PIPER JAFFRAY COMPANIES
Form 10-Q
November 05, 2018

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

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2018
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 1000 Minneapolis, Minnesota	55402
(Address of Principal Executive Offices)	(Zip Code)

(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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes þ No ¨

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

Large accelerated filer þ	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨
	Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No þ

As of October 31, 2018, the registrant had 14,827,021 shares of Common Stock outstanding.

Piper Jaffray Companies
Index to Quarterly Report on Form 10-Q

PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.
Piper Jaffray Companies
Consolidated Statements of Financial Condition

(Amounts in thousands, except share data)	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Cash and cash equivalents	$ 68,774	$ 33,793
Receivables from brokers, dealers and clearing organizations	174,065	145,394
Financial instruments and other inventory positions owned	635,893	663,330
Financial instruments and other inventory positions owned and pledged as collateral	162,227	720,047
Total financial instruments and other inventory positions owned	798,120	1,383,377
Fixed assets (net of accumulated depreciation and amortization of $61,897 and $55,944, respectively)	31,267	25,179
Goodwill	81,855	81,855
Intangible assets (net of accumulated amortization of $93,262 and $85,417, respectively)	14,989	22,834
Investments	152,380	176,212
Net deferred income tax assets	103,287	101,205
Other assets	68,699	54,834
Total assets	$ 1,493,436	$ 2,024,683
Liabilities and Shareholders' Equity		
Short-term financing	$ 49,957	$ 289,937
Senior notes	125,000	125,000
Payables to brokers, dealers and clearing organizations	6,371	19,392
Financial instruments and other inventory positions sold, but not yet purchased	254,585	399,227
Accrued compensation	252,448	400,092
Other liabilities and accrued expenses	57,660	49,800
Total liabilities	746,021	1,283,448
Shareholders' equity:		
Common stock, $0.01 par value:		
Shares authorized: 100,000,000 at September 30, 2018 and December 31, 2017;		
Shares issued: 19,517,285 at September 30, 2018 and 19,512,914 at December 31, 2017;		
Shares outstanding: 13,366,703 at September 30, 2018 and 12,911,149 at December 31, 2017	195	195
Additional paid-in capital	801,417	791,970
Retained earnings (1)	169,894	176,270
Less common stock held in treasury, at cost: 6,150,582 shares at September 30, 2018 and 6,601,765 shares at December 31, 2017	(270,046)	(273,824)
Accumulated other comprehensive loss	(1,249)	(1,279)
Total common shareholders' equity	700,211	693,332
Noncontrolling interests	47,204	47,903

Total shareholders' equity	747,415	741,235
Total liabilities and shareholders' equity	$ 1,493,436	$ 2,024,683

(1) Includes the cumulative effect adjustment upon adoption of ASU 2014-09, as amended. See Note 2 for further discussion.

See Notes to the Consolidated Financial Statements

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Piper Jaffray Companies
Consolidated Statements of Operations
(Unaudited)

(Amounts in thousands, except per share data)	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Revenues:				
Investment banking	$166,458	$190,482	$411,203	$461,260
Institutional brokerage	31,738	34,873	92,415	111,083
Asset management	13,377	12,818	38,706	44,011
Interest	6,592	7,164	25,183	22,649
Investment income/(loss)	3,068	(422)	6,706	15,406
Total revenues	221,233	244,915	574,213	654,409
Interest expense	3,705	4,348	14,142	15,568
Net revenues	217,528	240,567	560,071	638,841
Non-interest expenses:				
Compensation and benefits	139,151	169,469	369,895	438,161
Outside services	9,521	7,495	29,024	27,612
Occupancy and equipment	8,967	8,127	26,476	24,846
Communications	7,561	7,136	24,112	22,025
Marketing and business development	6,718	6,683	21,702	22,512
Deal-related expenses	7,671	—	18,888	—
Trade execution and clearance	2,049	2,125	6,240	5,864
Restructuring costs	—	—	3,770	—
Goodwill impairment	—	114,363	—	114,363
Intangible asset amortization	2,615	3,822	7,845	11,466
Back office conversion costs	—	1,293	—	3,027
Other operating expenses	3,640	2,290	9,187	8,525
Total non-interest expenses	187,893	322,803	517,139	678,401
Income/(loss) before income tax expense/(benefit)	29,635	(82,236)	42,932	(39,560)
Income tax expense/(benefit)	7,365	(31,423)	5,351	(26,912)
Net income/(loss)	22,270	(50,813)	37,581	(12,648)
Net income/(loss) applicable to noncontrolling interests	247	(1,100)	(1,271)	3,217
Net income/(loss) applicable to Piper Jaffray Companies	$22,023	$(49,713)	$38,852	$(15,865)
Net income/(loss) applicable to Piper Jaffray Companies' common shareholders	$19,377	$(50,415) (1)	$33,650	$(18,106) (1)

