How Securities Are Traded

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Chapter 3 (BKM)

Finance 650

Fall 1998

Lecture notes prepared by:
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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

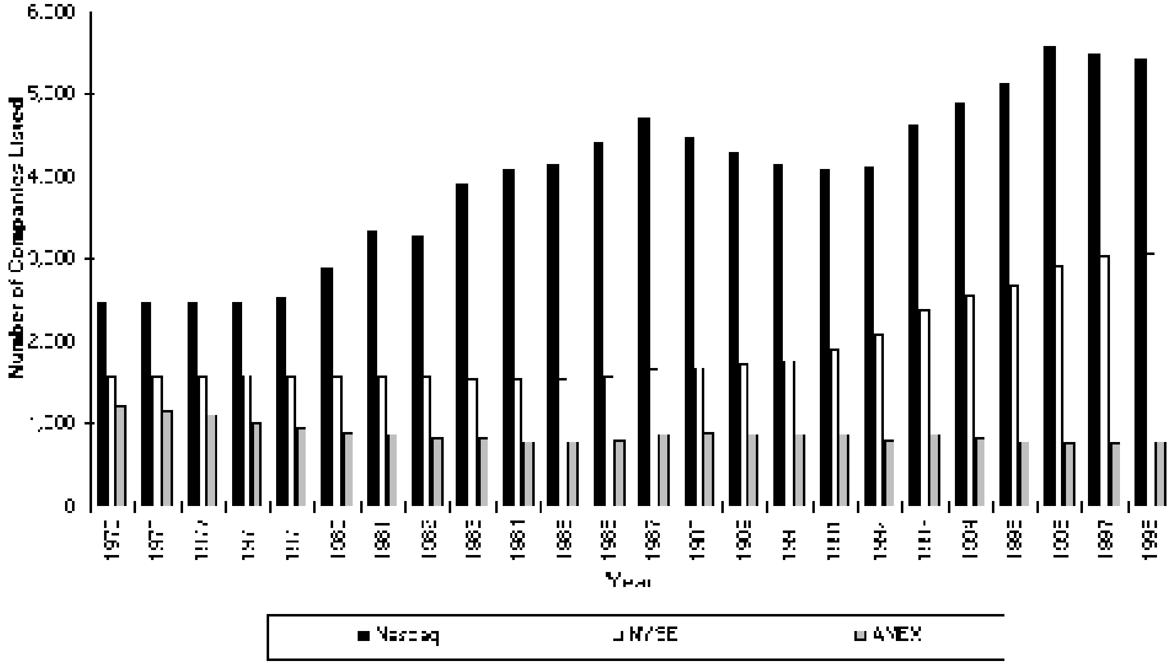
Investment Banking Arrangements

- 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

Comparison of companies listed on Nasdaq, NYSE, & AMEX



OTC Market

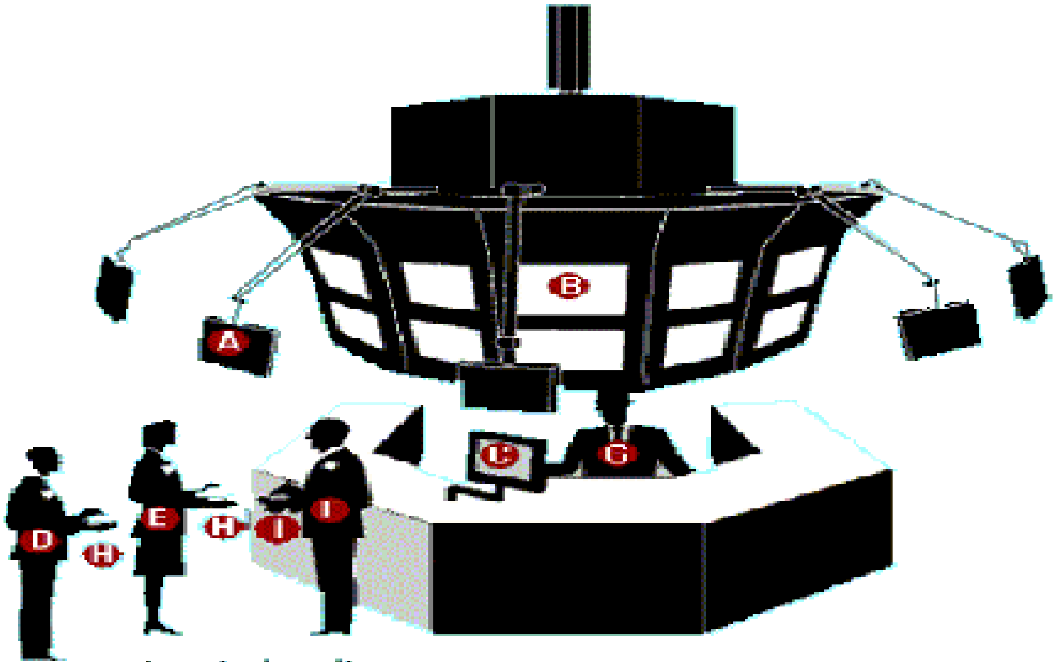
- Dealer market without centralized order flow
- NASDAQ: largest organized stock market for OTC trading; information system for individuals, brokers and dealers (3 levels)
  - Securities: stocks, bonds and some derivatives
  - Most secondary bonds transactions

- 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



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

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

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OTC versus Exchange Trading

- OTC
  - decentralized dealer market
  - trading through
- Exchange
  - centralized auction market
  - price priority
  - price discovery

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

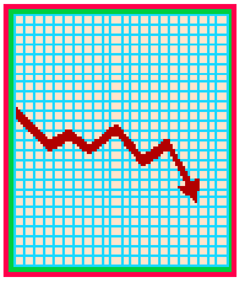
- Example:
- You have \$9,000
  - Initial margin is 50%; maintenance is 30%
- You buy 1000 shares at \$18
  - Margin = (\$18,000-9000)/\$18,000 = 50%
- Price falls to \$12, you owe \$9,000,
  - Margin = (12000-9000)/12000 = 25%

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' . . ."

Short Sale: example

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

Assets		Liab/equity	
Proceeds from Sale	$50,000	IBM short	$50,000
Initial Margin	$25,000	Equity	$25,000
	$75,000		$75,000

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

Assets		Liab/equity	
Proceeds from Sale	$50,000	IBM short	$60,000
Initial Margin	$25,000	Equity	$15,000
	$75,000		$75,000

Regulation of Security Markets

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

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