INVESTMENT BANKING & BROKERAGE Research Brief

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INVESTMENT BANKING & BROKERAGE

Research Brief

SASB’s Industry Research Brief provides evidence for the material sustainability issues in the industry. The brief opens with a summary of the industry, including relevant legislative and regulatory trends and sustainability risks and opportunities. Following this, evidence for each material sustainability issue (in the categories of Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance) is presented. SASB’s Industry Brief can be used to understand the research and data underlying SASB Sustainability Accounting Standards. For accounting metrics and disclosure guidance, please see SASB’s Sustainability Accounting Standards. For information about the legal basis for SASB and SASB’s standards development process, please see the Conceptual Framework.

SASB identifies the minimum set of sustainability issues likely to be material for companies within a given industry. However, the final determination of materiality is the onus of the company.

Related Documents

- Financials Sustainability Accounting Standards
- Industry Working Group Participants
- SASB Conceptual Framework
- Example of Integrated Disclosure in Form 10-K

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To ensure that investors are able to evaluate these factors, investment banking and brokerage companies should report on material sustainability risks and opportunities that are likely to affect value in the near and long term. Enhanced reporting will provide investors with a more holistic (and comparable) view of performance that includes both positive and negative externalities and the non-financial forms of capital that firms in this industry rely on to create long term value.

The sustainability issues that will drive competitiveness within the investment banking and brokerage industry include:

- Ensuring employee incentives and compensation are aligned with long-term value creation
- Promoting employee inclusion
- Incorporating environmental, social, and governance risk factors in all core products
- Complying with the legal and regulatory environment
- Developing management and mitigation strategies to protect against systemic risk

The full extent to which these sustainability issues impact value will become increasingly clear as financial sector regulation continues to evolve and emphasis is placed on ethical business practices, transparency, enhanced risk management, and limiting systemic disruption from interconnected and complex financial institutions.

### MATERIAL SUSTAINABILITY ISSUES

#### Human Capital
- Employee Incentives & Risk Taking
- Employee Inclusion

#### Business Model & Innovation
- Integration of Environmental, Social, and Governance Risk Factors in Advisory, Underwriting, and Brokerage Activities

#### Leadership & Governance
- Management of the Legal & Regulatory Environment
- Systemic Risk Management

### INTRODUCTION

The investment banking and brokerage industry continues to face regulatory pressure to reform and disclose aspects of business that contributed to the financial crisis in 2008. Specifically, firms are facing new capital requirements, stress testing, limits on proprietary trading, and increased scrutiny on compensation practices. These shifts indicate the importance of performance on key sustainability issues, and the material impact that these factors can have on profits, assets and liabilities, and cost of capital.
INDUSTRY SUMMARY

The investment banking and brokerage industry consists of firms performing a wide range of functions in the capital markets, including assisting with the capital-raising and allocation process and providing market-making and advisory services for corporations, financial institutions, governments, and high net-worth individuals.

Specific activities include financial advisory and securities underwriting services conducted on a fee basis; securities and commodities brokerage activities (this involves buying and selling securities or commodities contracts and options on a commission or fee basis for institutional investors); and trading and principal investment activities (this involves buying and selling of equities, fixed income, currencies, commodities, and related securities for client-driven and proprietary trading). Investment banks also originate and securitize loans for infrastructure projects.1

This is a mature industry with global revenues of $674 billion.1 Industry fees and other revenues are driven by capital market activity and global macroeconomic factors. Leading up to the financial crisis, the industry was characterized by significant levels of leverage, increasing complexity, globalization, and interconnectedness, but high-profile bankruptcies and significant losses during the financial crisis led to a reevaluation of business risks and opportunities. The industry is currently facing stringent regulation in the form of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which relates to several key aspects of the investment banking and brokerage industry. In addition, slow GDP growth in several key economies is leading to revenue pressures. Since 2008, investment banks have been looking to reduce costs to align with lower expected revenues, resulting in significant employee layoffs. The industry is also becoming increasingly dependent upon information technology and automation to achieve greater efficiencies.2 Companies are also attempting to strengthen their balance sheets and reduce capital risks.

Uncertainty regarding specific rules of the Dodd-Frank Act, sovereign debt risks, and litigation risks related to insider trading, money-laundering, market manipulation, and misselling are contributing to earnings and balance sheet risks for investment banks. However, robust long-term GDP growth, the development of emerging economy capital markets, and related investments in commodities and infrastructure are likely to lead to industry growth.

LEGISLATIVE & REGULATORY TRENDS IN THE INVESTMENT BANKING & BROKERAGE INDUSTRY

Although the legal and regulatory environment surrounding the investment banking and

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1 A list of five companies representative of this industry and its activities appears in Appendix I.
The brokerage industry continues to evolve, recent and future developments have the potential to impact shareholder value and further demonstrate the materiality of sustainability performance. The following section provides a brief summary of key trends that are likely to impact value and further amplify the importance of sustainability issues.1

In general, the investment banking and brokerage industry has faced periods of regulation and deregulation in response to financial crises or economic expansions. The Glass-Steagall Act of 1933, which followed the Great Depression, forced a separation of the commercial and investment banking businesses of financial institutions and created the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits. The Gramm-Leach-Bliley Act of 1999 reversed the Glass-Steagall restrictions on commercial and investment banking and amended the Bank Holding Company Act to allow affiliations among financial services companies, including banks, securities firms, and insurance companies.3

