

# FNCE 238/738: Capital Markets

## Prof. D. Musto

### Course Schedule

This course covers the techniques by which firms go to the capital markets, and the economic issues that arise. As the primary source of funds is debt issuance, the course focuses primarily on the different forms of corporate debt. We analyze the bank-run risk presented by short-term debt, and the mechanisms that have evolved to defend against it. The key issues that arise with longer-term debt are why and how debt contracts constrain issuers, and the legal and strategic environment of distressed or bankrupt borrowers. We cover financing through securitization, starting with the economics of consumer credit, and we address the role of investment intermediaries such as mutual funds. We also consider how issuers bring equity to the market, both at the IPO and later on, and the exercise of shareholder votes, particularly in the market for corporate control.

The course is in lecture format, with a 10-15 page note for each class (other than classes with the cases, for which there will be no note). All notes and other course material will be posted on the Canvas site. There is no textbook, but there is a bulkpack. You are advised to read the notes before class, and you are responsible for their content on the tests. The bulkpack readings are for background; you are responsible for their content only to the extent that we discuss it in class. You are generally responsible for the material we discuss in class, whether or not it appears in the notes or other readings.

The assignments to be handed in, on the indicated dates, are

- 6 homeworks; the top 5 of the 6 will count toward your grade
- 4 case write-ups

**There are six quizzes, roughly every two weeks starting September 11.** The quiz dates are 9/11, 9/25, 10/9, 10/28, 11/11 and 11/25. They will be in-class, taking approximately the first 30 minutes. I will count the top 5 of your 6 scores. There will be no makeups. There will be no tests other than these six quizzes, and there will be no final exam.

Homeworks are to be done individually, while the cases are to be done in groups of 3 to 6.

For the final grade, the coursework will be weighted as follows:

- 60% on the top 5 of the 6 tests
- 20% on the top 5 of the 6 homeworks
- 20% on the cases

Class participation can help at the margin.

There will be three guest speakers: Adam Cohen of Covenant Review, Paul Downs of Paul Downs Cabinetmakers, and Marc Lasry of Avenue Capital. The time for the last presentation is still being worked out. **It is very important to the Wharton School that you attend these presentations if at all possible.**

- August 28<sup>th</sup> **The Treasury Market**  
 Basic coupon bond  
 Pricing conventions: accrued interest, ytm  
 Floating and trading Treasuries; on vs. off-the run  
 Simple arbitrage relations  
 Short-term risk of long-term arbitrage
- September 4<sup>th</sup> **Going to the Money Market**  
 Bank runs – Diamond/Dybvig Model  
 Defending against bank runs  
     Deposit Insurance  
     Suspension of Convertibility  
     Lender of Last Resort  
 Shadow banking  
 Commercial Paper Market and Liquidity Facilities
- September 9<sup>th</sup> **Financing with Repos**  
*HW1, Treasury Pricing, Due*  
 Basic Repurchase agreement  
 Margin, pricing and collateral  
 Run on Repo  
 Tri-Party Repo and recent developments  
 Shorting with Repo; Securities Lending  
 Money Funds; Stable NAV and runs
- September 11<sup>th</sup> **FIRST QUIZ & Market Making**  
 Insider trading and the bid/ask spread  
 Tactics for trading inside the spread  
 Retail trading pathologies  
 Payment for order flow  
 New trading platforms
- September 16<sup>th</sup> **Guest Speaker: Andy Brooks from T Rowe Price, 3-4:30 only**
- September 18<sup>th</sup> **Options and Credit Default Swaps**  
*HW2, Repos, Due*  
 Put/Call Parity  
 One-period Binomial Option Pricing  
 Multi-period Binomial Option Pricing  
 Valuing default risk as put on firm value  
 Credit Default Swaps roughly analogous to Puts on Firm value
- September 23<sup>rd</sup> **Leverage and the Departure of Value from Shareholder Value**  
 Board has a fiduciary duty to shareholders, contractual duty to creditors  
 Leverage encourages risk and payouts at the expense of value  
 Underinvestment / Debt Overhang  
 Contingent Convertibles  
 Covenants in practice

