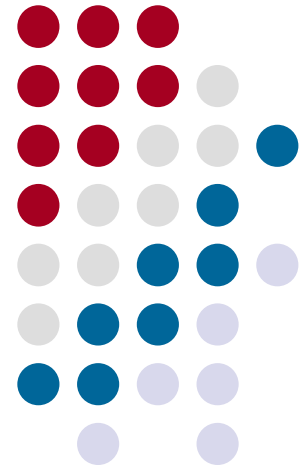
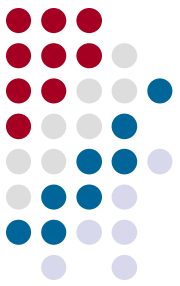


Chapter 7

Securities Firms and Investment Banks

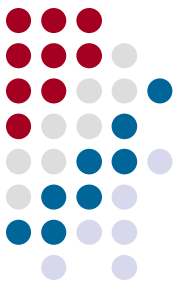


Securities Firms and Investment Banks (IBs)



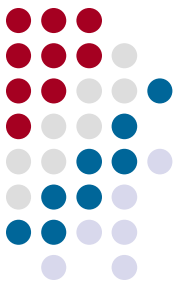
- **Investment banks (IBs)** help corporations and governments raise capital through debt and equity security issues in the **primary market**
 - **underwriting** is assisting in issuing new securities
 - IBs also advise on mergers and acquisitions (M&As) and corporate restructuring
- **Securities firms** assist in the trading of securities in **secondary markets**
 - **broker-dealers** assist in the trading of existing securities

Securities Firms and Investment Banks (IBs)



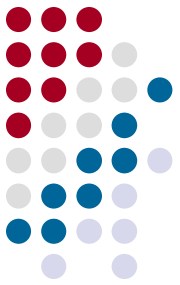
- The size of the industry is usually measured by the equity capital of firms rather than total asset size
 - Equity capital in the industry in 2012 was \$223 billion
- The number of firms in the industry changed due to economies of scale and scope, losses with the economy, scandals at some firms, and regulations that allowed both inter- and intra-industry mergers
 - 5,248 firms in 1980
 - 9,515 firms in 1987
 - 5,063 firms in 2010
- As with commercial banks, consolidation has largely occurred through mergers and acquisitions

Securities Firms and Investment Banks (IBs)



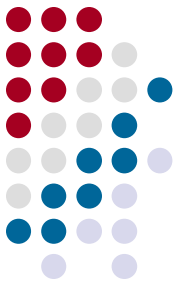
- **Commercial bank holding companies that operate diversified national full-line firms**
 - service both retail and wholesale customers by acting as broker-dealers
 - service corporate customers by underwriting security issues
- **National full-line firms** specializing in corporate finance
 - The second largest group of firms are full-service firms that specialize in corporate finance or primary market activity (i.e., focus less on secondary market activities)

Securities Firms and Investment Banks (IBs)



- **Large investment banks**
 - Have only limited branch networks concentrated in major cities and service primarily financial institution clients
- **Smaller specialized firms** such as:
 - regional investment bankers (sometimes labeled '**boutiques**')
 - discount brokers
 - Internet brokers
 - venture capital firms
 - exchange floor specialists
 - dealers in off exchange trading

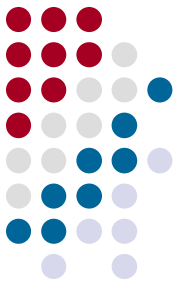
Lines of Business



● Investment banking

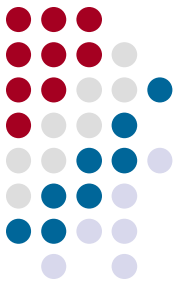
- first time debt and equity issues occur through **initial public offerings (IPOs)**
- new issues from a firm whose debt or equity is already traded are called **seasoned equity offerings (SEOs)**
- a **private placement** is a securities issue that is placed with one or a few large institutional investors
- **public offerings** are offered to the public at large
- IBs act only as an agent in **best efforts underwriting**
- IBs act as principals in **firm commitments**

