

CHAPTER 1

MARKET ORGANIZATION AND STRUCTURE

Presenter

Venue

Date



CFA Institute

WHAT ARE THE MAIN FUNCTIONS OF THE FINANCIAL SYSTEM?



Save money for future use

Borrow money for current use

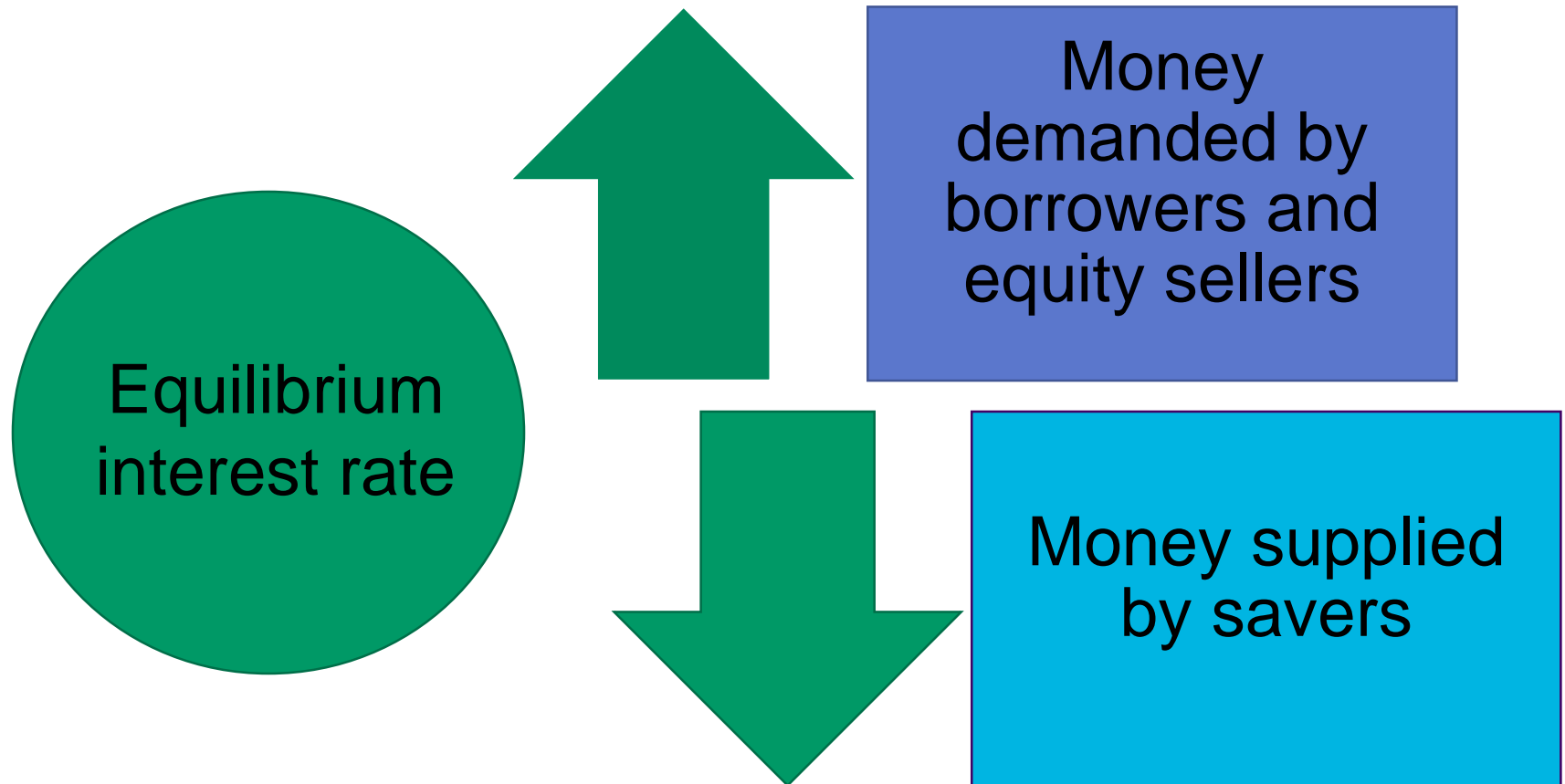
Raise equity capital

Manage risks

Exchange assets for immediate and
future deliveries

Trade on information

HOW ARE RATES OF RETURN DETERMINED?



HOW ARE MARKETS CLASSIFIED?

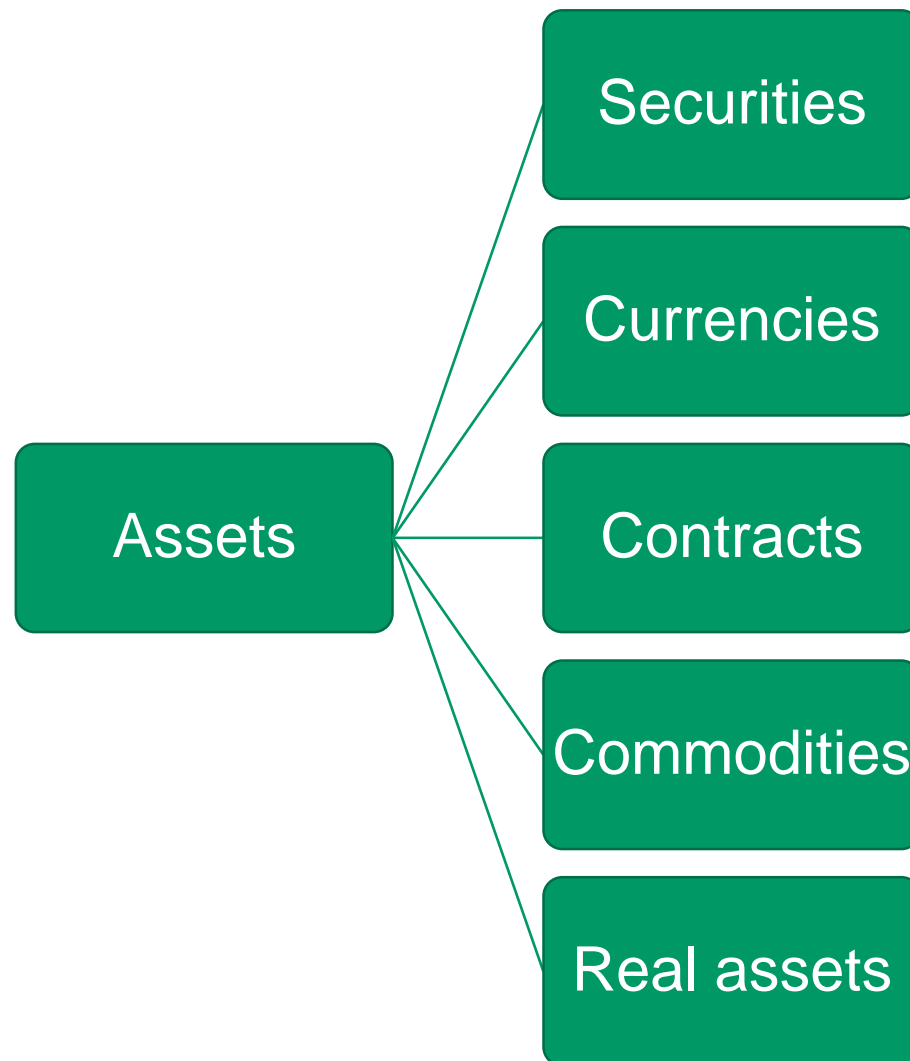
- Spot markets
- Forward and futures markets
- Options markets

