



PART 4

Capital Structure and Dividend Policy

CHAPTER 14
RAISING CAPITAL IN
THE FINANCIAL
MARKETS



CHAPTER 15
ANALYSIS AND IMPACT
OF LEVERAGE



CHAPTER 16
PLANNING THE FIRM'S
FINANCING MIX



CHAPTER 17
DIVIDEND POLICY AND
INTERNAL FINANCING





❖ LEARNING OBJECTIVES ❖

After reading this chapter, you should be able to

1. Understand the historical relationship between internally generated corporate sources of funds and externally generated sources of funds.
2. Understand the financing mix that tends to be used by firms raising long-term financial capital.
3. Explain why financial markets exist in a developed economy.
4. Explain the financing process by which savings are supplied and raised by major sectors in the economy.
5. Describe the key components of the U.S. financial market system.
6. Understand the role of the investment banking business in the context of raising corporate capital.
7. Distinguish between privately placed securities and publicly offered securities.
8. Be acquainted with the concepts of securities flotation costs and securities markets regulations.

Raising Capital in the Financial Markets

From February 4, 1994, through November 6, 2002, the Federal Reserve System (Fed), the nation's central bank, voted to change the "target" federal funds rate on 32 different occasions. Fourteen of these interest rate changes were in the upward direction. Eighteen decisions, therefore, moved short-term interest rates downward, indicating a loosening of monetary policy. Eleven consecutive times, in fact, during calendar year 2001 Federal Reserve policy makers chose to reduce the target federal funds rate. Such a pervasive stance occurs during periods of slowing aggregate economic activity, which we will shortly review. The federal funds rate is a short-term market rate of interest, influenced by the Fed, that serves as a sensitive indicator of the direction of future changes in interest rates.

We will review here five different interest rate cycles that have confronted major corporate officers, like those at Harley-Davidson or the Walt Disney Company. This will emphasize how alert and flexible top-level executives must be in planning their firms' cash availability and cash distributions within an always uncertain global economic environment. The

discussion also stresses that interest rate changes induce changes in the cost of capital to firms, and thereby, affects their capital budgeting decisions. The funds-management process, as you will shortly see, is continual. An overview of the five distinct cycles is displayed below.

Recent Interest Rate Cycles

PHASE AND TIME PERIOD	MAIN CONCERN OR RISK	POLICY ACTION
1. Early 1994	Inflation	Raise interest rates
2. Early 1997	Inflation	Raise interest rates
3. Fall 1998	International pressures	Lower interest rates
4. Summer 1999	Tight labor markets, strong aggregate, real growth, and inflation	Raise interest rates
5. Early 2001	Contracting manufacturing output, slower business capital spending, equity market sell-off, and formal recession	Lower interest rates

CHAPTER PREVIEW

This chapter focuses on the market environment in which long-term financial capital is raised. Long-term funds are raised in the capital market. By the term *capital market*, we mean all institutions and procedures that facilitate transactions in long-term financial instruments (such as common stocks and bonds).

The sums involved in tapping the capital markets can be vast. For example, new corporate securities offered to the investing marketplace for cash during 2001 totaled \$1.54 trillion. To be able to distribute and absorb security offerings of such enormous size, an economy must have a well-developed financial market system. To use that system effectively, the

financial manager must possess a basic understanding of its structure. This chapter will help you gain that understanding.

As you work through this chapter, be on the lookout for direct applications of several of our principles that form the basics of business financial management. Specifically, your attention will be directed to: **Principle 1: The Risk-Return Trade-Off**—We won't take on additional risk unless we expect to be compensated with additional return; **Principle 6: Efficient Capital Markets**—The markets are quick and the prices are right; and **Principle 10: Ethical Behavior Is Doing the Right Thing, and Ethical Dilemmas Are Everywhere in Finance**.

In early 1994, the central bank feared that inflationary pressures were building up in the U.S. economy and decided to take action, via raising nominal short-term interest rates, to stem those pressures by slowing down aggregate economic growth. The Fed remained committed to a course of higher interest rates throughout 1994 and the first half of 1995; then, on July 6, 1995, these monetary policy makers reversed course and began a series of three interest rate decreases. For over a year, from January 31, 1996, to March 25, 1997, the Fed stayed on the sidelines and let the nation's financial markets direct the course of interest rates.

But, during the first quarter of 1997, the Fed again became concerned that increased inflationary pressures were building up within the U.S. economic system. For example, the national economy was growing at a faster inflation-adjusted rate in the 1997 first quarter than was experienced in the first quarter of 1987—the year of the major equity market crash which later occurred during October of that year. As a result, the Fed chose to raise the target federal funds rate on March 25, 1997. The March 1997 interest rate increase directed by the Fed was followed by almost a year and a half of the central bank returning to the sidelines and observing the important relationship between the rate of inflation and real economic growth.

Then, during the Fall months of 1998, unfavorable international pressures from Brazil and Russia, among others, caused the commercial lending system to pull in the reins. This put financing strains on corporate America. Fearing a widening international economic slowdown, the Fed engineered a quick sequence of three more interest rate decreases that ended on November 17, 1998, aimed at stabilizing both the credit and equity markets. By the way, this maneuvering by the central bank in 1998 did, in fact, work.

Once again, commencing on June 30, 1999, the Fed became concerned about the relationship among (1) tight labor markets; (2) strong aggregate real economic growth, usually monitored by rates of change in real gross domestic product (GDP); and (3) the rate of observed inflation as well as inflationary expectations. During this phase of the business cycle, the Fed chose to increase short-term interest rates on six different occasions over the period ended May 16, 2000.

Realize that at this stage of the business cycle the U.S. economy was in uncharted territory, as the remarkable economic expansion that began in March 1991 entered its tenth year at the close of the 2000 first quarter. Such good performance within the aggregate domestic economy stood out, as it marked the longest, uninterrupted period of expansion in the United States, dating back to 1854 when reliable records began to be maintained. Thus, the Fed continued its vigilant monitoring stance by putting upward pressure on short-term interest rates in the hopes of meeting its twin objectives of supporting (1) maximum sustainable employment and (2) price stability. The "good times" began to be stressed during the summer of 2000. A wide-ranging series of events that included (1) a contracting manufacturing sector, (2) slower business investment in plant and equipment, (3) an equity market sell-off that made the term "dot-com" a less-than-desirable word, and (4) a build-up of business inventories notably suggested that the United States was poised to enter the tenth recession since the end of World War II.

So, on January 3, 2001, the Fed began a concerted drive that lasted across all of that year to stimulate the domestic economy by driving interest rates lower and reducing the cost of capital funds to businesses. In the midst of these record 11 interest-rate cuts, the United States officially slipped into recession in March of 2001. Thus, the record-setting U.S. commercial expansion ended at a duration of 120 months, outpacing the 106-month expansion from February 1961 into December 1969.

The implications for business financial officers and other corporate decision makers are important. The 32 monetary policy actions and resultant interest rate changes discussed here are displayed in the accompanying table.

From a financial management viewpoint, the 14 overt actions by the Fed to raise rates caused the *opportunity cost of funds* to rise. This means that firms like Harley-Davidson and the Walt Disney Company, for example, endured increases in their respective cost of capital funds.

This, in turn, made it more difficult for real capital projects to be financed and be included in those firms' capital budgets.

**Changes in the Target Federal Funds Rate and Commercial Bank Prime Lending Rate
February 1994–December 2002**

DATE	OLD TARGET RATE %	NEW TARGET RATE %	PRIME LENDING RATE %
1994			
February 4	3.00	3.25	6.00 (no change)
March 22	3.25	3.50	6.25
April 18	3.50	3.75	6.75
May 17	3.75	4.25	7.25
August 16	4.25	4.75	7.75
November 19	4.75	5.50	8.50
1995			
February 1	5.50	6.00	9.00
July 6	6.00	5.75	8.75
December 19	5.75	5.50	8.50
1996			
January 31	5.50	5.25	8.25
1997			
March 25	5.25	5.50	8.50
1998			
September 29	5.50	5.25	8.25
October 15	5.25	5.00	8.00
November 17	5.00	4.75	7.75
1999			
June 30	4.75	5.00	8.00
August 24	5.00	5.25	8.25
November 16	5.25	5.50	8.50
2000			
February 2	5.50	5.75	8.75
March 21	5.75	6.00	9.00
May 16	6.00	6.50	9.50
2001			
January 3	6.50	6.00	9.00
January 31	6.00	5.50	8.50
March 20	5.50	5.00	8.00
April 18	5.00	4.50	7.50
May 15	4.50	4.00	7.00
June 27	4.00	3.75	6.75
August 21	3.75	3.50	6.50

(continued)

DATE	OLD TARGET RATE %	NEW TARGET RATE %	PRIME LENDING RATE %
2001			
September 17	3.50	3.00	6.00
October 2	3.00	2.50	5.50
November 6	2.50	2.00	5.00
December 11	2.00	1.75	4.75
2002			
November 6	1.75	1.25	4.25



Do you need current interest rate data? Just go to www.federalreserve.gov/ and you will be at the Federal Reserve Board's Web site. Once you get there, click on "Research and Data" then examine the H.15 report called "Selected Interest Rates." This provides you with a long-term perspective on interest rate levels in the United States for a wide variety of instruments.

The 18 decisions to lower the target federal funds rate had the exact opposite effect (i.e., the given firm's cost of capital funds decreased). In this latter case, the company can take on more capital projects.

Also note in the far right column of the table that the commercial bank prime lending rate typically changes in the same direction and at about the same time that a shift in the federal funds rate occurs. The prime lending rate is the interest rate that banks charge their *most* creditworthy customers. Thus, the transmission of the central bank's policy move to the explicit cost of funds that the firm faces in the financial markets happens quickly. The commercial banking industry helps it along.

As you read this chapter you will learn about (1) the importance of financial markets to a developed economy and (2) how funds are raised in the financial markets. This will help you, as an emerging business executive specializing in accounting, finance, marketing, or strategy, understand the basics of acquiring financial capital in the funds marketplace.

Objective 1

THE FINANCIAL MANAGER, INTERNAL AND EXTERNAL FUNDS, AND FLEXIBILITY

At times, internally generated funds will not be sufficient to finance all of the firm's proposed expenditures. In these situations, the corporation may find it necessary to attract large amounts of financial capital externally or otherwise forgo projects that are forecast to be profitable.¹ Year in and year out, business firms in the nonfinancial corporate sector of the U.S. economy rely heavily on the nation's financial market system to raise cash.

Table 14-1 displays the relative internal and external sources of funds for such corporations over the 1981 to 2000 period. Notice that the percentage of external funds raised in any given year can vary substantially from that of other years. In 1982, for example, the nonfinancial business sector raised 25.4 percent of its funds in the financial markets. This was substantially less than the 39.4 percent raised externally only one year earlier, during 1981. After that, the same type of significant adjustment made by financial managers is evident. During 1988, we see that nonfinancial firms raised 36.3 percent of new funds in the external markets. By the end of 1991, this proportion dropped drastically to 9.7 percent.

Such adjustments illustrate an important point: Financial executives are perpetually on their toes regarding market conditions and the state of the overall economy. Changes in market conditions influence the precise way corporate funds will be raised.

¹ By *externally generated*, we mean that the funds are obtained by means other than through retentions or depreciation. Funds from these latter two sources are commonly called *internally generated funds*.

TABLE 14-1 Nonfinancial Corporate Business Sources of Funds: 1981–2000

YEAR	TOTAL SOURCES (\$ BILLIONS)	PERCENT INTERNAL FUNDS	PERCENT EXTERNAL FUNDS
2000	1,166.9	68.1	31.9
1999	1,200.1	62.5	37.5
1998	899.8	79.4	20.6
1997	967.6	75.6	24.4
1996	812.0	83.4	16.6
1995	878.4	70.7	29.3
1994	733.7	77.3	22.7
1993	593.1	81.6	18.4
1992	560.5	78.2	21.8
1991	471.7	90.3	9.7
1990	535.5	76.9	23.1
1989	567.9	70.4	29.6
1988	634.2	63.7	36.3
1987	564.7	66.6	33.4
1986	538.8	62.5	37.5
1985	493.8	71.3	28.7
1984	511.4	65.8	34.2
1983	444.6	65.7	34.3
1982	331.7	74.6	25.4
1981	394.4	60.6	39.4
Mean	—	72.3	27.7

Sources: *Economic Report of the President*, February 1995, p. 384; *Federal Reserve Bulletin*, June 2000, Table 1.57; and *Flow of Funds Accounts of the U.S.*, First Quarter 2000, Table F. 102, and Third Quarter 2001, Table F. 102.