In the wake of the 2008 financial crisis, the industry is facing a period of renewed scrutiny and regulation. The Dodd-Frank Act was passed in 2010, in an effort to address the market factors that contributed to the crisis and ensure future stability. Although elements of the Act continue to be implemented, Standard & Poor’s estimated in August 2012 that the reforms will lower pre-tax earnings for eight large complex banks (both commercial and investment banking businesses) by a total between $22 and $34 billion per year.10 This includes additional costs of $2–2.5 billion per year to meet new reporting and compliance requirements.4

The Dodd-Frank Act includes regulations on over-the-counter (OTC) derivatives and swaps markets, including central clearing and reporting requirements. In addition, investment banking and brokerage firms face new regulations on minimum risk-based capital and leverage requirements as well as new rules on corporate governance and executive compensation.5,6 Further, the Volcker rule, which will go into effect on April 1, 2014, will prohibit certain types of proprietary trading by banks.

Furthermore, specific firms will be required to submit to regulatory agencies an annual plan for their rapid and orderly resolution under the Bankruptcy Code. This applies to bank holding companies (including foreign banks with U.S. operations) with $50 billion or more in total assets and non-bank financial institutions designated for enhanced supervision.7 These rules, along with their counterparts in European and other jurisdictions and international regulatory standards such as Basel III, focus on capital adequacy and risk management, transparency, fairness in transactions, and the systemically important financial institution (SIFI) designation placed on some companies.

In addition to the requirements of the Dodd-Frank Act, the global and U.S. implementation of the Basel III capital standards will also influence investment banks’ profitability and

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1 This section does not purport to contain a comprehensive review of all regulations related to this industry, but is intended to highlight some ways in which regulatory trends are impacting the industry.

10 The upper end of the range reflects a stricter interpretation of the Volcker rule than originally proposed.
business models. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and FDIC issued three notices of proposed rulemaking (NPR) in 2012 that introduce strict capital requirements, including additional capital buffers and minimum capital ratios, which are consistent for the most part with the Basel III recommendations. These new rules will have a significant impact on profitability through the cost of carrying more capital and being limited in terms of leverage. These will require enhanced data management, stress testing, and risk and capital management from banking institutions. The NPRs also introduce requirements for qualitative and quantitative public disclosures, along with rules around their frequency, timing, and corporate governance; however, these only apply to banking organizations with $50 billion or more in consolidated assets.8

SUSTAINABILITY-RELATED RISKS & OPPORTUNITIES

Recent trends in the regulatory environment indicate a significant shift toward enhanced risk management, increased disclosure, and accountability. Legislation passed in response to the 2008 financial crisis demonstrates the potential for further alignment between the interests of society and those of long-term investors. As policymakers and investors increasingly demand the effective management of sustainability risks and opportunities, firms that are able to address all forms of capital – not just financial – will be better positioned to protect shareholder value. The following section provides a brief description of how the investment banking and brokerage industry depends on each form of capital and the specific sustainability issues that will drive performance, including evidence and value impact. The issues are divided into five categories: Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance. A table indicating the nature of the value impact and evidence of interest from stakeholders appears in Appendix IIA. Appendix IIB expands on the channels of financial impacts of each sustainability issue, and the recommended disclosure framework appears in Appendix III.

ENVIRONMENT

The environmental dimension of sustainability includes corporate impact on the environment, either through the use of non-renewable natural resources as input to the factors of production (e.g., water, minerals, ecosystems, and biodiversity) or through environmental externalities or other harmful releases in the environment, such as air and water pollution, waste disposal, and greenhouse gas emissions. As a service industry, investment banking and brokerage does not directly depend on natural
resources for revenue generation, nor does it engage in activities that have a direct impact on the environment. Although the consumption of energy to operate offices, data centers, and other facilities contributes to negative externalities, this issue does not meet the threshold of materiality for the investment banking and brokerage industry.

Companies in this industry do engage with industries that have a substantial and direct impact on the environment through lending and project financing activities. The importance of integrating environmental considerations into these processes is addressed below in the ‘Business Model and Innovation’ section.

**SOCIAL CAPITAL**

Social capital relates to the perceived role of business in society, or the expectation of business contribution to society in return for its license to operate. It addresses the management of relationships with key outside stakeholders, such as customers, local communities, the public, and the government. It includes issues related to access to products and services, affordability, responsible business practices in marketing, and customer privacy.

The investment banking and brokerage industry requires strong license to operate as market makers and trusted intermediaries in the public and private capital markets. Negative externalities on society can therefore erode investor and client trust, and negatively impact the public’s perception of the industry’s value. This can, in turn, lead to increased restrictions as was demonstrated by the 2008 financial crisis and the subsequent development of the Dodd-Frank Act and other reforms that place significant restrictions on investment banking and brokerage firms. The importance of legal and regulatory compliance is addressed below in the ‘Leadership and Governance’ section. As the industry’s clients consist of sophisticated investors and corporations, it does not face material issues related to social capital. However, the increasing complexity of products indicates that the issue of Transparent Information and Customer Responsibility may emerge as a material issue. It is currently addressed in the ‘SASB Industry Watch List’ section.