- Primary markets
- Secondary markets

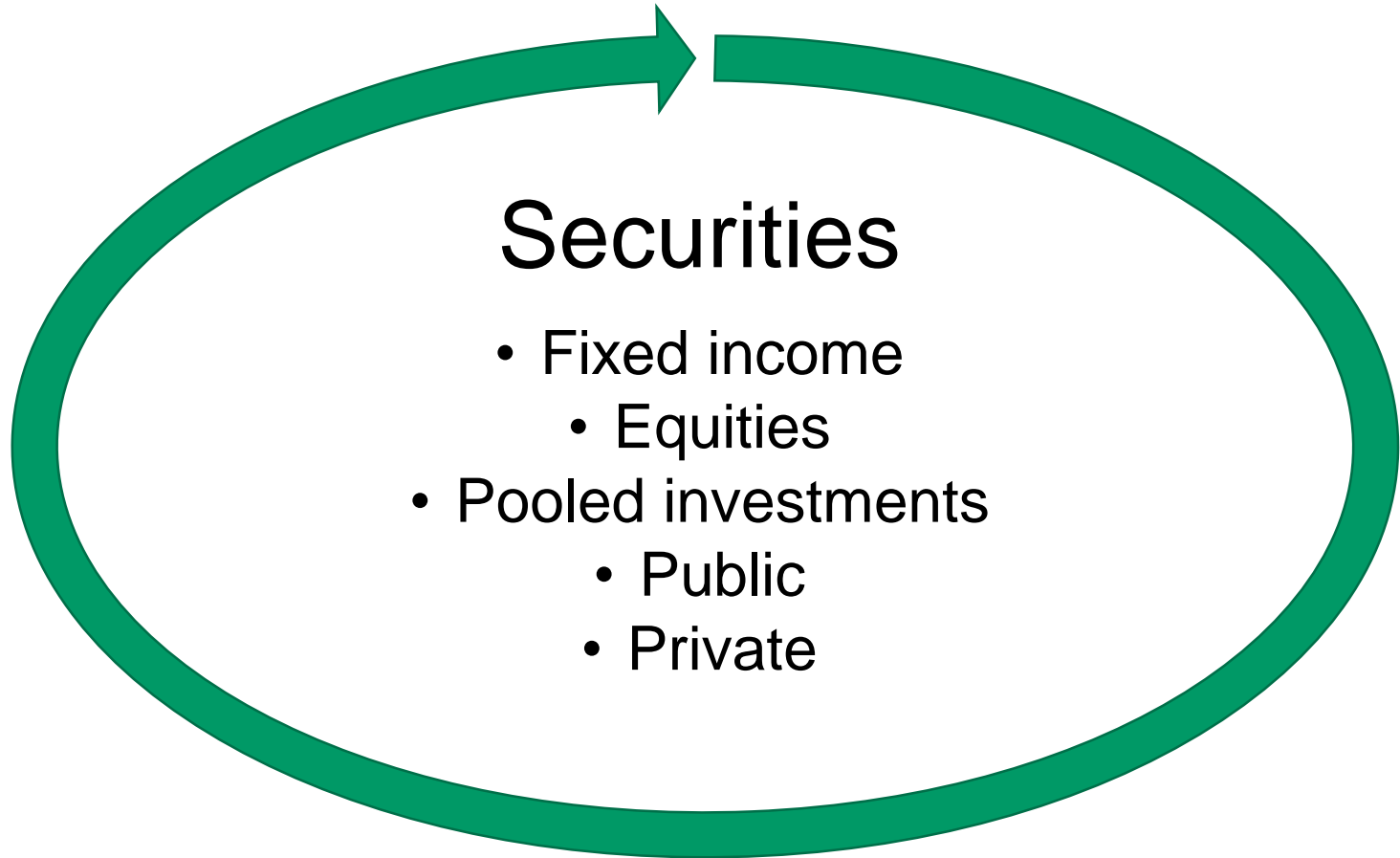
- Money markets
- Capital markets

- Traditional investment markets
- Alternative investment markets

HOW ARE ASSETS CLASSIFIED?



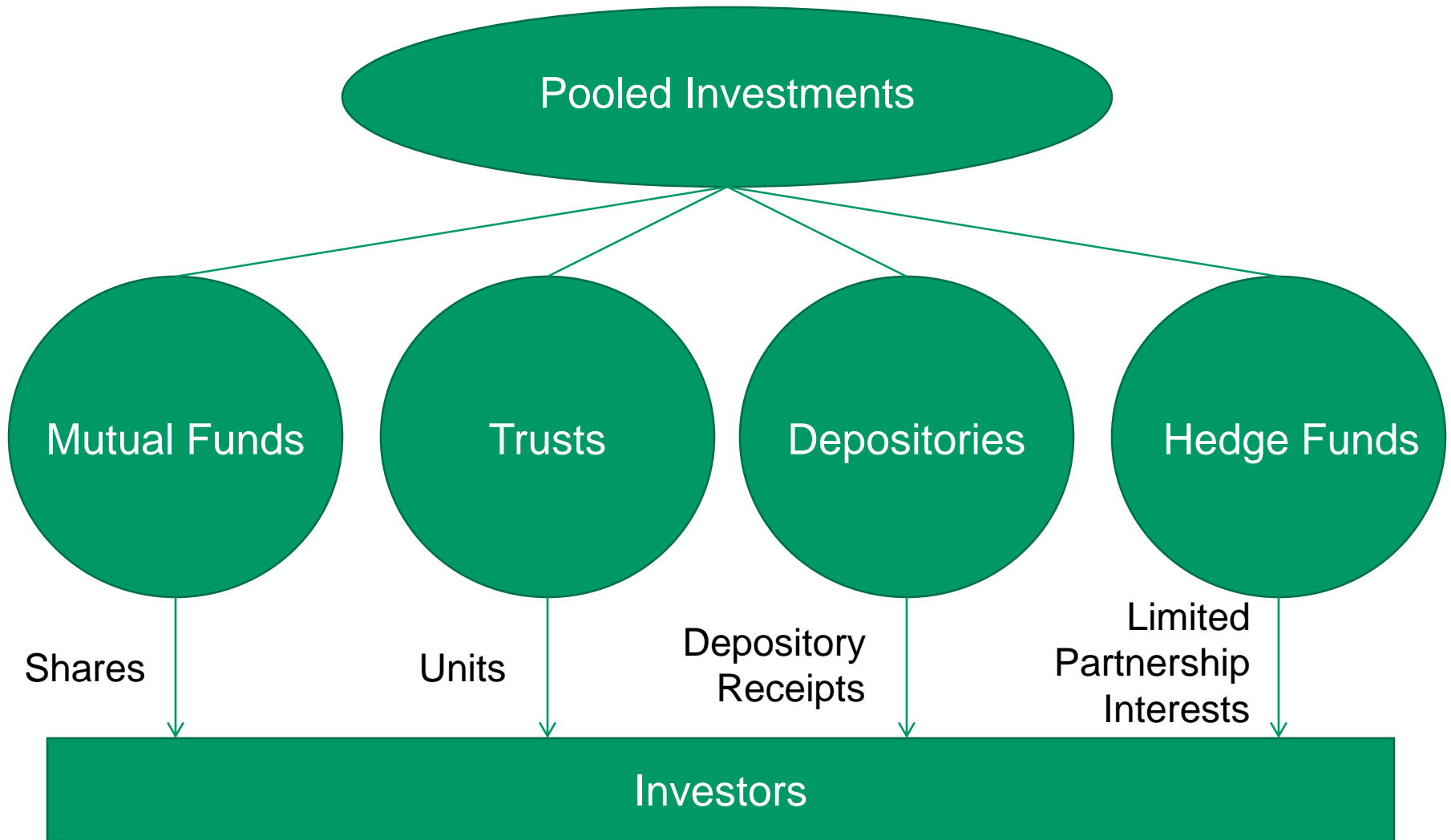
HOW ARE SECURITIES CLASSIFIED?



