The ABCs of U.S. Preferreds

1. PREFERRED SECURITIES DEFINED

Borrowing from two worlds, a preferred security has both equity and fixed income characteristics. As such, the preferred structure offers a flexible approach to constructing a preferred offering for an issuer.

Companies have many reasons to issue preferred securities. Financial institutions, for example, need to raise capital. Many times they will use the preferred market because of any required regulatory requirements, in addition to cost considerations. Banks and financial institutions are required to maintain a certain level of Tier 1 capital—which includes common equity and perpetual non-cumulative preferreds—as protection against the bank’s liabilities. Issuing more common equity comes at a cost, including the dilution of existing shares, which a company may not want to bear. Preferred securities are a cheaper alternative approach to raising capital.

Companies often use preferred stock for strategic reasons. Some of these uses include the following.

- Balance sheet management as a way for a company to potentially lower its debt-to-equity ratio by issuing preferred stock as opposed to traditional debt, thus keeping its ratio lower.
- The company’s credit rating. Credit rating agencies often award an “equity credit” to preferred securities in the analysis of capital structure. All other things being equal, this may contribute to more favorable analysis by ratings agencies for the preferred issuance, as opposed to a bond issuance.
- In cases of a merger, the acquiring company is not responsible for the preferred stock or debt of the target company. The company may choose to continue the obligation or can decide not to, depending on the situation and other political ramifications.
- When a company is facing bankruptcy, the courts will decide the settlement, but the ranking of security capital prioritization has been defined by whether the capital raised was through borrowing or selling ownership. Preferreds fall between the two approaches, so they are more senior than equity, but junior to other forms of debt.
2. BREAKING DOWN U.S. PREFERREDS

The design flexibility for the preferred security structure has led to a number of differences within this product. Some preferreds are basic or traditional, and others are non-standard. Recently developed securities may rank higher on the capital structure than the more traditional preferred structures because of additional features enhancing credit.

2.1: Perpetual Preferreds

Perpetual preferred is the common structure of preferred stock and can even be considered the “plain vanilla” traditional offering. They are non-maturing perpetual instruments in fixed par amounts that provide ownership in a company and generally pay out a dividend to holders before the equity shareholders. Dividends may be suspended at any time, for an undefined period without being considered in default and are non-cumulative. Non-cumulative means that if payments are deferred, they don’t accumulate and won’t be paid back later. For this reason, the yield on a preferred is higher than comparable investments in order to compensate for the risk to the investor. As a result of a company not paying dividends for an extended time period, the traditional preferred structure sometimes grants voting rights to the investors in this situation. Unlike the common stockholders, preferreds usually do not have voting rights and have less upside appreciation potential than common stock.

The dividend payments of some of these types of preferreds may receive advantageous tax treatment and be eligible for qualified dividend income treatment.

2.2: REIT Preferreds

REITs, or real estate investment trusts, were early adopters of preferred issuance. These corporations or trusts specialize in owning and managing real estate properties such as apartment buildings, office buildings, warehouses, hotels, and shopping centers. Some REITs do not deal with the physical aspect of real estate but are set up more for finance and investment dealing in securities protected by real estate collateral. The benefits afforded a REIT originate from the Real Estate Trust Act, which requires 75% or more of the assets invested in real estate and a minimum
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of 90% of taxable income paid out as dividends.\(^1\) Upon meeting these requirements, the REIT can avoid paying corporate income tax. The REIT preferred is subject to withholding tax for non-resident investors, making the security less attractive to non-resident investors.

2.3: DRD Eligible Preferreds

DRD eligible, or dividend received deduction eligible, preferreds are domestic perpetual preferred securities that are issued by a Delaware "C" Corporation. The coupon received by corporate investors from this style of security is eligible for a 70% deduction in federal tax on the income received.\(^2\) The benefit is only available to corporations, not individual investors, who hold the investment for 46 days or more. The issuer of these preferreds must account for the securities on the company balance sheet as preferred stock in the equity section and make dividend payments out of earnings and profits for tax purposes. Because of these tax considerations, the dividend is subject to withholding tax for non-resident investors, thus making them an unattractive investment for foreign investors. Though the corporate tax benefits don't apply for individuals, all U.S. DRD preferred dividends are considered Qualified Dividend Income (QDI) for individual investors. A separate tax benefit is available, as defined in the glossary at the end of this document.

