

## THE ROLE OF FINANCIAL INTERMEDIARIES IN EQUITY MARKETS

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### Abstract

In this paper, we will analyse the role of brokers, dealers and investment banks in the equity markets. Special attention will be given in analysing the role of financial intermediaries at initial public offerings and secondary offerings, according to the legal framework in Serbia. Serbia, as other transitional economies, has problems in mobilising funds for its stock exchange. Especially local savers do not trust the local financial system, especially the stock exchange. One of the major reasons for this distrust, besides bad experiences in the past, is a lack of knowledge about the functioning of stock exchanges. On the other hand, companies in Serbia often rely on debt-based financial instruments, where they have to pay high interest rates. However, equity financing with partners, especially with many partners is at a very low level. Therefore, we want to analyse the functioning of equity markets by explaining the concept of stocks, public offerings and the role of financial intermediaries in this process.

**Keywords:** Broker, dealer, investment banking, stocks, shares, stock exchange, initial public offering, secondary stock offering

### Introduction

The financial needs of the participants in the economy are different. For example, households need money to buy a house; companies need money to buy new machines and the government needs money to build new schools. This demand accrues, because the need for money is higher than the available funds ("savings") of the economic subjects. On the other hand, we have some economic subjects, who have higher earnings than expenditures. Therefore, they are able to save money. The reasons for this saving are manifold. For example, individuals save for retirement or for a certain event (e.g. marriage). But independent from the reasons for saving, this money will be hoarded for a certain period of time and therefore kept unproductive until it will be consumed. In order to use these idle funds, it is necessary to link these two sides, i.e. the demanders and suppliers of money. Thus, economic subjects do not have to delay their necessary consumption and investments anymore and savers will also receive a return on their savings, which will increase their income and possibly their motivation to save. With such a system, resources will be used efficiently and necessary

investments (e.g. building factories, infrastructure) could be executed. This will increase welfare on the long-term.

We can see that there would be great benefits if demanders and suppliers of money could communicate and interact efficiently. Enabling this "communication" is the goal of every financial system, i.e. a financial system has the important task to connect demanders and suppliers of money. Therefore, every financial system has to develop instruments and institutions in order to guarantee a smooth transfer of funds from suppliers to demanders.

A modern financial system consists of two institutions, which should guarantee the smooth transfer of funds:

- financial markets
- financial intermediaries

Savers, i.e. providers of money, can lend or invest their savings in two ways:

- The first way is to offer the savings **directly** on financial markets. Here, the saver directly gives his money to the demander for funds. For

example, when a company issues new stocks and an individual buys these stocks, then this individual gives his savings directly to the demander.

- On the other hand, if a saver is not an expert in finance, but still wants to receive a return on his savings, then he can instruct an intermediary to invest or lend his funds to demanders. In such a case, a financial intermediary is in direct contact with the demanders of funds and gives to the savers a certain amount of profit. Because an intermediary is included in this process, this way is called **indirect** finance.

In order to efficiently mobilise and invest funds, different financial market arose, where different contracts have been developed in order to meet the financial needs of economic subjects. Today's financial markets can be structured according to the needs of the demanders for money. These markets are:

- Capital market
- Money market
- Derivative market
- Foreign exchange market

The other pillar of a financial system is financial intermediaries. The main reasons for the existence of financial institutions are:

- transaction costs
- moral hazard
- adverse selection

The search for profitable investment opportunities causes costs, the so-called transaction costs. These costs especially arise due to the acquisition of information and the controlling of the investment. The same is valid for the demanders of money: the search for creditors or investors also causes costs. In order to minimise these costs, financial institutions exist. These institutions are specialised in the accumulation and investment of savings and due to economies of scale, the transaction costs for every investor are minimised. The other major task of financial institutions is decreasing the problem of moral hazard and adverse selection. Moral hazard means that the demanders of money could use the received money for unproductive purposes, e.g. increasing the salaries of managers, buying expensive cars. Adverse selection means that an investor could spend his funds into an unprofitable investment. Because, demanders for money with high risks are most eager in asking for money, the probability to make a wrong investment decision, especially for non-professional investors, is high. This information asymmetry should also be minimised by financial institutions, because they have professional personnel to analyse the possible profitability of investments and to monitor them.