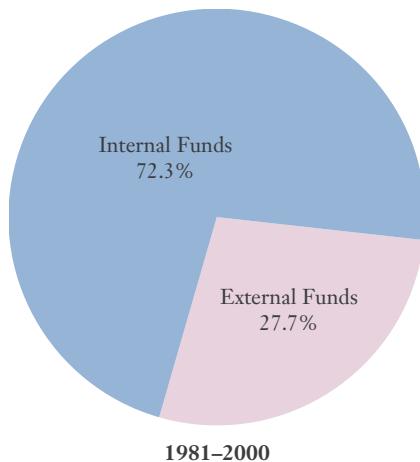
High relative interest rates, for instance, will deter use of debt instruments by the financial manager.

The financial market system must be both organized and resilient. Periods of economic recession test the financial markets and those firms that continually use the markets. Economic contractions are especially challenging to financial decision makers because all recessions are unique. This forces financing policies to become unique.

During the 1981 to 1982 recession, which lasted 16 months, interest rates remained high by historic standards during the worst phases of the downturn. This occurred because policy makers at the Fed decided to wring a high rate of inflation out of the economy by means of a tight monetary policy. Simultaneously, stock prices were depressed. These business conditions induced firms to forgo raising funds via external means. During 1982, 74.6 percent of corporate funds were generated internally (see Table 14-1). The same general pattern followed after the 1990 to 1991 recession ended in the first quarter of 1991. During 1991, businesses paid down their short-term borrowing and relied on internally generated sources for 90.3 percent of their net financing needs.

Corporate profitability also plays a role in the determination of the internal-external financing choice. In March 2000, the U.S. economy began the tenth year of economic expansion that ended during March 2001. The good economy translated into good corporate profits. Other things held equal, greater profits reduce the need for external financing. For example, in 1998 the reliance of firms on external finance dropped to 20.6 percent of their total funds sources. Whereas, when profits were more strained over the 1981 to 1984 period, financial managers relied more heavily on the market system for an average of 33 percent of their total funds needed.

The collective behavior of companies that results in firms retaining internally generated cash rather than paying it to stockholders as dividends or to creditors (bondholders)

FIGURE 14-1 Non-Financial Corporate Business Sources of Funds 1981–2000

as interest is referred to by financial economists and analysts as the *internal capital market*.² This is because the firm allocates the cash flows to new projects. However, if the cash payments were made directly to stockholders and creditors, the funds would ultimately be allocated to new projects through the external capital markets.

As Figure 14-1 shows, the internal capital market accounted for 72.3 percent of non-financial corporations' sources of funds over the 1981–2000 period. Changing economic conditions will cause this relationship to shift persistently because financial executives will continually adjust to the new information that encompasses the business cycle, interest rates, and stock prices.

The point here is an important one for the executive: As economic activity and policy shape the environment of the financial markets, financial managers must understand the meaning of the economic ups and downs and remain flexible in their decision-making processes. Remaining excessively rigid leads to financing mistakes. Those mistakes will generate costs that are ultimately borne by the firm's stockholders.

CONCEPT CHECK

1. What distinguishes the internal capital market from the external capital market?
2. What important factor(s) might affect a firm's internal-external financing choice?

Objective 2

THE MIX OF CORPORATE SECURITIES SOLD IN THE CAPITAL MARKET

When corporations decide to raise cash in the capital market, what type of financing vehicle is most favored? Many individual investors think that common stock is the answer to this question. This is understandable, given the coverage of the level of common stock

² A lengthier discussion on the relationship of the internal capital market to the external capital market is found in M. Berlin, "Jack of All Trades? Product Diversification in Nonfinancial Firms," *Business Review*, Federal Reserve Bank of Philadelphia (May–June 1999), pp. 19, 23.

TABLE 14-2 Corporate Securities Offered for Cash—Nonfinancial Corporations, Three-Year Cash Weighted Average, 1999–2001

TOTAL VOLUME (\$ MILLIONS)	PERCENT EQUITIES	PERCENT BONDS AND NOTES
\$1,326,850	23.1	76.9

Source: *Federal Reserve Bulletin*, Table 1.46, February 2003, A29.

prices by the popular news media. All of the major television networks, for instance, quote the closing price of the Dow Jones Industrial Average on their nightly news broadcasts. Common stock, though, is not the financing method relied on most heavily by corporations. The answer to this question is *corporate bonds*. *The corporate debt markets clearly dominate the corporate equity markets when new funds are being raised.* This is a long-term relationship—it occurs year after year. Table 14-2 highlights this fact for the recent time period of 1999 to 2001.

In Table 14-2, we see the annual average volume (in millions of dollars) of corporate securities sold for cash over the 1999 to 2001 period. The percentage breakdown between equities (both common and preferred stocks) and bonds and notes (corporate debt) is also displayed. Notice that debt-type instruments represented a full 76.9 percent of the annual average dollar amount offered to investors by nonfinancial corporations over this three-year time frame. Equities, therefore, represented the other 23.1 percent. We learned from our discussions of the cost of capital and planning the firm's financing mix that the U.S. tax system inherently favors debt as a means of raising capital. Quite simply, interest expense is deductible from other income when computing the firm's federal tax liability, whereas the dividends paid on both preferred and common stock are not.

Financial executives responsible for raising corporate cash know this. When they have a choice between marketing new bonds and marketing new preferred stock, the outcome is usually in favor of bonds. The after-tax cost of capital on the debt is less than that incurred on preferred stock. Likewise, if the firm has unused debt capacity and the general level of equity prices is depressed, financial executives favor the issuance of debt securities over the issuance of new common stock.

CONCEPT CHECK

1. Why might firms prefer to issue new debt securities rather than new common stock?
2. How does the U.S. tax system affect a firm's financing choices?

WHY FINANCIAL MARKETS EXIST

Financial markets are institutions and procedures that facilitate transactions in all types of financial claims. The purchase of your home, the common stock you may own, and your life insurance policy all took place in some type of financial market. Why do financial markets exist? What would the economy lose if our complex system of financial markets were not developed? We will address these questions here.

Some *economic units*, such as households, firms, or governments, spend more during a given period than they earn. Other economic units spend less on current consumption than they earn. For example, business firms in the aggregate usually spend more during a specific period than they earn. Households in the aggregate spend less on current consumption

Objective 3

Financial markets

Those institutions and procedures that facilitate transactions in all types of financial claims (securities).

than they earn. As a result, some mechanism is needed to facilitate the transfer of savings from those economic units with a surplus to those with a deficit. That is precisely the function of financial markets. Financial markets exist in order to allocate the supply of savings in the economy to the demanders of those savings. The central characteristic of a financial market is that it acts as the vehicle through which the forces of demand and supply for a specific type of financial claim (such as a corporate bond) are brought together.

BACK TO THE PRINCIPLES

In this chapter, we cover material that introduces the financial manager to the process involved in raising funds in the nation's capital markets and also rely on the logic that lies behind the determination of interest rates and required rates of return in those capital markets.

We will see that the United States has a highly developed, complex, and competitive system of financial markets that allows for the quick transfer of savings from those economic units with a surplus of savings to those economic units with a savings deficit. Such a system of highly developed financial markets allows great ideas (such as the personal computer) to be financed and increases the overall wealth of the economy. Consider your wealth, for example, compared to that of the average family in Russia. Russia lacks a complex system of financial markets to facilitate transactions in financial claims (securities). As a result, real capital formation there has suffered.

Thus, we return now to Principle 6: Efficient Capital Markets—The markets are quick and the prices are right. Financial managers like our system of capital markets because they trust it. This trust stems from the fact that the markets are "efficient." Managers trust prices in the securities markets because those prices quickly and accurately reflect all available information about the value of the underlying securities. This means that expected risks and expected cash flows matter more to market participants than do simpler things such as accounting changes and the sequence of past price changes in a specific security. With security prices and returns (such as interest rates) competitively determined, more financial managers (rather than fewer) participate in the markets and help ensure the basic concept of efficiency.

Now, why would the economy suffer without a developed financial market system? The answer is that the wealth of the economy would be less without the financial markets. The rate of capital formation would not be as high if financial markets did not exist. This means that the net additions during a specific period to the stocks of (1) dwellings, (2) productive plant and equipment, (3) inventory, and (4) consumer durables would occur at lower rates. Figure 14-2 helps clarify the rationale behind this assertion. The abbreviated balance sheets in the figure refer to firms or any other type of economic units that operate in the private as opposed to governmental sectors of the economy. This means that such units cannot issue money to finance their own activities.

Real assets

Tangible assets such as houses, equipment, and inventories.

Financial assets

Claims for future payment by one economic unit on another.

At stage 1 in Figure 14-2, only real assets exist in the hypothetical economy. **Real assets** are tangible assets, such as houses, equipment, and inventories. They are distinguished from **financial assets**, which represent claims for future payment on other economic units. Common and preferred stocks, bonds, bills, and notes all are types of financial assets. If only real assets exist, then savings for a given economic unit, such as a firm, must be accumulated in the form of real assets. If the firm has a great idea for a new product, that new product can be developed, produced, and distributed only out of company savings (retained earnings). Furthermore, all investment in the new product must occur simultaneously as the savings are generated. If you have the idea, and we have the savings, there is no mechanism to transfer our savings to you. This is not a good situation.

FIGURE 14-2 Development of a Financial Market System

Balance Sheet	
Stage 1:	Real assets Net worth
Total = Total	
Balance Sheet	
Stage 2:	Cash Net worth Real assets
Total = Total	
Balance Sheet	
Stage 3:	Cash Financial liabilities Other financial assets Net worth Real assets
Total = Total	
Stage 4:	The addition of (1) loan brokers, (2) security underwriters, and (3) secondary markets
Stage 5:	The addition of financial intermediaries

At stage 2, paper money (cash) comes into existence in the economy. Here, at least, you can *store* your own savings in the form of money.

Thus, you can finance your great idea by drawing down your cash balances. This is an improvement over stage 1, but there is still no effective mechanism to transfer our savings to you. You see, we will not just hand you our dollar bills. We will want a receipt.

The concept of a receipt that represents the transfer of savings from one economic unit to another is a monumental advancement. The economic unit with excess savings can lend the savings to an economic unit that needs them. To the lending unit, these receipts are identified as “other financial assets” in stage 3 of Figure 14-2. To the borrowing unit, the issuance of financial claims (receipts) shows up as “financial liabilities” on the stage 3 balance sheet. The economic unit with surplus savings will earn a rate of return on those funds. The borrowing unit will pay that rate of return, but it has been able to finance its great idea.

In stage 4, the financial market system moves further toward full development. Loan brokers come into existence. These brokers help locate pockets of excess savings and channel such savings to economic units needing the funds. Some economic units will actually purchase the financial claims of borrowing units and sell them at a higher price to other investors; this process is called **underwriting**. Underwriting is discussed in more detail later in this chapter. In addition, **secondary markets** develop. Secondary markets simply represent trading existing financial claims. If you buy your brother’s General Motors common stock, you have made a secondary market transaction. Secondary markets reduce the risk of investing in financial claims. Should you need cash, you can liquidate your claims in the secondary market. This induces savers to invest in securities.

The progression toward a developed and complex system of financial markets ends with stage 5. Here, financial intermediaries come into existence. You can think of financial intermediaries as the major financial institutions with which you are used to dealing.

Underwriting

The purchase and subsequent resale of a new security issue. The risk of selling the new issue at a profitable price is assumed (underwritten) by an investment banker.

Secondary markets

Transactions in currently outstanding securities.

Indirect securities

The unique financial claims issued by financial intermediaries. Mutual fund shares are an example.

Direct securities

The pure financial claims issued by economic units to savers. These can later be transformed into indirect securities.

