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Book-Building and Deregulation

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Here's how you sell bonds. You are an investment bank working for a company that wants to sell $1 billion of bonds. You go out and market the bonds, find people who want to buy them, take their orders, and "build a book" of demand. Eventually you get $1 billion worth of orders. But you can't stop there: If people want to buy exactly $1 billion worth of bonds, then their price will be pretty fragile; if even one investor decides to sell them, there'll be no one around to buy. It is not great for your reputation to underwrite deals that drop in price immediately. So you can't consider the deal a success until you have a nice cushion, say $2 billion worth of orders. Once you have that comfortable cushion, you stop, and price the deal, and issue the bonds.

But there's a problem -- two problems, really. The first problem is that you have $2 billion of orders for $1 billion of bonds, so you have to decide who gets the bonds. (You can't decide by *price*; the point is that you want $2 billion of orders at the deal price.) These decisions are ... awkward. You have your own preferences: Investors who give you a lot of business, or whom you like hanging out with, will get bigger allocations of popular deals than customers you barely know. Your issuer client's preferences might matter too: Investors who will probably hold on to the bonds, or even buy more, are better than investors who will quickly flip them. You also have preferences in your role as a repeat gate-keeper of the capital markets: Investors who helped get the last difficult deal done, or who will help with the next one, should be rewarded with big allocations in popular deals. But there are conflicts, and favoritism, and investors who are frozen out often feel aggrieved. Every so often you read about regulators investigating these allocation practices.

The second problem flows from the first. Everyone knows that you will be taking more orders than there are bonds. So they know that if they put in an order for $50 million of bonds, they may only get $25 million. So if they really want $50 million, they have to do something about it. One thing they can do is say "hey, we are a great customer, we really want $50 million, please help us out." That might work, if they really are a great customer. Another thing they can do is put in an order for $100 million.

But if lots of customers do *that*, then you need to take *even more orders* for the same-sized deal. If you get $2 billion of orders for a $1 billion deal, but everyone has inflated their demand by 100 percent, then you still have barely enough orders to price the deal. So you take $3 billion, just to be safe. (And if they know you're doing *that*, then their orders get even bigger, etc.) So you get $20 billion bond deals with $50 billion or $80 billion worth of orders. That's a lot of demand! Some of it is real, and the deals are hot, and the allocation process is contested. But

some of it is fake, because people know they're not getting $50 million worth of bonds unless they put in orders for $100 million.

Oh, one other thing that happens along the way is that as you are building the book, investors will ask you "how's it going," and you will respond "good." Because if you respond "bad," they're not going to put in an order, because who wants to buy bonds that no one else wants?

All of this is pretty intuitive. But it also ... creates ... the possibility ... of some dishonesty? Like, that investor who puts in an order for $100 million might really, in her heart of hearts, want only $50 million. She is being a bit dishonest with you. When investors call you up and ask how the deal is going, and you say "good, great, almost done," when really you only have $100 million worth of orders, you are being a bit dishonest with them. And when you go to the company with $3 billion worth of orders for a $1 billion deal, and the company says "hey wait why don't we just lower the interest rate a bit," and you say "no we can't do that because then all the demand will vanish" -- you might be right, in some broad sense, but the company might also have reason to doubt you and think that you just want a hot deal to allocate among your investor buddies.

It's a market! It's the *bond* market. People expect a certain amount of dishonesty, of fudging, of bluffing, of concealing information, of looking out for one's own best interests. But those excuses don't feel as good these days as they used to. The basic small-scale dishonesty that has long lubricated the bonds markets may now just be illegal. There have been criminal and civil cases against bond traders who misrepresented their positions to customers in ways that "have been tolerated for years." The new-issue book-building and allocation process, with its own customary mild dishonesty, looks ripe for disruption.

