Questions & Answers:

Chapter 1 – Overview of Investment Banking

Q1. What were the two main arguments for rejoining investment banks and retail deposit-taking banks that led to the passing of the Gramm-Leach-Bliley Act?

A. The first argument is that the rejoining of the two banking businesses provides for a more stable and countercyclical business model for these banks. The second argument is to allow US banks to better compete with international counterparts that were less encumbered by the Glass–Steagall Act.

Q2. Describe the three principal businesses of an investment bank.

A. The investment banking division arranges financing for governments and corporations as well as advises on M&A transactions. The sales and trading division sells and trades securities and other financial assets as an intermediary on behalf of institutional investing clients, and provides research to investing clients. The asset management division is responsible for managing money for individual and institutional investing clients.

Q3. Why might a universal bank be better able to compete against a pure-play investment bank for M&A and other investment banking engagements?

A. Universal banks are better able to use their balance sheet to lend money to corporations. Some companies prefer doing business with a bank that can both provide loans and investment banking products like M&A.

Q4. Investment bank clients can be categorized into two broad groups of issuers and investors. These two groups often have competing objectives (issue equity at highest possible price vs. acquire stock in companies at lowest possible price). Who within the investment bank is responsible for balancing these competing interests?

A. ECM bankers are the intermediaries between these two parties and are charged with balancing the needs of each.

Q5. What is a key consideration in determining the cost and other parameters of a corporate debt offering and why is it important?

A. Credit rating: impacts future cost of debt; also could trigger covenants in existing debt.If lowered to below investment grade, certain institutional investors can no longer invest in the company's bonds or common stock.

Q6. Why might an investment bank place higher priority on sell-side M&A engagements over buy-side engagements?

A. Completion-based fees: higher certainty of closing with sell-sides. In buy-sides, client is up against other bidders and may not win the bid.

Q7. What is two key considerations for bankers in the debt capital markets division when working with an issuer on an offering?

A. Determining the likely impact that a new debt offering will have on the issuer's credit ratings and investor reaction to a potential offering.

Q8. Define proprietary trading.

A. Using the bank's own capital to make short-term, nonclient-related investments in securities, commodities, and derivatives for the bank's own account, which is similar to the investment activity of hedge funds.

Q9. What conflicts might exist between a proprietary trading business and the rest of the investment bank?

A. Proprietary trading competes with the bank's hedge fund clients for trade opportunities. In addition, weak compliance policies could lead to lapses in confidentiality,which may result in trading on confidential information from other parts of the bank.

Q10. What conflicts might exist as a result of having both an Asset Management business and a Private Wealth Management business?

A. PW advisors may be encouraged to invest client assets in funds managed by the AM division, even when it's not in the best interest of the client.

Chapter 2 – Regulation of the Securities Industry

Q1. Following the 1929 Stock market crash, Congress passed a series of Acts to regulate the securities industries. Name four of these Acts and briefly describe their purpose.

A. The four Acts are:

i. Securities Act of 1933 – mandated all securities to be properly documented and disclosed to the investing public.
ii. Securities Act of 1934 – created the Securities and Exchange Commission (SEC) to oversee the trading practices of the securities industry.
iii. Investment Company Act of 1940 –regulated investment companies such as mutual funds. The Act mandated that open-end mutual funds could not take on debt and closed-end funds had restrictions on their leveraging capacity.
iv. Glass Steagall Act: separated deposit taking and loan making "commercial banking" from underwriting "investment banking."

Q2. A goal of many parts of U.S. regulatory legislation has been to eliminate/minimize conflicts of interest between issuers, investment banks, and investors. Provide examples of conflicts of interest in the U.S. investment banking industry and the corresponding regulations that attempted to resolve those issues.

A. Sell-side research vs.banking division: global research settlement; spinning: global research settlement; insider trading: ’34 Act; independence of outside auditors: Sarbanes-Oxley; commercial banks vs.investment banks: Glass-Steagall; bankers’ involvement in bankruptcies: Chandler Act; investment bank/mutual fund cross holdings/mgmt: ICA 1940.

