SOLUTIONS MANUAL
CHAPTER 2
SECURITY MARKETS

Answers to Text Discussion Questions

1. What is a market?

2-1. A market is a way of bringing buyers and sellers of assets together so that an exchange can take place. It need not be a central place or a physical structure.

2. What is an efficient market?

2-2. A market is considered efficient when prices respond quickly to new information, when each successive trade is made at a price close to the preceding price, and when larger amounts of assets can be bought and sold without changing prices significantly. In addition, liquidity—the ability to convert assets to cash at fair value—is an attribute of efficiency.

3. What is the difference between primary and secondary markets?

2-3. The primary markets are those in which new issues of securities are sold and the funds raised from the sale are received by the originator of the securities, usually a company or government. The secondary markets are those that facilitate exchange between investors and the funds flow directly between investors.

4. What is the difference between an investment banker providing an underwriting function and a “best-efforts” offering?

2-4. With an underwriting, the investment banker guarantees the selling firm that he will purchase the securities at a fixed price for resale. This eliminates the risk for the selling firm. Under a "best efforts" offering, the issuing firm assumes the risk and simply takes back any securities not sold after a fixed period of time.

5. What is a private placement?

2-5. In a private placement, a company sells its securities to a financial institution such as an insurance company, a pension fund or a mutual fund. The company may engage the services of an investment banker to find an institution willing to buy a large block of stocks or bonds. In any event, the public markets are bypassed. Private offerings are more commonly used with bonds than stocks.

6. What generally determines how firms are listed in a tombstone advertisement?

2-6. Firms are usually listed in the tombstone advertisement based on their clout in the investment-banking community, with firms at the top taking the biggest dollar position and the firms at the bottom taking a relatively small position.

7. What are house brokers on the New York Stock Exchange?

2-7. House brokers got their name because they represented NYSE member firms such as Merrill Lynch or Smith Barney which use to be known as investment houses. House brokers either trade for clients of the investment house or for the firms's direct account.

8. How do critics think the specialist system on the NYSE might be improved?

2-8. Critics feel that the specialist system on the NYSE might be improved by having more than one specialist for each stock. Many market watchers think that competing dealers on the over-the-counter market provide more price stability and fluid markets than the NYSE specialist system.

9. Briefly describe the Nasdaq Stock Market.

2-9. The Nasdaq Stock Market is linked by computer networks and provides up-to-the minute quotations or approximately 6,000 stocks.

10. What are electronic communication networks (ECNs)?

2-10. ECNs are electronic trading systems that automatically match buy and sell orders at specified prices. ECNs are also known as alternative trading systems (ATS) and have been given SEC approval to be more fully integrated into the national market system by choosing to either act as a broker-dealer or as an exchange.

11. Define a block trade. What does the increase in the number of block trades since 1965 tend to indicate about the nature of investors in the market?

2-11. A block trade is a single order of 10,000 shares or more. The increase in block trades since indicates the ever-increasing importance of institutional investors in the market.

12. Indicate the primary purpose of the Securities Act of 1933. Why was it enacted? Does the SEC certify that a security is fairly priced?

2-12. The primary purpose of the Securities Act of 1933 was to provide full disclosure of all pertinent information on a new security issue. It was enacted because of the abuses present in the securities markets during the 1929 crash and again in 1931. The SEC in no way certifies that the security is fairly priced, but only that the information seems to be factual and accurate.

13. How has the definition of an insider (inside trader) expanded over the past two decades?

2-13. Originally insiders were thought to be officers, directors, major stockholders, employees or relatives of key employees. In the last two decades, the SEC widened its interpretation to include anyone having information that was not public.

14. Explain the purpose of the Securities Investor Protection Corporation (SIPC).

2-14. The Security Investor Protection Corporation (SPIC) was established under the Security Investor Protection Act of 1970 to oversee liquidation of brokerage firms and to insure investors' accounts to a maximum value of $500,000 in case of bankruptcy of a brokerage firm.

15. What impact have electronic markets had on markets overall?

2-15. Electronic markets have made markets more efficient through lower cost transaction costs. Markets are very sensitive to costs and high volume traders gravitate to the lowest cost systems as long as they provide equal speed of transactions with the equal bid ask spreads. Electronic markets have also contributed to the liquidity in the market through high frequency trading and they have allowed algorithmic trading to flourish.