These include commercial banks, savings and loan associations, credit unions, life insurance companies, and mutual funds. Financial intermediaries share a common characteristic: They offer their own financial claims, called **indirect securities**, to economic units with excess savings. The proceeds from selling their indirect securities are then used to purchase the financial claims of other economic units. These latter claims can be called **direct securities**. Thus, a mutual fund might sell mutual fund shares (its indirect security) and purchase the common stocks (direct securities) of some major corporations. A life insurance company sells life insurance policies and purchases huge quantities of corporate bonds. Financial intermediaries thereby involve many small savers in the process of capital formation. This means there are more “good things” for everybody to buy.

A developed financial market system provides for a greater level of wealth in the economy. In the absence of financial markets, savings are not transferred to the economic units most in need of those funds. It is difficult, after all, for a household to build its own automobile. The financial market system makes it *easier* for the economy to build automobiles and all the other goods that economic units like to accumulate.

CONCEPT CHECK

1. What are financial markets?
2. Why will an economy suffer without a developed financial market system?
3. What distinguishes a real asset from a financial asset?
4. Can you distinguish between direct securities and indirect securities?

Objective 4**FINANCING OF BUSINESS: THE MOVEMENT
OF FUNDS THROUGH THE ECONOMY**

We now understand the crucial role that financial markets play in a capitalist economy. At this point, we will take a brief look at how funds flow across some selected sectors of the U.S. economy. In addition, we will focus a little more closely on the process of financial intermediation that was introduced in the preceding section. Some actual data are used to sharpen our knowledge of the financing process. We will see that financial institutions play a major role in bridging the gap between savers and borrowers in the economy. Nonfinancial corporations, we already know, are significant borrowers of financial capital.

THE FINANCING PROCESS

Table 14–3 shows how funds were supplied and raised by the major sectors of the U.S. economy over the five-year period from 1995 through 1999. The dollar amounts (in billions) are annual averages over those five years. We will specifically make comments on three of the five sectors identified in the table.

Households' net increase in financial liabilities exceeded their net increase in financial assets to the extent of \$50.3 billion, as shown in the right-hand column of the table. In the jargon of economics, the household sector was a *savings-deficit* sector over this period.

This financing behavior was unusual because the household sector over long periods of time is typically a major *savings-surplus* sector. This means the household sector normally is a key net supplier of funds to the financial markets. Actually, and for example, over the six-year period of 1991 through 1996, the household sector supplied an

TABLE 14-3 Sector View of Flow of Funds in U.S. Financial Markets for 1995–1999

SECTOR	[1] FUNDS RAISED \$ BILLIONS	[2] FUNDS SUPPLIED \$ BILLIONS	[2] – [1] NET FUNDS SUPPLIED \$ BILLIONS
Households ^a	447.4	397.1	–50.3
Nonfinancial corporate business	447.5	383.8	–63.7
U.S. government	73.9	62.9	–11.0
State and local governments	56.4	48.4	–8.0
Foreign	320.2	561.7	241.5

(Billions of Dollars, 5-Year Averages)

^aIncludes personal trusts and nonprofit organizations.Source: *Flow of Funds Accounts, First Quarter 2000, Flow of Funds Section, Statistical Release Z.1* (Washington, DC: Board of Governors of the Federal Reserve System, June 9, 2000).

annual average of \$170.0 billion to the markets. Since 1991, the household sector has been a savings-surplus sector for all years except the recent three covering the period 1997 through 1999. So why were those three years any different? We can see and understand the difference merely by looking at data from 1999. Because of prevailing low interest rates in the U.S. credit markets, households took on a huge \$411.0 billion in mortgages to finance home purchases. The result made the household sector a net user of financial capital in that year, and similar financing behavior was followed in the previous two years.

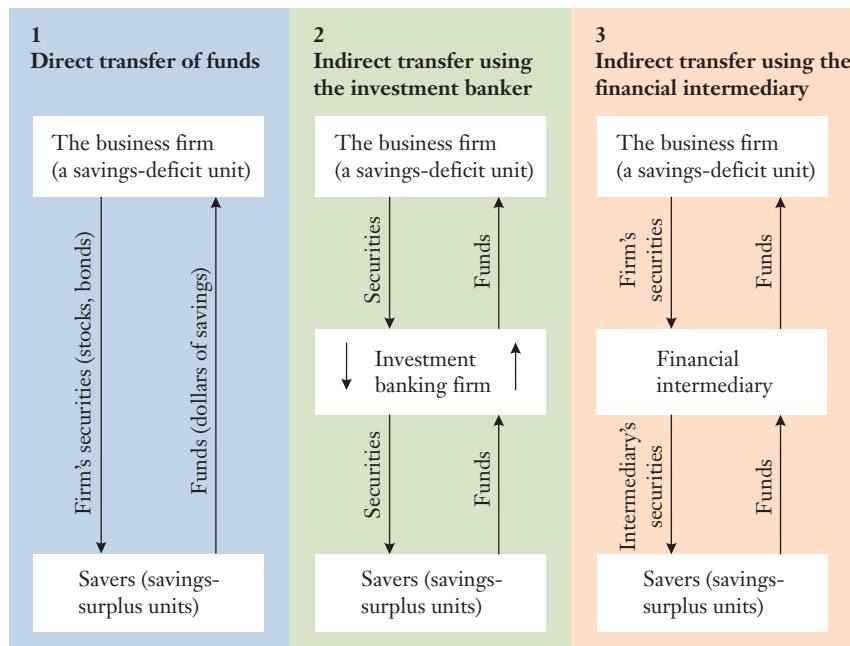
Notice that over the subject five years, as detailed in Table 14-3, the nonfinancial business sector was likewise a savings-deficit sector to the net extent of \$63.7 billion on average for each year. This means nonfinancial firms, such as General Motors, raised \$63.7 billion more in the financial markets than they supplied to the markets. While the nonfinancial business sector often is a savings-deficit sector, it can at times be a savings-surplus sector depending on aggregate economic conditions. The most important of those conditions is the level of corporate profitability.

Table 14-3 further highlights how important foreign financial investment is to the activity of the U.S. economy. On average, the foreign sector supplied a net \$241.5 billion to the domestic capital markets for each year of the 1995 through 1999 period. Thus, it was a crucial *savings-surplus* sector. Back in 1982, the foreign sector raised—rather than supplied—\$29.9 billion in the U.S. financial markets! This illustrates the dynamic nature of financial management and why financial-management practitioners have to be in tune with current business conditions. Actual capital-budgeting decisions, like those explored in earlier chapters, are made in the corporate board room—not within the rather sterile confines of an end-of-chapter problem.

We have seen here that the financial market system must exist to facilitate the orderly and efficient flow of savings from the surplus sectors to the deficit sectors of the economy. Over long periods, the nonfinancial business sector is typically dependent on the household sector to finance its investment needs. In addition, foreign financing plays an important role in the U.S. economy.

MOVEMENT OF SAVINGS

Figure 14-3 provides a useful way to summarize our discussion of (1) why financial markets exist and (2) the movement of funds through the economy. It also serves as an introduction to the role of the investment banker—a subject discussed in detail later in this chapter.

FIGURE 14-3 Three Ways to Transfer Financial Capital in the Economy

We see that savings are ultimately transferred to the business firm in need of cash in three ways:

- 1. The direct transfer of funds.** Here the firm seeking cash sells its securities directly to savers (investors) who are willing to purchase them in hopes of earning a reasonable rate of return. New business formation is a good example of this process at work. The new business may go directly to a saver or group of savers called *venture capitalists*. The venture capitalists will lend funds to the firm or take an equity position in the firm if they feel the product or service the new firm hopes to market will be successful.
- 2. Indirect transfer using the investment banker.** In a common arrangement under this system, the managing investment banking house will form a syndicate of several investment bankers. The syndicate will buy the entire issue of securities from the firm that is in need of financial capital. The syndicate will then sell the securities at a higher price to the investing public (the savers) than it paid for them. Merrill Lynch Capital Markets and Goldman Sachs are examples of investment banking firms. They tend to be called “houses” by those who work in the financial community. Notice that under this second method of transferring savings, the securities being issued just pass through the investment banking firm. They are not transformed into a different type of security.
- 3. Indirect transfer using the financial intermediary.** This is the type of system life insurance companies and pension funds operate within. The financial intermediary collects the savings of individuals and issues its own (indirect) securities in exchange for these savings. The intermediary then uses the funds collected from the individual savers to acquire the business firm’s (direct) securities, such as stocks and bonds.

We all benefit from the three transfer mechanisms displayed in Figure 14-3. Capital formation and economic wealth are greater than they would be in the absence of this financial market system.

CONCEPT CHECK

1. What is the difference between a savings-surplus sector and a savings-deficit sector? Give an example of each.
2. Why cannot all sectors be savings-deficit sectors?

COMPONENTS OF THE U.S. FINANCIAL MARKET SYSTEM**Objective 5**

Numerous approaches exist for classifying the securities markets. At times, the array can be confusing. An examination of four sets of dichotomous terms can help provide a basic understanding of the structure of the U.S. financial markets.

PUBLIC OFFERINGS AND PRIVATE PLACEMENTS

When a corporation decides to raise external capital, those funds can be obtained by making a public offering or a private placement. In a **public offering**, both individual and institutional investors have the opportunity to purchase the securities. The securities are usually made available to the public at large by a managing investment banking firm and its underwriting (risk-taking) syndicate. The firm does not meet the ultimate purchasers of the securities in the public offering. The public market is an impersonal market.

In a **private placement**, also called a **direct placement**, the securities are offered and sold to a limited number of investors. The firm will usually hammer out, on a face-to-face basis with the prospective buyers, the details of the offering. In this setting, the investment banking firm may act as a finder by bringing together potential lenders and borrowers. The private placement market is a more personal market than its public counterpart. We will now relate the private placement market to the need by firms for venture capital.

THE PRIVATE PLACEMENT MARKET AND VENTURE CAPITAL Private placements can be separated logically into two forms: (1) the organized private equity market and (2) the organized private debt market. Both of these markets are actively participated in by venture capitalists. Because issuing public equity or debt is not workable for new, small, or even most medium-sized firms, these younger business units seek out the financial capital of firms that specialize in rather risky company investments—the so-called venture capitalists.

The unseasoned firm finds that its need for financial capital is not appealing to the broader public markets owing to: (1) small absolute size, (2) a very limited or no historical track record of operating results, and (3) obscure growth prospects.³ Thus, the venture capitalist who is willing to accept such risks jumps into these more cloudy markets in hopes of a greater return (reward). This economic logic should remind you of **Principle 1: The Risk-Return Trade-Off—We won't take on additional risk unless we expect to be compensated with additional return.**

On the equity investment side, the venture capitalist firm will frequently acquire a meaningful dollar stake in the start-up firm. In exchange for this risk-taking, the venture capital firm will occupy a seat or seats on the young firm's board of directors and will take an active part in monitoring management activities, strategies, and

Public offering

A security offering where all investors have the opportunity to acquire a portion of the financial claims being sold.

**Private placement
(direct placement)**

A security offering limited to a small number of potential investors.

³ A useful discussion on financing challenges to younger firms is provided by Stephen Prowse, "Equity Capital and Entrepreneurs," in *Equity for Rural America: From Wall Street to Main Street*, Federal Reserve Bank of Kansas City, August 1999, pp. 10–26.

TABLE 14-4 Why Major Companies Participate in the Organized Private Equity Market

QUESTION	
If you have made equity investments in other companies during the previous year, what were your objectives?	
RESPONSES	PERCENT
1. Capital appreciation	34.2
2. Strategic alliance	76.3
3. An alternative/precursor to outright acquisition	15.8
4. To outsource research and development	21.1
5. To boost exposure to the Internet/technology	23.7
6. To acquire a minority stake as part of a separate acquisition or as consideration in another deal	10.5

capital-budgeting decisions. Other private equity investors with less financial capital committed to the venture will be given “observational rights” (as distinct from voting rights) at regular meetings of the board. This tendency reminds you of **Principle 7: The Agency Problem—Managers won’t work for owners unless it’s in their best interest.**

The private equity market is not the sole province of pure venture capital firms. Numerous established and well-known companies such as Microsoft, Intel, and Xerox have for years taken “minority investment positions” in emerging corporations or have created their own separate venture capital subsidiaries. The subsidiary approach has two major benefits to the seasoned company: (1) An incentive is created for human capital to remain with the firm, and (2) great ideas are retained as intellectual capital rather than departing as the basis for a start-up operation.

