

Solution Manual for Financial Institutions Management A Risk Management Approach 8th Edition by Saunders and Cornett ISBN 0078034809 9780078034800

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Chapter 04 - Financial Services: Securities Brokerage and Investment Banking

1. Explain how securities firms differ from investment banks. In what ways are they financial intermediaries?

Securities firms specialize primarily in the purchase, sale, and brokerage of securities, while investment banks primarily engage in originating, underwriting, and distributing issues of securities. In more recent years, investment banks have undertaken increased corporate finance activities such as advising on mergers, acquisitions, and corporate restructuring. In both cases, these firms act as financial intermediaries in that they bring together economic units who need money with those units who wish to invest money.

Both segments have undergone substantial structural changes in recent years. Some of the most recent consolidations include the acquisition of Bears Stearns by J.P. Morgan Chase, the bankruptcy of Lehman Brothers and the acquisition of Merrill Lynch by Bank of America. Indeed, as discussed later in the chapter, the investment banking industry has seen the failure or acquisition of all but two of its major firms (Goldman Sachs and Morgan Stanley) and these two firms converted to commercial bank holding companies in 2008.

2. In what ways have changes in the investment banking industry mirrored changes in the commercial banking industry?

First, both industries have seen a concentration of business among the larger firms. This concentration has occurred primarily through the merger and acquisition activities of several of the largest firms. Second, firms in both industries tend to be divided along product line services provided to customers. Some national full-line firms provide service to both retail customers, in the form of brokerage services, and corporate customers, in the form of new issue underwriting.

Other national full-line firms specialize in corporate finance and security trading activities. Third, the remaining firms specialize in more limited activities such as discount brokerage, regional full service retail activities, etc. This business line division is not dissimilar to that of the banking industry with money center banks, regional banks, and community banks. Clearly product line overlap occurs between the different firm divisions in each industry.

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3. What are the different types of firms in the securities industry and how does each type differ from the others?

The firms in the security industry vary by size and specialization. They include:

- a) National, full-line firms operating as commercial bank holding companies are the largest of the full service investment banks. They have extensive domestic and international operations and offer advice, underwriting, brokerage, trading, and asset management services. The largest of these firms include Bank of America (through their acquisition of Merrill Lynch), Morgan Stanley, and J.P. Morgan (through its many acquisitions including that of Bears Stearns, for \$240 million in 2008).

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- b) National firms specializing in corporate finance and trading, such as Goldman Sachs, Salomon Brothers (Citigroup), and Morgan Stanley.
 - c) Large investment banks that maintain more limited branch networks concentrated in major cities operating with predominantly institutional client bases. These firms include Lazard Ltd. and Greenhill & Co.
 - d) Specialized discount brokers providing trading services such as the purchase and sale of stocks, without offering any investment tips, advice or financial counseling.
 - e) Regional securities firms that offer most of the services mentioned above but restrict their activities to specific geographical locations.
 - f) Specialized electronic trading securities firms (such as E*trade) that provide a platform for customers to trade without the use of a broker. Rather, trades are enacted on a computer via the Internet.
 - g) Venture capital firms that pool money from individual investors and other FIs (e.g., hedge funds, pension funds, and insurance companies) to fund relatively small and new businesses (e.g., in biotechnology).
 - h) Other firms in this industry include research boutiques, floor specialists, companies with large clearing operations, and other firms that do not fit into one of the categories above. This would include firms such as Knight Capital Group (a leading firm in offexchange trading of U.S. equities) and floor specialist LaBranche & Co.
4. What are the key activity areas for investment banks and securities firms? How does each activity area assist in the generation of profits and what are the major risks for each area?

