

Tashkent State University of Economics



Finance and taxes department

Uzbek financial markets

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LECTURE 6. ROLE OF CAPITAL MARKETS



OUTLINE

- ▶ The Role of the Capital Markets
 - ▶ Economic Function
 - ▶ Continuous Pricing Function
 - ▶ Fair Pricing Function
- ▶ The Exchanges
 - ▶ National Exchanges
 - ▶ Regional Exchanges
 - ▶ Trading Systems
 - ▶ The Specialist System
 - ▶ SuperDOT and NYSE Direct+
 - ▶ Marketmakers
 - ▶ Circuit Breakers and Trading Curbs

OUTLINE

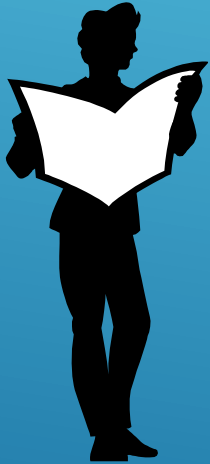
- ▶ The Nasdaq Stock Market
 - ▶ The Small Order Execution System (SOES)
 - ▶ The Nasdaq National Market
 - ▶ The Nasdaq Small Cap Market
- ▶ The Over-the-Counter Market
 - ▶ Over-the-Counter Bulletin Board (OTCBB)
 - ▶ Pink Sheet Stocks
 - ▶ Third and Fourth Markets

OUTLINE

- ▶ Regulation
 - ▶ The Exchanges
 - ▶ The SEC
 - ▶ Background
 - ▶ Primary Acts
 - ▶ The NASD
 - ▶ SIPC
- ▶ Ethics
 - ▶ Illegal vs. Unethical
 - ▶ The Chartered Financial Analyst Program
 - ▶ History
 - ▶ The CFA Program Exams
 - ▶ AIMR Standards of Professional Conduct

THE ROLE OF THE CAPITAL MARKETS

An exchange serves three principal functions.



◆ **Economic Function**

- ▶ Continuous Pricing Function
- ▶ Fair Pricing Function

ECONOMIC FUNCTION

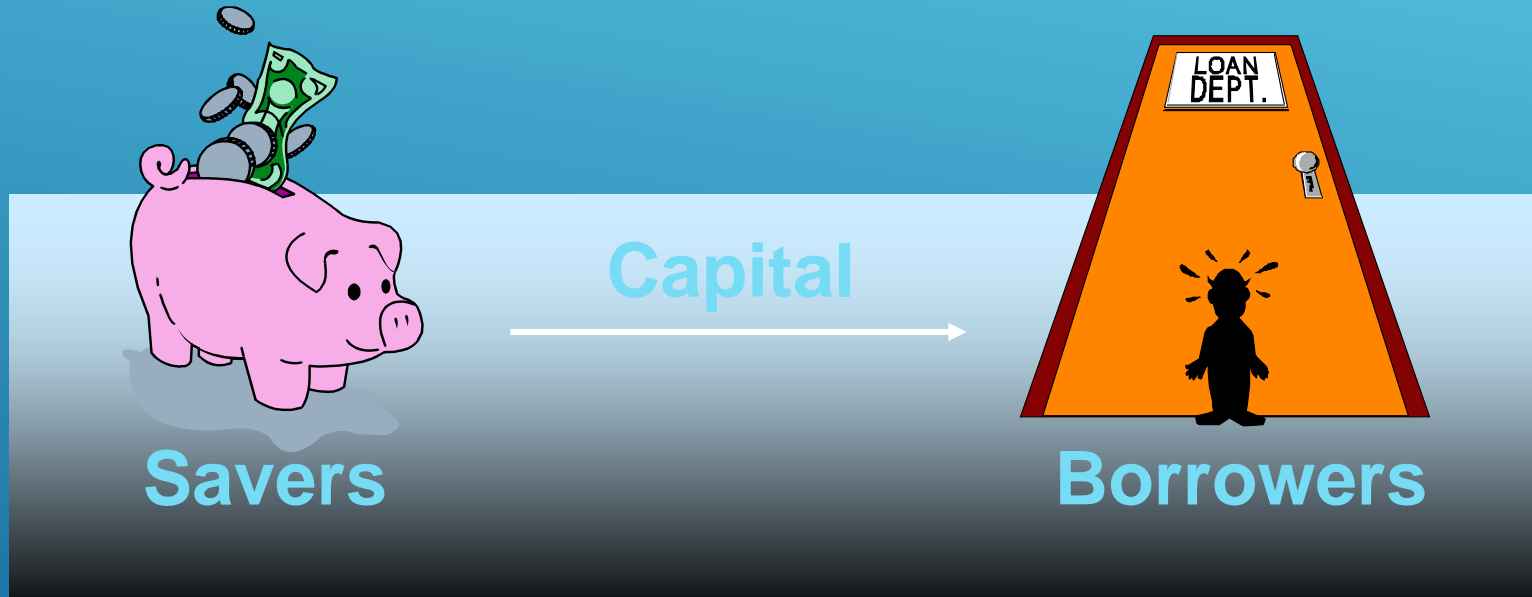
Even in the days before *perestroika*, socialism was never a monolith. Within the Communist countries, the spectrum of socialism ranged from the quasi-market, quasi-syndicalist system of Yugoslavia to the centralized totalitarianism of neighboring Albania. One time I asked Professor von Mises, the great expert on the economics of socialism, at what point on this spectrum of statism would he designate a country as "socialist" or not. At that time, I wasn't sure that any definite criterion existed to make that sort of clear-cut judgment.

