

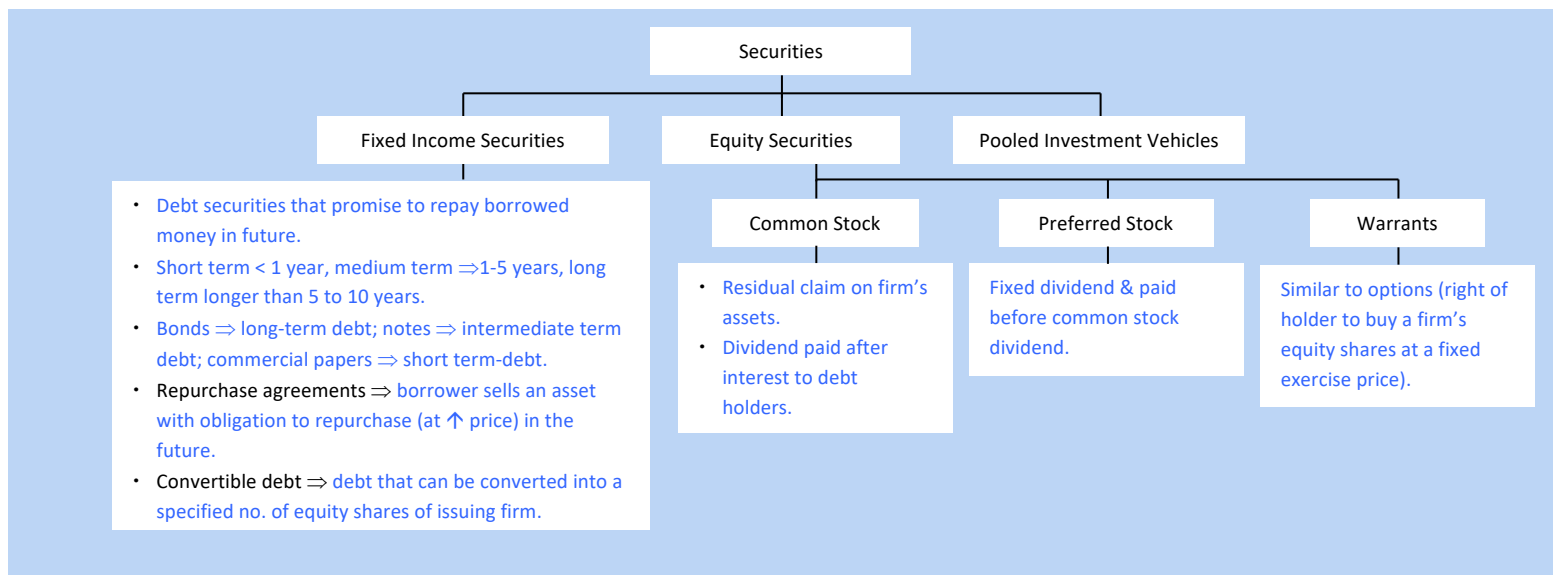
Market Organization and Structure

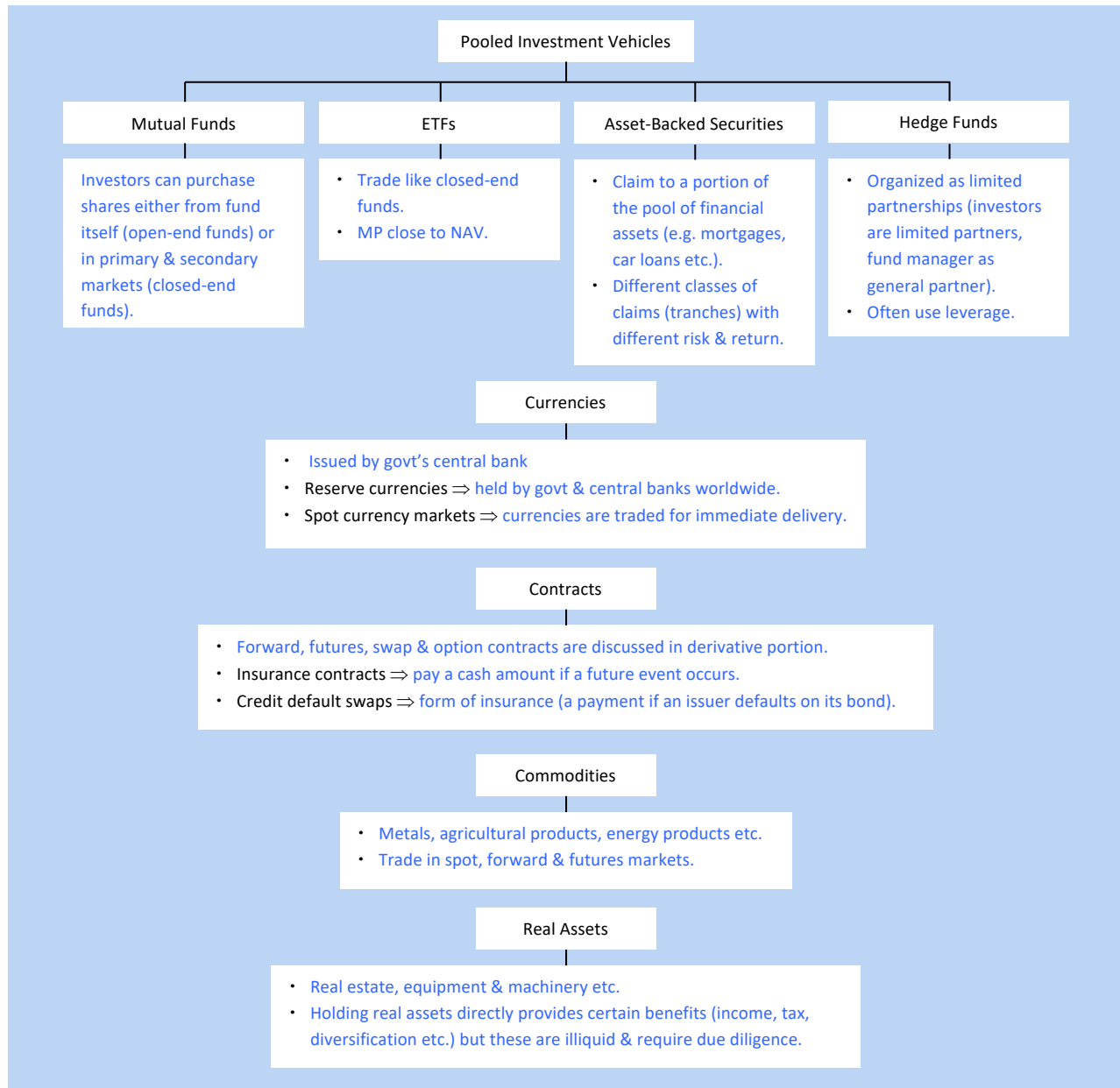
FI = Financial Intermediaries
IB = Investment Bank

MP = Market Price
NAV = Net Asset Value

- People use the financial system for the following purposes:
 - Save & borrow money, manage risks, trade information and exchange assets & raise equity capital.
- The three main functions of financial system are:
 - Determine equilibrium returns (interest rates) (\uparrow rate of return, \uparrow savings, \downarrow borrowings & vice versa).
 - Achievement of the purpose of the financial system.
 - Most efficient uses of capital.
- Financial system works best when markets are liquid, \downarrow transaction cost & information is readily available.
- Usually, risk can be hedged through derivatives.
- Investors weight risk/return of different investments to determine their most preferred investments.

- Financial assets \Rightarrow stocks, bonds, derivative contract & currencies.
- Real assets \Rightarrow real estate, equipment, commodities & other physical assets.
- Financial derivative contracts \Rightarrow based on debt & equity indexes or other financial contracts.
- Physical derivative contracts \Rightarrow derive their value from physical assets (e.g. gold, silver etc.).
- Primary market \Rightarrow market for newly issued securities
- secondary market \Rightarrow where subsequent sale of securities occurred.
- Money markets \Rightarrow markets for debt securities with maturities of one year or less.
- Capital markets \Rightarrow markets for debt & equity securities with longer-term maturities.





- FI = facilitate exchange of assets, capital & risk (stand b/w buyers & sellers).
- Allow greater efficiency & well functioning economy.

