Title: Two of Morgan Stanley’s competitors, Credit Suisse and Goldman Sachs, have gone so far as to alert the US Attorney’s office and the Hong Kong regulator SFC, respectively, about “potential issues” around block trades executed by Morgan Stanley!
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The investigation into block trades has gone quiet, but has it gone cold?

In February Morgan Stanley disclosed that regulators and prosecutors in the US were investigating its block trade business. The announcement sent shockwaves across Wall Street. Block trading generates hundreds of millions in fees for investment banks, but its importance goes well beyond revenues.

For one thing, block trades allow key clients such as private equity firms to sell sizeable stakes in companies listed on the stock market. The blocks can represent 20, 30, even 60 days of average daily trading volume — which are too big to dribble out without causing a significant share price drop.

For another thing, because the stock is almost always placed at a discount to the last closing price, investors have the opportunity to lock in a gain if the share price holds up. These investors — frequently hedge funds — are moreover important clients for other areas of investment banking business, such as prime broking.

Block trades also allow banks, which are often expected by sellers to guarantee the placement price, to quickly find investors to take the risk off their hands.This comes as a relief not only to shareholders but also to financial regulators, who understandably prefer a block of stock to be parcelled out among a range of investors to manage, instead of acting as a deadweight on the balance sheet of a bank.

The block trade business thus benefits several key constituencies and promotes market stability, but these gains are under threat as prosecutors probe business practices and sift through emails, trading records and call recordings.

Bankers worry about two possible outcomes: first, that regulators will over-reach, imposing new rules that limit an important market tool; and second, that market participants overreact and pull back on discussions and transactions that benefit everyone.Investigators have reportedly focused their probe on whether equity syndicate desks at investment banks have given advance notice to selected hedge funds about an impending block trade. It is important to understand why and how this could happen.

While attractive for investment banks, the block trade business is also a high-wire activity in which small misjudgments can translate into substantial losses. If an investment bank has to underwrite the placement price, it risks holding stock and potentially losing big money — as much as tens or (in extreme cases) hundreds of millions of dollars if there isn’t enough investor demand at that price.

The bank has to judge the market-clearing price just right. If it’s too conservative, the vendor will award the trade to another bank. If the bank bids too aggressively, it can struggle to distribute the offering, ending up with a “widow maker” trade.

Naturally, no bank likes to bid blind for a block of shares. If the bank has no inside information, it can speak to investors and gauge their appetite for a stock by using publicly available information, such as disclosure of large shareholdings and lock-up expiry dates. That bank may in turn reflect that interest to potential vendors to try to create a possible trade.

But one thing the bank must not do is to “cheat” by telling investors in advance about a block trade it knows about. If the bank has material non-public information, it cannot be talking with investors about the block before it is publicly announced. This is a red line that every capital markets banker knows not to cross.

So reports that investigators were examining whether investors had been tipped off about block trades have startled Wall Street and stirred a tidal wave of rumours and insinuations.If one puts aside the innuendo, several facts around the block trade story are quite striking.

First: this is not some routine Finra inquiry. Both the SEC and the US Department of Justice are investigating, making this potentially both a civil and a criminal matter.

Second: according to reports, two of Morgan Stanley’s competitors, Credit Suisse and Goldman Sachs, have gone so far as to alert the US Attorney’s office and the Hong Kong regulator SFC, respectively, about “potential issues” around block trades executed by Morgan Stanley.

Third: syndicate personnel at Morgan Stanley have been suspended and replaced for undisclosed reasons.

Fourth: Morgan Stanley has warned in a quarterly report that it faces potential civil liability from sellers in block trades claiming that the bank had caused a fall in share prices. Indeed, an investment fund has filed an arbitration demand with Finra alleging that Morgan Stanley tipped off investors or its proprietary trading desk of a block trade in Palantir shares, costing that fund tens of millions of dollars in proceeds.

Fifth: the media have picked up on seemingly anomalous share price movements around other Morgan Stanley-led block trades, such as those in ZoomInfo and Iqvia, as well as the Archegos-related liquidations of stocks such as Discovery Inc.

This noise goes well beyond the normal thrust-and-parry of a hyper-competitive business. Visceral grudges and grievances underlie these complaints; the Feds are on the case; unidentified people “close to the investigation” are briefing the media and naming names; and careers, livelihoods and reputations hang in the balance.

As Martin Lawrence’s character says in Bad Boys 2, “this shit just got real.”That said, prosecutors and regulators face a daunting task. They can subpoena trading records from a hedge fund but evidence, say, of short sales before a block trade is not a smoking gun. Most potential blocks are known to the market, and investors can legally trade as lockups expire or if they surmise that a sale could be imminent. Investors marked down Tesla shares last spring as soon as Elon Musk announced his bid for Twitter, because they expected him to sell some shares to finance the proposed acquisition. A similar logic may apply here, making it difficult to prove misconduct.

Moreover, no investigator will want to go through the kind of public humiliation that Australian regulators experienced for their ill-conceived prosecution of Citigroup and Deutsche Bank personnel over a block trade in ANZ Bank shares. The case (which alleged market manipulation and collusion) collapsed last February after four years of proceedings amid doubts that any law had been broken, with the presiding judge memorably describing it as a “complete shemozzle”.

It’s no surprise, then, that investigators have been taking some time to complete their work. The stakes are high not only for the individuals and firms under scrutiny, but also a broader array of market participants and stakeholders.

The current modus operandi around block trades may sound like a cozy system among banks, vendors and investors. But it works, provided — and this is a crucial proviso, not a footnoted qualification — that everyone plays by the rules and no one leaks or trades on nonpublic information. The SEC and DOJ findings will determine whether business can continue in the usual way or whether trust has been fractured and norms shattered, to the detriment of everyone involved.

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