Lines of Business



- **Venture capital (VC)** is a professionally managed pool of money used to finance new (i.e., start-up) and often high-risk firms
 - VC usually purchases an equity stake in the start-up
 - usually become active in management of the start-up
 - institutional venture capital firms find and fund the most promising new firms
 - venture capital limited partnerships
 - financial venture capital firms
 - corporate venture capital firms

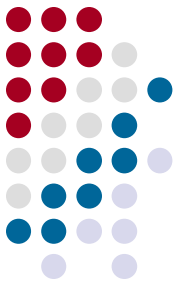
Lines of Business



- **Private equity investments**

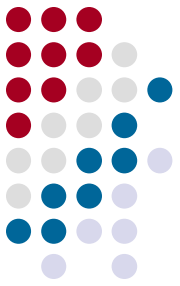
- Private equity (PE) differs from VC in funds sources and in types of investments
 - PE firms raise funds by selling securities rather than commingling private funds
 - PE firms often acquire established existing firms rather than purchase start-ups

Lines of Business



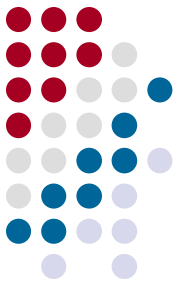
- **Market making** involves the creation of secondary markets for an issue of securities
 - **agency transactions** are two-way transactions on behalf of customers
 - with **principal transactions** market makers seek to profit for their own accounts
 - Goldman Sachs managed \$43 trillion in derivatives securities in 2013 (about 18% of total held by Fis)

Lines of Business



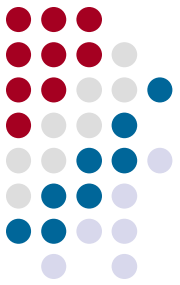
- **Trading** involves taking an active net position in an asset
 - **Position trading** involves relatively long-term positions in assets
 - **Pure arbitrage** involves attempts to profit from price discrepancies
 - **Risk arbitrage** involves attempts to profit by forecasting information releases
 - **Program trading** is the simultaneous buying and selling of at least 15 different stocks valued at \$1 million or more

Lines of Business



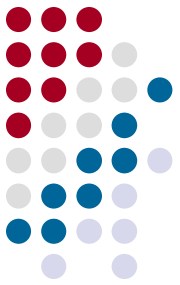
- **Trading** (continued)
 - **Stock brokerage** involves trading on behalf of customers
 - **Electronic brokerage** offers customers direct access, via the internet, to the trading floor

Lines of Business



- **Investing** involves managing pools of assets such as closed- and open-end mutual funds
 - as **agents**
 - as **principals**
- **Cash management** involves deposit-like accounts such as money market mutual funds (MMMFs) that offer check writing privileges

Lines of Business



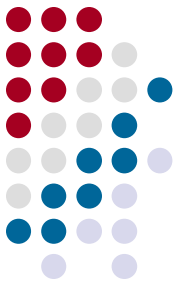
- **Merger and acquisition (M&A) assistance**

| M&A activity by year | | |
|----------------------|---------------|-----------------|
| | US | Global |
| 2008 | \$903 billion | \$2.90 trillion |
| 2009 | 713 | 1.70 |
| 2010 | 687 | 1.80 |
| 2011 | 861 | 2.33 |
| 2012 | 882 | 2.04 |
| 2013* | 594 | 1.45 |

* First nine months

- M&A activity brings large fees to bankers
- M&A business remains very cyclical and depends on the economy

