

PIPER JAFFRAY COMPANIES
Form 10-Q
May 03, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the Quarterly Period Ended March 31, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the transition period from _____ to _____

Commission File No. 001-31720

PIPER JAFFRAY COMPANIES

(Exact Name of Registrant as specified in its Charter)

DELAWARE

30-0168701

(State or Other Jurisdiction of Incorporation or
Organization)

(IRS Employer Identification No.)

800 Nicollet Mall, Suite 800

55402

Minneapolis, Minnesota

(Zip Code)

(Address of Principal Executive Offices)

(612) 303-6000

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of April 26, 2013, the registrant had 17,259,281 shares of Common Stock outstanding.

Piper Jaffray Companies
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

Piper Jaffray Companies

Consolidated Statements of Financial Condition

	March 31, 2013 (Unaudited)	December 31, 2012
(Amounts in thousands, except share data)		
Assets		
Cash and cash equivalents	\$22,515	\$105,371
Cash and cash equivalents segregated for regulatory purposes	45,012	31,007
Receivables:		
Customers	17,503	13,795
Brokers, dealers and clearing organizations	165,565	148,117
Securities purchased under agreements to resell	95,939	145,433
Financial instruments and other inventory positions owned	465,065	384,789
Financial instruments and other inventory positions owned and pledged as collateral	1,090,563	826,806
Total financial instruments and other inventory positions owned	1,555,628	1,211,595
Fixed assets (net of accumulated depreciation and amortization of \$62,350 and \$61,032, respectively)	13,802	15,089
Goodwill	196,844	196,844
Intangible assets (net of accumulated amortization of \$25,537 and \$23,876, respectively)	39,597	41,258
Other receivables	39,211	44,874
Other assets	132,326	129,697
Assets held for sale	5,936	4,653
Total assets	\$2,329,878	\$2,087,733
Liabilities and Shareholders' Equity		
Short-term financing	\$409,018	\$477,014
Variable rate senior notes	125,000	125,000
Payables:		
Customers	75,339	42,007
Brokers, dealers and clearing organizations	104,269	60,155
Securities sold under agreements to repurchase	83,040	50,000
Financial instruments and other inventory positions sold, but not yet purchased	592,797	357,201
Accrued compensation	35,517	132,124
Other liabilities and accrued expenses	42,939	53,193
Liabilities held for sale	179	864
Total liabilities	1,468,098	1,297,558
Shareholders' equity:		
Common stock, \$0.01 par value:		
Shares authorized: 100,000,000 at March 31, 2013 and December 31, 2012;		
Shares issued: 19,531,823 at March 31, 2013 and 19,530,359 at December 31, 2012;		
	195	195

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Shares outstanding: 16,000,677 at March 31, 2013 and 15,213,796 at December 31, 2012

Additional paid-in capital	741,290	754,566
Retained earnings	128,949	118,803
Less common stock held in treasury, at cost: 3,531,146 shares at March 31, 2013 and 4,316,563 shares at December 31, 2012	(118,519)	(140,939)
Accumulated other comprehensive income	519	667
Total common shareholders' equity	752,434	733,292
Noncontrolling interests	109,346	56,883
Total shareholders' equity	861,780	790,175
Total liabilities and shareholders' equity	\$2,329,878	\$2,087,733

See Notes to the Consolidated Financial Statements

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Piper Jaffray Companies
 Consolidated Statements of Operations
 (Unaudited)

	Three Months Ended March 31,	
(Amounts in thousands, except per share data)	2013	2012
Revenues:		
Investment banking	\$40,362	\$48,085
Institutional brokerage	43,260	44,080
Asset management	18,211	16,533
Interest	13,363	11,146
Other income	2,953	28
 Total revenues	 118,149	 119,872
 Interest expense	 8,616	 6,434
 Net revenues	 109,533	 113,438
 Non-interest expenses:		
Compensation and benefits	66,105	68,796
Occupancy and equipment	5,817	6,862
Communications	5,232	5,897
Floor brokerage and clearance	2,150	2,107
Marketing and business development	4,980	4,878
Outside services	7,214	5,838
Intangible asset amortization expense	1,661	1,736
Other operating expenses	(1,794	) 2,102
 Total non-interest expenses	 91,365	 98,216
 Income from continuing operations before income tax expense	 18,168	 15,222
 Income tax expense	 5,600	 7,553
 Income from continuing operations	 12,568	 7,669
 Discontinued operations:		
Loss from discontinued operations, net of tax	(521	) (3,303
 Net income	 12,047	 4,366
 Net income applicable to noncontrolling interests	 1,901	 1,437
 Net income applicable to Piper Jaffray Companies	 \$10,146	 \$2,929
 Net income applicable to Piper Jaffray Companies' common shareholders	 \$8,966	 \$2,480

