

## CHAPTER 3 Securities Markets

### 3.1 HOW FIRMS ISSUE SECURITIES

#### Primary Versus Secondary Markets

- Primary
  - New issue
  - Key factor: issuer receives the proceeds from the sale
- Secondary
  - Existing owner sells to another party
  - Issuing firm doesn't receive proceeds and is not directly involved

#### How Securities Are Issued

- Investment Banking
- Shelf Registration
- Private Placements
- Initial Public Offerings (IPOs)

#### Investment Banking Arrangements

- Underwritten vs. "Best Efforts"
  - Underwritten: firm commitment on proceeds to the issuing firm
- Negotiated vs. Competitive Bid
  - Negotiated: issuing firm negotiates terms with investment banker
  - Competitive bid: issuer structures the offering and secures bids

Figure 3.1 Relationship Among a Firm Issuing Securities, the Underwriters and the Public

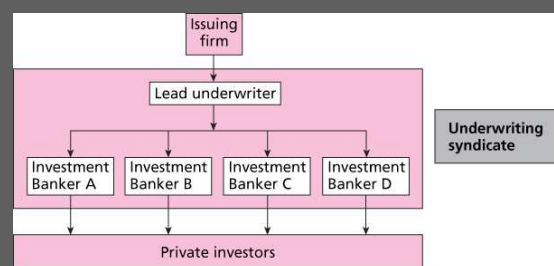
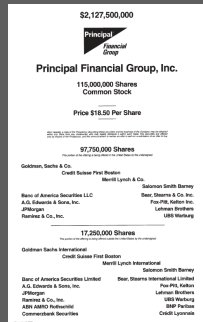


Figure 3.2 A Tombstone Advertisement



## Shelf Registrations

- SEC Rule 415
- Introduced in 1982
- Ready to be issued – on the shelf

## Private Placements

Private placement: sale to a limited number of sophisticated investors not requiring the protection of registration

- Allowed under Rule 144A
- Dominated by institutions
- Very active market for debt securities
- Not active for stock offerings

## Initial Public Offerings

- Process
  - Road shows
  - Bookbuilding
- Underpricing
  - Post sale returns
  - Cost to the issuing firm

Figure 3.3 Average Initial Returns for IPOs in Various Countries

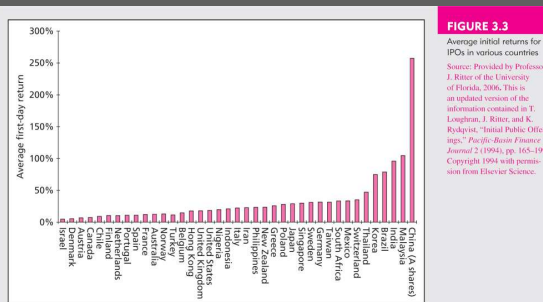
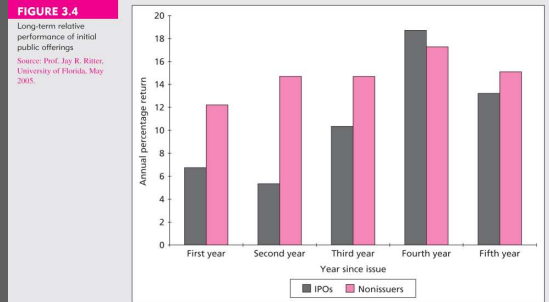


Figure 3.4 Long-term Relative Performance of Initial Public Offerings



### 3.2 HOW SECURITIES ARE TRADED

### Types of Secondary Markets

- Direct search
- Brokered
- Dealer
- Auction

### Types of Orders

- Market—executed immediately
  - Bid Price
  - Ask Price
- Price-contingent
  - Investors specify prices
  - Stop orders

Figure 3.5 Limit Order Book for Intel on Archipelago



**FIGURE 3.5**  
The limit order book for Intel on the Archipelago market, January 19, 2007.  
Source: New York Stock Exchange, www.nyse.com

Figure 3.6 Price-Contingent Orders

		Condition	
		Price falls below the limit	Price rises above the limit
Action	Buy	Limit buy order	Stop-buy order
	Sell	Stop-loss order	Limit sell order

### Trading Mechanisms

- Dealer markets
- Electronic communication networks (ECNs)
- Specialists markets

### 3.3 U.S. SECURITIES MARKETS

#### Nasdaq

- Nasdaq Global Select Market
- Nasdaq Global Market
- Nasdaq Capital Market
- Small stock OTC
  - Pink sheets