2.4: Floating Rate Preferreds (FRPs) & Adjustable Rate Preferreds (ARPs)

Usually DRD preferreds pay a fixed dividend, although there are some structures that offer a floating dividend or a combination fixed to float enacted upon passing a certain trigger date. The coupon rate on a floating-rate preferred resets quarterly and pays at a spread in basis points above a benchmark rate that is usually LIBOR (London Inter-Bank Offer Rate). In addition to the terms of the coupon float, deals may also include a rate floor, known as a minimum rate. The structure of an adjustable-rate preferred (ARP) provides a fixed dividend rate for a defined time frame up until a trigger date, at which point the coupon rate is converted to an adjustable dividend that is a basis point spread over the benchmark rate (usually three-month LIBOR).

2.5: Payment-in-Kind (PIK) Preferreds

Most fixed-rate preferreds pay a cash dividend. However some preferreds still contain a feature that was developed in the 1980s called payment-in-kind (PIK). PIK preferreds usually have a high coupon rate and may pay a cash dividend, but also have the option of paying a dividend of additional shares. The receipt of additional shares could be converted to cash for a

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financially strong company, but this structure is usually used by highly
leveraged companies in which the opposite is more likely. Taxable
investors are responsible for income tax on the shares dividend.

2.6: Trust Preferreds

The trust structure has been a favorite of U.S. banks because the
securities used to be counted as Tier 1 capital from a regulatory
perspective. Under the Dodd-Frank Act, starting in 2013, U.S. banks were
required to start phasing out the use of trust preferreds. For U.S. banks,
use of the Tier 1 structure is required to be fully phased out by the end of
2016. Non-U.S. banks will have until the end of 2022 to be fully regulatory
compliant. The regulatory requirement has prompted banks to call existing
issues and replace them with perpetual preferreds.

Even with these events, it is worth a quick look at the trust preferred
structure. These securities are issued in long maturities for U.S. issuers
and perpetual for foreign issuers. The key feature of the security is the
creation by the issuer of a Delaware limited trust. After the setup of the
trust, preferred securities are issued to investors whose proceeds then
purchase junior subordinated debentures with like terms to the preferred of
the issuing company into the holdings of the trust. The proceeds received
from the trust in exchange for the junior subordinated debentures can then
be used by the issuing company toward general business purposes and
expenditures. The coupon payments on the securities are tax deductible
for the issuers since they are paying interest on the debt sold to the trust
and treated from an accounting standpoint as a long-term liability.

One feature that really needs to be understood by an investor of trust
preferreds is that the issuer can defer on payments for up to five years
without being considered in default. Since the securities are cumulative,
the issuer has to make up missed payments. The problem for an investor
is a “phantom tax” in which the holder of trust preferreds is responsible for
taxes on income they have not received during this period.

2.7: Hybrid Preferreds

Similar to trust preferreds, hybrid preferreds are long-maturity securities.
They too have become less popular a structure for banks because of the
current changes to the benefits of Tier 1 capital required by Dodd-Frank.
Hybrids are also similar to trust preferreds in that the issuer can defer to
pay the coupon, but for these securities the time frame is 10 years as
opposed to the five years of trust preferreds. During a “non-payment”
timeframe, like trust preferreds, the investor would experience “phantom”
income by being responsible for taxes on income not yet received. Once
payments do resume, the company is obligated to pay off these structures
before payment to a more junior structure occurs. Hybrid preferreds
generally rank below the issuer’s senior unsecured debt, but above
preferred stock. Examples of hybrids include capital trust securities and junior subordinated debentures. Issuers need to keep a good reputation with investors, so there is plenty of incentive not to defer payment or default unless the issuer is in bad financial condition and is most likely facing bankruptcy.

2.8: Senior Notes/Baby Bonds

Senior notes or baby bonds are senior unsecured obligations of the issuer structured to trade like preferreds. The security is a debt product that pays quarterly interest and any missed payments would be considered a default. Missed payments are cumulative so the issuer must make good on the obligation before paying any more junior structures. Unlike bonds, they trade in USD 25 amounts, usually on an exchange. Most bond transactions are executed over-the-counter. The coupon received on these notes is treated as interest, not a dividend, so it is fully taxable for a retail investor, but deductible for the issuer.

2.9: Repackaged Preferreds

Repackaged preferreds, “repacks” or third-party preferreds, are bonds restructured in their terms to look more like preferred securities. Their terms are adjusted to match the USD 25 par with semi-annual coupons and may have call provisions. The repack can be called even when the underlying bond has not been. The credit of the repacked preferred remains tied to the issuer’s credit of the underlying security. These derivative securities of an underlying security are usually smaller in size and less liquid.