And so I was pleasantly surprised at the clarity and decisiveness of Mises's answer. "A stock market," he answered promptly. "A stock market is crucial to the existence of capitalism and private property. For it means that there is a functioning market in the exchange of private titles to the means of production. There can be no genuine private ownership of capital without a stock market: there can be no true socialism if such a market is allowed to exist."

- Murray Rothbard, from *Making Economic Sense*

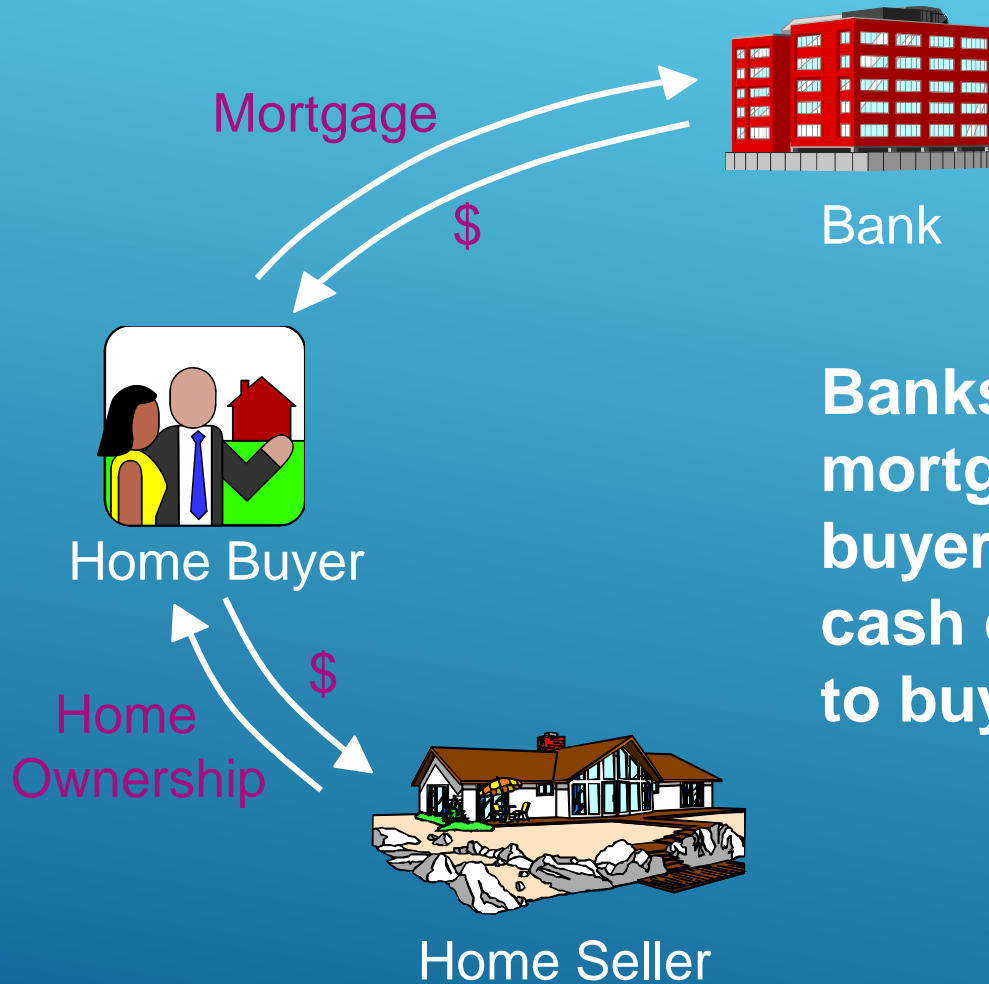
ECONOMIC FUNCTION

Capital markets facilitate the flow of capital from savers to borrowers.



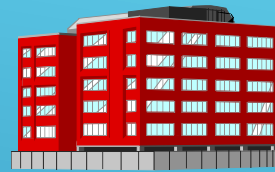
Capital Market

ECONOMIC FUNCTION: AN EXAMPLE

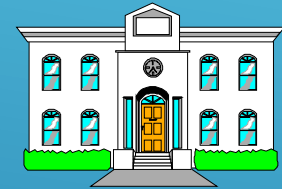


Banks offer home mortgages so that home buyers who are short of cash can borrow money to buy houses.

ECONOMIC FUNCTION: AN EXAMPLE



Bank



Gov't Agency



Investors