The seven major activity areas of security firms are:

- a) **Investment Banking:** Investment banks specialize in underwriting and distributing both debt and equity issues in the corporate market. New issues can be placed either privately or publicly and can represent either a first issued (IPO) or a secondary issue. Secondary issues of seasoned firms typically will generate lower fees than an IPO. In a private offering the investment bank receives a fee for acting as the agent in the transaction. In best-efforts public offerings, the firm acts as the agent and receives a

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fee based on the success of the offering. The firm serves as a principal by actually taking ownership of the securities in a firm commitment underwriting. Thus, the risk of loss is higher. Finally, the firm may perform similar functions in the government markets and the asset-backed derivative markets. In all cases, the investment bank receives fees related to the difficulty and risk in placing the issue.

- b) **Venture Capital:** A difficulty for new and small firms in obtaining debt financing from commercial banks is that CBs are generally not willing or able to make loans to new companies with no assets and business history. In this case, new and small firms often turn to investment banks (and other firms) that make venture capital investments to get capital financing as well as advice. Venture capital is a professionally managed pool of money used to finance new and often high-risk firms. Venture capital is generally provided to back an untried company and its managers in return for an equity investment in the firm. Venture capital firms do not make outright loans. Rather, they purchase an equity interest in the firm that gives them the same rights and privileges associated with an equity investment made by the firm's other owners.
- c) **Market Making:** Security firms assist in the market-making function by acting as brokers to assist customers in the purchase or sale of an asset. In this capacity the firms are providing agency transactions for a fee. Security firms also take inventory positions in assets in an effort to profit on the price movements of the securities. These principal positions can be profitable if prices increase, but they can also create downside risk in volatile markets.
- d) **Trading:** Trading activities can be conducted on behalf of a customer or the firm. The activities usually involve position trading, pure arbitrage, risk arbitrage, and program trading. Position trading involves the purchase of large blocks of stock to facilitate the smooth functioning of the market. Pure arbitrage involves the purchase and simultaneous sale of an asset in different markets because of different prices in the two markets. Risk arbitrage involves establishing positions prior to some anticipated information release or event. Program trading involves positioning with the aid of computers and futures contracts to benefit from small market movements. In each case, the potential risk involves the movements of the asset prices, and the benefits are aided

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by the lack of most transaction costs and the immediate information that is available to investment banks.

- e) **Investing:** Securities firms act as agents for individuals with funds to invest by establishing and managing mutual funds and by managing pension funds. The securities firms generate fees that affect directly the revenue stream of the companies.
- f) **Cash Management:** Cash management accounts are checking accounts that earn interest and may be covered by FDIC insurance. The accounts have been beneficial in providing full-service financial products to customers, especially at the retail level.
- g) **Mergers and Acquisitions:** Most investment banks provide advice to corporate clients who are involved in mergers and acquisitions. This activity has been extremely beneficial from a fee standpoint during the 1990s and 2000s.
- h) **Back-Office and Other Service Functions:** Security firms offer clearing and settlement services, research and information services, and other brokerage services on a fee basis.

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5. What is the difference between an IPO and a secondary issue?

An IPO is the first time issue of a company's securities, whereas a secondary offering is a new issue of a security that is already offered.

6. What is the difference between a private placement and a public offering?

A public offering represents the sale of a security to the public at large. A private placement involves the sale of securities to one or several large investors such as an insurance company or a pension fund.

7. What are the risk implications to an investment bank from underwriting on a best-efforts basis versus a firm commitment basis? If you operated a company issuing stock for the first time, which type of underwriting would you prefer? Why? What factors may cause you to choose the alternative?

In a best efforts underwriting, the investment bank acts as an agent of the company issuing the security and receives a fee based on the number of securities sold. With a firm commitment underwriting, the investment bank purchases the securities from the company at a negotiated price and sells them to the investing public at what it hopes will be a higher price. Thus, the investment bank has greater risk with the firm commitment underwriting, since the investment bank will absorb any adverse price movements in the security before the entire issue is sold.

Factors causing preference to the issuing firm include general volatility in the market, stability and maturity of the financial health of the issuing firm, and the perceived appetite for new issues in the market place. The investment bank will also consider these factors when negotiating the fees and/or pricing spread in making its decision regarding the offering process.