HOW ARE CONTRACTS CLASSIFIED?



POOLED INVESTMENTS



HEDGING WITH FORWARD CONTRACTS

Farmer needs to sell wheat to the miller at a future date.

- Risk: the price of wheat decreases.
- The farmer is currently long wheat in the spot market (needs to sell it in the future).
- The farmer hedges the spot market position by selling wheat forward.

Miller needs to buy wheat from the farmer at a future date to sell to bakers.

- Risk: the price of wheat increases.
- The miller is currently short wheat in the spot market (needs to buy it in the future).
- The miller hedges the spot market position by buying wheat forward.

FUTURES VERSUS FORWARD CONTRACTS

Futures contracts

Standardized

Clearinghouse
guarantees
performance

Strong secondary
markets

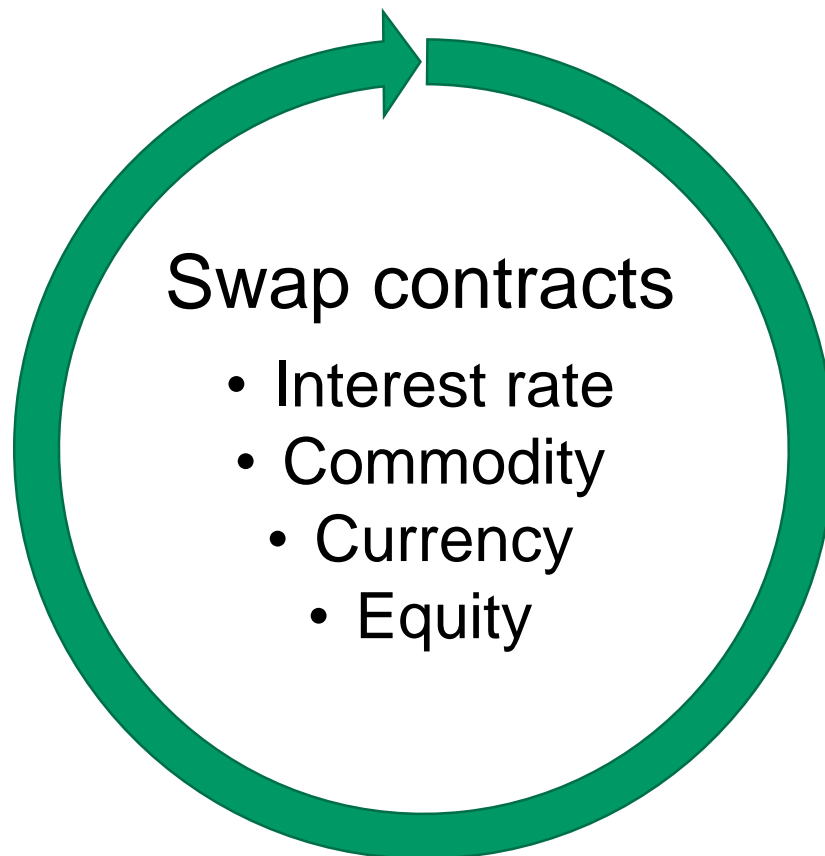
Forward contracts

Customized

Counterparty risk

Typically held to
maturity

SWAP CONTRACTS



OPTIONS

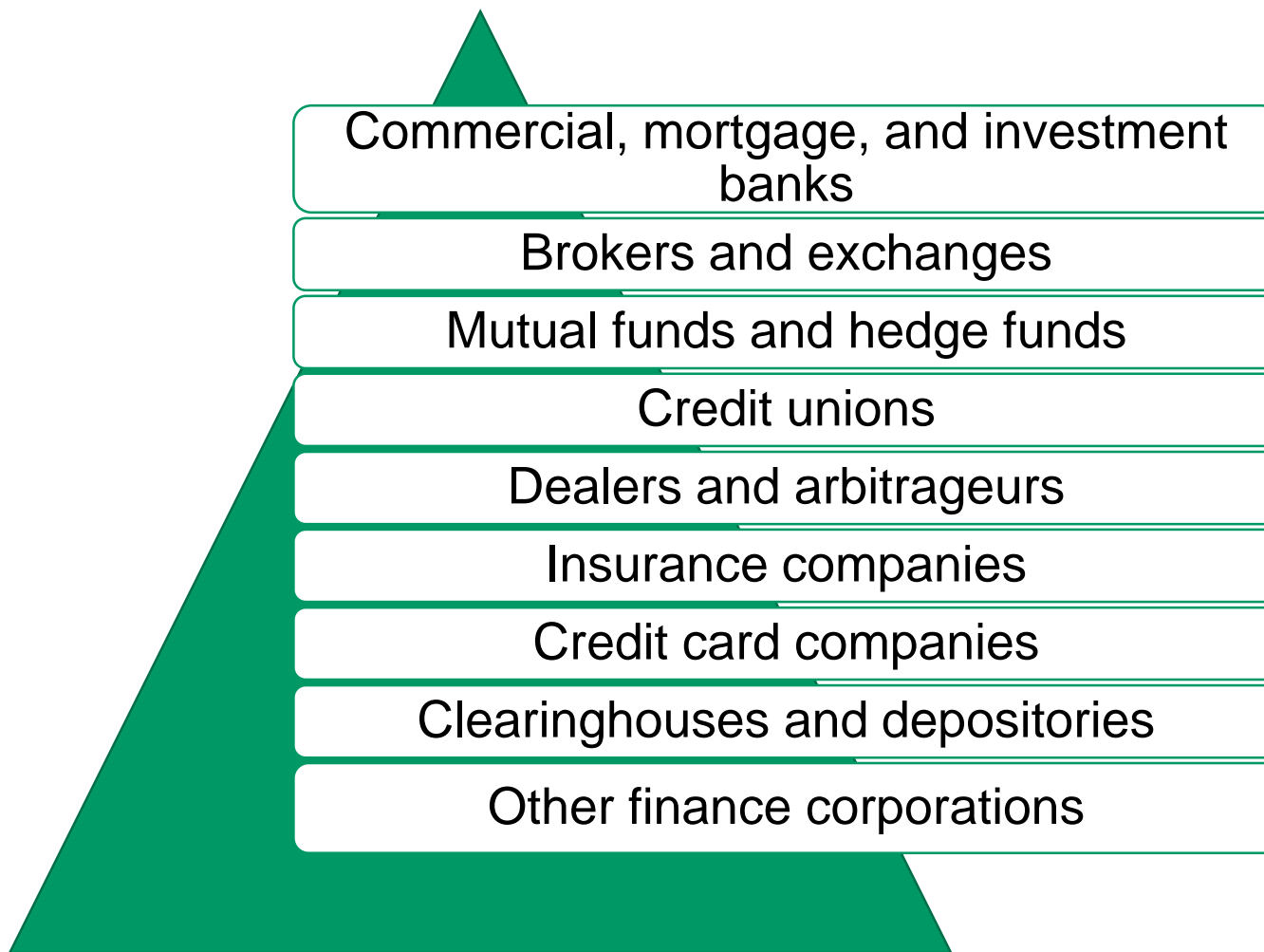
Put: Option to sell. Exercised when strike or exercise price is above market price.