Facilitated by government agencies such as the Federal National Mortgage Association, banks sell the mortgages to investors with surplus cash.

ECONOMIC FUNCTION



The ***primary market*** is the “new securities” market where securities are sold to the public for the first time.

The ***secondary market*** is the “used securities” market, where previously issued securities are traded among security holders.

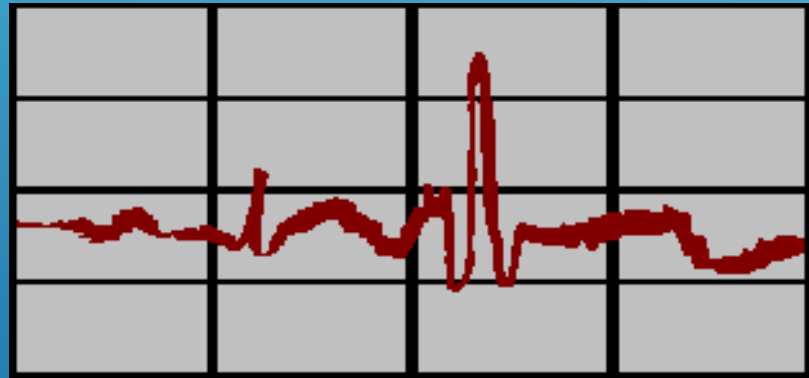
ECONOMIC FUNCTION

Dollar Holdings

<u>Investor Group</u>	<u>(billions)</u>	<u>% of Total</u>
Household sector	\$6,579	38.70%
State/local governments	115	0.68
Rest of world	1,712	10.07
Bank trusts/estates	315	1.85
Life insurance companies	938	5.52
Other insurance companies	179	1.05
Private pension funds	1,999	11.76
State/local retirement funds	1,937	11.39
Mutual funds	3,226	18.98
Total	\$17,000	100.00

CONTINUOUS PRICING FUNCTION

Capital markets enable market participants to get accurate, up-to-date price information.