#### New York Stock Exchange

- Largest exchange in the U.S.
- Automated for small orders
- Floor brokers for large orders
- Specialists

#### York Stock Exchange

- Now a publicly held company
- Block sales
- SuperDot
- Bond Trading
  - 2006 NYSE obtained approval to expand bond trading
  - May provide OTH dealer market in bonds

#### Other Exchanges and Trading Systems

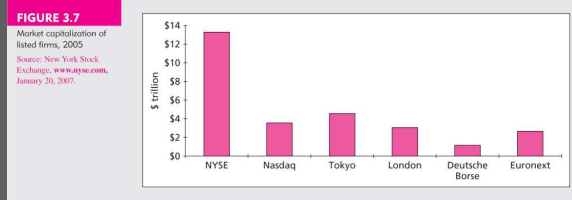
- American Stock Exchange (AMEX)
- Regionals
- Electronic Communication Networks (ECNs)
- National Market System

### 3.4 MARKET STRUCTURE IN OTHER COUNTRIES

## Other Countries

- London - predominately electronic trading
- Euronext – market formed by combination of the Paris, Amsterdam and Brussels exchanges
- Tokyo Stock Exchange

Figure 3.7 Market Capitalization of Listed Firms, 2005



## 3.5 TRADING COSTS

### Trading Costs

- **Commission:** fee paid to broker for making the transaction
- **Spread:** cost of trading with dealer
  - **Bid:** price dealer will buy from you
  - **Ask:** price dealer will sell to you
  - **Spread:** ask - bid
- **Combination:** on some trades both are paid

## 3.6 BUYING ON MARGIN

### Buying on Margin

- Using only a portion of the proceeds for an investment
- Borrow remaining component
- Margin arrangements differ for stocks and futures

## Buying on Margin

- Maximum margin is currently 50%; you can borrow up to 50% of the stock value
- Set by the Fed
- Maintenance margin: minimum amount equity in trading can be before additional funds must be put into the account
- Margin call: notification from broker you must put up additional funds

## Margin Trading - Initial Conditions

X Corp	\$70		
50%	Initial Margin		
40%	Maintenance Margin		
1000	Shares Purchased		
<u>Initial Balance Sheet Position:</u>			
Stock	\$70,000	Borrowed	\$35,000
		Equity	35,000

## Margin Trading - Maintenance Margin

Stock price falls to \$60 per share

New Balance Sheet Position:

Stock	\$60,000	Borrowed	\$35,000
		Equity	25,000

$$\text{Margin\%} = \$25,000 / \$60,000 = 41.67\%$$

## Margin Trading - Margin Call

How far can the stock price fall before a margin call?

Since  $1000P - \text{Amt Borrowed} = \text{Equity}$  then:

$$(1000P - \$35,000) / 1000P = 40\%$$

$$P = \$58.33$$

## 3.7 SHORT SALES

## Short Sales

Purpose: to profit from a decline in the price of a stock or security

Mechanics

- Borrow stock through a dealer
- Sell it and deposit proceeds and margin in an account
- Closing out the position: buy the stock and return to the party from which it was borrowed

### Short Sale - Initial Conditions

Z Corp	100 Shares
50%	Initial Margin
30%	Maintenance Margin
\$100	Initial Price

Sale Proceeds	\$10,000
Margin & Equity	5,000
Stock Owed	10,000

### Short Sale - Maintenance Margin

Stock Price Rises to \$110

Sale Proceeds	\$10,000
Initial Margin	5,000
Stock Owed	11,000
Net Equity	4,000
Margin % (4000/11000)	36%

### Short Sale - Margin Call

How much can the stock price rise before a margin call?

Since Initial margin plus sale proceeds = \$15,000, then:

$$(\$15,000 - 100P) / (100P) = 30\%$$

$$P = \$115.38$$

### 3.8 REGULATION OF SECURITIES MARKETS

### Major Regulations

- Securities Acts of 1933
- Securities Acts of 1934
- Securities Investor Protection Act of 1970

### Self-Regulation

- National Association of Securities Dealers (NASD)
  - Oversees participants in the Nasdaq market
- NYSE has its own regulatory arm

## Regulation Response to Recent Scandals

- Sarbanes-Oxley Act

## Circuit Breakers

- Trading halts
- Collars

## Insider Trading

- Illegal
- Definition of insiders can be ambiguous
- SEC's Official Summary of Securities Transactions and Holdings