***Financial Markets and Institutions, 7e* (Saunders)**

**Chapter 16 Securities Firms and Investment Banks**

1) For securities firms, income from investment management is more stable than income from underwriting or trading activities.

Answer: TRUE

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

2) Diversified full-line investment banks act as both broker-dealers and securities underwriters.

Answer: TRUE

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

3) An example of a national full-line investment banker that specializes in corporate finance is Goldman Sachs.

Answer: TRUE

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

4) The process of creating a secondary market for securities or contracts is termed brokerage.

Answer: FALSE

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

5) In a best efforts offering, the investment banker acts as an agent for the issuer rather than as a principal.

Answer: TRUE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

6) A market maker buys IBM at $185 for his own account and sells the stock later in the day at $187. He is acting as a broker in this transaction.

Answer: FALSE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

7) Buying large blocks of securities and holding them until the price rises sufficiently to warrant a sale is an example of pure arbitrage.

Answer: FALSE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

8) An example of a pure arbitrage strategy is to simultaneously buy and sell the same security in two different markets at different prices.

Answer: TRUE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

9) A stockbroker acts as a principal on behalf of the customer.

Answer: FALSE

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

10) Cash management accounts offered by a securities firm allow investors to write checks on funds invested in money market securities.

Answer: TRUE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

11) Program trading is the simultaneous buying and selling of at least 15 stocks worth a total of $1 million or more.

Answer: TRUE

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

12) If you buy 100 shares of IBM stock in anticipation that earnings will increase by more than anticipated, you are engaging in what is termed a risky arbitrage.

Answer: TRUE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

13) Although an investor can write checks on a cash management account held with a broker, regulations prevent the use of ATMs or debit cards on these accounts.

Answer: FALSE

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

14) Profitability at investment banking firms has been very stable each year since 2001.

Answer: FALSE

Difficulty: 3 Hard

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

15) The Securities Investor Protection Corporation protects investors against losses due to unfavorable market moves of up to $500,000.

Answer: FALSE

Difficulty: 2 Medium

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

16) Angel venture capitalists have invested more in start-up firms than institutional venture capital firms.

Answer: TRUE

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

17) Brokerage commission income and stock market valuations tend to move inversely in most years, including in 2010.

Answer: FALSE

Difficulty: 2 Medium

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

18) FINRA is a government agency with mandate to protect America's investors by making sure the securities industry operates fairly and honestly.

Answer: FALSE

Difficulty: 2 Medium

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

19) An advantage of private placements is no requirement to register with the SEC since the placements are made only to large, sophisticated investors; therefore, the cost of issuance gets lower.

Answer: TRUE

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

20) Firms underwriting securities assist corporate clients in selling them in secondary markets.

Answer: FALSE

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

21) Diversified full-line securities firms engage in all but which one of the following?

A) Trading and brokerage of existing securities

B) Corporate restructuring and advice

C) Issuing new securities

D) Raising money via insured deposits

Answer: D

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

22) A best efforts offering is one in which

A) the underwriter bears the risk of an unsuccessful offering.

B) the bid-ask spread is exceptionally high, but the investment banker does his best to sell the issue anyway.

C) the investment banker acts as a principal for the issuer.

D) the investment banker acts only as a distribution agent.

E) the issue can only be privately placed.

Answer: D

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

23) If an underwriter overestimates the demand for a firm's securities in a firm commitment offering, the underwriter can

A) sell the shares back to the issuing firm at a discount.

B) lower the bid price to the issuing firm.

C) increase the fees charged to the issuing firm.

D) cancel the issue and refund the fees paid by the issuing firm.

E) None of these options are correct.

Answer: E

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

24) Investment firms that pool money from individuals and/or institutions and invest equity funds in start-up firms are called

A) top-tier bankers.

B) Section 20 affiliates.

C) venture capital firms.

D) ECNs.

E) discount brokerage houses.

Answer: C

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

25) You buy euros in New York from Deutsche Bank and simultaneously sell them in London to Barclays for a gain. This is an example of

A) position trading.

B) program trading.

C) risk arbitrage.

D) pure arbitrage.

E) hedging.

Answer: D

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

26) An unregistered issue sold to a few large institutional buyers is an example of a(n)

A) best efforts offering.

B) fully underwritten public offering.

C) shelf offering.

D) private placement.

E) SEC Rule 415 offering.

Answer: D

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

27) An investment banker agrees to a firm commitment offering of two million shares of Ace stock. The offer price is set at $55 and the spread is 50 cents per share. If the stock is actually sold to the public at $53.80, however, what is the investment banker's gain or loss?