Anyway today the FICC Markets Standards Board, a U.K.-based trade organization made up of big investors, issuers and investment banks (and set up at the suggestion of the U.K. Treasury, Bank of England and Financial Conduct Authority), released its "New Issue Process Standard for the Fixed Income Markets." The standards are intended to make all of this a bit more honest. For instance:

Core Principle 3: Lead banks should agree a strategy on book disclosure frequency with the issuer before opening the book of investor interest. Any disclosure should be made public and must be accurate and not misleading at the time it is made.

Out: someone calling you up, asking how the deal is going, and you responding "good" when it's bad. In: you telling everyone, on a pre-set schedule, honestly, how the deal is going. Or:

Core Principle 5: Investors should be mindful that all orders: (i) should be a true representation of their demand; (ii) should take into account their investment limitations; and (iii) should be clear, fair and not misleading.

Out: putting in a $100 million order for a hot deal when you only want $50 million. In: putting in a $50 million order, but looking very solemn when you do.

Trump regulation etc.

I said last week: "If you are the law firm associate drafting the extensive flowchart showing how to comply with a recent controversial Obama financial regulation, you must feel a bit like you're wasting your time," what with all the bold but vague talk about how the Trump administration will roll back financial rules. I was thinking mostly of Davis Polk & Wardwell LLP, a firm that has produced many of our era's defining financial-regulatory flowcharts. (Try their Volcker Rule flowcharts! There are two!)

But they are moving right along, and they have produced, if not exactly a flowchart, at least a pretty comprehensive chart of what one major proposal -- the "Financial CHOICE Act," which would repeal a lot of the Dodd-Frank Act and do a bunch of other stuff -- would mean for financial regulation. I should clarify that, while law firm *associates* might feel a bit sad about tearing up all their Obama-era regulatory flowcharts, law firm *partners* are undoubtedly thrilled about the coming vast, piecemeal and uncertain changes to financial regulation. Just when they were winding up billing clients to help them respond to Dodd-Frank, now they can start billing clients to help them prepare for Financial CHOICE -- and whatever comes after that. Wild uncertain swings in financial regulation are probably bad for finance, but they're great for lawyers.

Anyway go read the chart if you want. I may wait for actual legislation? But if you're a bank, I guess you should start preparing now. Incidentally, if you are a bank, the news isn't all good: House Financial Services Committee Chairman Jeb Hensarling, the main sponsor of the Financial CHOICE Act, may want to repeal the Volcker Rule, but he is also a semi-populist who talks a lot about ending "too big to fail":

“Wall Street has long believed Hensarling is their obstacle to getting reasonable compromise,” said Mark Calabria, a financial regulation expert at the conservative think tank Cato Institute. “There’s a perception that he’s an ideologue who won’t compromise. When bankers go into meet with him, they feel like they are getting a lecture.”

But there's something else. Here's Politico:

“There is a joke going around here that if I’d have known how good Trump was going to be for Wall Street, I’d have campaigned for him,” said one Goldman Sachs executive who declined to be identified by name speaking about the incoming president. “What people are reacting to is this incredible cultural shift. People thought it might be 10 or 15 years until regulators stopped demanding heads and now all of a sudden you can envision it happening overnight.”

The Volcker Rule -- the rule that banks can't engage in "proprietary trading" -- isn't just the Volcker Rule; its effects go beyond the letter of the law. They are cultural and symbolic; they stand for the idea that trading, risk-taking, swagger are out of place in modern banks. The post-crisis period has been a dull gray time for the big banks. They make less money on trading, they pay more money in fines, and they generally feel unloved and unpopular, especially compared to tech unicorns and fintech startups. It is not 2007 any more; investment banks are not the cool place to be. Rolling back the last eight years of regulation won't necessarily change that: The culture, and the economy, have moved on for their own reasons. But you can see why nostalgic bankers might take some hope from it.

Another view: "Bankers predict Trump will not reshape regulatory agenda."

