Woodbine *Opinion*

Views on Issues Impacting the Capital Markets by the Analysts of Woodbine Associates

February 15, 2011

To Catch A Proprietary Trader

The new era of financial reform has promised increased transparency and a reduction in systemic risk. With the Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CTFC) moving through the research and rule-making phases of the new regulation, there has been substantial talk of cost, efficiency, and practicality of the process. We are all for clarity and consistency – where it makes sense. However, there are instances where establishing an intractable boundary is impractical. In our opinion, such is the case with identifying proprietary trading.

Regulators and practitioners alike think it would be easy to differentiate market making from proprietary trading by examining individual trades; however, we do not think it would be that clear. Both the trading community and regulators are trying to establish criteria that would clearly identify trades as either proprietary or customer trades. Such clarification would give the regulators the “clear cut” ability to penalize offenders of the Volker Rule. We think that a highly precise set of criteria to determine one type of trading from another is not entirely possible: one person’s proprietary trade would be another person’s “pre-hedge” in a client book of business.
So, how could regulators successfully distinguish proprietary trading from market making in a straightforward, easily understood way? Our answer would be to apply a general framework to evaluate trading using metrics that would indicate the possibility of proprietary trading. In-depth follow-up using other measures and unbiased, expert evaluation of trading patterns could then be undertaken where necessary to make a determination in areas where there is suspicious trading that may or may not be proprietary. Is this preferred? At this time we think it is the preferred method, as each instance would receive the individualized focus warranted to either confirm or deny proprietary trading. Is this practical? Again, we believe it is, as elaborated on below; the number of instances may not be substantial in the long run, as any false positive can be used to refine the flagging of suspicious trading. Is this appropriate? Again, we believe it is because the proprietary intent behind an individual trade cannot be determined on a trade-by-trade basis. Proprietary intent should be determined by the manner in which a book is handled over an extended period and how a particular book compares with the industry norm, in terms of risk and return.

So, how should regulators go about distinguishing proprietary trading from market making? One would expect a book of agency business to be hedged in such a way as to minimize market and basis risk. Return on the book is generated largely by volume of trading at the bid/ask spread and changes in inventory value. One would expect a book with embedded proprietary business to make more pronounced market risk plays to amplify returns. We would expect a book managed in a proprietary manner to display greater market risk, on an adjusted basis, than a pure agency book. We think normalized comparisons can be made across firms of various sizes by looking at the ratio of the total market risk relative to the amount of customer-generated market risk incurred over a specified period.

To better explain this approach, if a particular book of business at one market-making firm was shown to have decisively greater market risk on an ongoing basis than comparable books across the industry, this may be an indication that the additional risk is proprietary. Such an indicator should serve as a flag for regulators to examine the book, trades, trading patterns, and returns of the firm to determine if a case can be made that the book is being managed in a proprietary manner and in violation of the Volker Rule.

How would risk be viewed on a normalized basis across firms? We think this should be done with existing metrics in the market place and some additional reporting mandates. We would begin by taking a basic value-at-risk (VaR) measurement across comparable business units (e.g., desks) at similar financial institutions. We would then evaluate the customer-driven business and risk traded in each book on a product-by-product basis. This could be measured in a variety of ways, with the simplest example being the sum of the absolute values of the risk associated with the individual trades in each book. This would provide a basis to normalize differences in the size of firms' books and allow for an appropriate comparison. We believe that financial risk associated with running a customer facing and properly hedged book for a particular product would be constant on a risk-adjusted basis. A book's VaR for a particular product should reflect, and be a function of, the volume of customer business in that product. A book that shows abnormally greater value-at-risk, relative to the amount of customer risk, would be suspected of being run in a proprietary manner. However, the added risk would have to be proven "long" term and not just a daily anomaly.

Who would make the ultimate decision as to whether a book was being managed in a proprietary manner? Perhaps it is possible to create an expert committee of current or former buy-side and sell-side traders who have the expertise, are unbiased, and lack an allegiance to any market makers. If, in the eyes of these experts, there were sufficient evidence that the book was being managed more as a proprietary book rather than a market-making book, that market maker could be subject to appropriate action.

Admittedly, there is work to be done in the area of specifics, like setting the industry baselines for the appropriate risk ratios, which will be accomplished over time. With proprietary trading defined for us in the Dodd-Frank Act, the challenge now lies in identifying proprietary activity at the institutional and trading book level. The matter of setting criteria for what does and does not constitute proprietary trading is a topic many have views on, yet we believe that a majority of experienced traders, when presented with the facts, can determine when a book is being handled in a proprietary manner and in clear violation of the rule. Selecting the indicators, such as a measure of time that a book of business is "out of line" with other books on a VaR normalized basis, will take work. However, at this time we believe that if it is done right, it would not be overly difficult or resource intensive. It should largely be an extension of existing internal risk management practices.