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Amounts applicable to Piper Jaffray Companies			
Income from continuing operations	\$10,667		\$6,232
Loss from discontinued operations, net of tax	(521	)	(3,303
Net income applicable to Piper Jaffray Companies	\$10,146		\$2,929
Earnings/(loss) per basic common share			
Income from continuing operations	\$0.60		\$0.33
Loss from discontinued operations	(0.03	)	(0.17
Earnings per basic common share	\$0.58		\$0.15
Earnings/(loss) per diluted common share			
Income from continuing operations	\$0.60		\$0.33
Loss from discontinued operations	(0.03	)	(0.17
Earnings per diluted common share	\$0.57		\$0.15
Weighted average number of common shares outstanding			
Basic	15,582		16,072
Diluted	15,610		16,072
See Notes to the Consolidated Financial Statements			

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Piper Jaffray Companies
 Consolidated Statements of Comprehensive Income
 (Unaudited)

	Three Months Ended March 31,	
(Amounts in thousands)	2013	2012
Net income	\$12,047	\$4,366
Other comprehensive income/(loss), net of tax:		
Foreign currency translation adjustment	(148	) 88
Comprehensive income	11,899	4,454
Comprehensive income applicable to noncontrolling interests	1,901	1,437
Comprehensive income applicable to Piper Jaffray Companies	\$9,998	\$3,017

See Notes to the Consolidated Financial Statements

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Piper Jaffray Companies
 Consolidated Statements of Cash Flows
 (Unaudited)

	Three Months Ended March 31,	
(Dollars in thousands)	2013	2012
Operating Activities:		
Net income	\$12,047	\$4,366
Adjustments to reconcile net income to net cash provided by/(used in) operating activities:		
Depreciation and amortization of fixed assets	1,426	1,894
Deferred income taxes	12,070	8,983
Share-based and deferred compensation	795	(162)
Amortization of intangible assets	1,661	1,917
Amortization of forgivable loans	1,725	1,945
Decrease/(increase) in operating assets:		
Cash and cash equivalents segregated for regulatory purposes	(14,005)	9,002
Receivables:		
Customers	(3,708)	(33,978)
Brokers, dealers and clearing organizations	(17,448)	(21,929)
Securities purchased under agreements to resell	(49,763)	(19,605)
Net financial instruments and other inventory positions owned	(108,437)	(214,090)
Other receivables	3,930	(8,111)
Other assets	(14,822)	(512)
Increase/(decrease) in operating liabilities:		
Payables:		
Customers	33,332	5,575
Brokers, dealers and clearing organizations	44,114	103,955
Securities sold under agreements to repurchase	—	7,852
Accrued compensation	(74,265)	(52,518)
Other liabilities and accrued expenses	(10,211)	1,594
Assets held for sale	(1,283)	(982)
Liabilities held for sale	(685)	(677)
Net cash used in operating activities	(183,527)	(205,481)
Investing Activities:		
Purchases of fixed assets, net	(230)	(2,076)
Net cash used in investing activities	(230)	(2,076)
Financing Activities:		
Increase/(decrease) in short-term financing	(67,996)	173,976
Decrease in bank syndicated financing	—	(6,250)
Increase in securities sold under agreements to repurchase	132,297	20,167
Increase in noncontrolling interests	50,562	2,296
Repurchase of common stock	(13,929)	(15,404)
Excess tax benefit from share-based compensation	55	—

