is required to reduce the price of those orders on the ex-dividend (ex-split, ex-rights) date. The two critical things to remember are: what types of orders are reduced and by how much? The specialist will reduce all GTC (open) buy limit and sell stop orders on an ex-date. The acronym BLISS where the BL equals buy limit and the SS equals sell stop; may be used as a memory aid. The only time either of these orders will not be reduced is if the medical client turned in DNR (do not reduce) instructions. The price of the order is then reduced by enough to equal or exceed the amount of the dividend.

If we go back to the example approaching the specialist to buy or sell stock and there is no one in the "crowd", the specialist will first give the commission broker a quote from his book. That quote will be the highest bid price (the highest priced limit order to buy on his books) and the best asked price {the lowest priced sell limit on his books). If the commission broker is willing to buy at the lowest ask or offering price on the specialist's book, then a trade will take place; if the commission broker is looking to sell and is willing to accept the highest bid price on the specialist's book then, again, a trade will take place. It is the responsibility of the specialist to maintain an orderly market and to keep the spread between the bid and asked prices as narrow as possible. If the spread between bid and asked is too wide to generate market activity, the specialist will act on his own account.

If the specialist is presented with sell orders at the post and he has no buyers, he must bid at least 1/8 of a point higher than the best bid on his books. If he has buyers and no sellers, then he must offer stock from his inventory at a price at least, 1/8 of a point below the lowest offer on his book. Why? It's because the specialist cannot "compete" with public orders and if his bid matched a customer's bid or his offer matched a customer's offering or ask price, he would be considered to be "competing". Since the specialist is required to bid higher and ask lower than the best public orders on his book, the

spread is narrowed. That is why it is said that the specialist acts in a dual capacity, as a dealer and as a broker. When buying and selling for his own account, he is acting as a dealer. The specialist acts as a broker when he executes limit orders left with him by commission brokers. When these limit orders are executed out of the specialist's book (the doctor's limit price is reached), the specialist uses a priority, parity, and precedence system, as to which order is executed first. These rules, like most others, are designed to give preference to the general public, not to members of the exchange, on a first come first served basis.

Walking Through a Trade

To see how the transactions are actually handled on the floor of an exchange, let us assume that an order to buy 100 shares of General Electric has been given by a customer to the registered representative of a member firm in Atlanta. The order is a market order (an order to buy at the lowest possible price at the time the order reaches the floor of the exchange). This order is telephoned by direct wire or computer to the New York office of the member firm, which in turn telephones its order to its clerk on the floor of the exchange.

Each member firm has at least one member of the exchange representing them and making trades on the floor. Each one of these members is assigned a number for identification. When the floor clerk receives the order to purchase the General Electric, he causes his member call number to appear on 3 large boards situated so that one is always in view. These boards are constantly watched brokers so that they will know when they are wanted at the phone, since there's too much noise on the floor to use a paging system. Seeing his number on the board, the broker hurries to his telephone station or cell phone and receives the order to buy 100 shares of G.E. "at the market". Acting as a commission broker, he immediately goes to the post where G.E. is traded and asks "how's G.E", of the specialist?

Order and Position Types

At this point, it is important to understand the different types of orders and positions that can be used to buy and sell securities from the specialist.

Market Order:

A market order is an order to be executed at the best possible price at the time the order reaches the floor. Market orders are the most common of all orders. The greatest advantage of the market order is speed. The doctor specifies no price in this type of order, he merely orders his broker to sell or buy at the best possible price, regardless of what it may be. The best possible price on a buy is the lowest possible price. The best possible price on a sell is the highest possible price. In other words, if a medical professional customer is buying, he logically wants to pay as little as possible, but he is not going to quibble over price. He wants the stock now, whatever it takes to get it. If he's a seller, the doctor client wants to receive as much as possible, but will not quibble, he wants out, and will take what he can get, right now. No other type of order can be executed so rapidly. Some market orders are executed in less than one minute from the time the broker phones in the order. Because the investor has specified no price, a market order will always be executed. The doctor is literally saying, "I will pay whatever it takes, or accept whatever is offered".

Limit Order:

The chief characteristic of a limit order is that the doctor decides in advance on a price at which he decides to trade. He believes that his price is one that will be reached in the market in reasonable time. He is willing to wait to do business until he has obtained his price even at the risk his order may not be executed either in the near future or at all. In the execution of a limit order, the broker is to execute it at the limit price or better. Better, means that a limit order to buy is executed at the customer's price limit or lower, in a limit order to sell, at price limit or higher. If the broker can obtain a more favorable price for his doctor customer than the one specified, he is required to do so.

Order Length:

Now, even though the doctor has given his price limit, we need to know the length of effectiveness of the order. Is the order good for today only? If so, it is a day order, it automatically expires at the end of the day. Alternatively, the doctor

may enter an open or, "good until canceled" order. This type of order is used when the doctor believes that the fluctuations in the market price of the stock in which he's interested will be large enough in the future that they will cause the market price to either fall to, or rise to, his desired price, i.e. his limit price. He is reasonably sure of his judgment and is in no hurry to have/his order executed. He knows what he wants to pay or receive and is willing to wait for an indefinite period.

Years ago, such orders were carried for long periods of time without being reconfirmed. This was very unsatisfactory for all parties concerned. A doctor would frequently forget his order existed and, if the price ever reached his limit and the order was executed, the resulting trade might not be one he wished to make. To avoid the problem, open (GTC) orders must be reconfirmed by the doctor customer each six months. Does that mean six months after the order is entered? ...No! The exchange has appointed the last business day of April and the last business day of October as the two dates per year when all open orders must be reconfirmed.

*Example***:** Dr. Smith wants to buy 100 shares of XYZ. The price has been fluctuating between 50 and 55. He places a limit order to buy at 51, although the current market price is 54. Limit orders to buy (buy limit orders) are always placed below the current market. To do otherwise makes no sense. It is possible that, within a reasonable time, the price will drop to 51 and his broker can purchase the stock for him at that price. If the broker can purchase the stock at less that 51, that would certainly be fine with the doctor customer since he wants to pay no more than 51. A sell limit order works in reverse and is always placed above the current market price.

*Example***:** Dr. Smith wants to sell 100 shares of XYZ stock. The order is 54. A sell limit order is place at 56. Sell limit orders are always placed above the market price. As soon as the pride rises to 56, if it ever does, the broker will execute it at 56 or higher. In no case will it be executed at less than 56.

The advantage of the limit order is that the doctor has a chance to buy at less or to sell at more than the current market price prevailing when he placed the order. He assumes that the market price will become more favorable in the future than it is at the time the order is placed. The word" chance" is important. There is also the "chance" that the order will not be executed at all. The doctor just mentioned, who wanted to buy at 51, may never get his order filled since the price may not fall that low. If he wanted to sell at 56, the order may also not ever be executed since it might not rise that high during the time period the order is in effect.

