

SECURITIES MARKETS AND MARKET MECHANISMS (328-1)

Obj 1-1. **THE PRIMARY MARKET** handles new issues of securities and involves the company issuing the security selling its securities.

The purpose of the primary market is to help businesses get new money from investors.

THE MECHANICS OF THE PRIMARY MARKET:

1. **Public sale**--goes through an **investment banker**, usually a brokerage firm that agrees to buy the securities for resale (agrees to **underwrite** the issue).
Most underwriting is done on a **firm-commitment basis** (the banker buys the securities and resells them to the public at its own risk), but occasionally underwriting is done on a **best-effort basis** (the banker acts as the firm's agent).
When a private firm sells a substantial block of shares to the public (aka **goes, or going, public**), that sale is referred to as an **initial public offering (IPO)**.
The issuing firm files a registration statement with the SEC.
That registration is informally called a **red herring** because its front page contains a paragraph in red ink stating that the company is ***not*** attempting to sell its shares before SEC approval.
Shelf registration lets qualified companies file one registration statement for a large block of stock and then to sell the securities over time.
2. **Private placements**--let a small group of investors buy large lots of new issues of a start-up firm. Those initial investors pay a reduced price for **lettered stock** (which can be resold ***only*** after a reasonable holding period and ***only*** in a gradual manner that will ***not*** disrupt trading).

Obj 1-2. **THE SECONDARY MARKET** involves owners of securities selling those previously issued securities to others, often through brokers.

THE PARTICIPANTS IN THE SECONDARY MARKET:

1. **A broker (aka registered representative or floor broker)**--is employed by a brokerage firm to act as an agent in buying and selling securities for the firm's customers.
A broker must be licensed to sell securities.
The most common license is the **Series 7 license**, which qualifies the broker to solicit, buy, and/or sell all securities products.
A Series 6 license qualifies the broker to sell open-end mutual funds, initial offers of closed-end funds, ***and*** variable products if the broker also holds the appropriate insurance license.
2. **Specialists**--are exchange members (usually firms) who buy and sell stocks of one or more companies for their own accounts in order to maintain market price stability.
A specialist manages the auction process, executes orders for floor brokers, encourages trading, provides capital, ***and*** stabilizes prices.
3. **Floor traders (aka registered competitive market makers or RCMMs)**--own exchange seats and trade on their own accounts.

The distinction between brokerage firms and other financial services firms has become blurred since 1999, when the **Gramm-Leach-Bliley Act** repealed the **Glass-Steagall Act** (which had prevented competition among the banking, insurance, and securities industries).

Obj 1-3. THE FOUR COMPONENTS OF THE SECONDARY MARKET:

1. **Stock exchanges:**
 - a. **The New York Stock Exchange (aka NYSE or Big Board)** (Wall Street's largest organized stock exchange) lists large-capitalization to mid-capitalization (**mid-cap**) stocks. Only members (**aka seats**) can trade and only listed securities may be traded on the NYSE. In September 2005, the NYSE had about 2,800 listed companies and over 3,000 listed securities, including preferred stock, warrants, and rights.

- b. **The American Stock Exchange (aka AMEX or curb exchange)** is an organized stock exchange for small to mid-capitalization stocks that are too small to be listed on the NYSE. The AMEX has about 1,000 listed stocks.
 - c. **Regional exchanges**--have lower listing requirements than the AMEX and specialize primarily in companies located in their particular regions. Some regionals accept NYSE-listed companies, which then have **dual listing** (listings on more than one exchange).
Regional exchanges include the Chicago Stock Exchange (**CSE**), the Pacific Exchange (**PCX**), the Boston Stock Exchange (**BSE**), the Philadelphia Stock Exchange (**PSE**), *and* the National Stock Exchange (formerly the Cincinnati Stock Exchange).
2. **The OTC market**--The over-the-counter (**OTC**) market represents a network of securities dealers from whom investors buy and sell both listed and unlisted securities.
NASDAQ or National Association of Securities Dealers Automated Quotations is the automated quotation system used by the OTC market that shows current bid and asked prices for the stocks that trade on the OTC market.
There are three levels of subscriptions to NASDAQ quotations:
- a. **Level 3 subscribers** enter their own bid and ask prices.
Level 3 is for dealers who are making a market in one or more stocks.
 - b. **Level 2 subscribers** receive all prices, but can *not* enter quotes of their own.
Level 2 is for brokers who need current quotes.
 - c. **Level 1 subscribers** receive only the highest bid and lowest ask prices on a security.
Level 1 is for institutional investors who want current information, but do *not* initiate trades.
- The National Daily Quotation Service** produces daily **Pink Sheets** that report the bid and ask prices for all actively traded OTC issues. An investor who wants a current price must ask his broker to call one of the firms listed in the Pink Sheet.
- 3. **The third market**--allows institutional investors to trade securities listed on the organized exchanges during hours when the exchanges are not open.
 - 4. **The fourth market**--is an **electronic communications network (ECN)** of investors and large institutions which trade in large blocks of stock.
The fourth market bypasses brokers and dealers and saves commissions by allowing direct trades and exchanges of information between the participants.

