Chapter 3
The Financial Environment: Markets, Institutions, and Investment Banking
Learning Outcomes
Chapter 3

- Describe the role that financial markets play in improving the standard of living in an economy.
- Describe how various financial markets are differentiated.
- Discuss the role that an investment banking house plays in the financial markets.
- Describe the role that financial intermediaries play in the financial markets, and explain why there are so many different types of intermediaries.
- Describe how financial markets and financial intermediaries in the United States differ from those in other parts of the world.
The Financial Markets

- Financial markets are a system that includes individuals and institutions, instruments, and procedures that bring together borrowers and savers no matter the location.
- The primary role of financial markets is to facilitate the flow of funds from individuals and businesses that have surplus funds to individuals, businesses, and governments that need funds in excess of their incomes.
Flow of Funds

- Three financial phases
  - Young adults borrow
  - Older working adults save
  - Retired adults use savings
- Funds transferred from savers to borrowers
  - Direct transfer
  - Investment banking house
  - Financial intermediary
Diagram of the Capital Formation Process

1. **Direct Transfers**
   - Business’s Securities (Stocks or Bonds)
   - Funds
   - Savers (Investors)

2. **Indirect Transfers through an Investment Banker**
   - Business (Borrower)
   - Securities (Stocks/Bonds)
   - Funds less issuing costs
   - Investment Banker
     - Helps corporations issue securities (stocks or bonds)
     - Receives fees from the issues
   - Firm’s Stocks or Bonds
   - Funds
   - Savers (Investors)

3. **Indirect Transfers through a Financial Intermediary**
   - Business (Borrower)
   - Borrower’s Liability
   - Funds
   - Financial Intermediary
     - Uses funds to buy/create loans and other financial instruments
     - Pays a return/interest to attract funds
   - Intermediary’s Liability
     - (Account at intermediary)
   - Funds
   - Savers (Investors)
Market Efficiency

- **Economic Efficiency** - Funds are allocated to their optimal use at the lowest costs

- **Informational Efficiency** - Investment prices are adjusted quickly to reflect current information
  - Weak-form - all information contained in past price movements is reflected in current market prices
  - Semistrong-form - current prices reflect all publicly available information
  - Strong-form current prices reflect all pertinent information, both public and private
Types of Financial Markets

- Money versus capital markets
- Debt versus equity markets
- Primary versus secondary markets
- Derivatives markets
General Stock Market Activities

- The secondary market - trading in the outstanding, previously issued shares of established, publicly owned companies
- The primary market - additional shares sold by established, publicly owned companies
- IPO market - new public offerings by privately held firms
Stock Markets

- Physical stock exchanges
  - NYSE, AMEX, and regional exchanges

- Exchange members
  - Floor brokers
  - Specialists

- To have a stock listed
  - Apply to the exchange
  - Pay a relatively small fee
  - Meet the exchange’s minimum requirements
## Listing Requirements for Stock Exchanges and the Nasdaq

<table>
<thead>
<tr>
<th>Requirement</th>
<th>NYSE</th>
<th>Regional Exchanges(^a)</th>
<th>Nasdaq</th>
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</thead>
<tbody>
<tr>
<td>Round-lot (100 shares) shareholders</td>
<td>400</td>
<td>800</td>
<td>400</td>
</tr>
<tr>
<td>Number of public shares (millions)</td>
<td>1.1</td>
<td>0.5</td>
<td>1.1</td>
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<tr>
<td>Market value of public shares ($ millions)</td>
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<td>$3</td>
<td>$8</td>
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<tr>
<td>Shareholders’ equity ($ millions)</td>
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<td>$4</td>
<td>$15</td>
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<tr>
<td>Pre-tax income ($ millions)</td>
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<td>$0.75</td>
<td>$1.00</td>
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Stock Markets

Over-the-Counter Markets and the Nasdaq

- Network of brokers and dealers
- Auction market
- Organized Investment Network
- Electronic Communications Networks
Regulation of Securities Markets

Securities and Exchange Commission (SEC)
- Jurisdiction over most interstate offerings of new securities to the general public
- Regulation of national securities exchanges
- Power to prohibit manipulation of securities’ prices
- Control over stock trades by corporate insiders
The Investment Banking Process

Investment Banker

- Helps corporations design securities attractive to investors
- Buys these securities from the corporation
- Resells the securities to investors
The Investment Banking Process

Raising Capital: Stage I Decisions

1. Dollars to be raised
2. Type of securities used
3. Competitive bid versus negotiated deal
4. Selection of an investment banker
The Investment Banking Process

Raising Capital: Stage II Decisions

1. Reevaluating the initial decisions
2. Best efforts or underwritten issues
   - Underwritten Arrangement - investment bank guarantees the sale by purchasing the securities from the issuer
   - Best Effort Arrangement - investment bank gives no guarantee that the securities will be sold
3. Issuance (flotation) Costs
4. Setting the offering price
The Investment Banking Process

- **Selling Procedures**
  - **Underwriting Syndicate**: A syndicate of investment firms formed to spread the risk associated with the purchase and distribution of a new issuance of securities
  - **Lead or Managing Underwriter**: The member of an underwriting syndicate who actually manages the distribution and sale of a new security offering
  - **Selling Group**: A network of brokerage firms formed for the purpose of distributing a new issuance of securities
The Investment Banking Process

- **Shelf Registrations**
  - Securities registered with the SEC for sale at a later date
  - Held “on the shelf” until the sale
The Investment Banking Process

Maintenance of the Secondary Market

• When a company is going public for the first time, the investment banker is obligated to maintain a market for the shares after the issue has been completed.

• The lead underwriter agrees to “make a market” in the stock and keep it reasonably liquid.
Types of Financial Intermediaries

- Commercial banks
- Credit unions
- Savings and loan associations
- Mutual funds
- Whole life insurance companies
- Pension funds
The Role of Financial Intermediaries

- Facilitate the transfer of funds from those who have funds (savers) to those who need funds (borrowers)
- Manufacturing a variety of financial products that take the form of either loans or savings instruments
Benefits of Financial Intermediaries

- Reduced costs
- Risk/diversification
- Funds divisibility/pooling
- Financial flexibility
- Related services
International Financial Markets

- U.S. stock markets represent less than 50% of the total value worldwide
- U.S. markets still dominate the stock markets in other countries
- U.S. investors can participate in international markets by using American Depository Receipts - mutual funds that hold stocks or foreign securities certificates issued in dollar denominations
Financial Organizations in Other Parts of the World

- U.S. financial institutions are more heavily regulated
- U.S. financial institutions face greater limitations on branching, services and relationships with non-financial businesses