

LECTURE 2

Chapter 3

SECURITIES MARKETS

IPO Required Docs:

- Amendment to the certificate of incorporation
- Corporate Governance (Private are far less formal – responsibility)
- Recruit Independent Board Members / new board committees.
- Registration statements. – SOX (Sarbanes-Oxley Act)

- Primary Markets – First time Companies Issue securities (IPO) to raise capital – sell or float securities (Seasonal Issuers)
 - Underwriters (I Banks)– market the securities – SEC / prospectus (Red Hearing) – Prospectus – Shelf Registration – SEC approved – Rule 415 - regulated for 2 years to come into the market to raise capital
 - Private Placement – Cheaper – Rule 144A (with registration rights) – sophisticated investors
 - IPO Process – Road Shows / Book Building / Allocation / Valuation based on Supply and Demand / Valuation methods to justify stock price recommendation

➤ □ Securities Act of 1933

Congress enacted the Securities Act of 1933 in the aftermath of the stock market crash of 1929 and during the ensuing Great Depression.

The 1933 Act was the first major federal legislation to regulate the offer and sale of securities. The primary purpose of this act is to require full and fair disclosure in connection with the sale of securities to the public (during the 1920's – fraud in the issuance of securities /purchase on margins as little as 5% down). The Act enforces what securities & types of transactions need to register (Exempted (Regs A,D,S,147) and Non-Exempt).

- Secondary Markets - Not affecting each other stock – simply a transfer between investors

➤ **Securities Act of 1934**

- Created the SEC – delegated authority to enforce federal laws
- Required the registration of Broker/Dealer
- Required the registration of all exchanges and all national securities associations
- Required the registration of securities information process (SIP)
- Control the extension of credit (Loan/Margin) on securities

- Issuers of securities to file financial reports (10k, 10Q, 8K)
- Rules on insider trading / trading activity, market manipulation (Reg M, Rule 101, 102, 103, 104 (Stabilization), 105 (selling short constraints))

- How securities are traded – 4 types of markets:
 - Direct Search Markets - Not Organized – seek each other (buyers and sellers)
 - Broker Markets – Pay the broker to find the seller or the buyer
 - Dealer Markets – Purchase on their own – Inventory and markets them to retail (OTC)
 - Auction Markets – Bid and Ask – search across Dealers inventory for best price (NYSE)

Types of Orders:

- **Market Orders**
 - A market order is an order to buy or sell at the prevailing market price. (note: “not help market order” – discretion of the broker to execute)
- **Limit Order**
 - A limit order is an order to buy or sell at a specific price or better
- **Stop Order (a/k Stop Loss Order)**
 - A stop order is resting order to buy or sell that is activated when the stock trades at or through the stop price. Once triggered automatically on “the book” the orders become market order. The stop order takes two trades to execute (Triggers and then execution price – next price)
 - This is designed to protect the profit or prevent a loss if the stock begins to move the wrong direction.
 - It's not guarantee (like the limit order has)
 - These orders are canceled if they do not participate in the closing trade of the day.

Trade Settlement: T+3 (Regular way)

Market Centers – when a member firm's customer calls a broker to place an order to buy or sell, the firm forwards the order to the market center to be executed. The following are market centers that are available for trade execution:

1. Exchange (NYSE, Nasdaq) or Floor broker

- The firm may direct the order to that exchange or top a competing exchange.
- 2. Market Maker
 - A market maker is a firm that publishes quotes in a stock and stands ready to buy or sell a given number of shares on continuous basis – **required** to publish firm quotes.
- 3. Internalization
 - An order may be placed to a separate division of the member firm to be filled from inventory from the firms' proprietary account rather than sending it to a market maker or market.
- 4. Electronic Communications Network (ECN)
 - i. Orders may also be ordered through ECN, an electronic trading system that automatically matches buy and sell orders at specific prices
 - ii. ECN are SEC sanctioned alternative trading systems (ATS) that are open 24 hours a day and match buy and sell orders. *For years the trading needed to be done between 9.30-4pm but in the last 10 years the demand trading grew to afterhours trading (note: volume is low, often leading to higher volatility – care is needed)*