Our short introduction shows that a financial system is very complex. In our paper, we will limit our analysis to the role of financial intermediaries in direct finance. Here, the role of intermediaries is especially to be a service provider for

demanders and suppliers of funds. Furthermore, we will only analyse part of the capital market, i.e. equity market where companies offer their stocks.

### The importance of stocks in financing

Before, we will analyse financial intermediaries, we will look at the way stocks work. Generally, a corporations are a further development of partnerships. A corporation is a legal person, i.e. such a company is treated like an actual person and has its own rights and duties. This legal status holds the corporation liable unlimitedly for its debts. On the other hand, stockholders of a corporation enjoy a limited liability, due to this regulation. This is a major advantage in the mobilization of funds from investors.

The capital of the corporation is divided into a large number of stocks which are tradable at the stock exchange ("secondary market"). These distinctive features (large number of stocks and tradability) allow the mobilisation of large funds from investors, because these characteristics make an investment very interesting. Because the equity is divided into a large number of shares, also small investors can invest a small amount into the corporation. So, lots of capital from money holders can be mobilised. Furthermore, tradability of stocks increases the popularity for investors. So, investors can always sell their stocks at the stock exchange (on the condition that they will find a buyer) and thus end the contract with the issuing company.

Going public has two effects for a company. First, the ownership structure will change due to an increase in the number of owners. Second, the capital structure of the corporation will change because the amount of equity will increase, so the company can use the received funds to pay off some of its debt or to expand its operations. (Madura, 2010, p. 230)

There are two kinds of stocks:

1. common stocks
2. preferred stocks

Common stocks are the normal type of stocks and grant a right to vote in the annual general meeting of the shareholders. With the right to vote, stockholders can elect the board of directors and supervisory board. However, this is dependent on the regulation in each country. For example, in the U.S., stockholders elect the board of directors and the supervisory board. But in Germany, stockholders elect the supervisory board, which then elects the board of directors. The board of directors manages the corporation and the supervisory board monitors the work of the directors. Furthermore, the approval of the stockholders is necessary for important decisions (e.g. mergers). So, investors do not have to manage the day-to-day business of a corporation, which is a further advantage to mobilise funds from investors.

Furthermore, the holders of common stocks receive a profit share ("dividend") dependent on the number of stocks they own and the right to share proportionally in assets remaining after liabilities have been paid in case of a liquidation. (Ross, Westerfield & Jordan, 2003, p. 255)

In addition, stockholders have a pre-emptive right to buy new stocks when the company extends its equity. So the corporation that wishes to sell stock must first offer the new shares to the existing stockholders before offering it to the general public. The purpose is to give stockholders the opportunity to protect their proportionate ownership in the corporation, which also prevents a transfer of wealth from current stockholders to new stockholders. (Ross, Westerfield & Jordan, 2003, p. 255)

Preferred stocks differ from common stocks, because they have a preference over common stocks with regard to the payment of dividends, right to vote, pre-emptive rights or revenues in case of liquidation. (Wöhe, 2000, p. 696) The holders of preferred stocks must receive a dividend before the holders of common stocks. It is important to mention that holders of preferred stocks usually have no voting privileges. (Ross, Westerfield & Jordan, 2003, p. 256)

Thus, preferred stocks are a hybrid – they are similar to bonds in some respects and to common stock in others. The hybrid nature of preferred stocks becomes apparent when we try to classify them with regard to bonds and common stocks. Like bonds, preferred stocks have a nominal value and a fixed amount of dividends that must be paid before dividends can be paid to common stockholders. However, if the preferred dividend is not earned, the directors can skip it without throwing the company into bankruptcy. (Ehrhardt, Brigham, 2002, p. 212) Therefore the dividend paid on preferred stocks is no debt, as in the case with bonds.

It is important to mention that the supervisory board has an important function in the corporation. Because investors are not included in the day-to-day decisions in the company, they need a protection against negative behaviour of the directors. The directors manage the company and therefore have more information (e.g. information about potential losses, committing moral hazard) than the investors. This is a great disadvantage in a corporation, especially for small investors.