Call: Option to buy. Exercised when strike or exercise price is below market price.



Options

WHAT ARE THE MAJOR TYPES OF FINANCIAL INTERMEDIARIES?



EXCHANGES VERSUS ALTERNATE TRADING SYSTEMS (ATS)

Exchanges

- Marketplace (physical location) for trading.
- Increasingly arrange trades submitted via electronic order matching systems.
- Regulatory authority derived from governments or through voluntary agreements.

ATS

- Also called electronic communication networks (ECNs) or multi-lateral trading facilities (MTFs).
- Some offer services similar to exchanges, others offer innovative systems that suggest trades to clients.
- Do not exercise regulatory authority except with respect to trading.
- *Dark pools*—do not display orders.

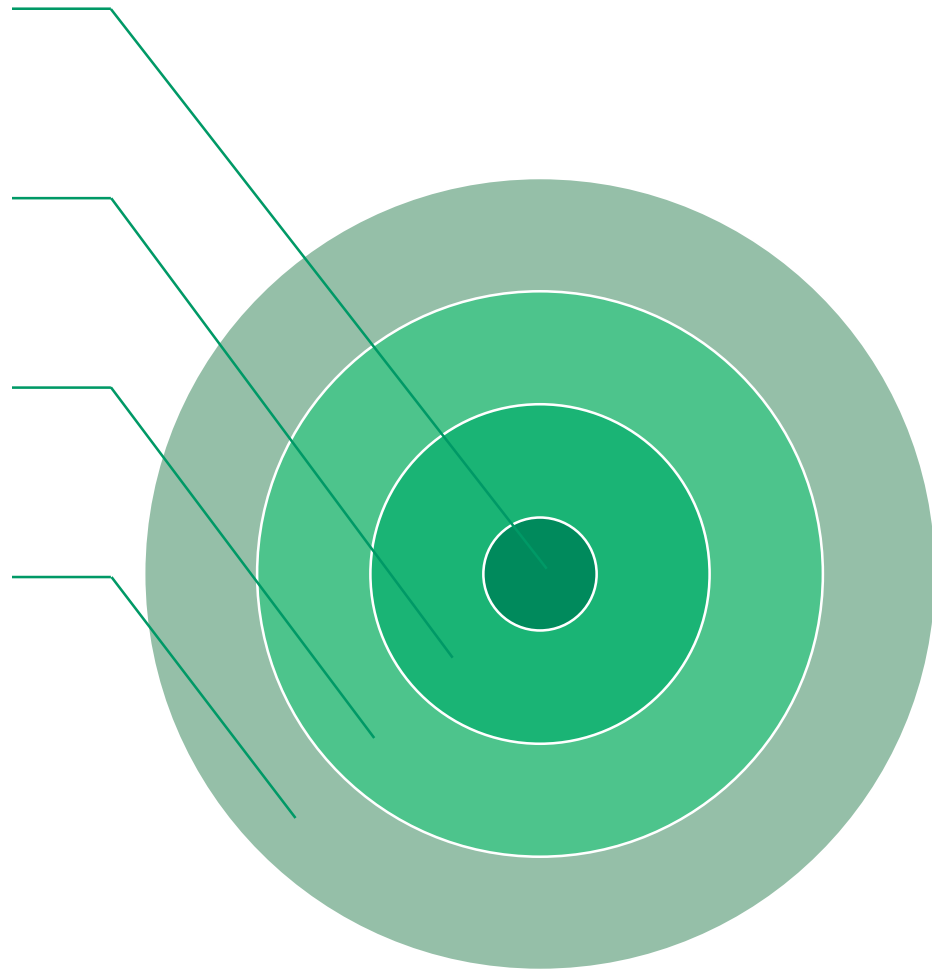
DEPOSITORY INSTITUTIONS

Credit union

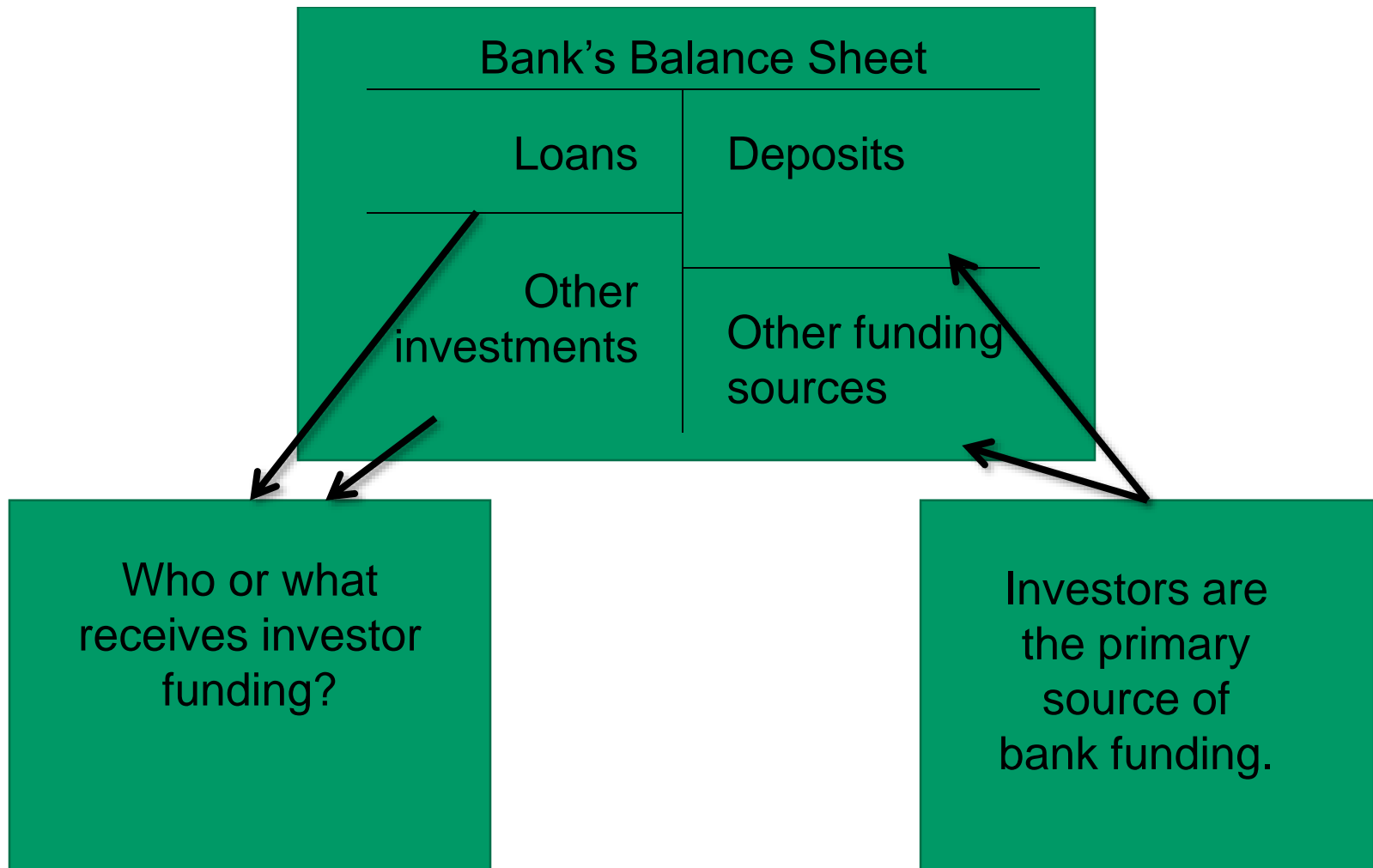
**Savings
association**

**Savings and
loan
association**

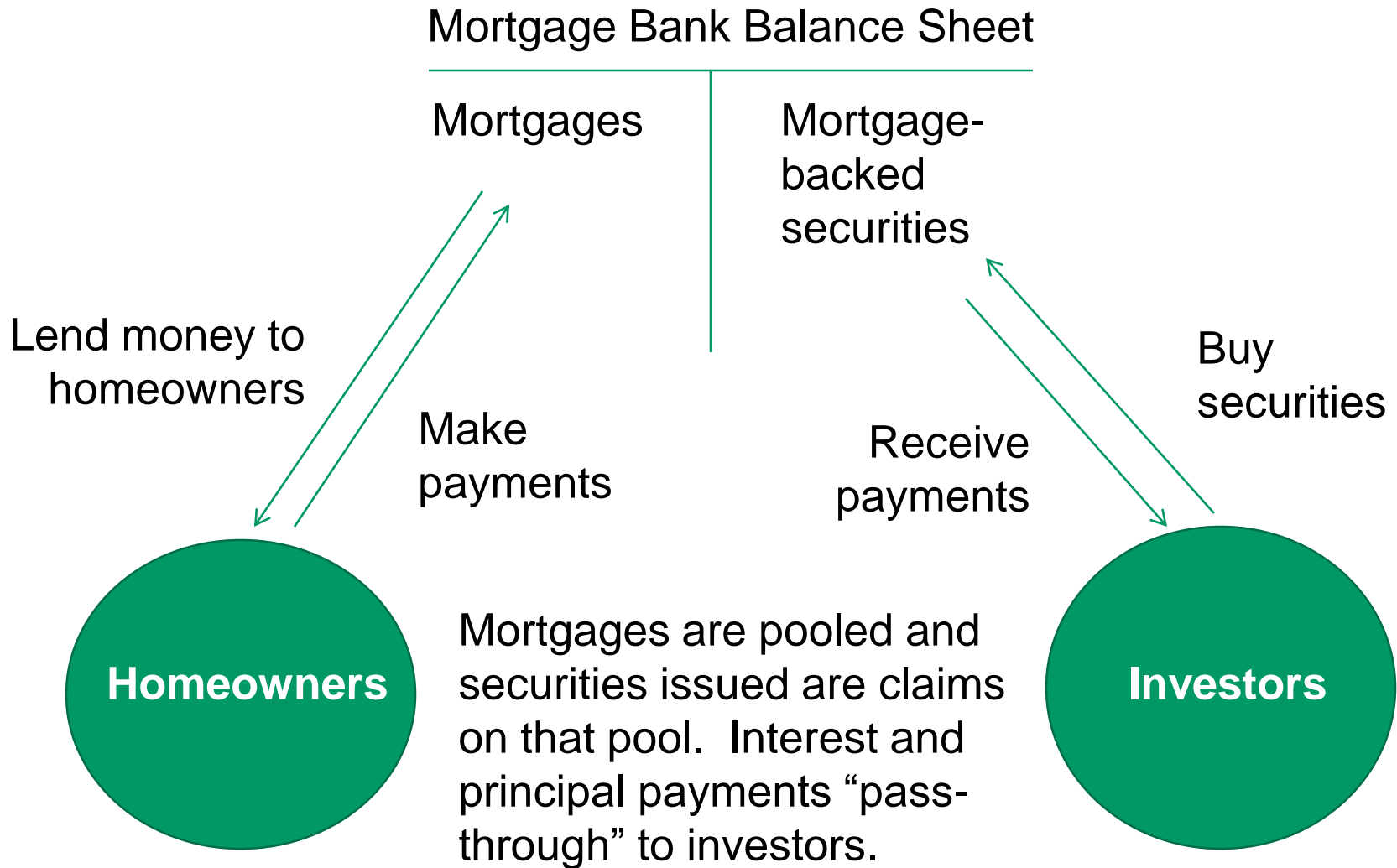
**Commercial
bank**



HOW DO INVESTORS INFLUENCE A BANK'S INVESTMENT DECISIONS?



EXAMPLE OF SECURITIZATION



INSURANCE COMPANIES



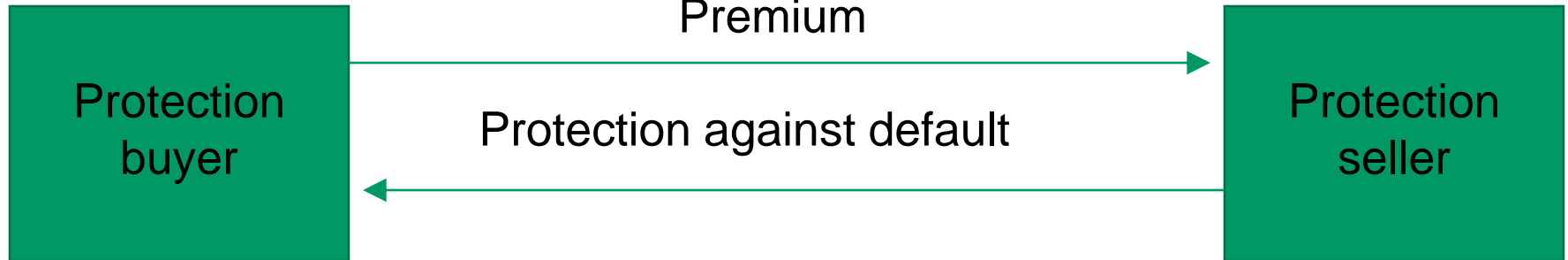
Parties
willing to
bear risk

Buyers of
insurance
contracts

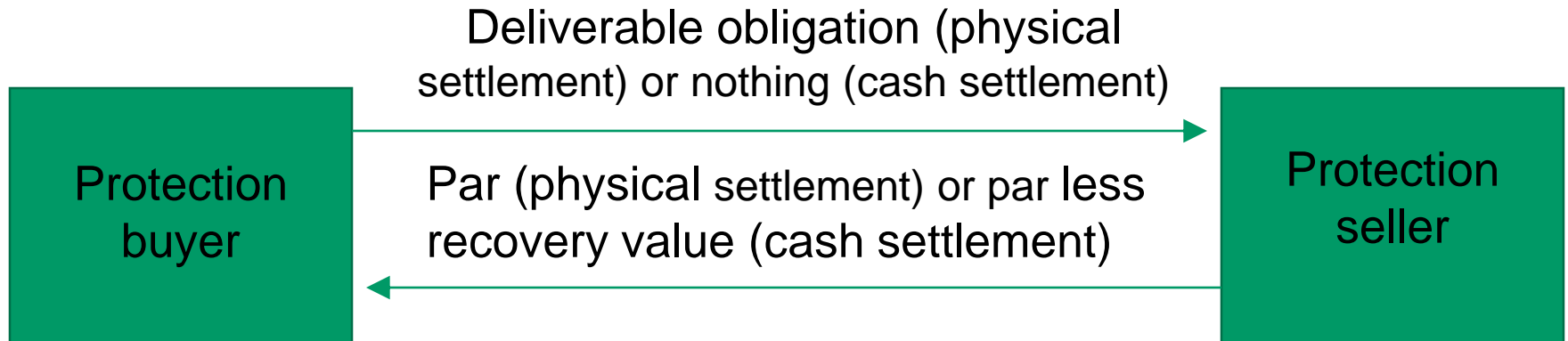
INTERMEDIATION

CREDIT DEFAULT SWAPS (CDS)