The other side of the subsidiary approach is for the seasoned company to acquire a minority equity interest in an emerging firm. This choice allows the established corporation to use the private equity market and gain access to new technology by investing directly in start-up organizations rather than taking the risks associated with internal research and development.

Along these lines, a survey of 1,600 Chief Financial Officers published in August 2000 reported that a whopping 76.3 percent of the responding CFOs said that the main objective of taking an equity position in another firm was to create some form of a strategic alliance.⁴ Other reasons for participating in the private equity market through minority investments are displayed in Table 14-4.

So we see that investment in young firms does not just come from venture capital companies; numerous established corporations use the private equity market to help fund start-up firms.

In recent years, the dollar volume of financing activity in the private equity market has benefited enormously from the rapid growth of the venture capital industry. We know that the U.S. economy emerged from the ninth recession since the end of World War II during March 1991. Table 14-5 displays the peaks and troughs of the last 10 U.S. business cycles. That roughly dates the beginning of the hot growth pattern of pure (dedicated) U.S. venture capital firms.⁵

⁴ CFO Forum, “The New R&D: Corporations Are Making More Minority Investments in Strategic Partners,” *Institutional Investor*, August 2000, p. 34.

⁵ Additional information and data on venture capital are available from the National Venture Capital Association and Venture Economics. Their Internet sites are www.nvca.org and www.ventureeconomics.com, respectively.

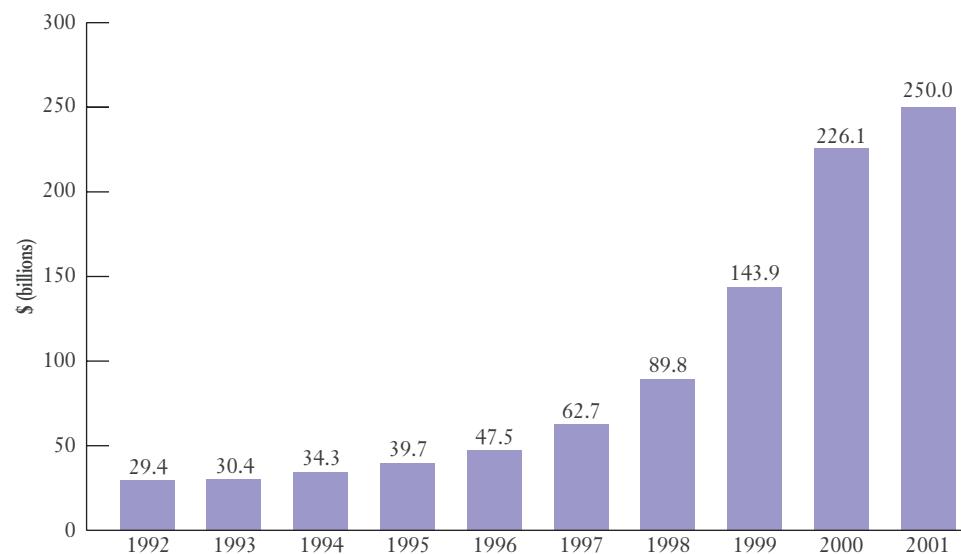
TABLE 14-5 Post-World War II U.S. Business Cycle Contractions

START OF RECESSION (PEAKS)	END (TROUGHS)	LENGTH (MONTHS)
November 1948	October 1949	11
July 1953	May 1954	10
August 1957	April 1958	8
April 1960	February 1961	10
December 1969	November 1970	11
November 1973	March 1975	16
January 1980	July 1980	6
July 1981	November 1982	16
July 1990	March 1991	8
March 2001	Not yet dated	—

Source: National Bureau of Economic Research. See www.nber.org/cycles.html. Reprinted by permission of The National Bureau of Economic Research.

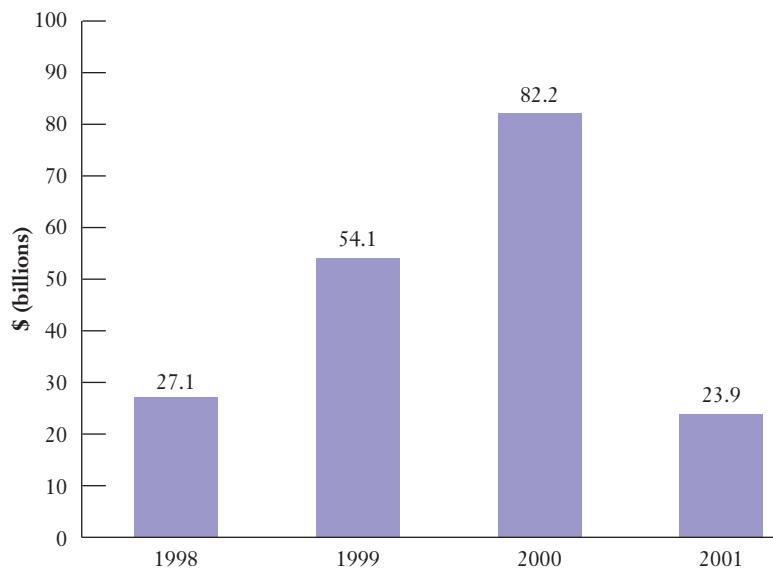
Notice in Figure 14-4 that U.S.-based venture capital companies had \$250.0 billion of financial capital under management at the end of 2001. Also observe that, back in 1992, the amount under management was a significantly lesser \$29.4 billion. Uninterrupted domestic economic growth provides a stable environment for venture capital activities, whether it be on the investment side by the venture capital fund, or on the operations side by the start-up firm with the great idea that needs financing.

But, when domestic growth slows, *additional* investments by venture capital firms also abate. A glance at Figure 14-5 in conjunction with Table 14-5 bears this out. As Table 14-5 shows, the tenth post-World War II recession began in March 2001. As recently as June 18, 2003, the end of this downturn had not been “dated” by the National Bureau of Economic Research (NBER). The NBER has an official group known as the “Business Cycle Dating Committee” that puts the fine points on the

FIGURE 14-4 Venture Capital Under Management

Source: *National Venture Capital Association, 2002 Yearbook*, p.17.

FIGURE 14-5 Changes in Financial Capital under Management from Previous Year (\$ Billions)



Source: Raw data from *National Venture Capital Association 2002 Yearbook*, p. 17. Calculations by author.

peaks and troughs of the U.S. business cycle.⁶ There is a group with which you want to go to Friday evening “happy hour.”

We see from Figure 14-5 that the propensity of venture capital firms to commit new funds to projects (such as firms in their portfolios) slowed drastically in 2001—the year the last recession officially began. Specifically, only \$23.9 billion of additional financial capital was committed to management in 2001 versus a much more robust \$82.2 billion in the previous year of 2000. The financial executive in the venture capital industry is directly impacted by the stage of the U.S. business cycle. The private equity market will rebound as the U.S. economy rebounds.⁷ See the An Entrepreneur’s Perspective box, “Financing the Deal: The Venture Capitalist’s Approach.”

PRIMARY MARKETS AND SECONDARY MARKETS

Primary markets

Transactions in securities offered for the first time to potential investors.

Primary markets are those in which securities are offered for the *first* time to potential investors. A new issue of common stock by AT&T is a primary market transaction. This type of transaction increases the total stock of financial assets outstanding in the economy.

As mentioned in our discussion of the development of the financial market system, *secondary markets* represent transactions in currently outstanding securities. If the first buyer of the AT&T stock subsequently sells it, he or she does so in the secondary market. All transactions after the initial purchase take place in the secondary market. The sales do *not* affect the total stock of financial assets that exist in the economy. Both the money market and the capital market, described next, have primary and secondary sides.

⁶ On June 18, 2003, concerning the recession that commenced in March 2001, the NBER said: “According to the most recent data, the U.S. economy continues to experience growth in income and output but employment continues to decline. Because of the divergent behavior of various indicators, the NBER’s Business Cycle Dating Committee believes that additional time is needed before interpreting the movements of the economy over the past two years.” See www.nber.org/cycles/recessions.pdf.

⁷ A short and useful volume published by the American Enterprise Institute provides a quick introduction to venture capital funds and the private equity market. See C. Beltz, ed. *Financing Entrepreneurs* (Washington, D.C.: AEI Press, 1994).

AN ENTREPRENEUR'S PERSPECTIVE

FINANCING THE DEAL: THE VENTURE CAPITALIST'S APPROACH

High-potential ventures typically grow at rates that cannot be financed by the entrepreneur alone. At some point, outside money must be brought in to help finance the firm. At that time, the entrepreneur enters the “private equity markets” for money, which for early stage capital may come from formal venture capital or business angels.

If a prospective investor comes to believe a venture is a good opportunity, then the negotiation process begins. The primary concern becomes how the two parties—the investor and the entrepreneur—will share the future cash flows, *if they occur*; and how they will share the risk of the venture. Each party, of course, wants to receive more of the cash (i.e., have a larger percentage ownership of the firm) and to assume less of the risk. A good deal is one where both parties feel good about how the cash and risk are to be shared—a win-win deal.

The investor's ownership share in a firm and the eventual cash flows that hopefully will be received are driven by an investor's required rate of return. The investor's required rate of return is affected by several factors: (1) the attractiveness or quality of the investment, (2) how the financing is structured, and (3) the stage of the investment. If an investment is particularly attractive, an investor is willing to accept a lower ownership percentage in the company for a given amount of investment. Secondly, we can structure the financing in ways that either increase or decrease the investor's risk exposure—and in turn affect the required rate of return. Finally, the stage of the investment drives the investor's required rate of return.

The investor's target internal rates of return (*IRRs*) for high-risk, high-potential ventures can be quite high. For instance, to invest in a start-up firm, investors might use a 75 percent target rate of return, or for a first stage firm, the target might be a 50 percent rate of return. However, investors know that it is totally unlikely that the investor will receive such high returns from all the investments, as some of the investments will be total losers. Thus, some of the other investments must produce really high returns in order to provide 25 to 30 percent rates of returns on the overall portfolio.

Valuing and Structuring the Deal: An Illustration

To illustrate the process of valuing and structuring a deal, consider an example of a firm, Bear, Inc., that you started last year. At that time, you invested \$1 million. Wanting to take the firm to the next level, you have approached a venture capitalist about making an additional \$2 million investment in the company.

The investor believes the opportunity is a good one and wants to own common equity in the company; thus, the question becomes what percentage of the stock will you own and how much will the investor own?

Given that Bear, Inc., is seeking first-stage financing, we expect the investor to have a required rate of return (discount rate) of 50 percent. For this rate of return and assuming that the investment will be for five years, the investor would need to receive \$15,187,500 when exiting the investment, computed as follows on a spreadsheet:

Investor's required rate of return	50%	Payments are zero because the investor will not receive any annual dividends.
Number of years (periods)	5	
Annual dividends (payments)	0	
Investment amount (present value)	\$2,000,000	
Solve for the investor's future value needed to earn a 50% rate of return		\$15,187,500

What is the likelihood that the investor will receive the \$15.2 million in five years? Well, it depends on the value of the firm as a whole at the end of the five years. If the firm has significant value, then the investor will receive a portion of that value. If it does not, then there will be little or no value to “harvest.”

Let's assume that if all goes as planned—which it never does—the company's total stockholder value will be \$35 million in five years. The venture capitalist needs to receive \$15,187,500 at that time in order to earn a 50 percent rate of return. Thus, the venture capitalist would need to own 43.39 percent of the firm's stock, computed as follows:

$$\begin{aligned} \text{venture capitalist's ownership percentage} &= \frac{\text{venture capitalist's equity value}}{\text{firm's equity value}} \\ &= \frac{\$15,187,500}{\$35,000,000} = 43.39\% \end{aligned}$$

Consequently, as the founder, you would own the remaining 56.61 percent of the common stock ($56.61\% = 100\% - 43.39\%$), which would entitle you to \$19,812,500, the portion of the \$35 million that remains after the venture capitalist is paid.