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Net cash provided by financing activities	100,989	174,785
Currency adjustment:		
Effect of exchange rate changes on cash	(88	) (3
Net decrease in cash and cash equivalents	(82,856	) (32,775
Cash and cash equivalents at beginning of period	105,371	85,024
Cash and cash equivalents at end of period	\$22,515	\$52,249
Supplemental disclosure of cash flow information -		
Cash paid/(received) during the period for:		
Interest	\$8,302	\$7,043
Income taxes	\$596	\$(1,365)
Non-cash financing activities -		
Issuance of common stock for retirement plan obligations:		
96,049 shares and 165,241 shares for the three months ended March 31, 2013 and 2012, respectively	\$3,939	\$3,814
Issuance of restricted common stock for annual equity award:		
431,582 shares and 487,181 shares for the three months ended March 31, 2013 and 2012, respectively	\$17,699	\$11,244
See Notes to the Consolidated Financial Statements		

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Note 1 Organization and Basis of Presentation

Organization

Piper Jaffray Companies is the parent company of Piper Jaffray & Co. (“Piper Jaffray”), a securities broker dealer and investment banking firm; Piper Jaffray Ltd., a firm providing securities brokerage and mergers and acquisitions services in Europe headquartered in London, England; Advisory Research, Inc. (“ARI”) and Fiduciary Asset Management, LLC (“FAMCO”), entities providing asset management services to separately managed accounts, closed-end and open-end funds and partnerships; Piper Jaffray Investment Group Inc., which consists of entities providing alternative asset management services; Piper Jaffray Financial Products Inc., Piper Jaffray Financial Products II Inc. and Piper Jaffray Financial Products III Inc., entities that facilitate derivative transactions; and other immaterial subsidiaries. Piper Jaffray Companies and its subsidiaries (collectively, the “Company”) operate in two reporting segments: Capital Markets and Asset Management. A summary of the activities of each of the Company’s business segments is as follows:

Capital Markets

The Capital Markets segment provides institutional sales, trading and research services and investment banking services. Institutional sales, trading and research services focus on the trading of equity and fixed income products with institutions, government and non-profit entities. Revenues are generated through commissions and sales credits earned on equity and fixed income institutional sales activities, net interest revenues on trading securities held in inventory, and profits and losses from trading these securities. Investment banking services include management of and participation in underwritings, merger and acquisition services and public finance activities. Revenues are generated through the receipt of advisory and financing fees. Also, the Company generates revenue through strategic trading activities, which focus on proprietary investments in municipal bond and non-agency mortgage-backed securities, and merchant banking activities, which involve equity or debt investments in late stage private companies. As certain of these efforts have matured and an investment process has been developed, the Company has created alternative asset management funds in merchant banking and municipal securities in order to invest firm capital as well as seek capital from outside investors. The Company receives management and performance fees for managing these funds.

As discussed in Note 4, the Company discontinued its Hong Kong capital markets business in 2012.

Asset Management

The Asset Management segment provides traditional asset management services with product offerings in equity securities and master limited partnerships to institutions and individuals. Revenues are generated in the form of management and performance fees. Revenues are also generated through investments in the partnerships and funds that the Company manages.

As discussed in Note 4, the Company's FAMCO subsidiary has been held for sale since December 31, 2012.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) and include the accounts of Piper Jaffray Companies, its wholly owned subsidiaries, and all other entities in which the Company has a controlling financial interest. Noncontrolling interests represent equity interests in consolidated entities that are not attributable, either directly or indirectly, to Piper Jaffray Companies. Noncontrolling interests include the minority equity holders’ proportionate share of the equity in a municipal bond fund, merchant banking fund and private equity investment vehicles. All material intercompany balances have been eliminated.

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates and assumptions are based on the best information available, actual results could differ from those estimates.

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Reclassification

In 2012, the Company reclassified the value of restricted stock forfeitures from other income to a reduction of compensation and benefits expense within the consolidated statements of operations to be consistent with the reporting of forfeitures for the Piper Jaffray Companies Mutual Fund Restricted Share Investment Plan and to more accurately reflect compensation expense. The prior period amount has been reclassified in the accompanying financial statements to conform to current period presentation. The reclassified amount within continuing operations was \$0.8 million for the three months ended March 31, 2012. This change had no effect on shareholders' equity, net income or cash flows for the period presented.

Note 2 Summary of Significant Accounting Policies

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for a full description of the Company's significant accounting policies.