The too-difficult-to-model argument would also be out. We believe that existing VaR metrics should be utilized, as described previously. However, instead of setting some arbitrary "hard" quantitative risk limit upon which an investigation/audit would be triggered, we would advocate monitoring risk relative to the industry mean for a particular type of product line or asset class. This type of comparison is particularly useful since it effectively eliminates the variability brought about by market movements (since all desks will likely hedge against anticipated risks). This approach would also substantially weaken the argument by any particular book manager aggressively "pre-hedging" customer business.

It is possible to raise the argument that trading audits could be made on an arbitrary basis if no "clear cut" standards are defined. As noted above, we believe that comparison to the industry norm is a tractable solution. This means that unless there is some kind of well-kept market-wide collusion, market risk levels across firms (on an adjusted basis) should be comparable. By examining books over time and on a risk-adjusted basis, suspicious

situations could be individually audited on a more granular level. This would allow suspicious situations to be handled with a degree of care and responsibility not possible where hard limits are established.

In summary, regulators should be looking for a pattern of proprietary trading -- not "proprietary trades." Instances of suspected proprietary trading could best be identified by using a risk-based methodology to examine comparable books across institutions on a relative basis. Furthermore, the threat of investigation under this methodology would provide a deterrent that would not exist under a hard-limit paradigm. No method of regulation or oversight will eliminate the rogue trader seeking to make an individual bet for a quick buck. However, a method such as the one we propose would go a long way toward preventing large-scale sustained abuses, maintaining efficient market operations, and enabling regulators to flush out suspect trading activity, with the objective of reducing systemic risk.

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About Woodbine Associates:

Woodbine Associates is a unique research and advisory firm serving the capital markets industry. Founded and staffed by highly experienced industry professionals, Woodbine Associates is raising the bar for quantitative, qualitative and survey-based research of critical capital markets topics by utilizing senior-level industry practitioners to dig deeper into the issues and render informed opinions and advice. In addition to a la carte reports, Woodbine's experts provide custom research and advisory services to the exchange, broker/dealer, asset manager, hedge fund and technology vendor communities.

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Woodbine *Opinion*

Views on Issues Impacting the Capital Markets by the Analysts of Woodbine Associates

October 25, 2011

The Volcker Rule Rocks!

We must admit, the new Volcker Rule is a real piece of work: 298 pages of text, with nearly 400 questions posed to the public. Despite this, we think it is an extremely effective piece of regulation. In the area of proprietary trading -- it does exactly what it sets out to do. The Volcker Rule makes clear, in no uncertain terms, the types of trading and risk taking that will be permitted for banking entities in the US.

Regulators have spelled out in detail that which is allowed, and that which is not. They list specific criteria that must be met for institutions to engage in market making, underwriting and other permitted types of trading. They cite examples to illustrate their points. They outline a multitude of quantifiable metrics that will be used to measure compliance, and explain how they will evaluate these metrics. If this were not enough, they add plain text annexes, written in conversational English, that outline the spirit of the regulation and the principals behind it.

The result is a surprisingly clear framework for securities and derivative trading at banking institutions. If there is such a thing as good regulation, this may be it. Congress deserves kudos -- if for once.

It’s Only for Banks

Let us not forget that the prohibition of proprietary trading pertains to US banks and bank holding companies (BHCs) and foreign banks and BHCs trading in the US. It applies to those institutions’ regulated affiliates, such as broker dealers, swap dealers, security-based swap dealers and other regulated entities. Foreign banks located in the US, those trading with US entities, or those trading on US venues are required to meet the same criteria as their US counterparts.

Exemptions

The Volcker Rule provides exemptions for certain securities and markets, such as treasuries and agency securities, including pass-through securities and securitizations, and municipal securities. For these, banks face no restrictions provided their trading does not present a conflict of interest with their customers, nor incorporates excessive risk to the firm or the markets.

Specific transactions types that are excluded from coverage include repo and securities lending transactions. Spot foreign exchange, physical commodities and loans are excluded from the definition

of “covered transactions” and are not subject to the law’s trading requirements. Transactions executed for bona fide liquidity management purposes are also excluded.

Exclusion of Permitted Trading

The Volcker Rule prohibits trading of any sort (market making, underwriting, and trading in treasuries, agencies and other securities and transactions) when it results in a material conflict of interest between a bank and its customers, clients or counterparties; results in material exposure to the banks from high risk assets or trading strategies; or poses a threat to the safety or soundness of the bank or the US financial system. These issues are what drove the Rule to be drafted in the first place.

Market Making

Banks are permitted to engage in market making-related activities, to the extent that they provide intermediation and liquidity services to customers. Regulators address the difficulties of distinguishing between “pure” market making from positioning in a customer-oriented trading book. They will require firms to meet specified criteria to ensure that their market making is “bona fide.” To do this, a banking entity must meet seven criteria in which it:

1) Must establish a comprehensive compliance program.