As the owner, you might think that the venture capitalist is being greedy to expect to take 43 percent of *your* company. Who does he think he is? So you “shop the deal” with other venture capitalists, and behold, you find out that they are “greedy” as well. You might try to “bootstrap” the financing by borrowing against your house or whatever it takes to get some of the needed money and then figure out ways to get by on less. But before you do, at least know what rate of return you will earn if the opportunity performs as projected. You invested \$1 million one year ago, which means that you will have invested for six years by the time the venture capitalist will have

(continued)

FINANCING THE DEAL: THE VENTURE CAPITALIST'S APPROACH (CONTINUED)

invested for five years. Given that you expect to receive \$19,812,500 in value five years from now (six years since you made the investment), your rate of return would be 64 percent, calculated as follows:

Number of years (periods)	6
Annual interest/dividends (payments)	—
Your original investment (present value)	\$(1,000,000)
Total future firm value	\$35,000,000
Venture capitalist's future equity value	<u>15,187,500</u>
Your future equity value	\$19,812,500
Your rate of return	64%

(Note: to 3 decimals this IRR = 64.496%)

This return is not bad, but you still may think that you should receive an even better return; after all, this was your idea and you have shed a lot of blood, sweat, and tears. However, you realize that you cannot capture the opportunity without the additional capital. Thus, you need to see if the financing can be structured in a way that the investor will accept a lower rate of return, which usually occurs by the owner assuming more of the risk. This is when the real negotiations begin.

MONEY MARKET AND CAPITAL MARKET

Money market

All institutions and procedures that facilitate transactions in short-term credit instruments.

The key distinguishing feature between the money and capital markets is the maturity period of the securities traded in them. The **money market** refers to all institutions and procedures that provide for transactions in short-term debt instruments generally issued by borrowers with very high credit ratings. By financial convention, *short-term* means maturity periods of one year or less. Notice that equity instruments, either common or preferred, are not traded in the money market. The major instruments issued and traded are U.S. Treasury bills, various federal agency securities, bankers' acceptances, negotiable certificates of deposit, and commercial paper. Keep in mind that the money market is an intangible market. You do not walk into a building on Wall Street that has the words "Money Market" etched in stone over its arches. Rather, the money market is primarily a telephone and computer market.

The **capital market** refers to all institutions and procedures that provide for transactions in long-term financial instruments. *Long-term* here means having maturity periods that extend beyond one year. In the broad sense, this encompasses term loans and financial leases, corporate equities, and bonds. The funds that comprise the firm's capital structure are raised in the capital market. Important elements of the capital market are the organized security exchanges and the over-the-counter markets.

ORGANIZED SECURITY EXCHANGES AND OVER-THE-COUNTER MARKETS

Organized security exchanges

Formal organizations involved in the trading of securities. They are tangible entities that conduct auction markets in listing securities.

Organized security exchanges are tangible entities; they physically occupy space (such as a building or part of a building), and financial instruments are traded on their premises. The **over-the-counter markets** include all security markets *except* the organized exchanges. The money market, then, is an over-the-counter market. Because both markets are important to financial officers concerned with raising *long-term capital*, some additional discussion is warranted.

ORGANIZED SECURITY EXCHANGES

For practical purposes there are seven major security exchanges in the United States. These are the (1) New York Stock Exchange, (2) American Stock Exchange, (3) Chicago Stock Exchange, (4) Pacific Stock Exchange, (5) Philadelphia Stock Exchange, (6) Boston

Stock Exchange, and (7) Cincinnati Stock Exchange. The New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) are called *national* exchanges, whereas the others are loosely described as *regionals*. All of these seven active exchanges are registered with the Securities and Exchange Commission (SEC). Firms whose securities are traded on the registered exchanges must comply with reporting requirements of both the specific exchange and the SEC.

An example of the prominent stature of the NYSE is provided by the sheer number of companies that have stocks listed on this exchange. In 2001, the NYSE handled such listings from 2,798 firms—up from 1,885 some 10 years earlier. This represented a 48.4 percent absolute increase in the number of firms listed over this period. Even though the NASDAQ, soon to be discussed, has surpassed the NYSE in trading volume, the NYSE remains the preeminent exchange in the United States. The collapse in market value of numerous high-tech and “dot.com” firms during the years of 2000 to 2001 just reinforced the importance of the NYSE to the general credibility of the U.S. financial market system. The total market value of shares listed on the NYSE in 2001 amounted to \$11.71 trillion, up from \$3.71 trillion in 1991.⁸ As a point of comparison, the nominal value of gross domestic product for the United States as of the 2001 fourth quarter was \$10.22 trillion.⁹

The business of an exchange, including securities transactions, is conducted by its *members*. Members are said to occupy “seats.” There are 1,366 seats on the NYSE, a number that has remained constant since 1953. Major brokerage firms own seats on the exchanges. An officer of the firm is designated to be the member of the exchange, and this membership permits the brokerage house to use the facilities of the exchange to effect trades. During 2002, the prices of seats that were exchanged for cash ranged from a low of \$2.0 million to a high of \$2.55 million.¹⁰ The high price in 1999 of \$2.65 million was an all-time high.

STOCK EXCHANGE BENEFITS

Both corporations and investors enjoy several benefits provided by the existence of organized security exchanges. These include

1. **Providing a continuous market.** This may be the most important function of an organized security exchange. A continuous market provides a series of continuous security prices. Price changes from trade to trade tend to be smaller than they would be in the absence of organized markets. The reasons are that there is a relatively large sales volume in each security, trading orders are executed quickly, and the range between the price asked for a security and the offered price tends to be narrow. The result is that price volatility is reduced.
2. **Establishing and publicizing fair security prices.** An organized exchange permits security prices to be set by competitive forces. They are not set by negotiations off the floor of the exchange, where one party might have a bargaining advantage. The bidding process flows from the supply and demand underlying each security. This means the specific price of a security is determined in the manner of an auction. In addition, the security prices determined at each exchange are widely publicized.
3. **Helping business raise new capital.** Because a continuous secondary market exists where prices are competitively determined, it is easier for firms to float new security offerings successfully. This continuous pricing mechanism also facilitates the determination of the offering price of a new issue. This means that comparative values are easily observed.

⁸ New York Stock Exchange, *Fact Book for the year 2001* (New York, April 2002), p. 105.

⁹ U.S. Department of Commerce, Bureau of Economic Analysis, January 30, 2002, *Gross Domestic Product: Fourth Quarter 2001* (Advance), Table 3.

¹⁰ New York Stock Exchange, *2002 Fact Book Online* (New York, 2003), www.nysedata.com/factbook.

TABLE 14-6 A Sample of NYSE Listing Requirements for Domestic (U.S.) Companies**PROFITABILITY (EARNINGS)**

Earnings before taxes (EBT) for the most recent year must be at least \$2.5 million. For the two years preceding that, EBT must be at least \$2.0 million.

MARKET VALUE

The market value of publicly held stock must be at least \$100.0 million. For initial public offerings (IPOs), the value must be at least \$60.0 million.

PUBLIC OWNERSHIP (DISTRIBUTION CRITERIA)

There must be at least 1.1 million publicly held common shares.

There must be at least 2,000 holders of 100 shares or more.

Source: New York Stock Exchange, 2002 *Fact Book Online* (New York, 2003), www.nysedata.com/factbook.

LISTING REQUIREMENTS To receive the benefits provided by an organized exchange, the firm must seek to have its securities listed on the exchange. An application for listing must be filed and a fee paid. The requirements for listing vary from exchange to exchange; those of the NYSE are the most stringent. The general criteria for listing fall into these categories: (1) profitability, (2) size, (3) market value, and (4) public ownership. To give you the flavor of an actual set of listing requirements, a selected sample of those set forth by the NYSE are displayed in Table 14-6.

OVER-THE-COUNTER MARKETS

Many publicly held firms do not meet the listing requirements of major stock exchanges. Others may want to avoid the reporting requirements and fees required to maintain a listing. As an alternative, their securities may trade in the over-the-counter markets. On the basis of sheer numbers (not dollar volume), more stocks are traded over-the-counter than on organized exchanges. As far as secondary trading in corporate bonds is concerned, the over-the-counter markets are where the action is. In a typical year, more than 90 percent of corporate bond business takes place over-the-counter.

Most over-the-counter transactions are done through a loose network of security traders who are known as broker-dealers and brokers. Brokers do not purchase securities for their own account, whereas dealers do. Broker-dealers stand ready to buy and sell specific securities at selected prices. They are said to "make a market" in those securities. Their profit is the spread or difference between the price they will pay for a security (bid price) and the price at which they will sell the security (asked price).



A fine source of up-to-the-minute price quotes for securities listed or traded on the NASDAQ, AMEX, or NYSE is provided at the Nasdaq Stock Market's Web site. Go to www.nasdaq.com. Price and volume data for certain indices like that of the NASDAQ and the Dow Jones Industrial Average are continuously displayed.

PRICE QUOTES AND THE NASDAQ The availability of prices is not as continuous in the over-the-counter market as it is on an organized exchange. Since February 8, 1971, however, when a computerized network called NASDAQ came into existence, the availability of prices in this market has improved substantially. NASDAQ stands for National Association of Security Dealers Automated Quotation System. It is a telecommunications system that provides a national information link among the brokers and dealers operating in the over-the-counter markets. Subscribing traders have a terminal that allows them to obtain representative bids and ask prices for thousands of securities traded over-the-counter. NASDAQ is a quotation system, not a transactions system. The final trade is still consummated by direct negotiation between traders.

The NASDAQ system has become an increasingly important element of the U.S. financial market system in recent years. It provides a nationwide communications element that was lacking in the over-the-counter side of the securities markets.

The Nasdaq Stock Market, Inc., describes itself as a “screen-based, floorless market.” It now is actually home to the securities of more companies than the NYSE; in 2002 some 3,600 public companies had securities traded by means of the NASDAQ system. It has become highly popular as the trading mechanism of choice of several fast-growth sectors in the United States, including the high-technology sector. The common stock of computer chip maker Intel Corporation, for example, is traded via the NASDAQ as is that of Dell and Starbucks.¹¹

NASDAQ price quotes for many stocks are published daily in *The Wall Street Journal*. This same financial newspaper also publishes prices on hundreds of other stocks traded over-the-counter. Local papers supply prices on stocks of regional interest.

CONCEPT CHECK

1. What are the differences between (a) public offerings and private placements, (b) primary markets and secondary markets, (c) the money market and the capital market, and (d) tangible-organized security exchanges and over-the-counter markets?
2. What benefits are derived from the existence of stock exchanges?
3. Briefly describe what is meant by the “NASDAQ system.”

THE INVESTMENT BANKER

Objective 6

We touched briefly on the investment banking industry and the investment banker earlier in this chapter when we described various methods for transferring financial capital (see Figure 14-3). The investment banker is to be distinguished from the commercial banker in that the former's organization is not a permanent depository for funds. For the moment, it is important for you to learn about the role of the investment banker in the funding of commercial activity because of the importance of this institution within the financial market system.

Most corporations do not frequently raise long-term capital. The activities of working-capital management go on daily, but attracting long-term capital is, by comparison, episodic. The sums involved can be huge, so these situations are considered of great importance to financial managers. Because most managers are unfamiliar with the subtleties of raising long-term funds, they enlist the help of an expert. That expert is an investment banker.

DEFINITION

The **investment banker** is a financial specialist involved as an intermediary in the merchandising of securities. He or she acts as a “middle person” by facilitating the flow of savings from those economic units that want to invest to those units that want to raise funds. We use the term *investment banker* to refer both to a given individual and to the organization for which such a person works, variously known as an *investment banking firm* or an *investment banking house*. Although these firms are called investment bankers, they perform no depository or lending functions. The activities of commercial banking and investment banking as we know them today were separated by the Banking Act of 1933 (also known as the Glass-Steagall Act of 1933). Then, after considerable political debate, the Financial Modernization Act was passed by the U.S. Congress on November 12, 1999. This recent legislation is also referred to as the Gramm-Leach-Bliley Act of 1999, in honor of its congressional sponsors. The act actually repealed significant portions of the Depression-era

Investment banker

A financial specialist who underwrites and distributes new securities and advises corporate clients about raising external financial capital.

¹¹ See www.nasdaq.com/investorrelations/ar2002/pdf/NDQ_AR_2002_complete.pdf.