Stop Orders:

A very important type of order is the stop order, frequently called a stop-loss order. There are two distinct types of stop orders. One is the stop order to sell, called a sell stop, and the other is a stop order to buy, called a buy stop. Either type might be thought of as a suspended market order; it goes into effect only if the stock reaches or passes through a certain price.

The fact that the market price reaches or goes through the specified stop price does not mean the broker will obtain execution at the exact stop price. It merely means that the order becomes a market order and will be executed at the best possible price thereafter. The price specified on a stop order bears a relationship to the current market price exactly opposite to that on a limit order. Whereas a sell limit is placed at a price above the current market, a sell stop is placed at a price below the current market. Similarly, while a buy limit is placed at a price below the current market, a buy stop is placed at a price above the current market. Why would a doctor investor use a stop order?

There are two established uses for stop orders. One of them might be called *protective;* the other might be called *preventive.*

Protective:

This order protects a doctors' existing profit on a stock currently owned. For example, a doctor purchases a stock at 60. It rises to 70. He has made a paper profit of $10 per share. He realizes that the market may reverse itself. He therefore gives his broker a stop order to sell at 67. If the reversal does occur and the price drops to 67 or less, the order immediately becomes a market order. The stock is disposed of at the best possible price. This may be exactly 67, or it may be slightly

above or below that figure. Why? ...Because what happened at 67 was that his order became a market order; the price he actually received was dependent upon the next activity in the market. Let us suppose that the sale was made at 66 1/2. The doctor customer made a gross profit of 6 1/2 points per share on his original purchase. Without the stop order, the stock may have dropped considerably below that before the customer could have placed a market order and his profit might have been less or, in fact, he might have even sold at a loss.

Preventive:

A doctor purchases 100 shares of a stock at 30. He obviously anticipates that the price of the stock will rise in the near future (why else would he buy?). However, he realizes that his judgment may be faulty. He therefore, at the time of purchase, places a sell stop order at a price somewhat below his purchase price, for example, at 28. As yet, he has made neither profit nor loss; he's merely acting to prevent a loss that might follow if he made the wrong bet and the stock does fall in price. If the stock does drop, the doctor knows that once it gets as low as 28, a market order will be turned in for him and, therefore, he will lose only 2 points or thereabout. It might have been much more had he not used the sell stop.

Miscellaneous Orders and Positions

Beside market, limit and stop orders, there are some other miscellaneous orders for the ME, Inc physician or guided investor, to know:

A *stop limit order* is a stop order that, once triggered or activated, becomes a *limit* order. Realize that it is possible for a stop limit to be triggered and not executed, as the limit price specified by the doctor may not be available.

In addition, there are *all or none* and *fill* or *kill orders*, and even though both require the entire order to be filled, there are distinct differences. An all or none (AON) is an order in which the broker is directed to fill the entire order or none of it. A fill or kill (FOK) is an order either to buy or to sell a security in which the broker is directed to attempt to fill the entire' amount of the order immediately and in full, or that it be canceled.

The difference between an all or none and a fill or kill order is that with an all or none order, immediate execution is not required, while immediate execution is a critical component of the fill or kill. Because of the immediacy requirement, FOK orders are never found on the specialist's book. Another difference is that AON orders are only permitted for bonds, not stocks, while FOK orders may be used for either.

Also, there exists an immediate or cancel order (IOC), which is an order to buy or sell a security in which the broker is directed to attempt to fill immediately as much of the order as possible and cancel any part remaining. This type of order differs from a fill-or-kill order which requires the entire order to be filled. An IOC order will permit a partial fill. Because of the immediacy requirement, IOC and FOK orders are never found on the specialist's book.

Long and Short Positions

A long buy position means that shares are for sale from a market makers inventory or owned by the medical investor outright. Market makers take long positions when customers and other firms wish to sell, and they take short positions when customers and other firms want to buy in quantities larger than the market maker's inventory. By always being ready, willing, and able to handle orders in this way, market makers assure the investing public of a ready market in the securities in which they are interested. When a security can be bought and sold at firm prices very quickly and easily the security is said to have a high degree of liquidity, also known as marketability.

A short position investor seeks to make a profit by participating in the decline in the market price of a security.
Now; let's see how these terms, long and short, apply to transactions by medical investors [rather than market makers] in the securities markets.

When a doctor buys any security - he is said to be taking a long position in that security. This means the investor is an owner of the security. Why does a doctor take a long position in a security? Well, receiving dividend income to make a profit from an increase in the market price is one reason. Once the security has risen sufficiently in price to satisfy the

investor's profit needs, the investor will liquidate his long position, or sell his stock. This would officially be known as a long sale of stock, though few people in the securities business use the label "long sale". This is the manner in which the above investor had made a profit is the traditional method used; buy low, sell high.

Let's look at an actual investment in General Motors to investigate this principle further. A medical investor has taken a long position in 100 shares of General Motors stock at a price of $70 per share. This means that the manner in which he can do that is by placing a market order which will be executed at the best "available market price at the time, or by the placing of a buy limit order with a limit price of $70 per share. The investor firmly believes, on the basis of reports that he has read about the automobile industry and General Motors specifically, that at $70 a share, General Motors is a real bargain. He believes that based on its current level of performance, it should be selling for a price of between $80 and $85 per share. But, the doctor investor has a dilemma. He feels certain that the price is going to rise but he cannot watch his computer, or call his broker, every hour of every day. The reason he can't watch is because patients have to be seen in the office. The only people who watch a computer screen all day are those in the offices of brokerage firms (stock broker registered representatives), and doctor day traders, among others.

In the above example, with a sell limit order, if the doctor investor was willing to settle for a profit of $12 per share, what order would he place at this time? If you said, "sell at $82 good 'til canceled", you are correct. Why GTC rather than a day order? Because our doctor investor knows that General Motors is probably not going to rise from $70 to $82 in one day. If he had placed an order to sell at $82 without the GTC qualification, his order would have been canceled at the end of this trading day. He would have had to re-enter the order each morning until he got an execution at 82. Marking the order GTC (or open) relieves him of any need to replace the order every morning. Several weeks later, when General Motors has reached $82 per share in the market, his order to sell at 82 is executed. The medical investor has bought at 70 and sold at 82 and realized a $12 per share profit for his efforts.

Let's suppose that the medical investor, who has just established a $12 per share profit, has evaluated the performance of General Motors common stock by looking at the market performance over a period of many years. Let's further assume that the investor has found by evaluating the market price statistics of General Motors that the pattern of movement of General Motors is cyclical. By cyclical, we mean that it moves up and down according to a regular pattern of behavior.

