How Securities Are Traded

Chapter 3

Primary vs. Secondary Security Sales

- Primary
  - new issue – issuer receives the proceeds from the sale
  - first-time issue:
    - *IPO* = issuer sells stock for the first time
    - *seasoned new issue* = new issue by a company that already has floated equity
  - target: public offering vs. private placement
- Secondary
  - existing owner sells to another party
  - issuing firm doesn't receive proceeds and is not directly involved

Investment Banking Arrangements

- Underwriting
  - investment bankers form an underwriting syndicate
  - they buy the shares from issuer (at the initial offering price less a spread) and resell them to the public (*firm commitment*)
  - underwriters assume full risk
- Best Efforts
  - investment bankers just “help” the issuer
  - act as intermediaries – no firm commitment, no risk

Public Offerings

- Public offerings
  - registered with the SEC and sale is made to the investing public.
  - shelf registration (rule 415, since 1982): shares can be sold for 2 years after initial registration
- Initial Public Offerings (IPOs)
  - underwriters gather info from large investors on their interest, then allocate shares accordingly
  - discounted price to reward information shared ➔ underpricing (another cost of the issue)
  - good initial performance, but poor after 5 years

Private Placements

- direct sale to a limited number of sophisticated investors not requiring the protection of registration with SEC
- cheaper than public offerings
- dominated by institutions
- not suitable for very large offerings
- very active market for debt securities
- not traded on secondary markets (less liquidity) ➔ lower price

Organization of Secondary Markets

- Organized exchanges
- Over-the-Counter (OTC) market
- Third market
- Fourth market

Organized Exchanges

- auction markets with centralized order flow
- only members can trade (commission broker)
- listing requirements
- securities: stock, futures contracts, options, and to a lesser extent, bonds
- examples: NYSE, Amex, regional exchanges

OTC Market

- dealer market without centralized order flow
- no listing or membership requirements
- *Nasdaq*:
  - largest organized stock market for OTC trading
  - information system for individuals, brokers and dealers
  - requirements for listing on the computer network
  - 3 levels: “inactive” investors, brokerage firms, market makers
- securities: stocks, bonds and some derivatives
- most secondary bonds transactions

Third and Fourth Market

- Third Market
  - trading of listed securities away from the exchange (NYSE-listed firms on OTC)
  - institutional market: to facilitate trades of larger blocks of securities
- Fourth Market
  - direct trading of investors of exchange-listed securities, with no middleman involved in the transaction
  - Electronic Communication Networks (ECN) – allow members to post orders and be matched with other orders, for a per-transaction fee

Trading on Exchanges

- Participants
  - (commission) broker – acts at the order of the client
  - dealer ("specialist") – acts as market-maker, centralizing all orders for a specific stock
- Features
  - only one specialist in a stock, but usually more stocks per specialist
  - all trading in a stock is conducted at *specialist's post* ➔ price priority (best orders executed first)

Types of Orders

- Market Order
  - buy or sell order to be executed immediately at the market price
  - actual price may vary because of order volume or "trading inside the quoted spread"
- Limit Orders
  - investors specify prices at which they are willing to buy (*limit-buy*) or sell (*limit-sell*)
- Stop-Loss
  - stock is sold when its price falls below a limit
  - *stop-buy* order = opposite transaction (used with short-sales)

Trading on the OTC Market

- same kinds of participants as on exchanges, but more than one dealer per stock (no specialists)
- brokers look for the dealer with best price
- *trading through* = dealers execute trades at their bid/ask prices rather than better prices from limit orders by public customers

Costs of Trading

- Commission
  - fee paid to broker for making the transaction
  - brokers can be *full-service brokers* (financial consultants) or *discount brokers*
- 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

Buying on Margin

- investor borrows a part of the purchase price from the broker (*brokers' call loan*), with the shares being used as collateral
- interest rate paid = interest rate charged by bank + service charge
- *margin* = the part of the purchase price contributed by the investor
- *percentage margin* = equity in account / market value of equity
- maximum margin is set by the Fed (currently 50%)

Buying on Margin (cont.)

- as stock prices fluctuate, the value of equity in the account changes ➔ the margin changes
- if the margin falls below the *maintenance margin*, the broker issues a *margin call*:
  - the investor can add stocks or cash to the account
  - the broker can sell some of the shares
- investor's return compared to just buying stock
  - higher profit if price increases
  - higher loss if price falls
  - loss equal to interest if price stays the same

Short Sales

- investor borrows shares from their broker and sell them on the market
- later, they need to *cover their short position*, i.e. buy the shares on the market and return them to the broker (and pay the dividends paid during the loan, if any)
- only allowed if last change in price was positive to eliminate speculation against stocks
- the investor is required to keep cash or other securities in their account (collateral) worth at least the margin on short sales

Short Sales (cont.)

- as stock prices fluctuate, the value of equity in the account changes ➔ the margin changes
- if the margin falls below the *maintenance margin*, the broker issues a *margin call*:
  - the investor can add stocks or cash to the account
  - the investor can cover the short position

  ➔ usually accompanied by stop-buy orders
- investor's return
  - high profit if price falls
  - high loss if price rises

Regulation of Securities Markets

- Government Regulation
  - federal agencies: SEC, SIPC
  - in response to accounting scandals
- Self-Regulation
  - circuit breakers = stop trading during periods of high volatility, to allow market participants to acquire better information
- Insider Trading
  - the usage of *inside information* is illegal