8. An investment bank agrees to underwrite an issue of 15 million shares of stock for Looney Landscaping Corp.

a. If the investment bank underwrites the stock on a firm commitment basis, it agrees to pay \$12.50 per share to Looney Landscaping Corp. for the 15 million shares of stock. It

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can then sell those shares to the public for \$13.25 per share. How much money does Looney Landscaping Corp. receive? What is the profit to the investment bank? If the investment bank can sell the shares for only \$11.95, how much money does Looney Landscaping Corp. receive? What is the profit to the investment bank?

If the investment bank sells the stock for \$13.25 per share, Looney Landscaping Corp. receives $\$12.50 \times 15,000,000 \text{ shares} = \$187,500,000$. The profit to the investment bank is $(\$13.25 - \$12.50) \times 15,000,000 \text{ shares} = \$11,250,000$. The stock price of Looney Landscaping Corp. is \$13.25 since that is what the public agrees to pay. From the perspective of Looney Landscaping Corp., the \$11.25 million represents the commission that it must pay to issue the stock.

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If the investment bank sells the stock for \$11.95 per share, Looney Landscaping Corp. still receives $\$12.50 \times 15,000,000 \text{ shares} = \$187,500,000$. The profit to the investment bank is $(\$11.95 - \$12.50) \times 15,000,000 \text{ shares} = -\$8,250,000$. The stock price of Looney Landscaping Corp. is \$11.95 since that is what the public agrees to pay. From the perspective of the investment bank, the -\$8.25 million represents a loss for the firm commitment it made to Looney Landscaping Corp. to issue the stock.

- b. Suppose, instead, that the investment bank agrees to underwrite the 15 million shares on a best-efforts basis. The investment bank is able to sell 13.6 million shares for \$12.50 per share, and it charges Looney Landscaping Corp. \$0.275 per share sold. How much money does Looney Landscaping Corp. receive? What is the profit to the investment bank? If the investment bank can sell the shares for only \$11.95, how much money does Looney Landscaping Corp. receive? What is the profit to the investment bank?

If the investment bank sells the stock for \$12.50 per share, Looney Landscaping Corp. receives $(\$12.50 - \$0.275) \times 13,600,000 \text{ shares} = \$166,260,000$, the investment bank's profit is $\$0.275 \times 13,600,000 \text{ shares} = \$3,740,000$, and the stock price is \$12.50 per share since that is what the public pays.

If the investment bank sells the stock for \$11.95 per share, Looney Landscaping Corp. receives $(\$11.95 - \$0.275) \times 13,600,000 \text{ shares} = \$158,780,000$, the investment bank's profit is still $\$0.275 \times 13,600,000 \text{ shares} = \$3,740,000$, and the stock price is \$11.95 per share since that is what the public pays.

9. An investment bank agrees to underwrite a \$500 million, 10-year, 8 percent semiannual bond issue for KDO Corporation on a firm commitment basis. The investment bank pays KDO on Thursday and plans to begin a public sale on Friday. What type of interest rate movement does the investment bank fear while holding these securities? If interest rates rise 0.05 percent, or five basis points, overnight, what will be the impact on the profits of the investment bank? What if the market interest rate falls five basis points?

An increase in interest rates will cause the value of the bonds to fall. If rates increase 5 basis points over night, the bonds will lose \$1,695,036.32 in value. The investment bank will absorb

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the decrease in market value, since the issuing firm has already received its payment for the bonds. If market rates decrease by 5 basis points, the investment bank will benefit by the \$1,702,557.67 increase in market value of the bonds. These two changes in price can be found with the following two equations respectively:

$$-\$1,695,036.32 = \$20,000,000PVA_{i=4.025\%,n=20} + \$500,000,000PV_{i=4.025\%,n=20} - \$500,000,000$$

$$\$1,702,557.67 = \$20,000,000PVA_{i=3.975\%,n=20} + \$500,000,000PV_{i=3.975\%,n=20} - \$500,000,000$$

10. An investment bank pays \$23.50 per share for 4 million shares of JCN Company. It then sells those shares to the public for \$25 per share. How much money does JCN receive? What is the profit to the investment bank? What is the stock price of JCN?