### **Financial intermediaries in the stock exchange**

In this section we will analyse the possible roles of financial intermediaries in the stock exchange according to Serbian law. According to the "Law on Securities and other Financial Instruments" a broker-dealer is "a legal entity established as a joint stock company (corporation) engaged in activities on the securities market in compliance with the law." (Law on Securities and other Financial Instruments, Article 123) Of course, a broker-dealer cannot not be carried out without the permission of the Commission for the Securities, which supervises trade

with securities. A broker-dealer, according to Serbian law, can execute the following activities: (Law on Securities and other Financial Instruments, Article 124)

1. intermediation in purchase and sale of securities and other financial instruments, and purchase and sale of securities on its own and on behalf of the principal, or in the name and on behalf of the client (brokerage);
2. purchase and sale of securities and other financial instruments in its name and for its own account for the difference in price (dealer);
3. mandatory purchase and sale of securities and other financial instruments in its name and for its own account that are announced in advance (market maker);
4. management of securities and other financial instruments on behalf and for the account of the client (portfolio manager);
5. organization of emission of securities and other financial instruments without a firm commitment to take unsold securities, or organizing the inclusion of securities in the regular market (issuing agent);
6. organizing the issuance of securities and other financial instruments with the obligation to purchase from the issuer for resale, or the obligation to purchase unsold securities (underwriter);
7. advisory services in connection with the operations of securities and other financial instruments (investment adviser).

Securities brokers and dealers conduct trading in secondary markets. Brokers act as agents for investors in the purchase or sale of securities. Their function is to match buyers with sellers, a function for which they are paid brokerage commissions. In contrast to brokers, dealers link buyers and sellers by standing ready to buy and sell securities at given prices. Therefore, dealers hold inventories of securities and make their living by selling these securities for a slightly higher price than they paid for them - i.e. on the "spread" between the asked price and the bid price. This can be a high-risk business because dealers hold securities that can rise or fall in price. Brokers, by contrast, are not as exposed to risk because they do not own the securities involved in their business dealings.

Market makers match buy and sell orders submitted at the same price and so performs a brokerage function. However, if buy and sell orders do not match up, the market maker buys stocks or sells from a personal inventory of securities, in this manner performing a dealer function. By assuming both functions, the market maker maintains orderly trading of the securities for which he is responsible. Other names for market makers are specialist or liquidity provider.

Portfolio managers conduct the asset management for individuals, i.e. in this case, the broker-dealer look for the best investment alternative in the stock exchange or OTC

market for his client. In consultation with the client, the portfolio manager may, for example, only invest in securities of a particular industry.

The activities from number 5 to 7 are classic tasks of an investment bank. When a corporation wishes to borrow (raise) funds, it normally hires the services of an investment banker to help sell its securities. Investment bankers assist in the sale of securities as follows. This investment bank will develop a prospectus, specify the price of the security and place the stocks in the primary market. Investment bankers assist in the sale of securities consulting company whether to issue bonds or stocks. If, for example, the company proposes to issue stocks, the investment bank gives advice about the prices of such stocks. This task is easier if the company has already issued securities in the market earlier. However, when a company issues stocks for the first time, setting the right price is quite difficult. Here, all skills and expertise of the investment bankers are needed to determine the most appropriate price. (Mishkin, 2004, p. 303)

When the corporation decides which kind of financial instrument it will issue, it offers them to underwriters - investment bankers that guarantee the corporation a price on the securities and then sell them to the public. If the issue is small, only one investment banking firm underwrites it (usually the original investment banking firm hired to provide advice on the issue). If the issue is large, several investment banking firms form a syndicate to underwrite the issue jointly, thus limiting the risk that any one investment bank must take. The underwriters sell the securities to the general public by contacting potential buyers, such as banks and insurance companies.

On the other hand, if an investment bank does not want to take the risk of selling securities, it can take the role of an issuing agent. In this case, it will organize the sale, without the obligation of purchase. In this case, the risk of selling the securities is borne by the issuing company.

