

Chapter 11

Securities Markets



Learning Objectives

- **LO 11.1 Describe the processes and institutions used by businesses to distribute new securities to the investing public in the primary market including the use of underwriting and best efforts agreements.**
- **LO 11.2 Summarize activities of a well-known public offering**
- **LO 11.3 Explain various ways that investment banks can assist security offerings in addition to traditional underwriting efforts.**
- **LO 11.4 Describe the costs of “going public” when issuing securities in the primary market**



Learning Objectives

- **LO 11.5 Describe other functions of investment bankers, their recent attempts to innovate, and the regulations they follow.**
- **LO 11.6 Explain the role of secondary markets in securities trading and the structure of organized exchanges such as the New York Stock Exchange**
- **LO 11.7 Summarize the types of orders used in securities trading and when they might be used by traders.**
- **LO 11.8 Describe the various types of over-the-counter markets for securities trading.**



Learning Objectives

- **LO 11.9 Explain factors that make for a good market for trading securities and the role of brokerage commissions in securities trading.**
- **LO 11.10 Discuss issues of importance to investors, including how security market indexes are constructed and how to trade foreign securities.**
- **LO 11.11 Recognize the role and importance of ethics in securities transactions and analysis.**



LO 11.1 Issuing Securities: Primary Security Markets

- **Primary versus secondary securities markets**
- **Initial Public Offerings (IPOs)**
- **Investment Banks**



Functions of Investments Banks

■ Three Main Functions:

- Origination
- Underwriting
- Selling

■ Origination

- Public Offering
- Private Placement
- Prospectus

Investment Bank Functions, continued

- **Underwriting**
 - “Carrying the risk”



- **Best efforts**



Investment Bank Functions, continued

- **Selling**
 - **Syndicate**
 - **Tombstone Ad**
 - **Aftermarket**



LO 11.2 Facebook IPO

- **Syndicate: Morgan Stanley (lead) and 32 other investment banking firms**
- **Offer price: \$38 per share**
 - **Firm value at offer price: \$104 billion**
 - **Underwriting fees: \$176 million**
 - **Underwriters, firm agreed to raise offer price to \$38 and increase number of shares to be sold shortly before the IPO**