Earnings/(loss) per common share

Basic	$1.45	$(3.91)		$2.54	$(1.42)	
Diluted	$1.43	$(3.91)	(2)	$2.50	$(1.42)	(2)
Dividends declared per common share	$0.38	$0.31		$2.75	$0.94	
Weighted average number of common shares outstanding						
Basic	13,343	12,898		13,248	12,774	
Diluted	13,508	12,975	(2)	13,444	12,945	(2)

(1) No allocation of undistributed income was made due to loss position. See Note 14.

(2) Earnings per diluted common share is calculated using the basic weighted average number of common shares outstanding for periods in which a loss is incurred.

See Notes to the Consolidated Financial Statements

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Piper Jaffray Companies
Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(Amounts in thousands)	2018	2017	2018	2017
Net income/(loss)	$22,270	$(50,813)	$37,581	$(12,648)
Other comprehensive income/(loss), net of tax:				
Foreign currency translation adjustment	(102)	142	30	1,137
Comprehensive income/(loss)	22,168	(50,671)	37,611	(11,511)
Comprehensive income/(loss) applicable to noncontrolling interests	247	(1,100)	(1,271)	3,217
Comprehensive income/(loss) applicable to Piper Jaffray Companies	$21,921	$(49,571)	$38,882	$(14,728)

See Notes to the Consolidated Financial Statements

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Piper Jaffray Companies
Consolidated Statements of Cash Flows
(Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2018	2017
Operating Activities:		
Net income/(loss)	$37,581	$(12,648)
Adjustments to reconcile net income/(loss) to net cash provided by operating activities:		
Depreciation and amortization of fixed assets	6,199	5,343
Deferred income taxes	(2,082)	(47,984)
Stock-based compensation	32,046	26,459
Goodwill impairment	—	114,363
Amortization of intangible assets	7,845	11,466
Amortization of forgivable loans	3,789	5,207
Decrease/(increase) in operating assets:		
Receivables:		
Customers	—	31,917
Brokers, dealers and clearing organizations	(28,671)	131,850
Securities purchased under agreements to resell	—	159,697
Net financial instruments and other inventory positions owned	440,615	18,021
Investments	23,832	(11,470)
Other assets	(17,439)	7,185
Increase/(decrease) in operating liabilities:		
Payables:		
Customers	—	(29,352)
Brokers, dealers and clearing organizations	(13,021)	13,423
Securities sold under agreements to repurchase	—	(15,046)
Accrued compensation	(134,470)	4,666
Other liabilities and accrued expenses	4,178	7,864
Net cash provided by operating activities	360,402	420,961
Investing Activities:		
Purchases of fixed assets, net	(12,329)	(4,310)
Net cash used in investing activities	(12,329)	(4,310)

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Piper Jaffray Companies
Consolidated Statements of Cash Flows – Continued
(Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2018	2017
Financing Activities:		
Decrease in short-term financing	$(239,980)	$(342,035)
Repayment of senior notes	—	(50,000)
Payment of cash dividend	(41,631)	(14,217)
Increase/(decrease) in noncontrolling interests	572	(11,714)
Repurchase of common stock	(31,664)	(25,065)
Proceeds from stock option exercises	—	1,703
Net cash used in financing activities	(312,703)	(441,328)
Currency adjustment:		
Effect of exchange rate changes on cash	(389)	1,235
Net increase/(decrease) in cash, cash equivalents and restricted cash (1)	34,981	(23,442)
Cash, cash equivalents and restricted cash at beginning of period (1)	33,793	70,374
Cash, cash equivalents and restricted cash at end of period (1)	$68,774	$46,932
Supplemental disclosure of cash flow information –		
Cash paid during the period for:		
Interest	$14,586	$15,397
Income taxes	$16,638	$7,781

(1) Upon adoption of ASU 2016-18, restricted cash includes cash and cash equivalents previously segregated for regulatory purposes. See Note 2 for further discussion.