No matter, whether an IPO or a secondary offering is in plan, brokers-dealers can undertake consulting activities, e.g. whether the company should buy its own shares or issue new securities. However, according to Serbian law a broker-dealer cannot only conduct the business of investment adviser. (Law on Securities and other Financial Instruments, Article 124) Permission to perform investment adviser is not required when such activities are performed:

1. regarding the provision of advisory services if it is core business of a practicing lawyer, tax advisor, accountant or auditor - if the person who provides advice to make no additional charge, except the fee for performing the basic activities;
2. within the core activities of legal entities established in accordance with the provisions of a special law - if the provision of advisory services related to the operation of securities by the law as a basic activity. (Law on Securities and other Financial Instruments, Article 125)

Broker, investment advisor and portfolio manager can only be conducted by individuals who are licensed to perform these tasks. The Commission for securities shall organize the training and examination for certified investment advisor and portfolio manager, issue a certificate on the acquisition of the mentioned titles, gives permission for such activities and maintain a register of such persons. (Law on Securities and other Financial Instruments, Article 128)

The cash portion of the initial capital of the broker-dealer company shall not be less than:

1. € 50,000 in dinar equivalent according to the middle exchange rate of the National Bank of Serbia on the day of payment for brokerage and advisory services;
2. € 100,000 in dinar equivalent according to the middle exchange rate of the National Bank of Serbia on the day of payment for dealer activities and issuing agent;
3. € 200,000 in dinar equivalent according to the middle exchange rate of the National Bank of Serbia on the date of payment for the performance of market makers and portfolio managers;
4. € 300,000 in dinar equivalent according to the middle exchange rate of the National Bank of Serbia on the day of payment for underwriter jobs. (Law on Securities and other Financial Instruments, Article 126)

The broker-dealer shall not engage in securities that would threaten the stability of regulated markets and in particular may: (Law on Securities and other Financial Instruments, Article 161)

1. give false information on the price of the securities;
2. spreading false information in order to change the price of securities;
3. dispose securities owned by the customer without their consent;
4. execute client orders in a manner not in accordance with this Law and other laws governing the execution of client orders a broker-dealer;
5. buy, sell or borrow for its own account the securities that are the subject of the client prior to acting upon the client;
6. buy, sell or borrow securities under contracts for management of securities solely for the purpose of charging;
7. encourage clients to make frequent transactions solely for the purpose of charging.

The commission can take the licence of a broker-dealer: (Law on Securities and other Financial Instruments, Article 174)

1. if the activity for which the license was granted is not performed more than three months;

2. if the operating license was obtained on the basis of false information;
3. if the work in connection with the securities is not done in accordance with this law;
4. if it ceases to meet the requirements for obtaining an operating license;
5. if it violates the prohibition of manipulation;
6. if it does not meet the requirements for operation in accordance with the provisions of this law on the elimination of risk;
7. if it fails to comply with the decision on the temporary ban of the activity;
8. if it fails to act within a certain date, directed by the Commission, shall comply with the order to eliminate illegalities and irregularities.

### **The role of financial intermediaries at initial public offerings**

Trade with equities is done on the primary and secondary market. In the primary market, new corporations offer their stocks for the first time. Investment funds, corporations and other investors can buy these stocks there. On the other hand, when corporations offer additional "new" stocks, e.g. to finance new investments, the this transaction is called a "secondary offering".

Because companies that engage in an IPO are not well known to investors, they must provide detailed information about their operations and their financial condition. In order to conduct this task as good as possible, an investment bank will take this job. A few months before the IPO, the issuing company will develop a prospectus and files it with the Commission for securities. Details about this process are defined in article 25 and 26 in the Law on Securities and other Financial Instruments. Essentially, the prospectus must contain detailed information about the company and include financial statements and a discussion of the risks involved. The prospectus is divided into two parts:

1. introductory section of the prospectus, which contains basic information about the issuer, information about the securities to be issued, and information on the plan to use obtained funds by issuing such securities;
2. base prospectus, which contains detailed information about the issuer, the issuer's operations and details of the securities issued and not withdrawn, respectively they have not expired yet. (Article 26, Law on Securities and other Financial Instruments)

However, this prospectus is not published to the public, but the so-called "simplified prospectus". The simplified prospectus is an excerpt from the prospectus and contains data from the introductory section of the prospectus. The prospectus should inform about the risks that investors will encounter if they opt for the issuer's stocks. Within 20 days of receipt of the complete application for approval of the

prospectus, the Commission for Securities will issue a decision on the approval of the prospectus for issuing securities. The IPO can only be executed if the Commission sanctions the prospectus of the issuer.