JCN receives $\$23.50 \times 4,000,000$ shares = \$94,000,000. The profit to the investment bank is $(\$25.00 - \$23.50) \times 4,000,000$ shares = \$6,000,000. The stock price of JCN is \$25.00 since that is what the public must pay. From the perspective of JCN, the \$6,000,000 represents the commission that it must pay to issue the stock.

11. XYZ, Inc., has issued 10 million new shares of stock. An investment bank agrees to underwrite these shares on a best-efforts basis. The investment bank is able to sell 8.4 million shares for \$27 per share, and it charges XYZ \$0.675 per share sold. How much money does XYZ receive? What is the profit to the investment bank? What is the stock price of XYZ?

XYZ receives $(\$27.00 - \$0.675) \times 8,400,000$ shares = \$221,130,000, the investment bank's profit is $\$0.675 \times 8,400,000$ shares = \$5,670,000, and the stock price is \$27 per share since that is what the public pays.

12. What is venture capital?

Venture capital is a professionally managed pool of money used to finance new and often highrisk firms. Venture capital is generally provided by investment institutions or private individuals willing to back an untried company and its managers in return for an equity investment in the firm. Venture capital firms do not make outright loans. Rather, they purchase

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an equity interest in the firm that gives them the same rights and privileges associated with an equity investment made by the firm's other owners. As equity holders, venture capital firms are not generally passive investors. Rather, they provide valuable expertise to the firm's managers and sometimes even help in recruiting senior managers for the firm. They also generally expect to be fully informed about the firm's operations, any problems, and whether the joint goals of all of the firm's owners are being met.

13. What are the different types of venture capital firms? How do institutional venture capital firms differ from angel venture capital firms?

Institutional venture capital firms are business entities whose sole purpose is to find and fund the most promising new firms. Private-sector institutional venture capital firms include venture capital limited partnerships (that are established by professional venture capital firms, acting as general partners in the firm: organizing and managing the firm and eventually liquidating their equity investment), financial venture capital firms (subsidiaries of investment or commercial banks), and corporate venture capital firms (subsidiaries of nonfinancial corporations which generally specialize in making start-up investments in high-tech firms). Limited partner venture capital firms dominate the industry. In addition to these private sector institutional venture capital firms, the federal government, through the SBA, operates Small Business Investment Companies (SBICs). SBICs are privately organized venture capital firms licensed by the SBA that make equity investments (as well as loans) to entrepreneurs for start-up activities and expansions. As federally sponsored entities, SBICs have relied on their unique opportunity to obtain investment funds from the U.S. Treasury at very low rates relative to private-sector institutional venture capital firms. In contrast to institutional venture capital firms angel venture capitalists (or angels) are wealthy individuals who make equity investments. Angel venture capitalists have invested much more in new and small firms than institutional venture capital firms.

14. What are the advantages and disadvantages to a new or small firm of getting capital funding from a venture capital firm?

A difficulty for new and small firms in obtaining debt financing from banks is that banks are generally not willing or able to make loans to new companies with no assets and business

Chapter 04 - Financial Services: Securities Brokerage and Investment Banking history. In this case, new and small firms often turn to venture capital firms to get capital financing as well as advice. As equity holders, venture capital firms are not generally passive investors. Rather, they provide valuable expertise to the firm's managers and sometimes even help in recruiting senior managers for the firm. They also generally expect to be fully informed about the firm's operations, any problems, and whether the joint goals of all of the firm's owners are being met. Venture capital firms look for two things in making their decisions to invest in a firm. The first is a high return. Venture capital firms are willing to invest in high-risk new and small firms. However, they require high levels of returns (sometimes as high as 700 percent within five to seven years) to take on these risks. The second is an easy exit. Venture capital firms realize a profit on their investments by eventually selling their interests in the firm. They want a quick and easy exit opportunity when it comes time to sell. Basically, venture capital firms provide equity funds to new, unproven, and young firms. This separates venture capital firms from commercial banks and investment firms, which prefer to invest in existing, financially secure businesses.