Let's say the investor has observed that in the past, General Motors had repeated a pattern of moving from prices in the $60 per share range as a low, to a high of approximately $90 per share. Further, our investor has observed that this pattern of performance takes approximately 10 to l2 months to do a full cycle; that is, it moves from about 60 to about 90 and back to about 60 within a period of roughly l2 months. If this pattern repeats itself continually, the investor would be well advised to buy the stock at prices in the low to mid 60's hold onto it until it moves well into the 80's, and then sell his long position at a profit. However, what this means is that our investor is going to be invested in General Motors only 6 months of each year. That is, he will invest when the price is low and, usually within half a year, it will reach its high before turning around and going back to its low again. How can the doctor-investor make a profit not only on the rise in price of General Motors in the first 6 months of the cycle, but on the fall in price of General Motors in the second half of the cycle? One technique that is available is the use of the short sale.

The Short Sale

If a doctor investor feels that GM is at its peak of $ 90 per share, he may borrow 100 shares from his brokerage firm and sell the 100 shares of borrowed GM at $ 90. This is selling stock that is not owned and is known as a short sale. The transaction ends when the doctor returns the borrowed securities at a lower price and pockets the difference as a profit. In this case, the doctor investor has sold high, and bought low.

Odd Lots

Most of the thousands of buy and sell orders executed on a typical day on the NYSE are in 100 share or multi-100 share lots. These are called round lots. Some of the inactive stocks traded at post 30, the non-horseshoe shaped post in the northwest corner of the exchange, are traded in 70 share round lots due to their inactivity. So, while a round lot is normally 700 shares, there are cases where it could be 10 shares. Any trade for less than a round lot is known as an odd lot. The execution of odd lot orders is somewhat different than round lots and needs explanation.

When a stock broker receives an odd lot order from one of his doctor customers, the order is processed in the same manner as any other order. However, when it gets to the floor, the commission broker knows that this is an order that will not be part of the regular auction market. He takes the order to the specialist in that stock and leaves the order with the specialist. One of the clerks assisting the specialist records the order and waits for the next auction to occur in that particular stock. As soon as a round lot trade occurs in that particular stock as a result of an auction at the post, which may occur seconds later, minutes later, or maybe not until the next day, the clerk makes a record of the trade price.

Every odd lot order that has been received since the last round lot trade, whether an order to buy or sell, is then executed at the just noted round lot price, the price at which the next round lot traded after receipt of the customer's odd lot order, plus or minus the specialist's "cut ". Just like everything else he does, the specialist doesn't work for nothing. Generally, he will add 1/8 of a point to the price per share of every odd lot buy order and reduce the proceeds of each odd lot sale order by 1/8 per share. This is the compensation he earns for the effort of breaking round lots into odd lots. Remember, odd lots are never auctioned but, there can be no odd lot trade unless a round lot trades after receipt of the odd lot order.

Over The Counter (OTC) Markets

Securities are bought and sold every day by medical investors who never meet each other. The market impersonally enables transfer (or sale) of securities from individuals who are selling to those who are buying. These trades may occur on an organized exchange such as the New York Stock Exchange, or a decentralized dealer-to-dealer market, which is called the over-the-counter (OTC). Any transaction that does not take place on the floor of an exchange, takes place over-the-counter.

The over-the-counter market is a national negotiated market, without a central market place, without a trading floor, composed of a network of thousands of brokers and dealers who make securities transactions for themselves and their customers. Professional buyers and sellers seek each other out electronically and by telephone and negotiate prices on the most favorable basis that can be achieved. Often, these negotiations are accomplished in a matter of seconds; there is no auction procedure comparable to that on the floor of an exchange.

The over-the-counter market is by far the largest market in terms of numbers of securities issues traded. There are over 30,000 issues on which regular quotations are published OTC; while there are less than 4,000 stocks listed on all securities exchanges. There are frequently days when the reported volume of over-the-counter trades exceeds that of the NYSE. What really is the over-the-counter market? Is it where securities of inferior quality trade? Here is a list to remember of the types of securities traded exclusively over-the- counter:

- All Government bonds.
- All municipal bonds.
- All mutual funds.
- All new issues (primary distributions).
- All variable annuities.
- All tax shelter programs.
- All equipment trust certificates.

Of course, the OTC market is also where all of the "unseasoned" issues are traded and most of them are quite speculative, but there certainly are many high quality issues available over-the- counter. Now, let's take a look at how this over-the-counter market works.

Market Maker

Whereas, the "main player" on the exchange is the specialist, his OTC counterpart, in terms of importance, is the market maker. In the over-the-counter market, many securities firms act as dealers by creating and maintaining markets in selected securities. Dealers act as principals in a securities transaction and buy and sell securities for their own account and risk. Since they do not act as agents or brokers but instead as principals or dealers in securities transactions, they do not receive any commission for their services but instead buy at one price and sell at a higher price making a profit from

"mark-up" on the security price. A dealer is said to have a position in a stock when he purchases and holds a security in his inventory. He, of course takes a risk that the market price of the security he holds may decline in value. This is how dealers make money; they buy wholesale and sell it retail, and the medical professional or other investor pays retail.

The OTC market bears little resemblance to the one of the mid-sixties. The major difference has been the electronic technological advances as embodied by the NASDAQ system. NASDAQ stands for National Association of Securities Dealers Automated Quotation system. Back in 1966, if you wanted to find out who was the market maker in the particular security you would go to a brightly colored stack of papers called the pink sheets, containing a listing, alphabetically, of over-the-counter stocks and underneath each issue is listed the name of one or more market makers, securities firms willing to trade that stock. After each firm name is the firm's telephone number and a "bid and ask price", that is, an approximate price representing what the dealer is asking for the stock and is bidding for the stock.

Back 35 years ago, the only way of locating a market maker was by using the pink sheets, while 0-T-C traded corporate bonds are quoted on yellow sheets. Under certain conditions, it could take a good deal of effort to try to get the best deal. Today, with the computer that sits on doctor's desks, you can push a few buttons and instantaneously see the best bid and the best offer that exists right now on over 4,000 of the most active over-the- counter stocks. Not only that, you can pull up the names of every market maker in that particular stock and the actual (firm) quotes on those securities right now.

Electronic Sources of Securities Information

Level 1 service, available on the stock broker's desk top, provides price information only on the highest bid and the lowest offer (the inside market). No market makers are identified, and since this is an inside quote, it may not be used by the registered representative (stock broker) for giving firm quotes.

Level 2 service provides a doctor subscriber with price information and quotation sizes of all participating registered market makers. When a trader, or medical investor, looks at his computer screen on Level 2, he sees who's making a market, their firm bid-or-ask, and the size of the market. One can get firm calls from level 2 information.

Level 3 takes it one step further; and allows registered market makers to enter bid and ask prices (quotes) and quotation sizes into the NASDAQ system and to report their trades. This is the level of service maintained by market makers.