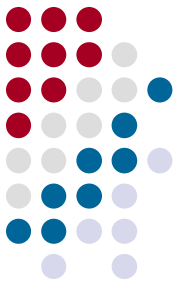
Lines of Business



- **Other Service Functions**

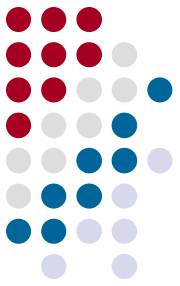
- Security custodian services
- Clearance and settlement services
- Escrow services, research and advice on divestitures, and asset sales

Industry Performance



- Industry trends depend heavily on the state of the stock market and the economy
 - Commission income fell after the 1987 stock market crash and the 2001-2002 stock market decline
 - Improvements in the U.S. economy in the mid-2000s led to increases in commission income, but income fell with the stock market in 2006-2008 because of rising oil prices and the subprime mortgage collapse

Industry Performance



- Performance (continued)
 - Revenues and profits fell record amounts in 2008, but rebounded sharply in 2009
 - Industry employment fell sharply
 - Low interest rates and strong stock market helped fuel profit recovery
 - Profits began to recover in 2010 but the ‘fiscal cliff’ problems and Euro area problems hurt profits in 2011 and 2012, but profits improved in 2013

Balance Sheets of Securities Firms and Investment Banks (IBs)

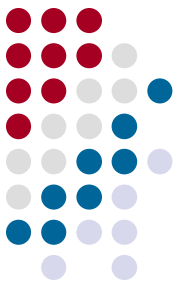


TABLE 16-7 Assets and Liabilities of Broker-Dealers as of 2012 (in billions of dollars)

| | | Percent of Total Assets |
|---|------------------|----------------------------|
| Assets | | |
| Cash | \$ 133.3 | 2.80% |
| Receivables from other broker-dealers | 1,248.6 | 26.19 |
| Receivables from customers | 215.4 | 4.52 |
| Receivables from noncustomers | 89.2 | 1.87 |
| Long positions in securities and commodities | 1,162.5 | 24.38 |
| Securities and investments not readily marketable | 22.0 | 0.46 |
| Securities purchased under agreements to resell | 1,631.0 | 34.21 |
| Exchange membership | 0.3 | 0.01 |
| Other assets | 265.4 | 5.56 |
| Total assets | <u>\$4,767.7</u> | <u>100.00%</u> |

- Receivables represent trading activity
- What are securities purchased under agreements to resell?

Balance Sheets of Securities Firms and Investment Banks (IBs)

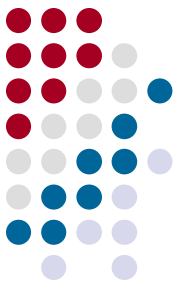


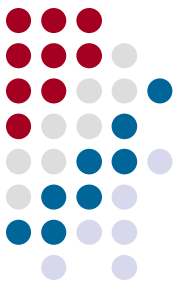
TABLE 16-7 Assets and Liabilities of Broker-Dealers as of 2012 (in billions of dollars)

| | | Percent of Total Assets |
|---|-----------|----------------------------|
| Liabilities | | |
| Bank loans payable | \$ 57.9 | 1.21% |
| Payables to other broker-dealers | 678.5 | 14.23 |
| Payables to noncustomers | 45.1 | 0.95 |
| Payables to customers | 731.7 | 15.35 |
| Short positions in securities and commodities | 368.9 | 7.74 |
| Securities sold under repurchase agreements | 2,185.3 | 45.83 |
| Other nonsubordinated liabilities | 360.5 | 7.56 |
| Subordinated liabilities | 116.8 | 2.45 |
| Total liabilities | \$4,544.7 | 95.32% |
| Capital | | |
| Equity | \$ 223.0 | 4.68% |
| Total capital (equity capital and subordinate debt) | 339.8 | 7.13% |
| Number of firms | 4,286 | |

Source: *Focus Report*, Office of Economic Analysis, U.S. Securities and Exchange Commission, 2013, Washington, DC. www.sec.gov

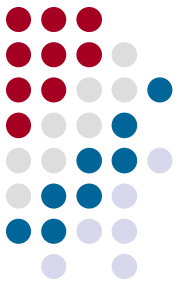
- What are the major sources of financing?
- Is there a sufficient level of equity capital?

