Operation of Stock Exchange

Topics to be Discussed

Stock Market Transactions
Types of Brokers
Role of Specialist
Types of Trading Orders
Trading and Settlement Dates

Stock Market Transactions

When you buy, you buy from another person
When you sell, you sell to another person
The stock exchange itself neither buys, sells, nor sets prices
The exchange provides the marketplace

Types of Brokers

Commission House Broker

a member executing orders on behalf of his own organization and its customers

Floor Broker ($2 Broker)

a member standing ready, willing, and able to execute orders in any security for any organization
Online Trading

Action

- Buy
- Sell
- Buy on Margin
- Sell Short
Buying on Margin

“Margin” is borrowing money from your broker to buy a stock and using your investment as collateral.

Example

Buy paying full price
Buy stock at $60. Stock price goes to $90.

Return = (90 - 60)/60 = 50%

Buy on “margin”
Buy stock at $60. Borrow $30; you pay $30. Stock price goes to $90.

You have $90
Owe $30
You have, net $60
You paid $30

Return = (60 – 30)/30 = 100%

Possible problems with margin call

Sell Short

Short selling is selling stock you do not own. The stock you borrow comes from either the brokerage firm’s own inventory, the margin account of another of the firm’s clients, or another brokerage firm.

You will benefit only if the stock price drops
Possibility of making large profits
Example – Bank of America
October 1, 2008 – $38.13 – sell short

Profit (not counting interest expense) $38.13 – 20.87 = $17.86 per share (83%)

October 10, 2008 - $20.87 – buy stock to replace stock sold
Types of Trading Orders

Price Limits

- Market order
  - the broker must buy or sell at the best price obtainable
    ⇒ the customer is certain that a market order will be completed

- Limit order
  - the broker is to execute at the limit or better
    ⇒ a limit order to **buy** is executed at the limit or **lower**
    ⇒ a limit order to **sell** is executed at the limit or **higher**
    ⇒ there is a chance that the order may not be executed

- Stop order
  - to buy -- limit price is placed above the current market price
    ⇒ stop order becomes a market order when the stock sells at or above
      the stop price
  - to sell -- limit price is placed below the current market price
    ⇒ stop order becomes a market order when the stock sells at or below
      the stop price

- Stop limit order
  - to buy -- limit price is placed above the current market price
    ⇒ stop order becomes effective as soon as there is a sale at the stop
      price or higher, and then it is executed, if possible, at the limit or
      lower
  - to sell -- limit price is placed below the current market price
    ⇒ stop order becomes effective as soon as there is a sale at the stop
      price or lower, and then it is executed, if possible, at the limit or
      higher

- Time limits
  - Day order
    ⇒ to buy or sell during the day or expire at the end of that trading day
  - Open order (Good Till Canceled)
    ⇒ to buy or sell at a set price until the order is either executed or can-
      celled
  - Fill or kill
    ⇒ if the order cannot be filled at once, **in its entirety**, at the stipulated
      price, it is canceled and a fresh quote is given from the floor
  - Immediate or cancel
    ⇒ similar to the fill or kill order except the broker may fill as much of
      it as possible and cancel the remainder
Role of Specialist

Specialist is member of exchange appointed to maintain an orderly succession of prices in selected stocks
- specialist expected to buy securities in declining markets and to sell securities in rising markets
- specialist buys for his/her own account

Designated Market Makers (DMM) – replaced specialists
- no longer having first/exclusive look at buy and sell orders
- they can now compete against other exchange members for trades, rather than facilitate trades for them, as had been their charge
- charged with providing liquidity for market
Trading and Settlement Dates

Confirmation statements - provided by broker
- number of shares
- name of the securities purchased/sold
- unit price
- amount that is due/receivable

Trading date
- date of purchase/sale

Settlement date
- purchaser has three business days after trading date to pay amount that is due
- seller has three business days after trading date to deliver stock to broker