Third Market

In most cases, a market maker of a stock in the NASDAQ system must report his trade in 90 seconds, but there is another circumstance in which the trade must be reported. This is called the third market, and is defined as transactions in exchange listed securities in the OTC market. For example, even though IBM is listed on the NYSE, an OTC market marking firm can acquire the IBM stock and begin to make a market for it just like an OTC stock. All of these trades are considered the third market, and are reported to the Consolidated Quotation System (CQS) within 90 seconds of the trade.

Fourth Market

The fourth market is defined as private transactions made directly between large medical investors, institutions such as banks, mutual funds, and insurance companies, without the use of a securities firm. In other words, fourth market trading is usually one institution swapping securities in its portfolio with another large institution. From the stock broker's viewpoint, there is one problem with the fourth market. Since no broker/dealer is involved, no registered representative is involved and there is no commission to be earned. These trades are reported on a system called *Instinet.* This is advantageous to larger medical foundations or institutional investors.

BROKERAGE ACCOUNTS, MARGIN AND DEBT

Most medical professionals execute orders, and buy securities, for cash. This occurs either through a stock broker, telephone order, computerized on-line trade or the rapid fire buy/sell momentum of day trading. Regardless, since cash is used, this brokerage account is known as a *cash account.* Now; we will explore the use of credit to buy securities. This

process, called buying on margin, is done in a *margin account***,** and is allowed through an SEC ruling known as Regulation T.

Regulation T

Regulation T, of the Securities Exchange Act of 1934, defined the two basic types of accounts, cash and margin. A cash account is one in which the medical professional agrees to pay the full purchase price of his trade within 3 full business days of the trade date. The trade date is the day on which the buy order was executed, either on an exchange, or over-the-counter (0TC). Regulation T requires a broker/dealer to cancel the trade if payment is not made on time.

If the doctor-client has made a partial payment but owes more than $1,000 by the end of the 3rd business day, the unpaid portion will be sold off. If, however, only $1,000 or less is owed, the broker/dealer is permitted to use its own best judgment as to whether to give the doctor client more time to come up with the amount owed.

If a doctor-client feels his reasons for not paying on time are exceptional, a request can be made by the broker/dealer for an extension of the 3 business day time limit. Only three organizations can approve such an extension: a national securities exchange, the National Association of Securities Dealers (NASD) – Financial Industry Regulatory Authority [FINRA], or a Federal Reserve Bank.

If a doctor-client violates Regulation T, his broker/dealer will cancel the trade or liquidate the unpaid portion, and his cash account will be *frozen* for 90 *calendar days.* This means that if the doctor wishes to purchase additional securities in his cash account during the next 90 days, he must pay for the trade in full *in advance.* An easy way to remember the rule is: in a frozen cash account, cold cash up front is required for new purchases. Interestingly, margin accounts are never frozen, only cash accounts.

Regulation T Percentage (Credit)

The use of credit to finance securities transactions is governed by Regulation T of the Securities Exchange Act of 1934. Regulation T empowers the *Federal Reserve Board* to establish standards by which such transactions may take place. These standards include margin ability (which securities may be purchased on credit), and the applicable percentage of down payment required from the doctor when financing such a transaction. This percentage is commonly referred to as the Regulation T percentage, or just Regulation T.

Although Regulation T is 50% today, and has been since January, 1974, the following examples will assume a Regulation T of 60% (unless otherwise stated), strictly for the purposes of clarity since using 50 % can sometimes become confusing when discussing the 50% down payment versus the other 50%, which is the loan value.

Margin Terms and Definitions

1. A M*argin Account* is opened for the purposes of engaging in securities transactions using credit extended by the brokerage firm.

2. Hypothecation is the pledging of securities as collateral for a margin loan. Before a brokerage firm can lend any money whatsoever, the law requires the loan to be secured or collateralized. The doctor desiring the loan hypothecates the stock in order to obtain the financing in the margin account.

3. Rehypothecation is a brokerage firm's pledge of a doctor's securities to secure loans from a bank. These loans help the brokerage industry to afford to carry margin accounts for their doctor clients. Legally, the maximum dollar amount of a security that may be re-hypothecated for carrying a margin account is 140% of the loan.

4. Street Name Registration occurs so a broker may be in a position to liquidate the loan collateral quickly, since the securities are registered in the name of the brokerage firm, or its nominee.

5. Beneficial Owner represents the healthcare professional whose securities are registered in street name remains the actual owner of all benefits of ownership, such as dividends or interest, capital appreciation, voting rights, pre-emptive rights, and, of course, the right to sellout the position and liquidate the account in whole or in part. Remember, though, the securities are actually in the name of the brokerage firm.

6. Commingling is an abuse that occurs when a brokerage firm mixes, or combines, its own securities with those of its clients to obtain loans and other benefits that go beyond what is fair and reasonable according to the law. This is an illegal practice.

7. Debit Balance is the amount of the loan from the brokerage firm, to the doctor, to finance the purchase of margin able securities.

Now let's learn the mechanics of the loan by working a problem from the inception of physician-client Dr. William D. Smith's margin purchase through the effects of market fluctuations on the account's status.

Initial Margin Call and Equity

Let's suppose that Dr Smith purchases 100 shares of Microsoft stock, at $100 per share, in a margin account, with Regulation T at 60%. To calculate the initial margin call, use the formula: Regulation T times purchase price or, 60% x $10,000 = $6,000. A phrase to clearly express equity in a margin account is: "what you own, minus what you owe, is your equity".

Note, since the doctor is required to put up $6,000, the broker is lending the other $4,000, or 40%, of the purchase price. This 40% figure is known as the loan value of the account and represents the maximum loan the broker is permitted to extend to Dr. Smith based upon current market value. This percentage and the Regulation T % will always add up to 100%.

Securities in Lieu of Cash

An initial margin call may also be met with securities, in lieu of cash. Since a stock broker (registered representative) is permitted to loan 40% of the current market value (CMV)of their securities (Regulation T @ 60%), Dr. Smith can deposit into his margin account stock he owns outright, obtain a loan of 40% of CMV, and utilize that loan to meet a margin call on a purchase.

For instance, in the initial example in which Dr. Smith purchased $10,000 worth of Microsoft stock, the margin call could have been satisfied with $15,000 worth of fully-paid-for margin able stock in lieu of cash: 60% / 40% x $10,000 = $15,000.

In other words, the $10,000 purchase would require a cash deposit of 60% or $6,000. Since Dr. Smith is not going to put up cash, he must deposit marginable securities with a loan value of $6,000. The broker/dealer will loan him the $6,000, if he will deposit $15,000 of paid for securities. Again, here's how he does it: $ 6,000 = 40% /$15,000

Excess Equity (SMA) and Buying Power

Let's look at what happens should Microsoft stock appreciate in value. Suppose the stock rises in price from $100, to $120 per share, or to $ 12,000. The main thing to keep in mind is that while the market value of the shares changes continuously in the marketplace, Dr. Smith's original loan from the broker does not change. The debit balance remains constant. An analogy that may be helpful is that homeowner Dr. Smith's mortgage does not change when there is a rise in the value of his property.