15. How do agency transactions differ from principal transactions for market makers?

Agency transactions are done on behalf of a customer. Thus, the investment bank is acting as a stockbroker, and the company earns a fee or commission. In a principal transaction, the investment bank is trading on its own account. In this case, the profit is made from the difference in the price that the company pays for the security and the price at which it is sold. In the first case the company bears no risk, but in the second case the company is risking its own capital.

16. One of the major activity areas of securities firms is trading.

a. What is the difference between pure arbitrage and risk arbitrage?

Pure arbitrage involves the buying and selling of similar assets trading at different prices. Pure arbitrage has a lock or assurance of the profits that are available in the market. This profit position usually occurs with no equity investment, the use of only very short-term borrowed funds, and reduced transaction costs for securities firms.

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Risk arbitrage also is based on the principle of buying low and selling high a similar asset (or an asset with the same payoff). The difference between risk arbitrage and pure arbitrage is that the prices are not locked in, leaving open a certain speculative component that could result in real economic losses.

- b. What is the difference between position trading and program trading?

Position trading involves the purchase of large blocks of stock for the purpose of providing consistency and continuity to the secondary markets. In most cases, these trades are held in inventory for a period of time, either after or prior to the trade. Program trading involves the ability to buy or sell entire portfolios of stocks quickly and often times simultaneously in an effort to capture differences between the actual futures price of a stock index and the theoretically correct price. The program trading process is useful when conducting index arbitrage. If the futures price is too high, an arbitrageur would short futures contract and buy the stocks in the underlying index. The program trading process in effect is a coordinated trading program that allows for this arbitrage process to be accomplished.

17. If an investor observes that the price of a stock trading in one exchange is different from the price in another exchange, what form of arbitrage is applicable, and how can the investor participate in that arbitrage?

The investor should short sell the more expensive asset and use the proceeds to purchase the cheaper stock to lock in a given spread. This transaction would be an example of a pure arbitrage rather than risk arbitrage. The actual spread realized would be affected by the amount of transaction costs involved in executing the transactions.

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18. An investor notices that an ounce of gold is priced at \$1,518 in London and \$1,525 in New York.

a. What action could the investor take to try to profit from the price discrepancy?

An investor would try to buy gold in London at \$1,518 and sell it in New York for \$1,525 yielding a riskless profit of \$7 per ounce.

b. Under which of the four trading activities would this action be classified?

This transaction is an example of pure arbitrage.

c. If the investor is correct in identifying the discrepancy, what pattern should the two prices take in the short-term?

The prices of gold in the two separate markets should converge or move toward each other. In all likelihood, the prices will not become exactly the same. It does not matter which price moves most, since the investor should unwind both positions when the prices are nearly equal.

d. What may be some impediments to the success of the transaction?

The success or profitability of this arbitrage opportunity will depend on transaction costs and the speed at which the investor can execute the transactions. If the price disparity is sufficiently large, other investors will seize the opportunity to attempt to achieve the same arbitrage results, thus causing the prices to converge quickly.

19. What three factors are given credit for the steady decline in brokerage commissions as a percent of total revenues over the period beginning in 1977 and ending in 1991?