A) $1,400,000 gain

B) $1,400,000 loss

C) $500,000 gain

D) $500,000 loss

E) None of these options are correct.

Answer: B

Explanation: (53.80 − (55.00 − 0.50)) × 2,000,000 = −1,400,000

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

28) Day-to-day trading practices of securities firms currently may be regulated by which of the following?

I. FINRA

II. SEC

III. Federal Reserve

IV. SIPC

A) I only

B) II only

C) I and II only

D) I and III only

E) II and IV only

Answer: A

Difficulty: 2 Medium

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

29) Firms in the securities industry are required to maintain a minimum capital to asset ratio of \_\_\_\_\_\_\_\_.

A) 2 percent.

B) 4 percent.

C) 6 percent.

D) 8 percent.

E) 10 percent.

Answer: A

Difficulty: 2 Medium

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-03 Differentiate among the major assets and liabilities held by securities firms.

Accessibility: Keyboard Navigation

30) An investment banker agrees to a firm commitment offering of 1.2 million shares of Bally stock. The offer price is set at $25.50 and the spread is 30 cents per share. If the stock is actually sold to the public at $26.00, however, what is the amount of funds Bally receives? (Ignore any other fees or expenses.)

A) $31,200,000

B) $30,600,000

C) $30,240,000

D) $29,280,000

E) $28,120,000

Answer: C

Explanation: ($25.50 − $0.30) × 1,200,000 = $30,240,000

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

31) The major result of the NSMIA was to

A) reduce state regulatory powers over securities firms.

B) establish the SIPC.

C) create the NASD.

D) All of these choices are correct.

E) None of these choices are correct.

Answer: A

Difficulty: 1 Easy

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

32) An investment banker agrees to a best efforts offering of 2.5 million shares of Crew stock. The offer price is set at $35 per share. If the stock is actually sold to the public at $34.50 and the banker charges a 3.45 cent commission per share sold, what is the amount of funds Crew receives? (Ignore any other fees or expenses.)

A) $88,750,000

B) $87,500,000

C) $86,163,750

D) $85,176,430

E) $84,122,560

Answer: C

Explanation: (34.50 − 0.0345) × 2,500,000 = 86,163,750

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

33) \_\_\_\_\_\_\_\_ are examples of investment bankers offering traditional commercial banking services.

A) Online brokers

B) Cash management accounts

C) Underwriting corporate debt and equity offers

D) Venture capital funds

E) Mergers and acquisition services

Answer: B

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

34) The trading activity involving purchases of large blocks of securities on the expectation of a favorable price move over the next several weeks or months is called

A) program trading.

B) pure arbitrage.

C) day trading.

D) position trading.

E) hedging.

Answer: D

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

35) An entrepreneur looking for financing to get her small personally owned business up and running should probably consider

A) an IPO.

B) a seasoned stock offering.

C) a public debt offering.

D) a venture capitalist.

E) a syndicated loan.

Answer: D

Difficulty: 1 Easy

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

36) Which one of the following statements about venture capitalists is not correct?

A) Venture capitalists contribute to equity financing rather than make loans.

B) Venture capitalists are passive investors.

C) Most private venture capitalists are organized as limited partnerships.

D) The federal government licenses some private firms to provide lower-cost funds to entrepreneurs.

E) Angel venture capitalists are wealthy individuals who fund business start-ups.

Answer: B

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

37) In 2016, the greatest dollar volume of U.S. corporate underwriting occurred for which type of security?

A) Straight corporate debt

B) Asset-backed debt

C) Common stock

D) Preferred stock

E) Convertible debt

Answer: A

Difficulty: 2 Medium

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

38) The \_\_\_\_\_\_\_\_ insures losses of funds deposited with securities firms in the event of failure of a securities firm.

A) SEC

B) NASD

C) SIA

D) SIPC

E) FDIC

Answer: D

Difficulty: 1 Easy

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

39) In 2016, the top five underwriters engaged in about \_\_\_\_\_\_\_\_ of total U.S. underwriting volume.

A) 15.8 percent

B) 22.4 percent

C) 26.7 percent

D) 44.7 percent

E) 56.2 percent

Answer: C

Difficulty: 3 Hard

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

40) Which one of the following securities firms' activities is normally the most risky?

A) Best efforts offering

B) Private placement

C) Firm commitment offering

D) Pure arbitrage

E) Program trading

Answer: C

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

41) The largest asset on the typical broker-dealers' balance sheet in 2015 was

A) receivables from other broker-dealers.

B) long positions in securities and commodities.

C) reverse repurchase agreements.

D) repurchase agreements.

E) cash.

Answer: A

Difficulty: 2 Medium

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-03 Differentiate among the major assets and liabilities held by securities firms.