Glass-Steagall Act and is aimed at increasing competitiveness among modern financial services companies. Through the creation of operating subsidiaries, the act provides for business combinations among banks, underwriters of financial securities (investment bankers), insurance firms, and securities brokers. Here we focus on investment banking and its important middleman role. That is most easily understood in terms of the basic functions of investment banking.

FUNCTIONS

The investment banker performs three basic functions: (1) underwriting, (2) distributing, and (3) advising.

UNDERWRITING The term *underwriting* is borrowed from the field of insurance. It means “assuming a risk.” The investment banker assumes the risk of selling a security issue at a satisfactory price. A satisfactory price is one that will generate a profit for the investment banking house.

The procedure goes like this. The managing investment banker and its syndicate will buy the security issue from the corporation in need of funds. The **syndicate** is a group of other investment bankers who are invited to help buy and resell the issue. The managing house is the investment banking firm that originated the business because its corporate client decided to raise external funds. On a specific day, the firm that is raising capital is presented with a check (cash) in exchange for the securities being issued. At this point, the investment banking syndicate owns the securities. The corporation has its cash and can proceed to use it. The firm is now immune from the possibility that the security markets might turn sour. If the price of the newly issued security falls below that paid to the firm by the syndicate, the syndicate will suffer a loss. The syndicate, of course, hopes that the opposite situation will result. Its objective is to sell the new issue to the investing public at a price per security greater than its cost.

DISTRIBUTING Once the syndicate owns the new securities, it must get them into the hands of the ultimate investors. This is the distribution or selling function of investment banking. The investment banker may have branch offices across the United States, or it may have an informal arrangement with several security dealers who regularly buy a portion of each new offering for final sale. It is not unusual to have 300 to 400 dealers involved in the selling effort. The syndicate can properly be viewed as the security wholesaler, and the dealer organization can be viewed as the security retailer.

ADVISING The investment banker is an expert in the issuance and marketing of securities. A sound investment banking house will be aware of prevailing market conditions and can relate those conditions to the particular type of security that should be sold at a given time. Business conditions may be pointing to a future increase in interest rates. The investment banker might advise the firm to issue its bonds in a timely fashion to avoid the higher yields that are forthcoming. The banker can analyze the firm's capital structure and make recommendations as to what general source of capital should be issued. In many instances, the firm will invite its investment banker to sit on the board of directors. This permits the banker to observe corporate activity and make recommendations on a regular basis.

DISTRIBUTION METHODS

Several methods are available to the corporation for placing new security offerings in the hands of final investors. The investment banker's role is different in each of these. Sometimes, in fact, it is possible to bypass the investment banker. These methods are described in this section. Private placements, because of their importance, are treated separately later in the chapter.

Syndicate

A group of investment bankers who contractually assist in the buying of a new security issue.

NEGOTIATED PURCHASE In a negotiated underwriting, the firm that needs funds makes contact with an investment banker, and deliberations concerning the new issue begin. If all goes well, a *method* is negotiated for determining the price the investment banker and the syndicate will pay for the securities. For example, the agreement might state that the syndicate will pay \$2 less than the closing price of the firm's common stock on the day before the offering date of a new stock issue. The negotiated purchase is the most prevalent method of securities distribution in the private sector. It is generally thought to be the most profitable technique as far as investment bankers are concerned.

COMPETITIVE BID PURCHASE The method by which the underwriting group is determined distinguishes the competitive bid purchase from the negotiated purchase. In a competitive underwriting, several underwriting groups bid for the right to purchase the new issue from the corporation that is raising funds. The firm does not directly select the investment banker. The investment banker that underwrites and distributes the issue is chosen by an auction process. The syndicate willing to pay the greatest dollar amount per new security will win the competitive bid.

Most competitive bid purchases are confined to three situations, compelled by legal regulations: (1) railroad issues, (2) public utility issues, and (3) state and municipal bond issues. The argument in favor of competitive bids is that any undue influence of the investment banker over the firm is mitigated and the price received by the firm for each security should be higher. Thus, we would intuitively suspect that the cost of capital in a competitive bid situation would be less than in a negotiated purchase situation. Evidence on this question, however, is mixed. One problem with the competitive bid purchase as far as the fundraising firm is concerned is that the benefits gained from the advisory function of the investment banker are lost. It may be necessary to use an investment banker for advisory purposes and then by law exclude that same banker from the competitive bid process.

COMMISSION OR BEST-EFFORTS BASIS Here, the investment banker acts as an agent rather than as a principal in the distribution process. The securities are *not* underwritten. The investment banker attempts to sell the issue in return for a fixed commission on each security actually sold. Unsold securities are returned to the corporation. This arrangement is typically used for more speculative issues. The issuing firm may be smaller or less established than the investment banker would like. Because the underwriting risk is not passed on to the investment banker, this distribution method is less costly to the issuer than a negotiated or competitive bid purchase. However, the investment banker only has to give it his or her "best effort." A successful sale is not guaranteed.

PRIVILEGED SUBSCRIPTION Occasionally, the firm may feel that a distinct market already exists for its new securities. When a new issue is marketed to a definite and select group of investors, it is called a **privileged subscription**. Three target markets are typically involved: (1) current stockholders, (2) employees, or (3) customers. Of these, distributions directed at current stockholders are the most prevalent. Such offerings are called *rights offerings*. In a privileged subscription, the investment banker may act only as a selling agent. It is also possible that the issuing firm and the investment banker might sign a *standby agreement*, which would obligate the investment banker to underwrite the securities that are not accepted by the privileged investors.

Privileged subscription
The process of marketing a new security issue to a select group of investors.

DIRECT SALE In a **direct sale**, the issuing firm sells the securities directly to the investing public without involving an investment banker. Even among established corporate giants, this procedure is relatively rare. A variation of the direct sale, though, was used more frequently in the 1970s than in previous decades. This involves the private placement of a new issue by the fundraising corporation *without* use of an investment banker as an intermediary. Texaco, Mobil Oil (prior to its merger with Exxon), and

Direct sale
The sale of securities by the corporation to the investing public without the services of an investment banking firm.

TABLE 14-7 Leading U.S. Investment Bankers, 2002
Global Stocks and Bonds

FIRM	PROCEEDS (BILLIONS OF DOLLARS)	PERCENT OF MARKET
Citigroup/Salomon Smith Barney	\$414.9	10.6%
Merrill Lynch	316.8	8.1
Credit Suisse First Boston	309.4	7.9
Morgan Stanley	286.4	7.3
J.P. Morgan Chase	286.1	7.3
Lehman Brothers	269.6	6.9
UBS Warburg	248.2	6.4
Goldman Sachs	232.5	6.0
Deutsche Bank AG	231.6	5.9
Banc of America Securities	164.6	4.2

Source: *Wall Street Journal*. Eastern Edition (Staff produced copy only). Copyright © 2003 by Dow Jones & Company, Inc. Reproduced with permission of Dow Jones & Company, Inc. in the format Textbook via Copyright Clearance Center.

International Harvester (now Navistar) are examples of large firms that have followed this procedure.

INDUSTRY LEADERS All industries have their leaders, and investment banking is no exception. We have discussed investment bankers at some length in this chapter. Table 14-7 gives us some idea who the major players are within the investment banking industry. It lists the top 10 houses in 2002 based on the dollar volume of security issues that were managed. Notice in the table that the U.S. investment banking industry is a highly concentrated one. The top five bankers with regard to underwriting volume during 2002 accounted for a full 41.2 percent of the total market. This degree of concentration is pervasive over time.

BEST

PRACTICES

SELECTION CRITERIA FOR AN INVESTMENT BANKER

Dr. David R. Klock is CEO and Chairman of the Board of Directors of CompBenefits Corporation, headquartered in Atlanta, Georgia. Dr. Klock holds a Ph.D. in Finance from the University of Illinois and is a nationally known insurance economist. The firm, CompBenefits, is a privately held national leader in providing a wide range of dental and vision insurance products. The firm's annual revenues are in the vicinity of \$285 million annually. The firm continually works with venture capitalists who provide equity capital and access to debt capital in the nation's financial market system. Dr. Klock authored the checklist below that deals with selecting an investment banker within the context of seeking what are called "strategic buyers" by venture capital firms. Dr. Klock is highly familiar with the field, having spent time at the investment banking firm of Goldman Sachs earlier in his career.

I. Competency

- Technical skills/resources of total team
- People skills/resources of total team

- Knowledge of the firm
- Knowledge of key potential buyers and their needs/ability to pay

II. Connections

- Recent firm history of working with potential buyers
- Individual banker's recent history of working with key potential buyers
- Reputation of investment banking firm with potential buyers
- Intangibles

III. Conviction on Enterprise Value of the Firm

- Valuation range and strength of valuation methods/matrix
- Ability to strongly tell firm's story and to be heard/understood by key individuals at potential buyers
- Level of commitment to this transaction within the banking firm

CONCEPT CHECK

1. What is the main difference between an investment banker and a commercial banker?
2. What are the three major functions that an investment banker performs?
3. What are the five key methods by which securities are distributed to final investors?

MORE ON PRIVATE PLACEMENTS: THE DEBT SIDE*Objective* **7**

Earlier in this chapter we discussed the private placement market and its important relationship to the market for venture capital. There we emphasized the private equity side of private placements. Here we take a closer look at the debt side of the private placement market and how it is used by more seasoned corporations as distinct from “start-ups.” Thus, when we talk of private placements in this section, we are focusing on debt contracts. This debt side of the private placement market is always a significant portion of the total private market.

Private placements are an alternative to the sale of securities to the public or to a restricted group of investors through a privileged subscription. Any type of security can be privately placed (directly placed). The major investors in private placements are large financial institutions. Based on the volume of securities purchased, the three most important investor groups are (1) life insurance companies, (2) state and local retirement funds, and (3) private pension funds.

In arranging a private placement, the firm may (1) avoid the use of an investment banker and work directly with the investing institutions or (2) engage the services of an investment banker. If the firm does not use an investment banker, of course, it does not have to pay a fee. Conversely, investment bankers can provide valuable advice in the private placement process. They are usually in contact with several major institutional investors; thus, they will know if a firm is in a position to invest in its proposed offering, and they can help the firm evaluate the terms of the new issue.

Private placements have advantages and disadvantages compared with public offerings. The financial manager must carefully evaluate both sides of the question. The advantages associated with private placements are these:

1. **Speed.** The firm usually obtains funds more quickly through a private placement than a public offering. The major reason is that registration of the issue with the SEC is not required.
2. **Reduced flotation costs.** These savings result because the lengthy registration statement for the SEC does not have to be prepared, and the investment banking underwriting and distribution costs do not have to be absorbed.
3. **Financing flexibility.** In a private placement, the firm deals on a face-to-face basis with a small number of investors. This means that the terms of the issue can be tailored to meet the specific needs of the company. For example, all of the funds need not be taken by the firm at once. In exchange for a commitment fee, the firm can “draw down” against the established amount of credit with the investors. This provides some insurance against capital market uncertainties, and the firm does not have to borrow the funds if the need does not arise. There is also the possibility of renegotiation. The terms of the debt issue can be altered. The term to maturity, the interest rate, or any restrictive covenants can be discussed among the affected parties.

The following disadvantages of private placements must be evaluated:

- 1. Interest costs.** It is generally conceded that interest costs on private placements exceed those of public issues. Whether this disadvantage is enough to offset the reduced flotation costs associated with a private placement is a determination the financial manager must make. There is some evidence that on smaller issues—say, \$500,000 as opposed to \$30 million—the private placement alternative would be preferable.
- 2. Restrictive covenants.** Dividend policy, working-capital levels, and the raising of additional debt capital may all be affected by provisions in the private-placement debt contract. That is not to say that such restrictions are always absent in public debt contracts. Rather, the financial officer must be alert to the tendency for these covenants to be especially burdensome in private contracts.
- 3. The possibility of future SEC registration.** If the lender (investor) should decide to sell the issue to a public buyer before maturity, the issue must be registered with the SEC. Some lenders, then, require that the issuing firm agree to a future registration at their option.

CONCEPT CHECK

1. Within the financial markets, what do we mean by "private placements"?
2. What are the possible advantages and disadvantages of private placements?

Objective 8

Flotation costs

The underwriter's spread and issuing costs associated with the issuance and marketing of new securities.