See Notes to the Consolidated Financial Statements

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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; Piper Jaffray Finance LLC, which facilitates corporate debt underwriting in conjunction with affiliated credit vehicles; Advisory Research, Inc. ("ARI"), which provides asset management services to separately managed accounts, closed-end and open-end funds and partnerships; Piper Jaffray Investment Group Inc. and PJC Capital Management LLC, which consist of entities providing alternative asset management services; Piper Jaffray Financial Products Inc. and Piper Jaffray Financial Products II Inc., entities that facilitate derivative transactions; and other immaterial subsidiaries.

Effective August 7, 2017, Piper Jaffray transitioned from a self clearing securities broker dealer to a fully disclosed clearing model. Pershing LLC ("Pershing") is Piper Jaffray's clearing broker dealer responsible for the clearance and settlement of firm and customer cash and security transactions.

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 investment banking services and institutional sales, trading and research services. Investment banking services include financial advisory services, management of and participation in underwritings and public finance activities. Revenues are generated through the receipt of advisory and financing fees. 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. Also, the Company generates revenue through strategic trading and investing activities, which focus on investments in municipal bonds, U.S. government agency securities, and merchant banking activities involving equity investments in late stage private companies. The Company has created alternative asset management funds in merchant banking, energy and senior living in order to invest firm capital and to manage capital from outside investors. The Company receives management and performance fees for managing these funds.

Asset Management

The Asset Management segment provides traditional asset management services with product offerings in master limited partnerships and equity securities 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.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information and the rules and regulations of the Securities and Exchange Commission ("SEC"). Pursuant to this guidance, certain information and disclosures have been omitted that are included within complete annual financial statements. Except as disclosed herein, there have been no material changes in the information reported in the financial statements and related disclosures in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

The consolidated financial statements 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 the Company's alternative asset management funds. All material intercompany balances have been eliminated.

Management is required 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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Note 2 Accounting Policies and Pronouncements

Summary of Significant Accounting Policies

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for a full description of the Company's significant accounting policies. Changes to the Company's significant accounting policies are described below.

Revenue Recognition

Investment Banking – Investment banking revenues, which include advisory and underwriting fees, are recorded when the performance obligation for the transaction is satisfied under the terms of each engagement. Expenses associated with such transactions are deferred until the related revenue is recognized or the engagement is otherwise concluded. Investment banking revenues are presented gross of related client reimbursed deal expenses. Expenses for completed deals are reported separately in deal-related expenses on the consolidated statements of operations. Expenses related to investment banking deals not completed are recognized as non-interest expenses on the consolidated statements of operations.

The Company's advisory fees generally consist of a nonrefundable up-front fee and a success fee. The nonrefundable fee is recorded as deferred revenue upon receipt and recognized at a point in time when the performance obligation is satisfied, or when the transaction is deemed by management to be terminated. Management's judgment is required in determining when a transaction is considered to be terminated.

The substantial majority of the Company's advisory and underwriting fees (i.e., the success related advisory fee) are considered variable consideration and recognized when it is probable that the variable consideration will not be reversed in a future period. The variable consideration is considered to be constrained until satisfaction of the performance obligation. The Company's performance obligation is generally satisfied at a point in time upon the closing of a strategic transaction, completion of a financing or underwriting arrangement, or some other defined outcome (e.g., providing a fairness opinion). At this time, the Company has transferred control of the promised service and the customer obtains control. As these arrangements represent a single performance obligation, allocation of the transaction price is not necessary. The Company has elected to apply the following optional exemptions regarding disclosure of its remaining performance obligations: (i) the Company's performance obligation is part of a contract that has an original expected duration of one year or less and/or (ii) the variable consideration is allocated entirely to a wholly unsatisfied promise to transfer a distinct service that forms part of a single performance obligation.

Institutional Brokerage – Institutional brokerage revenues include (i) commissions received from customers for the execution of brokerage transactions in listed and over-the-counter (OTC) equity, fixed income and convertible debt securities, which are recognized at a point in time on the trade date because the customer has obtained the rights to the underlying security provided by the trade execution service, (ii) trading gains and losses, recorded on changes in the fair value of long and short security positions in the reporting period and (iii) fees received by the Company for equity research, which are generally recognized in the period received. The Company permits institutional customers to allocate a portion of their gross commissions to pay for research products and other services provided by third parties. The amounts allocated for those purposes are commonly referred to as soft dollar arrangements. As the Company is not acting as a principal in satisfying the performance obligation for these arrangements, expenses relating to soft dollars are netted against commission revenues and included in other liabilities and accrued expenses on the consolidated statements of financial condition.