Accessibility: Keyboard Navigation

42) The largest liability of broker-dealers in 2015 was

A) bank loans payable.

B) short positions in securities and commodities.

C) subordinated debt.

D) repurchase agreements.

E) equity.

Answer: D

Difficulty: 2 Medium

Topic: Recent Trends and Balance Sheets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-03 Differentiate among the major assets and liabilities held by securities firms.

Accessibility: Keyboard Navigation

43) As a result of the alleged conflicts of interest between analysts and underwriting, which of the following changes were implemented?

I. Analysts cannot participate in nor attend certain presentations to potential investors conducted by investment bankers associated with underwriting an issue.

II. Analyst compensation can no longer be tied to the amount of underwriting business a firm generates.

III. Securities firms must divest stock research divisions to ensure independence from their investment banking business.

A) I only

B)  I and II only

C) I and III only

D) II and III only

E) I, II, and III

Answer: B

Difficulty: 3 Hard

Topic: Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 16-04 Know the main regulators of securities firms and investment banks.

Accessibility: Keyboard Navigation

44) Underwriting new securities issuance requires that the investment bank

A) buys the issue at a certain price and then sells it in the primary market.

B) provides research and legal advice only to the issuing company.

C) buys the issue at a certain price and then sells it in the secondary market.

D) provides its best effort to sell the securities, the unsold portion goes back to the issuer.

E) purchases securities in the secondary market when they are undervalued.

Answer: A

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Understand; Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

45) When the investment banker sells the new securities on commission without guaranteeing the sale of the whole issue, the process is called:

A) Private placement

B) Best effort

C) Brokered sale

D) Underwriting

E) Syndicate offering

Answer: B

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

46) An investment manager directs a certain client's orders to a certain broker for execution in exchange for research from the broker. This arrangement is referred to as a:

A) Soft dollar arrangement

B) Best effort arrangement

C) Position trading

D) Private placement

E) Commission trades

Answer: A

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

47) Security dealers who will buy or sell securities at any time in the market are called:

A) Brokers

B) Program traders

C) Underwriters

D) Market makers

E) Dealers

Answer: D

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

48) A company issued 5 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 3.7 million shares for $34.50 per share, and it charges commission of $0.52 per share sold. How much money will the company receive?

A) $125,726,000

B) $127,650,000

C) $130,000,000

D) $169,900,000

E) $172,500,000

Answer: A

Explanation: 3,700,000 × (34.50 − 0.52) = 125,726,000

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

49) An investment bank agrees to pay $26.75 for 5 million shares of a company in a firm commitment stock offering. It then can sell those shares to the public for $25.50 per share. What is the profit to the investment bank?

A) Profit of $6,250,000

B) Loss of $6,250,000

C) Loss of $5,000,000

D) Loss of $7,500,000

E) Profit of $1,000,000

Answer: B

Explanation: (25.5 − 26.75) × 5,000,000 = −6,250,000

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

50) An investment bank agrees to underwrite a $100 million, 15-year, 10 percent semiannual bond issue for a company on a firm commitment basis. The investment bank pays the company on Monday and plans to begin a public sale on Tuesday. If interest rates rise 0.5 percent, or fifty basis points, overnight, what will be the impact on the profits of the investment bank?

A) $4,258,365; loss

B) $4,258,365; gain

C) $3,735,975; loss

D) $3,735,975; gain

E) $1,239,175; gain

Answer: C

Explanation: With a financial calculator: Input N = 30, I = 5.25, PMT = 5,000,000, FV = 100,000,000 and solve for PV to get $96,264,025.

The value of the investment went down from $100,000,000 to $96,264,025 for a loss of $3,735,975.

Difficulty: 3 Hard

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Apply

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

51) What are the major types of firms in the investment banking industry? Briefly describe each.

Answer: Diversified full-line investment banks that serve retail customers via trading activities and corporate customers in underwriting securities.

Full-line national firms that specialize in corporate finance activities such as underwriting, mergers, and acquisitions.

Various specialized types of firms ranging from regional investment bankers to commercial bank subsidiaries to Internet brokerage firms, and venture capital firms that specialize in start-up and small businesses.

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Understand; Remember

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

52) Why is capital a more important measure of the size of a securities firm than the amount of assets? What other measures would be useful, given the diversity of this industry?

Answer: The size of investment banking and securities trading is not properly measured by industry assets because, unlike loans or insurance policies, investment bankers and securities firms need not permanently hold securities. Their purpose is to turn them over quickly. Equity capital measures a firm's ability to turn over large issues, since firms will only risk limited amounts of their capital at one time.

