Stock Market Development: Role of Securities Firms and New Products

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Emerging markets have made tremendous progress in the last decade. Stock markets are no longer seen as legalized gambling but their important role has been well documented. Stock market development and long-run economic growth are closely linked together. Markets serve many different roles that are particularly important in emerging markets.

Countries not only need a well-functioning banking sector but in addition also need a well-developed stock market. Demirguc-Kun and Maksomovic (1995) clearly show that banks in emerging markets do not need to be fearful of stock market development. They find that improvements in the functioning of a developing stock market results in higher debt-equity ratios, and thus more business for banks. Stock markets and banks play different but complementary roles.

Stock markets exist to help allocate funds to firms and liquidity to investors. Capital markets also allow the transfer of risk between different parties because investments are inherently risky. There is a critical need for firms in emerging markets to use equity as a source of capital as opposed to relying too much on debt. Equity and debt financing are not perfect substitutes. Equity markets directly provide a number of indirect benefits such as, managing conflicts of interest between stakeholders and stronger corporate governance. They impose discipline on firms. It will soon be important for emerging markets to recognize that stock options can serve as an important substitute for other forms of compensation to attract talent. These stock options also help to align the interests of different stakeholders.
Emerging markets have developed considerably in the last decade but there continues to exist tremendous opportunities to improve. This paper discusses two specific areas that can help in the further development of emerging markets:

- Role of financial intermediaries
- Role of new exchange-based products

In today’s global market, technology is playing a major role in defining the future. Emerging markets will face two important challenges associated with global investors and global issuers in this integrated economy if they do not develop fully.

**Global Investors**

Investors are no longer restricted by national boundaries. Technology has made it easy for investors to invest wherever they find the best risk-return tradeoffs. The internet will continue to make trading easy, transactions costs low, and access to information almost free.
Research clearly shows that emerging markets have also become more integrated with world markets

**Global Issuers**

Firms raising capital are no longer restricted by national boundaries. They will seek capital wherever it is cheapest. In order to compete in the global marketplace, it is important for firms in both developed and developing markets to seek the cheapest capital. We have started to see two trends that will continue. A number of blue chip companies from emerging markets have dual-listed in developed markets. A large proportion of trading and liquidity for these companies occurs in the foreign market and not the home market. Price discovery is taking place in the foreign market rather than in the home country. ADRs such as, Telebras, Telmex, YPF, Taiwan Semiconductor and Grupo Televisa tend to be some of the most active stocks trading in the U.S. ADR trading volume continues to grow every year on the U.S. exchanges (Source: Bank of New York website). Many of these ADRs are blue chips from emerging markets.

**ADRs Trading Volume by Exchange**

(Billions of shares)
Emerging markets have recovered well after the Asian crisis. Bank of New York (BNR) tracks several ADR indexes. The BNY ADR Index and the BNY Emerging Markets ADR Index are shown below (Source: Bank of New York website). The Emerging Markets ADR Index has performed quite well as compared to the overall ADR Index. Now that some of the financial problems in emerging markets are under control, ADRs from emerging markets should show even stronger performance.

Role of Financial Intermediaries

In emerging markets financial intermediaries are often associated with banks. It is important to help develop intermediaries that are independent of banks. These financial intermediaries must be able to earn sufficient compensation so that they have an incentive to enter the business. The role of the following financial intermediaries is discussed here:
Market Makers

Stock markets provide a platform for trading to occur between buyers and sellers. A security’s price is determined based on the market process. Market makers can provide many different services and facilitate trading. The service provided by market makers depends on the structure of the market. A market maker sometimes acts as a broker in which case her role is to bring buyers and sellers together. Another important role of a market maker is to provide liquidity to the market particularly in situations when the market for a stock does not clear automatically at one price. The market maker steps in and supplies securities out of her inventory or buys the stock with her capital in case there is excess supply. Most stocks in emerging markets tend to be thinly traded and lack liquidity, therefore this role of the market maker becomes even more crucial. Market makers do not themselves determine the trading price.

Market makers need to be compensated for this “dealer” role. When acting as a dealer, the market maker posts a bid and a ask price for each security that she wants to trade in. She earns the spread as compensation for providing immediacy and price continuity. This price continuity should result in smaller price swings from transaction to transaction and hence lower price volatility. Dealers face three types of costs:

- **Order-Processing Costs**: These include the cost of space, communication, and labor.
- **Risk-Bearing Costs**: By stepping in the market maker they hold an inventory position.
- **Adverse-Information Costs**: Market Makers can be victimized by information traders.
Market makers should be required to post continuous two-sided quotes that are firm for the size posted. They should be bound only for the posted size but within this posted size they should not be able to back away. Stock exchanges should make it fairly easy to allow somebody to become a market maker. For example, on Nasdaq any member can become a market maker as long as they satisfy minimum net capital requirements. A market maker can also withdraw its registration fairly easily. If he withdraws voluntarily then he cannot make a market in that security for 2 business days.

