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Bank Relationships and Index Rules

Also Bancor, leaky brokers, Martin Shkreli, slot machines and unicorns.

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Relationships.

The basic business of banking is relationships, and a basic fact about relationships is that they are imprecise things. You do not give a company a loan, or buy its chief executive officer a steak dinner, in exchange for a merger mandate. You give the company a loan, and you buy the chief executive a steak dinner, to build a sense of loyalty. Then, later, the company gives you a merger mandate, out of loyalty. The difference is in how you *feel* about it: Ideally -- and this ideal is not always achieved -- but ideally you both feel like you have a mutual relationship of trust and support, rather than a cold soulless accounting of inflows and outflows. You do not *account* for your friendship.

I mean, you do! If you are a relationship banker covering a company, you probably do get scored internally on how much you spend on loss-leading products and how much you bring in in revenue. But you try not to think about it in your day-to-day relationship, and if that accounting is unpleasant, you find ways to soften it in your mind. "Sure I have bought this CEO a lot of steak dinners and not won any merger mandates," you tell yourself and anyone who will listen, "but she has given me a lot of insight into her industry at those steak dinners, which I will use to win merger mandates from other companies," or whatever, I don't know, you'll think of something good. The

point is that you are trying to win business by convincing the CEO that you are her friend, but you are probably also convincing yourself that you're her friend.

Or not; this is a sort of idealized and old-fashioned description, and the financial world is becoming ever more impersonal and transactional. But a key insight of the old relationship model is that relationships are complex and multifaceted and hard to reduce to a single easily digestible statement of sources and uses of cash. And it would be a little crass to do so, really: Your relationship is about personal trust and connection, not quid pro quos, and each transaction stands on its own. If you pay \$5 million for steak dinners, and get paid \$20 million for your merger mandate, then that is a \$20 million merger mandate; calling it a \$15 million mandate -- netting out the cash flows -- cheapens the relationship.

Today Barclays Plc and four former executives have been charged with, and are expected to plead not guilty to <https://www.bloomberg.com/news/articles/2017-06-20/barclays-four-former-executives-charged-over-qatar-fundraising>, conspiracy to commit fraud around Barclays's 2008 capital raising from Qatar. I have no idea what went on in that deal, and no views on anyone's guilt or innocence, but I suppose the court in that case will have to give some consideration to how banking relationships work. Here are the U.K. Serious Fraud Office news release <https://www.sfo.gov.uk/2017/06/20/sfo-charges-in-barclays-qatar-capital-raising-case/> and Barclays's statement <http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/BARC/13266200.html> . Here's the issue <https://www.wsj.com/articles/barclays-four-former-top-executives-charged-with-fraud-over-fundraising-with-qatari-investors-1497941440> :

The allegations center on how Barclays structured two capital injections from Qatari investors as the bank raised £11.8 billion (\$15 billion) to prop it up during the 2008 financial market meltdown. Barclays said it paid £322 million in “advisory services” to Qatari investors, which wasn’t initially disclosed after the capital was raised.

The SFO’s charges also relate to a \$3 billion loan facility Barclays made to the State of Qatar acting through the ministry of economy and finance in November 2008, just after its second capital raise.

Indexing.

Is Facebook Inc. a company? Hmm <<https://www.wsj.com/articles/proposal-puts-focus-on-share-class-structure-1497873601?tesla=y>> :

A proposal being floated by a large index firm could force finance chiefs at companies like Alphabet Inc., Facebook Inc. and Ford Motor Co. to choose between keeping their places in broad stock benchmarks or changing their share class structures.

FTSE Russell is proposing possible restrictions on the inclusion of companies with unequal voting rights in its indexes, but the firm will weigh input from clients and investors before working out specifics.

Let's say you want to invest in the entire U.S. stock market. The Russell 3000 index, which covers about 98 percent of the U.S. public stock market, is a reasonable proxy for that. So you might buy a Russell 3000 index fund.