Note that since the debit does not change, the equity increased exactly $2,000, the same as the amount of increase in the CMV ($12,000 -$10,000). Any change in market value (either up or down) causes a dollar for dollar change in equity. When securities purchased in a margin account increase in value, we have a situation called excess equity. Let's examine this concept further by looking at the example after its appreciation to the new CMV of $12,000.

Your broker is permitted to give loans of 40% of the current market value of Microsoft, with Regulation T at 60%. Thus, the amount that could be loaned to Dr. Smith, on securities which are now worth $12,000, is $4,800. (40% times $12,000). However, the doctor has only borrowed $4,000 to this point in time. Therefore, there is an $800 ($4,800 -$4,000) amount that represents additional borrowing power available to Dr. Smith if, and when, he wishes to utilize it. This $800 is called excess equity, also referred to as SMA, which is the Special Memorandum Account that brokers use to record excess equity. Dr Smith has three distinct choices regarding excess equity.

1. First, he could borrow it in cash and remove it from the account.

In this case, the doctor requests that the cashier forward a check for $800. When this is done, the doctor's new debit balance is $4,800, because he is, in fact, borrowing the money. It may be easier to understand SMA, if you consider the initials to stand for, Second Mortgage Account. In the same way that an increase in the market value of a home makes it possible to obtain a second mortgage (the lender is willing to loan money on the higher collateral value), an increase in the market value of an account gives more collateral which translates into more loan value or SMA. But, just as taking out a second mortgage (or home equity loan) on your home increases total indebtedness (your first and second mortgages) removing your SMA increases your debit balance.

2. Second, he could use it to buy more Microsoft stock.

In this case, Dr. Smith may make an additional purchase in his margin account and utilize the excess equity to "offset" his Regulation T down payment requirement on the new purchase. For example, he could make a $12,000 new purchase and be required to deposit only $6,400, instead of the $7,200 that would have been required under Regulation T had there been no excess equity in the account.

3. Thirdly, he could reserve the right to do either l, or 2, at a later time.

Now let's compute the exact amount of securities he can buy without putting up any new money, using only excess equity to meet the call, with the formula:

EXCESS EQUITY / REGULATION T = $800 / 60% = $1,333.33, called *BUYING POWER.*

This means that if Dr. Smith were to place an order to buy exactly $1,333.33 worth of Microsoft stock on margin, he would not have to put up a penny out of his own pocket. To verify, compute the normal Regulation T margin call on a $1,333.33 purchase: 60% x $1,333.33 = $800. This "call" for $800 would be "met" by instructing his-broker that he wishes to use the excess equity of $800 in his account for that purpose.

The easiest way to remember the formula for buying power is by using the expression SMA/RT.
In this case, SMA / RT means SMA divided by the Regulation T%, by remembering the expression, "it's SMART to use your buying power". In this case, Dr. Smith chooses to wait until a later time to utilize his excess equity and his buying power. To this end, brokerage firms normally make a written record of the amount of the excess equity at the time it is created by a rise in CMV. In this way, it is reserved for future use.

From an accounting point of view, the broker will make a written entry in the Special Memorandum Account (SMA). Among other things, this special account is used to record these additional loan amounts that result due to market value increases. What do you think happens when a cash dividend is received on stock held in a margin account? Dr. Smith has the option of taking the dividend out of the account or leaving the money in. If he chooses the latter, from a bookkeeping standpoint, the cash is used to reduce the debit balance and the SMA is increased by that amount.

Once the excess equity amount has been entered into the SMA, it remains there until used, even if the market turns down subsequently. This is done primarily to encourage additional transactions, by Dr. Smith, even if he didn't wish to act at the precise moment the excess equity comes into existence. Remember this important statement about SMA: You only lose it, if you use it! Excess equity has been given many names in Wall Street jargon. Among them are: equity excess, margin excess, Regulation T excess, SMA, or additional loan value.

Restricted Accounts

Let's now take a look at what happens in a margin account when CMV declines. In the following examples, Regulation T of 50% is used. Assume a purchase of l00 Microsoft shares at $80, followed by a decline in CMV to $70. Note as before, the debit balance is constant and the equity changed exactly
$1,000, the same amount the CMV changed downward.

Initial CMV		**CMV after Decline**	
CMV	$ 8,000	CMV	$ 7,000
(-) Debit	$ 4,000	(-)	$ 4,000
Equity	**$ 4,000**	**Equity**	**$ 3,000**

A margin account in which the equity has fallen below the Regulation T percentage is called a Restricted Margin Account. Therefore, the account is restricted since it has less than $3,500 equity and the equity percentage is 43% ($3,000 / $ 7,000), rather than 50% ($3,500 / $ 7,000). What are the consequences of a restricted account on subsequent purchases, and sales?

Purchases - A doctor wishing to buy additional securities in a restricted account will find there are no restriction on the ability to do so. He is only required to deposit the Regulation T percentage on each new purchase, just as in a non-restricted account.

Sales - A doctor wishing to liquidate some of his holdings in a restricted margin account will find that the Retention Rule of the Federal Reserve comes into play. The Retention Rule requires the brokerage firm to retain 50% of the sale proceeds and use this retention to reduce the client's debit balance. The other 50% is made available to the client to do with as he so chooses. He may take it in cash, buy more stock, or leave it in the account for future use.

For instance, in the above example, suppose Dr. Smith sells 10 of his 100 Microsoft shares, at the CMV of $70 per share. What transpires?

Liquidation proceeds = 10 x $ 70 = $ 700
Retention by broker = 50% x $ 700 = $ 350
Available to Dr. Smith = $700 - $ 350 = $ 350

Failure to Meet a Margin Call

If a medical professional doesn't meet an initial margin call under Regulation T in an existing margin account, the firm is required to sell off securities in the account in an amount equal to twice the margin call, assuming Regulation T is 50%. However, the account would not be frozen, since only a cash account can be frozen.

Withdrawal of Distributions in a Restricted Account

In a restricted account, it is the usual industry practice that all dividends and interest received are automatically taken out of the margin account, and put into the SMA (Special Memorandum Account) on the day received. For example, if dividends of $200 were received into the account, the debit balance would be reduced by $200 and the SMA increased by that same $200.

Same Day Substitutions

This term refers to the netting of a purchase and sale of different securities in a doctor's restricted margin account, on the same day. A determination of any margin call due, or proceeds due a doctor, is done by the brokerage firm, at the end of the day.