Note 3 Recent Accounting Pronouncements

Adoption of New Accounting Standards

Disclosures about Offsetting Assets and Liabilities

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-11, "Disclosures about Offsetting Assets and Liabilities," ("ASU 2011-11") amending FASB Accounting Standards Codification Topic 210, "Balance Sheet." The amended guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. In January 2013, the FASB issued ASU No. 2013-01, "Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities," ("ASU 2013-01") to limit the scope of ASU 2011-11 to derivatives, repurchase agreements, and securities lending arrangements. ASU 2011-11 and ASU 2013-01 were effective for the Company as of January 1, 2013. The adoption of ASU 2011-11 and ASU 2013-01 did not impact the Company's results of operations or financial position, but did impact the Company's disclosures about the offsetting of certain assets and liabilities, and related arrangements.

Indefinite-Lived Intangible Assets

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment," ("ASU 2012-02") amending FASB Accounting Standards Codification Topic 350, "Intangibles - Goodwill and Other." The amended guidance permits companies to first assess qualitative factors in determining whether the fair value of an indefinite-lived intangible asset is less than its carrying amount. ASU 2012-02 was effective for annual and interim indefinite-lived intangible asset impairment tests performed by the Company for the fiscal year beginning as of January 1, 2013. The adoption of ASU 2012-02 did not impact the Company's results of operations or financial position.

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Notes to the Consolidated Financial Statements

(Unaudited)

Note 4 Discontinued Operations

The Company's Hong Kong capital markets business ceased operations as of September 30, 2012. In accordance with the provisions of FASB Accounting Standards Codification Topic 205-20, "Discontinued Operations," the results from this business, previously reported in the Capital Markets segment, have been classified as discontinued operations for all periods presented.

The components of discontinued operations for the Hong Kong capital markets business are as follows:

	Three Months Ended March 31,	
(Dollars in thousands)	2013	2012
Net revenues	\$—	\$2,055
Total non-interest expenses	397	4,940
Loss from discontinued operations before income tax expense/(benefit)	(397	) (2,885
Income tax expense/(benefit)	(73	) 36
Loss from discontinued operations, net of tax	\$(324	) \$(2,921

On March 8, 2013, the Company signed a definitive agreement to sell FAMCO and the transaction closed on April 30, 2013 for consideration of \$4.0 million. FAMCO's results, previously reported in the Asset Management segment, have been presented as discontinued operations for all periods presented and the related assets and liabilities have been classified as held for sale. The disposal group primarily consists of intangible assets, other receivables and accrued compensation at March 31, 2013 and December 31, 2012, respectively.

The components of discontinued operations for FAMCO are as follows:

	Three Months Ended March 31,	
(Dollars in thousands)	2013	2012
Net revenues	\$1,276	\$1,372
Total non-interest expenses	1,583	1,338
Income/(loss) from discontinued operations before income tax expense/(benefit)	(307	) 34
Income tax expense/(benefit)	(110) 416
Loss from discontinued operations, net of tax	\$(197) \$(382

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Note 5 Financial Instruments and Other Inventory Positions Owned and Financial Instruments and Other Inventory Positions Sold, but Not Yet Purchased

Financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased were as follows:

(Dollars in thousands)	March 31, 2013	December 31, 2012
Financial instruments and other inventory positions owned:		
Corporate securities:		
Equity securities	\$28,398	\$16,478
Convertible securities	47,858	44,978
Fixed income securities	52,041	33,668
Municipal securities:		
Taxable securities	372,987	164,059
Tax-exempt securities	398,650	418,189
Short-term securities	150,461	68,328
Asset-backed securities	107,681	116,195
U.S. government agency securities	359,137	304,259
U.S. government securities	625	4,966
Derivative contracts	37,790	40,475
	\$1,555,628	\$1,211,595
Financial instruments and other inventory positions sold, but not yet purchased:		
Corporate securities:		
Equity securities	\$32,992	\$27,090
Convertible securities	1,443	1,015
Fixed income securities	12,493	19,314
Municipal securities:		
Short-term securities	—	60
U.S. government agency securities	124,171	73,724
U.S. government securities	415,906	231,043
Derivative contracts	5,792	4,955
	\$592,797	\$357,201

At March 31, 2013 and December 31, 2012, financial instruments and other inventory positions owned in the amount of \$1.1 billion and \$826.8 million, respectively, had been pledged as collateral for repurchase agreements, short-term financings and to the prime broker of the Company's municipal bond funds.