The reasons often offered for the decline in brokerage commissions over this period are the abolition of fixed commissions by the SEC in 1975, the resulting competition among firms, and the stock market crash of 1987. The stock market crash caused a decline in the amount of equity and debt underwriting which subsequently had a negative effect on income. Although the equity

Chapter 04 - Financial Services: Securities Brokerage and Investment Banking markets rebounded during the 1990s, the continued growth of discount brokerage firms by depository institutions and the advances of electronic trade continued to affect commissions.

20. What factors are given credit for the resurgence of profitability in the securities industry beginning in 1991? Are firms that trade in fixed-income securities more or less likely to have volatile profits? Why?

Profits for securities firms increased beginning in 1991 because of (a) the resurgence of stock markets and trading volume, (b) increases in the profits of fixed-income trading, and (c) increased growth in the underwriting of new issues, especially corporate debt issues. However, rising oil prices and the subprime mortgage market collapse and the eventual full market crash in 2008 through 2009 pushed stock market values down. As a result, commission income in the securities industry declined as well. As the economy and the stock market recovered in the early 2010s, commission income again rose to almost 20 percent of total revenues.

However, profits from trading in fixed-income instruments are volatile, especially if interest rate changes are rather common. Hence, even though profits in fixed-income trading were up in 2001-2003, they declined in 2004-2006 because interest rates increased quite suddenly. Many firms with exposed interest rate instruments reported large losses.

21. Using Table 4-6, which type of security accounts for most underwriting in the United States? Which is likely to be more costly to underwrite: corporate debt or equity? Why?

According to Table 4-6, debt issues were greater than equity issues by a ratio of roughly four to one in the middle 1980s and late 2000s, and a ratio of thirteen to one in the mid-2000s. Debt is less risky than equity, so there is less risk of an adverse price movement with debt compared to equity. Further, debt is more likely to be bought in larger blocks by fewer investors, a transaction characteristic that makes the selling process less costly.

22. How did the financial crisis affect the performance of securities firms and investment banks?

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Signs of the impending financial crisis arose in 2007. The industry began 2007 on a strong note, but hit by the subprime mortgage market meltdown that began in the summer of 2007, ended the year with pretax profits of just \$0.78 billion. Many revenue lines showed solid growth in 2007 and total revenues reached a record high of \$474.2 billion in 2007. However, trading and investment account losses were large; totaling a loss of \$6 billion in 2007 compared to a gain of \$43 billion in 2006. Further, expenses grew faster than revenues, to a record \$473.4 billion in 2007. The worst of the financial crisis hit in 2008 as the industry reported a record loss for the year of \$34.1 billion. Revenues were \$290.5 billion, down 38.7 percent from 2007. Nearly all revenue lines decreased from 2007 levels, with trading and investment account losses being the largest (-\$65.0 billion in 2008).

As quickly as industry profits plunged during the financial crisis, they recovered in 2009. Pretax profits were a record \$61.4 billion. Revenues totaled \$288.1 billion for the year. Commission and fee income was \$49.0 billion of the total, reflecting improved trading volume. Trading revenues, which had been negative for six consecutive quarters, grew to \$45.3 billion. Industry expenses for 2009 were \$212.4 billion, 33.7 percent below 2008 levels. Of this, interest expenses fell to just \$21.9 billion, 82.2 percent below 2008 levels. While still in a fragile state, the industry seemed to be recovering along with the economy.

The U.S. and world economies grew very slowly after the financial crisis. While interest rates remained at historic lows, concerns about the health of Eurozone economies and the U.S. fiscal cliff kept economic growth at a standstill. Memories of the financial crisis were still fresh in the minds of investors. Events such as the May 2010 “flash crash,” the October 2011 collapse of MF Global Holdings, and the August 2012 trading glitch at Knight Capital, caused individual and institutional investors to limit capital market activity. Industry pretax profits fell to \$34.8 billion, \$10.6 billion, and \$12.4 billion in 2010, 2011, and 2012, respectively.

23. How do the operating activities, and thus the balance sheet structures, of securities firms differ from the operating activities of depository institutions? How are the balance sheet structures of securities firms similar to depository institutions?