Once the Commission approves the prospectus, a public invitation for subscription and payment for securities has to be made and, furthermore, the simplified prospectus has to be published in at least one daily newspaper distributed throughout the Republic of Serbia. The mentioned public invitation has to include:

1. information on the starting date of registration and payment and the deadline for registration and payment of securities;
2. details of where an investor can subscribe and pay, or see or obtain a copy of the prospectus for the issue of securities;
3. important information about the issuer and the securities to be issued. (Article 41, Law on Securities and other Financial Instruments)

In addition to this formal process, the company's management and the investment bank have to meet with institutional investors. In many cases, this meetings will take place in many cities within the country or even abroad. The institutional investors are informed about these meetings in advance, so they can attend if they are interested in purchasing stocks of the IPO. Institutional investors are targeted, because they may be willing to buy large blocks of stocks at the time of the IPO. Therefore, they typically have priority over individual investors in purchasing stocks during an IPO. (Madura, 2010, p. 235)

The other major task, which an investment bank undertakes, is to determine the so-called offer price at which the stocks will be offered at the time of the IPO. The price that investors are prepared to pay per stock is influenced by prevailing market and industry conditions. If other publicly traded companies in the same industry are priced high, relative to their earnings or sales, then the price assigned to stocks in the IPO will be relatively high. Before a company goes public, it attempts to estimate the price that will be paid for its stocks. During the meeting with institutional investors, the investment bank collects information about the interest in the IPO by institutional investors to the number of stocks they demand at various possible offer prices. This process is called "book building". (Madura, 2010, p. 235)

Let us assume the following example: company "NP" has agreed with the investment bank "S-Invest" to sell its stocks on the stock exchange. S-Invest will organise some meetings with institutional investors. At these presentations, company "NP" will explain its products, strategies and how it will use the received funds. S-Invest will analyse the level of interest of institutional investors with regard to the IPO, i.e. how much stocks at which price the investors are willing to buy. Table 1 shows the results of these meetings.

**Table 1. Example for a Bookbuilding Process at an Initial Public Offering**

| Possible Offer Price | Total Stocks Demanded | Total Proceeds To Issuer |
|----------------------|-----------------------|--------------------------|
| € 15                 | 1,000,000             | € 15,000,000             |
| € 14                 | 1,500,000             | € 21,000,000             |
| € 13                 | 2,000,000             | € 26,000,000             |
| € 12                 | 2,100,000             | € 25,200,000             |

According to the table shown above, we can conclude that the best price for our stocks would be € 13, because we can maximise proceeds at this price. However, it has to be mentioned that this decision is very difficult. For example, if the company could sell 2,500,000 stocks at a price of € 13, then the company would give up 6.5 million Euros. On the other hand, a lower offer price guarantees to sell all planned stocks. This is especially important for the investment bank, if it acts as an underwriter.

In order to reduce the risk for an investment bank (underwriter), investment banks can act as a syndicate and share the fees to be received for the underwriting. Each underwriter in the syndicate contacts institutional investors and informs them of the offering. (Madura, 2010, p. 236) A syndicate can be used for large IPOs, e.g. the privatisation of state-owned enterprises.

The transaction cost to the issuing company is usually 7 percent of the funds raised. In addition, the issuer incurs other costs, such as the cost of assessing whether to go public, compiling data for the prospectus, and ensuring that the prospectus is properly written. It also incurs fees from hiring legal or financial advisers during this process. Thus, the total cost of engaging in an IPO may be close to 10 percent of the total offering. (Madura, 2010, p. 236)

After the public offering is completed, the issuer shall, within seven days of the expiry of the subscription and payment of securities, the Commission give a proof of the number of subscribed securities and submit a request for approval of issuance securities. (Article 47, Law on Securities and other Financial Instruments) Following the Commission's response, the issuer must publish the result of a public offer within three days in a newspaper of general circulation throughout the Republic, which must contain information about the subscribed and paid for the securities, as well as an indication if the public offer has been successful or not. (Article 48, Law on Securities and other Financial Instruments)

If the IPO is successful, the issuer will, within seven days from the receipt of the issuance of securities, apply through the Central Registry to open an account and register the securities in the register. (Article 49, Law on Securities and other Financial Instruments) After successful registration, the issuer has to decide whether the stocks will be listed on the stock exchange or traded over the counter.