Financial instruments and other inventory positions sold, but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, thereby creating a liability to purchase the security in the market at prevailing prices. The Company is obligated to acquire the securities sold short at prevailing market prices, which may exceed the amount reflected on the consolidated statements of financial condition. The Company economically hedges changes in the market value of its financial instruments and other inventory positions owned using inventory positions sold, but not yet purchased, interest rate derivatives, credit default swap index contracts, futures and exchange-traded options.

Derivative Contract Financial Instruments

The Company uses interest rate swaps, interest rate locks and credit default swap index contracts to facilitate customer transactions and as a means to manage risk in certain inventory positions. The following describes the Company's derivatives by the type of transaction or security the instruments are economically hedging.

Customer matched-book derivatives: The Company enters into interest rate derivative contracts in a principal capacity as a dealer to satisfy the financial needs of its customers. The Company simultaneously enters into an interest rate derivative contract with a third party for the same notional amount to hedge the interest rate and credit risk of the initial client interest rate derivative contract. In certain limited instances, the Company has only hedged interest rate risk with a third party, and retains uncollateralized

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

credit risk as described below. The instruments use interest rates based upon either the London Interbank Offer Rate (“LIBOR”) index or the Securities Industry and Financial Markets Association (“SIFMA”) index.

Trading securities derivatives: The Company enters into interest rate derivative contracts to hedge interest rate and market value risks associated with its fixed income securities. The instruments use interest rates based upon either the Municipal Market Data (“MMD”) index, LIBOR or the SIFMA index. The Company also enters into credit default swap index contracts to hedge credit risk associated with its taxable fixed income securities.

The following table presents the total absolute notional contract amount associated with the Company’s outstanding derivative instruments:

(Dollars in thousands)		March 31,	December 31,
Transaction Type or Hedged Security	Derivative Category	2013	2012
Customer matched-book	Interest rate derivative contract	\$5,457,237	\$5,569,096
Trading securities	Interest rate derivative contract	219,000	244,250
Trading securities	Credit default swap index contract	344,552	230,650
		\$6,020,789	\$6,043,996

The Company’s interest rate derivative contracts and credit default swap index contracts do not qualify for hedge accounting, therefore, unrealized gains and losses are recorded on the consolidated statements of operations. The following table presents the Company’s unrealized gains/(losses) on derivative instruments:

(Dollars in thousands)		Three Months Ended March 31,	
Derivative Category	Operations Category	2013	2012
Interest rate derivative contract	Investment banking	\$(538)	\$(741)
Interest rate derivative contract	Institutional brokerage	5,935	2,145
Credit default swap index contract	Institutional brokerage	(1,874)	(911)
		\$3,523	\$493

The gross fair market value of all derivative instruments and their location on the Company’s consolidated statements of financial condition prior to counterparty netting are shown below by asset or liability position (1):

(Dollars in thousands)		Asset Value at		Liability Value at	
Derivative Category	Financial Condition Location	March 31, 2013	Financial Condition Location	March 31, 2013	
Interest rate derivative contract	Financial instruments and other inventory positions owned	\$538,872	Financial instruments and other inventory positions sold, but not yet purchased	\$510,776	
Credit default	Financial instruments and other inventory positions owned	9,406	Financial instruments and other inventory positions sold, but not yet purchased	7,026	

swap index
contract

\$548,278

\$517,802

(1) Amounts are disclosed at gross fair value in accordance with the requirements of FASB Accounting Standards Codification Topic 815, "Derivatives and Hedging" ("ASC 815").

Derivatives are reported on a net basis by counterparty (i.e., the net payable or receivable for derivative assets and liabilities for a given counterparty) when a legal right of offset exists and on a net basis by cross product when applicable provisions are stated in master netting agreements. Cash collateral received or paid is netted on a counterparty basis, provided a legal right of offset exists.

Credit risk associated with the Company's derivatives is the risk that a derivative counterparty will not perform in accordance with the terms of the applicable derivative contract. Credit exposure associated with the Company's derivatives is driven by uncollateralized market movements in the fair value of the contracts with counterparties and is monitored regularly by the Company's financial risk committee. The Company considers counterparty credit risk in determining derivative contract fair value. The majority of the Company's derivative contracts are substantially collateralized by its counterparties, who are major financial institutions. The Company has a limited number of counterparties who are not required to post collateral. Based on market movements, the uncollateralized amounts representing the fair value of the derivative contract can become material, exposing the Company to the credit risk of these counterparties. As of March 31, 2013, the Company had \$29.1 million of uncollateralized

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Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

credit exposure with these counterparties (notional contract amount of \$202.8 million), including \$16.0 million of uncollateralized credit exposure with one counterparty.