Securities firms and investment banks primarily help net suppliers of funds (e.g., households) transfer funds to net users of funds (e.g., businesses) at a low cost and with a maximum degree of

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efficiency. Unlike other types of FIs, securities firms and investment banks do not transform the securities issued by the net users of funds into claims that may be “more” attractive to the net suppliers of funds (e.g., banks and their creation of bank deposits and loans). Rather, they serve as brokers intermediating between fund suppliers and users.

The short-term nature of many of the assets in the portfolios of securities firms demonstrates that an important activity is trading/brokerage. As a broker, the securities firm receives a commission for handling the trade but does not take either an asset or liability position. Thus, many of the assets appearing on the balance sheets of securities firms are cash-like money market instruments, not capital market positions. In the case of depository institutions, assets tend to be medium-term from the lending position of the depository institutions.

A major similarity between securities firms and all other types of FIs is a high degree of financial leverage. That is, all of these firms use high levels of debt that is used to finance an asset portfolio consisting primarily of financial securities. A difference in the funding is that securities firms tend to use liabilities that are extremely short term (see the balance sheet in Table 4-7). Nearly 30 percent of the total liability financing is payables incurred in the transaction process. In contrast, depository institutions have fixed-term time and savings deposit liabilities.

24. Based on the data in Table 4-7, what were the largest single asset and the largest single liability of securities firms in 2012? Are these asset and liability categories related? Exactly how does a repurchase agreement work?

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The largest asset category was a reverse repurchase agreement, and the largest liability was a repurchase agreement. When a financial institution needs to borrow funds, one source is to sell an asset. In the case of financial assets, the institution often finds it more beneficial to sell the asset under an agreement to repurchase the asset at a later time. In this case, the current money market rate of interest is built into the agreed upon repurchase price, and the asset literally does not leave the balance sheet of the borrowing institution. The borrowing institution receives cash and a liability representing the agreement to repurchase. The lending institution, which has excess funds, replaces cash as an asset with the reverse repurchase agreement.

25. How did the National Securities Markets Improvement Act of 1996 (NSMIA) change the regulatory structure of the securities industry?

The NSMIA removed most of the regulatory burden that had been imposed by individual states, effectively giving the SEC exclusive regulatory jurisdiction over securities firms.

26. Identify the major regulatory organizations that are involved in the daily operations of the investment securities industry, and explain their role in providing smoothly operating markets.

The primary regulator of the securities industry is the Securities and Exchange Commission (SEC), established in 1934 largely in response to abuses by securities firms that many at the time felt were partly responsible for the economic problems in the United States. The primary role of the SEC includes administration of securities laws, review and evaluation of registrations of new securities offerings (ensuring that all relevant information is revealed to potential investors), review and evaluation of annual and semiannual reports summarizing the financial status of all publicly held corporations, and the prohibition of any form of security market manipulation. The National Securities Markets Improvement Act (NSMIA) of 1996 reaffirmed the significance of the SEC as the primary regulator of securities firms. According to the NSMIA, states are no longer allowed to require federally registered securities firms to be registered in a state as well. States are also now prohibited from requiring registration of securities firms' transactions and from imposing substantive requirements on private placements. Prior to the NSMIA, most securities firms were subject to regulation from the SEC and from each state in which they operated. While the NSMIA provides that states may still require securities firms to pay fees and

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file documents to be submitted to the SEC, most of the regulatory burden imposed by states has been removed. Thus, the NSMIA effectively gives the SEC the exclusive regulatory jurisdiction over securities firms.

The early 2000s saw a reversal of this trend toward the dominance of the SEC, with states—especially their attorneys general—increasingly intervening through securities-related investigations. Several highly publicized securities violations resulted in criminal cases brought against securities law violators by mainly state and some federal prosecutors. In the spring of 2003 the issue culminated in an agreement between regulators and 10 of the nation's largest securities firms to pay a record \$1.4 billion in penalties to settle charges involving investor abuse. The long-awaited settlement centered on civil charges that securities firms routinely issued overly optimistic stock research to investors in order to gain favor with corporate clients and win their investment banking business.