**HUMAN CAPITAL**

Human capital addresses the management of a company’s human resources (employees and individual contractors), as a key asset to delivering long-term value. It includes factors that affect the productivity of employees, such as employee engagement, diversity, and incentives and compensation, as well as the attraction and retention of employees in highly competitive or constrained markets for specific talent, skills, or education. It also addresses the management of labor relations in industries that rely on economies of scale and compete
on the price of products and services or in industries with legacy pension liabilities associated with vast workforces. Lastly, it includes the management of the health and safety of employees and the ability to create a safety culture for companies that operate in dangerous working environments.

Employee compensation represents the largest expense for companies in the investment banking and brokerage industry. In order to maximize long-term shareholder value, investment banking and brokerage companies must also ensure that compensation and incentives are structured to encourage sustained value creation rather than risk-taking. Further, the industry can generate significant value through encouraging employee diversity. Enhanced disclosure on employee incentives, risk taking, and employee inclusion will better allow shareholders to understand which companies in this industry are positioned to ensure shareholder value.

Employee Incentives & Risk Taking

Employee compensation in the investment banking industry can incentivize short-term or long-term performance. Structures that focus on the short-term are likely to encourage risk-taking and present adverse implications for long-term corporate value. Specifically, compensation can lead employees to take significant risks that favor potential short-term gains over long-term value creation. For individuals, these risks are typically accompanied by tremendous opportunities for personal financial reward and the risk of penalty. Firms in the investment banking and brokerage industry are faced with a need to balance the risks created by certain types of compensation packages with the need to offer attractive and competitive remuneration in order to attract talent.

Concern over this issue has led to increased regulatory and shareholder scrutiny since the financial crisis. In 2009, the Financial Stability Forum’s ‘Principles for Sound Compensation Practices’ and ‘Implementation Standards’ provided guidance on reforms, including deferred bonuses, linking bonuses to a firm’s overall performance, and providing for ex-ante adjustments to compensation.9 A 2012 study by the Financial Stability Board, found that most of the proposed principles and standards have been implemented in the U.S., except for recommendations to tie compensation to performance. The report concludes that compliance with the Pillar 3 Basel Committee requirements for remuneration, however, should assist in leveling international inconsistencies in reporting compensation.10

Given these findings, improved disclosure of employee compensation, focusing on the use of performance metrics and variable remuneration, will provide shareholders with a clear understanding of how investment banking and brokerage companies are protecting corporate value.
Evidence

Between 2009 and 2012, the median compensation ratio for the investment banking and brokerage industry fell by 0.04 percent, while ROE fell by nearly 40 percent, indicating a significant mismatch between compensation and corporate performance.\textsuperscript{11}

The factors that contribute to this apparent misalignment were recently addressed in ‘Financial Sector Compensation and Excess Risk-Taking – a Consideration of the Issues and Policy Lessons.’ The paper examines the relationship between financial sector compensation and excess risk-taking and points to specific asymmetries in: the treatment of gains and losses; the term, magnitude, and probability of gains and losses; and incentives created by standard equity-based compensation for finance executives.\textsuperscript{12} Specifically, these factors were suggested to contribute to tail risks and a focus on short-term profitability rather than the long-term health of a company.

In addition, the paper discusses a study by the Office of the New York State Comptroller in 2009 that indicated that bonuses and overall compensation in the financial sector did not mirror underlying corporate performance, even in 2007 and 2008 when investment banking and brokerage firms experienced significant losses.

In response to this misalignment that allowed compensation costs at the nine largest global investment banks to increase at a faster rate than revenue between 2004 and 2008, several institutions appear to be shifting policies to focus on shareholder value.\textsuperscript{13} Several firms have announced bonus caps, deferrals, and clawback provisions in an effort to boost their returns.

In 2012, Morgan Stanley announced that it would limit most cash bonuses at $125,000, and Deutsche Bank increased the vesting period for deferred bonuses from three to five years. Morgan Stanley’s shares subsequently increased as it cut compensation, generating a scenario that had not occurred in 15 years and demonstrating significant investor interest in this issue.\textsuperscript{14}

Although investment banking and brokerage firms continue to respond to investor and regulatory pressure relating to compensation, there have been several high profile examples of excessive risk-taking that articulate the consequences of mismanagement in this area. In 2012, JPMorgan experienced a $6.2 billion loss when a trader for its Chief Investment Office took significant positions on credit-derivatives.\textsuperscript{15} As a result, the firm was criticized by the Federal Reserve and ordered to enhance the oversight of risk management, internal audit, and finance functions and overhaul its Executive compensation system to account for adverse risk outcomes and control deficiencies.

In the previous year, a UBS trader created $8 billion in unauthorized positions on equity index futures that led to a $2.3 billion loss for the firm, resignation of key personnel, and significant damage to the investment bank’s reputation. The trader started working at UBS in its back office but was given responsibility...
for several million dollars’ worth of trading after less than three years at the firm. His knowledge of the back office risk-control systems allowed him to hide his losses. A finding by the U.K.’s Financial Services Authority found that the bank’s risk controls and management policies had been ‘seriously defective.’

Value Impact
The structure of employee incentives and compensation in the investment banking and brokerage industry can encourage excessive risk-taking. Specifically, payments or bonuses that reward short-term results can lead to significant losses on investment portfolios for companies. Whereas, companies that align employee incentives with long-term value creation will limit losses, penalties, and reputational damage associated with risky behavior in the near and long term.