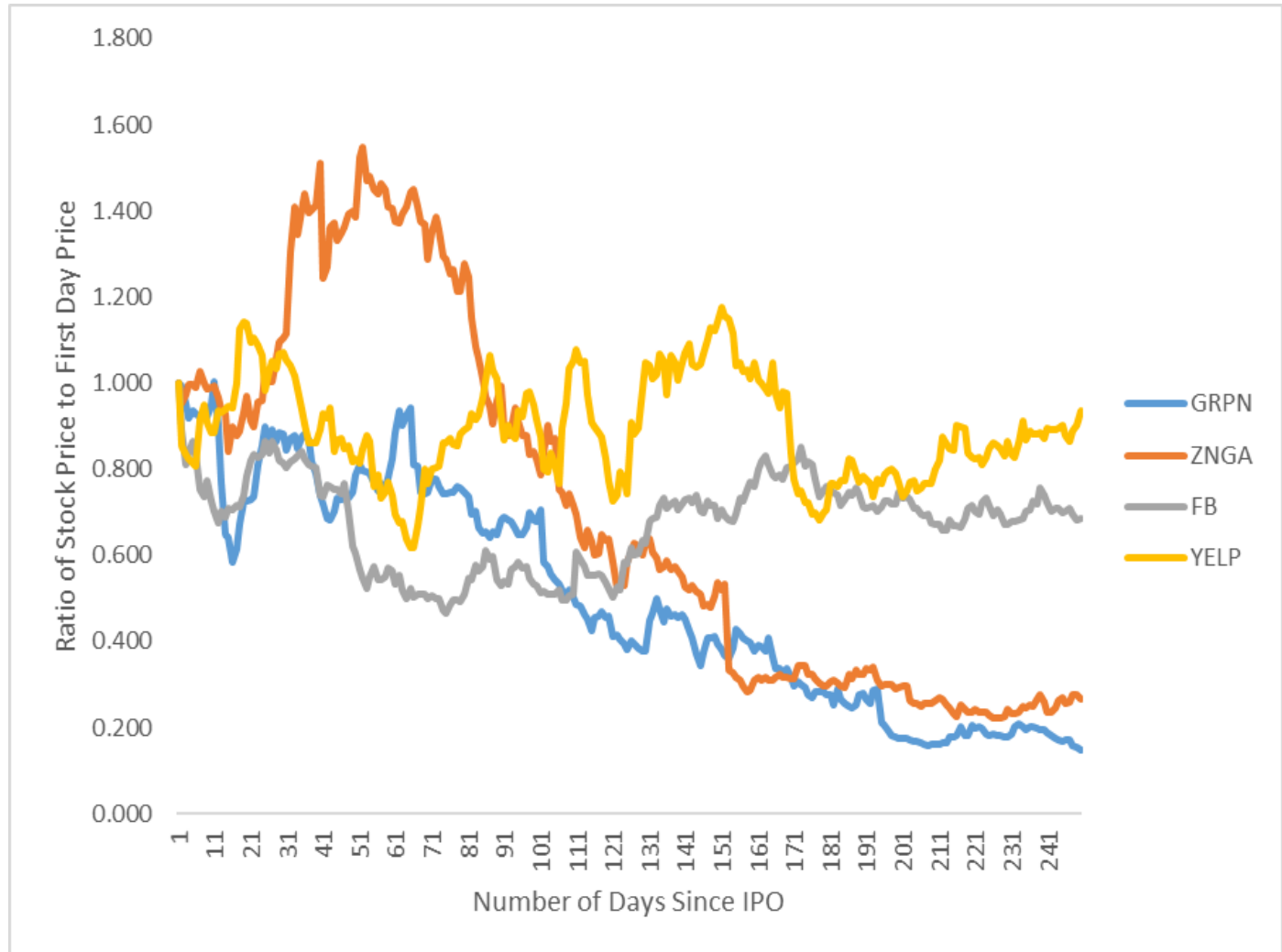


Facebook IPO

- **Initial ‘pop’ at IPO...followed by price decline**
 - **Computer and trading issues at Nasdaq**
 - **Disappointing sales, profit news; GM pullout**
 - **Research analysts were reducing profit estimates for FB**
 - **Tough market—Groupon, Yelp, and Zynga hi-tech IPOs followed by price declines**