FLOTATION COSTS

The firm raising long-term capital incurs two types of **flotation costs**: (1) the underwriter's spread and (2) issuing costs. Of these two costs, the underwriter's spread is the larger. The *underwriter's spread* is simply the difference between the gross and net proceeds from a given security issue expressed as a percent of the gross proceeds. The *issue costs* include (1) printing and engraving, (2) legal fees, (3) accounting fees, (4) trustee fees, and (5) several other miscellaneous components. The two most significant issue costs are printing and engraving and legal fees.

Data published by the SEC have consistently revealed two relationships about flotation costs. First, the costs associated with issuing common stock are notably greater than the costs associated with preferred stock offerings. In turn, preferred stock costs exceed those of bonds. Second, flotation costs (expressed as a percent of gross proceeds) decrease as the size of the security issue increases.

In the first instance, the stated relationship reflects the fact that issue costs are sensitive to the risks involved in successfully distributing a security issue. Common stock is riskier to own than corporate bonds. Underwriting risk is, therefore, greater with common stock than with bonds. Thus, flotation costs just mirror these risk relationships. In the second case, a portion of the issue costs is fixed. Legal fees and accounting costs are good examples. So, as the size of the security issue rises, the fixed component is spread over a larger gross proceeds base. As a consequence, average flotation costs vary inversely with the size of the issue.

CONCEPT CHECK

1. What are the two major categories of flotation costs?
2. Are flotation costs greater for a new bond issue or a new common stock issue?

REGULATION

Since late 1986, there has been a renewal of public interest in the regulation of the country's financial markets. The key event was a massive insider trading scandal that made the name Ivan F. Boesky one of almost universal recognition—but unfortunately, in a negative sense. This was followed by the October 19, 1987, crash of the equity markets. In early 1990, the investing community (both institutional and individual) became increasingly concerned over a weakening in the so-called "junk bond market." Then several financial failures and breakdowns in corporate governance and democracy made firms such as Enron, WorldCom, Global Crossing, Adelphia, Tyco, Arthur Andersen, and HealthSouth household names in a negative context over the very recent 2001 to 2003 time frame. The accompanying notoriety associated with these firms and their key management personnel led Congress to pass the Sarbanes-Oxley Act of 2002. This recent act is reviewed later in this section. The upshot of all of this enhanced awareness is a new appreciation of the crucial role that regulation plays in the financial system.

Following the severe economic downturn of 1929 to 1932, Congressional action was taken to provide for federal regulation of the securities markets. State statutes (blue sky laws) also govern the securities markets where applicable, but the federal regulations are clearly more pressing and important. The major federal regulations are reviewed here.

PRIMARY MARKET REGULATIONS

The new issues market is governed by the Securities Act of 1933. The intent of the act is important. It aims to provide potential investors with accurate, truthful disclosure about the firm and the new securities being offered to the public. This does *not* prevent firms from issuing highly speculative securities. The SEC says nothing whatsoever about the possible investment worth of a given offering. It is up to the investor to separate the junk from the jewels. The SEC does have the legal power and responsibility to enforce the 1933 act.

Full public disclosure is achieved by the requirement that the issuing firm file a registration statement with the SEC containing requisite information. The statement details particulars about the firm and the new security being issued. During a minimum 20-day waiting period, the SEC examines the submitted document. In numerous instances, the 20-day wait has been extended by several weeks. The SEC can ask for additional information that was omitted in order to clarify the original document. The SEC can also order that the offering be stopped.

During the registration process, a preliminary prospectus (the "red herring") may be distributed to potential investors. When the registration is approved, the final prospectus must be made available to the prospective investors. The prospectus is actually a condensed version of the full registration statement. If, at a later date, the information in the registration statement and the prospectus is found to be lacking, purchasers of the new issue who incurred a loss can sue for damages. Officers of the issuing firm and others who took part in the registration and marketing of the issue may suffer both civil and criminal penalties.

Generally, the SEC defines public issues as those that are sold to more than 25 investors. Some public issues need not be registered. These include

1. Relatively small issues, where the firm sells less than \$1.5 million of new securities per year. Such issues of less than \$1.5 million are not entirely regulation-free. They are monitored through what is usually called the *small-issues exemption*. These small issues, then, fall under the auspices of Regulation A, which is just a very short offering statement compared to the full-blown registration statement. The latter is very onerous; it often ends up in the 50–100 page range.

2. Issues that are sold entirely intrastate.
3. Issues that are basically short-term instruments. This translates into maturity periods of 270 days or less.
4. Issues that are already regulated or controlled by some other federal agency. Examples here are the Federal Power Commission (public utilities) and the Interstate Commerce Commission (railroads).

SECONDARY MARKET REGULATIONS

Secondary trading is regulated by the Securities Exchange Act of 1934. This act created the SEC to enforce securities laws. The Federal Trade Commission enforced the 1933 act for one year. The major aspects of the 1934 act can be best presented in outline form:

1. Major security exchanges must register with the SEC. This regulates the exchanges and places reporting requirements on the firms whose securities are listed on them.
2. Insider trading is regulated. Insiders can be officers, directors, employees, relatives, major investors, or anyone having information about the operation of the firm that is not public knowledge. If an investor purchases the security of the firm in which the investor is an insider, he or she must hold it for at least six months before disposing of it. Otherwise, profits made from trading the stock within a period of less than six months must be returned to the firm. Furthermore, insiders must file with the SEC a monthly statement of holdings and transactions in the stock of their corporation.¹²
3. Manipulative trading of securities by investors to affect stock prices is prohibited.
4. The SEC is given control over proxy procedures.
5. The Board of Governors of the Federal Reserve System is given responsibility for setting margin requirements. This affects the flow of credit into the securities markets. Buying securities on margin simply means using credit to acquire a portion of the subject financial instruments.

SECURITIES ACTS AMENDMENTS OF 1975

The Securities Acts Amendments of 1975 touched on three important issues. First, Congress mandated the creation of a national market system (NMS). Only broad goals for this national exchange were identified by Congress. Implementation details were left to the SEC and, to a much lesser extent, the securities industry in general. Congress was really expressing its desire for (1) widespread application of auction market trading principles, (2) a high degree of competition across markets, and (3) the use of modern electronic communication systems to link the fragmented markets in the country into a true NMS. The NMS is still a goal toward which the SEC and the securities industry are moving. Agreement as to its final form and an implementation date have not occurred.

A second major alteration in the habits of the securities industry also took place in 1975. This was the elimination of fixed commissions (fixed brokerage rates) on public transactions in securities. This was closely tied to the desire for an NMS in that fixed brokerage fees provided no incentive for competition among brokers. A third consideration of the 1975 amendments focused on such financial institutions as commercial

¹² On November 14, 1986, the SEC announced that Ivan F. Boesky had admitted to illegal insider trading after an intensive investigation. Boesky at the time was a very well-known Wall Street investor, speculator, and arbitrageur. Boesky was an owner or part owner in several companies, including an arbitrage fund named Ivan F. Boesky & Co. L. P. Boesky agreed to pay the U.S. government \$50 million, which represented a return of illegal profits, and another \$50 million in civil penalties; to withdraw permanently from the securities industry; and to plead guilty to criminal charges. The far-reaching investigation continued into 1987 and implicated several other prominent investment figures.

banks and insurance firms. These financial institutions were prohibited from acquiring membership on stock exchanges in order to reduce or save commissions on their own trades.

SHELF REGISTRATION

On March 16, 1982, the SEC began a new procedure for registering new issues of securities. Formally it is called SEC Rule 415; informally, the process is known as a **shelf registration**, or a **shelf offering**. The essence of the process is rather simple. Rather than go through the lengthy, full registration process each time the firm plans an offering of securities, it can get a blanket order approved by the SEC. A master registration statement that covers the financing plans of the firm over the coming two years is filed with the SEC. On approval, the firm can market some or all of the securities over this two-year period. The securities are sold in a piecemeal fashion, or “off the shelf.” Prior to each specific offering, a short statement about the issue is filed with the SEC.

Corporations raising funds approve of this new procedure. The tedious, full registration process is avoided with each offering pulled off the shelf. This should result in a saving of fees paid to investment bankers. Moreover, an issue can more quickly be brought to the market. Also, if market conditions change, an issue can easily be redesigned to fit the specific conditions of the moment.

As is always the case, there is another side to the story. Recall that the reason for the registration process in the first place is to give investors useful information about the firm and the securities being offered. Under the shelf registration procedure, some of the information about the issuing firm becomes old as the two-year horizon unfolds. Some investment bankers feel they do not have the proper amount of time to study the firm when a shelf offering takes place.

Shelf registration (shelf offering)

A procedure for issuing new securities where the firm obtains a master registration statement approved by the SEC.

SARBANES-OXLEY ACT OF 2002

As previously mentioned, several disappointing lapses in corporate behavior became public knowledge after the year 2000. Numerous unflattering instances of poor judgment occurred involving the major fundamental building blocks of Western capitalism. These included the (1) public accounting industry, (2) legal industry, (3) investment banking industry, (4) security analysts' industry, and (5) subject firms themselves, even involving their elected boards of directors. Both individual investors and some institutional investors lost hugely significant amounts of invested capital as a result of this monumental breakdown in corporate morality.

One glaring example involved the board of the energy-sector company, Enron Corporation. Enron failed financially in December 2001. Prior to that formal failure (bankruptcy) the firm's board of directors overtly voted on two occasions to temporarily suspend its own “code of ethics” to permit its CFO to engage in risky personal financial ventures that involved the financial structure and cash flow streams of Enron. This should remind you of our **Principle 10: Ethical behavior is doing the right thing, and ethical dilemmas are everywhere in finance.**

In a research paper that focused on accounting practices at energy firms, Richard Bassett and Mark Storrie summarized the problems at Enron as follows:¹³

In brief, Enron's senior management and others engaged in a systematic attempt to use various accounting and reporting techniques to mislead investors.

¹³ Richard Bassett and Mark Storrie, “Accounting at Energy Firms After Enron: Is the Cure Worse Than the Disease?” *Policy Analysis*: Cato Project on Corporate Governance, Audit and Tax Reform, No. 469, February 12, 2003, p. 2.

TABLE 14-8 Sarbanes-Oxley Act of 2002

Key Elements

TITLE	AREA OF EMPHASIS
I	Public Company Accounting Oversight Board
II	Auditor Independence
III	Corporate Responsibility
IV	Enhanced Financial Disclosures
V	Analyst Conflicts of Interest
VI	Commission Resources and Authority
VII	Studies and Reports
VIII	Corporate and Criminal Fraud Accountability
IX	White-Collar Crime Penalty Enhancements
X	Corporate Tax Returns
XI	Corporate Fraud and Accountability

Source: U.S. Congress, H.R. 3763. Passed by the 107th Congress of the United States on July 25, 2002; signed by President Bush on July 30, 2002.

Under intense public scrutiny resulting from a large series of corporate indiscretions like those previously noted, Congress passed in July 2002 the Public Company Accounting Reform and Investor Protection Act, commonly known as the Sarbanes-Oxley Act of 2002. The act contains 11 “titles” which are displayed in Table 14-8.¹⁴ Those 11 titles provide the flavor of the act which tightened significantly the latitudes given to corporate advisors (like accountants, lawyers, company officers, and boards of directors) who have access to or influence company decisions.

In effect, such advisors are now held strictly accountable in law for any instances of misconduct. The act very simply and directly identified its purpose as being “To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” In a speech given in March 2003, SEC Commissioner Paul S. Atkins directly recognized the relationship of the act to corporate valuations. He said:¹⁵

Fundamentally, Sarbanes-Oxley acknowledges the importance of stockholder value. Without equity investors and their confidence, our economic growth and continued technological innovations would be slowed. Sarbanes-Oxley strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders’ interest.

As evidenced by being the initial title of the act, a critical part of this law was the creation of the Public Company Accounting Oversight Board. This board’s purpose is to regulate the accounting industry relative to public companies that they audit. Table 14-9 highlights the composition of the board’s membership and its duties. As recently as June 30, 2003, the oversight board itself published a set of ethics rules to police its own set of activities.¹⁶ This ethics code was sent to the SEC for approval as it was intended to “insulate itself from perceptions or accusations of conflicts of interest.”

¹⁴ The full Sarbanes-Oxley Act can be viewed at the Library of Congress Web site at <http://thomas.loc.gov>.

