Topic 9: Financial Markets

I. Types of Financial Markets

The financial markets bring people or organizations that have excess savings together with people or organizations that need to borrow money. We might find it useful to make these distinctions:

A. Money Markets *vs.* Capital Markets

Money market transactions are typically defined as those involving financial commitments lasting less than one year. Buying a 3-month US Treasury Bill is an example of a money market transaction.

Capital market transactions are typically defined as those involving financial commitments lasting a year or longer. Buying common stock and long-term bonds are examples of capital market transactions.

The money and capital markets have become much more complex and internationalized in recent decades as information and communication technologies have improved, and as new financial tools have been developed for diversifying and managing risks.

B. Public Markets *vs.* Private Markets

Common stock traded in a public market ("publicly-held") can be owned by any private investor – any *member* of the public – who buys the stock through a brokerage firm or directly from a current owner. Publicly-held does not mean that the firm is collectively owned by the public, like a school or park or street would be.

Common stock that is not publicly traded is said to be *closely-held* by a small group of investors. Sometimes closely-held stock is owned by heirs of an older company's founders; sometimes it is held by *venture capitalists* that help new companies, especially in the high-tech sector, get started with *private equity* investments. Venture capitalists provide both money and advice to startup companies. But because venture capitalists face high risks in dealing with new firms, they expect to have a say in how business is conducted (including appointing some members of the board of directors), and to receive a generous share of any financial returns generated. If the stock is closely-held, then you and I (the "public") can not buy/sell it through a broker, and perhaps can not even buy it from a current owner (or sell it if you are a current owner) without the consent of other current owners. So privately held securities place liquidity risks on those who hold them.

C. Primary Market *vs*. Secondary Market

A *primary market* transaction involves the sale of newly-created securities, in which the provider of money gets the newly-created claim and the issuing firm or other organization gets the use of the money paid. When talking about the primary market for common stocks, we sometimes distinguish between

- Seasoned equity offerings (SEO): new shares of stock sold by a firm whose stock already is publicly traded

- Initial Public Offerings (IPOs): stock sold to the public (typically through brokers) for the first time (such that the firm was previously a *closely-held* corporation)

A *secondary market* transaction involves sales among individual or *institutional* (mutual funds, pension funds, large banks) investors of securities (stocks or bonds) that were issued at earlier times. Money changes hands among investors (often facilitated by brokers), but the issuing corporation gets none of this money. When the nightly news anchor talks about stock trading activity on the New York Stock Exchange and the NASDAQ market, what is being reported on is secondary market transactions.

Question: Since the issuing corporation does not get any of the money, does it care about secondary market activity? Answer: YES, for at least two reasons:

1) The price observed in the secondary market indicates the investing public's up-to-the-minute evaluation of management's performance

2) If there were no *secondary* market, people would have been reluctant to buy the shares when issued in a *primary* market offering (or would have insisted on higher returns, due to *liquidity risks,* and thus would have paid lower prices for the securities in those primary market offerings)

The existence of organized public secondary capital markets reduces the liquidity risks that investors face when they buy long-term securities, thereby reducing their required rates of return and allowing them to pay more than they otherwise would for securities. Their willingness to pay more for a given security means that organizations can obtain money from lenders or owners at a lower periodic percentage cost. Thus the financial markets allow our economy to more efficiently direct money from those that have it to those that can make productive use of it.

A secondary market transaction might even allow for buying something someone could not buy in a primary market transaction. Perhaps you would like to earn financial returns

by lending money, you identify XYZ Company as a strong party to lend to, and you have a desire to be repaid in 13 years. It is very unlikely that XYZ is issuing bonds today that have 13-year maturities (companies tend to issue bonds with round-number lives, like 10 or 20 or 25 or 50 years). But in a secondary market transaction you might well find bonds available to buy that were issued seven years ago with 20-year maturities, and thus will mature in 13 years when you wish to receive repayment.

II. Financial Market Organizations

Financial transactions are facilitated by institutions that help to efficiently direct money from those that have it to those that can productively use it. We might classify these institutions in a couple of ways for our current purposes:

A. Institutions that deal with households and small businesses

These institutions are the commercial and savings banks, credit unions, and insurance companies that accept money from households or small businesses and offer the management of financial risks in return. (A bank repays a saver's money even if the loan made with that money is not repaid; a life insurance company accepts premium payments from a person and then pays money to the surviving family members if the person dies while children or others are still financially dependent on him/her.)