Employee Inclusion
Investment banking and brokerage companies can generate significant value by ensuring diversity through inclusive recruiting, training, and development practices. Specifically, companies that have policies and procedures that ensure diversity at all employment levels and leverage this to yield new ideas, improved services, and innovation will benefit from both productivity and performance.

Enhanced disclosure on employee diversity will allow shareholders to assess how companies in this industry are managing the risks and opportunities associated with employee inclusion.

Evidence
Recent research has focused on the importance of diversity in the investment banking and brokerage industry, indicating that increased diversity among leaders and managers could have a positive impact on shareholder value. A recent study by Barclays Wealth found that “variations in how women and men think, behave, and take action in their investment decisions and inheritance planning have far reaching implications. As the rate of women’s wealth rises exponentially across the world, it is becoming increasing vital that financial institutions and wealth managers address and understand these differences.”

Another study suggests that companies that have mostly women on their board of directors outperform those with fewer women in terms of return on invested capital (ROIC) by 26 percent. Further, companies with sustained high representation of women board directors outperformed those with sustained low representation by 60 percent on ROIC and 46 percent on return on equity.

Despite these findings, the median percentage of women on the boards of investment banks was 16 percent in 2011, and the percentage of women executives was roughly four percent. This is compared to 22 percent in management positions and 41 percent in the general workforce.

In addition to the potential for value creation through increased diversity, investment banks may also be exposed to costs associated with lawsuits alleging bias. Several banks have settled cases with current or former employees.
alleging bias. In 2013, Bank of America’s Merrill Lynch agreed to pay $160 million to settle a class-action race discrimination lawsuit brought by employees who alleged that the company had a segregated workforce and policies that steered black workers into clerical positions.21 The same year, the company paid $39 million to settle a discrimination lawsuit brought on behalf of women employees.22

Smith Barney settled a lawsuit for $33 million in 2008, brought against it by female Financial Advisors that alleged discrimination in compensation and business opportunities.23

Value Impact
A diverse workforce can contribute to returns on both equity and invested capital. Alternatively, gender, race, or age biases can lead to litigation, increasing contingent liabilities, and potentially damaging brand value and reputation.

BUSINESS MODEL & INNOVATION

This dimension of sustainability is concerned with the impact of environmental and social factors on innovation and business models. It addresses the integration of environmental and social factors in the value creation process of companies, including resource efficiency and other innovation in the production process, as well as product innovation and looking at efficiency and responsibility in the design, use-phase, and disposal of products. It includes management of environmental and social impacts on tangible and financial assets—either a company’s own or those it manages as the fiduciary for others.

The investment banking and brokerage industry relies on rapid innovation and growth to meet the demands of clients and changes in technology. The primary opportunities for innovation as they relate to sustainability are associated with the increasing need to address environmental, social, and governance factors that can present indirect and direct risks and opportunities.

The industry depends heavily on the continued profitability of industries that have substantial direct impacts on the environment and those that depend heavily on natural resources and social capital. For example, evolving regulatory efforts to address climate change could limit returns on traditional power generation, while presenting opportunities new products associated with renewable energy and carbon markets. Similarly, social trends provide opportunities for new products and growth. Enhanced disclosure on how environmental, social, and governance factors are integrated into services and lending will allow shareholders to assess which companies are better positioned to address these associated risks and opportunities.
Integration of Environmental, Social, and Governance Risk Factors in Advisory, Underwriting, and Brokerage Activities

Environmental, social, and governance (ESG) factors are increasingly contributing to the financial performance of specific projects and companies at large. The value implications, both negative and positive, exist for the financing of projects or companies that generate environmental or social externalities and those that are exposed to risks associated with climate change, resource depletion, or other issues. The potential for both value creation and destruction associated with ESG factors suggests that investment banking and brokerage firms have a responsibility to their shareholders and clients to integrate these factors into analysis and valuation related to all core products, including sell-side research, advisory services, origination, underwriting, and principal transactions.

Specifically, products structured around commodities or fossil fuels should account for environmental impacts and the risks associated with regulation and reputation, all of which can impact valuation. This is particularly relevant for advisory or underwriting services for industries with high levels of GHG emissions, which could be substantially impacted by certain scenarios of regulatory responses to climate change. Further, ESG factors can have significant impacts on cash flows associated with financed projects. On the opportunity side, firms in this industry are in the position to provide liquidity and capital to businesses or projects that provide environmental or social benefits, including renewable energy development financing, social impact and green bond origination, and micro-finance underwriting.

Investment banking and brokerage companies that fail to address these risks and opportunities could face diminished returns and reduced value for shareholders. Companies should subsequently disclose how ESG factors are integrated into core products and services.

Evidence

Increased investor interest and recognition of the potential for both value creation and destruction associated with the integration of ESG factors have led numerous firms in the investment banking and brokerage industry to become signatories to the Equator Principles, the Carbon Principles, and the United Nations Principles for Responsible Investment. Although these initiatives differ in their scope and intent, they demonstrate the growing recognition that firms that consider environmental and social performance across their activities will be best positioned to protect shareholder value.
For example, firms that adopt the Carbon Principles recognize that there is “growing uncertainty around federal climate change policy and potential carbon costs. This lack of clarity has raised concerns in the industry around the economic viability of proposed coal-fired power plants, leading to a growing number of regulatory rejections of new projects. From our perspective as financial institutions, there is a clear need for a consistent approach to assessing these uncertainties.” These considerations have led companies in the investment banking and brokerage industry to address both the risks and opportunities associated with ESG factors.