Regulation of Securities Firms and Investment Banks (IBs)



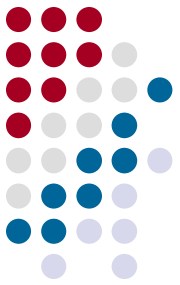
- The **Securities and Exchange Commission (SEC)** is the primary regulator of the securities industry
- The **National Securities Markets Improvement Act (NSMIA) of 1996** reaffirmed federal (over state) authority
 - Even so, state attorneys generally intervene through securities-related investigations that have led to many highly publicized criminal cases

Regulation of Securities Firms and Investment Banks (IBs)



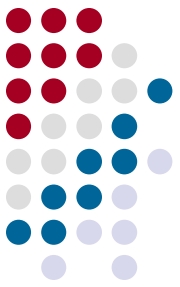
- **The Sarbanes-Oxley Act (SOX) of 2002**
 - created an independent auditing oversight board under the SEC
 - increased penalties for corporate wrongdoers
 - forced faster and more extensive financial disclosure
 - created avenues of recourse for aggrieved shareholders

Regulation of Securities Firms and Investment Banks (IBs)



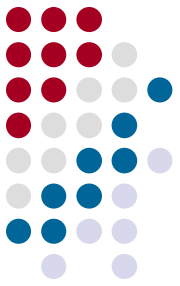
- The SEC sets rules governing underwriting and trading activity
 - **SEC Rule 144A** defines boundaries between public offerings and private placements
 - The SEC is investigating ‘dark pool’ trading and high frequency ‘flash’ trading

Regulation of Securities Firms and Investment Banks (IBs)



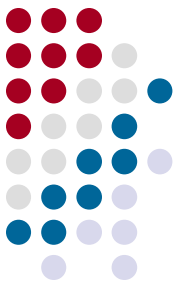
- Two **self-regulatory organizations** oversee the day-to-day regulation of trading practices
 - the **New York Stock Exchange (NYSE)**
 - the **Financial Industry Regulatory Authority (FINRA)**
- The **U.S.A. Patriot Act** became effective in 2003
 - firms must verify identities of customers
 - firms must maintain records of identities of customers
 - firms must verify customers are not on suspected terrorist lists

Regulation of Securities Firms and Investment Banks (IBs)



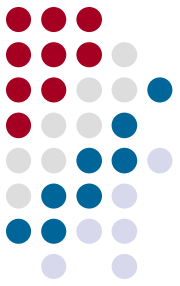
- Investors in the industry are protected by the **Securities Investor Protection Corporation (SIPC)**
 - protects investors against losses of up to \$500,000 due to securities firm failures (but not against poor investment decisions)
 - created following passage of the **Securities Investor Protection Act in 1970**

Regulation of Securities Firms and Investment Banks (IBs)



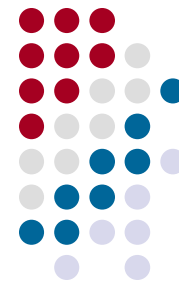
- Under the Dodd-Frank Act, the Financial Services Oversight Council (FSOC) has oversight of systemic risk of the industry
 - More investment advisors will have to be registered with either the SEC or state advisors
 - Securitization markets should now have more oversight and originators will have to retain a greater interest in loans that will be resold
 - Greater transparency and regulation for OTC derivatives

Regulation of Securities Firms and Investment Banks (IBs)



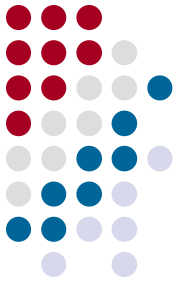
- The government can also mandate higher capital requirements for larger and for interconnected firms
- Conclusion: Government oversight of industry practices has increased as a result of the law

