

Securities Markets

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

Before you begin, you may find it useful to click the thumbnails button to utilize thumbnails for navigating your way through this document. Thumbnails break the document into separate pages. Clicking the third thumbnail quickly advances the screen to the third page, clicking the sixth thumbnail quickly advances the screen to the sixth page, clicking the first thumbnail sends the screen back to page one, etc. Bookmarks operate similarly by advancing to different sections of the document. Simply use your mouse to click on the section of your choice.

Securities Markets

Introduction

The term secondary market refers to trading securities initially sold in the primary market. Primary issues are new issues; secondary refers to outstanding issues. The locations for secondary trading are the stock exchanges and the over-the-counter market. The Securities Exchange Act of 1934 protects investors who buy securities in the secondary market. This Act created the Securities and Exchange Commission (SEC) and specifies its powers.

A stock exchange is simply a private association of brokers organized to provide a central meeting place for its broker-members. The central meeting place, called the floor, is where members trade securities. A stock exchange does not own any of the securities that are traded on its floor daily. The securities are owned by the exchange members or their clients. The price of the securities traded is determined by supply and demand in a free and open auction, not by the stock exchange.

Only two exchanges are national exchanges. They are the New York Stock Exchange (NYSE), by far the largest and most important of all the exchanges, and the American Stock Exchange (AMEX). The Philadelphia Exchange, the Chicago Exchange, The Pacific Exchange, the Boston Exchange and the Cincinnati Exchange are regional exchanges. Only listed stocks that meet stringent requirements are traded on the exchanges. The requirements are different for different exchanges, but one common requirement is that the issuer agrees to solicit proxy votes from shareholders who cannot attend shareholder meetings.

Stocks are assigned to a specific post on the floor of the exchange so that brokers/dealers know where to locate each stock for ease of buying and selling. A market order is an order to buy at the lowest possible price at the time the order reaches the floor of the exchange. A market order, which has speed as an advantage, is the most widely used type of order on the floor. Market orders will always be executed because no price for selling or buying is specified. Some market orders are completed in less than one minute from the time the registered representative phones it in. Clients whose priority is time rather than price use market orders.

In contrast to a market order, a limit order is one in which the customer decides ahead of time what price he wants and he will wait any length of time necessary to get that specific price. The risk of a limit order is that it may not be executed either in the near future or at all. If a broker can obtain a more favorable price (lower for a buyer and higher for a seller) than specified, he must do so. Limit orders may be good for one day only; if so, it is called a day order. An open or “good until canceled” (GTC) order remains in force until the client orders that it be canceled, or until it is executed. Clients who use GTC orders are willing to wait for an indefinite period of time to be paid or to buy at a specific price. All GTC orders must be reconfirmed by a client every six months. The last business day of April and the last business day of October are the two dates each year when all open orders must be reconfirmed. All limit orders to buy are placed below the current market price. That is, the client hopes that the current market price will drop to the price he specifies in his order. All limit orders to sell are placed higher than the current market price. The client hopes that the price will rise and his return will be higher. An advantage of a limit order is that the customer has a chance to buy lower or sell higher than when he placed the order. A disadvantage is that the order may never be executed because the specified price may never be reached.

The Specialist

A specialist is so named because he specializes in trading one or more specific stocks at his particular post on the exchange floor. He conducts the auction at his post and allows the laws of supply and demand to determine the price and volume of trade. A sell is made when two brokers (one representing the buyer and one representing the seller) agree on a price. The three factors involved in the auction are priority, parity, and precedence.

A specialist may act as a dealer and as a broker at various times during a typical day on the exchange floor. He may buy stock from a commission broker if no one is in the crowd near his post who wants to buy or he may sell stock from his inventory if no one in the crowd wants to sell. He keeps track of all transactions and intentions to transact in his specialist's book. Orders are entered in his book according to price and in the sequence in which they are received by the specialist at his post. Buy orders are entered on the left and sell orders are on the right. If the crowd near his post is not busy, the specialist may quote the best bid (that is, the highest buy limit order) and the best offer (that is, the lowest sell limit) on his book. He will also give the number of shares being bid for and offered at the best bid and the best ask prices. His quote includes price and size, excluding stop orders. For stop and limit orders below the market, the specialist must reduce the price on the ex-dividend date. For GTC buy limit and sell stop orders, the specialist must reduce the price on an ex-date. The price of the order must be decreased by enough to equal or exceed the amount of the dividend. It is the specialist's job to oversee an orderly market and keep the spread between the bid and ask prices as narrow as possible.