Asset Management – Asset management fees include revenues the Company receives in connection with management and investment advisory services performed for separately managed accounts and various funds and partnerships. The performance obligation related to the transfer of these services is satisfied over time and the related fees are recognized under the output method, which reflects the fees that the Company has a right to invoice based on the services provided during the period. Fees are defined in client contracts as a percentage of portfolio assets under management. Amounts related to remaining performance obligations are not disclosed as the Company applies the output method.

Asset management revenues may also include performance fees. Performance fees, if earned, are recognized when it is probable that such revenue will not be reversed in a future period. For the Company's alternative asset management funds, management will consider such factors as the remaining assets and residual life of the fund to conclude whether it is probable that a significant reversal of revenue will not occur in the future. For the Company's traditional asset management funds, performance fees are earned when the investment return on assets under management exceeds certain benchmark targets or other performance targets over a specified measurement period (e.g., monthly, quarterly or annually). These performance fees are typically annual performance hurdles and recognized in the fourth quarter of the applicable year, or upon client liquidation.

See Note 15 for revenues from contracts with customers disaggregated by major business activity.

Adoption of New Accounting Standards

Revenue Recognition

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09"), which supersedes previous revenue recognition guidance, including most industry-specific guidance. ASU 2014-09, as amended, requires a company to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services, and also requires enhanced disclosures.

The Company adopted this guidance effective as of January 1, 2018 under the modified retrospective method, in which the cumulative effect of applying the standard was recognized at the date of initial application. The cumulative effect adjustment that the Company recognized upon adoption as of January 1, 2018 was a decrease to retained earnings of $3.6 million, net of tax. The Company applied the guidance only to those contracts that were not completed at the date of initial application.

The previous broker dealer industry treatment of netting deal expenses with investment banking revenues was superseded under the new guidance. As a result of adopting ASU 2014-09, the Company now presents investment banking revenues gross of related client reimbursed deal expenses and deal-related expenses as non-interest expenses on the consolidated statements of operations, rather than the previous presentation of netting deal expenses incurred for completed investment banking deals within revenues. For the three and nine months ended September 30, 2018, the Company reported higher investment banking revenues and higher non-compensation expenses of $7.7 million and $18.9 million, respectively. This change did not impact earnings. In addition, the Company now defers the recognition of performance fees on its merchant banking, energy and senior living alternative asset management funds until such fees are no longer subject to reversal, which will cause a delay in the recognition of these fees as revenue. For the nine months ended September 30, 2018, the amount of asset management revenue from performance fees that the Company would have recognized if not for this change was not material. With the exception of the above, the Company's previous methods of recognizing investment banking revenues were not significantly impacted by the new guidance.

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The amendments in ASU 2016-01 address certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 became effective for the Company as of January 1, 2018. There was no material impact to the Company's results of operations, financial position or disclosures upon adoption as the Company's financial instruments are already recorded at fair value.

Statement of Cash Flows

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments" ("ASU 2016-15"). ASU 2016-15 clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows. The amendments in ASU 2016-15 became effective for the Company as of January 1, 2018, with retrospective application. There was no material impact to the Company's presentation of its consolidated statements of cash flows upon adoption of ASU 2016-15.

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In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash" ("ASU 2016-18"). Under ASU 2016-18, restricted cash will be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period amounts shown on the consolidated statements of cash flows. ASU 2016-18 became effective for the Company as of January 1, 2018, with retrospective application. As a registered broker dealer, Piper Jaffray is subject to Rule 15c3-3 of the Securities Exchange Act of 1934, which requires broker dealers carrying customer accounts to maintain cash or qualified securities in a segregated reserve account for the exclusive benefit of its customers. These accounts were previously classified as cash and cash equivalents segregated for regulatory purposes on the consolidated statements of financial condition. Subsequent to transitioning to a fully disclosed clearing model in 2017, Piper Jaffray no longer carries customer accounts and is no longer subject to Rule 15c3-3. The following table provides a reconciliation of cash, cash equivalents and restricted cash for all periods presented on the consolidated statements of cash flows:

