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More on Margin

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Short Sales

Short Sale: example

Short sale: oops!

Regulation of Security Markets
How Securities Are Traded

Chapter 3 (BKM)
Finance 650
Fall 1998

Lecture notes prepared by:
Dr. Susan D. Jordan

Chapter 3 (BKM)

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Primary versus Secondary

• Primary
  – New issue (IPO or seasoned 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
Private Placements

- Private placements: sale to a limited number of sophisticated investors not requiring the protection of registration
  - Dominated by institutions
  - Very active market for debt securities
  - Not active for stock offerings
Private Placements

• Public offerings
  – registered with the SEC and sale is made to the investing public
    • prospectus & red herring
    • Shelf registration (Rule 415, since 1982)
  – Initial Public Offerings (IPOs)
    • Evidence of underpricing
    • Performance
Investment Banking Arrangements

• 3 Basic Services
  – Advice
  – Distribution
  – Underwritten vs. “Best Efforts”
    • Underwritten: firm commitment on proceeds to the issuing firm
    • Best Efforts: no firm commitment

• Selection
  – Negotiated
  – Competitive
Where Securities Are Trades

- Organized Exchanges
  - NYSE, ASE (AMEX), Regional
  - Listing Requirements
  - Seat or membership
- The Over-the-Counter Market (OTC)
- Third Market
- Fourth Market

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Comparison of companies listed on Nasdaq, NYSE, & AMEX

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OTC Market

- Dealer market without centralized order flow
- NASDAQ: largest organized stock market for OTC trading; information system for individuals, brokers and dealers (3 levels)
  - Securities: stocks, bonds and some derivatives
  - Most secondary bonds transactions
- **Third Market**
  - Trading of listed securities away from the exchange
  - Institutional market: to facilitate trades of larger blocks of securities
  - Involves services of dealers and brokers

- **Fourth Market**
  - Institutions trading directly with institutions
  - No middleman involved in the transaction
  - Organized information and trading systems
    - INSTINET
    - POSIT
Trading on the Exchange

- Commission Broker
- Floor Broker
- Odd Lot Dealer
- Registered Trader
- Specialist
  - broker => limit & special orders
  - dealer => maintain fair & orderly market
  - book => electronic work station

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A typical trading post:
A: Post information display
B: Flat panel display screen
C: Point-of-sale workstation
D: Broker
E: Broker
F: Specialist
G: Specialist trading assistant
H: Wireless data system
I: Wireless data system

Chapter 3 (BKM)
Types of orders

- Market
- Limit
- Stop
  - loss (sell)
  - buy
- Stop Limit
- Other features (FK; GTC; Day order)
Trading Securities

- Block transaction
- Settlement
  - 3 business days since June '95 (T plus 3)
  - Clearing house & netting
  - Street name
- SuperDot
- Program Trading
OTC versus Exchange Trading

- **OTC**
  - decentralized dealer market
  - trading through

- **Exchange**
  - centralized auction market
  - price priority
  - price discovery

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More on Trading

- Trading costs
  - commissions
  - dealer bid-asked spread
  - price concession
Trading on Margin

- Borrow part of the purchase price from broker (call money rate)
- Margin = equity/MV of securities
  - equity = MV - Loan Balance
    - Initial margin
    - Maintenance margin
    - Margin call (If actual < maintenance)
    - Restricted (Initial > Actual > Maintenance)
Trading on Margin

- Example:
  - You have $9,000
    - Initial margin is 50%; maintenance is 30%
  - You buy 1000 shares at $18
    - Margin = ($18,000 - 9000)/$18,000 = 50%
  - Price falls to $12, you owe $9,000,
    - Margin = (12000 - 9000)/12000 = 25%

Chapter 3 (BKM)

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More on Margin

• Margin call occurs at what price?
  – Equity/MV = 0.30
  – 0.30 = (MV - $9,000)/MV
  – MV = Loan/(1-.30) = $9000/.7 = $12,857
  – P = $12857/1000 = $12.86
More on Margin

• Gains and losses
  – Interest is 5%, you pay $450

• Stock price up by 20%, price is $21.60
  – ($21,600 - $18,450)/$9,000 = 35%

• Stock price down by 20%; price is $14.40
  – ($14,400 - $18,450)/$9,000 = -45%
Short Sales

- The long and short of it
- The uptick rule and bear raids
- Hypothecation
- Use of the proceeds
- Margin requirements
- Dividends
- Potential losses
- "He that sells what is'n' his'n' . . ."

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Short Sale: example

- Sell 1,000 IBM at $50
- Initial margin = 50%
- Maintenance margin = 40%
- Margin = 0.50 x $50,000 = $25,000

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liab/equity</th>
</tr>
</thead>
<tbody>
<tr>
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Chapter 3 (BKM)
Short sale: oops!

• IBM rises to $60
  – Equity = $15,000
  – Margin = $15,000/$60,000 = 20%
  – Critical price: Equity/(1000 x P) = 0.4
    • ($75,000 - 1000 x P)/(1000 x P) = 0.4
    • P = $53.57

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- Government Regulation
- Self-Regulation
- Circuit Breakers
- Insider Trading
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