



**CFA Institute**<sup>®</sup>  
Investment Foundations

**It's Free!**

**Do it!**

## **Module 5: INDUSTRY STRUCTURE**

### **Chapter 13: Structure of the Investment Industry**

Ted Stephenson, CFA, CPA, CMA, CFP, MBA  
Professor, George Brown College  
St. James Campus  
290 Adelaide St. E.,  
Toronto, Ontario, M5T 2T9  
Canada

[Faculty Bio](#)



Module	Topic	Weight	LOS	Exam Qs	Hours to Study	Module Practice Qs	Chapter Practice Qs
<b>Module 1</b>	<b>Industry overview</b>	5%	7	6	5	28	28
Chapter 1	The Investment Industry: A Top-Down View						
<b>Module 2</b>	<b>Ethics and regulation</b>	10%	14	12	10	91	
Chapter 2	Ethics and Investment Professionalism						49
Chapter 3	Regulation						42
<b>Module 3</b>	<b>Inputs and tools</b>	20%	50	24	20	291	
Chapter 4	Microeconomics						53
Chapter 5	Macroeconomics						57
Chapter 6	Economics of International Trade						47
Chapter 7	Financial Statements						70
Chapter 8	Quantitative Concepts						64
<b>Module 4</b>	<b>Investment instruments</b>	20%	29	24	20	213	
Chapter 9	Debt Securities						69
Chapter 10	Equity Securities						72
Chapter 11	Derivatives						42
Chapter 12	Alternative Investments						30
<b>Module 5</b>	<b>Industry structure</b>	20%	27	24	20	96	
Chapter 13	Structure of the Investment Industry						28
Chapter 14	Investment Vehicles						29
Chapter 15	The Functioning of Financial Markets						39
<b>Module 6</b>	<b>Serving client needs</b>	5%	12	6	5	76	
Chapter 16	Investors and Their Needs						35
Chapter 17	Investment Management						41
<b>Module 7</b>	<b>Industry controls</b>	20%	24	24	20	154	
Chapter 18	Risk Management						51
Chapter 19	Performance Evaluation						53
Chapter 20	Investment Industry Documentation						50
	<b>Total</b>	<b>100%</b>	<b>163</b>	<b>120</b>	<b>100</b>	<b>949</b>	<b>949</b>

## AFTER COMPLETING THIS CHAPTER, YOU SHOULD BE ABLE TO DO THE FOLLOWING:

- a) Describe needs served by the investment industry;
- b) Describe financial planning services;
- c) Describe investment management services;
- d) Describe investment information services;
- e) Describe trading services;
- f) Compare the roles of brokers and dealers;
- g) Distinguish between buy-side and sell-side firms in the investment industry;
- h) Distinguish between front-, middle-, and back-office functions in the investment industry;
- i) Identify positions and responsibilities within firms in the investment industry.

## INVESTOR NEEDS SERVED BY THE INVESTMENT INDUSTRY

**Determine their financial goals**—in particular, how much money they will need to invest for future uses and how much money they can withdraw over time

**Identify potential investments**

**Evaluate the risk and return prospects** of potential investments

**Trade investment securities and assets**

**Hold, manage, and account** for investment securities and assets

**Evaluate the performance** of their investments

LOS a: Describe needs served by the investment industry.

# FINANCIAL PLANNING SERVICES

## Financial planners help their clients understand

- their current and future financial needs,
- the risks they face when investing,
- their ability to tolerate investment risks, and
- their preferences for capital preservation versus capital growth.

LOS b: Describe financial planning services.

## INVESTMENT MANAGEMENT SERVICES

Some high-net-worth and institutional clients rely on investment professionals to take care of the entire investment process, from identifying potential investments to implementing the investments and evaluating their performance; others use the services of investment professionals selectively.

Many investment professionals receive authority from their clients to trade securities and assets on their behalf. Those who have such discretionary authority are often called investment managers or asset managers.

LOS c: Describe investment management services.