The specialist is not allowed to compete with public orders. He must bid at least $1/16^{\text{th}}$ of a point higher than the best bid on his books if he is given a sell order and has no buyers. He must offer at least $1/16^{\text{th}}$ of a point below the lowest offer on his book if he has a buyer and no sellers. The specialist buys from the public when other bids are not available and sells to the public when offers to sell are not available.

The specialist acts as a broker when he fills limit orders left with him by commission brokers. If the sell is made from his book, he earns a commission from the firm which submitted the order. If a broker in the crowd offers to buy at a price suitable to a broker who has an order to sell, a transaction will take

place. If a broker in the crowd offers to buy, but no other broker responds, he may buy from the specialist. If two brokers call out “sold” at a given price at the same time, there are stringent rules of priority, parity, and precedence to take care of the situation. These rules give precedence to the public on a first come, first served basis.

Most orders are transmitted directly to the specialist by a communication system called the Designated Order Turnaround System (DOT) or SuperDot 250. There is a DOT terminal at each specialist’s post. As an order comes in, the specialist decides on the spot how to fill it. His options include matching it to another current order, referring it to another broker, or referring it to another exchange. Some size limitations are placed on orders received from the DOT system.

The Intermarket Trading System (ITS) connects the seven major stock markets and makes the quotes of all securities available on all markets which trade that specific security. In this way, if a broker sees a better price available on a different market, he can send an order to that location.

If a customer wants to place a limit order good for a week, a month or until some specified date, the order is placed as a GTC order. It is the broker’s responsibility to remember to cancel the order at the appropriate time if the order has not been executed. Failure to do so could result in a legal responsibility for any money lost by the client.

Stocks are quoted in dollars and fractions of a dollar. $10 \frac{1}{2}$ means \$10.50; $10 \frac{1}{4}$ means \$10.25, etc. Usually, $1/16^{\text{th}}$ of a dollar ($6 \frac{1}{4}$ cents) is the smallest fraction used, but $1/64^{\text{th}}$ is possible.

Stopping stock is a process used by a specialist to guarantee a price to a commission broker for a public order. That is, in a situation where the broker is unwilling to accept the current price, the specialist may promise to freeze the price for a given time period should that broker return with a change of heart.

Odd Lots

Most orders executed on the NYSE each day are in 100 share or multi-100 share lots. These are referred to as round lots. Some of the less active stocks are traded in 10 share round lots. Any trade for less than a round lot is called an odd lot. Odd lot orders are not processed by the commission broker as part of his regular auction market. He turns them over to the specialist who waits for the next auction to take place in that particular stock. When the next auction occurs, the specialist's clerk makes a record of the trade price. All odd lot orders received since the last round lot trade is then executed at the given price, plus or minus the specialist's commission which is generally $1/8^{\text{th}}$ of a point. This is what he receives for breaking the round lots into odd lots. Odd lots are not auctioned; they must be held until the next round lot is traded, at which time they may be processed.

Stop Orders

A stop order to sell is called a sell stop and a stop order to buy is called a buy stop. Both are essentially suspended market orders. The sell stop becomes a market order when the stock sells at or below the stop price. The buy stop becomes a market order when the stock sells at or above the stop price. The two main uses of stop orders are protective for a client's existing profit on stock currently owned and preventive to guard against a major loss that might follow if the market goes in the opposite direction he has hoped. Stop orders are entered into the specialist's book on the same pages as the limit orders. When the market price reaches the point where the specialist can take action, the trade is executed by the specialist.

Some stop orders are designated as stop limit orders. Once a stop limit order is activated, it becomes a limit order, but it may not be executed because the specified price may not be available. An all or none (AON) order is an order that directs the broker to fill the entire order or none of it. A fill or kill (FOK) order is an order to either buy or sell a stock immediately and in full or to cancel it completely. Both AON and FOK orders call for the entire order to be filled; the difference is that a FOK calls for immediate execution. An immediate or cancel order (IOC) directs the broker to fill immediately as much of the order as possible and cancel any remaining part. An IOC allows a partial fill. FOK and IOC orders are never on a specialist's book because they must be filled immediately.

An order which allows the floor broker to use his judgment concerning the time and/or price in executing an order to buy or sell is called a not held order. It may not be filled because the floor broker may believe that the most desirable price or time has not yet been met. It is also called a market not held order and like the IOC and the FOK, it is never on the specialist's book.