(Dollars in thousands)	December 31, 2017	September 30, 2017	December 31, 2016
Cash and cash equivalents	$ 33,793	$ 40,916	$ 41,359
Cash and cash equivalents segregated for regulatory purposes	—	6,016	29,015
Cash, cash equivalents and restricted cash	$ 33,793	$ 46,932	$ 70,374

Future Adoption of New Applicable Accounting Standards

Leases

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). ASU 2016-02 requires lessees to recognize a right-of-use asset and lease liability on the consolidated statements of financial position and disclose key information about leasing arrangements. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from current U.S. GAAP. ASU 2016-02 is effective for the Company as of January 1, 2019. As of September 30, 2018, the Company had approximately 65 operating leases for office space with aggregate minimum lease commitments of $71.1 million. Upon adoption, lease commitments will be reflected on the statement of financial condition as a right-of-use asset and a lease commitment liability. The Company has identified its arrangements that are within the scope of the new guidance, and continues to evaluate their potential impact on the consolidated statements of financial condition and related disclosures. Upon adoption of ASU 2016-02, the Company does not expect material changes to the recognition of rent expense in its consolidated statements of operations. The new guidance is not expected to materially impact Piper Jaffray's net capital position.

Financial Instruments – Credit Losses

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). The new guidance requires an entity to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts as opposed to delaying recognition until the loss was probable of occurring. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019. Early adoption is permitted for annual and interim periods beginning after December 15, 2018. The Company does not expect the adoption of ASU 2016-13 to have a material impact on its consolidated financial statements.

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Note 3 Financial Instruments and Other Inventory Positions Owned and Financial Instruments and Other Inventory Positions Sold, but Not Yet Purchased

(Dollars in thousands)	September 30, 2018	December 31, 2017
Financial instruments and other inventory positions owned:		
Corporate securities:		
Equity securities	$ 21,473	$ 51,896
Convertible securities	126,641	74,456
Fixed income securities	42,976	30,145
Municipal securities:		
Taxable securities	41,766	67,699
Tax-exempt securities	226,702	744,241
Short-term securities	150,090	62,251
Mortgage-backed securities	16	481
U.S. government agency securities	173,477	317,318
U.S. government securities	1,561	9,317
Derivative contracts	13,418	25,573
Total financial instruments and other inventory positions owned	$ 798,120	$ 1,383,377
Financial instruments and other inventory positions sold, but not yet purchased:		
Corporate securities:		
Equity securities	$ 116,712	$ 101,517
Fixed income securities	31,187	30,292
U.S. government agency securities	37,245	49,077
U.S. government securities	65,205	213,312
Derivative contracts	4,236	5,029
Total financial instruments and other inventory positions sold, but not yet purchased	$ 254,585	$ 399,227

At September 30, 2018 and December 31, 2017, financial instruments and other inventory positions owned in the amount of $162.2 million and $720.0 million, respectively, had been pledged as collateral for short-term financings.

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, U.S. treasury bond futures and exchange traded options.

Derivative Contract Financial Instruments

The Company uses interest rate swaps, interest rate locks, credit default swap index contracts, U.S. treasury bond futures and equity option contracts as a means to manage risk in certain inventory positions. The Company also enters into interest rate swaps to facilitate customer transactions. 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 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.

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Trading securities derivatives: The Company enters into interest rate derivative contracts and uses U.S. treasury bond futures to hedge interest rate and market value risks associated with its fixed income securities. These instruments use interest rates based upon 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 and option contracts to hedge market value risk associated with its convertible securities.

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. The total absolute notional contract amount, representing the absolute value of the sum of gross long and short derivative contracts, provides an indication of the volume of the Company's derivative activity and does not represent gains and losses. The following table presents the gross fair market value and the total absolute notional contract amount of the Company's outstanding derivative instruments, prior to counterparty netting, by asset or liability position:

	September 30, 2018			December 31, 2017		
(Dollars in thousands)	Derivative	Derivative	Notional	Derivative	Derivative	Notional
Derivative Category	Assets (1)	Liabilities (2)	Amount	Assets (1)	Liabilities (2)	Amount
Interest rate						
Customer matched-book	$159,244	$147,944	$2,602,498	$239,224	$225,890	$2,819,006
Trading securities	1,714	368	243,175	126	4,459	399,450
Equity options						
Trading securities	—	—	—	6	—	9,635
	$160,958	$148,312	$2,845,673	$239,356	$230,349	$3,228,091

(1) Derivative assets are included within financial instruments and other inventory positions owned on the consolidated statements of financial condition.