# INVESTMENT MANAGEMENT SERVICES

## **Asset Allocation**

The proportion of a portfolio that should be invested in various asset classes to help meet financial goals.

## **Investment Analysis**

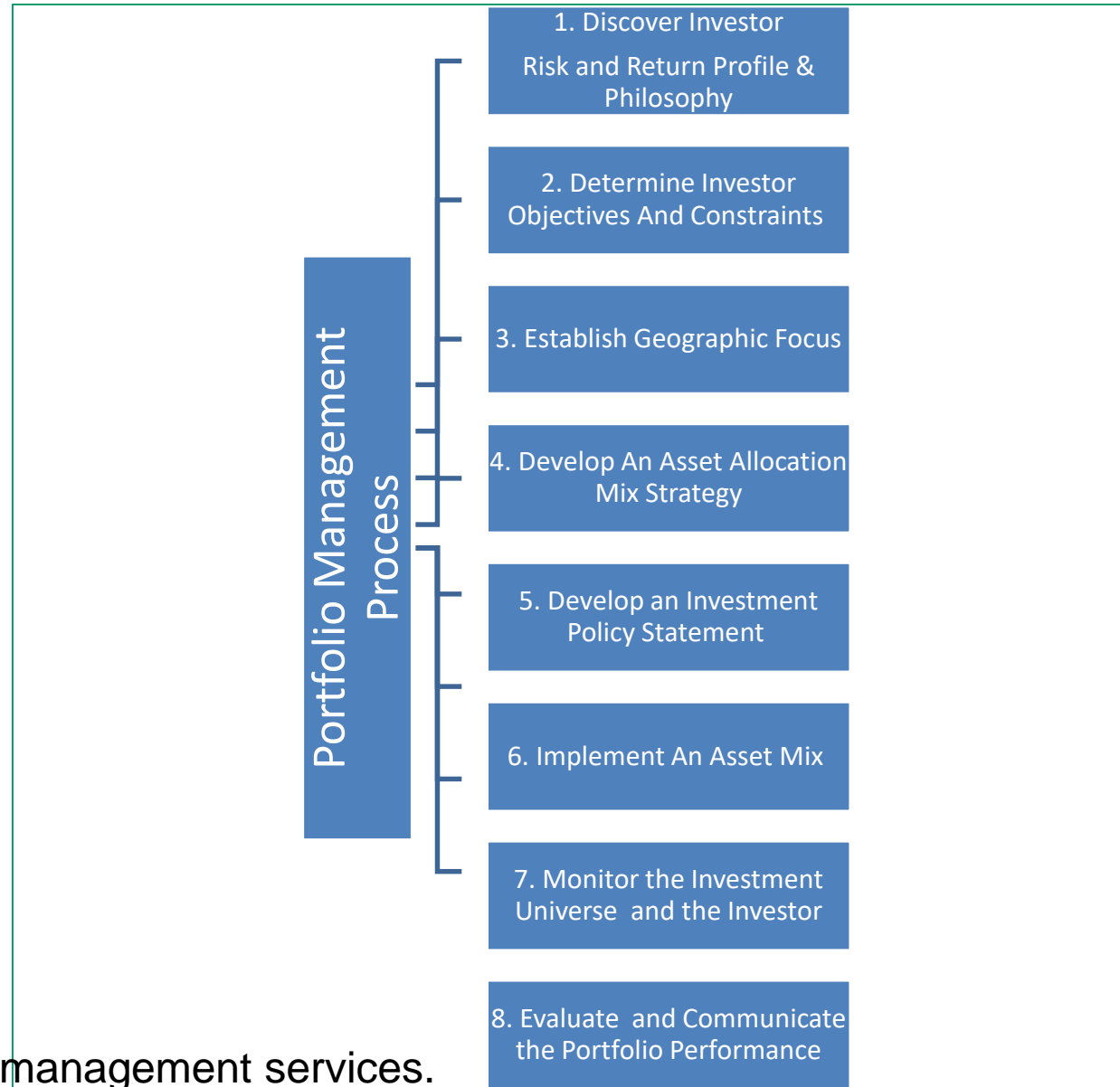
Involves estimating the fundamental value of potential investments and identifying attractive securities and assets. An investment's fundamental value, also called intrinsic value, indicates the price that investors would pay for the investment if they had a complete understanding of the investment's characteristics.