### The role of financial intermediaries at secondary stock offerings

A secondary stock offering is a new stock offering by a specific firm whose stock is already publicly traded. Secondary stock offerings are a way for a company to increase outstanding stock and spread market capitalisation over a greater number of stocks. Secondary offerings, in which new stocks are underwritten and sold, weaken the ownership position of stockholders who own stocks that were issued in the IPO. This is the major disadvantage of secondary stock offerings. Therefore, each company tends to issue new stocks when the price of its existing stocks is relatively high. In this case, there is a large number of investors who are willing to buy the shares. However, we must take into account the interests of existing shareholders. Given that the stock price will decrease after the secondary stock offering, they have to be compensated for this loss. Here, we have to mention that the price of new stocks, according to Serbian law, cannot be less than 90% of market value.

In what way stockholders are compensated for their losses, the following example will show:

We assume that NP Inc. wants to increase its capital (book value) through a secondary stock offering. The current number of stocks is 2 million, as the previous example showed, and we assume a nominal value per stock of € 5. Moreover, we suppose a current stock price (on the stock exchange) of € 20. The company plans to issue 400,000 new stocks at a price of 18 € with the same nominal value. How will this transaction affect the stock price of the company?

The condition prior to the issuance of new stocks is as follows:

- Market value of stocks before the secondary stock offering is:  $2,000,000 * € 20 = € 40,000,000$
- Market value of new stocks is:  $400,000 * € 18 = € 7,200,000$
- Total market value (old and new stocks) will be: € 47,200,000

Therefore, we can calculate the weighted average in order to receive the new value of stocks after the secondary offering:

$$\text{New stock price} = \frac{€47,200,000}{2,400,000} = €19.67$$

So, any "old" stockholder loses € 0.33 per stock due to the issuance of new stocks. Given that each stockholder receives for every 5 old stock one new stock, i.e. a ratio of 5:1. This ratio is obtained by dividing the total book value of old stocks with the total book value of new stocks, i.e.  $(5 * 2,000,000) / (5 * 400,000)$ . Thus, we can conclude that the pre-emption right to buy a new stock is worth € 0.33, on the condition that a stockholder owns at least five old stocks. This can be calculated with the following formula:

$$PER = \frac{(P_o - P_n - D_1)}{\left(\frac{m}{n} + 1\right)}$$

where:

PER = Value of pre-emption right

P<sub>o</sub> = Price of old stocks

P<sub>n</sub> = Price of new stocks

D<sub>1</sub> = loss of part of the dividend

m/n = ratio of old and new stocks

In our example, we receive the following result:

$$PER = \frac{(20 - 18)}{\left(\frac{5}{1} + 1\right)} = € 0.33$$

### Conclusion

Our analysis shows that in direct finance, i.e. financing via financial markets without intermediaries, we still need specialised intermediaries who will facilitate the flow of funds from investors to demanders of money. However, it is important to mention that these intermediaries do not collect the savings from investors in order to decide about possible investments on the stock exchange, but only offer services to the issuer of securities. This analysis shows that issuing stocks is quite a complex job, with many bureaucratic steps. These steps, aimed to increase investor protection, increase transaction costs for the issuing company enormously. High transaction costs and a low level of investors' trust, lead to the fact that investments into stock is limited. From the aspect of issuers, we can see that especially formerly state-owned enterprises are now listed as public limited companies. Only a small number of privately owned companies from the beginning have made the step to become a public limited company. The reason is certainly that the number of institutional investors on the Belgrade Stock Exchange is relatively small. Only a small number of investment funds investment, with relative success, are active on this stock exchange. Small investors, who often received their stocks in the form of "free stocks" of formerly state-owned enterprises, often do not know what rights they do have with their stocks and often are in a hurry to sell their received stocks as soon as possible. Furthermore, high transaction costs, lack of knowledge and small returns are also reasons why small investors avoid investing in stocks.

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