

## FINANCIAL MARKETS

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## I. NATURE AND PURPOSE OF FINANCIAL MARKETS

- A. Nature of markets -- facilities for exchange
- B. Nature and purpose of money
  - 1. Kinds of money
    - a. Coins
    - b. Paper money
    - c. Book entries
  - 2. Methods of transferring money
    - a. Physical delivery
    - b. Mailing – checks
    - c. Debit cards
- C. Distinction between financial markets and non-financial markets
  - 1. Nature of what is being traded
  - 2. Interdependence of participants in the market
- D. Purpose of financial markets
- E. Types of financial markets
  - 1. Credit markets
  - 2. Insurance markets
  - 3. Futures markets
  - 4. Capital markets (stock markets)
  - 5. Individual vs. institutional markets
  - 6. Primary vs. secondary markets
  - 7. Auction vs. dealer markets – intermediation
- F. Recent trends in financial markets
  - 1. Growth in size and complexity
  - 2. Technological change – computers and telecommunications
  - 3. Deregulation and blurring of functional categories

## II. SHORT-TERM CREDIT MARKETS

- A. The nature and purpose of banks
  - 1. Origins of the US banking system
  - 2. Types of short-term borrowers
    - a. Corporations and other businesses
    - b. Governments – federal, state and local
    - c. Individuals
  - 3. Sources of funds
    - a. Checking account deposits
    - b. Borrowings by banks
    - c. Banks' power to create money

4. Regulation of banks -- purposes
  - a. State regulation
    - i. Requirements for establishing banks
    - ii. Geographical restrictions
  - b. Federal regulation
    - i. Federal chartering of banks – Controller of the Currency
    - ii. Regulation of credit – Federal Reserve System
    - iii. Insurance of deposits – Federal Deposit Insurance Corporation
- B. Other sources of short-term credit
  1. Finance companies
  2. The “commercial paper” market
- C. Consumer credit – the credit card revolution
  1. Origin of credit cards
  2. Problems of credit cards
    - a. Operational problems
    - b. Identity theft
    - c. Excessive charges

### III. LONG-TERM CREDIT – THE BOND AND MORTGAGE MARKETS

- A. Importance of the long-term bond market
  1. Importance to borrowers
  2. Importance to lenders (investors)
- B. Risks of long-term credit
  1. Risk of default
    - a. Protective provisions
    - b. Different classes of debt
    - c. The role of rating agencies
    - d. The “junk bond” phenomenon
  2. Interest-rate risk
    - a. The effect of leverage
- C. The primary market – initial sale of the debt
  1. Federal government debt – distribution through banks
  2. State and local government debt and corporate debt
    - a. The underwriting process
    - b. The “private placement” process – insurance companies
- D. The secondary market – bonds as investment instruments
  1. Size and scope of the markets
  2. Appeal of different kinds of bonds
- E. The home mortgage market
  1. Origins of savings and loan associations
  2. Conversion from mutual to stock form
  3. The problem of mismatched maturities
  4. The savings and loan crisis
  5. “Securitization” as the answer
  6. The problems of securitization and the current crisis

#### IV. INSURANCE MARKETS

- A. Types of insurance
  - 1. Life insurance
  - 2. Casualty insurance
- B. Regulation of the insurance business
  - 1. Regulation only by state insurance commissions -- no federal regulation
  - 2. Content of regulation
    - a. Terms of policies
    - b. Selling practices and charges
    - c. Financial reserve requirements
    - d. Restrictions on types of investments
- C. Life insurance
  - 1. "Term" life insurance
  - 2. "Whole" life insurance
  - 3. Annuities
  - 4. Investment policies of life insurance companies
- D. Casualty insurance
  - 1. Insurance of financial instruments – local government bonds
  - 2. Investment policies of casualty insurance companies

#### V. THE "FUTURES" MARKET

- A. Commodity futures contracts
  - 1. Purpose and historical development
  - 2. What commodities are traded?
  - 3. Exchanges on which they are traded
  - 4. Regulation – Commodity Futures Trading Commission (CFTC)
  - 5. How they work
  - 6. Risks and dangers
- D. Forward contracts and swaps
  - 1. Purpose and historical development
  - 2. How they work
  - 3. Regulation – none
  - 4. Risks and dangers
  - 5. "Credit default swaps" and the current crisis

#### VI. THE STOCK MARKET

- A. Differences between the stock and bond markets
  - 1. Basic difference between common stock and debt instruments
    - a. Hybrid instruments – preferred stock and convertibles
  - 2. Different participants in the markets
    - a. Separation of commercial and investment banking – Glass-Steagall Act
    - b. Consequences of repeal of Glass-Steagall (1999)
  - 3. Different system of regulation