Stocks can trade simultaneously on the NYSE, regional exchanges, and the OTC market.

MARKETS FOR OTHER SECURITIES--Commercial paper, large CDs, municipal bonds, and other money market instruments are traded over-the-counter.

Obj 1-4. **THE THREE COMPONENTS OF TRANSACTION FEES:**

- 1. **Commissions** (broker fees)--Since May 1, 1975 (**aka May Day**), each brokerage firm has set its own commission rate schedule.
- 2. **Bid-ask spreads** (wholesale/retail markups)--**Both OTC dealers and specialists quote**
 - a. **a bid price** at which they will buy *and*
 - b. **an ask price** at which they will sell**in the securities in which they make a market.**
The difference between the ask price (**aka asked price**) and the bid price is the dealer's mark-up. Bid-spreads on actively traded OTC issues average between 2% and 4% of the price, but usually constitute a larger percentage for lower priced and less actively traded issues. In general, listed stocks have a lower bid-ask spread (ie, are more marketable) than OTC stocks. One concern involves a practice called **paying for order flow**, which occurs when a dealer pays a broker for the number of orders.
The dealer makes more money on trades and the broker gets bonus income on top of commissions, *but* the customer suffers if he pays an inflated price for the stock.

3. **Price concessions**--are adjustments in the bid-ask spread that might occur when specialists process larger orders.

TYPES OF ORDERS: Brokers take their customers' orders to **trading stations** or **posts** (places in the exchange where stocks are traded).

1. **Market orders**--are orders to buy or sell at the best price when the order reaches the trading floor. A market order presents the risk of a transaction at an unanticipated price. A market order can result in a transaction at an unfavorable price if the stock is volatile or if the order is based on an incorrect quote.
2. **Limit orders**--are orders to buy and sell at specified prices. Limit orders present the risk of non-execution. There is *no* guarantee that a limit order will be filled because orders entered at the same price are executed in the order received.
Limit orders can be further defined:
 - a. **Day orders**--are effective for one day.
 - b. **GTC (good 'til canceled) orders**--remain in effect until canceled or filled.
 - c. **All-or-nothing orders**--must be executed as a block with a single commission. All-or-nothing orders are automatically superceded by any other limit orders placed by other customers at the same price.
 - d. **Fill or kill orders**--must be executed immediately or canceled.
3. **Stop orders**--are orders to buy and sell a stock after it reaches a certain price level. A **stop-loss order** implements a market order when a specific price is reached. A **stop-limit order** activates a limit order if a specified price is reached. The actual buy/sell price received may be different from the stop order price since this type of order only instructs *when* to initiate the order, *not* what the actual price will be.
4. **Versus purchase orders**--let the seller specify the block of stock from his holdings to be sold. Normally, when an investor sells only part of his holdings of a particular issue, the shares bought earliest are considered the first shares sold (ie, **FIFO**: first in, first out). If a versus purchase order specifies the shares with the highest basis, the investor can reduce his profit or increase his loss for tax purposes.
5. **Program trading**--occurs when an investor wants the simultaneous execution of multiple orders.
6. **Market-if-touched (MIT) order**--implements a market order if a trade occurs at the designated price or better.

Obj 1-5. **SHORT SELLING** occurs when the investor sells shares that he does *not* actually own.

The investor anticipates the stock's value will fall, thereby allowing the investor to buy shares at the lower price to cover the 'sale' at the higher price.

The difference in the two prices equals the investor's profit.

Short selling is a common market strategy used in margin accounts, since the non-owned stock must be borrowed from the brokerage firm in order to be sold.