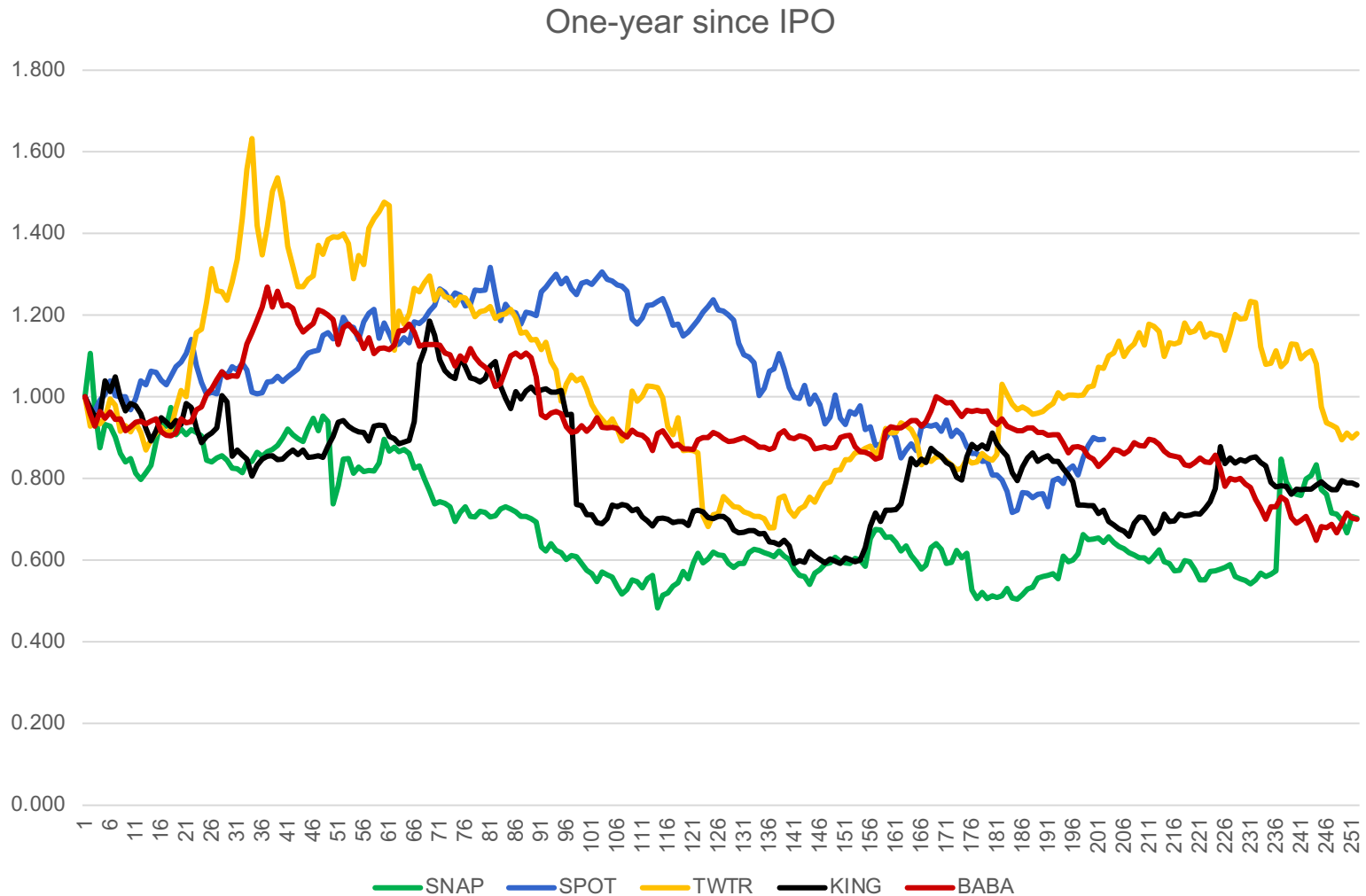
Facebook IPO

Figure 11.3 Panel A Share price performance of Selected High-tech IPOs from IPO to One Year Later



Facebook IPO

Figure 11.3 Panel B Share price performance of Selected High-tech IPOs from IPO to One Year Later
(SPOT: only $\frac{3}{4}$ year due to data restrictions)





LO 11.3

Other Ways Investment Banks Can Assist with Security Offerings

- **Shelf registration**
- **Private placement**
- **Rights offerings**
- **Competitive bids**
- **Dutch auction**



Dutch Auction Example

- Yoogole to offer 100 million shares

■ Bidder	Price	Number of shares
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A	\$20.50	25 million
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B	\$20.47	25 million
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C	\$20.45	25 million
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D	\$20.43	25 million
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E	\$20.40	25 million
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- Clearing price: \$20.43



LO 11.4 The Costs of Raising Capital

- **The costs of issuing stocks and bonds are called “flotation costs.”**
 - Out-of-pocket costs
 - Spread
 - Underpricing
- **The sum of these costs can total 20-30% or more of the funds raised**
- **Hot/cold IPO markets**



LO 11.5 Other Investment Bank Functions, Regulations, Innovations

- **Commercial paper**
- **Mergers and acquisitions**
- **Manage investment funds (e.g., company pension funds)**



Investment Banking Regulations

- **Securities Act of 1933**
 - Full, fair, and accurate disclosure
 - Prevent fraud
- **Securities Exchange Act of 1934**
 - Established SEC
 - Brokers, dealers register with SEC
- **State “blue sky” laws**



Investment Banking Regulations

- **Glass-Steagall Act**
 - Commercial banks cannot underwrite securities
- **Gramm-Leach-Bliley Act**
 - Removed many restraints of Glass-Steagall on financial services firms



Innovations in Investment Banking

- **Security design to meet needs of issuers/purchases**
- **Offering securities via internet “dutch auctions”—both stocks and bonds (Internotes, Direct Access Notes)**