- a. Creation of Securities and Exchange Commission (SEC) (1934)
  - b. Emphasis on disclosure, rather than protection
- B. The “primary” market – initial issuance of stock
  - 1. The “underwriting” process
    - a. Use of underwriting “syndicates”
    - b. The role of venture capitalists
    - c. Problems
      - i. Lack of information
      - ii. Price manipulation
  - 2. Regulation of initial issuances
    - a. “Registration” with the SEC
    - b. Disclosure requirements – the “prospectus”
    - c. Civil liability of issuer, underwriters and others
- C. The “secondary” market – trading in previously-issued stock
  - 1. “Auction” and “dealer” markets
    - a. The dual role of “broker-dealers”
  - 2. Historical development of stock exchanges
    - a. Dominant role of New York Stock Exchange (NYSE)
    - b. The “specialist” system
    - c. Fixed minimum commission rates
  - 3. Regulation of exchange trading and members
    - a. “Self-regulation”
    - b. Relation between exchanges and the SEC
  - 4. Shift from individual to institutional trading
    - a. Pressure on market systems – “block trading”
    - b. Pressure on clearing and settlement systems
    - c. Pressure on commission rate structure – “give-ups”
  - 5. The over-the-counter (OTC) market
    - a. Historical development and method of operation
    - b. Development of an automated quotation system (NASDAQ)
    - c. Competition between NASDAQ and NYSE
    - d. Separation of market operation from regulation
  - 6. The options market
    - a. Purpose and historical development
    - b. What options are traded?
    - c. Exchanges on which they are traded
    - d. Regulation – Securities and Exchange Commission (SEC)
    - e. How they work
    - f. Risks and dangers
- D. The setting of market prices for stock
  - 1. Pricing of individual stocks – the importance of information
    - a. Exchange and SEC disclosure requirements
    - b. Financial statements – the role of accountants
    - c. Projections of earnings
    - d. “Insider trading”
  - 2. Price movements in the market generally

- a. Causes of wide fluctuations in price
  - i. Emotional factors – hope and fear
  - ii. Automated programs – the crash of 1987
- b. Techniques to curb wide fluctuations
  - i. Limiting leverage – the “margin regulations”
  - ii. Suspension of trading – “circuit breakers”
- 3. Importance of stock market indexes as indicators of confidence
  - a. Dow-Jones Industrial Average
  - b. Standard & Poor’s (S&P) 500

## VII. THE MARKET FOR INVESTMENT MANAGEMENT

- A. Major classes of managed funds
  - 1. Open-end investment companies (mutual funds)
  - 2. Pension funds
  - 3. Hedge funds
- B. Mutual funds
  - 1. Origins and growth
  - 2. Unique structure of mutual funds
    - a. Organized as corporations
    - b. Contracts with separate organization for management
    - c. Continuous selling and buying of its own shares at “net asset value”
    - d. No secondary market in its stock
  - 3. Sources of income to mutual fund managers
    - a. Management fee (% of assets)
    - b. “Sales load” (commission) on sale of fund shares
    - c. Commissions on purchases and sales of portfolio securities
  - 4. Types of mutual funds
    - a. Stock funds – growth, income, sector
    - b. Bond funds – US Govt, state & local govt, corporate
    - c. Money market funds
  - 5. Management techniques
    - a. Active management
    - b. Passive management – “index funds”
  - 6. Regulation of mutual funds by SEC
    - a. Disclosure in prospectus in sale of fund shares
    - b. Requirements for independence of fund directors
    - c. Limitations on compensation and fees
  - 7. Alternatives to mutual funds
    - a. Closed-end investment companies
    - b. Exchange-traded funds
  - 8. Effects on the stock market
- C. Pension funds
  - 1. Origin and development
    - a. Change in investment approach
    - b. Shift from defined-benefit to defined-contribution plans

2. Types of pension funds
  - a. State government, individual company, industry-wide
  - b. Competition for pension business
    - i. banks, insurance companies, mutual fund managers.
3. Regulation of pension funds – ERISA (1974)
  - a. Funding requirement – affected by market fluctuations
4. Effects on the stock market
- D. “Hedge funds”
  1. Nature and purpose
  2. Absence of regulation
  3. Effects on market

## VIII. THE MARKET FOR CORPORATE CONTROL

- A. Rationales for and against hostile takeovers
  1. Pro: Replace “tired old management” with more profit-oriented leaders
  2. Con: “Corporate raiders” looting fine old companies
- B. Methods of taking over a publicly-held corporation
  1. “Proxy fight” to elect new board of directors
  2. Purchase a majority of the stock
- C. Changes in the 1960s
  1. More stock in the hands of institutions
  2. More sources of money to finance takeovers
- D. Techniques for acquiring control
  1. Direct purchases from institutions
  2. Published “tender offers” to stockholders generally
- E. Response by incumbent managements
  1. Enactment of state laws restricting takeovers
  2. Push for federal law restricting takeovers, resulting in “Williams Act” (1968)
    - a. Generally neutral as between management and raiders
    - b. Emphasis on protecting stockholders of target company
  3. Adoption of internal corporate changes – “poison pills”
- F. Long-term effects
  1. “Leveraged buy-outs” -- replacing equity with debt
  2. Emphasis on boosting stock price, not long-term health of company