FAIR PRICING FUNCTION

Capital markets remove the fear that people have of buying or selling at a rip-off price.

The greater the number of participants and the more formal the marketplace, the “fairer” the price.



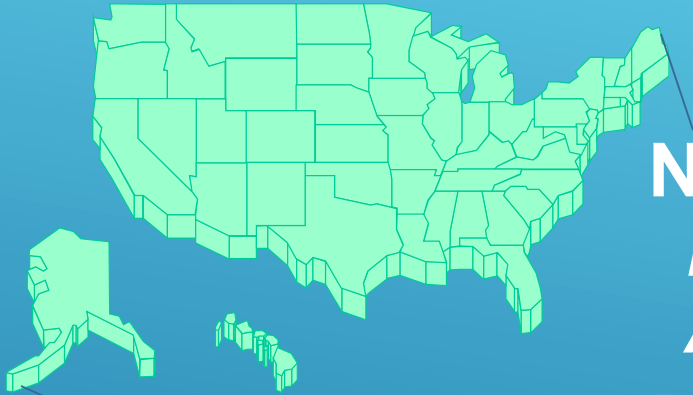
THE ROLE OF THE CAPITAL MARKETS

Functions of the Capital Markets

- **Fair price function**
- **Continuous pricing function**
- **Economic function**

THE EXCHANGES

United States



National Exchanges

New York Stock Exchange (NYSE)

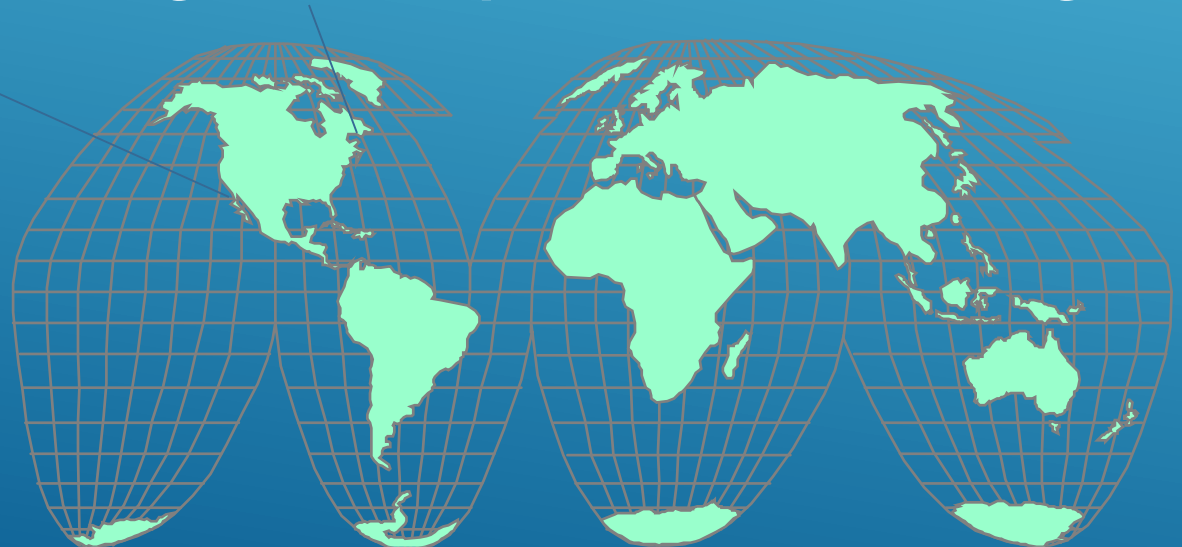
American Stock Exchange (till 1999)