Other measures may include these:

* Level of underwriting volume in particular categories
* Number of brokers/dealers, availability of electronic trading (securities firms trading activities)
* Number of corporate relationships (M&A and consulting activities)
* Amount of global presence such as overseas offices and foreign transactions

Difficulty: 3 Hard

Topic: Recent Trends and Balance Sheets

Bloom's: Understand; Evaluate

AACSB: Reflective Thinking

Learning Goal: 16-03 Differentiate among the major assets and liabilities held by securities firms.

Accessibility: Keyboard Navigation

53) Describe an agency transaction (brokerage) and a principal transaction (dealer) that is involved in trading. What determines profits in each activity? Which is riskier?

Answer: Market makers act as an agent by processing buy and sell orders from the public and they profit by charging a small commission on the order. A large amount of trading volume is required to generate substantial profits, but the agent takes on no risk.

In a principal transaction market makers buy and sell securities for their own account. They can profit in two ways. First, market makers charge a slightly higher price to sell securities while buying at a lower price. As with the broker, a high volume of either buys or sells or both can thus lead to high profits. The principal carries an inventory of securities and does bear the risk of a large price move, so the principal has more risk than the broker. Market makers can also take on even more risk by taking larger bullish or bearish positions if they believe they can predict the direction of the security's price change. This kind of speculative market making activity is more risky but can lead to larger profits.

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Industry

Bloom's: Understand; Evaluate

AACSB: Reflective Thinking

Learning Goal: 16-01 Know the different types of securities firms and investment banks.

Accessibility: Keyboard Navigation

54) Classify the following trading activities as either a position trade, a pure arbitrage trade, or a risk arbitrage trade.

I. Buy Intel at $120 and hold it for six months in hopes of a price rise.

II. Buy GE on the NYSE and immediately sell it at a higher price on the Pacific Exchange.

III. Short sell Dell in anticipation of a poor quarterly earnings report.

Answer: I. Position trade; II. Pure arbitrage; III. Risk arbitrage; respectively.

Difficulty: 2 Medium

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

55) What are soft dollar fees or commissions? How can these lead to conflicts of interest for investment bankers?

Answer: The term "soft dollar" can mean different things, but it can refer to fees allocated to pay for research and advisory services provided to clients. In the past, independent investment houses specialized in providing research services, but in many cases today the investment banker has his/her own analysts that provide research. This can lead to the tendency to reward analysts for research that helps the banker in encouraging customers to buy the stock regardless of whether the analyst really thinks the stock is a good buy. The customer believes he or she is receiving an objective analysis when in fact he or she may not be. This is an obvious conflict of interest.

Difficulty: 3 Hard

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Remember; Evaluate

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

56) Why did profitability of security firms drop precipitously in 2005 and rebound in 2006 only to fall again in 2007?

Answer: Underwriting and trading income remained high in the mid-2000s, but increasing interest rates also increased interest expense on borrowed funds used to finance their securities inventory and this kept profits down in 2005. Revenue increases in 2006 pushed profits back up. The subprime fallout in 2007 dramatically reduced profitability. Many securities firms had extensive investments in mortgage-backed securities and had even acquired mortgage originators to facilitate the securitization process. When subprime default rates rose dramatically in 2007 these investments and acquisitions performed very poorly.

Difficulty: 3 Hard

Topic: Recent Trends and Balance Sheets

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation

57) Darby Minerals wants to hire an investment banker to sell two million shares of stock to the public. Darby is considering using either a firm commitment or a best efforts offering.

(a) If Darby goes with a firm commitment, the offer price will be $15.00 per share and the spread will be 25 cents a share and all two million shares will be sold. The actual sale price to the public is $14.55.

(b) Suppose that Darby uses a best efforts offering. The actual sale price to the public is again $14.55 and the investment banker charges 4 cents per share sold as commission. Assume that in the best efforts offer only 1.85 million shares can be sold.

What are the proceeds to Darby from the sale of stock in the firm commitment and the best efforts and what is the investment banker's gain or loss in each case? Ignore any other costs and expenses.

Answer:

(a) Firm Commitment Option:

Firm Proceeds: ($15.00 − $0.25) × 2,000,000 = $29,500,000

Investment Banker's Gain or Loss = ($14.55 − $14.75) × 2,000,000 = −$400,000

(b) Best Efforts

Firm Proceeds ($14.55 − $0.04) × 1,850,000 = $26,843,500

Investment Banker's gross profits = ($0.04 × 1,850,000) = $74,000

Difficulty: 3 Hard

Topic: Securities Firm and Investment Bank Activity Areas

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 16-02 Understand the major activity areas in which securities firms and investment banks engage.

Accessibility: Keyboard Navigation