But let's say you also think that Good Governance Is Good, and that dual-class shares are bad. Then you might ... well, you might do a lot of things. One thing you could do is buy the Matt 2997 index fund that I just made up, which buys all of the stocks in the Russell 3000 except Alphabet, Facebook and Ford. Or if you are a big institutional investor you can replicate that yourself: Just look at a list of the Russell 3000 stocks, observe which ones have dual-class shares, and buy the rest of them.

Then one of three things will happen:

1. You will outperform the index, because Good Governance Is Good and leads to better performance; or
2. You will underperform the index, because Good Governance Is Good Only On Some Longer Timeframe or whatever, but you will feel good about striking a

blow for good governance.

3. You will underperform the index, conclude that Good Governance Is Bad, and go back to buying Facebook stock.

Any of those things would be fine, really! This is life, and investing: You make choices, and sometimes your choices work out well, and sometimes they don't. But of course the passive-investing revolution is about *not making choices*, so making this choice is awkward. You can't just buy 2997 of the Russell 3000 stocks, especially if the omissions are as big as Alphabet and Facebook. That would be active management, and your belief that Active Management Is Bad is even stronger than your belief that Good Governance Is Good.

So the trick is to get FTSE Russell to make the choice for you: If the Russell 3000 doesn't contain dual-class stocks, then you can just buy the index, avoid those stocks, and neither outperform nor underperform the index. *This is purely cosmetic*: Facebook and Alphabet still exist, and if you invest in the Neo-Russell 3000 and they outperform it, then you have still missed out on performance by not buying their shares. But it is performance that you don't care about, because your performance is measured against the index, not against the actual universe of all investable stocks. So you're fine, as long as FTSE Russell makes the decision that you want it to make.

"The future of the markets are at stake," said James Andrus, an investment manager at the California Public Employees' Retirement System," and it's an extraordinarily silly thing to say. He works for Calpers! They have a lot of money! They can just buy the stocks that they think are good and not buy the stocks that they think are bad! They don't have to outsource that decision to FTSE Russell, and then lobby FTSE Russell desperately to make the decision they want! They can just make the decision they want! But they can't, because that would be Active.

Elsewhere <<https://www.wsj.com/articles/your-etf-isnt-what-you-think-it-is-1497889558?tesla=y>> , "MSCI will decide on Tuesday whether to include Chinese domestic stocks in the benchmark emerging markets index":

Investors in mutual- and exchange-traded funds tracking indexes often think they're making a simple decision to follow what the market's doing. In reality the indexes have mutated from measures of the market into primitive investing algorithms, with sometimes odd effects.

Bancor is fun.

Initial coin offerings by ... blockchain ... things ... are all the rage <https://www.bloomberg.com/view/articles/2017-06-15/blockchain-icos-and-uber-ceos> these days, and a recent huge one was done by a ... blockchain ... thing ... called Bancor <https://bancor.network/> , which raised over \$140 million dollars in its ICO. Bancor is fascinating! It is a cryptocurrency built on top of the Ethereum platform that will provide a platform for people to build more cryptocurrencies. I think. Here is a delightful blog post from Emin Gün Sirer and Phil Daian making fun of it <http://hackingdistributed.com/2017/06/19/bancor-is-flawed/> . They start with Bancor's fondness for economics-y buzzwords:

"Double coincidence of wants" is a real problem in economics today in the sense that the "itsy bitsy spider" problem is a real problem in zoology -- that is, it's something one might learn in grade school, and it's completely irrelevant in the real world.

To be fair, you might indeed come to the market with two rabbits one day and I might come to the market with two chickens on the same day. I might also have an aversion to rabbit meat and a family history of mal de caribou. We would then be unable to conduct a trade.

In reality, this never happens, because...

