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Threat from the bank with no name

Throw together three technology venture capital firms, three of the largest on-line brokers in the US and a senior investment banker from Merrill Lynch and what do you get? It's what some market observers consider to be the entrant to on-line investment banking that's most likely to succeed, even if it doesn't yet have a name.

Charles Schwab's chief executive, David Pottruck, is the brains behind the operation. Back in June he and his chief strategist, Daniel Leemon, started ringing around to see how much interest there was in setting up yet another investment bank.

It's true the world is awash with such newcomers but several of the firms they contacted saw an opening. Into the consortium came two other on-line brokers: TD Waterhouse (owned by Toronto Dominion Bank) and Ameritrade. They were joined by three venture capital firms: Kleiner Perkins Caufield & Byers, Trident Capital and Benchmark Capital. The man running the new bank is Scott Ryles, who until last October was a managing director and co-head of technology investment banking for Merrill Lynch.

The three venture capital firms add the real spice to this offering. They have invested in some of the most successful technology and dot.com companies, such as Sun Microsystems, Intuit, amazon.com, MapQuest.com, Pegasus systems, eBay and many others. They know the management, they know the strategies, and above all they are intimately involved in the exit strategy, which is so often an IPO.

On the other side are the on-line brokers, who have access to a large and dynamic investor base. The figures they put out state that combined the three have over half of the on-line accounts. And each side of this set-up has a gripe with the investment banks now that technology is opening up the marketplace. The venture capital firms want a greater say in, and share of, IPOs. If technology allows them, in certain cases, to bypass the investment banks and take a larger slice of the pie, then so be it. As for the brokers, they are aggrieved at the lack of flow they get at the IPO stage. When it comes to technology stocks, the retail investor is the ultimate owner, says Scott Ryles, CEO of the as yet unnamed new bank. Within days of such an IPO the customers of Schwab, TD Waterhouse and Ameritrade combined own more stock in those companies than any single or combined institutional investor. Yet they get a paltry share of the IPO itself.

Those figures are open to dispute, of course. But the bottom line is that retail is poorly served at the IPO stage, with all the benefits going to the institutions with the mighty investment banks behind them. It's easy to see why the retail lock-out has been perpetuated. Communication with a potentially large group of investors was hard, time-consuming and costly. Concentrating on the big institutions was easier. But the internet is changing all that.

Securities & Exchange Commission chairman Arthur Levitt partly addressed these concerns in a speech on information and the equity markets presented to the Economic Club of New York in October. Levitt appealed to companies, in the spirit of fair play: make your quarterly conference calls open to everyone, post them on the internet, invite the press.

There is another issue here: debunking the myth that retail investors are flippers: they buy to sell as quickly as possible to make a fast buck. Day traders have helped to perpetuate this notion, where in reality what they do is what the proprietary desks of most institutional players have always done – whatever they can to rake in the cash. The protagonists in this new venture argue that institutions buy up to 95% of an IPO but that within two or three weeks usually no more than 25% still in their hands.

The conclusion? At best, institutions are making money out of their exalted position and the desire and new-found ability of retail players to dominate the secondary market. At worst, traditional investment banks and asset managers are actively deceiving companies about the ultimate destination of their stock in an attempt to maintain their influence, their research, origination and sales infrastructures, and their inflated share of the market.

In the year 2000, the biggest issue facing the world's leading wholesale financial services firms is how far and how quickly the old order will be replaced by such new investment banking start-ups. Today's leaders in investment banking will hardly give up without a fight. Aside from their vast resources across the board, they have a brand. No matter how wedded a technology company CEO is to the internet, how many would not love to see names such as Goldman Sachs, Morgan Stanley, CSFB, Merrill, JP Morgan, Salomon or others to grace their term sheet? And these firms can offer more than just IPOs – the ability to offer all types of financing was the rationale behind most major mergers and acquisitions by banks and investment banks in the 1990s.

Yet investment bankers at the traditional firms, many of whom airily dismiss the prospects for new internet-based investment banks, would do well to study this new model more closely.

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