Introduction to Equity Market and Institutional Structure

A Financial Market is a market where securities are issued in traded.

Primary market – new financial assets created and exchanged for funds
Secondary market – existing financial assets are traded

ECONOMY => Financial Markets *(An important component)*
(1) Lending/borrowing of funds
(2) Create and trade financial assets
(3) Facilitates flow of funds and resource allocation within an economy

FUNCTIONS – (1) Provides market in which publicly listed companies can <u>have their securities traded</u> (2) Helps publicly listed companies <u>raise funds</u> (3) Provides <u>investment opportunities</u> for individuals and institutional investors (4) Helps <u>government raise funds</u> through issue of bonds or shares (privatisation of public companies)

The value chain of a securities exchange
1. Issuers –primary market (the listed companies)
2. Exchange – secondary market
3. Investors - individual and institutional investors
4. Intermediaries – brokers (facilitates trading)/dealers (participates in trading)
5. Settlement organisations – ensure delivery of traded securities and payment of money within predefined period of working days (usually 2-3 working days).

Macroeconomic objective: <u>Resource allocation</u> - well-functioning capital market necessary for economic growth and development of free market economy.
Microstructure objective: <u>Price discovery</u> - Fair and orderly price discovery is key to market's trustworthiness
Legal objective: <u>Investor protection</u>
Operational objective: <u>Reliability</u> – secure, user-friendly systems and easy access

OBJECTIVE – The **overall objective** of an exchange is to <u>attract liquidity</u>, to execute orders with <u>reasonable speed</u> and <u>minimal cost</u>, and to <u>find appropriate prices</u> for customers.

To achieve the overall objective the following must considered:
- Participants
- Instruments
- Regulations
- Technology
- Protocols

Demutualization: exchanges restructured to become shareholder-owned corporations (e.g. ASX). Purpose to raise capital to finance technology and infrastructure expenses.

Trading Sessions
Call markets – all trades take place only when market is called.

Advantage: increased liquidity - focus the attention of all traders interested in a given instrument at the same time and place.

Continuous markets – traders may trade anytime the market is open.
Advantage: flexibility - allow traders to arrange trades anytime.

Execution Systems
Quote driven market – where dealers post quotes and participate on at least one side of every trade (most OTC and bond markets)
Order driven market – where traders can trade without intermediation of dealers (most exchanges)
Brokered market – where many blocks are broker-negotiated
Hybrid market – have characteristics of more than one of the above.

Participants in Equity Markets

MARKET PARTICIPANTS
Buy side: individuals, firms, government demand liquidity and use markets to help solve problems.

Trader type	**Example**	**Why they trade**	**Typical instruments**
Investors	Individuals Institutions	To move wealth from the present to the future for themselves or for their clients	Stocks Bonds
Borrowers	Homeowners Corporations	To move wealth from the future to the present	Mortgages Bonds Notes
Hedgers	Farmers Manufacturers Miners Financial institutions	To reduce business operating risks	Derivatives such as futures, forwards, etc
Gamblers	Individuals Institutions	To entertain themselves	Various

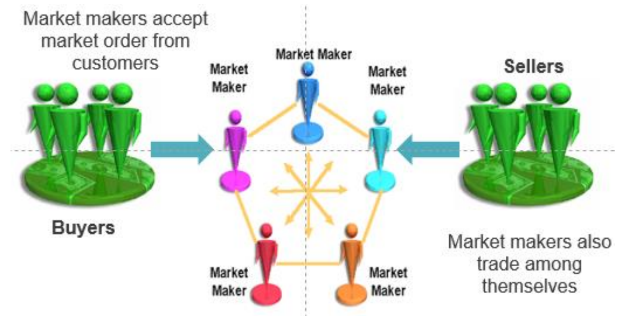
Sell side: Includes dealers and brokers who supply liquidity to the buy side.

Trader type	**Example**	**Why they trade**
Dealers	Market makers Specialist Floor broker	To earn trading profit by supplying liquidity
Brokers	Retail brokers Discount brokers Full-service brokers Institutional brokers Block brokers	To earn commissions by arranging trades for clients
Brokers-Dealers	Dual traders	To earn trading profit and trading commissions

Dealers *(aka market makers)*
Profit-motivated traders who profit by supplying liquidity to those who want to trade. Profits from the bid-ask spread.

- Dealers quote prices to control their inventories and to obtain two-sided order flows. Dealers need to maintain a balanced inventory, because e.g. what if market falls when the dealer holds an excessive amount of stocks?

- Informed trading hurts dealers – dealers should adjust quotes to cover their position quickly before prices move against them (or alternatively enlarge spread).



Dealers make money by attracting order flow. Dealers can do this by quoting prices aggressively (lower the spread), quoting large sizes and creating professional relationships with clients/brokers.

Risk dealers face: **(1) Inventory risk** (dealer must control inventories).
(2) Adverse Selection Risk (bearing losses trading with an informed trader).

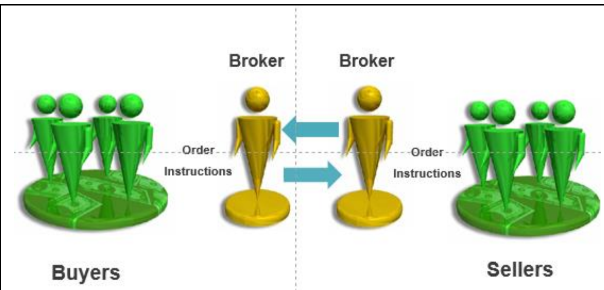
Specialists
Trade for other brokers. Trade to prevent large price movements.

Brokers
Agents who **arrange trades** for their client. Receive commission for their service. Some offer investment advice and information.

Deep discount brokers: orders must be submitted online. Some investment information resources.
Discount brokers: orders must be submitted over the phone or at a discount online. Investment information resources + stock reports.
Full-service brokers: brokers know clients well. Brokers supply investment research and give investment and financial planning advice. Paid on annual fee basis.

Brokers stake their reputation on whether clients will settle their trades (this solves settlement risk)

They provide financial advice (generate reports on investment opportunities with buy/sell recommendations). They are experts due to their exposure to information received from different traders.



Brokers make money through commissions (primary income stream), payments for order flows (dealers pays broker to obtain orders from their clients), interest on margin loans (loans brokers make to clients), underwriting fees (for IPO issues)

Risks brokers face: **(1) Client risk** (clients fail to settle trades).
(2) Risk of submitting a market order instead of a limit order (thereby transacting at a price different from quote).