2.10: Foreign Perpetual Preference Shares

Foreign banks, financial companies, and insurance companies who, by the nature of their businesses, are heavily dependent on raising capital have used preferred structures to meet their funding needs. These issuers of U.S. dollar-denominated preferreds, also known as “Yankee preferreds” or American Depository Receipts (ADRs), use both the fixed and floating structures of preferreds.

3. THE RISKS

The higher yields of preferred securities can be attractive to an investor, but the rewards have to be balanced with any additional risks. The following outlines some of these risks.

- Interest Rate Risk: Preferred securities usually have long maturities or are perpetual with no maturity at all. Because of the length of the security, they are sensitive to interest rate movements.
- Call Risk: A number of preferred structures have call features that entitle the issuer to call the security back from the investor at an
agreed upon price or terms. Preferred securities with a call or mandatory conversion feature have reinvestment risk in which an investor is forced to reinvest funds at the prevailing interest rates.

- **Credit Risk:** Preferred stocks rank lower in the capital structure than other forms of debt, so credit risk is higher than senior debt. This is of particular concern in environments where default risk is high.

- **Industry Sector Risk:** The issuance of preferred securities has historically been favored by banks and finance companies. Real estate and utilities have issued preferred securities in the past, but to a lesser degree. Diversity of holdings by industry type can lessen the risk exposure to a certain industry within an investor's preferred holdings.

- **Liquidity Risk:** Certain preferred security structures may be less liquid than other securities issued by the same firms.

4. **THE S&P U.S. PREFERRED STOCK INDEX**

4.1: About the Index

The S&P U.S. Preferred Stock Index is designed to serve the investment community’s need for an investable benchmark representing the U.S. preferred stock market. The index seeks to track U.S.-traded preferred stocks that meet criteria relating to size, liquidity, issuance type, exchange listing, and time to maturity. Index membership is reviewed quarterly. Rebalancing occurs after the close on the third Friday of January, April, July, and October. The reference date for additions and deletions is after the last trading date of the month immediately preceding the rebalancing month. Share changes for existing index components occur semi-annually in January and July.

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<tr>
<th>INDEX</th>
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<tr>
<td>S&amp;P U.S. Preferred Stock Index (Total Return)</td>
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<tr>
<td>S&amp;P U.S. Preferred Stock Index (Price Return)</td>
<td>SPPREF</td>
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</tbody>
</table>

Source: S&P Dow Jones Indices. Table is provided for illustrative purposes.
4.2: Index Eligibility Criteria

- Exchange Listing. Preferred stocks trading on the NYSE (including NYSE Arca and NYSE Amex), the NASDAQ Global Select Market, the NASDAQ Select Market, or the NASDAQ Capital Market are eligible. Over-the-counter, bulletin board and unregistered (144[A]) securities are excluded.

- Type of Issuance. Preferred stocks issued by a company to meet its capital or financing requirements are eligible. These include floating- and fixed-rate preferreds, cumulative and non-cumulative preferreds, preferred stocks with a callable or conversion feature, and trust preferreds. Included are some trust preferreds issued by a company to meet capital requirements that carry a brand name or moniker. However, structured products and brand name products issued by financial institutions that are packaged securities linked to indices, baskets of stocks, or another company’s stock are excluded. Also excluded are special ventures such as toll roads or dam operators that may issue preferred-like securities.
4.3: Inclusion Criteria

- Maturity or Conversion Schedule. Preferred stocks that do not have a mandatory conversion or scheduled maturity within the next 12 months.
- Market Capitalization. Preferred stocks with a market capitalization of more than USD 100 million.
- Volume. Preferred stocks that have traded more than 250,000 shares per month over the previous six months. Issues with fewer than six months of trading history will be evaluated over the available period and may be included should size and available trading history infer the issue will satisfy this requirement.
- Indicated Yield. Preferred stocks for which S&P Dow Jones Indices cannot determine an indicated dividend yield are not eligible.
- Different Lines of the Same Issuer. There is no limit to the number of lines of a single company’s preferred stock allowed in the index. However, a maximum weight of 10% is set per issuer. All eligible lines for an issuer will be included in the index and capped on a pro rata basis to a maximum of 10% by issuer of the index market capitalization.

