

**KEY TERMS**

- aftermarket
- American depository receipt (ADR)
- ask price
- best-effort agreement
- bid price
- blue-sky laws
- broker
- buying on margin
- commission brokers
- dealer
- designated market markets (DMMs)
- due diligence
- Dutch auction
- floor brokers
- flotation
- flotation costs
- fourth market
- global depository receipt (GDR)
- house brokers
- independent brokers
- initial margin
- initial public offering (IPO)
- investment bankers
- limit order
- maintenance margin
- margin
- margin call
- market maker
- market order
- market stabilization
- odd lot
- offer price
- pre-emptive rights
- primary market
- private placement
- program trading
- prospectus
- public offering
- registered traders
- round lot
- secondary market
- shelf registration
- short sale
- spread
- stop-loss order
- street name
- Supplemental Liquidity Providers (SLPs)
- syndicate
- third market
- tombstones
- underpricing
- underwriters
- underwriting agreement

**DISCUSSION QUESTIONS**

1. Why do corporations employ investment bankers?
2. Identify the primary market functions of investment bankers.
3. Discuss how investment bankers assume risk in the process of marketing securities of corporations. How do investment bankers try to minimize these risks?
4. Briefly describe the process of competitive bidding and discuss its relative advantages and disadvantages.
5. Explain market stabilization.
6. Identify the costs associated with going public.
7. Briefly describe how investment banking is regulated.
8. Describe the inroads into investment banking being made by commercial banks.
9. In 2003, several investment banking firms were fined \$1.4 billion for ethics abuses related to the underwriting process. Will this be a deterrent for ethical lapses?
10. What are some of the characteristics of an organized securities exchange?
11. Describe the types of members of the New York Stock Exchange.
12. Why is there a difference between bid and ask prices at some point in time for a specific security?
13. Describe the differences among the following three types of orders: market, limit, and stop loss.
14. What is a short sale?
15. Describe buying on margin.
16. What is program trading?

17. Describe several differences between the organized exchanges and the over-the-counter (OTC) market.
18. What factors differentiate a "good market" from a "poor market"?
19. A security's liquidity is affected by what influences?
20. Why may a stock trade that takes 1 second to execute be preferable to a trade that takes 9 seconds to execute?
21. How do the third and fourth markets differ from other secondary markets?
22. What are some factors that influence the commission on a stock trade with a broker?
23. Give some examples of market indexes. Why are there so many different indexes?
24. What are American Depository Receipts (ADRs)?
25. Why is it illegal to trade on insider information?
26. What is Regulation FD, and how does it affect security trading?
27. Visit the Web site of the CFA Institute, <http://www.cfainstitute.org>. Type the word "ethics" into the site's search function. Discuss, in your own words, the ethics issues that the CFA Institute is analyzing or discussing.
28. Visit the Web site of the CFP Board, <http://www.cfp.net>. Type the word "ethics" into the site's search function. Describe a few of the pages that appear from the search.
29. What are the advantages of having a specialist-based or DMM (open outcry) trading system? An electronic trading system?
30. Discuss this statement: "Technology and globalization are two current forces impacting stock exchanges."

**PROBLEMS**

1. You are the president and chief executive officer of a family owned manufacturing firm with assets of \$45 million. The company articles of incorporation and state laws place no restrictions on the sale of stock to outsiders. An unexpected opportunity to expand arises that will require an additional investment of \$14 million. A commitment must be made quickly if this opportunity is to be taken. Existing stockholders are not in a position to provide the additional investment. You wish to maintain family control of the firm regardless of which form of financing you might undertake. As a first step, you decide to contact an investment banking firm.
  - a. What considerations might be important in the selection of an investment banking firm?
  - b. A member of your board has asked if you have considered competitive bids for the distribution of your securities compared with a negotiated contract with a particular firm. What factors are involved in this decision?
  - c. Assuming that you have decided upon a negotiated contract, what are the first questions that you would ask of the firm chosen to represent you?
  - d. As the investment banker, what would be your first actions before offering advice?
  - e. Assuming the investment banking firm is willing to distribute your securities, describe the alternative plans that might be included in a contract with the banking firm.
  - f. How does the investment banking firm establish a selling strategy?
  - g. How might the investment banking firm protect itself against a drop in the price of the security during the selling process?
  - h. What follow-up services will be provided by the banking firm following a successful distribution of the securities?
  - i. Three years later, as an individual investor, you decide to add to your own holding of the security but only at a price that you consider appropriate. What form of order might you place with your broker?
2. In late 2010, you purchased the common stock of a company that has reported significant earnings increases in nearly every quarter since your purchase. The price of the stock increased from \$12 a share at the time of the purchase to a current level of \$45. Notwithstanding the success of the company, competitors are gaining much strength. Further, your analysis indicates that the stock may be overpriced based on your projection of future earnings growth. Your analysis, however, was the same one year ago and the earnings have continued to increase. Actions that you might take range from an outright sale of the stock (and the payment of capital gains tax) to doing nothing and continuing to hold the shares. You reflect on these choices as well as other actions that could be taken. Describe the various actions that you might take and their implications.
3. Which of the following securities is likely to be the most liquid according to this data? Explain.

STOCK	BID	ASK
R		
S	\$39.43	\$39.55
T	13.67	13.77
	116.02	116.25

4. You purchased shares of Broussard Company using 50 percent margin; you invested a total of \$20,000 (buying 1,000 shares at a

price of \$20 per share) by using \$10,000 of your own funds and borrowing \$10,000. Determine your percentage profit or loss under the following situations (ignore borrowing costs, dividends, and taxes). In addition, what would the percentage profit and loss be in these scenarios if margin were not used?

- a. the stock price rises to \$23 a share
  - b. the stock price rises to \$30 a share
  - c. the stock price falls to \$16 a share
  - d. the stock price falls to \$10 a share
5. Currently the price of Mattco stock is \$30 a share. You have \$30,000 of your own funds to invest. Using the maximum margin allowed, what is your percentage profit or loss under the following situations (ignore dividends and taxes)? What would the percentage profit or loss be in each situation if margin were not used?
    - a. you purchase the stock and it rises to \$33 a share
    - b. you purchase the stock and it rises to \$35 a share
    - c. you purchase the stock and it falls to \$25 a share
    - d. you purchase the stock and it falls to \$20 a share
  6. The Trio Index is comprised of three stocks, Eins, Zwei, and Tri. Their current prices are listed below.

STOCK	PRICE AT TIME (t)
Eins	\$10
Zwei	\$20
Tri	\$40

- a. Between now and the next time period, the stock prices of Eins and Zwei increase 10 percent while Tri increases 20 percent. What is the percentage change in the price-weighted Trio Index?
- b. Suppose instead that the price of Eins increases 20 percent while Zwei and Tri rise 10 percent. What is the percentage change in the price-weighted Trio Index? Why does it differ from the answer to part a?
7. The four stocks below are part of an index. Using the information below:
  - a. Compute a price-weighted index by adding their prices at time  $t$  and time  $t + 1$ . What is the percentage change in the index?
  - b. Compute a value-weighted index by adding their market values at time  $t$  and time  $t + 1$ . What is the percentage change in the index?
  - c. Why is there a difference between your answers to (a) and (b)?

STOCK	# OF SHARES OUTSTANDING	PRICE AT TIME (t)	PRICE AT TIME (t + 1)
Eeny	100	10	15
Meeny	50	20	22
Miney	50	30	28
Moe	20	40	42

8. The Quad Index is comprised of four stocks, Uno, Dos, Tres, and Fore.