

Lecture 17: Investment Banking and Secondary Markets

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Glass-Steagall Act 1933

- The modern concept of “Investment Bank” was created in the Glass-Steagall act (Banking Act of 1933). Glass Steagall separated commercial banks, investment banks, and insurance companies.
- Carter Glass, Senator from Virginia, believed that commercial banks securities operations had contributed to the crash of 1929, that banks failed because of their securities operations, and that commercial banks used their knowledge as lenders to do insider trading of securities.

Henry Paulson's Proposal

- Objectives-Based Regulation
- Market stabilization Regulator
- Prudential Financial Regulator
- Business Conduct Regulator

Paulson Continued

- Federal Charter for insurance
- Mortgage Origination Commission
- SEC and CFTC merge
- Merge OTS with OCC
- Equip fed to monitor risks

Investment Banks

- Bulge bracket firms: First Boston, Goldman Sachs, Merrill Lynch, Morgan Stanley, Salomon Brothers, Lehman Brothers.
- Traditionally were often partnerships, but partnership form is disappearing.

Graham-Leach Act 1999

- President Clinton November 1999 signs Graham-Leach Bill which rescinded the Glass-Steagall Act of 1933.
- Consumer groups fought repeal of Glass-Steagall saying it would reduce privacy. Graham-Leach calls for a study of the issues of financial privacy

Mergers among Commercial Banks, Investment Banks & Insurance Companies

- Travelers' Group (insurance) and Citicorp (commercial bank) 1998 to produce Citigroup, on anticipation that Glass-Steagall would be rescinded. Brokerage Smith Barney
- Chase Manhattan Bank (commercial bank) acquires JP Morgan (investment bank) (2000) for \$34.5 billion
- UBS Switzerland buys Paine Webber (brokerage) 2000
- Credit Suisse buys Donaldson Lufkin Jenrette (investment bank) 2000

Lehman Brothers

- Founded 1850, by Henry Lehman, a young German immigrant, and his brothers
- Investment banking, private equity, private banking, etc.
- Rumored to be in trouble
- Lehman announced April 1 that investors have agreed to give it more capital

Bear Stearns: Investment Banks Come and Go

- Founded in 1923 by Joseph Bear, Robert Stearns and Harold Mayer
- June 2007 had to bail out with \$3.2 billion the Bear Stearns High Grade Structured Credit Fund and the Bear Stearns High-Grade Structured Credit Enhanced Leverage Fund, which invested in CDOs, started contagion
- March 16, 2008, Bear merged with JP Morgan in a stock swap of \$2 a share, Fed non-recourse loan to JP Morgan assuming the risk of Bear's worst assets
- Collateral will be managed by Blackrock

UBS AG

- Union Bank of Switzerland founded in 1912 by merger of Bank in Winterthur (1862) and Toggenburger Bank (1863)
- Merged with Swiss Bank Corp 1998, Paine Webber 2000
- April 1, 2008, announced it had already written down \$18 billion in bad investments and expects to write down another \$19 billion
- Said it would raise \$15 billion in new capital from shareholders

Underwriting of Securities

- Issuance of shares and corporate debt
- Seasoned issue versus IPO
- Underwriter provides advice for issuer, distribution of securities, sharing of risks of issue, and stabilization of aftermarket.
- Underwriter also “certifies” the issue by putting its reputation behind the issue.

Moral Hazard Problem Mitigated by Investment Banks

- Firms have incentive to issue shares when they know their earnings are only temporarily high.
- This problem can be “solved” by resorting to bank loans instead of new equity
- Problem can also be solved by issuing security with an investment bank that has a reputation to protect.
- Studies show that investment banks that repeatedly underprice or overprice issues suffer a market share loss afterwards.

Two Basic Kinds of Offerings

- Bought deal (synonym: Firm commitment offering): The underwriter agrees to buy all shares that are not sold
- Best efforts: the underwriter says that if the issue is not sold, deal collapses.

The Underwriting Process I

- Prefiling period
- Advise issuers about their choices
- Agreement among underwriters, designates manager, fees
- Filing of registration statement with SEC, begins cooling-off period
- Cooling off period – distribute preliminary prospectus (red herring), nothing else

The Underwriting Process II


- Call prospective clients for indication of interest
- Due diligence meeting between underwriter and corporation
- Decide on offering price,
- underwriting agreement, which underwriter sells what
- Dealer agreement, dealers purchase from underwriters at a discount from public price
- Effective date
- Support the price in the aftermarket

Tombstone

This announcement is not an offer to sell or a solicitation of an offer to buy these securities. The offering is made only by the Prospectus and the related Prospectus Supplement, copies of which may be obtained in any State in which this announcement is circulated only from the undersigned or others as may lawfully offer these securities in such State.

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Initial Public Offerings

- Price tends to jump up immediately after an IPO is issued.
- Apparently “leave money upon the table”
- “Impressario hypothesis” explains why they do this.