There are a lot of ways to end that sentence, of which "we both have credit cards" and "you can't really trade rabbits on the blockchain" would be excellent sensible ones. Sirer and Daian go with "one can always use ether as a medium of exchange," which, you know what, fine, on the Ethereum blockchain, one can always use ether as a medium of exchange, sure. ("Move Over, Bitcoin. Ether Is the Digital Currency of the Moment," is the New York Times headline <https://www.nytimes.com/2017/06/19/business/dealbook/ethereum-bitcoin-digital-currency.html?smid=tw-dealbook&smtyp=cur> .)

There is much fun cryptocurrency and economics and computer-science stuff in their post, but what I particularly loved about it was the market-structure stuff. One innovation of Bancor -- described in its [white paper <https://bancor.network/static/Bancor_Protocol_Whitepaper_en.pdf>](https://bancor.network/static/Bancor_Protocol_Whitepaper_en.pdf) -- is a smart-contract-based automatic market maker. Let's say you are setting up a distributed cloud-storage network and offering your own digital token -- StuffCoin -- to allow people to buy and sell cloud storage. You sell a bunch of the StuffCoins to early adopters, and then you use a portion of the proceeds to establish a "reserve" fund to basically stabilize the price of your coin. The reserve fund -- which is denominated in Bancor's own tokens, called "BNT" -- is maintained by a smart contract that acts as a market maker; if people want to buy StuffCoins, it will sell them, at ever-increasing prices; if people want to sell StuffCoins, it will buy them, at ever-decreasing prices.

It's a Treynor market maker http://www.jstor.org/stable/4479073?seq=1#fndtn-page_scan_tab_contents implemented via smart contract! (I mean, its algorithm for changing prices isn't quite the classical Treynor one, but it's the same basic idea.) Of course computer implementations of market making are nothing new; the basic idea of high-frequency trading in financial markets is that you program a computer to follow some sort of simple market-making algorithm. But doing it by smart contract -- having the market maker be just a pot of money with rules attached, rather than a trading firm that happens to use computers -- does seem novel.

Also: not a great idea? At least, not with such simple rules, which Siner and Daian criticize on straightforward market-structure grounds. For one thing, if there is new information, then the "true" market price of StuffCoins might crash from 20 BNT to 5 BNT, while the actual market price that the market maker pays will creep down slowly:

If you used Bancor, your Bancor smart contract would have no knowledge of what is happening out there in the real world. It wouldn't know the market movements, it wouldn't know where the coin ought to be, and it would follow its blind strategy of offering bid/ask prices. That strategy involves making a market through thick and thin, without any information about reality. In fact, that reality is determined purely by

external markets, and the contract will, unstrategically, use its reserves to discover and match what the markets demand of it at that instant.

And:

If the price is going to be doing some ups and downs around a single mean value, Bancor can help facilitate trades by acting as a market maker.

But the situation is pretty bad when the price is leaving one level for another. If it's going down, then Bancor will bleed its reserves to keep the price close to the higher point that the price used to be at. And if it's going up, Bancor will sell coins at a price lower than the equilibrium point of the market, and therefore slow down the up movement.

Anyone who has followed debates about [high-frequency trading](https://www.bloomberg.com/view/articles/2016-10-07/flash-crashes-and-insider-trading) [<https://www.bloomberg.com/view/articles/2016-10-07/flash-crashes-and-insider-trading>](https://www.bloomberg.com/view/articles/2016-10-07/flash-crashes-and-insider-trading) , or about [bond market liquidity](https://www.bloomberg.com/view/articles/2015-06-03/people-are-worried-about-bond-market-liquidity) [<https://www.bloomberg.com/view/articles/2015-06-03/people-are-worried-about-bond-market-liquidity>](https://www.bloomberg.com/view/articles/2015-06-03/people-are-worried-about-bond-market-liquidity) , should recognize these issues. The classical market-making function works really well when prices fluctuate around a stable value; it works more poorly when prices move rapidly in one direction. Classical market-making is not a good strategy to follow in a panic, which is one reason that high-frequency traders sometimes turn off their computers during crashes -- and why some people are skeptical that banks would really step in to support bond prices in a crisis. Everyday liquidity provision in a stable market is different from trading against a crisis, whether in stocks or currencies or bonds or blockchain tokens. Also, of course, if you build a predictable algorithm, people will game it -- and if you build an algorithm that reacts slowly to new information, people who react more quickly to that information will pick it off.