EXCHANGE NATIONAL MARKETS

The New York Stock Exchange (NYSE)

- NYSE maintains a physical floor-based trading model.
- The NYSE trading model includes several important market participants:
 - **Designated Market Makers (DMM)** – also called specialists
 - These individuals bring order and liquidity to an exchange floor.
 - Each listed stock is assigned is assigned to a DMM
 - Stock exchanges have controls (volume and price movements), so the DMM know how much buying or selling is required, as principal, to keep the stock from running wild.

- **Special Liquidity Provider (SLPs)**
 - Another set of individuals – electronic market maker that is permitted to compete with the DMMs.
 - The requirement is different – bid or offer (one-sided).
 - Their job is to add liquidity to the market.

- **Floor Brokers**
 - These individuals are generally employees of the member firms that have a trading license.
 - Their primary function is to handle the order flow received from buy-side customers from the upstairs trading rooms of their employers and other member firms. *(Note: Two-Dollar Brokers are floor brokers who receive business from other floor brokers when they are too busy to handle all of their firms' orders)*

NYSE trading halts and limitations:

New Rule for market halts – New Rule 80B (April 2014):

Level of Market Declines	S&P from the Previous Trading Day	Halt Times
Level 1	7%	15 min
Level 2	13%	15 min
Level 3	20%	rest of the day

National Associations of Securities Dealers Automated Quotation (NASDAQ)

- In August of 2006 NASDAQ stock market began to operate as an independent national securities exchange (it used be an OTC)
- Is a screen-based, SEC registered stock exchange.
- Divided into 3 main components:
 - Global Select Market (GSM) (larger companies listed)
 - Global Market (GS)
 - Capital Market
- Minimum listing requirements (GSM, GM) (Initial: 3 Market makers / \$4, Ongoing: 2 Market Makers / \$1) – Minimum Number of shareholders owning 100 shares or more.
- Two levels of service (Level 1, 2 and 3)

- a. Level 1: This is for Registered Reps and individuals investors (more info)
- b. Level 2: This for OTC traders and financial institutions (firm quotes displayed):

ABCD Last \$31.10

Market Maker	Bid	Ask	Size
MLCO	31	31.12	10-12
MHMY	31.10	31.20	16-25
SALD	31.05	31.15	3-10
WEED	31	31.12	2-15

MLCO is willing to buy up to 1,000 shares at 31 and set up to 2,000 shares at 31.13. MHMY is willing to buy up to 1,600 shares at 31.10 and sell up to 2,500 shares at 31.20, and so on.

- c. Level 3: This is for Market makers – it provides the services of Level 2 plus the capability to enter the system to update quotes and/or display,

OTC MARKETS

OVER THE COUNTER BULLETIN BOARD (OTCBB)

- The OTCBB is an electronic interdealer quotation service for more than 3,300 issues that do not meet the listing requirements of stock markets such as NASDAQ or NYSE.
- At least One Market Maker per security
- Quotes (Bid/Ask) MM can be one-sided bid
- SEC require that all issuers whose securities are quoted on the Bulletin Board be current in their regulatory filings.

OVER THE COUNTER PINK MARKETPLACE

- No requirement for companies quoted in the OTC Pink
- Quotation system - Penny Stocks (less than \$5)

THE THIRD MARKETS

CONSOLIDATED QUOTATION SYSTEM (CQS)

- Quotes from both third market makers and DMMs in listed stocks

CONSOLIDATED TAPE SYSTEM (CTS)

- Reports real-time trade information on listed equity securities

NASDAQ Trading & Reporting Services

Nasdaq Level 3 Service Screen Shot

NASDAQ
GO

NASDAQ STOCK MKT INC CUSIP: 631103108 NGS: Market Open

Cross Data

Order Entry

Quote Mana...

OrderEx Sc...