In 2012, Goldman Sachs, which pledged to finance $40 billion in renewable energy over the span of 10 years, has become the leading arranger of renewable energy stock offerings with three deals valued at $405.6 million. The company also reports that its “commodities activities, particularly our power generation interests and our physical commodities activities, subject us to extensive regulation, potential catastrophic events and environmental, reputational and other risks that may expose us to significant liabilities and costs.”

In 2013, Bank of America launched a new 10-year, $50 billion environmental business goal. The company reports that the initiative “will consist primarily of lending, equipment finance, capital markets and advisory activity, carbon finance, and advice and investment solutions for clients.”

In addition to financing activities, investment banking and brokerage companies are investing in innovative products that support social and environmental performance. Between 2007 and 2013, JPMorgan Chase issued 19 green bonds with a total value of over $1.5 billion. Since 2006, Morgan Stanley has intermediated more than $700 million of microfinance securities globally and is working with the Acumen Fund on a U.S. domestic initiative to provide ‘patient capital’ to support businesses with high growth and impact potential that provide quality health care, education, and other services to underserved communities.

**Value Impact**

Investment banking and brokerage companies providing products and services that fail to account for ESG risks and opportunities could be considered negligent in their responsibilities. The omission of material information relating to products or failure to incorporate in advisory services could result in significant legal penalties or settlements as a result of litigation.

Further, firms face indirect impacts associated with this issue, including reputational damage that could arise from serving clients that create significant negative externalities. Firms that engage in activities that lead to environmental or social benefits can strengthen brand value, generate new profit opportunities, and increase market share. ESG issues can also present direct implications on value through impacts on proprietary investments and lending portfolios.
LEADERSHIP & GOVERNANCE

As applied to sustainability, governance involves the management of issues that are inherent to the business model or common practice in the industry and that are in potential conflict with the interest of broader stakeholder groups (government, community, customers, and employees) and therefore create a potential liability, or worse, a limitation or removal of license to operate. This includes regulatory compliance, lobbying, and political contributions. It includes risk management, safety management, supply chain and resource management, conflict of interest, anti-competitive behavior, and corruption and bribery. It also includes risk of business complicity with human rights violations.

Strict and evolving regulatory environments coupled with complex and often interconnected lines of business elevate the importance of strong governance in the investment banking and brokerage industry. Governance structures must ensure compliance with national and international regulations. In addition, companies must ensure that policies and practices are in place to address the risks and reporting requirements associated with systemic risk. Enhanced disclosure on governance performance is essential for shareholders to assess and benchmark management quality and a company’s ability to protect long-term value.

Management of the Legal & Regulatory Environment

The regulatory environment surrounding the investment banking and brokerage industry continues to evolve, both nationally and internationally. Companies are subsequently required to adhere to a complex and inconsistent set of rules relating to both performance and disclosure on issues including insider trading, anti-trust, price fixing, and market manipulation. In addition, investment banking and brokerage companies are subject to rules against tax evasion, fraud, money laundering, and corrupt practices.

In the U.S., provisions of the Dodd-Frank Act continue to be implemented, and companies will also face new capital adequacy, stress testing, and market liquidity risk standards established under Basel III. Although many of these regulations are specific to the issue of ‘Systemic Risk Management,’ (see below) it demonstrates the evolving nature of the regulatory landscape and the need to have strong governance practices in place. For example, enhanced rewards for whistleblowers established under the Dodd-Frank may lead to an increase in the number of complaints brought to regulators.

Investment banking and brokerage companies are exposed to potential conflicts of interest as a result of the increasingly complex nature of products and services and the number of
obligations and interests maintained. Firms act as market makers and channels for financial assets of clients, earn income from proprietary trading, and provide research on products and services. Subsequently, firms are in a position to provide investment advice while also profiting from trading. In addition, investment banking and brokerage companies have access to confidential information, which raises the risk of insider trading. The risks associated with conflicts of interest will be elevated with the adoption of the Volcker Rule, which bans conflict of interest trading.

Firms that are able to manage these regulatory concerns and ensure compliance through strong internal processes and policies will be better positioned to protect shareholder value and limit future liabilities.

Evidence

In 2013, JPMorgan Chase admitted to violating securities laws in the previous year when top managers withheld information from the board associated with trades in what became known as the London Whale case. In addition to $920 million in penalties, the company has increased spending on internal controls by an estimated $1 billion and dedicated more than $750 million to address various consent orders. The SEC, U.S. Justice Department, and Commodity Futures Trading Commission continue to investigate these trades, and the possibility for additional fines remains.

Fourth quarter earnings in 2013 for both Deutsche Bank and Credit Suisse were impacted by ongoing legal costs. Deutsche Bank reported an unexpected loss of $1.62 billion in the fourth quarter, partly attributing it to lawsuits and other official inquiries. Credit Suisse experienced limited profit in the same quarter as a result of having to set aside money for legal costs associated with mortgage litigation and a tax dispute with the U.S.