(2) Derivative liabilities are included within financial instruments and other inventory positions sold, but not yet purchased on the consolidated statements of financial condition.

The Company's derivative contracts do not qualify for hedge accounting, therefore, unrealized gains and losses are recorded on the consolidated statements of operations. The gains and losses on the related economically hedged inventory positions are not disclosed below as they are not in qualifying hedging relationships. The following table presents the Company's unrealized gains/(losses) on derivative instruments:

		Three Months Ended		Nine Months Ended	
(Dollars in thousands)		September 30,		September 30,	
Derivative Category	Operations Category	2018	2017	2018	2017
Interest rate derivative contract	Investment banking	$(301)	$(300)	$(1,567)	$(1,076)
Interest rate derivative contract	Institutional brokerage	980	1,627	5,212	(16,028)
Credit default swap index contract	Institutional brokerage	—	4,304	—	4,482
		$679	$5,631	$3,645	$(12,622)

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 September 30, 2018, the Company had $13.5 million of uncollateralized credit exposure with these counterparties (notional contract amount of $178.6 million), including $10.8 million of uncollateralized credit exposure with one counterparty.

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Note 4 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 and risk 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.

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.

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.

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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 expected recovery rate on the securities.

Mortgage-backed securities – Mortgage-backed securities are valued using observable trades, when available. Certain mortgage-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. To the extent we hold, these mortgage-backed securities are categorized as Level II. Certain mortgage-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 mortgage-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 on spreads over U.S. treasury securities, or models based upon prepayment expectations. 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 swaps, interest rate locks, credit default swap index contracts, U.S. treasury bond futures and equity option contracts. These instruments derive their value from underlying assets, reference rates, indices or a combination of these factors. The Company's equity option derivative contracts are valued based on quoted prices from the exchange for identical assets or liabilities as of the period-end date. To the extent these contracts are actively traded and valuation adjustments are not applied, they are categorized as Level I. The Company's credit default swap index contracts are valued using market price quotations and are classified as Level II. 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 included 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.

Investments

The Company's investments valued at fair value include equity investments in private companies and partnerships, investments in registered mutual funds and private company debt. Investments in registered mutual funds are valued based on quoted prices on active markets and classified as Level I. Investments in private companies are valued based on an assessment of each underlying security, considering rounds of financing, third party transactions and market-based information, including comparable company transactions, trading multiples (e.g., multiples of revenue and earnings before interest, taxes, depreciation and amortization ("EBITDA")) 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. Merchant banking and other equity investments of $3.3 million and $14.1 million, included within investments on the consolidated statements of financial condition, are accounted for at fair value and are classified as Level III assets at September 30, 2018 and December 31, 2017, respectively. The realized and unrealized net gains from fair value changes included in earnings as a result of electing to apply the fair value option to certain financial assets were $0.9 million and $1.4 million for the nine months ended September 30, 2018 and 2017, respectively.

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 September 30, 2018:

	Valuation Technique	Unobservable Input	Range	Weighted Average (1)
Assets:				
Financial instruments and other inventory positions owned:				
Derivative contracts:				
Interest rate locks	Discounted cash flow	Premium over the MMD curve in basis points ("bps") (2)	1 - 11 bps	8.7 bps
Investments at fair value:				
Equity securities in private companies	Market approach	Revenue multiple (3)	2 - 6 times	4.8 times
		EBITDA multiple (3)	13 - 16 times	14.4 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 in bps (2)	7 - 16 bps	8.9 bps

Uncertainty of fair value measurements:
(1) Unobservable inputs were weighted by the relative fair value of the financial instruments.

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

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 September 30, 2018:

