Effective Implementation of the Volcker Rule's Limited Ban on Proprietary Trading

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Better Markets' 5 Volcker Rule Comment Letters

- November 5, 2010: Key principles addressed
- February 13, 2012: Response to 4 agencies
- April 16, 2012: Response to CFTC, but response addressed to all agencies
- June 19, 2012: Response to SEC on entry of market makers and metric to test for risk mitigating hedging
- January 8, 2013: Submission of report of Goldman's proprietary trading around the Volcker Rule

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Many important topics/issues

- Covered in the Better Markets comment letters
  - Won't go over everything
- Focus today on the reportedly "key issues" still outstanding
  - But, many other equally key issues (like conflicts of interest and economic analysis) are addressed in the comment letters and should be included in the final rule

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Distortions and baseless claims about the Volcker Rule

- Much has been said about the Volcker Rule and much of it is inaccurate and unsupported by evidence/data, but in fact:
  - Narrow in application and limited in scope
  - Prohibition itself narrowly targeted at specific, high risk behavior
  - Does not prohibit proprietary trading
    - Only at a handful of the largest banks
    - Prop trading will continue robustly by other existing and new market entrants (addressed in 6/19/12 comment letter)

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Intent and Provisions

- The intent of the Volcker Rule is to eliminate covered entities' proprietary trading and the risks that arise from that trading
  - "a banking entity shall not engage in proprietary trading" (Sec. 13(a)(1)(A))
- There are certain, specified, narrow "permitted activities"
  - But, the intent of the rule is not to, for example, maximize a covered entity's ability to market make or hedge or serve anything they call a "client"

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Accomplishing Both

- In implementing the prohibition and the permitted activities, the method that accomplishes both is required, rather than subordinating one to the other
  - Prop trading is banned, but the specified market making and risk mitigating hedging, for example, are permitted
    - Both can be done without prop trading
- That's what all but the biggest banks do: they don't have the balance sheet/capital access

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The Solution: break the link between prop trading and banker bonuses

1. Limit all compensation to fees, commissions and observable bid/ask spread

2. Large, swift penalties on executives, supervisors, traders, etc.

AND

3. Require market makers to lay off or hedge their positions and run a flat book

4. Require high correlation, congruence for all risk mitigating hedging

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The Result:
Clear, workable, enforceable boundaries for market participants and regulators

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The proposed rule invites evasion for market making

- Market making revenue “primarily” from bid/ask spread
- Profits consistent and volatility low under “normal” market conditions
- Compensation “designed not to reward proprietary risk taking”
- Proposed metrics are a morass making all this worse
  - Detailed in comment letters (esp. 4/16/12)

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The proposed rule is unenforceable: What is "Market making"?

- What is "(1) reasonably expected (2) near term (3) demands of (4) clients, customers or counterparties"?
- When is revenue "designed" to be "primarily" from bid/ask, etc.?
- When is a compensation arrangement "designed not to reward proprietary risk-taking"?
  - Can compensation include capital gain/arbitrage profits if it is ostensibly not the "design"?
    - If so, ultimate form over substance, defeating entire rule

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The proposed rule's risk mitigating hedging provisions are also problematic and unworkable

- Purchase or sale of covered position
  - Meets internal control standards
  - Mitigates one or more specific risks
  - Is "reasonably correlated" with risks to be hedged
  - Doesn't create significant new unhedged exposures
  - Is subject to continuing review
  - Compensation is "designed not to reward proprietary risk-taking"

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What is "Risk mitigating hedging"?

- What is a "reasonable level of correlation"?
- When is "inception"?
- What is "significant exposure"?
- What is "mitigation" of said "significant exposure"?
- Again, what are "compensation arrangements" that are "designed not to reward proprietary risk taking"?
  - Again, focus on "design" is the ultimate form over substance, defeating entire rule

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Regulatory arbitrage is also likely because incentives are wrong

- When “market makers” or “hedgers” share in capital gains/arbitrage profits, they have strong reason to rationalize in-the-money positions as
  - “intended to meet expected customer demand”
  - the result of “unexpected market volatility”
  - “reasonably correlated” with a hedged position under “prevailing industry standards”
- Regulation and enforcement then takes place, ex post facto, on very difficult, ambiguous legal terrain = nightmare

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How to align incentives with the goal of the Volcker Rule: eliminate prop pay

- Restricting the sources of income for "market makers" and "hedgers" to **fees, commissions and observable bid/ask spread**
  - Prevents traders from participating in capital gains/arbitrage profits
  - Preserves incentives for efficient market making and hedging

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How to align incentives with the goal of the Volcker Rule: eliminate prop revenues

- Require market makers to lay off or hedge their positions and run a flat book
  - What most market makers do today
- Require actual high correlation **and** congruent hedges for all risk mitigating hedging
  - Also what most actual hedgers do today
  - With computers, hedges and hedge equivalents are routine, highly developed, nearly standardized

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Limits on revenue/trader compensation make the rules clear and enforceable

- Revenue and compensation data are readily available and easy to interpret
  - Proprietary traders are in it for their share of capital gains/arbitrage profits
  - Internal accounting of this revenue/income is detailed and precise
  - Nothing is more carefully tracked than the **bonus pool**: regulators must use it

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Can be done with minimal changes to proposed rule: examples

- "…designed not to exceed [and do not exceed] the reasonably expected near term demands…."
- "…designed to [and in fact] generate revenues ~~primarily~~ from fees, commissions, bid/ask spreads…."
- "The compensation arrangements … are designed not to [and do not] reward proprietary risk-taking."

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Finally, large penalties are essential

- Given that the bonus rewards of prop trading are irresistible, the deterrent of swift, certain and substantial penalties is essential
  - Directed at executives, supervisors, risk/compliance/legal, traders and, where appropriate, Board members
- Must be many multiples of any gains or losses plus personal fines, time out bars, injunctions, etc.
- Cannot just say/assume regulators will rely on enforcement mechanisms elsewhere in the law
  - Trying to affect trader etc. calculations
  - Must clearly state in the rule itself
    - See 2/13/12 Comment Letter for more info

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Provisions of a workable, enforceable Volcker Rule

- Limit all compensation to fees, commissions and observable bid/ask spreads
- Require market makers to lay off or hedge their positions and run a flat book
- Require high correlation and congruence for all risk mitigating hedging
- Large, swift penalties on executives, supervisors, traders, etc.

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