How Securities Are Traded

Chapter 5
Charles P. Jones, Investments: Analysis and Management,
Ninth Edition, John Wiley & Sons
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
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
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
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
END