## **Portfolio Construction**

Requires investment managers to invest in the attractive securities and assets they identified through their investment analysis, taking into account the client's requirements and appropriate asset allocation.

LOS c: Describe investment management services.

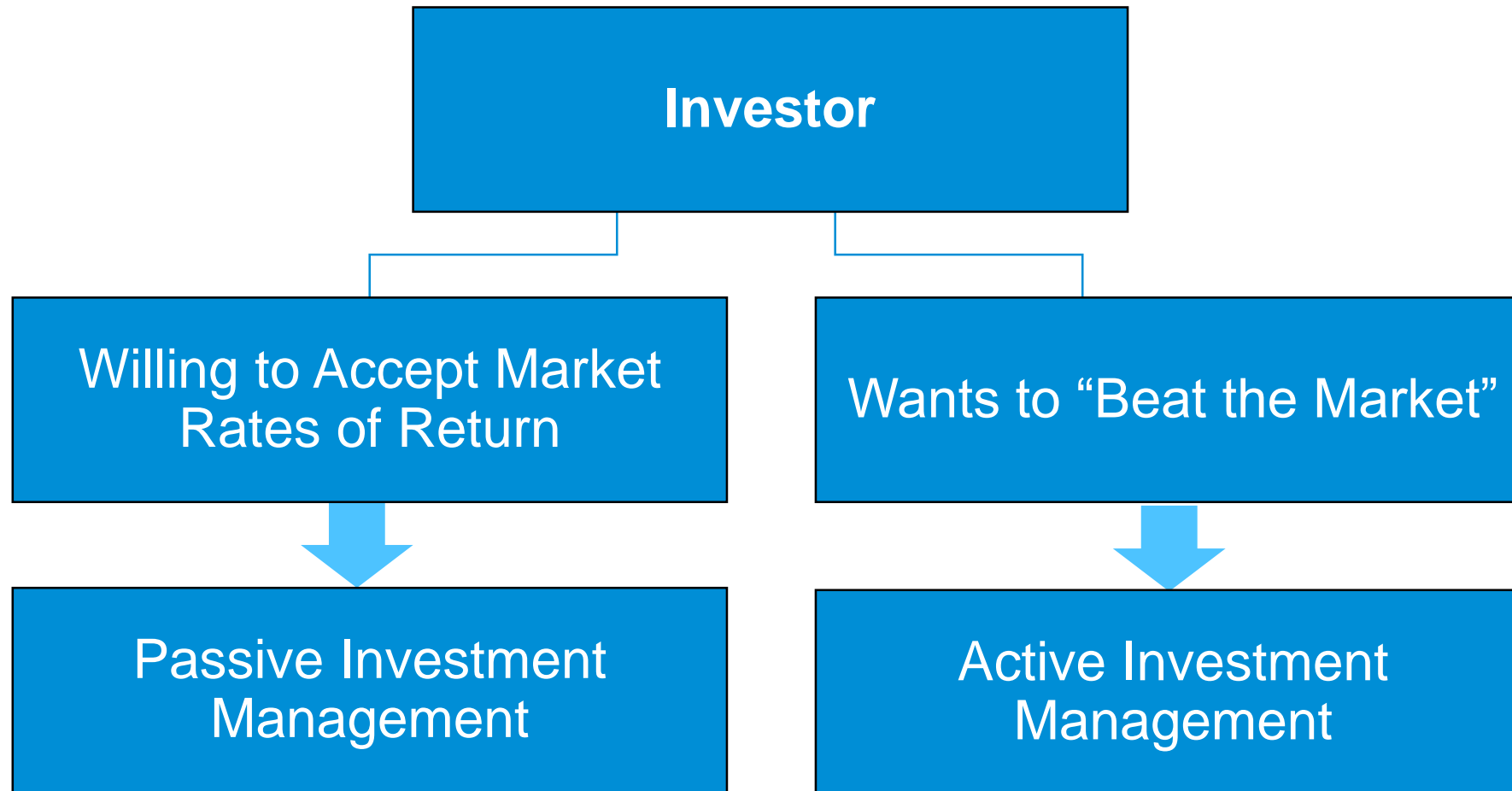
# PORTFOLIO MANAGEMENT PROCESS



LOS c: Describe investment management services.



# PASSIVE VS. ACTIVE INVESTMENT MANAGEMENT



LOS c: Describe investment management services.

# PORTFOLIO MANAGEMENT PROCESS

## Strategic versus Tactical Asset Allocation



LOS c: Describe investment management services.

Source: (Credit Suisse 2013)

## SERVICES FOR RETAIL CLIENTS

Retail investors do not typically have access to the same level of service as high-net-worth and institutional investors.

Many retail clients obtain assistance and advice on investment management activities, including asset allocation, investment analysis, and portfolio construction, from investment professionals who work for financial institutions or brokers.

Some investment professionals receive commissions from the firms that sell mutual funds and life insurance policies for the trades and contracts they recommend.

Others are fee-only professionals who accept payments only from their clients.

LOS c: Describe investment management services.

# INVESTMENT INFORMATION SERVICES

## **Investment Research Providers**

- To produce their research, these companies employ data collectors, financial reporters, and expert analysts.
- Most investment reports are largely based on publicly available information.

LOS d: Describe investment information services.

# INVESTMENT INFORMATION SERVICES

## **Credit Rating Agencies**

- Credit rating agencies specialise in providing opinions about the credit quality of bonds and of their issuers.
- Most rating agencies do not charge investors for their ratings, although they may charge them for the detailed reports on which the ratings are based.
- Instead, corporate issuers pay rating agencies to rate their securities because ratings generally make securities more marketable.
- An obvious conflict of interest thus arises because issuers are likely to direct their business to those agencies that will provide high ratings.