   A banking entity must have effective policies, procedures, and internal controls designed to ensure that prohibited proprietary trading positions are not taken under the guise of permitted market making-related activity.

2) Must hold itself out as a market maker and both buy and sell securities in which it trades. The criteria to be considered a “bona fide” market maker are detailed as follows:

   In liquid markets, such as listed equities, this means:

   a) Making continuous two-way markets in securities.

   b) Making roughly equal purchases and sales.

   c) Providing continuous quotes at or near both sides of the market.

d) Providing widely accessible and broadly disseminated quotes.

In less liquid markets, such as those traded over-the-counter, this means:

a) Provide quotes on a regular basis, not necessarily continuous.

b) Actively trade the securities in the market from customers.

c) Ensure that transaction volumes and risks taken are proportionate to historical customer liquidity and investments needs. Positioning in anticipation of block trades is permitted, provided it is oriented toward risk intermediation.

3) Must conduct its market making such that it does not exceed the "reasonably expected near-term demands of clients, customers, and counterparties."

   This can and should vary by market liquidity and convention. "Near term demand" is firm-specific and should reflect a banking entity's unique customer base. In other words, the risks taken by firms making markets must be commensurate with their customer volumes.

4) Must register required entities, such as a broker dealer or swap dealer, under US securities or commodities laws.

5) Must design its market making to generate revenues primarily from fees, commissions and bid/ask spreads, and not from changes in the value of inventory or related hedges.

6) Must ensure that its compensation and incentive policies do not encourage proprietary risk taking. They should encourage customer service and fee income.

7) Must ensure that market making activity conforms to the commentary in Appendix B of the regulation.

   This is essentially the catch-all application of the principals of the regulation. It outlines market making as a customer oriented, fee or spread driven business that is conducted with minimal risk. It describes trading and risk taking that is not permitted and details how the regulation will be enforced through the evaluation of myriad quantitative metrics that must be calculated on a daily basis. It is a nice addition that explains in very readable detail what the regulators seek,

just in case they might have failed to address a particular situation or left an open loophole.

Identified Prop Trading

The regulation also lists six factors that could indicate a firm is engaging in proprietary trading within its market making activity. These are:

1) Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers.

2) Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than from customer revenues.

3) Trading activity in which a trading unit: (i) generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility.

4) Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with the orders of others, or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near term customer demands.

5) Trading activity in which a trading unit routinely pays rather than earns fees, commissions or spreads.

6) The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.

This list is not exhaustive, but it reinforces the spirit of the regulation with specific examples. The emphasis continues to fall on the relationship between trading book risk and inventory, and the needs of a banking entity's customers.

Market Making Related Hedging

Trading to hedge risk or inventory acquired through market making activity is permitted if it meets two

criteria:

1) The hedging transactions must be to hedge risk incurred through customer market making.

2) The hedging transactions must also meet the criteria specified for general risk mitigating hedging, which include:

    a) The hedging must be done in accordance with written rules and policy.

    b) The hedging must be risk-reducing and specific to the risk being hedged. Hedging is allowed to be done on an aggregated basis.

    c) The hedging must be reasonably correlated with the risk being hedged.

    d) The hedging cannot create new exposures at the time of execution.

    e) The hedging must be subject to continuous and ongoing review.

So What Does it Mean?

The Volcker Rule is a necessarily lengthy regulation, addressing many of the nuances associated with positioning for customer market making that in many cases are outwardly identical to positioning for proprietary profits. For many trades the difference lies in the intent behind the position taken, which must now be justified by customer-related business or a corresponding reduction in risk.

For treasury, agency and municipal securities, and the other products and transactions that are not restricted, there will be no discernable change to bank trading, underwriting or market making. Precautionary restrictions exist if trading presents a conflict of interest with their customers or if it creates excessive risk. Otherwise it's business as usual.

For other covered securities and derivatives, the framework makes it very clear that banks will not be permitted, nor will they have much incentive, to take proprietary risk beyond that which is required for their customers' business. Their market making related trading will be driven by fee and bid/ask spread income from their near term customer needs. Hedging will be done entirely for risk reduction. Both will be examined in significant detail to ensure that banking entities are not taking proprietary risk in areas that are not allowed.

In the end, we believe the regulators deserve credit. They put in place a fairly bulletproof regulation that will allow banks to continue to make markets without taking unnecessary proprietary risk. It may have taken them 298 pages to make their point crystal clear -- but in the end they did just that.

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About Woodbine Associates:

Woodbine Associates is a unique research and advisory firm serving the capital markets industry. Founded and staffed by highly experienced industry professionals, Woodbine Associates is raising the bar for quantitative, qualitative and survey-based research of critical capital markets topics by utilizing senior-level industry practitioners to dig deeper into the issues and render informed opinions and advice. In addition to a la carte reports, Woodbine's experts provide custom research and advisory services to the exchange, broker/dealer, asset manager, hedge fund and technology vendor communities.

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