Leaky brokers.

We talked a little last year [<https://www.bloomberg.com/view/articles/2016-11-08/politics-polls-art-and-bribery>](https://www.bloomberg.com/view/articles/2016-11-08/politics-polls-art-and-bribery) about [this paper](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860118) [<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860118>](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860118) , by Marco Di Maggio, Francesco Franzoni, Amir Kermani and Carlo Sommovilla, finding that "an important

source of alpha for fund managers is the access to better connections rather than superior skill": Investors who trade through brokers with good trading networks get higher returns than those who trade through less-central brokers. Here is a new version of the paper http://www.nber.org/papers/w23522?utm_campaign=ntw&utm_medium=email&utm_source=ntw with more fun results:

We show that after large informed trades, a significantly higher volume of other institutional investors execute similar trades through the same broker, allowing them to capture higher returns in the first few days after the initial trade. In contrast, we find that when the informed asset manager is affiliated with the broker, such imitation does not occur.

Ha!

Similarly, we show that the clients of the broker employed by activist investors to execute their trades tend to buy the same stocks just before the filing of the 13D.

Ha! One thing that all activist investors believe is that their brokers are leaking their trades; it turns out they're right.

How's Martin Shkreli doing?

"Amazing," is the only possible answer, based on [this story](http://www.cnbc.com/2017/06/19/martin-shkreli-appears-at-federal-court-hearing-for-upcoming-trial.html) <http://www.cnbc.com/2017/06/19/martin-shkreli-appears-at-federal-court-hearing-for-upcoming-trial.html> about his lawyer's recent effort to get his bail reduced:

Despite that, Brafman conceded, Shkreli recently has made some "preposterous promises" to pay rewards. Those include a \$40,000 payment for a math proof, and \$100,000 for the identity of the murderer of a Democratic National Committee staffer, in what the lawyer said was an effort to remain in the public eye.

The lawyer said Shrekli has actually not made good on any such reward payment. He said his client is "traveling to his [own] very unique

drummer."

Brafman also suggested that the one-of-a-kind Wu-Tang Clan album that Shkreli paid \$2 million for several years ago is "probably worthless."

I like that Shkreli's lawyer, in his *securities fraud case*, is *defending* him by saying, well, you know, he just makes a lot of "preposterous promises" to make people rich, but it's not like they're ever going to see any of the money.

Slot machines.

Yeah, I'm with her <http://gothamist.com/2017/06/18/queens_woman_sues_resorts_world_cas.php> :

A Queens woman who won a \$43 million jackpot from a New York City casino slot machine, only for the casino to tell her the slot machine malfunctioned, is suing the gambling den after they offered a steak dinner instead of millions of dollars.

Katrina Bookman, a Queens resident, hit what she said was a huge jackpot on a "Sphinx Slot Machine" last year. However, Resorts World Officials told her that the machine was on the fritz and that the jackpot was void. Instead, the casino offered her a steak dinner as a way to try to make up for what they said was an error, but Bookman didn't think a steak had the same taste as \$43 million.

Look, casinos: You control the slot machines. You have programmed them to take a dollar of Bookman's money and give her back 95 cents <<http://www.cdcgamingreports.com/commentaries/resorts-world-new-york-ranked-best-for-payout/>> . It is a great business, one with essentially risk-free profits. All you have to do -- but it is crucial -- is not blurt out "here's \$43 million!" If you can't manage that, you don't deserve to keep the \$43 million.

People are worried about unicorns.

One popular unicorn worry this week is that Lyft Inc., the Not-Quite-Ubercorn, is reinventing the bus <<http://jalopnik.com/silicon-valley-invents-bus-1796221702>> :

Lyft is testing out a new service called Lyft Shuttle, which runs at a lower cost than its usual it's-not-a-taxi app, but runs on a preset route picking up at preset stops. You may be familiar with this concept already, as in other parts of the world that are not Silicon Valley, this is known as a "bus."