**Investment Banks**

Investment banks perform a number of different functions. A typical investment bank’s services will include:

- **Financing Services:** They help companies and governments raise capital by issuing different types of securities such as, equity, debt, private placements, commercial paper, medium-term notes.

- **Investment Services:** They trade and make a market in major equity and fixed income products. Many of them specialize in block trading.

- **Research:** Maintenance of large databases that allows them to produce research reports on economies, markets, companies, stocks, and bonds.

- **Mergers and Acquisitions:** Advise on mergers, acquisitions, and divestitures to help companies become more competitive.

Some of these critical financial intermediary services need further development in emerging markets. If financial intermediaries start performing these functions the markets will become more efficient and information flow will increase making the markets less volatile in the long-run. Next, the specific role of investment banks is discussed in capital raising in the primary markets.
Primary Markets

The capital raising process in emerging markets is clearly lacking. If enough issuers do not enter the primary market by doing a public float then lack of liquidity and depth in the secondary market will certainly exist. In an initial public offering (IPO) the issuing firm sells shares to the general public for the first time. After the IPO the shares of the issuing company are expected to trade on an exchange. This liquidity allows the original owners to sell their shares in the secondary market. The liquidity also results in lowering the firm’s cost of capital. The issuing firm typically hires an investment bank to assist in the process of going public. Investment banks perform several functions in helping firms raise capital.

IPO pricing can occur in several different ways. The most common method for pricing IPOs around the world is the “fixed price” offering in which a price is fixed and all shares in the issue must be sold at that price. Investment banks can take a firm public in one of two way: Firm commitment or best efforts. In a firm commitment offering, the underwriter buys the entire offering from the issuer at a certain price and sells it to investors at the fixed price.

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**Role of Investment Banker in an IPO**

- Due diligence investigation of the firm
- Prepare the prospectus
- File with regulatory bodies and exchanges
- Pricing the offering: IPOs can be priced in several different ways
- Marketing of the offering
- Road Shows
- Distribution of the offering
- Risk Taking
- Market Making
- Exercise of Green Shoe
- Research
- Stabilization
The difference between the two prices is the underwriter’s compensation. If an offering is not fully distributed the underwriter is left holding the overpriced shares. Therefore underwriters form a syndicate to mitigate the risk and help in the distribution process. In a best efforts offering the underwriter tries to sell as many shares as possible but the ultimate risk of total proceeds received is left to the issuer. These financial intermediaries must have enough capital to perform these functions. Several new methods have been developed in the IPO process and I discuss two of them here.

*Auction Pricing*

Some countries for example, Chile and Japan use the auction process in addition to the fixed price method to determine the price of an offering. In the United States concern about underpricing and large underwriting commissions has led to new methods of going public. One such new system is called OpenIPO and is offered by W R Hambrecht for companies going public. This Dutch auction process uses a mathematical model to determine the price of an offering. The clearing price is set as one at which the deal can be completed. Institutional investors do not get a preference over individual investors. The timeline for the process is depicted below. The price under this system is determined by an auction process and therefore should eliminate underpricing. The company has taken public three companies so far, two of which are trading far below their offer price and the third had a large price run-up just like any other IPO. In the long-run such methods may make it easier to reach investors, distribute the offering, and determine the IPO process.
Wit Capital’s Distribution Process

Wit Capital was founded in 1996 as the world’s first online investment banking firm. It provides individual investors an opportunity to participate in IPOs and secondary offerings. Wit Capital sends an e-mail notice of a new offering and investors place a conditional order. If there is enough capital in the account customers are asked to confirm their orders and they are informed by e-mail whether they received an allocation or not. In order for this system to work in emerging markets basic internet and e-mail capabilities need to exist.

Security Analysts

Security analysis examines and evaluates individual securities to estimate the results of investing in them. In making judgment about valuation of securities the analyst must seek out reliable information. This information can come from financial statements, discussions with company executives, clients, and suppliers. The discipline requires detailed analysis and diligence.