Regulation of Securities Firms and Investment Banks (IBs)



- Executive compensation restrictions imposed by the Obama administration
 - Strengthen the independence of the compensation committee from senior management
 - Shareholders now also have a non-binding vote on executive compensation packages
 - Administration has a say on executive pay for firms that accepted bailout money

Continuing Ethical Problems

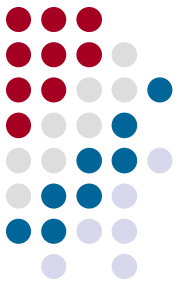


| Date | Firm/Principal | Activity | Settlement Payment |
|---------------|--|---|--------------------|
| January 2011 | Primary Global Research LLC, Bob Nguyen | Soliciting information for inside trading | |
| June 2012 | Barclays Bank | LIBOR manipulation | \$450 million |
| July 2012 | Peregrine Financial, Russell Wassendorf, Sr. | Misallocating and misreporting usage of \$215 million in client funds | |
| December 2012 | Goldman Sachs trader Matthew Taylor | Concealed \$8.3 billion futures position | \$1.5 million |
| December 2012 | Morgan Stanley | Senior banker influenced analyst and share allocation of Facebook IPO | |
| December 2012 | UBS | LIBOR manipulation | \$1.5 billion |
| December 2012 | HSBC | Money laundering | \$1.9 billion |
| February 2013 | Royal Bank of Scotland | LIBOR manipulation | \$610 million |
| October 2013 | J. P. Morgan | Bad mortgage practices origination and sale | \$13 billion |
| October 2013 | J. P. Morgan | Trade error in London cost firm \$6 billion | \$920 million |
| October 2013 | J. P. Morgan | Excessive credit card charges | \$ 80 million |
| October 2013 | J. P. Morgan | Manipulating energy markets | \$410 million |
| December 2013 | Deutsche Bank | Euribor manipulation | \$981 million |
| February 2014 | Morgan Stanley | Bad mortgage practices origination and sale | \$1.25 billion |
| July 2014 | Citigroup | Bad mortgage practices origination and sale | \$7.00 billion |

Sources: Text, Wall Street Journal and Bloomberg, various issues

- **Are bankers unethical?**
- **Are regulations sufficient to limit ethical breaches?**

Global Issues



- Securities firms and investment banks are by far the most global of any group of financial institutions
- U.S. firms are increasingly looking to expand their business abroad—particularly into China and India
- Increase in cross-border strategic alliances

Global Issues

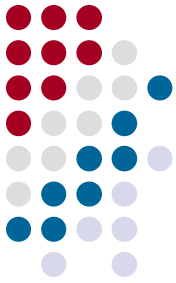
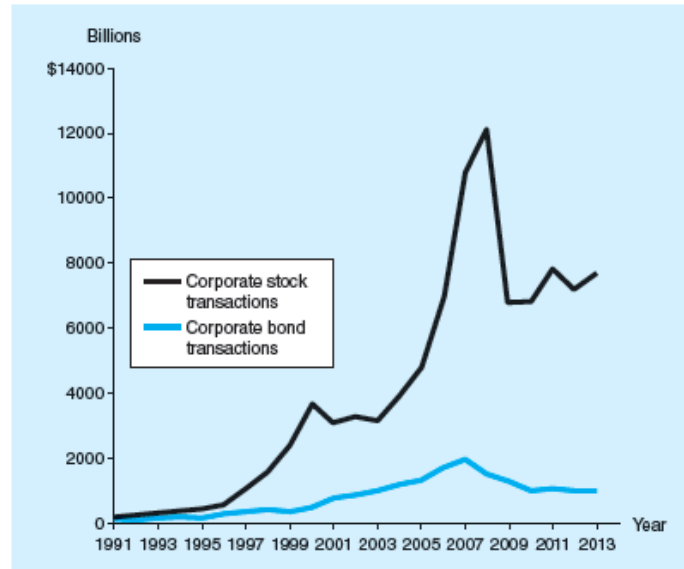
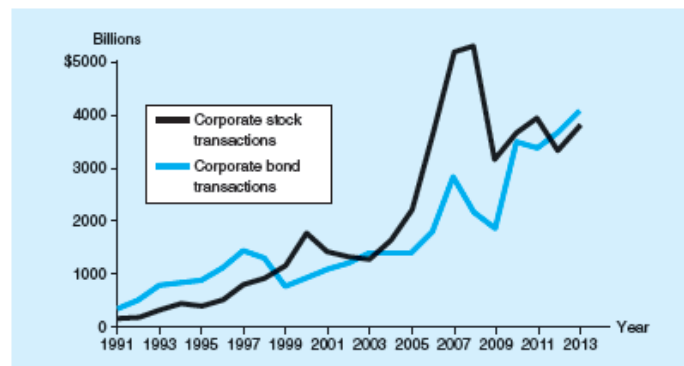


