

How Securities Are Traded

Chapter 5

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Management,**

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Brokerage Operations

- Brokerage firms earn commissions on executed trades, sales loads on mutual funds, profits from securities sold from inventory, underwriting fees and administrative account fees
 - Full-service brokers offer order execution, information on markets and firms, and investment advice
 - Discount brokers offer order execution

Account Types

- Cash account: Investor pays 100% of purchase price for securities
- Margin account: Investor borrows part of the purchase price from the broker
- Asset management account: automatic reinvestment of excess cash balances in money market fund

Account Types

- Cash management account
 - Checks can be written against account's assets
 - Instant loans at a markup to call money rate based on the account's assets
- Wrap account: Brokers match investors with outside money managers
 - All costs, fees wrapped into one

Fees and Costs

- Brokerage commissions differ by security, broker, and investor
 - Institutional investors have greatest negotiating power
- Dividend reinvestment plans permit reinvestment of dividends in additional stock
 - Avoids commissions, administrative fees

Orders in Auction Markets

- Most NYSE volume from matched public buy and sell orders
- Specialists act as both brokers and dealers in the stocks assigned to them
 - Maintain the limit order book
 - Keep a fair and orderly market by providing liquidity

NYSE Automation

- SuperDot: An electronic order recording, reporting, routing, and matching system
 - Specialist's Electronic Book records and reports limit and market orders
 - Preopening buy and sell orders matched and imbalance reported to specialist
 - Members send orders directly to specialist for execution and confirmation

Orders in OTC Markets

- Dealers ready to either buy or sell
 - Bid price is highest offer price to buy
 - Ask price is lowest price willing to sell
 - Ask price - Bid price >0 (dealer spread)
 - “Makes a market” in the security
 - More than one dealer for each security in over-the-counter markets
- Transition to trading in decimals instead of eighths complete in 2001
 - Narrowing of bid-ask spreads

Types of Orders

- Market orders: Authorizes immediate transaction at best available price
- Limit orders: Specifies a particular market price before a transaction is authorized
- Stop orders: Specifies a particular market price at which a market order is authorized

Settlement

- Most settlement dates are three business days after the trade date
 - Legal ownership transferred and financial arrangements settled with brokerage firm
 - Book-entry system reduces costs
- Transfer of securities and funds between exchange members facilitated by a clearinghouse

Investor Protection: Regulation

- SEC Act of 1934 created the Securities and Exchange Commission
 - Administers all securities law
 - Monitors public securities transactions
 - Requires issuer registration for public offers
 - Investigates indications of violations such as “insider trading”
- Securities Investor Protection Act of 1970: insures accounts

Self-Regulation

- Stock exchanges are also self-regulated
 - In own self-interest to regulate and monitor member behavior
 - NYSE “circuit-breakers” attempt to reduce volatility
- NASD: Trade association that regulates OTC brokers and dealers

Margin Accounts

- To open margin account, exchanges set minimum required deposit of cash or securities
- Investor then pays part of investment cost, borrows remainder from broker
 - Margin is percent of total value that cannot be borrowed from broker
 - Cash: 100% loan value; securities: 50%

Margin Accounts

- Federal Reserve sets the minimum initial margin on securities
 - Unchanged since 1974 at 50%
- Actual margin at any time cannot go below the maintenance margin level set by exchanges, brokers
 - Investor's equity changes with price
 - Margin call when equity below maintenance level

Short Selling

- Investor borrows stock from broker or held in “street name” accounts
- Borrowed security sold in open market, to be repurchased later at an expected price lower than sale price
 - Investor liable for declared dividends
 - Short sale proceeds held by broker
 - Demand loan of stock

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