Contents

I Introduction to the Securities Industry

1 Introduction 3

Design of the Study 4
The New Economics of Organization 5
Strategic Choice 5
A Brief Look at Structural Change Between 1960 and 1980 6
Regulation 7
An Overview of the Book 8

2 Accelerating Change, 1980-1992 9

Changing Economic Conditions Junk Bonds 13 Financial Futures and Options New Approaches to Managing Risk 15 Program Trading Derivative Securities 17 The Impact of Program Trading and Derivatives on Broker-Dealers' **Trading Activities** Corporate Restructuring with Innovative Financing 20 Bridge Loans Merchant-Banking Activities The Private Placement Market Conclusion 23

3 An Overview of the Securities Industry 24

Types of Broker-Dealers 24

Long-Term Industry Trends 25

Organization and Services of Securities Firms 33

Discount Brokers 37

Securities Firms' Jobs 37

x Contents

II

4

5

6

Ш

7

Individuals

Institutions

83

85

Securities Firms' Capital 39
Firm Classifications 39
Overall Industry Model 41
The Legislative and Regulatory Framework
The Legislative Framework 45
The Original Legislation 45 The Glass-Steagall Act 46 Legislation in the 1960s 48 The Securities Investor Protection Act of 1970 48 The Securities Act Amendments of 1975 49 Integrating the Disclosure Requirements of the 1933 and 1934 Acts 50 Antitrust Issues 51 Economic Analyses of the Regulatory Framework of the Securities Markets 52
The Safety and Soundness of Broker-Dealers: The Net Capital Rule 55
The History of the Net Capital Rule 55 The Logic of the Net Capital Rule 56 Alternative Net Capital Rules 57 The Customer Protection Rule 58 Capital Trends 61 Net Capital During the 1987 Market Crash 62 Customer Protection Proceedings: The Experience 64 Benefits of Self-Regulation 65 Conclusion 65
Principal-Agent Problems in the Securities Industry 67
Fiduciary Obligations of Securities Firms 67 Conflicts as a Result of Growth and Diversification 68 Conflicts in the Brokerage Business 68 Conflicts in the Dealer Business 72 Conflicts with Institutional Customers 73 Conflicts in Investment Banking 74 The General Economic View of Agency Problems 75 Overall Conflict Control 76 Economic Models of Specific Agency Problems in the Securities Industry 78 Conclusion 79
Elements of Securities Industry Structure
Characteristics of Demand 83

Contents хi

	Demand Characteristics 89 Demand in the Core Lines of Business 89 Conclusion 93
8	Costs and Entry Barriers in the Securities Industry 95
	Fixed Costs, Sunk Costs, and Entry Barriers 95 Barriers to Entry into the Securities Industry 97 Strategically Created Barriers to Entry 99 Measures of Fixed Costs 101 Cost Estimates Using Brokerage Commission Data 102 Conclusion 104
9	Mergers, Concentration, and Multiproduct Economies of Scale and Scope 106
	Merger History 106 Concentration in the Securities Industry 108 Economies of Scale and Scope in the Securities Industry 111 Conclusion 123
IV	Conduct
10	Securities Brokerage Pricing 127
	Pricing for Individuals 127 Pricing for Institutions 131 An Economic Rationale for Soft Dollars 137
11	Market Making, Proprietary Trading, and Derivatives 140
	United States Government Securities 140 The Corporate Bond Market 142 The Municipal Bond Market 143 The OTC Market in Stocks 145 Proprietary Trading 149 Interest Rate and Currency Swaps 150 Derivatives 151 Market Making and Contestability 152 Conclusion 153
12	Investment Banking 154
	The Underwriting Function 154 Elasticity of Demand for Underwriting Services 155 Entry and Contestability in Investment Banking 156 Lack of Diversification by Large Investment Bankers into Retail Brokerage 159 Concentration Trends in Underwriting 159 Stability of Leading Positions 160 Prices 160

xii Contents

Impact of Rule 415 on Underwriting 162 Key Investment-Banking Lines in the 1980s 164 Strategic Mapping in Investment Banking Strategy Versus Contestability in Investment Banking 169 Conclusion 170 13 **Competition Through Innovation** The Links Between Market Structure and Innovation 172 Model Development 173 Market Structure Considerations in the Securities Industry 179 Empirical Research on Innovation in the Securities Industry 179 Conclusion 181 Diversification by Securities Firms 14 183 Motives for Diversification 183 The Securities Industry Environment 186 Modes of Entry 189 **Facilitating Conditions** 190 The Decision Framework 191 Diversification and Relative Position in the Industry 191 Diversification Choices at Problem Firms Diversification into the Securities Industry by Large Financial Institutions The Potential for Creating Strategic Barriers to Entering New Lines 194 of Business 196 Performance and Public Policy Merrill Lynch, Morgan Stanley, and Salomon Brothers Adapt 203 Merrill Lynch 204 Morgan Stanley 206 Salomon Brothers 208 Conclusion 212 Competition in the International Securities Markets 214 Developments in World Securities Markets 214 Stock Market Capitalization 215 United States Firms in London 217 Competition with the Japanese Securities Industry 218 Conclusion 223

225

225

15

16

17

Performance of the Securities Industry

What We Have Learned from Structure and Conduct Analysis

Lack of Evidence of Widespread Collusion in the Industry

Contents xiii

Overall Profitability in the Securities Industry DuPont Analysis of Profits of Publicly Held Firms 229 Employment by Firm Category in the 1980s 231 Risk in the Industry 232 Liquidation Risk 236 Compensation in the Securities Industry 236 The Technology of Trading and Fragmented Markets Comparing the Cost of Capital for U.S. and Japanese Securities Firms 238 Sources of Extraordinary Profit for Broker-Dealers Focusing on Revenues Rather than Profits Overall Performance of the Securities Industry

18 Policy Implications and Recommendations 242

International Competition 242
The Value of U.S. Securities Firms as International Competitors: The Case of Salomon Brothers 243
Property Rights for New Products and Services 244
SEC-CFTC Jurisdictional Disputes 245
Banks' Entry into the Securities Industry 246
Broker-Dealers' Capital and SIPC Insurance 249
More Economic Input into SEC Policymaking 250

References 253
Author Index 265
Subject Index 269