¹⁵ Paul S. Atkins, “The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation,” Speech by the SEC Commissioner, March 25, 2003, p. 2 of 6. See www.sec.gov/news/speech/spch032503psa.htm.

¹⁶ See www.money.cnn.com/2003/06/30/news/companies/accounting_ethics.reut/index.htm.

TABLE 14-9 Public Company Accounting Oversight Board**I. THE BOARD: ESTABLISHMENT OF AN INDEPENDENT OVERSIGHT BOARD FOR AUDITORS**

The board consists of five financially literate members, appointed for five-year terms. Two of the members must be or have been certified public accountants, and the remaining members must not be nor have ever been CPAs. Members cannot share in the profits or receive payments from a public accounting firm (other than fixed continuing payments such as retirement benefits). Members are appointed by the SEC, after consultation with the chairman of the Federal Reserve Board and the Secretary of the Treasury. Members can be removed from the board by the SEC for good cause.

II. BOARD DUTIES:

1. Register public accounting firms.
2. Establish or adopt, by rule, auditing, quality control, ethics independence, and other standards relating to the preparation of audit reports for issuers.
3. Conduct inspections of audit firms.
4. Conduct investigations and disciplinary proceedings, and impose appropriate sanctions.
5. Conduct such other duties or functions as necessary and appropriate.
6. Enforce compliance with the act, the rules of the board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto.
7. Set the budget and manage the operations of the board and its staff.

Source: *Sarbanes-Oxley Act of 2002*.

CONCEPT CHECK

1. What are the main elements of the Securities Act of 1933 and the Securities Exchange Act of 1934?
2. What is meant by "insider trading"?
3. What is a "shelf registration"?
4. What is the purpose of the Sarbanes-Oxley Act of 2002?

THE MULTINATIONAL FIRM: EFFICIENT FINANCIAL MARKETS AND INTERCOUNTRY RISK

We have discussed and demonstrated in this chapter that the United States has a highly developed, complex, and competitive system of financial markets that allows for the quick transfer of savings from those economic units with a surplus of savings to those economic units with a savings deficit. Such a system of robust and credible financial markets allows great ideas (like the personal computer) to be financed and increases the overall wealth of the given economy. Real capital formation—for example, a Ford Motor Company manufacturing plant in Livonia, Michigan—is enhanced by the financial market mechanism.

One major reason why underdeveloped countries are indeed underdeveloped is that they lack a financial market system that has the confidence of those who must use it—like the multinational firm. The multinational firm with cash to invest in foreign markets will weigh heavily the integrity of both the financial system and the political system of the prospective foreign country.

A lack of integrity on either the financial side or the political stability side will retard direct investment in the lesser-developed nation. Consider the Walt Disney Company

headquartered in Burbank, California. Disney common stock trades on the NYSE (ticker symbol DIS), while the firm has significant overseas real investments in projects known as the Disneyland Paris Resort and Tokyo Disneyland. Disney has confidence in the French financial markets, and those of western Europe and Japan. As an example, that confidence led Disney executives to launch three new projects in Japan during 1998—a new theme park and two new hotels.¹⁷

However, Disney did not launch any new projects in Thailand because the basic currency in Thailand, called the “baht,” lost a full 98 percent of its value against the U.S. dollar over the short period from June 1997 to February 1998. Profits generated in Thailand and measured by the baht would have bought significantly fewer U.S. dollars after the devaluation. This type of situation is typically referred to as *exchange rate risk*. Currencies, too, trade within financial markets and those risks are closely studied by wise multinational firms.

CONCEPT CHECK

1. Identify one major reason why underdeveloped countries remain underdeveloped.
2. Give an example of “foreign exchange risk.”

HOW FINANCIAL MANAGERS USE THIS MATERIAL

Corporate financial executives are constantly balancing the internal demand for funds against the costs of raising external financial capital. In order to finance favorable projects, the financial executive at times will have to choose between issuing new debt, preferred stock, or common stock. Further, the executive will decide whether to raise the external capital via a public offering or private placement of the new securities to a limited number of potential investors. Most of these activities will involve the counsel of an investment banking firm and an awareness of securities markets regulations.

We know that when financial executives decide to raise cash in the capital market, the issuance of corporate debt clearly dominates other forms of financing instruments. This preference rests on economic logic: Interest expense is deductible from other taxable income when computing the firm’s tax liability; dividends paid on either preferred stock or common stock are not. This puts **Principle 8: Taxes Bias Business Decisions** into action. Stated alternatively, firms would rather suffer a lower tax bill as opposed to a higher tax bill. Wouldn’t you? As a result of this knowledge, U.S. corporate executives raised 75.3 percent of their external cash from bonds and notes (debt capital) during the 1996 to 1999 period.

Financial executives are fully aware of **Principle 8**, but also the need to create wealth for their common stock investors. The use of fixed-income financing (leverage) has to be wisely done—not overdone, or it will ultimately raise overall capital costs and the risk of bankruptcy. The Walt Disney Company displays this perspective in the following statement: “Disney shareholders benefit from the prudent leverage in the company’s capital structure represented by total borrowings of \$11.1 billion at year end. Attractive borrowing rates help to reduce the company’s overall cost of capital, thereby creating value for shareholders. Disney still has substantial financial flexibility to borrow, should sound business opportunities present themselves.”¹⁸

¹⁷ The Walt Disney Company, *Annual Report*, 1998, pp. 24–25, 57.

¹⁸ The Walt Disney Company, *Annual Report* (1997), 17.

SUMMARY

This chapter centers on the market environment in which corporations raise long-term funds, including the structure of the U.S. financial markets, the institution of investment banking, and the various methods for distributing securities.

When corporations go to the capital market for cash, the most favored financing method is debt. The corporate debt markets clearly dominate the equity markets when new funds are raised. The U.S. tax system inherently favors debt capital as a fundraising method. In an average year over the 1981 to 1996 period, bonds and notes made up 75.6 percent of external cash that was raised, and 75.3 percent over the more recent 1996 to 1999 period.

The function of financial markets is to allocate savings efficiently in the economy to the ultimate demander (user) of the savings. In a financial market, the forces of supply and demand for a specific financial instrument are brought together. The wealth of an economy would not be as great as it is without a fully developed financial market system.

Most years, households are a net supplier of funds to the financial markets. The nonfinancial business sector is most always a net borrower of funds. Both life insurance companies and private pension funds are important buyers of corporate securities. Savings are ultimately transferred to the business firm seeking cash by means of (1) the direct transfer, (2) the indirect transfer using the investment banker, or (3) the indirect transfer using the financial intermediary.

Corporations can raise funds through public offerings or private placements. The public market is impersonal in that the security issuer does not meet the ultimate investors in the financial instruments. In a private placement, the securities are sold directly to a limited number of institutional investors.

The primary market is the market for new issues. The secondary market represents transactions in currently outstanding securities. Both the money and capital markets have primary and secondary sides. The *money market* refers to transactions in short-term debt instruments. The *capital market*, in contrast, refers to transactions in long-term financial instruments. Trading in the money and capital markets can occur in either the organized security exchanges or the over-the-counter market. The money market is exclusively an over-the-counter market.

The investment banker is a financial specialist involved as an intermediary in the merchandising of securities. He or she performs the functions of (1) underwriting, (2) distributing, and (3) advising. Major methods for the public distribution of securities include (1) the negotiated purchase, (2) the competitive bid purchase, (3) the commission or best-efforts basis, (4) privileged subscriptions, and (5) direct sales. The direct sale bypasses the use of an investment banker. The negotiated purchase is the most profitable distribution method to the investment banker. It also provides the greatest amount of investment banking services to the corporate client.

Privately placed debt provides an important market outlet for corporate bonds. Major investors in this market are (1) life insurance firms, (2) state and local retirement funds, and (3) private pension funds. Several advantages and disadvantages are associated with private placements. The financial officer must weigh these attributes and decide if a private placement is preferable to a public offering.

Flotation costs consist of the underwriter's spread and issuing costs. The flotation costs of common stock exceed those of preferred stock, which, in turn, exceed those of debt. Moreover, flotation costs as a percent of gross proceeds are inversely related to the size of the security issue.

The new issues market is regulated at the federal level by the Securities Act of 1933. It provides for the registration of new issues with the SEC. Secondary market trading is regulated by the Securities Exchange Act of 1934. The Securities Acts Amendments of 1975 placed on the SEC the responsibility for devising a national market system. This concept is still being studied. The shelf registration procedure (SEC Rule 415) was initiated in March 1982. Under this regulation and with the proper filing of documents, firms that are selling new issues do not have to go through the old, lengthy registration process each time the firm plans an offering of securities.

Objective 1

Objective 2

Objective 3

Objective 4

Objective 5

Objective 6

Objective 7

Objective 8

On July 30, 2002, President Bush signed into law the Public Company Accounting Reform and Investor Protection Act, commonly known as the Sarbanes-Oxley Act of 2002. Its intended purpose as stated in the act is “To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”

KEY TERMS



Go To:
www.prenhall.com/keown
 for downloads and current
 events associated with this
 chapter

Capital market, 486
Direct sale, 491
Direct securities, 478
Financial assets, 476
Financial markets, 475
Flotation costs, 494
Indirect securities, 478
Investment banker, 489
Money market, 486

Organized security exchanges, 486
Over-the-counter markets, 486
Primary markets, 484
Private placement (direct placement), 481
Privileged subscription, 491

Public offering, 481
Real assets, 476
Secondary markets, 477
Shelf registration (shelf offering), 497
Syndicate, 490
Underwriting, 477

STUDY QUESTIONS

- 14-1.** What are financial markets? What function do they perform? How would an economy be worse off without them?
- 14-2.** Define in a technical sense what we mean by *financial intermediary*. Give an example of your definition.
- 14-3.** Distinguish between the money and capital markets.
- 14-4.** What major benefits do corporations and investors enjoy because of the existence of organized security exchanges?
- 14-5.** What are the general categories examined by an organized exchange in determining whether an applicant firm's securities can be listed on it?
(Specific numbers are not needed here, but rather areas of investigation.)
- 14-6.** Why do you think most secondary market trading in bonds takes place over-the-counter?
- 14-7.** What is an investment banker, and what major functions does he or she perform?
- 14-8.** What is the major difference between a negotiated purchase and a competitive bid purchase?
- 14-9.** Why is an investment banking syndicate formed?
- 14-10.** Why might a large corporation want to raise long-term capital through a private placement rather than a public offering?
- 14-11.** As a recent business school graduate, you work directly for the corporate treasurer. Your corporation is going to issue a new security plan and is concerned with the probable flotation costs. What tendencies about flotation costs can you relate to the treasurer?
- 14-12.** When corporations raise funds, what type of financing vehicle (instrument or instruments) is most favored?
- 14-13.** What is the major (most significant) savings-surplus sector in the U.S. economy?
- 14-14.** Identify three distinct ways that savings are ultimately transferred to business firms in need of cash.

WEB WORKS

14-1WW. Table 14-5 in the text identified all of the U.S. business cycle contractions that have occurred since the end of World War II. The tenth of these recessions began in March 2001 according to the National Bureau of Economic Research (NBER). Visit the NBER's Web site at www.NBER.ORG and determine when this research group suggested that the last recession officially ended.

14-2WW. Negative real interest rates occur when the rate of inflation exceeds the rate of interest on fixed-income financing instruments like corporate bonds, government bonds, and U.S. Treasury bills. Negative real rates of interest generally are associated with slow periods of economic growth. During such periods corporations usually prefer to raise external cash via new debt issues rather than equity issues. Two Web sites can give you insights into whether current real rates of interest are negative or positive. Visit www.federalreserve.gov to check on the H.15 Selected Interest Rates report to assess nominal interest rates. Then check on www.stats.bls.gov to assess several different inflation indices. Estimate the level of the real rate of interest on the 10-year Treasury note (and any other maturity period that excites you), using more than one inflation index. *Hint:* The consumer price index and producer price index for finished goods are two commonly used indicators looked at by security and financial analysts.

14-3WW. Visit www.nvca.org and assess whether or not the private equity markets have recovered their momentum since the general business contraction that commenced during 2001. This is the Web site of the National Venture Capital Association. Would you characterize the state of the private equity markets as either "hot" or "tepid"?