In 2012, U.S and European regulators fined UBS $1.5 billion for manipulating benchmark interest rates in the London interbank offered rate (Libor) and Japanese markets. UBS posted a quarterly loss of nearly $2 billion during the fourth quarter of 2012, after booking the Libor fine (and including costs related to job cuts). The same year, Barclays was fined $451 million for interest rate manipulation, which led to an 18 percent decrease in share price. Additional fines have been levied against Citigroup, JPMorgan Chase, Deutsche Bank, Royal Bank of Scotland, and Société Générale for improperly influencing Libor.

Value Impact

Failure to comply with relevant regulations can have a significant impact on corporate value and on the industry as a whole. Specifically, conflicts of interest resulting in unfair business practices could increase general and administrative expenses, thereby reducing operational efficiency, due to the potential for enhanced regulatory oversight. Poor performance on this issue can also generate significant contingent liabilities and limits on specific business activities. Further, there is potential for the withdrawal of a firm’s business license and criminal prosecution of employees.
In addition, the potential for negative publicity associated with poor performance in this area can damage a firm’s reputation and lead to a devaluation of intangible assets. This could further result in lost revenue and market share as clients seek alternatives. Combined, these factors can lead to credit rating downgrades, higher cost of capital, and diminished shareholder value. This could further result in lost revenue and market share as clients seek alternatives. Combined, these factors can lead to credit rating downgrades, higher cost of capital, and diminished shareholder value. This could further result in lost revenue and market share as clients seek alternatives. Combined, these factors can lead to credit rating downgrades, higher cost of capital, and diminished shareholder value.

The fact that the regulatory environment surrounding investment banking and brokerage continues to evolve creates some uncertainty about the potential impact on corporate value. However, evidence suggests that current and developing regulations can present a material impact in both the near and long term.

Systemic Risk Management

The recent financial crisis articulated the importance of managing risks to capital in the investment banking and brokerage industry. Specifically, firms that failed to ensure adequate capital reserves were unable to protect shareholder value, which contributed to a significant market disruption. The systemic nature of the risk results from the interconnectedness of financial institutions and has become a central concern of federal and international regulators.

The capital requirements developed by the Federal Reserve and under Basel III are intended to ensure that firms have adequate capital to withstand a financial stress. In addition, the management of the size, quality, and stability of a company’s capital has been demonstrated to be essential to protecting shareholder value and preventing a systemic market disruption. Subsequently, there is increased recognition of the importance of metrics such as skewness and kurtosis of trading revenue, risk limit management, and exposure to OTC derivative positions as key indicators of stability.

Further, banks are required to undergo stress tests to evaluate whether the company has the capital to absorb losses, continue operations, and meet obligations in the event of adverse economic and financial conditions.

In an effort to demonstrate how these risks are being managed, investment banking and brokerage companies should enhance disclosure on metrics, including the results of annual stress tests, Basel III liquidity coverage ratios, exposure to OTC derivatives, and management of risk limits.

Evidence

The collapse and near failure of several financial institutions (including Lehman Brothers and Bear Stearns) during the 2008 financial crisis provides the most compelling evidence of the importance of systemic risk management and the extreme impact on value that can arise from both internal and external risk. Although those examples represent an extreme, most investment banks wrote down significant amounts of capital during the financial crisis due to inadequate risk assessments, unsustain-
able leverage ratios, and spill-over effects from firms’ off-balance sheet liabilities and losses at counterparties. Subsequently, shares of Citigroup, Bank of America, Goldman Sachs, and JPMorgan trade at less than book value, indicating a continued lack of investor confidence in capital accounting at these firms. In addition, investment banking and brokerage companies continue to face significant fines and an evolving regulatory environment as a result of the actions that contributed to the financial crisis.

In 2013, JPMorgan Chase agreed to pay $13 billion to resolve the U.S. Justice Department’s investigation into the company’s sale of mortgage bonds that contributed to the downturn. To date, the six biggest banks in the U.S., including JPMorgan and Bank of America, have incurred more than $100 billion in legal costs since 2008, demonstrating the direct costs associated with actions that contribute to systemic risk.

In 2003, the SEC completed enforcement actions against 10 investment banks following joint investigations by regulators into ‘allegations of undue influence of investment banking interests on securities research at brokerage firms.’ In sum, companies were required to pay $1.4 billion under the global settlement, which according to the SEC at the time, included ‘some of the highest ever imposed in civil enforcement actions under the securities laws.’

Value Impact

The development and implementation of regulations related to system risk management are intended to improve the ability of companies to absorb shocks arising from financial and economic stress. The adoption of these requirements and the improvement of capital ratios beyond specified levels is likely to provide investment banking and brokerage companies a strong competitive advantage. In addition, increased quality, transparency, and consistency of a firm’s capital base are likely to improve credit rating and lower the cost of capital. Higher liquidity ratios also have a positive impact on operational efficiency and profitability, thereby contributing to shareholder value.

A failure to adapt to new and developing standards could lead to enhanced regulatory oversight and litigation, thereby increasing recurring, general, and administrative expenses, imposing contingent liabilities, and diminishing the value of intangible assets. Further, this could lead to a lack of trust on the part of clients and a potential loss of market share. Finally, inadequate risk assessment and a failure to accurately price financial assets is likely to have a negative impact on a firm’s balance sheet.

