ECON 412: Financial Markets
Structure, Institutions and Regulations

Course Description  The course focuses on stock markets and their role in providing financing. The first part of the course focuses on stock market microstructure, that is, how secondary trading on stock exchanges is organized and regulated, and how this affects their functioning in terms of liquidity, informational efficiency and other measures of performance. The second part of the course focuses on the role of the stock market as a primary market, that is, in raising capital: the listing decision, IPO pricing, the tradeoffs that firms face in choosing a mix of publicly traded and closely held sources of financing.

Prerequisites  Economics 318 (Corporate Finance) and Economics 305 (Microeconomic Theory).

Schedule  In general, two lectures and one class hour a week. We will keep the division between lectures and classes flexible:

Lectures: Tuesday 1:30 – 3:10 p.m., Frist 304.
Classes/Students’ Presentations: Tuesday 3:30 – 4:20 p.m., Frist 304.

The midterm test will be held on Tuesday Oct 24, at 1:30 p.m. (subject to change).

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Office hours: Wednesdays 1:00 – 2:15 p.m.

Requirements/grading
Class exercises and paper/presentation: 30 %
Midterm test: 30 %
Final examination: 40 %
READING LIST

There is no specific textbook for the course. Readings will be made available.

1. STOCK MARKET MICROSTRUCTURE

1. INTRODUCTION AND DESCRIPTION OF INSTITUTIONS

Harris, Larry, *Trading and Exchanges* (incomplete draft), Oxford University Press (forthcoming)


Daly, Robert and Harry Newton, *What Should It Really Cost to Trade?* Technology Investor, September 2000, pp. 52-56. (http://www.technologyinvestor.com)


Gitman, Lawrence J. and Joehnk Michael D., *Fundamentals of Investing* (7th edition), Chapter 2 only

2. INCORPORATING INFORMATION IN THE STOCK PRICE: RATIONAL EXPECTATIONS EQUILIBRUM


3. - 4. STOCK MARKET LIQUIDITY AND TRADING COSTS: THEORY AND EVIDENCE


Comparison of market trading systems


Trading mechanisms, insider trading, trade execution and reporting rules


New competing trading mechanisms – ECNs etc.

Hendershott, Terrence, and Haim Mendelson, Crossing Networks and Dealer Markets: Competition and Performance, Journal of Finance. (forthcoming) [only main idea]

Overview article

6. – 7. CRASHES AND VOLATILITY

Background reading:


**Herding Models:**


**Crash Models:**


**Bubbles:**


8. Keynes’ Beauty Contest – Investigative Herding


II. THE STOCK MARKET AS A SOURCE OF CAPITAL

9.–10. GOING PUBLIC

Liquidity and the cost of capital


Lecture notes.

The primary market


IPO pricing


Why go public?


Cost of an IPO


11. STOCK PRICE AND ALLOCATIVE EFFICIENCY


12. FINANCIAL MARKETS AND GROWTH (OPTIONAL)


III. CREDIT RATIONING

13. CREDIT RATIONING (OPTIONAL)


IV. POSSIBLE STUDENT PRESENTATIONS

How does short-selling really work? What are the costs? Can one always short-sell?
Explaining the Palm Saga!
Discriminatory-price versus single-price auctions (-)
Continuous trading versus batch (call) auctions
Insider trading rules (legal versus economic view)
Margin requirements and the stock market crash in 1929
The burst of the Internet bubble in April 2000 – What were the causes for the burst according to the print media?
Competition between Exchanges/Trading Systems
Electronic Communication Networks (ECN)
Day trading and the Internet – Do day traders provide liquidity or take liquidity away?
Indices and the impacts on stock prices
Investors’ Psychology – Behavioral Finance
Emerging markets – In what way are they different?
Tick size, preferencing and spreads (-)
The NASDAQ odd-eighths episode (-)
When does liquidity dry up? Why?
Transparency issues

David Skeie, our preceptor, has a lot of institutional background concerning financial markets. He will be happy to answer specific questions in his office hour.
You are required to submit (e-mail) preliminary drafts of your presentation (slides) on Friday prior to your presentation.

V. USEFUL/FUN MATERIAL ON THE INTERNET

Be a market maker:
http://www.academic.nasdaq.com/HeadTrader/head_trader.htm
http://LHarris.USC.edu/trading/DealerGame/Default.htm

Trade with play money first!
For example:
http://game.etrade.com