Note 6 Fair Value of Financial Instruments

Based on the nature of the Company's business and its role as a "dealer" in the securities industry or as a manager of alternative asset management funds, the fair values of its financial instruments are determined internally. The Company's processes are designed to ensure that the fair values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, unobservable inputs are developed based on an evaluation of all relevant empirical market data, including prices evidenced by market transactions, interest rates, credit spreads, volatilities and correlations and other security-specific information. Valuation adjustments related to illiquidity or counterparty credit risk are also considered. In estimating fair value, the Company may utilize information provided by third-party pricing vendors to corroborate internally-developed fair value estimates.

The Company employs specific control processes to determine the reasonableness of the fair value of its financial instruments. The Company's processes are designed to ensure that the internally estimated fair values are accurately recorded and that the data inputs and the valuation techniques used are appropriate, consistently applied, and that the assumptions are reasonable and consistent with the objective of determining fair value. Individuals outside of the trading departments perform independent pricing verification reviews as of each reporting date. The Company has established parameters which set forth when the fair value of securities are independently verified. The selection parameters are generally based upon the type of security, the level of estimation risk of a security, the materiality of the security to the Company's financial statements, changes in fair value from period to period, and other specific facts and circumstances of the Company's securities portfolio. In evaluating the initial internally-estimated fair values made by the Company's traders, the nature and complexity of securities involved (e.g., term, coupon, collateral, and other key drivers of value), level of market activity for securities, and availability of market data are considered. The independent price verification procedures include, but are not limited to, analysis of trade data (both internal and external where available), corroboration to the valuation of positions with similar characteristics, risks and components, or comparison to an alternative pricing source, such as a discounted cash flow model. The Company's valuation committee, comprised of members of senior management, provides oversight and overall responsibility for the internal control processes and procedures related to fair value measurements.

The following is a description of the valuation techniques used to measure fair value.

Cash Equivalents

Cash equivalents include highly liquid investments with original maturities of 90 days or less. Actively traded money market funds are measured at their net asset value and classified as Level I.

Financial Instruments and Other Inventory Positions Owned

The Company records financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased at fair value on the consolidated statements of financial condition with unrealized gains and losses reflected on the consolidated statements of operations.

Equity securities – Exchange traded equity securities are valued based on quoted prices from the exchange for identical assets or liabilities as of the period-end date. To the extent these securities are actively traded and valuation adjustments are not applied, they are categorized as Level I. Non-exchange traded equity securities (principally hybrid preferred securities) are measured primarily using broker quotations, prices observed for recently executed market transactions and internally-developed fair value estimates based on observable inputs and are categorized within Level II of the fair value hierarchy.

Convertible securities – Convertible securities are valued based on observable trades, when available. Accordingly, these convertible securities are categorized as Level II. When observable price quotations are not available, fair value is determined using model-based valuation techniques with observable market inputs, such as specific company stock price and volatility, and unobservable inputs such as option adjusted spreads over the U.S. treasury securities curve. These instruments are categorized as Level III.

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Corporate fixed income securities – Fixed income securities include corporate bonds which are valued based on recently executed market transactions of comparable size, internally-developed fair value estimates based on observable inputs, or broker quotations. Accordingly, these corporate bonds are categorized as Level II. When observable price quotations or certain observable inputs are not available, fair value is determined using model-based valuation techniques with observable inputs such as specific security contractual terms and yield curves, and unobservable inputs such as credit spreads over U.S. treasury securities. Corporate bonds measured using model-based valuation techniques are categorized as Level III.

Taxable municipal securities – Taxable municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II.

Tax-exempt municipal securities – Tax-exempt municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II. Certain illiquid tax-exempt municipal securities are valued using market data for comparable securities (maturity and sector) and management judgment to infer an appropriate current yield or other model-based valuation techniques deemed appropriate by management based on the specific nature of the individual security and are therefore categorized as Level III.