FIVE RULES OF SHORT SELLING:

1. The short seller must cover any dividends declared on short stock.
2. The short seller must have a margin account and must meet the account margin requirements.
3. The investor does *not* have immediate access to proceeds from short sales. The broker holds the net proceeds for protection against an over-leveraged account. If the stock price falls, the investor may draw funds from the account. If the price increases, the investor must deposit additional funds into the account.
4. There is *no* time limit on a short sale. Unless the lender of the securities wants them back (and the investor can *not* borrow shares from elsewhere), the seller can remain short indefinitely.
5. It is illegal to use short sales to drive down the price of a stock (aka **bear raid**).

FOUR TYPES OF LARGE SECONDARY MARKET TRADES:

1. **Block trade**--is a trade involving a block of 10,000 shares or more by a professional trader (**block house**) who specializes in facilitating large transactions with minimum disruption to the market.
2. **Special offering**--is a large block of shares sold through an exchange with special incentive fees offered to brokers who buy shares for their clients.
3. **Secondary offering or distribution**--disposes of a large block of securities outside the regular exchange or OTC market.
4. **Tender offer**--is an offer by a large investor to buy a large amount of a firm's stock at a premium price to gain control or to **go private** (become a privately-held company with only a few owners).

Obj 1-6. **SECURITIES MARKET REGULATION:**

1. **Banking Act of 1933**--created the FDIC, which provides up to \$100,000 insurance protection per account holder.
2. **Securities Act of 1933**--
 - a. prohibits misrepresentations and fraud in the sale of securities,
 - b. requires all public securities offerings to be accompanied by a **prospectus** providing full disclosure of all pertinent information, ***and***
 - c. is often called the 'truth in securities' law.
3. **Securities Exchange Act of 1934**--
 - a. created the Securities and Exchange Commission (**SEC**), which oversees the securities industry,
 - b. requires all publicly owned firms to provide periodic financial statements to the SEC, the exchanges, and their stockholders, ***and***
 - c. prohibits unethical practices such as market manipulation and insider trading (but fails to define who would be considered an 'insider').
4. **Investment Company Act of 1940**--requires each investment company to disclose its financial status and investment policies to investors when its stock is initially sold and on a regular basis thereafter.
5. **Investment Advisers Act of 1940**--requires entities that are paid to advise others about securities investments to register with the SEC ***and*** to comply with the Act's antifraud provisions.
6. **Securities Investor Protection Act of 1970**--created the **Securities Investor Protection Corporation (SIPC)**, which insures brokerage customers against losses resulting from the insolvency of their **clearing firm** (brokerage firm that holds customers' cash and securities and sends periodic statements to customers).
The introducing firm takes the customers' orders.
The SIPC protects investors against losses up to \$500,000 (but only \$100,000 may be in cash). SIPC coverage does ***not*** apply to funds placed in a brokerage account solely to earn interest.
7. **Sarbanes-Oxley Act of 2002**--was passed in response to corporate and accounting scandals. The Sarbanes-Oxley Act sets accountability standards for corporate boards and auditors.

Obj 1-7. **STREET NAME REGISTRATION** refers to the practice of registering security certificates in the name of the brokerage firm, rather than the individual investor.

Advantages: Street name registration provides safe storage and facilitates trades without having to reissue certificates.

The investor receives only one Form 1099 from the brokerage firm rather than separate forms for each stock owned.

Disadvantages: Assets are tied up if the broker goes bankrupt.

The broker can retain dividends and interest in a non-interest-bearing account for up to one month.

Dividends and interest might be credited to the wrong account.

TYPES OF BROKERAGE ACCOUNTS:

1. **Discretionary account**--lets the broker use discretion when making trades on the client's behalf. A discretionary account creates the risk of **churning** (trades made to generate commissions).
2. **A limited discretionary account** gives the broker authority to make only specified types of trades.
3. **Wrap account**--charges a single annual fee (**wrap fee**) that covers all commissions and expenses.
4. **Cash account**--lets an investor buy stock *only* if the account already contains enough cash to cover the amount of the purchase.
5. **Margin account**--lets the investor borrow a portion of the transaction cost from the brokerage firm using the purchased stock as collateral.
6. **Option account**--lets the investor make trades in puts and calls.

PORTFOLIO TURNOVER RATIO measures trading activity on the investor's account.

The turnover ratio equals the *lesser of* total purchases *or* total sales during the investment period *divided by* the average value of total assets during that period.

Turnover creates transaction fees and capital gains (and hence capital gains taxes).

An actively managed portfolio *could* have turnover ratios approaching 100% or even 200%, *but* a ratio over 300% probably indicates an excessive trading on the account.