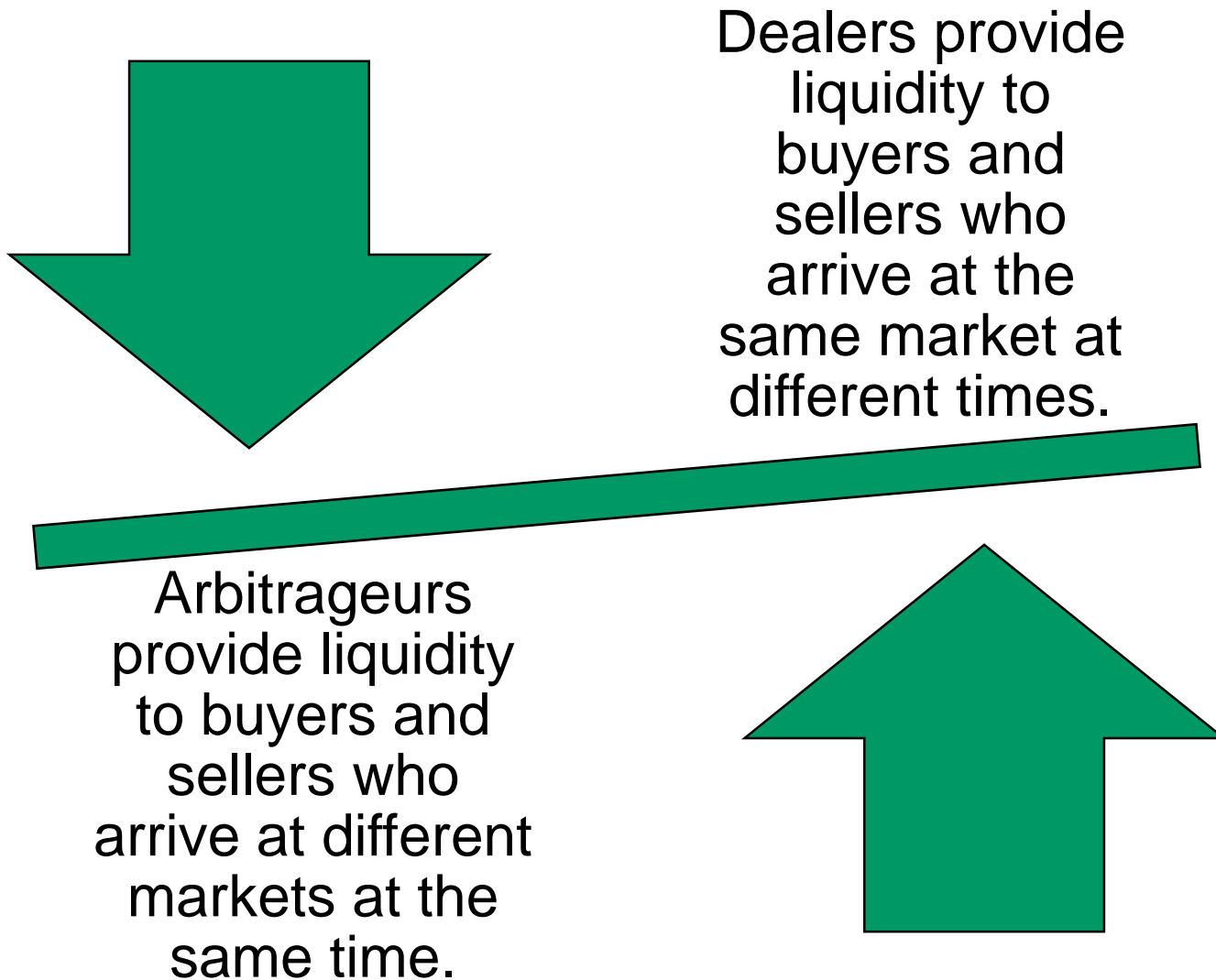
Prior to maturity or default



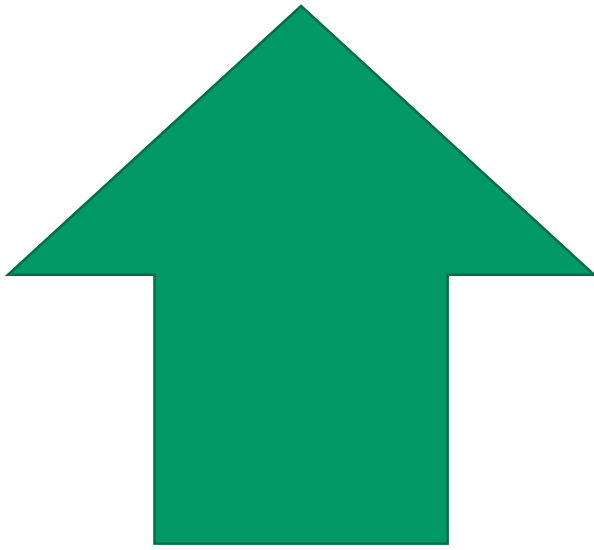
In the event of default



DEALERS VERSUS ARBITRAGEURS

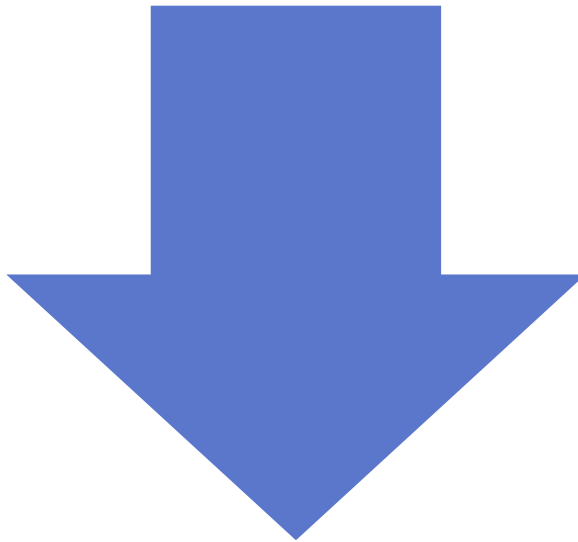


WHAT POSITIONS CAN I TAKE IN AN ASSET?



Long positions

- Assets or contracts are owned
- Position benefits from price appreciation




Short positions

- Assets not owned are sold or contracts are sold
- Position benefits from a decrease in price

OPTION POSITIONS AND THEIR UNDERLYING RISK EXPOSURES

<u>Strategy</u>	<u>Option position</u>	<u>Exposure to underlying risk</u>
Buy call	Long	Long
Sell call	Short	Short
Buy put	Long	Short
Sell put	Short	Long

TERMINOLOGY FOR LEVERED POSITIONS



Buying on margin
Margin loan
Call money rate
Initial margin requirement
Maintenance margin requirement
Margin call
Leverage ratio

EXAMPLE 1-19 COMPUTING TOTAL RETURN TO A LEVERAGED STOCK PURCHASE

A buyer buys stock on margin and holds the position for exactly one year, during which time the stock pays a dividend. For simplicity, assume that the interest on the loan and the dividend are both paid at the end of the year.