Figure 16-4 Foreign Transactions in U.S. Securities Markets



Source: Treasury Bulletin, U.S. Treasury, various issues. www.ustreas.gov

Figure 16-5 U.S. Transactions in Foreign Securities Markets



Source: Treasury Bulletin, U.S. Treasury, various issues. www.ustreas.gov

Global Issues

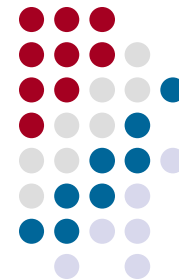


TABLE 16–8 Value of International Security Offerings (in billions of dollars)

| Type of Offering | 1995 | 2002 | 2005 | 2007 | 2008 | 2009 | 2010 | 2012 | 2013* |
|--|---------|-----------|-----------|-----------|------------|-----------|-----------|-----------|----------|
| Total international offerings | | | | | | | | | |
| Floating-rate debt | \$ 63.0 | \$ 199.0 | \$ 666.2 | \$1,140.6 | \$1,202.14 | \$ 174.0 | –\$ 129.4 | –\$ 418.0 | –\$118.0 |
| Straight debt | 250.4 | 800.1 | 1,153.4 | 1,616.6 | 1,138.9 | 2,357.1 | 1,588.6 | 1,104.1 | 230.0 |
| Convertible debt | 0.0 | 10.1 | –19.6 | 35.2 | 5.4 | 42.2 | 39.8 | –5.9 | 17.3 |
| Equity | 54.3 | 103.0 | 308.5 | 499.1 | 392.2 | 734.8 | 765.8 | 566.2 | 337.6 |
| Total offerings | \$367.7 | \$1,112.2 | \$2,108.5 | \$3,291.5 | \$2,738.6 | 3,308.1 | \$2,264.8 | \$1,246.4 | \$466.9 |
| International offerings by U.S. issuers | | | | | | | | | |
| Floating-rate debt | \$ 26.5 | \$ 22.4 | \$ 90.9 | \$ 392.2 | \$ 176.9 | \$ 29.6 | –\$ 91.8 | –\$ 44.4 | \$ 38.0 |
| Straight debt | 56.9 | 415.6 | 390.8 | 749.4 | 507.6 | 1,140.9 | 1,119.7 | 613.9 | 311.2 |
| Convertible debt | 0.0 | 0.0 | –5.7 | 12.4 | 2.5 | 40.2 | 47.9 | –4.1 | 13.4 |
| Equity | 9.6 | 1.2 | 6.0 | 13.0 | 98.9 | 246.8 | 166.4 | 222.9 | 115.9 |
| Total offerings | \$ 93.0 | \$ 439.2 | \$ 482.0 | \$1,167.0 | \$ 785.9 | \$1,457.5 | \$1,242.2 | \$ 788.3 | \$478.5 |

*Through June.

Source: "Quarterly Review: International Banking and Financial Market Developments," Bank for International Settlements, various issues. www.bis.org