

Notes: Markets for Financial Instruments (Section 3.1-3.2 in BKM)

Primary vs. Secondary Market

Before we proceed in discussing the various markets in which financial securities trade it is important to distinguish between primary and secondary markets for securities.

Primary market transactions involve the initial sale of securities, when stocks and bonds are first sold to the public. This is also when the interaction between borrowers (issuers) and lenders (investors) takes place → ie. when firms acquire new capital from lenders by issuing new stocks and/or bonds.

Secondary market transactions involve the sale of already issued securities; that is, when the investor who originally bought the stock or bond sells it to another entity, usually another investor. These transactions involve the interaction of two investors and do NOT involve the interaction of borrowers and lenders. This means that funds are transferred from one investor to another, and no funds are transferred to borrowers from lenders. Since issuers do not obtain any new funds in secondary market transaction, they do not directly affect the issuer.

Examples of primary vs. secondary market transactions:

- i) Nike issues a new round of stock and I buy 10 shares. This is a primary market transaction → Nike acquires new funds from me and I acquire new shares
- ii) I decide to sell the Nike shares to a mutual fund. This is a secondary market transaction → I acquire funds from the mutual fund and the fund acquires the shares. Nike (the issuer) gets NOTHING in this transaction. It is simply money changing hands from one investor to another.
- iii) The U.S. government issues 10 year Treasury Notes to finance the deficit. Calpers, a large institutional investor, buys a portion of this new issue. This is a primary market transaction → U.S. government acquires new funds from Calpers and Calpers acquires new bonds
- iv) Calpers then sells these bonds on the market to Vanguard, a mutual fund company. This is a secondary market transaction → Calpers acquires Vanguard's money, Vanguard gets the bonds. The U.S. government (the issuer) receives NOTHING from this transaction.

It is very important that you understand the distinction between primary market and secondary market transactions. The majority of trading activity that we see in securities is comprised of secondary market transactions, which means that no money is being channeled to borrowers.

If this is so, why are secondary market transactions still important for issuers (borrowers). Why do issuers care about the trading activity of already issued stocks and bonds?

1. Secondary market trading determines the current prices for the issuer's stocks and bonds. It indicates what the market for a new issue of stocks and bonds would be like for the issuer, by indicating approximately the price they could receive and the amount they would be able to sell.

2. Issuers with more actively traded securities might have an easier time selling new stocks and bonds because investors value liquidity.
3. If an issuer wants to "retire" stocks or bonds early (that is, redeem them), they can purchase them on the secondary markets.

Where Securities Are Traded

Secondary market trading consist of: national and local securities exchanges, the over-the-counter market, and direct trading between two parties. We will focus on the first two.

1. National and Local Securities Exchanges- Stock Exchanges
 - a. National Exchanges
 - i. NYSE- New York Stock Exchange
 1. The largest and most important stock exchange in the U.S. It accounts for 85-90% of trading that takes place on U.S. stock exchanges (not including OTC market)
 2. In order to be listed on the NYSE the issuer must have a minimum of 1.1 million publicly held shares and minimum market capitalization of \$40 million.
 3. Roughly 3000 shares are listed.
 4. The right to trade on the exchange is purchased. Brokers wanting to trade must purchase a seat on the exchange. Prices vary, but the approximate cost of a seat at present is \$2 million.
 - ii. AMEX- American Stock Exchange
 1. Much smaller than NYSE. Daily trading volume is less than a tenth of the NYSE or NASDAQ.
 2. In order to be listed must have a min. of 500,000 publicly traded shares and a min market capitalization of \$3 million.
 3. Right to trade is also through membership, which is purchased.
 - b. Local Exchanges
 - i. There are regional exchanges throughout the U.S. Larger regional exchanges are located in Boston, Chicago and Los Angeles.
2. Over-the-Counter Market (OTC)
 - a. Unlike the National Exchanges, the over-the-counter market is not a formal exchange. There is no physical location where trading takes place (NYSE and AMEX have actual buildings), there are no membership requirements for trading, and sometimes there are no requirements for securities to be listed.
 - b. In OTC markets can oftentimes find smaller stocks that aren't actively traded.
 - c. NASDAQ- National Association of Securities Dealers
 - i. The computer linked network for trading over the counter securities- that is, prices are listed and trades happen over a computer network
 - ii. The requirements to be listed are much less stringent than those for either the NYSE or AMEX. Lower market cap and outstanding share requirements. It is the country's largest securities market.

- iii. Roughly 4000 shares are listed. Trading volume exceeds that of the NYSE, with roughly 1 billion shares traded daily.
- iv. Trading on NASDAQ requires a subscription to the service. Levels of subscription vary across the different needs of dealers.

NASDAQ has increased in importance over the past 10-15 years. Notice that 28 out of the 30 companies that currently comprise the Dow Jones Industrial Average are listed on NYSE. However, the two exceptions are Microsoft and Intel, both of which are listed on NASDAQ, despite the fact that they are large enough to be listed on the NYSE.

Recent Trends

- Electronic trading is becoming increasingly prevalent. Major exchanges, such as the NYSE, have recently purchased electronic exchanges so as not to lose out. Overall electronic trading has led to a reduction in the costs to issuers and investors of accessing different markets
- The expansion of electronic exchanges has led to increased competition amongst exchanges. This has led to a wave of mergers and acquisitions

*More details can be found in: BKM Section 3.1-3.2
WSJ pg 60-65*