*Example***:** If, in a restricted margin account, Dr. Jones makes a same day substitution by selling $ 5,000 of Lucent stock, and then purchases $ 6,000 of Cisco systems, with Regulation T at 60%, the required margin deposit would be $ 600. The net trade in this case is a buy of $1,000. The Regulation T on a buy of $1,000 is 60% of that, or $600.

Sales in a Non-Restricted Account

If a doctor's equity is equal to the Regulation T percentage, a sale of securities in her account releases proceeds equal to the Regulation T percentage.

For example:

$ 10,000 CMV	Sell $ 1,000 worth of securities
- $ 4,000 Debit	$ 1,000 X 60% = $ 600 to Dr. Jones
$ 6,000 Equity (60% = Regulation T)	$ 1,000 X 40% = $ 400 to pay down debit balance.

Minimum Maintenance Requirements (Long Cash Account)

What happens if the market continues to decline, say to $50 per share? Again, keep in mind that the debit balance remains constant, as the market value changes. Then, $5,000 CMV - $ 4,000 debit = $ 1,000 equity. Again as before, the doctor's equity has changed by the exact amount of the change in CMV (a $3,000 decline in the market = a $3,000 decline in equity). And, suppose the market continued to decline to a point below $40 per share? In what position would that put the brokerage firm? It would be holding collateral worth less than $4,000 on a loan of $4,000 which is an intolerable situation for any lender! In fact, to prevent this from occurring, the SROs created a rule which requires a client to maintain at all times equity of at least 25% of the market value of the securities in his margin account. This is known as the Minimum Maintenance Requirement.

To better understand maintenance, let's look again at the above account with the $1,000 equity and the $5,000 CMV. The NYSE / NASD minimum equity requirement of this account is 25% of $5,000 or $1,250. Therefore, there is a deficiency of $250 ($1,250- $1,000) in this account.

An account with equity below the NYSE / NASQ minimum maintenance requirement is called an under-margined account. NYSE / NASD rules insist that if equity drops below 25% it must be brought back up to 25% immediately. Note that there is no requirement to bring the equity back to a point higher than the minimum 25% level. The doctor in this example will be issued a maintenance margin call in the amount of the $250 deficiency. The $250 is used by the firm to reduce the debit balance.

Note that before the maintenance call was satisfied, the equity percentage was 20% ($1,000/$5,000). After the call was satisfied, the equity percentage rose to 25% ($1,250/$5,000); the minimum equity percentage allowed under this SRO rule.

*Example***:** Suppose a doctor wanted to know how low his account market value could fall before the account would be at the maintenance level. Can he determine the minimum market value down to which an account may drop without incurring a maintenance call? Yes -multiply the doctor's debit balance by 4/3.

In the example we have been using, the doctor's debit balance is $4,000. We can immediately compute the market value down to which the account may drop as follows:

4/3 x Debit = maintenance Level
4/3 x $ 4,000 = $ 5,333.33

This means, if the stock drops from $80 per share to $53.33 per share, the equity in the account will have fallen to the NYSE minimum level of 25%. ($ 5,333.33 CMV - $ 4,000 debit = $ 1,333.33).

NYSE / NASD Minimum Credit Requirements

These rules stipulate that no brokerage firm may arrange for any credit to any client whose margin account does not have equity of at least $2,000. The principal application of this rule is to initial transactions in newly opened margin accounts, however, it does apply at all times.

*Example***:** A doctor buys 100 shares, at $15, in a new margin account. His margin call is $1,500.

Rationale: $2,000 would be too much to require as it exceeds the total purchase price. However, a loan to the doctor isn't allowed to be extended until, and unless, the account has equity of $2,000. The trade is simply paid in full -100% of the purchase price is the margin call.

Example: A doctor buys 200 shares, at $15, in a new margin account (assume Regulation T = 60%).
His margin call is $2,000.

Rational: Regulation T 60% would be $1,800 (60% x $3,000). Since this would be $200 shy of the minimum equity level of $2,000, the call is the $2,000 minimum equity.

Example: A doctor buys 300 shares, at $15, in a new margin account. (assume Regulation T = 60%) His margin call is $2, 700.

Rationale: The account will have equity of $2, 700 (60% x $4,500), which is more than the $2,000 minimum. Therefore, the Regulation T initial requirement prevails.

The important points to remember about minimum credit requirements are:

1. You are not called upon to pay more than the purchase price.

2. You cannot be granted a loan until the account has an equity of at least $2,000.

3. If a decline in the market value of an existing account puts the equity below $2,000, there is no requirement to bring the equity back up to $2,000.

4. You may not withdraw money or securities from the account, if in doing so, you either:
   a. bring the equity below $ 2,000, or
   b. bring the equity below the maintenance level

These are the only times SMA may not be withdrawn from an account

The Short Sale

Selling short is engaged in by medical professionals who anticipate a market decline. By selling borrowed property (shares of stock) at the current market value, the doctor expects to return the borrowed property (shares of the same issuer bought in the marketplace) to the lender, normally the investor's brokerage firm, when the market price is lower, thus profiting from the drop in price.

Essentially; this is the buy low, and sell high philosophy. However, when executing a short sale one is selling high initially, then buying low later to "cover", or close out the deal by buying low and selling high in the reverse order.

Bear in mind that the short seller is borrowing property, not money. However, due to the high degree of risk inherent in short selling, it is permitted only in a margin account. A Regulation T call is required as a show of good faith, a way the client demonstrates the financial wherewithal to buy back the property. Let's look at a short sale transaction and the subsequent effects of market fluctuations on equity, as we did previously with buying on margin (long margin).

Credit Balance and Equity

A doctor shorts (sells short) 100 shares at $100 per share with Regulation T at 60%. The margin account would be credited with the proceeds of the sale, though the doctor has no access to these monies at this point in the deal. The account should also be credited with the doctor's required Regulation T margin call. Therefore, the credit balance in a doctor's margin account is the sum of the proceeds of the short sale, plus the Regulation T margin call. This number will not change, regardless of future market fluctuations. The credit balance in a short margin account is a constant.

What does change with market fluctuations?

1. the cost of buying back the borrowed property to cover the short sale.
2. the equity in the account.

Equity in a short margin account is computed as follows:
Credit of $ 16,000 - CMV $10,000 equals $ 6,000 equity.

Now, let's evaluate the effect of appreciation in the market price
If the stock rises to $120 per share, then the credit of $16,000 – CMV $ 2, 000, equals $ 4,000 equity.

Remember, the credit balance does not change when CMV fluctuates. The equity in this account is no longer Regulation T.