There are several barriers to the development of the security analysis profession in emerging markets. Lack of timely and reliable information is of utmost importance. If information is available late or has been manipulated then the security analyst cannot do the
valuation. If it is too costly to obtain the information then that becomes another hurdle. There is also a lack of expertise available to do this research and analysis.

Security analysts can play an important role in advising potential investors on a wide range of corporate governance issues that include shareholder rights, independent directors, and hostile takeovers.

Role of New Exchange Based Financial Products

Global investors are demanding innovative and more efficient investment products. Stock exchanges do not typically offer too many innovative products. Index shares have been one of the most successful new products introduced in recent years on stock exchanges. Emerging markets often have only a few companies actively trading on their stock exchange therefore these new products can potentially fill an important role. They provide investors the benefits of diversification with low transactions costs. The benefits of diversification have been well documented.

Index shares provide diversification benefits associated with a basket of stocks and at the same time have the advantages of a stock including liquidity, ease of trading, and dividend income. Investors trade the “market” with a single investment as easily as trading a stock.

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<th>Advantages of Index Shares</th>
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<td>• Take a long-term position in a benchmark portfolio of leading companies</td>
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<tr>
<td>• Receive cash dividend distributions in certain cases</td>
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<tr>
<td>• Acquire an instantly diversified portfolio</td>
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<td>• Buy or sell at any time during the trading day</td>
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In the United States several types of Index Shares have been introduced recently. These include SPDRS, DIAMONDS, WEBS, and Nasdaq-100. Some of these are quite appropriate for emerging markets and are discussed here. Emerging markets can easily introduce products similar to Nasdaq-100, SPDRS, DIAMONDS that are based on their own major market index.

WEBS trade on the American Stock Exchange and were introduced in March 1996. WEBS shares are 17 country-specific series of securities. The countries included are: Australia, Austria, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, Netherlands, Singapore, Spain, Sweden, Switzerland, and UK. They give investors easy access to international markets. They make it easy to hold a diversified portfolio of international stocks. WEBS correspond to a specific Morgan Stanley Capital International Index. These indexes generally tend to reflect 60% of the country’s capitalization. Barclay’s Global Fund Advisors is responsible for the investment management of WEBS and Morgan Stanley Trust Company is the global custodian. They do not tend to trade at a large premium or discount to net asset value as closed-end funds may. This is because WEBS can be
created or redeemed by large institutions at any time. Such products representing countries in the region and major trading partners can be quite useful in emerging markets. For example, Brazil may benefit by trading WEB types of products on Argentina, Mexico, Chile, and the United States. Thailand can potentially trade similar products on countries such as Hong Kong, Singapore, Thailand, Indonesia, Malaysia, and Japan.

Nasdaq-100 Shares allows investors to participate in the collective performance of the Nasdaq-100 Index in a single transaction. This one stock gives ownership in 100 stocks. These shares can be bought on margin and sold short. These shares can be bought and sold at any time during the trading day in contrast to mutual funds that can be transacted only at the day’s ending net asset value. Investors simply call their brokers to place orders to do transactions. In the first two hours of trading in this product on March 10, 1999 a total of 2.6 million shares exchanged. The daily trading volume has been over 6.2 million shares. As of June 1999, 63 institutions held 5.9 million shares representing 40.6 percent ownership. The remaining 59.4 percent was non-institutional. As shown below the Tracking Stock closely follows the Nasdaq-100 Index.

![Nasdaq-100 Index Versus Nasdaq-100 Tracking Stock](image)

- Nasdaq-100 Index
- Nasdaq-100 Tracking
SPDRs (“Spiders”) and MidCap SPDRs are an investment vehicle to track the market performance of leading companies in the United States. These Depository Receipts trade on the American Stock Exchange (AMEX) and are based on the S&P 500 Composite Stock Price Index. The SPDR Trust is a unit investment trust that holds shares of all companies in the S&P 500. This investment vehicle allows a one-investment diversified portfolio. Transactions costs for this product are fairly low. It is similar to a stock transaction and allows for trading and tracking continuously during trading hours. SPDRs are designed to trade at approximately 1/10 the level of the S&P 500. Trust expenses for SPDRs are 0.18% and for MidCap SPDRs 0.30%. Because of these expenses and accrued dividends their performance does not fully track the index.

Conclusions

Emerging markets have made dramatic progress during the last decade. However, in order to compete in the global economy stock markets in both developed and developing economies must continue to make changes in order to meet the needs of their stakeholders. These stakeholders include investors, issuers, shareholders, member firms, and also governments.