Purchase price \$20/share Sale price \$15/share

Shares purchased 1,000 Leverage ratio 2.5

Call money rate 5% Dividend \$0.10/share

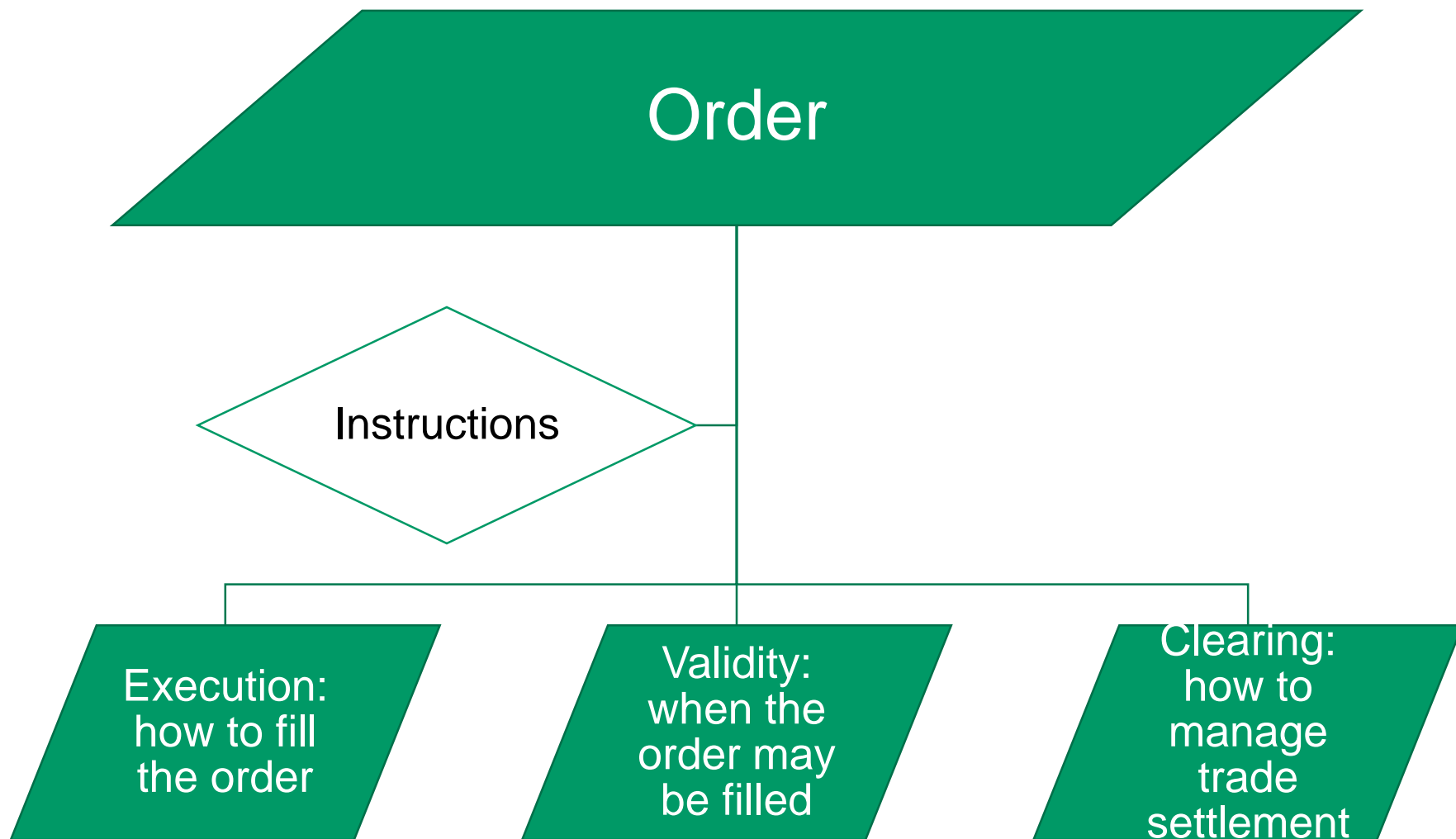
Commission \$0.01/share

1. What is the total return on this investment?
2. Why is the loss greater than the 25 percent decrease in the market price?

EXAMPLE 1-20 MARGIN CALL PRICE

A trader buys stock on margin posting 40 percent of the initial stock price of \$20 as equity. The maintenance margin requirement for the position is 25 percent. Below what price will a margin call occur?

COMPARE AND CONTRAST EXECUTION, VALIDITY, AND CLEARING INSTRUCTIONS



COMPARE AND CONTRAST MARKET ORDERS WITH LIMIT ORDERS

Market order

- Executes immediately
- Receives best available price
- May be expensive to execute

Limit order

- Executes at limit price or better
- Receives best available price
- Mitigates concerns over price concessions

VALIDITY INSTRUCTIONS

Day order

Good-till-cancelled order (GTC)

Immediate-or-cancel order (IOC)

Good-on-close order

Market-on-close order

Good-on-open order

STOP ORDERS (STOP-LOSS ORDERS)