Institutional investors conduct most of the block trading on the floor of the NYSE. Block trading refers to trading in units of 10,000 or more shares.

Position means that a client, dealer or broker is either long or short in a security. If anyone owns a security, he has a long position. If anyone does not own a security but has sold a security and borrowed to make delivery, he has a short position. The purpose of selling short is to make a profit in anticipation of a decline in the market price of a security. The short seller sells borrowed

securities at a high price and later buys the replacement issue at a low price. A short seller's gains are potentially unlimited since there is no limit to how low a stock's price may go. Likewise, his losses are potentially unlimited since there is no limit to how high the price may climb; a long investor can only lose the amount of his total investment. The Securities Exchange Act of 1934 requires that no short sale take place unless the price at which the sale occurs is higher than the last different transaction price in the stock. This prevents short selling from creating a runaway down market. That is, short selling must be done in an up market. This is known as the up-tick rule. Because of this rule, the law requires that all sell orders be labeled either long or short.

When prices go up, the tick is called an up- or plus-tick. If prices stay the same, the tick is a zero-tick and if prices decrease, the tick is known as a down- or minus-tick. When an up-tick is followed by a zero-tick, the pattern is called a zero plus-tick. A short sale may be executed only on a plus-tick or a zero plus-tick.

Market makers have long positions when clients and other firms want to sell securities and the market makers have short positions when clients and other firms want to purchase securities in quantities larger than their current inventory. Whenever an equity can be bought and sold at firm prices very quickly and easily, the equity has a high degree of liquidity or marketability.

Trade Reporting

The NYSE reports its trading through the exchange's transaction reporting system known as the stock ticker. All information is handled electronically and is readily available throughout the world. Whenever a sale is made on the floor, a trade reporter gives the information to a page who sends it over an optical scanning machine so the information is sent to the exchange reporting system. Sales are reported by flashing symbols on the electronic board followed by the number of shares traded and the execution price. Three things are reported on the ticker tape: the name of the issue traded, the volume of the trade, and the price of the trade. Stock symbols run from one to three letters each and are readily available in stock symbol books.

Equities which are not listed on an exchange are called unlisted and must be traded over-the-counter (OTC). Since the over-the-counter market is a negotiated market, its buyers and sellers bargain to arrive at an agreeable price. The over-the-counter market does not have a trading floor or a central market place. It is made up of a network of thousands of brokers and dealers who make transactions for themselves and their customers. The process of negotiating agreeable prices takes place electronically and by telephone. The over-the-counter market has over 30,000 issues with regular quotations. These include all government bonds, all municipal bonds, all mutual funds, all new issues, all variable annuities, all tax shelter programs, and all equipment trust certificates. Principals or dealers in the OTC market buy at one price and sell at a higher price. That is, they make a profit from marking up the price of the security.

Pink sheets are alphabetical listings of over-the-counter stocks and the name of one or more firms willing to trade that security. These lists are compiled daily by the National Quotation Bureau and contain wholesale quotations between dealers. The ask and bid prices on pink sheets are approximate, not actual, prices.

A firm quote indicates a bid and an offer at which an OTC dealer has committed to buy or sell at least one round lot of a particular security immediately. As market conditions change, OTC firms change their firm quotes. Spread is the difference between the bid and offer for OTC securities.

Third market trades refer to listed securities which are traded over-the-counter. Most trading of listed securities takes place on the NYSE, but it is possible for an OTC market making firm to secure an inventory of one or more listed securities and to begin making a market in it. These trades must be reported through the Consolidated Quotation System (CQS) within ninety seconds of the trade.

Fourth market trades are generally private transactions between institutions such as banks or insurance companies. These institutions swap securities without involvement from brokers or dealers and the trades are reported on a system referred to as Instinet.

Common stock, preferred stock, municipal bonds and corporate bonds all use CUSIP numbers in trade confirmations.

Newspaper reports of NYSE transactions include valuable information for security's customers, brokers, and dealers. To the left of the corporation's name is found the highest and the lowest price it has traded during the previous 52 weeks. After the abbreviation of the company's name, the current annual dividend per share is listed. The next column is the yield. The next column reports the price earnings ratio (PE) followed by the sales in hundreds and then the high, low, and the last trade of the day. The last column is the net change. There are no listings for PE ratio for preferred stock because preferred stockholders only have a fixed claim against earnings.

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