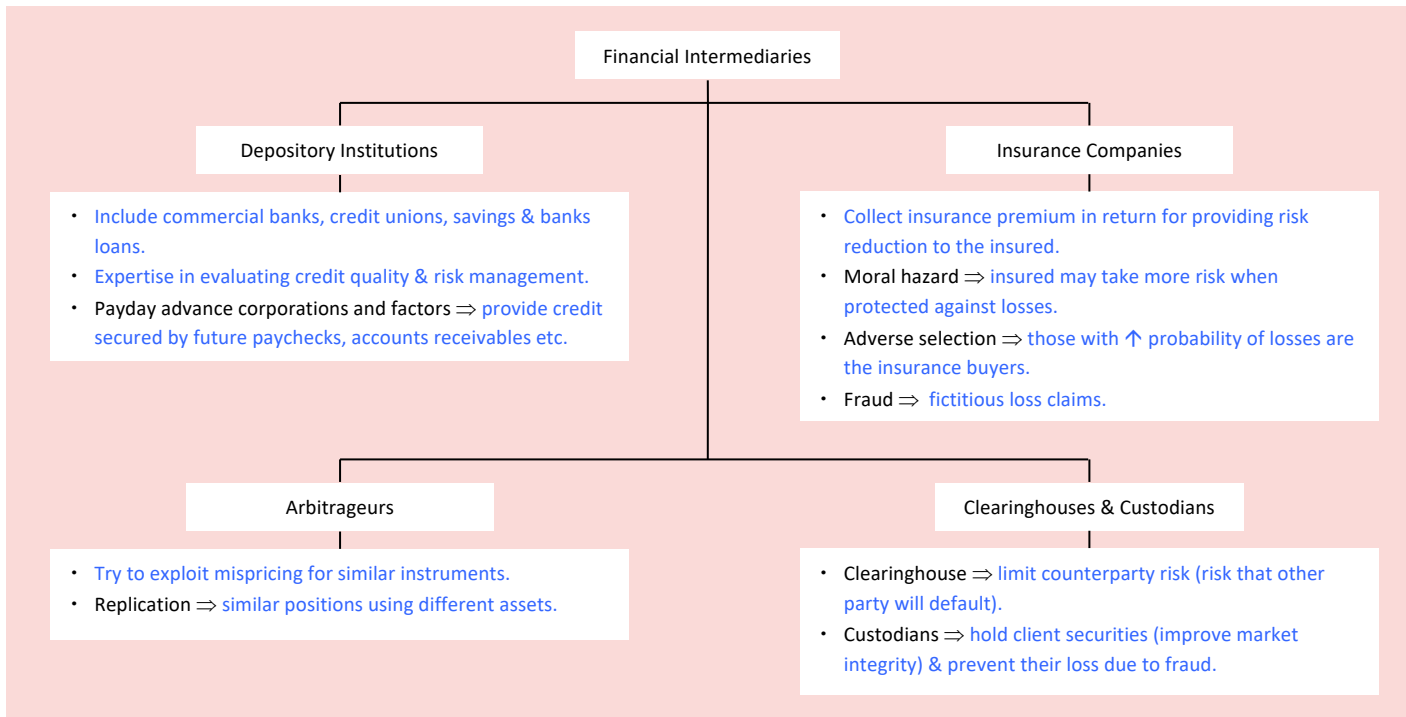
Financial Intermediaries

Brokers, Dealers & Exchanges

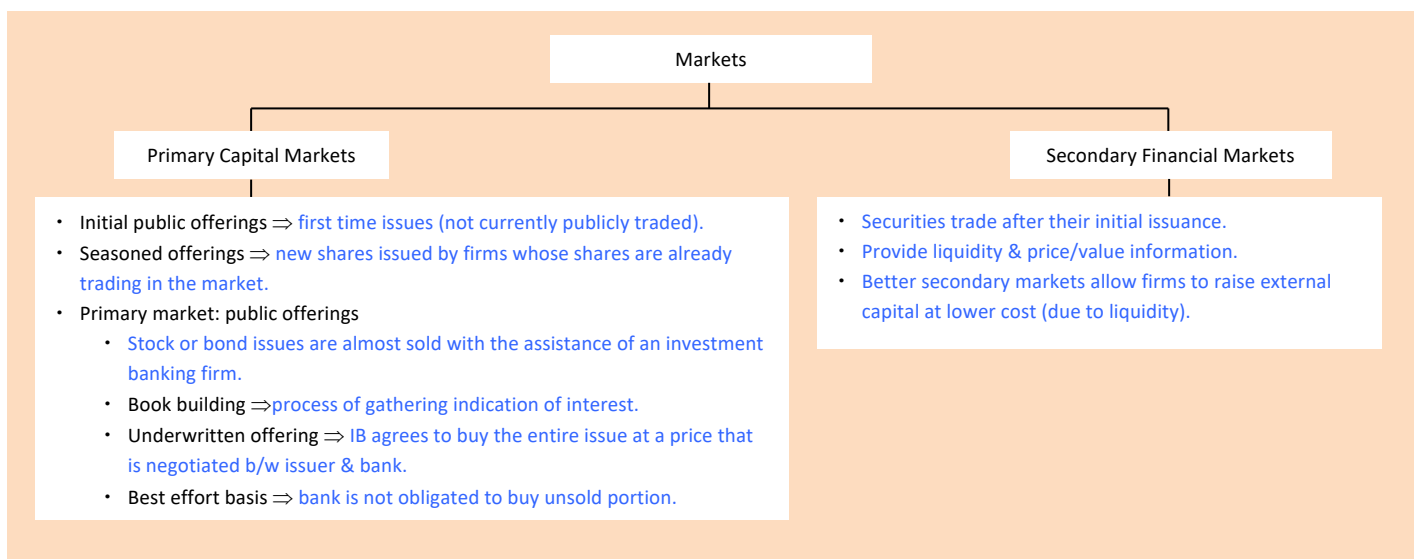
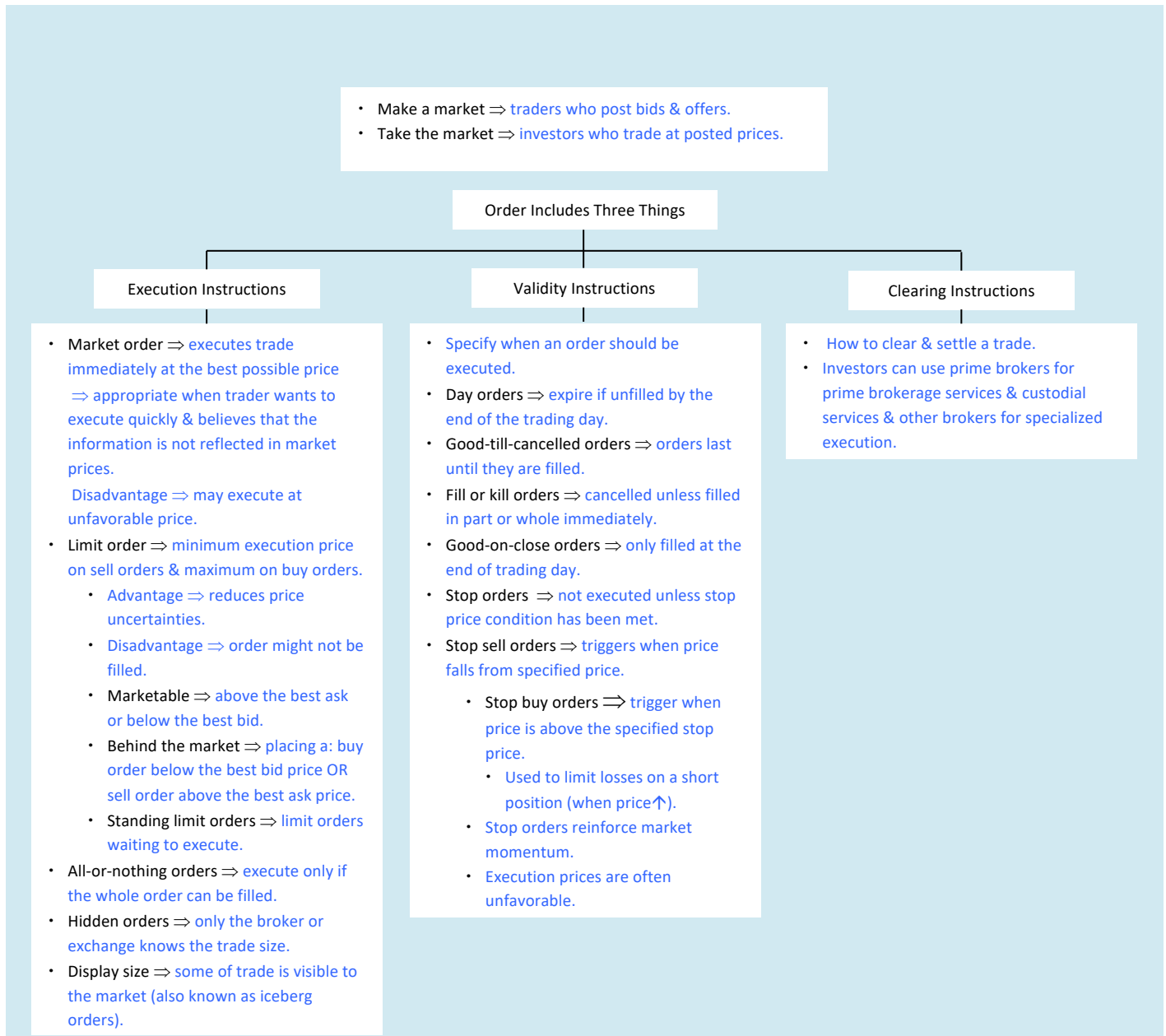
- Brokers ⇒ help clients in buying & selling securities by finding counterparties.
- Block brokers ⇒ assist in large placements.
- Investment banks ⇒ help corporations in selling securities.
- Exchanges ⇒ venue where traders can meet (sometimes act as brokers by providing electronic order matching).
- Alternative trading systems (ATS) ⇒ same trading function as exchanges but no regulatory function.
- Dark pools ⇒ ATS that do not reveal current client orders.
- Dealers ⇒ buying for or selling from their own inventory (provide liquidity & earn spread b/w bid/ask).
- Broker-dealer ⇒ dealer also act as broker (inherent conflict of interest).
- Primary dealers ⇒ trade with central bank which influences money supply.