- September 25<sup>th</sup> **SECOND QUIZ & Bond Defaults and Amendments**  
*HW3, Options, Due*  
Ratings and Rating Agencies and Dodd/Frank  
Events of Default: Financial vs. Technical  
Role of Trustee  
Consent solicitations
- September 30<sup>th</sup> **Adam Cohen from Covenant Review, 4:30-6**
- October 2<sup>nd</sup> **Corporate Bankruptcy**  
Liquidating in Chapter 7  
Automatic Stay  
Reversal of Preferences / Fraudulent Transfers  
Involuntary Filings  
Absolute Priority  
Reorganizing in Chapter 11  
DIP Finance; Super-priority  
Voting rules; exclusivity; blocking power  
Section 363: asset auctions taking over bankruptcy practice
- October 7<sup>th</sup> **Financial Distress and Restructuring**  
Free-Rider problem  
Structuring Exchange Offers: minimum participation; exit consent; threat to file  
Prepackaged Bankruptcy  
Distressed-Debt Investing  
PIPEs
- October 9<sup>th</sup> **THIRD QUIZ & Alternatives to Straight Debt**  
Convertibles  
Preferred Equity: Taxable, Non-Taxable  
Floating Rate  
Auction-Rate; Death Spiral; other dormant/extinct security designs
- October 14<sup>th</sup> **Cases: *Breaking the Buck and LTCM***
- October 16<sup>th</sup> **Consumer Credit**  
Payment Cards  
Mortgages; Fannie & Freddie; basic mechanics  
Car loans and other installment loans  
Personal bankruptcy: chapters 7 & 13  
Recent regulation & current events
- October 21<sup>st</sup> **Mortgage-Backed Securities**  
*HW4, Convertibles and Exchange Offers, Due*  
Prepayment risk  
Unit of prepayment risk  
Sequential tranching  
IO/PO; Floaters & Inverse Floaters; PACs & Support bonds

- October 23<sup>rd</sup> **Guest Speaker: Paul Downs, Paul Downs Cabinetmakers**
- October 28<sup>th</sup> **FOURTH QUIZ / Asset-backed securities**  
Risk mitigation: reserve accounts, subordination, excess spread  
Soft-bullet structure  
Servicing; delinquency, default, forbearance, foreclosure  
CDOs/CLOs/SIVs
- October 30<sup>th</sup> **Mutual Funds**  
Open-End Funds  
Closed-End Funds  
ETFs/ETNs
- November 4<sup>th</sup> **Hedge Funds**  
*HW5, Mortgage-Backed Securities, Due*  
Regulatory environment  
Incentive Fees, HWMs  
Prime Brokerage, Margining  
Performance  
Liquidity / Side Pockets
- November 6<sup>th</sup> **Marc Lasry, Avenue Capital, time TBA**
- November 11<sup>th</sup> **FIFTH QUIZ / Muni Market**  
Security designs popular in this market  
Principal trading  
Implied tax rates & yield curve  
Muni bankruptcy
- November 13<sup>th</sup> **UNDERWRITING: IPOs, SEOs and Rights Offerings**  
Structure of rights offerings  
SEOs: traditional / shelf offerings / bought deals  
IPOs: mechanism and underpricing
- November 18<sup>th</sup> **Market for Corporate Control**  
Corporate voting  
Free-rider problem with takeovers  
Poison pills / Staggered boards / other defenses  
Merger tactics  
Important cases
- November 20<sup>th</sup> **Project Finance**  
*HW6, Equity Offerings, Due*  
Myers/Majluf Model  
Tax incentives  
Ownership Flip

November 25<sup>th</sup> **SIXTH QUIZ / Credit Default Swaps**  
Market Structure  
Valuation (roughly)  
Settlement after Credit Event  
Sovereign CDS

December 2<sup>nd</sup> TBA

December 4<sup>th</sup> ***Cases: Airgas and Google IPO***

December 9<sup>th</sup> **Wrapup**