Elsewhere Blue Apron Holdings Inc., the Pre-Portioned Unicorn, probably wishes it had gotten its initial public offering done <https://www.bloomberg.com/news/articles/2017-06-19/blue-apron-to-sell-as-much-as-587-million-in-stock-in-ipo> before Amazon bought Whole Foods:

Blue Apron is scheduled to price its shares on June 28, according to data compiled by Bloomberg. That gives management less than 10 days to convince potential investors of its growth prospects as they embark on IPO road show presentations. In the wake of the Amazon-Whole Foods deal, Blue Apron executives have already been tweaking the message, according to a person familiar with the matter.

Things happen.

Argentina, which "has defaulted on its debt seven times in the past 200 years and three times in the past 23 years," is issuing [100-year bonds](https://www.bloomberg.com/news/articles/2017-06-19/argentina-plans-to-sell-first-100-year-bond-as-soon-as-monday) <https://www.bloomberg.com/news/articles/2017-06-19/argentina-plans-to-sell-first-100-year-bond-as-soon-as-monday>. The [London Whale Guy](http://dealbreaker.com/2017/06/the-london-whale-guy-would-like-to-have-a-few-hundred-thousand-words-with-jamie-dimon/) <http://dealbreaker.com/2017/06/the-london-whale-guy-would-like-to-have-a-few-hundred-thousand-words-with-jamie-dimon/> Would Like To Have A Few Hundred Thousand Words With Jamie Dimon. The lost Goldman Sachs 1985 fixed income [recruiting video](http://news.efinancialcareers.com/us-en/287496/goldman-sachs-1985-fixed-income-recruiting-video/?_ga=2.220937304.1939333842.1497964244-274610637.1496220699) http://news.efinancialcareers.com/us-en/287496/goldman-sachs-1985-fixed-income-recruiting-video/?_ga=2.220937304.1939333842.1497964244-274610637.1496220699. Amazon Met Whole Foods on a 'Blind Date' <https://www.wsj.com/articles/amazon-met-whole-foods-on-a-blind-date-but-its-no-tinder-relationship-1497916368?tesla=y> — But It's No 'Tinder Relationship.' "The truth, though, is that Amazon is buying a *customer* <https://stratechery.com/2017/amazons-new-customer/> — the first-and-best customer that will instantly bring its grocery efforts to scale." Elizabeth Warren Urges Fed to [Oust Wells Fargo Board Members](https://www.bloomberg.com/politics/articles/2017-06-19/elizabeth) <https://www.bloomberg.com/politics/articles/2017-06-19/elizabeth>

[warren-urges-fed-to-oust-wells-fargo-board-members](#) . "When the speaker takes even the slightest pause for breath you simply [start talking](#) [<https://www.ft.com/content/923c9c3e-526b-11e7-bfb8-997009366969>](#) ." Cracking the Biggest Art Heist [<https://www.bloomberg.com/news/features/2017-06-20/the-hunt-for-the-isabella-stewart-gardner-museum-artwork>](#) in History. Billions' Worth of [Baubles](#) [<https://www.nytimes.com/2017/06/19/business/dealbook/billions-worth-of-baubles-could-wind-up-in-us-hands-in-1mdb-case.html?ref=dealbook>](#) Could Wind Up in U.S. Hands in 1MDB Case. Italian Man Lives Life of Luxury, Brushes Shoulders with Celebrities for Years by Posing as "Prince of Montenegro [<http://www.odditycentral.com/news/italian-man-lives-life-of-luxury-brushes-shoulders-with-celebrities-for-years-by-posing-as-prince-of-montenegro.html>](#) ." Snake regurgitates pair of [barbecue tongs](#) [<http://www.upi.com/Odd_News/2017/06/19/Snake-regurgitates-pair-of-barbecue-tongs/8371497899990/>](#) .

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