LO 11.6 Trading Securities: Secondary Securities Markets

- **Organized Exchange versus Over-the-Counter (OTC)**
- **Organized Exchange: NYSE**
- **NYSE is a private firm which went “public” in 2006 by acquiring a publicly traded firm (Archipelago) which offers electronic trading of securities**



Structure of the NYSE

- **Before 2006: members own “seats”**
- **Now: 1500 trading licenses exist—called Stock Exchange Auction Trading System (SEATS)**
- **SEATS allow holders access to the NYSE trading floor (physical location) and electronic trading access.**



Structure of the NYSE

- **Floor brokers**
 - House or commission brokers
 - Independent brokers
- **Registered traders**
- **Designated Market Makers**
 - Maintain inventory of stocks assigned to them
 - Maintain a liquid and orderly market
 - Took over the role of “specialists” on the NYSE



Securities Markets and Ethics Issues

- **In the past, some market makers and specialists have been accused of:**
 - **Front running**
 - **Negative obligation**
 - **Maintaining high spreads**



Structure of the NYSE

- **Companies need to meet listing requirements, pay fees**
- **Original listing fee: \$125,000-\$250,000**
- **Annual fee: \$42,000-\$500,000 depending on number of shares**
- **Listing requirements:**

[https://www.nyse.com/publicdocs/nyse/listing/NYSE Initial Listing Standards Summary.pdf](https://www.nyse.com/publicdocs/nyse/listing/NYSE_Initial_Listing_Standards_Summary.pdf)



LO 11.7 Security Transactions

- **Bid price: offered by buyer**
- **Ask: requested by seller**
- **Spread: the difference between them**
 - **Narrower spreads imply more liquidity and faster completion of a trade**
- **Typical display:**
 - **Bid: 30.42 x 50900**
 - **Ask: 30.43 x 50800**



Security Transactions

- **Market order**
- **Limit order**
- **Stop order**
- **Short sale**
 - **Uptick rule**
 - **19.95 19.95 20.00 20.00: can do short sale**
 - **20.07 20.01 20.01: cannot do short sale**
 - **Current rule: restricts short sales on stocks whose price has fallen more than 10 percent from previous day's closing price**



Buying on Margin

- **“Buying on margin” means to use some of your money (equity) and some borrowed funds to purchase a security**
- **Margin: investor’s equity position**
- **Margin requirements: minimum percentage of the purchase price that the investor must pay from his/her funds**

Margin's effect on trading profits

Assume: 60% margin

Initially buy securities worth \$50,000

Initial			
	position	t=1	t=2
Mkt value	\$50,000	\$55,000	\$45,000
Less: borrowed			
funds	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>
Equity	\$30,000	\$35,000	\$25,000

More investing terms

- Margin call
- Maintenance margin

Margin = equity/market value

$$= (MV - \$ \text{ borrowed}) / MV$$

$$= \underline{(\text{price} \times \# \text{ shares} - \$ \text{ borrowed})}$$

$$\text{price} \times \# \text{ shares}$$

Price for margin call:

$$\$ \text{ borrowed} / [\# \text{ shares} (1 - \text{maint. margin})]$$



More terms...

- **Round lot**
- **Odd lot**
- **Program trading**



LO 11.8 Over-The-Counter Market (OTC)

- **NASDAQ**
- **Not just for small firms**
 - Intel, Apple, Microsoft
- **Centralized versus non-centralized location**
- **Specialists versus dealers**



Other Secondary Markets

■ Third Market

- Large blocks (10,000 shares) traded OTC

■ Fourth Market

- Electronic trading, ECNs



Need for speed—High-frequency Trading (HFT)

- **Trading by computers with pre-programmed algorithms to try to detect profitable trades.**
- **Trades executed in milliseconds; but need more speed to beat other traders.**
- **Pro: provide liquidity and can correctly correct small mispricing**
- **Con: trading strategies give the illusion of more market orders than really exist; can the small investor compete?**



LO 11.9 What Makes a Good Market?