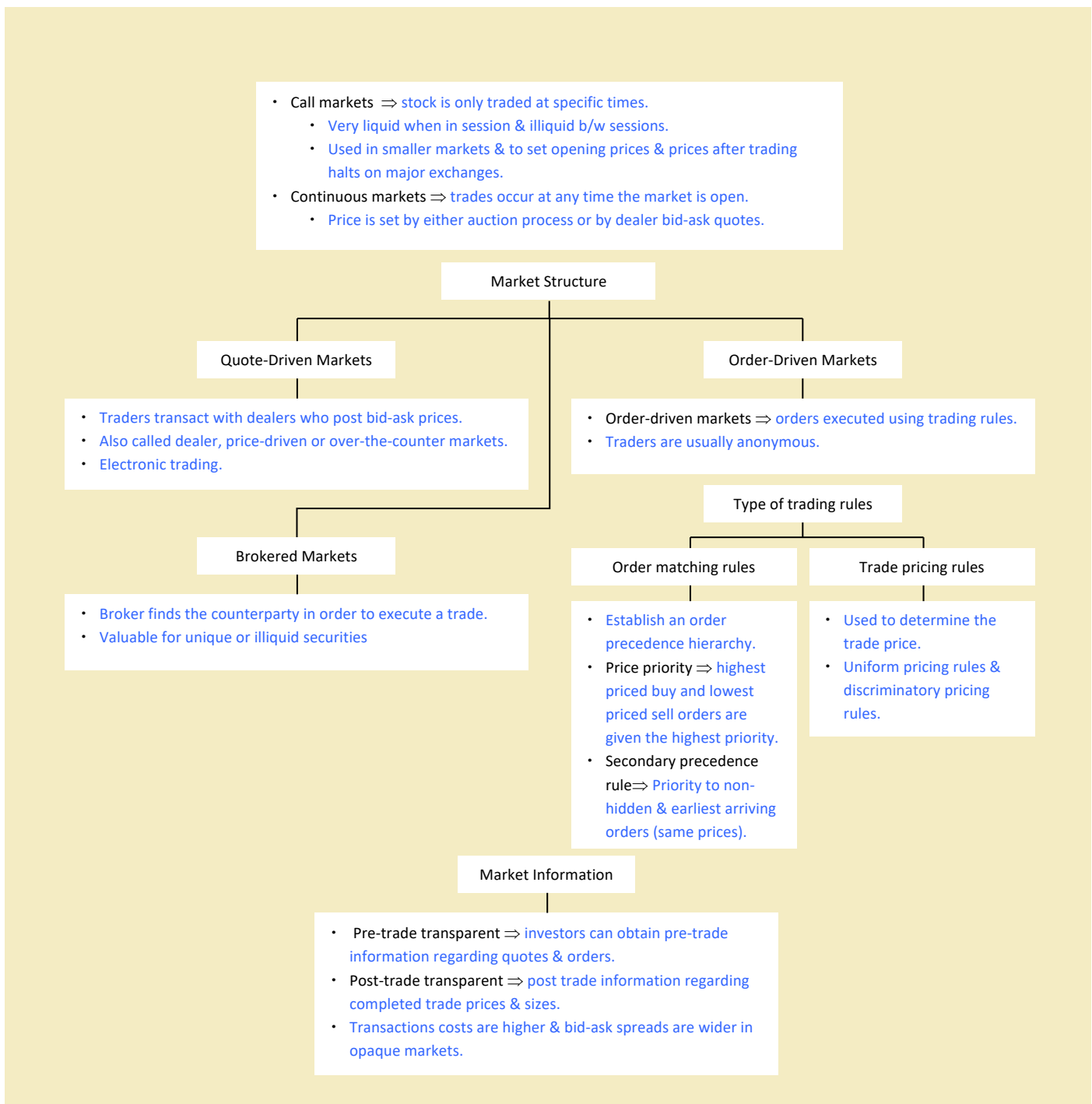
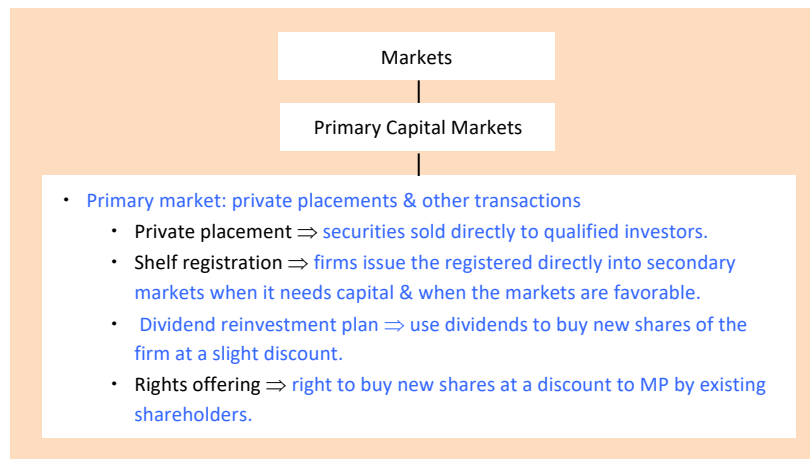
Securitizers

