

# 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 10.** The quiz dates are 9/10, 9/24, 10/8, 10/22, 11/5 and 11/24. They will be in-class, taking approximately the first 30 minutes. In order to account for illnesses, emergencies, interviews and other events that might take you from the classroom, I will count only 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 several guest speakers. Most I'm still finalizing, but I know that Andy Brooks from T. Rowe Price will be here on October 13<sup>th</sup>. On a day with a guest speaker, that talk is the only class of the day. **It is very important to the Wharton School that you attend these presentations if at all possible.**

Office Hours TBA. TAs are Nathaniel Barzideh, Frank Ragusa and Bianca Stoica

- August 27<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  
Using Duration
- September 3<sup>rd</sup> **Going to the Money Market**  
Bank runs – Diamond/Dybvig Model  
Defending against bank runs  
    Deposit Insurance  
    Suspension of Convertibility  
    Lender of Last Resort  
Money Funds; Stable NAV and runs
- September 8<sup>th</sup> **Repos & CP**  
*HW1, Treasury Pricing, Due*  
Basic Repurchase agreement  
Margin, pricing and collateral  
Run on Repo  
Shadow banking  
Tri-Party Repo and recent developments  
Shorting with Repo; Securities Lending  
Commercial Paper Market and Liquidity Facilities
- September 10<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 15<sup>th</sup> **Options**  
*HW2, Repos, Due*  
Put/Call Parity  
One-period Binomial Option Pricing  
Multi-period Binomial Option Pricing  
Valuing default risk as put on firm value
- September 17<sup>th</sup> **Leverage and Enterprise vs. Shareholder Value**  
Fiduciary vs. Contractual duties  
Leverage encourages risk and payouts at the expense of value  
Underinvestment / Debt Overhang  
Contingent Convertibles  
Covenants in practice

September 22<sup>nd</sup> **Guest Speaker TBA**

September 24<sup>th</sup> **SECOND QUIZ & Bond Defaults and Amendments**

*HW3, Options, Due*

Role of Bond Ratings

Events of Default: Financial vs. Technical

Role of Trustee

Consent solicitations

September 29<sup>th</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; cram-downs and cram-ups

Voting rules; exclusivity; blocking power

Section 363: asset auctions taking over bankruptcy practice

October 1<sup>st</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 6<sup>th</sup> **Cases: LTCM and Breaking the Buck**

October 8<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 13<sup>th</sup> **Andy Brooks from T Rowe Price, 3-4:30**

October 15<sup>th</sup> **Consumer Credit**

Payment Cards

Mortgages; Fannie & Freddie; basic mechanics

Car loans and other installment loans

Personal bankruptcy: chapters 7 & 13

October 20<sup>th</sup> **Mortgage-Backed Securities**

Prepayment risk

Unit of prepayment risk

Sequential tranching

IO/PO; Floaters & Inverse Floaters; PACs & Support bonds

- October 22<sup>nd</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 27<sup>th</sup> **Guest Speaker TBA**
- October 29<sup>th</sup> **Mutual Funds**  
Open-End Funds  
Closed-End Funds  
ETFs/ETNs
- November 3<sup>rd</sup> **Hedge Funds**  
*HW4, Mortgage-Backed Securities, Due*  
Regulatory environment  
Incentive Fees, HWMs  
Prime Brokerage, Margining  
Performance  
Liquidity / Side Pockets
- November 5<sup>th</sup> **FIFTH QUIZ / Muni Market**  
Security designs popular in this market  
Principal trading  
Implied tax rates & yield curve  
Muni bankruptcy
- November 10<sup>th</sup> **Guest Speaker TBA**
- November 12<sup>th</sup> **UNDERWRITING: IPOs, SEOs and Rights Offerings**  
Structure of rights offerings  
SEOs: traditional / shelf offerings / bought deals  
IPOs: mechanism and underpricing
- November 17<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 19<sup>th</sup> **Guest Speaker TBA**

November 24<sup>th</sup> **SIXTH QUIZ / Credit Default Swaps**  
*HW5, Equity Offerings, Due*  
Market Structure  
Valuation (roughly)  
Settlement after Credit Event  
Sovereign CDS

December 1<sup>st</sup> ***Cases: Airgas and Google IPO***

December 3<sup>rd</sup> **Guest Speaker TBA**

December 8<sup>th</sup> **Wrapup**  
***HW6 Due***