(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	$266	$21,207	$—	$—	$21,473
Convertible securities	—	126,641	—	—	126,641
Fixed income securities	—	42,976	—	—	42,976
Municipal securities:					
Taxable securities	—	41,766	—	—	41,766
Tax-exempt securities	—	226,702	—	—	226,702
Short-term securities	—	150,045	45	—	150,090
Mortgage-backed securities	—	—	16	—	16
U.S. government agency securities	—	173,477	—	—	173,477
U.S. government securities	1,561	—	—	—	1,561
Derivative contracts	—	159,685	1,273	(147,540)	13,418
Total financial instruments and other inventory positions owned	1,827	942,499	1,334	(147,540)	798,120
Cash equivalents	40,793	—	—	—	40,793
Investments at fair value	39,501	—	104,285 (2)	—	143,786
Total assets	$82,121	$942,499	$105,619	$(147,540)	$982,699
Liabilities:					
Financial instruments and other inventory positions sold, but not yet purchased:					
Corporate securities:					
Equity securities	$112,642	$4,070	$—	$—	$116,712
Fixed income securities	—	31,187	—	—	31,187
U.S. government agency securities	—	37,245	—	—	37,245
U.S. government securities	65,205	—	—	—	65,205
Derivative contracts	—	147,944	368	(144,076)	4,236
Total financial instruments and other inventory positions sold, but not yet purchased	$177,847	$220,446	$368	$(144,076)	$254,585

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

(2) Noncontrolling interests of $47.2 million are attributable to third party ownership in consolidated merchant banking and senior living funds.

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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, 2017:

(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	$1,863	$50,033	$—	$—	$51,896
Convertible securities	—	74,456	—	—	74,456
Fixed income securities	—	30,145	—	—	30,145
Municipal securities:					
Taxable securities	—	67,699	—	—	67,699
Tax-exempt securities	—	743,541	700	—	744,241
Short-term securities	—	61,537	714	—	62,251
Mortgage-backed securities	—	—	481	—	481
U.S. government agency securities	—	317,318	—	—	317,318
U.S. government securities	9,317	—	—	—	9,317
Derivative contracts	6	239,224	126	(213,783)	25,573
Total financial instruments and other inventory positions owned	11,186	1,583,953	2,021	(213,783)	1,383,377
Cash equivalents	3,782	—	—	—	3,782
Investments at fair value	39,504	—	126,060 (2)	—	165,564
Total assets	$54,472	$1,583,953	$128,081	$(213,783)	$1,552,723
Liabilities:					
Financial instruments and other inventory positions sold, but not yet purchased:					
Corporate securities:					
Equity securities	$91,934	$9,583	$—	$—	$101,517
Fixed income securities	—	30,292	—	—	30,292
U.S. government agency securities	—	49,077	—	—	49,077
U.S. government securities	213,312	—	—	—	213,312
Derivative contracts	—	225,916	4,433	(225,320)	5,029
Total financial instruments and other inventory positions sold, but not yet purchased	$305,246	$314,868	$4,433	$(225,320)	$399,227

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

(2) Noncontrolling interests of $44.4 million are attributable to third party ownership in consolidated merchant banking and senior living funds.

The Company's Level III assets were $105.6 million and $128.1 million, or 10.7 percent and 8.2 percent of financial instruments measured at fair value at September 30, 2018 and December 31, 2017, respectively. There were no significant transfers between levels for the nine months ended September 30, 2018.

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The following tables summarize the changes in fair value associated with Level III financial instruments held at the beginning or end of the periods presented:

(Dollars in thousands)	Balance at June 30, 2018	Purchases	Sales	Transfers in	Transfers out	Realized gains/ (losses) (1)	Unrealized gains/ (losses) (1)	Balance at September 30, 2018	Unrealized gains/ (losses) for assets/ liabilities held at September 30, 2018 (1)
Assets:									
Financial instruments and other inventory positions owned:									
Municipal securities:									
Short-term securities	$45	$—	$—	$ —	$—	$ —	$—	$ 45	$ —
Mortgage-backed securities	18	—	—	—	—	—	(2)	16	(2)
Derivative contracts	930	—	(90)	—	—	90	343	1,273	441
Total financial instruments and other inventory positions owned	993	—	(90)	—	—	90	341	1,334	439
Investments at fair value	108,121	10,000	(14,199)	—	(357)	4,949	(4,229)	104,285	(4,229)
Total assets	$109,114	$10,000	$(14,289)	$ —	$(357)	$ 5,039	$(3,888)	$ 105,619	$ (3,790)
Liabilities:									
Financial instruments and other inventory positions sold, but not yet purchased:									
Derivative contracts	$1,005	$(210)	$40	$ —	$—	$ 169	$(636)	$ 368	$ (464)
Total financial instruments and other inventory positions sold, but not yet purchased	$1,005	$(210)	$40	$ —	$—	$ 169	$(636)	$ 368	$ (464)

(1) Realized and unrealized gains/(losses) related to financial instruments, with the exception of customer matched-book derivatives, are reported in institutional brokerage on the consolidated statements of operations. Realized and unrealized gains/(losses) related to customer matched-book derivatives are reported in investment banking. Realized and unrealized gains/(losses) related to investments are reported in investment banking revenues or investment income/(loss) on the consolidated statements of operations.