Regional Exchanges

e.g. Philadelphia Stock Exchange

International Exchanges

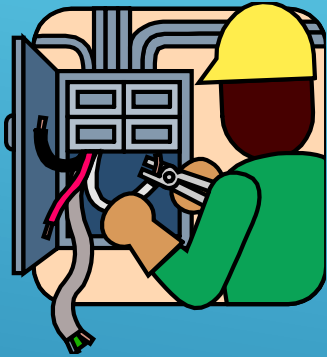
*e.g. England,
France,
Japan,
Thailand*



TRADING SYSTEMS

- ▶ *Specialists* are charged with making a fair and orderly market in one or more assigned securities at *posts* on the exchange floor.
- ▶ *SuperDot* and *NYSE Direct+* are electronic systems enabling NYSE firms to send market and limit orders directly to the specialists' posts.
- ▶ *Marketmakers* are groups of competing individuals who maintain a fair and orderly market through *open outcry* trading in *pits* on the exchange floor.

CIRCUIT BREAKERS AND TRADING CURBS



Both *trading curbs* and *circuit breakers* are designed to reduce temporary volatility in the market.

At the NYSE, when the Dow Jones Industrial Average fluctuates by more than 2%, the circuit breaker is activated and computerized trading becomes restricted.

When a trading curb is triggered, *all* trading at the exchange is halted.

THE NASDAQ STOCK MARKET

- ▶ The Nasdaq (National Association of Securities Dealers Automated Quotations) market is a worldwide computerized linkup of brokerage firms, investment houses and large commercial banks.
- ▶ The Nasdaq market is sometimes still erroneously called the over-the-counter (OTC) market.

THE NASDAQ STOCK MARKET

- ▶ In Nasdaq trading, bids and offers for securities ranging from small unfamiliar firms to some of the largest companies in the world are posted to an electronic bulletin board.
- ▶ Trades of up to 1,000 shares can be executed in less than one minute via the *Small Order Execution System (SOES)*.

THE NASDAQ STOCK MARKET

- ▶ The Nasdaq stock market comprises two distinct markets:
 - ① *The Nasdaq National Market*. The largest and most established firms in the Nasdaq market are the national market issues.
 - ② *The Nasdaq Small Cap Market*. These small-cap issues have a low level of capitalization.