- Pool large amount of securities or other assets & then sell interests in the pool to other investors.
- Create liquidity & economies of scale.
- CF from securitized assets can be segregated by risk (tranches).



- Leverage ratio ⇒ value of assets/value of equity.
- Maintenance margin requirement ⇒ minimum equity % the investor must maintain to ensure that the loan is covered by the value of assets.
- Margin call ⇒ request to bring equity % back to maintenance margin %.
- Margin call price ⇒ $P_0 \left[\frac{1 - \text{initial margin}}{1 - \text{maintenance margin}} \right]$.
- In a short sale margin call will be triggered in case of ↑ in price.





- Complete markets fulfill the following:
 - Fair rate of return for future savings.
 - Creditworthy borrowers can obtain funds.
 - Hedgers can manage their risks & traders can obtain needed assets.
- Operationally efficient markets \Rightarrow low trading costs.
- Informationally efficient markets \Rightarrow security prices reflect all information associated with fundamental value.
- Allocationally efficient markets \Rightarrow capital is allocated to its most productive use.

- Market regulations are used to prevent fraud & theft, insider trading, defaults & costly information.
- Regulations can be provided by govt. as well as self-regulatory organizations.
- When regulations fail to address problems, liquidity \downarrow , new ideas go unfunded & growth slows.