Time and Sa...

ACT Trade E...

ACT Trade S...

Last:	31.75	P	-0.33	12:00	Last Vol:	403,666	
PCL:	32.06	Hi:	32.24	Low:	31.75		
NOOP:	32.07	NOCP:		Imb:	950 \$	Paired:	7787

Q	11	31.75	NBBO	31.76	9	Q
DQT						
PQT						

B:	Price	Size		A:	Price	Size
▲		▼	▼	▲		▲
		0.01	▲			▼

NSDQ	11	31.75	▲	31.76	▼	9	NSDQ
EDGX	3	31.75		31.76		2	ARCX
ARCX	1	31.74		31.76		2	GNN
MSCO	1	31.74		31.85		1	BTRD
GNN	2	31.73		31.87		1	FPKJ
FBRC	1	31.73		31.89		3	EDGX
FPKJ	1	31.72		31.89		1	CBOE
PIPR	1	31.71		31.89		1	GSCO
AUTO	9	31.70		32.00		1	FBRC
GSCO	1	31.66		32.04		1	PIPR
CBOE	1	31.62		32.10		1	TWPT
WCHV	1	31.57		32.11		1	DOWN
DOWN	1	31.51		32.25		1	MSCO
SOLR	1	31.51		32.34		1	GANT
UBSS	11	31.50		32.35		1	NTE

Order Bitter

Market Minder

Ticker

Trade Mana...

Indices

B 10@MKT

B 100@MKT

B 1000@MKT

S 10@MKT

S 100@MKT

S 1000@MKT

Level 3 Quote for NASDAQ OMX Group, Inc. (illustrative)

KEY:
 NBBO: National Best Bid and Offer
 NOOP: NASDAQ Official Opening Price
 NOCP: NASDAQ Official Closing Price

- BUYING ON MARGIN – Borrow to return higher – 50%
 - Trigger margin Call – at margin level – at trigger it requires:
 - Equity injection
 - Sell of security
 - IRR higher when on Margin

BUYING ON MARGIN

One Year (Holding Period) - Assuming No Dividends

		Per			Margin		Interest			
		Share	Shares	Total	Borrow	Borrow	Rate	Pmt	NW	HPR
No Margin	Buy stock	20	1,000	20,000	0%	-			20,000	
	Sell Stock	25	1,000	25,000					25,000	
	Profit			5,000					5,000	25.0%
With Margin	Buy stock	20	1,000	20,000	50%	10,000	5.0%	500	10,000	
	Sell Stock	25	1,000	25,000		10,000		500	14,500	5.0%
	Profit			5,000					4,500	45.0%

- SHORT SELLING – First you sell and then you buy shares
 - An investor borrows a share of stock from broker and sells it. Later, the stock seller must purchase the stock in order to replace the stock that they borrow – betting on going down for the profit. THIS is COVERING THE SHORT POSITION
 - Exchanges permit short selling only when the last change of price is positive
 - Also require that the proceeds for the stock sale must be kept with the broker.

SHORT SELLING

Current Price 20

		Per			Margin		Interest			
		Share	Shares	Total	Borrow	Borrow	Rate	Pmt	NW	HPR
	Borrow shares	20	1,000	20,000	Cr	0%	-		20,000	Cr
	Buy Shares	15	1,000	15,000					15,000	
	Profit			5,000					5,000	25.0%

Chapter 4

Investment Companies: Financial Intermediaries

Funds – set for purpose – profit measurement – NAV (Equity)

$$\text{NAV} = \text{MV} - \text{Liabilities or per share (MV} - \text{Liabilities)} / \text{Shares outstanding}$$

Types:

1. Unit Investment Trusts:

Pools of money in a portfolio – fixed for life of the fund (Unmanaged). To form a unit investment trust, a sponsor, typically a brokerage firm buys a portfolio of securities.

Then sells to the public shares (units in the trust), called Redeemable trust certificates (municipal, corporate).