- **NYSE, AMEX, NASDAQ, 3rd and 4th market all compete for listings, trades**
- **Four characteristics of a “good” market:**
 - Liquidity (breadth and depth)
 - Quick, accurate trade execution
 - Reasonable listing requirements
 - Low costs



Commissions

Commission affected by:

- **Type of broker**
 - Full service brokers
 - Discount brokers
 - On-line brokers
- **Size of trade, security price**
- **Liquidity of securities traded**
- **Ethics:**
 - Account churning
 - Placing funds in high-commission or “fee kickback” products



Some issuing firms allow...

- **Direct investing**
 - Buy shares directly from the firm
- **Dividend Reinvestment Plan**



LO 11.10 Indexes and Investing Overseas

- **How's the Market Doing?**
- **Security Market Indexes are used to track overall market and sector performance for stocks, bonds, and other investments**
- **Well-known stock market indexes:**
 - **Dow Jones Industrial Average**
 - **Based on price**
 - **Standard & Poor's (S&P) 500**
 - **Based on market value**



Wandering from Home: Investing Overseas

- **Diversification benefits**
- **Harder to do trades**
 - Liquidity
 - Currency differences
 - Regulations, tax laws
- **Solutions:**
 - American Depositary Receipts
 - Global Depositary Receipts
 - Mutual funds--professional investing



LO 11.11 Ethics Issues

- **Insider trading**
- **An insider: someone with access to important non-public information**
- **can be a corporate officer, investment banker, major shareholder**
- **blue-collar workers, too (e.g., printing press operators)**



Ethics

- **Regulation FD**
- **Churning of accounts**
- **Professional designations (CFA®, CFP™) have ethics components as a central feature of their certification programs**



Learning Extension 11

Introduction to Futures and Options

- **What is a derivative security?**
- **Why do they exist?**
- **Future Contracts**
- **Options**



What is a derivative security?

A derivative security has its value determined by, or derived from, the value of another investment vehicle.

They represent a contract on an underlying security or asset



Why do derivatives exist?

- **Shift risk from those who don't want to carry risk to those who are willing to do so.**
- **Bring additional information into the market from hedgers, speculators, market expectations.**
- **Lower commissions and margin requirements than in spot market**



Futures contracts

- A futures contract obligates the owner to purchase the underlying asset at a specified price (the exercise or strike price) on a specified date



Types of futures contracts

- **Corn, wheat, soybeans...**
- **Stock indexes, interest rates, foreign currency values...**
- **Gold, copper, silver, oil...**
- **Coffee, sugar, cocoa...**



Options

An options contract gives the owner the choice of trading the underlying asset at a specified price (the exercise or strike price) on or before a specified date or expiration date.



Two basic types of options

- **Call option: an option to buy the underlying asset at the strike price**
- **Put option: an option to sell the underlying asset at the strike price**



Call Options

- **Suppose you buy an option to buy 100 shares of ExxonMobil stock at \$75 a share. How much is the option worth if on the expiration date the price of Exxon is:**
 - **a) \$60 a share?**
 - **b) \$75 a share?**
 - **c) \$80 a share?**

Call Options--ANSWERS

- Suppose you buy an option to buy 100 shares of ExxonMobil stock at \$75 a share. How much is the option worth if on the expiration date the price of Exxon is:
- a) \$60 a share? **\$0**—cheaper to buy in the market at \$60 than at the \$75 strike price
- b) \$75 a share? **\$0**—as strike price = market price
- c) \$80 a share? **\$5**—intrinsic value as option allow you to purchase for \$75 a stock with a market value of \$80.



Put Options

- **Suppose you buy an option to sell 100 shares of ExxonMobil stock at \$75 a share. How much is the option worth if on the expiration date the price of Exxon is:**
 - **a) \$60 a share?**
 - **b) \$75 a share?**
 - **c) \$80 a share?**

Put Options--ANSWER

- Suppose you buy an option to sell 100 shares of ExxonMobil stock at \$75 a share. How much is the option worth if on the expiration date the price of Exxon is:
- a) \$60 a share? **\$15**—can sell for a price of \$75 when the market price is \$60.
- b) \$75 a share? **\$0**—as strike price = market price
- c) \$80 a share? **\$0**—can sell for a higher price in the market than the put's strike price of \$75