Although regulations relating to systemic risk management continue to evolve and take effect, the potential impact on value is clear and likely to present material implications in the near and long term.
The following section provides a brief description of sustainability issues that did not meet SASB’s materiality threshold at present, but could have a material impact on the investment banking and brokerage industry in the future.

**Regulatory Capture and Political Influence**

The issue of regulatory capture and political influence continues to be prominent in the investment banking and brokerage industry. Specifically, companies are widely seen as having had a significant influence on the development of new regulations since the 2008 financial crisis, through lobbying, contributions, and direct relationships with regulators.

The material implications of lobbying efforts and campaign contributions remain controversial. Specifically, there is little evidence on how these actions impact shareholder value and whether the cost of these activities is outweighed by corporate gains. Additionally, the issue raises questions of the efficacy of lobbying for or against a regulation that protects near-term profits but is misaligned with longer-term strategic investments and initiatives.

Although investor interest in the issue appears to be increasing, it is not clear whether shareholder resolutions requiring such disclosure will receive widespread support. Additionally, after indicating it as a priority issue for 2013, the SEC dropped the issue of political spending from its 2014 agenda.

**Transparent Information and Customer Responsibility**

The investment banking and brokerage industry serves financially sophisticated clients, including corporations, institutional investors, hedge funds, and asset managers. Further, companies in this industry often have multiple relationships with specific clients that vary based on services provided.

Despite the financial sophistication of these clients, the recent financial crisis articulated the importance of transparent information and responsibility toward customers due to the complex nature of these relationships and the products offered. Investment banking and brokerage companies have a subsequent responsibility to provide transparent information and pricing on all products, including origination, wholesale market-making, and algorithmic or high-frequency trading.

The complex nature of these relationships and the products offered can lead to actual or perceived instances where legal responsibilities were not adequately disclosed. Enhanced disclosure on how this issue is managed would allow shareholders to understand how value is being protected.
APPENDIX I: Five Representative Companies | Investment Banking & Brokerage

<table>
<thead>
<tr>
<th>COMPANY NAME (TICKER SYMBOL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs (GS)</td>
</tr>
<tr>
<td>JPMorgan Chase (JPM)</td>
</tr>
<tr>
<td>Nomura Holdings (NMR)</td>
</tr>
<tr>
<td>Morgan Stanley (MS)</td>
</tr>
<tr>
<td>Credit Suisse Group (CS)</td>
</tr>
</tbody>
</table>

This list includes five companies representative of the Investment Banking & Brokerage Industry and its activities. Only companies that are US listed and where at least 20 percent of revenue is generated by activities in this industry according to the latest information available on Bloomberg Professional Service were included.
## APPENDIX IIA:
### Evidence for Material Sustainability Issues

<table>
<thead>
<tr>
<th>MATERIAL SUSTAINABILITY ISSUES</th>
<th>EVIDENCE OF INTEREST</th>
<th>EVIDENCE OF FINANCIAL IMPACT</th>
<th>FORWARD-LOOKING IMPACT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HM (1-100)</td>
<td>IWGs</td>
<td>%</td>
</tr>
<tr>
<td>HUMAN CAPITAL</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee Incentives &amp; Risk Taking</td>
<td>25</td>
<td>88</td>
<td>4</td>
</tr>
<tr>
<td>Employee Inclusion</td>
<td>50</td>
<td>59</td>
<td>5</td>
</tr>
<tr>
<td>BUSINESS MODEL &amp; INNOVATION</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integration of Environmental, Social, and Governance Risk Factors in Advisory, Underwriting, and Brokerage Activities</td>
<td>40</td>
<td>73</td>
<td>3</td>
</tr>
<tr>
<td>LEADERSHIP &amp; GOVERNANCE</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management of the Legal &amp; Regulatory Environment</td>
<td>60</td>
<td>96</td>
<td>1</td>
</tr>
<tr>
<td>Systemic Risk Management</td>
<td>58</td>
<td>92</td>
<td>2</td>
</tr>
</tbody>
</table>

**HM:** Heat Map, a score out of 100 indicating the relative importance of the issue among SASB’s initial list of 43 generic sustainability issues. The score is based on the frequency of relevant keywords in documents (i.e., 10-Ks, shareholder resolutions, legal news, news articles, and corporate sustainability reports) that are available on the Bloomberg terminal for the industry’s publicly listed companies.

**IWGs:** SASB Industry Working Groups

%: The percentage of IWG participants that found the issue to be material. (-) denotes that the issue was added after the IWG was convened.

**Priority:** Average ranking of the issue in terms of importance. One denotes the most material issue. (N/A) denotes that the issue was added after the IWG was convened.