Short-term municipal securities – Short-term municipal securities include auction rate securities, variable rate demand notes, and other short-term municipal securities. Variable rate demand notes and other short-term municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II. Auction rate securities with limited liquidity are categorized as Level III and are valued using discounted cash flow models with unobservable inputs such as the Company's expectations of recovery rate on the securities.

Asset-backed securities – Asset-backed securities are valued using observable trades, when available. Certain asset-backed securities are valued using models where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data. These asset-backed securities are categorized as Level II. Other asset-backed securities, which are principally collateralized by residential mortgages, have experienced low volumes of executed transactions resulting in less observable transaction data. Certain asset-backed securities collateralized by residential mortgages are valued using cash flow models that utilize unobservable inputs including credit default rates, prepayment rates, loss severity and valuation yields. As judgment is used to determine the range of these inputs, these asset-backed securities are categorized as Level III.

U.S. government agency securities – U.S. government agency securities include agency debt bonds and mortgage bonds. Agency debt bonds are valued by using either direct price quotes or price quotes for comparable bond securities and are categorized as Level II. Mortgage bonds include bonds secured by mortgages, mortgage pass-through securities, agency collateralized mortgage-obligation (“CMO”) securities and agency interest-only securities. Mortgage pass-through securities, CMO securities and interest-only securities are valued using recently executed observable trades or other observable inputs, such as prepayment speeds and therefore are generally categorized as Level II. Mortgage bonds are valued using observable market inputs, such as market yields ranging from 65-105 basis points (“bps”) on spreads over U.S. treasury securities, or models based upon prepayment expectations ranging from 350-450 Public Securities Association (“PSA”) prepayment levels. These securities are categorized as Level II.

U.S. government securities – U.S. government securities include highly liquid U.S. treasury securities which are generally valued using quoted market prices and therefore categorized as Level I. The Company does not transact in securities of countries other than the U.S. government.

Derivatives – Derivative contracts include interest rate and basis swaps, forward purchase agreements, interest rate locks, futures and credit default swap index contracts. These instruments derive their value from underlying assets, reference rates, indices or a combination of these factors. The majority of the Company's interest rate derivative contracts, including both interest rate swaps and interest rate locks, are valued using market standard pricing models based on the net present value of estimated future cash flows. The valuation models used do not involve material subjectivity as the methodologies do not entail significant judgment and the pricing inputs are market observable, including contractual terms, yield curves and measures of volatility. These instruments are classified as Level II within the fair value hierarchy. Certain interest rate locks transact in less active markets and were valued using valuation models that used the previously mentioned observable inputs and certain unobservable inputs that required significant judgment, such as the premium over the MMD curve. These instruments are classified as Level III. The Company's credit default swap index contracts are valued using market price quotations and are classified as Level II.

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Investments

The Company's investments valued at fair value include equity investments in private companies, investments in public companies and warrants of public or private companies. These investments are included in other assets on the consolidated statements of financial condition. Exchange traded direct equity investments in public companies and registered mutual funds are valued based on quoted prices on active markets and classified as Level I.

Company-owned warrants, which have a cashless exercise option, are valued based upon the Black-Scholes option-pricing model and certain unobservable inputs. The Company applies a liquidity discount to the value of its warrants in public and private companies. For warrants in private companies, valuation adjustments, based upon management's judgment, are made to account for differences between the measured security and the stock volatility factors of comparable companies. Company-owned warrants are reported as Level III assets. Equity securities in private companies are valued based on an assessment of each underlying security, considering rounds of financing and third-party transactions, discounted cash flow analyses and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. These securities are generally categorized as Level III.

Fair Value Option – The fair value option permits the irrevocable fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The fair value option was elected for certain merchant banking and other investments at inception to reflect economic events in earnings on a timely basis. At March 31, 2013, \$19.1 million in merchant banking and other equity investments, included within other assets on the consolidated statements of financial condition, are accounted for at fair value and are classified as Level III assets. The gains from fair value changes included in earnings as a result of electing to apply the fair value option to certain financial assets were \$3.2 million for the three months ended March 31, 2013.