2. Managed Investment Companies

Board of Directors hires management company to manage the fund – paying an annual fee (.2 – 1.5%)

- a. **Closed-end:** ready to redeem or issue shares at the NAV price.

Closed-End Funds

	NAV	Market Price	Premium/Disc (Liquidity)	52-week
Adams Express	15.96	13.85	-13.22	13.84

Selling at a discount

$$(\text{Price} - \text{NAV}) / \text{NAV}$$

- b. **Open-end:** Do not redeem or issue shares - exchange within owners – it's usually traded at the NAV level
Sales Charge (Load)

3. Other Investment Organization

- a. Commingled Funds – partnership of investments that pool their funds (insurance, partnerships, banks)
- b. REIT (closed end funds) – invest in RE with leverage (70%) - Raise the Capital
- c. Hedge Funds (structured as a private partnership)

HEDGE FUNDS

- Require the investor to have an initial “lock-up” agreement for withdrawals distributions. – This will allow the Hedge Fund Manager to invest in illiquid assets.
- Since they are not SEC regulated (private – sophisticated investors) the manager invests in other types of investments such as Derivatives, short selling and leverage.
- Compensation fee + share of profit (1.5% + 20% of profit)
- Hedge funds are designed to invest in various funds – focus on derivatives, distress firms, currency speculation, convertible bonds, emerging markets, mega arbitrages.
- Section of growth – Fund of Funds

MUTUAL FUNDS

- Each fund has an INVESTMENT POLICY - Discussed in the prospectus – allocation (short / Low / Risk – Fidelity, Vanguard, Dreyfus)
- Money Markets (CD, CP, Deposits – one month average)
- Equity Funds (Stock – 95% of stock, 5% Money market)
 - Income Funds (high dividends)
 - Growth Funds (capital gain, No dividends)
- Specialized Section Funds (specific Industry – i.e. Healthcare)
- Bond Funds (Corporate Funds, Municipal Funds)
- Investment Funds (Global funds)
- Balanced Funds (Equity, Bonds)
 - Life-cycle funds (aggressive for young investor) – (Conservative for older)
 - Targeted Maturity funds – targeted to change as you get older
- Asset Allocation flexible fund (market timing between equity and bonds depending of economic environment)

- Index Funds
 - Vanguard 500
 - S&P 500
 - FEES: front-end load / back-end load / operating expenses

FEES AND EXPENSES

Before Fees - NAV

$$(NAV_1 - NAV_0 + \text{Income} + \text{Capital Gain}) / NAV_0 = \text{Rate of Return}$$

$$NAV = \text{Value of the Funds} - \text{Debt (leverage)}$$

Front-end Load	Back-end Load	12b-1 Charges
Commission or sale charge paid when you purchase the securities	Redemptions % exit fee when you sell the security	SEC allows managers of 12b-1 funds to pay for advertising/marketing – fees from investors.
No more than 8.5%	5-6% and reduces it by 1% from every year the fund are left invested – contingent –or deferred sales charge	
Using 3.0% \$1,000 paid for fund 6% Load = 94 price $60/940 = 0.064$ 6.4%		

Expenses – referred to as “soft dollars”

Taxation – “pass-through states” – U.S. Tax code

If the fund is held at IRA / 401K – No taxes – retirement accounts

EXCHANGED-TRADED FUNDS (ETF) - trades like a stock

Allow investors to trade Index portfolios

SPIDER (SPDR) or S&P Depository receipt - daily trades – unlike Mutual funds, the NAV is calculated at the end of the day.

DIAMONDS (DIA) – DJIA 30

QUBES (QQQ) – NASDAQ 100

WEBS – World Equity benchmark shares – foreign indices

Mutual end performance – compared to the Index / stock market

INFORMATION ON FUNDS – SEC required – Prospectus

- a. Statement on Investment Objective
- b. Investment Policies and Risks
- c. Fund Advisory and Management Bios
- d. Cost Structure (Expense Loads)
- e. Statement of Additional Information (“SAI”) – part B of the prospectus.