Elsewhere, he sighed heavily: "Trump's Changes to the Tax Codes May Encourage Dynastic Wealth." "Mnuchin's Bank Accused of Redlining Black, Latino Home Buyers." "The Glory Days of Elizabeth Warren'sCFPB Are Numbered." "How Republicans Plan to Spend Like CrazyWithout Running Up Debt." "An NFL Executive Thinks Football Will Thrive Under Trump Because America Will Be 'More Raw and Brutal.'" And the president-elect is trying to delay the fraud trial over his fake university until after he is inaugurated.

Jamie Dimon.

When should I stop beating the drum for Jamie Dimon to be Treasury Secretary? He has apparently already said no, repeatedly, so there's that. I suppose when Donald Trump names someone else, that will be a reason for me to stop. But what if the Senate doesn't confirm him? What if Trump fires him? Let's keep a slow fire burning under Dimon for a little while, no?

You know who can help with that? All the people named in this article about Dimon's possible successors as Chief Executive Officer of JPMorgan Chase & Co. Daniel Pinto, Doug Petno, Mary Erdoes, Marianne Lake, Matt Zames: This is a rare opportunity for you to combine patriotic duty with personal ambition. Maybe whisper in Dimon's ear a bit, see what happens.

Also, a word on that list. I think of JPMorgan as being like the old General Electric Co., a training ground for generalist managerial talent. So the fact that Petno runs commercial banking, say, or that Zames is a former fixed-income trader with London Whale cleanup experience doesn't necessarily tell you what to expect from them. If Petno is the next CEO, that doesn't mean that JPMorgan is re-focusing on commercial banking; Zames doesn't mean a return to high-risk bond and derivatives trading. But if Dimon does leave, it will be at least a little tempting to interpret his choice of successor as a sign of the new cultural climate for universal banks.

Congrats TeslaCity!

The biggest shareholder of SolarCity Corporation is Elon Musk. Musk is also the biggest shareholder of Tesla Motors Inc. He is also the chief executive officer and chairman of the board at Tesla, and the board chairman at SolarCity. (There are other connections.) He wanted to merge Tesla and SolarCity. The boards of the two companies -- with conflicted directors, like Musk, recused -- thought about it and approved the deal. They put it to shareholders. Musk called it a "no-brainer." Some investors complained that it was a conflicted bailout of Musk's troubled solar company by his more stable car company. Institutional Shareholder Services recommended voting for the deal. Glass Lewis & Co. recommended against, calling it a "thinly veiled bailout plan." Yesterday shareholders voted, and the deal passed with about 85 percent of the (non-Musk) vote.

The second biggest shareholder of SolarCity is FMR LLC, the reporting entity for Fidelity, the giant mutual fund company. FMR is also the second biggest shareholder of Tesla. The third biggest shareholder of SolarCity is the Vanguard Group, which is also the fifth-biggest holder of Tesla. The Bank of Montreal and BlackRock are both top-10 holders of both companies. That doesn't always mean that their interests are aligned -- Fidelity has lots of different funds, and

presumably some of them own Tesla but not SolarCity or vice versa -- but there is clearly some overlap. If the deal really was a bailout for SolarCity, some Tesla shareholders would have liked it anyway, because they are also SolarCity shareholders.

There is also an obvious investing-thesis overlap. Tesla and SolarCity are in different though vaguely related (renewable energy, etc.) businesses. But apart from that, Tesla is run by Elon Musk, and SolarCity is ... let's say, spiritually affiliated with Elon Musk. You might invest in Tesla or SolarCity because you like cars or solar panels, but you might also invest because you like Elon Musk. "Vision is what Tesla's shareholders are buying into," and Musk's vision encompasses SolarCity. If you invest in Tesla because you like Elon Musk, then acquiring SolarCity just gives you more Elon Musk. What's not to like?