PRIMARY AND SECONDARY MARKETS



Primary
market

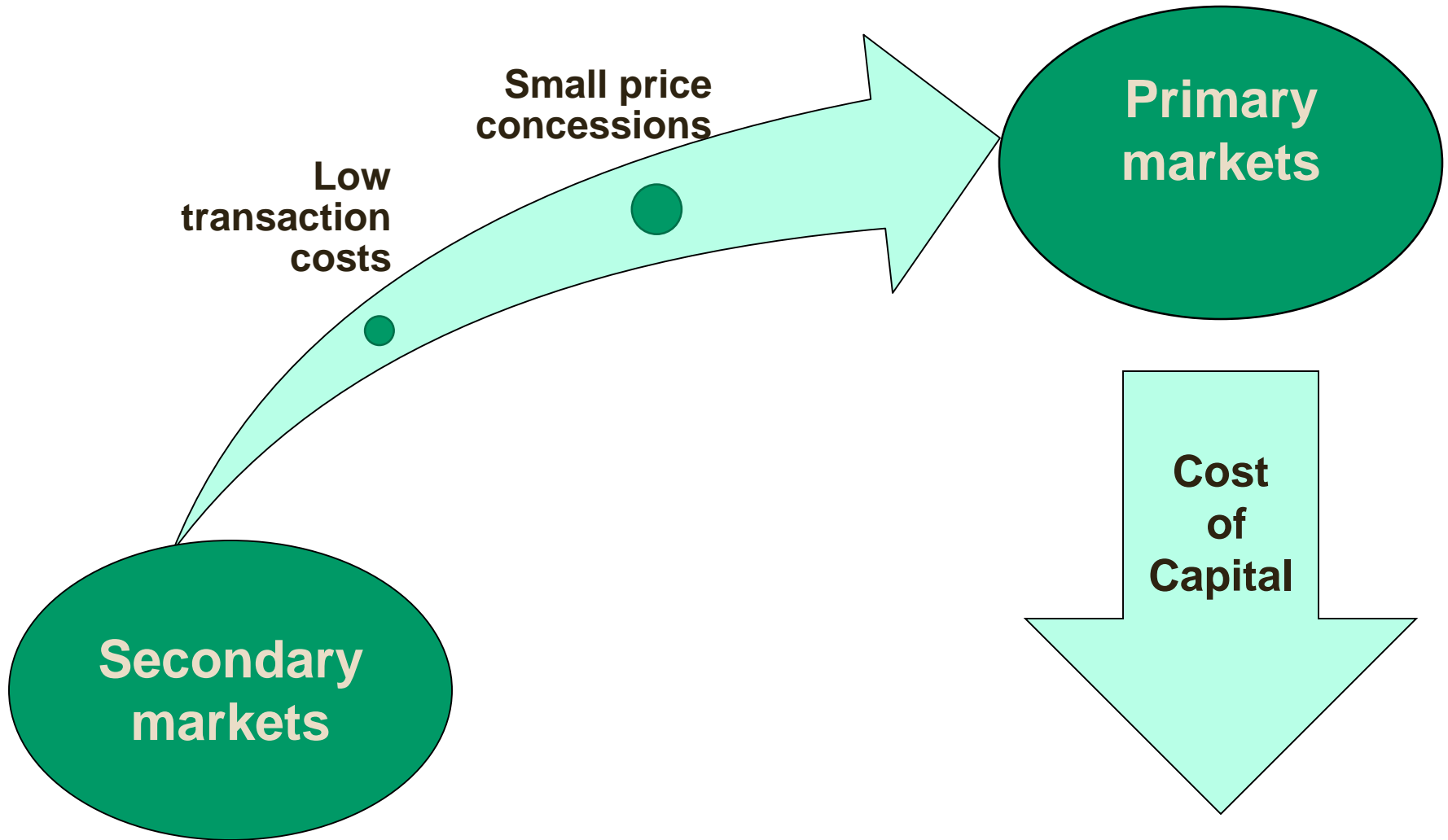


Secondary
market

- Public offering: Initial public offering (IPO)
 - Public offering: Seasoned offering
 - Private placement
 - Shelf registration
 - DRPS or DRIPS
 - Rights offering

- Call markets
- Continuous markets

HOW DO SECONDARY MARKETS SUPPORT PRIMARY MARKETS?



EXECUTION MECHANISMS

Order-driven markets

- Customers trade with dealers
- Bond, currency, and most spot commodity trading

Quote-driven markets

- Order-matching systems or ATS matches trades
- Stock trading

Brokered markets

- Brokers arrange trades
- Trading in unique instruments

ORDER-DRIVEN MARKETS

Order matching rules

Order precedence hierarchy

- Price priority
- Secondary precedence rules

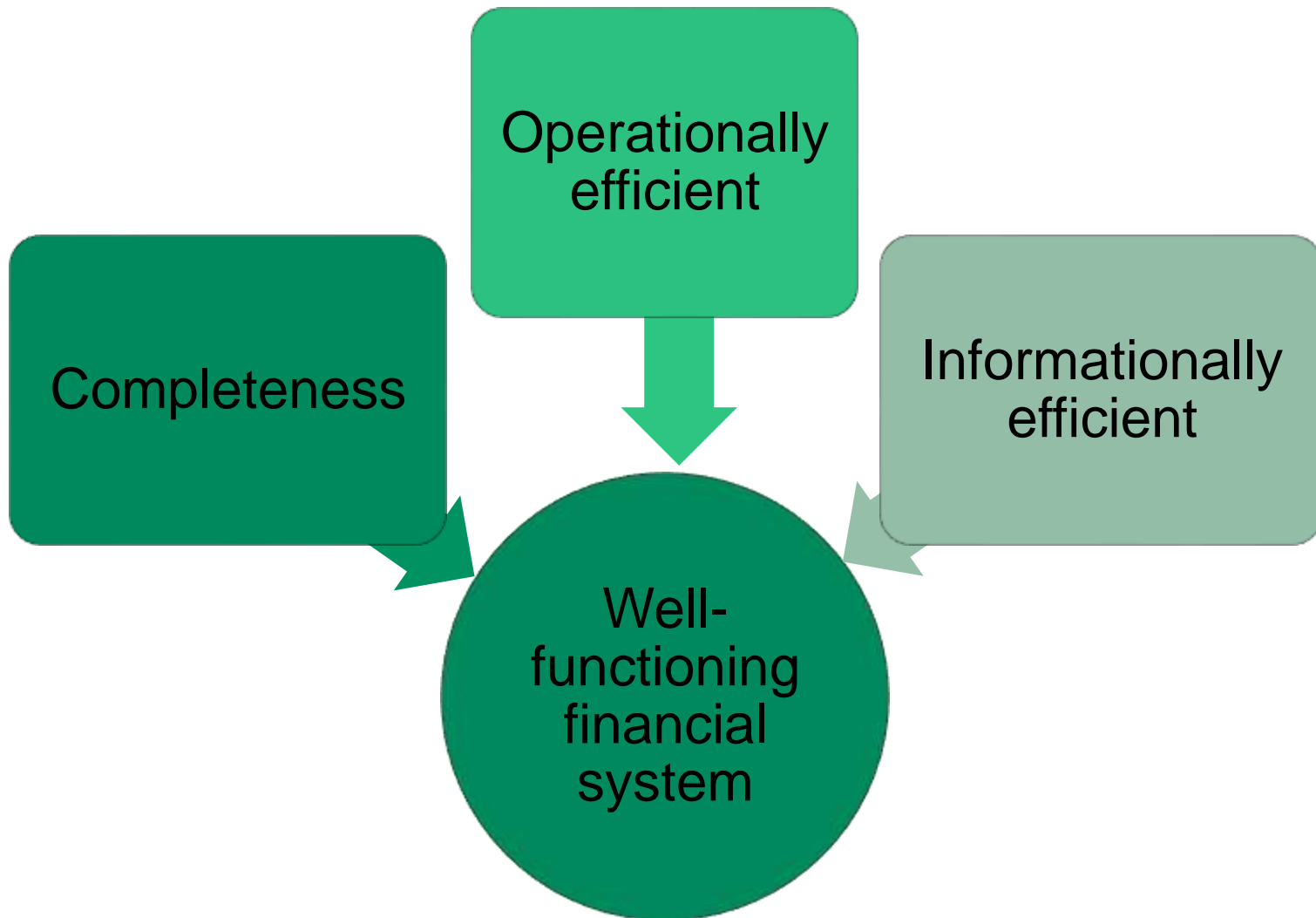
Trade pricing rules

Uniform pricing rule

Discriminatory pricing rule

Derivative pricing rule

WHAT ARE THE CHARACTERISTICS OF WELL-FUNCTIONING FINANCIAL SYSTEM?



WHAT ARE THE OBJECTIVES OF MARKET REGULATION?

Control fraud

Control agency problems

Promote fairness

Set mutually beneficial standards

Prevent exploitation

Insure liabilities are funded

SUMMARY

- Main functions of the financial system
- Classifications of assets and markets
- Financial intermediaries
- Long and short positions
- Leveraged positions
- Execution, validity, and clearing instructions
- Market and limit orders
- Primary and secondary markets
- Quote-driven, order-driven, and brokered markets
- Characteristics of a well-functioning market
- Objectives of market regulation