Let's determine the amount by which the account is restricted (remember, any margin account with equity below Regulation T is restricted). Or, 60% X $12,000 = $ 7,200 - $ 4,000 = $ 3,200

Also, it should be clear, the equity percentage of this account is less than 60%, by the formula:
Equity / CMV = $ 4,000/$ 12,000 = 33.33%

This is the basic principle of the short sale; as the market price of the shorted stock increases, the equity decreases. The reverse is also true; as the price declines, the equity rises. Remember, short sellers are anticipating a market decline. Also, when buying long, or selling short, any change in market value causes a dollar for dollar change in equity.

Minimum Maintenance Requirements (Short)

If the market continues to appreciate to $160 per share, the equity drops to zero. Suppose that the market price rose to its theoretical maximum, or infinity? The doctor’s loss would be infinite. Remember, the maximum potential loss on a short sale is unlimited!

To protect against such an occurrence, industry Self Regulatory Organizations (SROs) developed regarding the minimum equity that must be maintained in a margin account. The minimum maintenance in a short account is equity of 30% of CMV. Note that this is higher than the 25 % figure for long margin accounts due to the nature of extreme risk of loss in the short sale.

Given that the CMV has risen to $160 per share ($16,000 total CMV), the minimum equity required to be maintained under SRO rules is 30% x CMV or $4,800 equity. The doctor would receive a $4,800 maintenance call to bring his equity from -0- to the $4,800 minimum.

Remember, as in (cash) long accounts, there is no requirement to bring a margin account up to Regulation T equity. The maintenance equity is the percentage up to which the account must be brought when and if equity drops below the 25% or 30% levels.

Excess Equity (SMA) and Buying Power

We have seen what market appreciation does to a short seller. Let's evaluate the effects of market depreciation in value. If the declines to $85, per share, then $ 16,000 credit – CMV $ 8,500 = $ 7,500 equity. Again, market fluctuations don't affect credit balance. The equity in the account is now higher than Regulation T, and SMA (excess equity) has just been created.

And, as before, excess equity (SMA) can be used to buy more securities. Couldn't it also be used as the Regulation T down payment on another sale? Yes, this is another use of SMA that is called shorting power or "selling power". The formula for buying power as well as shorting power is exactly the same: Remember, it's SMA / RT to use buying power.

In this case, $2,400 / 60% = $4,000 of buying (shorting) power after the decline to $85, the doctor could buy long or sell short another $4,000 worth of stock and use his SMA to meet his 60% ($2,400) Regulation T Margin call. Recall, the margin call for a short sale is the same as for a long purchase.

Cheap Stock Rule

The SROs created a set of special maintenance rules in short margin accounts to protect against unreasonable risk in low-priced issues. These rules are appropriately labeled the "cheap stock" rules.

At all times, a doctor must maintain equity in a short margin account of the greater of the following:

1. 30% of the CMV (SRO Minimum Maintenance Requirement)
2. $2,000 (SRO Minimum Credit Requirement)
3. Equity as required under the rules below

The cheap stock rules are as follows:

Stock Price	**Minimum Maintained Equity**
0 – $2.50 per share	$ 2.50 per share
$2.50 – $5.00 per share	100% of per share price
$5.00 per share and up	$ 5.00 per share

Example: A doctor shorts 1,000 shares of a $1.50 per share stock. How much must he deposit initially and how much must be maintained in the account?

First, since Regulation T won't come into play until equity hits $2,000 the SRO minimum credit requirement of $2,000 should come into play. However, since this is a cheap stock, we determine if the requirements of those special rules require more than $2,000. They do, and require a minimum be maintained in this short margin account of at least $2.50 per share sold short (1,000 shares at $2.50 each = $2,500 minimum that needs to be in this account at all times to comply with SRO rules).

Furthermore, if the market begins to rise, the cheap stock rules would require that at all times the amount of money in the account be at least 100% of the price per share until the stock hits $5. For example, if the stock rose to $4 per share, the doctor would have to have $4,000 in the account to carry the position (1,000 shares times 100% of CMV, $4 per share in this case).

Options Trading

Stock options are contracts that obligate medical investors to either buy or sell a stock at a specific price, by a specific date. For example, a put option is a bet on falling prices. Let's suppose Dr. Jane Smith holds a put option on XYZ stock, with a $ 50 exercise price, and the stock falls to $ 45. The value of the put rises in the options market because it lets her sell a $ 50 share, which is above the market price. A call option, on the other hand, is a bet on rising prices. Again, Dr. Smith holds a call option on XYZ stock, with an exercise price of $ 50. If the share rises to $ 55, the value of the option increases since she may buy for $50, a stock now worth $ 55.

In 1999, Charles Schwab, the biggest on-line brokerage executed more than 30 million option trades. Due to this demand, Schwab launched other complex services, such as the on-line simultaneous buying and selling of options. Also crowding the options field, are new upstart on-line brokerages, such as: Interactive Brokers, Preferred Capital Markets Technology and CyberCorp. They provide powerful software which will allow options in the future to trade as effortlessly and efficiently as stocks.

In mid-2000 the Reuters Group PLC Instinet Corporation, the electronic network most widely used by institutional investors, opened an Internet brokerage aimed at consumers, including healthcare practitioners. Instinet will let retail clients place orders alongside institutions, and will offer access to charts, news and research. Thus, artificially empowering the individual investor, as well as again tempting the compulsive prone addict.

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OVER HEARD IN THE DOCTOR'S LOUNGE
[On Projecting PP-ACA Winners and Losers]

The first trading session following the election on Wednesday, November 7, 2012 gave us some clues on how different sectors of the health care market may be affected by the PP-ACA, as President Obama's election win confirmed that health reform marches forward. "Mr. Market" will speak.

For those that may be unaware, "Mr. Market" was Benjamin Graham's term for the stock market in explaining fluctuations. Graham is the father of value investing and Warren Buffet's most influential mentor. According to Graham, Mr. Market is emotionally unstable but doesn't mind being slighted. If Mr. Market's quotes are ignored, he will be back again tomorrow with a new quote.

So, the point is that successful investors do not place themselves in emotional whirlwinds often created by the market. This first post-election trading session was one such a whirlwind. Large groups of people (such as those that voted with their pocketbook in this telling stock market session) are smarter than an elite few, or so goes the premise of James Surowiecki's Wisdom of the Crowds.

Now; what did we learn from the combined investing public wisdom about the future of healthcare companies profitability with ACA?

David K. Luke MIM, MS-PFS, CMP™
[Net Worth Advice]
Salt Lake City, Utah

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Future Prognostications?

Keep in mind the overall market was down 2.4% on the day as measured by both the Dow Jones Industrial Average and the Standard & Poor 500. The biggest concern of the day was investor worry about the so called "fiscal cliff" and the debate over billions in spending and tax increases. Considering the total market on November 7th 2012, health care stocks performed as a group better than the averages, but Mr. Market definitely parsed health care stocks by sector from "great" to "dreadful" based on the implications of impending health care reform:

Great:

Hospital Stocks

- Health Management Associates (HMA) +7.3%
- HCA Holdings Inc. (HCA) +9.4%
- Community Health Systems Inc. (CYH) +6.0%
- Tenet Healthcare Corp. (THC) +9.6%

Yes, there were stocks that went up stridently on the big down day. Not surprisingly, hospital stocks are expected to benefit from the estimated 30 million Americans lined-up for the insurance coverage that began in 2014, increasing profits and decreasing bad debts.