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(Dollars in thousands)	Balance at June 30, 2017	Purchases	Sales	Transfers in	Transfers out	Realized gains/ (losses) (1)	Unrealized gains/ (losses) (1)	Balance at September 30, 2017	Unrealized gains/ (losses) for assets/ liabilities held at September 30, 2017 (1)
Assets:									
Financial instruments and other inventory positions owned:									
Municipal securities:									
Tax-exempt securities	$1,117	$—	$(267)	$ —	$ —	$—	$(100)	$ 750	$ (100)
Short-term securities	721	—	—	—	—	—	(16)	705	(16)
Mortgage-backed securities	4,251	—	—	—	—	—	70	4,321	70
Derivative contracts	383	105	—	—	—	(105)	303	686	686
Total financial instruments and other inventory positions owned	6,472	105	(267)	—	—	(105)	257	6,462	640
Investments at fair value	113,885	18,250	—	—	—	—	(1,975)	130,160	(1,975)
Total assets	$120,357	$18,355	$(267)	$ —	$ —	$(105)	$(1,718)	$ 136,622	$ (1,335)
Liabilities:									
Financial instruments and other inventory positions sold, but not yet purchased:									
Derivative contracts	$5,573	$—	$3,461	$ —	$ —	$(3,461)	$(1,323)	$ 4,250	$ 1,430
Total financial instruments and other inventory positions sold, but not yet purchased	$5,573	$—	$3,461	$ —	$ —	$(3,461)	$(1,323)	$ 4,250	$ 1,430

(1) Realized and unrealized gains/(losses) related to financial instruments, with the exception of customer matched-book derivatives, are reported in institutional brokerage on the consolidated statements of operations. Realized and unrealized gains/(losses) related to customer matched-book derivatives are reported in investment banking. Realized and unrealized gains/(losses) related to investments are reported in investment banking revenues or investment income/(loss) on the consolidated statements of operations.

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(Dollars in thousands)	Balance at December 31, 2017	Purchases	Sales	Transfers in	Transfers out	Realized gains/ (losses) (1)	Unrealized gains/ (losses) (1)	Balance at September 30, 2018	Unrealized gains/ (losses) for assets/ liabilities held at September 30, 2018 (1)
Assets:									
Financial instruments and other inventory positions owned:									
Municipal securities:									
Tax-exempt securities	$ 700	$ —	$ —	$ —	$ (700)	$ —	$ —	$ —	$ —
Short-term securities	714	—	(725)	—	—	51	5	45	—
Mortgage-backed securities	481	—	(5)	—	—	—	(460)	16	(93)
Derivative contracts	126	4	(2,965)	—	—	2,961	1,147	1,273	1,273
Total financial instruments and other inventory positions owned	2,021	4	(3,695)	—	(700)	3,012	692	1,334	1,180
Investments at fair value	126,060	11,708	(29,139)	—	(502)	14,015	(17,857)	104,285	(8,307)
Total assets	$ 128,081	$ 11,712	$ (32,834)	$ —	$ (1,202)	$ 17,027	$ (17,165)	$ 105,619	$ (7,127)
Liabilities:									
Financial instruments and other inventory positions sold, but not yet purchased:									
Derivative contracts	$ 4,433	$ (1,600)	$ 3,266	$ —	$ —	$ (1,666)	$ (4,065)	$ 368	$ 368
Total financial instruments and other inventory positions sold, but not yet purchased	$ 4,433	$ (1,600)	$ 3,266	$ —	$ —	$ (1,666)	$ (4,065)	$ 368	$ 368

(1) Realized and unrealized gains/(losses) related to financial instruments, with the exception of customer matched-book derivatives, are reported in institutional brokerage on the consolidated statements of operations. Realized and unrealized gains/(losses) related to customer matched-book derivatives are reported in investment banking. Realized and unrealized gains/(losses) related to investments are reported in investment banking revenues or investment income/(loss) on the consolidated statements of operations.

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						Unrealized gains/ (losses) for assets/ liabilities held at
Balance at			Realized	Unrealized	Balance at	
December 31,	Transfers	Transfers	gains/	gains/		