4.4: Exclusion Criteria

- Market Capitalization: Preferred stocks with market capitalization of less than USD 75 million as of the rebalancing reference date.
- Volume: Preferred stocks that have not traded more than 125,000 shares per month over the previous six months as of the rebalancing reference date. No issue is removed from the index for the violation of this requirement for 12 months following its addition effective date.
- Indicated Yield: Preferred stocks for which S&P Dow Jones Indices cannot determine an indicated dividend yield as of the rebalancing reference date.

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Note: For the purposes of index membership, S&P Dow Jones Indices applies the inclusion and exclusion criteria separately. While the inclusion criteria explicitly excludes issues that have a mandatory conversion or scheduled maturity within 12 months of the rebalancing effective date, no such rule exists for continued membership.
## GLOSSARY OF TERMS

**Exhibit 4: Glossary**

<table>
<thead>
<tr>
<th>TERM</th>
<th>DEFINITION</th>
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<tbody>
<tr>
<td>Adjustable-Rate Preferreds (ARPS)</td>
<td>A type of preferred stock where the dividends issued will vary with a benchmark, most often a T-bill rate. The value of the dividend from the preferred share is set by a predetermined formula to move with rates, and because of this flexibility preferred prices are often more stable then fixed-rate preferred stocks.</td>
</tr>
<tr>
<td>American Depositary Receipt (ADR)</td>
<td>A negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock that is traded on a U.S. exchange. ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. ADRs help to reduce administration and duty costs that would otherwise be levied on each transaction.</td>
</tr>
<tr>
<td>Basis Points</td>
<td>A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.</td>
</tr>
<tr>
<td>Callable</td>
<td>A security with an embedded call provision that allows the issuer to repurchase or redeem the security by a specified date. Since the holder of a callable security is exposed to the risk of the security being repurchased, the callable security is generally less expensive than comparable securities that do not have a call provision.</td>
</tr>
<tr>
<td>Cumulative Preferred</td>
<td>A type of preferred stock with a provision that stipulates that if any dividends have been omitted in the past, they must be paid out to preferred shareholders first, before common shareholders can receive dividends.</td>
</tr>
<tr>
<td>Dividends Received Deduction (DRD)</td>
<td>A tax deduction received by a corporation on the dividends paid to it by companies in which it has an ownership stake. The purpose of this deduction is to soften the consequences of triple taxation. Triple taxation occurs because the company paying the dividend does so with after-tax money and the receiving company is subject to income tax on the dividends. Therefore, if the company that receives the dividends decides to pay out its shareholders, the money will have been taxed three times.</td>
</tr>
<tr>
<td>Floating Rate</td>
<td>A bond or other type of debt whose coupon rate changes with market conditions (short-term interest rates). Also known as floating-rate debt.</td>
</tr>
<tr>
<td>LIBOR</td>
<td>An interest rate benchmark used to establish the floating interest rate that is paid on the notional principal in an interest-rate swap. LIBOR flat has no spread added to it and represents the best interest rate available in the current market. It is the most common reference on which other interest rates are based.</td>
</tr>
<tr>
<td>Non-Cumulative Preferred</td>
<td>A type of preferred stock that does not pay the holder any unpaid or omitted dividends. If the corporation chooses to not pay dividends in a given year, the investor does not have the right to claim any of those forgone dividends in the future.</td>
</tr>
<tr>
<td>Payment-in-Kind (PIK)</td>
<td>A financial instrument that pays interest or dividends to investors of bonds, notes or preferred stock with additional debt or equity instead of cash. Payment-in-kind securities are attractive to companies who would prefer not to make cash outlays. They are often used in leveraged buyouts.</td>
</tr>
<tr>
<td>Qualified Dividend Income (QDI)*</td>
<td>Qualified Dividend Income (QDI) status for U.S. individual investors means that the individual investor’s dividend income is taxed at a preferential rate of up to 20% versus the ordinary-income rate that can be as high as 39.6%. High wealth individuals bear an additional charge allocated as a Medicare surtax, which adds 3.8% on both interest and dividend income, increasing the dividend rate to 23.8% and the interest income rate to 43.4%.</td>
</tr>
<tr>
<td>REITS</td>
<td>A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.</td>
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</tbody>
</table>

PERFORMANCE DISCLOSURE

The S&P U.S. Preferred Stock Index was launched on September 15, 2006. All information presented prior to an index’s Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. Complete index methodology details are available at www.spdji.com.

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live: index values provided for any date or time period prior to the index’s Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company’s website. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed “Date of introduction”) is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the index’s public release date.

Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the Index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

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