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The following table summarizes quantitative information about the significant unobservable inputs used in the fair value measurement of the Company's Level III financial instruments as of March 31, 2013:

	Valuation Technique	Unobservable Input	Range	Weighted Average
Assets:				
Financial instruments and other inventory positions owned:				
Municipal securities:				
Tax-exempt securities	Discounted cash flow	Debt service coverage ratio (2)	5 - 69%	24.7%
Short-term securities	Discounted cash flow	Expected recovery rate (% of par) (2)	77 - 80%	79.6%
Asset-backed securities:				
Collateralized by residential mortgages	Discounted cash flow	Credit default rates (3)	1 - 12%	4.9%
		Prepayment rates (4)	2 - 11%	5.8%
		Loss severity (3)	50 - 100%	58.7%
		Valuation yields (3)	4 - 8%	5.4%
Derivative contracts:				
Interest rate locks	Discounted cash flow	Premium over the MMD curve (1)	3 - 58 bps	27.2 bps
Investments:				
Warrants in public and private companies	Black-Scholes option pricing model	Liquidity discount rates (1)	30 - 40%	34.1%
Warrants in private companies	Black-Scholes option pricing model	Stock volatility factors of comparable companies (2)	38 - 144%	44.6%
Equity securities in private companies	Discounted cash flow/ Market approach	Revenue multiple (2)	2 - 4 times	2.8 times
Liabilities:				
Financial instruments and other inventory positions sold, but not yet purchased:				
Derivative contracts:				
Interest rate locks	Discounted cash flow	Premium over the MMD curve (1)	15 - 62 bps	24.9 bps

Sensitivity of the fair value to changes in unobservable inputs:

(1) Significant increase/(decrease) in the unobservable input in isolation would result in a significantly lower/(higher) fair value measurement.

(2) Significant increase/(decrease) in the unobservable input in isolation would result in a significantly higher/(lower) fair value measurement.

(3)

Significant changes in any of these inputs in isolation could result in a significantly different fair value. Generally, a change in the assumption used for credit default rates is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally inverse change in the assumption for valuation yields.

(4) The potential impact of changes in prepayment rates on fair value is dependent on other security-specific factors, such as the par value and structure. Changes in the prepayment rates may result in directionally similar or directionally inverse changes in fair value depending on whether the security trades at a premium or discount to the par value.

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The following table summarizes the valuation of the Company's financial instruments by pricing observability levels defined in FASB Accounting Standards Codification Topic 820, "Fair Value Measurement" ("ASC 820") as of March 31, 2013:

(Dollars in thousands)	Level I	Level II	Level III	Counterparty and Cash Collateral Netting (1)	Total
Assets:					
Financial instruments and other inventory positions owned:					
Corporate securities:					
Equity securities	\$6,703	\$21,695	\$—	\$—	\$28,398
Convertible securities	—	47,858	—	—	47,858
Fixed income securities	—	52,041	—	—	52,041
Municipal securities:					
Taxable securities	—	372,987	—	—	372,987
Tax-exempt securities	—	397,219	1,431	—	398,650
Short-term securities	—	149,805	656	—	150,461
Asset-backed securities	—	27	107,654	—	107,681
U.S. government agency securities	—	359,137	—	—	359,137
U.S. government securities	625	—	—	—	625
Derivative contracts	—	545,906	2,372	(510,488)	37,790
Total financial instruments and other inventory positions owned:	7,328	1,946,675	112,113	(510,488)	1,555,628
Cash equivalents	774	—	—	—	774
Investments	6,391	—	41,653	—	48,044
Total assets	\$14,493	\$1,946,675	\$153,766	\$(510,488)	\$1,604,446
Liabilities:					
Financial instruments and other inventory positions sold, but not yet purchased:					
Corporate securities:					
Equity securities	\$32,992	\$—	\$—	\$—	\$32,992
Convertible securities	—	1,443	—	—	1,443
Fixed income securities	—	12,493	—	—	12,493
U.S. government agency securities	—	124,171	—	—	124,171
U.S. government securities	415,906	—	—	—	415,906
Derivative contracts	—	517,403	399	(512,010)	5,792
Total financial instruments and other inventory positions sold, but not yet purchased:	\$448,898	\$655,510	\$399	\$(512,010)	\$592,797

- (1) Represents cash collateral and the impact of netting on a counterparty basis. The Company had no securities posted as collateral to its counterparties.

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The following table summarizes the valuation of the Company's financial instruments by pricing observability levels defined in ASC 820 as of December 31, 2012:

(Dollars in thousands)	Level I	Counterparty and Cash Collateral
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