Q3. Disclosure of information to investors is another recurring theme in U.S. regulation of the securities industry. Provide examples of disclosure required by U.S. regulations.

A. Securities Act of 1933: investors must receive financial and other significant information about a company offering securities for public sale; ’34 Act: periodic reporting of information by companies with publicly traded securities; ICA 1940: investment companies must disclose financial condition and investment policies to investors; Sarbanes-Oxley: greater disclosure of off-balance sheet transactions, disclosure and reconciliation of non-GAAP financial measures; global research settlement: disclosure of potential conflicts of interest between the research department and the investment banking department.

Q4. What is the role of states in the U.S. in regulating investment banks?

A. Only anti-fraud matters.

Q5. What type of U.S. securities offerings do not need to be registered with the SEC?

A. Private offerings to limited number of persons or institutions; offerings of limited size; intrastate offerings; securities of municipal, state and federal governments

Q6. What is a “Red Herring”?

A. A “Red Herring” is a preliminary registration statement that has been filed with the SEC and which carries a front-page statement (written with red ink) which cautions prospective investors that the SEC has not approved the registration and sales cannot be completed until a “final” registration statement is declared effective by the SEC and is delivered to investors. Red Herrings are provided by sales people to their prospective clients to educate, rather than to be used as a final sales document.

Q7. Before an SEC registration statement is declared effective, companies (or their underwriters) that sell stock or are deemed to be promoting the sale of stock have a securities law problem. What is this problem called and what are its consequences?

A. Gun jumping. The company must withdraw the issuance until the SEC is satisfied that no fraud or manipulation has occurred. The company may also be required to pay a fine.

Q8. What are the “Risk Factors” in a prospectus? Why are they important to the issuer and to the investor?

- **A.** Risk Factors are disclosures about potential problems the company may encounter, including possible losses, unpredictable revenue, capacity constraints, reliance on suppliers, technological change, competition, litigation regulation, customer mix, etc.
  - i. Issuer: The issuer must list every reasonable risk in order to meet full disclosure requirements of securities laws and to therefore have a defense in case they are sued by shareholders if the company’s share price drops.
  - ii. Investors: Investors should read these disclosures to ensure that they understand all relevant risks before making decisions regarding purchase of securities.

Q9. What is the significance of the Gramm-Leach-Bliley Act of 1999 in relation to the securities industry?

- **A.** The Gramm-Leach-Bliley Act, in essence, repealed the Glass Steagall Act of 1933 and allowed the creation of financial holding companies that could participate in both commercial and investment banking, a practice formerly separated by the Glass-Steagall Act. This act paved the way for conglomerate, multi-service providers such as Citigroup and JP Morgan and permitted the convergence of banking, insurance and securities businesses.

Q10. What are some securities regulations in place in the U.K., Japan and China that mirror U.S. regulations?

- **A.** Japan and China: Originally separated the functions of commercial and investment banks (these changes happened within a much shorter time frame for China). Later, like the U.S., those restrictions were eliminated. Also, various Japanese laws requiring disclosure and internal controls in public companies were similar to those in the U.S. The U.K. also has an SRO system like the U.S. Chinainstituted anti-fraud and insider trading rules in 2005 similar to those in the U.S.

Q11. What are some major differences between the regulatory frameworks of the four countries covered in this chapter?

- **A.** One main difference is the U.S. has somewhat fragmented and decentralized securities regulatory bodies, whereas in the other three countries, securities regulation is centralized.

Q12. Compare the regulatory bodies of the four countries covered in this chapter.

- **A.** The Financial Supervisory Agency in Japan, the Financial Services Authority in U.K., and the China Securities Regulatory Commission are the sole financial regulators in those countries. In the U.S., the two main regulators are the Fed and the SEC. In addition, entities such as the Commodity Futures Trading Commission and the FDIC also have regulatory powers.

Q13. What does the Dodd-Frank Act of 2010 mainly focus on?

A. This Act mainly focused on protecting consumers, ending "too big to fail" bailouts, improving coordination between various regulatory agencies, identifying systemic risk early, creating greater transparency for complex financial instruments and providing greater transparency for executive compensation.