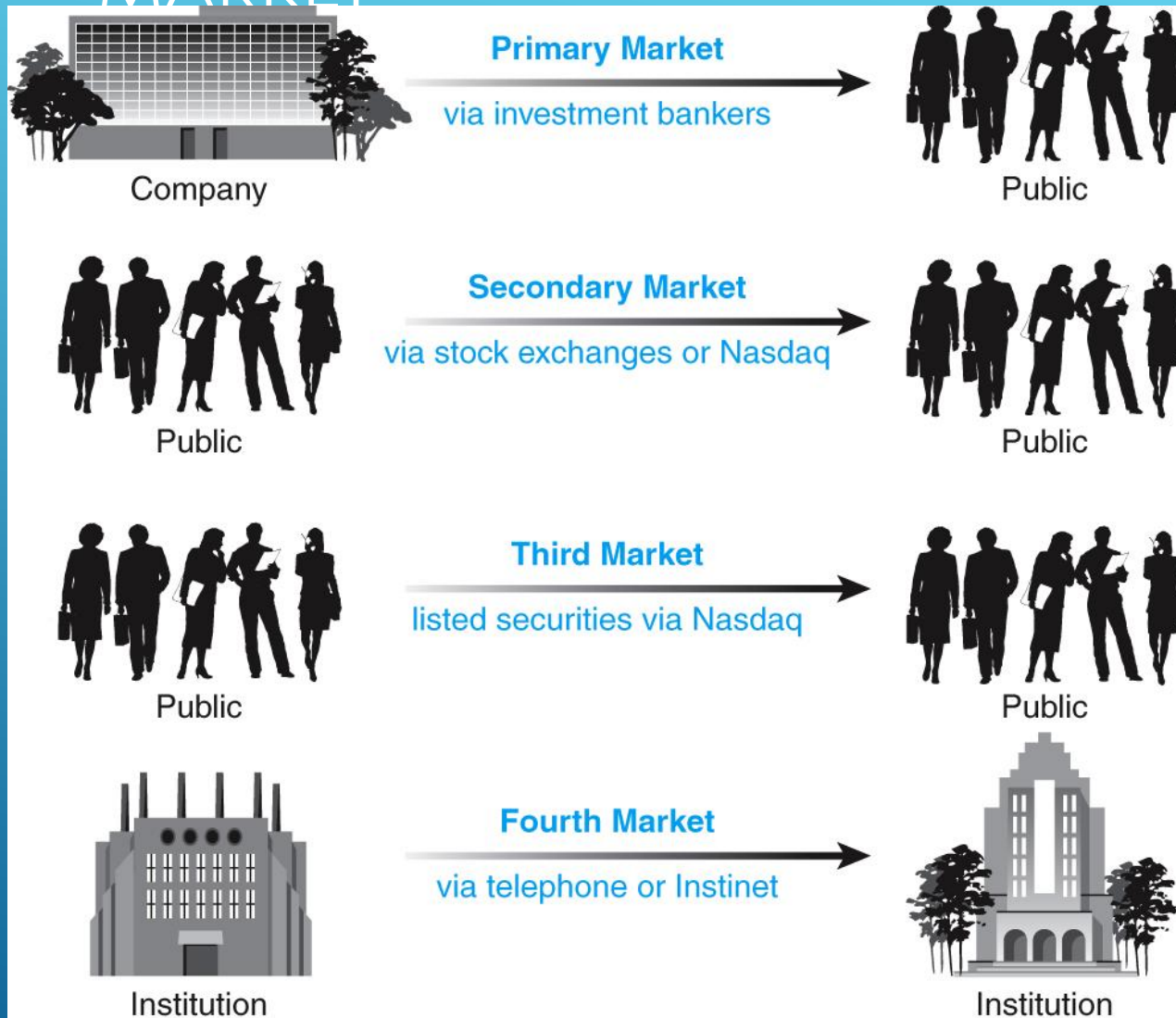
THE OVER-THE-COUNTER MARKET

- ▶ Today, the term *OTC equity security* refers to an equity security that is not traded on Nasdaq or a national or regional exchange.
- ▶ OTC securities trade in two ways:
 - ① The *OTC Bulletin Board (OTCBB)* is a regulated quotation service providing real-time information.
 - ② Data on the smallest and often most speculative *pink sheet stocks* can be accessed via the Internet.