B. Institutions that deal with businesses or governments in huge dollar transactions

Large banks and insurance companies often lend large amounts of money to large companies. But a large organization that wants to issue bonds or stock in order to access the huge amounts of investment dollars in the *public* markets deals with an institution called an *investment bank.* An investment banker can serve as

- Advisor, helping the firm/agency to determine what type of security to issue and when to issue it
- Agent in a private placement, perhaps placing tens or hundreds of millions of dollars in new bonds with an insurance company or other large institutional investor
- Underwriter in a public offering of new securities, perhaps buying all of the new common stock a company issues so the company gets its money quickly, and then reselling the stock to the public
- Dealer, or market maker (to assure liquidity after new securities have been issued)

How can the investment banker assume the risks of underwriting new shares of stock? By making a thorough analysis of the market, and by expecting to charge stock buyers a higher price than is paid to the issuing firm (a "spread"). [The money ceded to the underwriter, and other "flotation" costs, can be so high that companies' creation of new securities – especially new shares of common stock – is a fairly infrequent event.]

But there is a danger to the investment banker, in that the price paid to the issuer could turn out to be *higher* than the price the investing public will pay. If that happens, the investment banker bears the loss. To spread the risk, especially for a very large issue of new securities, an investment banker might put together a *syndicate* of investment banking firms, all of whom purchase some of the securities and then bear the risks of reselling them. A "tombstone ad" in the *Wall St. Journal* or other financial publication lists the names of all the investment banking firms involved in a particular underwriting. Yet there is risk to the issuing firm, as well: it may accept a price per share from the investment bankers that is much lower than the investing public ends up paying after the market has stabilized. This *underpricing* transfers wealth from the issuing firm (the current shareholders) to the initial buyers of the new shares.

III. Financial Market Regulation *[In mid 2010 Congress undertook a major overhaul of U.S. financial market regulation through the Dodd-Frank financial reform act. Among its creations were the Volcker Rule, which limits the investments banks can make; the Consumer Financial Protection Bureau, with great power to control financial products it deems unfair/abusive; and the Financial Stability Oversight Council, which exerts added regulation on financial institutions deemed "systematically important," i.e. too-big-to-fail. Yet even by mid 2012 the new law's regulations were still being hammered out. So we will not spend time on this section. Some material shown below is likely to remain current after the final regulations are in place, but some may not.]*

We regulate the securities markets to help assure the free flow of information to investors, and to prevent manipulation of the markets. Securities markets in the U.S. are regulated by various government agencies and private organizations:

- *Securities and Exchange Commission* (SEC; a federal agency): oversees the registration and sale of new securities, punishes *insider trading* by high-level managers who can benefit from special knowledge that other investors lack But note that the SEC's approval for the sale of new securities does not assure the public that the securities would be a good investment; it assures only that the issuing company has complied with certain information-reporting requiurements.
- *Federal Reserve System* (federal agency): sets *margin requirements* for borrowing money to buy stock (≤ 50% of stock value since 1974)
- *State securities regulators* in the 50 states: enforce state securities ("blue sky") laws; have worked in recent years for greater coordination among states in their regulatory efforts
- *Stock Exchanges* (private organizations): require information in excess of minimum legal requirements (*e.g.*, New York Stock Exchange requires quarterly reports), can halt trading in a stock if the public lacks access to new information that might have a major impact on the company's stock. Along with the NYSE

is another “national” exchange, the American Stock Exchange (ASE or AMEX), on which somewhat smaller corporations’ stock shares tend to be listed. There are “regional” exchanges as well (including the Chicago Stock Exchange); these exchanges list the stocks of large corporations that may also be listed on the NYSE or ASE, and also those of smaller regional firms that are large enough to be publicly traded but too small for listing on a national exchange.

- *Financial Industry Regulatory Authority (Finra) [formerly National Association of Securities Dealers*, or NASD]. A private organization that can discipline stock brokers for improper activities.
- Newer electronic communication networks that facilitate the buying and selling of securities will have to develop their own self-regulation systems, or they will risk harm to their reputations and, possibly, special government oversight.