



Fall 2013  
ADVANCED FINANCIAL INSTRUMENTS AND MARKETS

**Lecture No. 07**  
**Organization and Structure of Markets**

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**Functions of Investment Bankers**

- \* Advising issuer on terms and timing of offering
- \* advisor
- \* Buying securities from issuer
- \* underwriting
- \* Distributing issue to public
- \* distributor

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**Public Sale of New Securities**

- \* Underwriting
- \* Firm-commitment underwriting
- \* Best-efforts underwriting
- \* Underwriting Syndicate

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## Investment Banking Firms

- \* Commercial Banks
  - \* underwrite securities
- \* Securities Houses
  - \* distributor
  - \* market makers
  - \* brokers

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## Classification of Securities Firms

- \* Bulge-Bracket Firms
- \* Major Bracket Firms
- \* Submajor Bracket Firms

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## Regulation of the Primary Market

- \* Securities and Exchange Commission (SEC)
  - \* regulates underwriting activities
- \* Securities Act of 1933
  - \* governs issuance of securities
- \* Rule 415: Shelf Registration Rule
  - \* file single registration document for selling securities on a continuous basis

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## Variations in the Underwriting Process

- \* Bought Deal
  - \* underwriting of bonds
- \* Auction Process
  - \* underwriting of stocks and bonds
- \* Preemptive Rights Offering
  - \* underwriting common stock

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## Bought Deal

- \* Investment banking firm or group of firms offers to buy an entire issue from the issuer.
- \* Attractive features:
  - \* quick in bringing issue to market
  - \* lower risk of capital loss

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## Auction Process

- \* Competitive Bidding Underwriting
- \* Single-Price Auction or Dutch Auction
- \* Multiple-Price Auction

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## Preemptive Rights Offering

- \* Existing shareholders have the right to buy new common stock at a price below market value.
- \* Elements of a rights offering:
  - \* Subscription price
  - \* Number of rights
  - \* Option to transfer rights
  - \* Right's expiration time
- \* Standby Underwriting Arrangements

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## Private Placement of Securities

- \* Sale of securities to a limited number of institutional investors.
- \* SEC specified conditions to be met for private placement.
- \* Issuers work with investment bankers.

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## Session - II



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### Function of Secondary Markets

- \* Providing security values and required returns
- \* Providing liquidity

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### Trading Locations

- \* Organized Exchanges
  - \* NYSE
  - \* AMEX
  - \* Regional Exchanges
- \* Over-The-Counter Exchanges

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### Foreign Stock Exchanges

- \* United Kingdom
  - \* London Stock Exchange (LSE)
- \* Germany
  - \* Frankfurt Stock Exchange
  - \* Other regional exchanges (7)
- \* Japan
  - \* Tokyo Stock Exchange (TSE)

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## Market Structures

- \* Continuous Market
  - \* prices are determined continuously throughout the trading day
- \* Call Market
  - \* orders are grouped together for simultaneous execution at the same price
- \* Mixed Market
  - \* using elements of the continuous and call market

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## Perfect Markets

- \* Large number of buyers and sellers
- \* Buyers and sellers are price takers
- \* Commodity traded is homogeneous
- \* Market is frictionless with no transactions costs, taxes and other impediments
- \* Ability to sell short

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## Brokers as Match Makers

- \* A broker acts on behalf of an investor who wishes to execute orders.
- \* Broker functions:
  - \* Receives, transmits and executes orders
  - \* Brings together buyers and sellers
  - \* Negotiates prices
- \* In return, the broker receives a commission.

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## Dealers as Market Makers

- \* The dealer holds in inventory the financial asset traded.
- \* Dealer functions:
  - \* Takes a position (long or short) in the asset
  - \* Provides opportunity to trade immediately
  - \* Offers price information
  - \* Serves as auctioneer
- \* Dealer profit is the bid-ask spread.

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## Electronic Trading

- \* Types of electronic trading systems for bonds:
  - \* dealer-to-customer systems
  - \* exchange systems
- \* Advantages of electronic trading:
  - \* liquidity
  - \* price discovery
  - \* use of new technologies
  - \* trading efficiencies

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## Market Efficiency

- \* Operational Efficiency
  - \* Offers investors reasonably priced services related to buying and selling securities.
- \* Pricing Efficiency
  - \* Prices fully reflect all available information relevant to the valuation of securities.

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