LOS d: Describe investment information services.

# INVESTMENT INFORMATION SERVICES

## Financial Data Vendors

Many data vendors provide current and accurate data about companies and market conditions, including the following:

- **Macroeconomic data information** about economic activity and international trade
- **Accounting data information** about a company's financial statements, including the balance sheet, income statement, and cash flow statement
- **Historical market data information** about past market prices and trading volumes

LOS d: Describe investment information services.

# INVESTMENT INFORMATION SERVICES

## Financial Data Vendors

- **Newsfeeds** provide real-time news about companies and markets that investors need to know because such news may affect the value of the companies' securities
- **Market data feeds** provide real-time information about market quotes and orders, as well as recent trades, that is helpful for investors who want to trade

LOS d: Describe investment information services.

# TRADING SERVICES

**Brokers** find sellers for their clients who want to buy and buyers for their clients who want to sell.

- Clients pay commissions to their brokers for arranging their trades.
- Brokers often also ensure that their clients settle their trades.

**Block brokers** help investors who want to trade large blocks of securities by finding a counterparty willing to buy or sell a large number of securities.

**Prime brokerage** refers to a bundle of services that brokers provide to some of their clients, usually investment professionals engaged in trading.

LOS e: Describe trading services.

LOS f: Compare the roles of brokers and dealers.



## TRADING SERVICES

**Dealers** make it possible for their clients to trade without having to wait to find a counterparty.

- They are ready to buy from clients who want to sell and to sell to clients who want to buy.
- Dealers provide liquidity to their clients by allowing them to buy and sell when they want to trade.

**Primary dealers** are dealers with which central banks trade when conducting monetary policy.

LOS e: Describe trading services.

LOS f: Compare the roles of brokers and dealers.