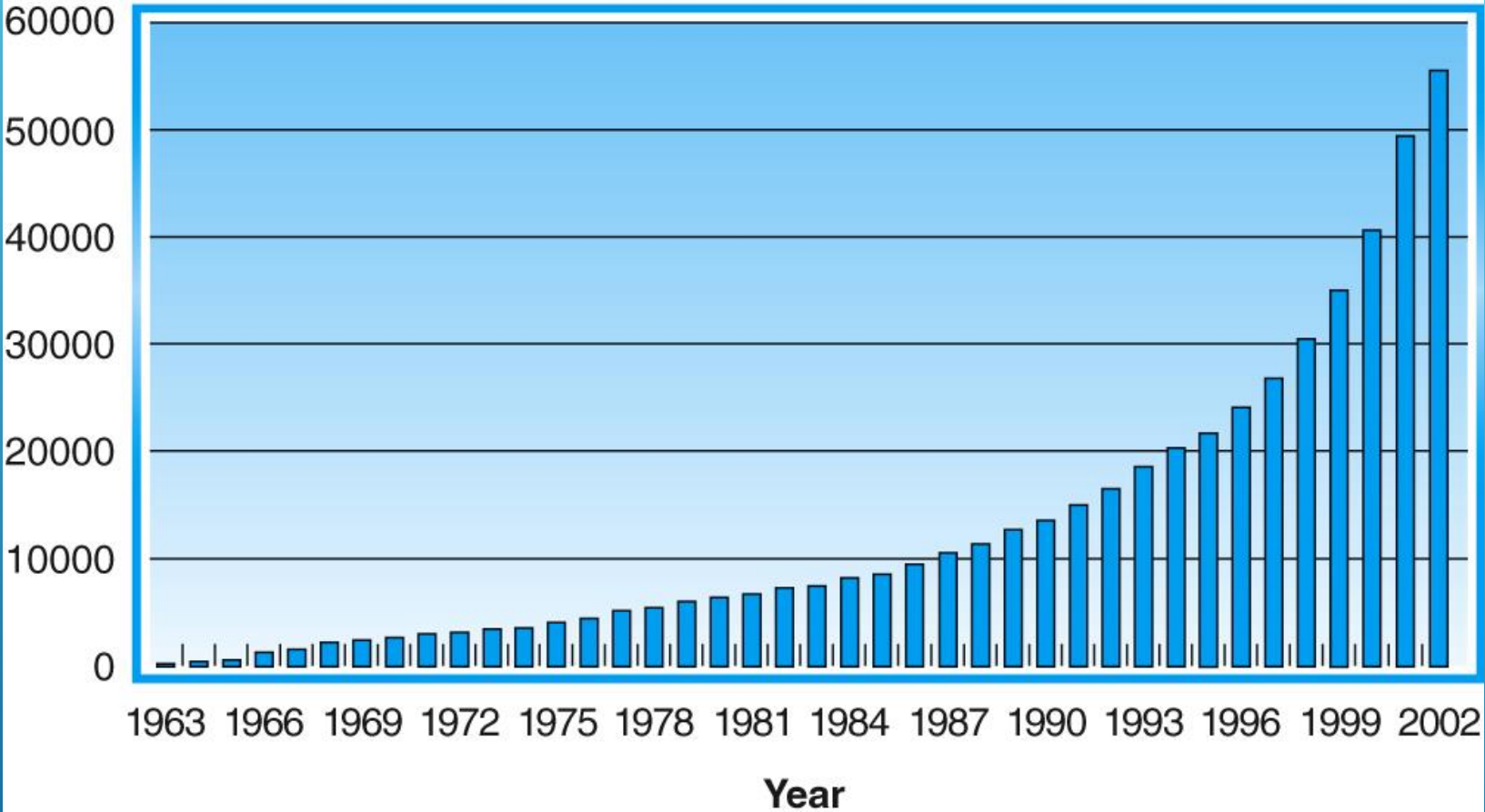
THIRD AND FOURTH MARKETS

- ▶ The trading of listed securities in the Nasdaq market is known as the *third market*.
- ▶ Direct trades between large institutional investors comprise the *fourth market*.

THE OVER-THE-COUNTER MARKET



THE MARKETS



REGULATION

- ▶ The Exchanges have rules regarding...
 - ▶ the financial capacity of members serving as stock specialists
 - ▶ the financial & market activity of listed firms
 - ▶ the disclosure & annual reporting of listed firms

REGULATION

- ▶ The *Securities and Exchange Commission (SEC)* was established ...
 - ▶ to ensure that investors have adequate information to make an informed investment decision
 - ▶ to help prevent price manipulations and abuses like the *Ponzi scheme*
- ▶ Two primary acts influencing the investment industry today are the *Securities Act of 1933* and the *Securities Exchange Act of 1934*.

REGULATION

- ▶ The *National Association of Security Dealers (NASD)* is a self-regulatory body that licenses brokers and generally oversees the trading practices of OTC securities.
- ▶ The *Securities Investor Protection Corporation (SIPC)* protects investors from loss due to brokerage firm failure, fraud, natural disaster, or theft.

ETHICS

- ▶ A wide range of investment activities may be *legal* but carry substantial *ethical* baggage.
- ▶ The *Chartered Financial Analyst (CFA)* program promotes investment education and ethical behavior among those involved in the investment business.
- ▶ The program is administered by the *Association for Investment Management and Research (AIMR)*.

ETHICS

- ▶ To earn a CFA designation, candidates must pass three separate exams taken at least a year apart.
- ▶ Persons who have earned the CFA designation must subscribe to the AIMR standards of professional conduct.

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