Medicaid HMOs

- Molina Healthcare Inc. (MOH) +4.6%
- Centene Corp. (CNC) +10.1%
- WellCare Health Plans Inc. (WCG) +4.4%

Health insurers that typically focus heavily on Medicaid are up in line with ACA provisions to expand care for the poor. Mr. Market tips his hat to Centene Corporation, which has been successful in procuring multi-line coverage contracts with States including long-term care, vision, dental, behavioral health, CHIP and disability.

Good:

Drug Wholesalers

- McKesson (MCK) +1.3%
- Cardinal Health (CAH) +.5%
- AmerisourceBergen (ABC) +1.0%

Growth in prescription drug spending means increased revenues for the drug wholesalers, so the ACA should ultimately be a positive for this group. But, because a majority of wholesaler profits come from generic drugs, and because wholesalers are indirectly affected by changes in pharmacies, pricing pressures will keep the wholesalers in check.

Fair:

Pharmacy Benefit Mangers

- Express Scripts (ESRX) -0.4%
- CVS Caremark Corp (CVS) -0.4%

As an intermediary between the payer and everyone else in the health-care system, PBMs process prescriptions for groups such as insurance companies and corporations and use their large size to drive down prices. These companies are incentivized to cut costs are thought to benefit greatly from ACA, and expanded prescription drug insurance plans.

Generic Pharmaceuticals

- Teva Pharmaceutical Industries Ltd ADR (TEVA) -0.7%
- Mylan Inc (MYL) -0.8%
- Dr. Reddy's Labs (RDY) -0.6%

Health care reform is good for generic drugs with anticipated increased dispensing of drugs in general. With more funds spent on Medicaid, the ACA will certainly be generic oriented and should fare better than the name-brand drugs. Pricing pressures are expected over the longer term however.

Testing Laboratories

- Quest Diagnostics (DGX) -1.5%
- Laboratory Corp of America (LH) -1.9%

More patients than you would think would mean more medical tests. In a recent survey, physicians attributed 34 percent of overall healthcare costs to defensive medicine (think diagnostic blood tests/invasive biopsies, etc). The ACA may curb this expensive part of medicine and appears to have very negative implications

going forward as Labs will have intense pressure to reduce rates. However, these larger labs held up better than the market averages suggesting that lab work isn't going away with ACA.

Big Pharmaceutical Companies

- Pfizer Inc. (PFE) -2.2%
- GlaxoSmithKline PLC (GSK) -0.8%
- Eli Lily & Co. (LLY) -1.2%

The name-brand large Pharmaceutical companies agreed to rebate Uncle Sam on Medicaid purchases and must give the elderly discounts. But, there will be a lot more of us taking drugs too.

These 4 health care sectors are ranked as "fair" considering that broader stock market averages were down 2.4% for the day and Mr. Market was kinder to this group with only a slight negative. Likewise, it appears that he is anointing this group as a benefactor of upcoming reforms.

Not Good:

Medical Device Companies

- Medtronic Inc. (MDT) -3.0%
- Stryker Corporation (SYK) -1.6%
- Boston Scientific Corp. (BSX) -3.6%
- Zimmer Holdings Inc. (ZMH) -1.8%

The 2.3% excise tax on revenue of medical-device companies is looking more inevitable, in spite of industry lobbying group efforts.

Dreadful:

Medicare Part D Companies

- Humana Inc. (HUM) -7.9%
- WellPoint (WLP) -5.5%
- Cigna Corp. (CI) -0.7%

Even though managed-care companies should gain millions of new customers thanks to the ACA, profit margins are expected to decline significantly. Mr. Market went easy on Cigna, perhaps because of the company's focus on self-insured large employers.

Currently it is unclear how the increased revenue generated from more patients will affect the increased margins to the various sectors of the healthcare market. Also, too much weight should not be placed on this one day action by the market. One thing is clear however, and that is how Mr. Market and the market at large feels at first blush towards the ACA based on the November 7, 2012 trading of these respective stocks. But, what happens going forward is anyone's guess …. How have these positions faired today?

So remember; Mr. Market is temperamental and can change his mind anytime! Buyer-beware!

Day Trading and the Internet

Since most people, including medical professions, initially lose at day trading, they give up and decide not to do it anymore. As there is a minimum amount of money, about $ 25,000-50,000 of trading capital needed to start; this loss is a powerful de-motivator. Still, scared by Mark O Barton, the murderous day-trader in Atlanta a more than a decade ago, the NASD-FINRA and NYSE have recently proposed new rules for those who engage in questionable day trading activities. One proposal would provide that a minimum equity of $ 25,000 be maintained at all times, versus the current $ 2,000 for other margin accounts. If the amount fell below the new threshold, no further trading would be permitted until the threshold was maintained.

Still, internet day trading has become an investment bubble of late, suggesting that something lighter than air can pop and disappear in an instant. This has occurred despite the fact that most lay and healthcare professionals that engage in such activities do not appreciate even the basic rules of margin and debt, as reviewed herein. History is filled with examples: from the tulip mania of 1630 Holland and the British South Sea Bubble of the 1700's to the Florida land boom of the roaring twenties and the Great Crash of 1929 and to the collapse of Japans stock and real estate market in early 1990's. To

this list, one might now add day Internet trading during the bull markets of 1999-2000 and 2014.

High Frequency Traders and the Market

Is the US stock market rigged, with elite traders buying access to a high-speed network [600 orders per second for a single stock] that allows them to figure out what you've just ordered; order it first, then raise the price before your order is complete? Well, it may be according to Michael Lewis, author of a new book about High-Frequency Trading [HFT] called "Flash Boys." And, this form of "front running" is completely legal. So, you decide?

Nevertheless, to counter HFT trading, IEX may be the first equity trading venue owned exclusively by a consortium of buy-side investors, including mutual funds, hedge funds, and family offices. Dedicated to institutionalizing fairness in the markets, IEX is reported to provide a more balanced marketplace by simplified market structure design and cutting-edge technology. IEX aims to offer a fair-access platform to any qualified broker dealer. IEX is driven by a team of cross-industry experts with backgrounds spanning market venues, electronic trading, and broker-dealers. http://www.iextrading.com/

CONCLUSION

A general review of investment banking, securities markets and margin accounts was presented in this chapter. Such vital information is rarely included in a text of this type.

COLLABORATE: Discuss this chapter online with others at: www.MedicalExecutivePost.com

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THE END