**EI:** Evidence of Interest, a subjective assessment based on quantitative and qualitative findings.

**EFI:** Evidence of Financial Impact, a subjective assessment based on quantitative and qualitative findings.

**FLI:** Forward Looking Impact, a subjective assessment on the presence of a material forward-looking impact.
## Evidence of Financial Impact

<table>
<thead>
<tr>
<th>EVIDENCE OF FINANCIAL IMPACT</th>
<th>REVENUE &amp; EXPENSES</th>
<th>ASSETS &amp; LIABILITIES</th>
<th>RISK PROFILE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue</td>
<td>Operating Expenses</td>
<td>Non-operating Expenses</td>
</tr>
<tr>
<td>Human Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee Incentives &amp; Risk Taking</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee Inclusion</td>
<td>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business Model &amp; Innovation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integration of Environmental, Social, and Governance Risk Factors in Advisory, Underwriting, and Brokerage Activities</td>
<td>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leadership &amp; Governance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management of the Legal &amp; Regulatory Environment</td>
<td>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Systemic Risk Management</td>
<td>*</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Impact Levels
- **High Impact**
- **Medium Impact**
- **Low Impact**

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## APPENDIX III: Sustainability Accounting Metrics | Investment Banking & Brokerage

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Incentives &amp; Risk Taking</td>
<td>Discussion of variable compensation policies and practices</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0102-01</td>
</tr>
<tr>
<td></td>
<td>Percentage of total compensation that is variable for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0102-02</td>
</tr>
<tr>
<td></td>
<td>Percentage of variable compensation that is equity for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0102-03</td>
</tr>
<tr>
<td></td>
<td>Percentage of employee compensation which includes ex post adjustments for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0102-04</td>
</tr>
<tr>
<td></td>
<td>Number of instances when risk limits were breached and number and percentage by response: (1) position reduced, (2) risk limit temporarily increased, (3) risk limit permanently increased, (4) other</td>
<td>Quantitative</td>
<td>Number (#), percentage (%)</td>
<td>FN0102-05</td>
</tr>
<tr>
<td>Employee Inclusion</td>
<td>Percentage of gender and racial/ethnic group representation for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%)</td>
<td>FN0102-06</td>
</tr>
<tr>
<td>Management of the Legal &amp; Regulatory Environment</td>
<td>Amount of legal and regulatory fines and settlements associated with financial industry regulation and percentage that resulted from whistleblowing actions(^{\text{V}})</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0102-07</td>
</tr>
<tr>
<td></td>
<td>Number of inquiries, complaints, or issues received by the legal and compliance office through an internal monitoring or reporting system, and percentage that were substantiated(^{\text{V}})</td>
<td>Quantitative</td>
<td>Number (#), percentage (%)</td>
<td>FN0102-08</td>
</tr>
<tr>
<td></td>
<td>Number of conflicts of interest disclosed to clients, customers, and/or counterparties</td>
<td>Quantitative</td>
<td>Number (#)</td>
<td>FN0102-09</td>
</tr>
</tbody>
</table>

\(^{\text{V}}\) Note to FN0102-07 – Disclosure shall include a description of fines and settlements and corrective actions implemented in response to events.

\(^{\text{V}}\) Note to FN0102-08 – Disclosure shall include a description of the nature of the inquiries, complaints, or issues and of any corrective actions taken by the registrant in response to information received by its legal and compliance office through an internal monitoring and/or reporting system.
### APPENDIX III: Sustainability Accounting Metrics | Investment Banking & Brokerage (Cont.)

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic Risk Management</td>
<td>Results of stress tests under adverse economic scenarios,(^{\text{VII}}) including the following measures (actual and projection): (1) Loan losses (2) Losses, revenue, and net income before taxes (3) Tier 1 common capital ratio (4) Tier 1 capital ratio (5) Total risk-based capital ratio (6) Tier 1 leverage ratio</td>
<td>Quantitative</td>
<td>U.S. dollars ($), ratio in U.S. dollars ($)</td>
<td>FN0102-10</td>
</tr>
<tr>
<td></td>
<td>Basel III Liquidity Coverage Ratio (LCR)</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0102-11</td>
</tr>
<tr>
<td></td>
<td>Net exposure to written credit derivatives</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0102-12</td>
</tr>
<tr>
<td></td>
<td>Level 3 assets: (1) total value and (2) percentage of total assets</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0102-13</td>
</tr>
<tr>
<td></td>
<td>Skewness and kurtosis of trading revenue</td>
<td>Quantitative</td>
<td>n/a</td>
<td>FN0102-14</td>
</tr>
<tr>
<td>Integration of Environmental, Social, and Governance Risk Factors in Advisory, Underwriting, and Brokerage Activities</td>
<td>Discussion of how environmental, social, and governance (ESG) factors are incorporated into core products and services</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0102-15</td>
</tr>
<tr>
<td></td>
<td>Amount of sustainability-focused services, activities, and products, broken down by: (1) origination, (2) market making, and (3) advisory and underwriting(^{\text{VIII}})</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0102-16</td>
</tr>
<tr>
<td></td>
<td>Deal size of advisory and underwriting transactions for companies in the following sectors/industries: Energy/Oil&amp;Gas, Materials/Basic Materials, Industrials, and Utilities</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0102-17</td>
</tr>
</tbody>
</table>

\(^{\text{VII}}\) Note to **FN0102-10** – Disclosure shall include a description of the most significant drivers of changes in regulatory capital ratios.

\(^{\text{VIII}}\) Note to **FN0102-16** – Disclosure shall include a description of sustainability-focused services, activities, and products, broken down by: (1) origination, (2) market making, and (3) advisory and underwriting.
APPENDIX IV: Analysis of 10-K Disclosures | Investment Banking & Brokerage

The following graph demonstrates an aggregate assessment of how the top ten U.S. domiciled companies, by revenue, in the investment banking & brokerage industry are currently reporting on material sustainability issues in the Form 10-K.
References


17 Ibid.


References (Cont.)