# TRADING SERVICES

## Clearing Houses and Settlement Agents

**Clearing** refers to all activities that occur from the arrangement of the trade to its settlement.

**Settlement** consists of the final exchange of cash for securities.

Reliable settlement of all trades promotes liquidity because it reassures investors that their trades will be settled.

LOS e: Describe trading services.

## CUSTODIANS AND DEPOSITORIES

**Custodians** are typically banks and brokerage firms that hold money and securities for safekeeping on behalf of their clients.

**Depositories** act not only as custodians but also as monitors.

Having reputable third-party custodians and depositories hold all assets managed by an investment manager helps prevent investment fraud, such as Ponzi schemes.

## PRACTICE Q: DIFFICULT

Which of the following statements is most accurate? Dealers:

- A. match buyers and sellers.
- B. serve as trade negotiators.
- C. provide liquidity in securities markets.

## PRACTICE Q: DIFFICULT

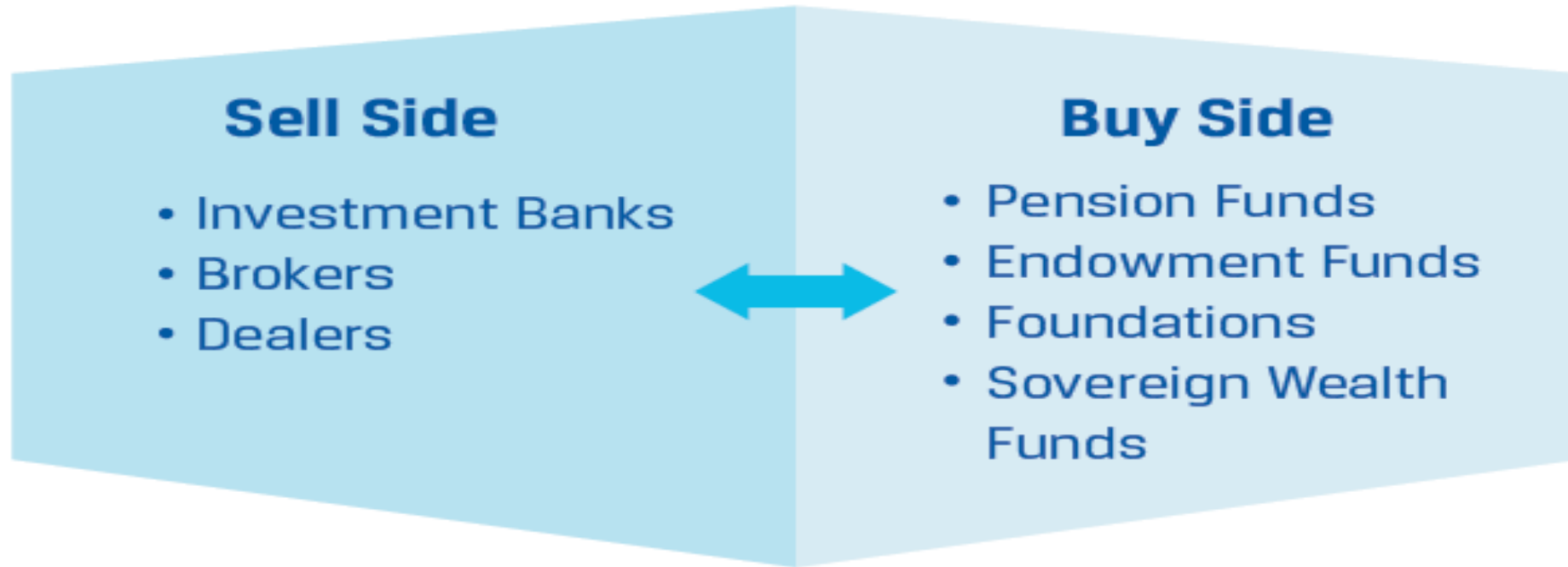
Which of the following statements is most accurate? Dealers:

- A. match buyers and sellers.
- B. serve as trade negotiators.
- C. provide liquidity in securities markets.**

**C is correct.** Dealers provide liquidity in securities markets by trading on demand; they buy when their clients want to sell and sell when their clients want to buy.