We talk a lot about the governance and antitrust implications of diversified shareholders -- like Fidelity and Vanguard -- owning shares in multiple companies in the same industry. These shareholders, the theory goes, will push companies to compete less, since their main incentive is to maximize overall industry profits. But they'll also be more welcoming to mergers: Target shareholders won't demand huge takeover premiums if they are also shareholders of the acquirer. They'll share in the profits either way. The first objection isn't really relevant here: Tesla and SolarCity are in different businesses and never really competed with each other. But the second might be. Should we care? Musk's interests, as a huge shareholder of both Tesla and SolarCity, aren't necessarily aligned with the interests of a Tesla-only or SolarCity-only shareholder. But they *are* aligned with the interests of a broadly diversified investor. The broadly diversified investor is increasingly the norm. Should mergers-and-acquisitions decisions start catering to her?

People are worried about unicorns.

Jonathan Badeen is a co-founder of Tinder. He is very rich. This is why:

About half way through my shower I realized I forgot to turn on the fan. No big deal, it happens all the time. When I stepped out, the room was especially foggy. I wiped the mirror clean, but within a minute it was fogging up again. I wiped it clean a second time, only this time, I wiped in the opposite direction. I saw a familiar face looking back at me in the clear sliver of the mirror that my hand had just…*swiped.*

The coolest of stories, from the bro-est of bros. I don't care that Tinder is not technically a unicorn.

Meanwhile, Airbnb has apparently decided that its future is as a travel agency?

Airbnb said Thursday that it is expanding beyond its core short-term rental business, which faces pushback from local governments around the world, to become a fuller service travel agency. In a step toward that, the company launched a service called Trips, which will provide tours, tailored activities and other experiences.

Disruptive! And Udacity, an online learning startup, is moving into the gig economy for startup workers?

The program, called Blitz, provides what is essentially a brief contract assignment, much like an internship. Employers tell Udacity the skills they need, and Udacity suggests a single candidate or a few. For the contract assignment, which usually lasts about three months, Udacity takes a fee worth 10 to 20 percent of the worker's salary. If the person is then hired, Udacity does not collect any other fees, such as a finder's fee.

This is about improving and democratizing the hiring process, reducing reliance on elite-school pedigrees, etc. I think. Or is it about making high-skilled technical jobs as temporary and precarious as Uber driving gigs?

Elsewhere, here's a story about ties between Peter Thiel's Palantir Technologies, the Spy Unicorn, and Michael Flynn, the apparent incoming national security adviser. And: "Tech IPOs Want to Get Ahead of Trump."

People are worried about bond market liquidity.

Here's a Center for American Progress report from this week called "Phantom Illiquidity." "There simply are not, at present, broad or significant liquidity issues in the fixed-income markets," say the authors. "What's more, the entire theoretical foundation of the illiquidity argument is off base. Dealers do not jump into the market—known as catching the falling knife—to provide liquidity during times of market stress." And: "Rather than trying to undo financial reform, regulators should stay the course and ensure strong, reliable capital and regulatory approaches." Tough timing on that one!

Me yesterday.

I wrote about Valeant and Philidor. John Hempton is more negative.

Things happen.

Fed chief Yellen stands by central bank independence. (Hertestimony.) Chipotle, Ackman Near Settlement. Bank Bosses Soften Tone on Brexit as May Extends Olive Branch. Wells Fargo customer account openings plunge 44%. Dry Bulk Bubble Bursts: Dry Ships Sinks as Trading Resumes. Probe Over Guinea Payments Led Rio Tinto to Fire Top Officials. SEC Charges Renewable Energy Company, CEO, and Others With Defrauding Investors. Federal Court in Chicago Orders U.K. Resident Navinder Singh Sarao to Pay More than $38 Million in Monetary Sanctions for Price Manipulation and Spoofing. Audit shows risks for ECB's role as bank watchdog. Goldman Sachs Maps Out Its Top Ten Market Themes for 2017. Ex-Banker Sells New York Townhouse for $12 Million Less Than He Paid. Labatt Has Been Forced to Stop Giving Retired Workers Free Beer for Life. Westworld Version 4.5.2 Patch Notes. Dog triathlons.