Subsequent to these investigations, the SEC instituted rules requiring Wall Street analysts to vouch that their stock picks are not influenced by investment banking colleagues and that analysts disclose details of their compensation that would flag investors to any possible conflicts. If evidence surfaces that analysts have falsely attested to the independence of their work, it could be used to bring enforcement actions. Violators could face a wide array of sanctions, including fines and other penalties, such as a suspension or a bar from the securities industry. In addition, the SEC now requires that top officials from all public companies sign off on financial statements.

While the SEC sets the overall regulatory standards for the industry, the Financial Industry Regulatory Authority (FINRA) is involved in the day-to-day regulation of trading practices. The FINRA monitors trading abuses (such as insider trading) trading rule violations, and securities firms' capital (solvency) positions. FINRA's expanded oversight is intended to monitor and determine whether orders placed in dark pools are indeed attempts at moving stock prices. FINRA also announced that it is increasing its surveillance of high speed trading and rapid-fire trading across exchanges.

Also overseeing this industry at the federal level is the U.S. Congress. Along with changes instituted by the SEC, the U.S. Congress passed the Sarbanes-Oxley Act in July 2002. This act

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created an independent auditing oversight board under the SEC, increased penalties for corporate wrongdoers, forced faster and more extensive financial disclosure, and created avenues of recourse for aggrieved shareholders. The goal of the legislation was to prevent deceptive accounting and management practices and to bring stability to jittery stock markets battered in the summer of 2002 by corporate governance scandals of Enron, Global Crossings, Tyco, WorldCom, and others.

More recently, the U.S. Senate Permanent Subcommittee on Investigations was created with the broad mandate to determine whether any changes are required in U.S. law to better protect the public from actions of investment banks and securities firms. In the spring of 2010, a subcommittee hearing focused on the role of investment banks in contributing to the financial crisis. The 2010 Wall Street Reform and Consumer Protection Act, passed in response to the financial crisis, set forth many changes in the way securities firms and investment banks are regulated. The bill's Financial Services Oversight Council of financial regulators was given oversight of the industry in its charge to identify emerging systemic risks. Also under the act, effective July 21, 2011, the dollar threshold for determining whether an investment advisor must register under federal or state law increased. Specifically, all advisors with assets under management of under \$100 million must register with state regulators and those with over \$100 million under management must register with the SEC. Prior to that date, only advisors with assets under management of under \$25 million registered with a state regulator. The bill also gave new authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability and called for stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms. Investment banks also saw stricter oversight as the bill called for the regulation of securitization markets, stronger regulation of credit rating agencies, a requirement that issuers and originators retain a financial interest in securitized loans, comprehensive regulation of all over-the-counter derivatives, and new authority for the Federal Reserve to oversee payment, clearing, and settlement systems. Finally, the bill gave authority to the government to resolve nonbank financial institutions whose failure could have serious systemic effects and revised the Federal Reserve's emergency lending authority to improve accountability.

Finally, the Securities Investor Protection Corporation (SIPC) protects investors against losses of up to \$500,000 caused by securities firm failures. This guaranty fund was created after the passage of the Securities Investor Protection Act in 1970 and is based on premium contributions

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from member firms. The fund protects investor accounts against the possibility of a member broker–dealer not being able to meet its financial obligations to customers. The fund does not, however, protect against losses on a customer’s account due to poor investment choices that reduce the value of a portfolio.

27. What are the three requirements of the U.S.A. Patriot Act that financial service firms must implement after October 1, 2003?

FIs must (1) verify the identity of people opening new accounts; (2) maintain records of the information used to verify the identity; and (3) determine whether the person opening an account is on a suspected terrorist list.