A and B are incorrect because matching buyers and sellers and serving as trade negotiators are services provided by brokers, not by dealers.

# SELL-SIDE VS. BUY-SIDE FIRMS



LOS g: Distinguish between buy-and sell-side firms in the investment industry.

# FIRM ORGANISATION



## Front Office

Handle client-facing activities, such as capturing and executing trades.

- Sales
- Marketing
- Customer Service



## Middle Office

Support front office activities by validating, booking, and confirming trades.

- Risk Management
- Information Technology
- Corporate Finance
- Portfolio Management
- Research



## Back Office

Provide administrative support by clearing and settling trades, as well as providing accounting and financial support.

- Accounting
- Human Resources
- Payroll
- Operations

LOS h: Distinguish between front-, middle-, and back-office functions in the investment industry.

## PRACTICE Q: EASY

Such activities of an investment firm as information technology, corporate finance, and risk management are housed in the:

- A. back office.
- B. front office.
- C. middle office.



## PRACTICE Q: EASY

Such activities of an investment firm as information technology, corporate finance, and risk management are housed in the:

- A. back office.
- B. front office.
- C. middle office.



**C is correct.** Information technology, corporate finance, and risk management are activities housed in the middle office of a sell-side firm.

A is incorrect. The back office houses administrative and support functions.

B is incorrect. The front office consists of client facing activities such as sales and marketing.

# LEADERSHIP TITLES AND RESPONSIBILITIES

Title	Responsibility
Chief executive officer (CEO)	Manages the firm.
Chief financial officer (CFO)	Responsible for financing the firm and for financial reporting.
Chief operating officer (COO)	Responsible for the day-to-day management of the firm.
Chief investment officer (CIO)	Responsible for any investment advice that the firm provides to its clients and for the investment decisions that the firm makes for itself and on behalf of its clients.
Head trader	Responsible for all trading operations. At firms that engage in proprietary trading, the head trader is responsible for all positions, risk, and profits.
Chief accountant (also known as finance controller)	Responsible for the accounting and financial systems.

LOS i: Identify positions and responsibilities within firms in the investment industry.

# LEADERSHIP TITLES AND RESPONSIBILITIES

Title	Responsibility
Treasurer	Responsible for cash management, including the investment of receipts and payment of bills.
Chief risk officer	Responsible for identifying and managing the risks to which either the firm or its clients are exposed.
Chief compliance officer	Responsible for ensuring that the firm complies with all constraints placed on it by laws, regulations, exchanges, clearinghouses, and clients.
Chief audit executive	Leads the internal audit department, which is responsible for providing independent assessments of the firm's operational systems along with suggestions for improvement.
General counsel	Leads the legal department, which reviews and helps write contracts, responds to or initiates lawsuits, and interprets regulations, among many other activities.

LOS i: Identify positions and responsibilities within firms in the investment industry.

## INVESTMENT STAFF

- **Portfolio managers** at buy-side firms make investment decisions for one or more portfolios.
- **Buy-side, sell-side**, and independent **research analysts** produce the investment research portfolio managers use to make decisions. They also write the research reports that some firms sell.
- **Research assistants** assist the research analysts with the collection and analysis of investment information.
- **Buy-side traders** interact with **sell-side firms** to trade orders created by their portfolio managers.

LOS i: Identify positions and responsibilities within firms in the investment industry.

## OTHER POSITIONS

- **Sales traders** at sell-side firms help arrange trades for their buy-side customers.
- **Sales managers** manage all sales for regions, products, or customer types.
- **Salespeople** identify potential clients and sell them the firm's products and services.
- **Sales assistants** provide administrative and creative support to the salespeople.
- **Client service agents and their assistants** answer client questions and help clients open, close, and manage their accounts.

LOS i: Identify positions and responsibilities within firms in the investment industry.