



The Volcker Rule Proprietary Trading Ban: A Practical Approach to Implementation

The final form of the Dodd Frank Wall Street Reform and Consumer Protection Act is essentially complete and awaiting Senate confirmation; now, attention will turn toward how regulators will implement provisions of the new law and the impact of these changes on the financial markets.

The “Volcker Rule,” a central element of the new legislation, has received a great deal of attention for numerous reasons, ranging from outright practicality to issues regarding the potential for global regulatory arbitrage. No doubt, implementation of the final rule will be hotly debated as the markets will look to federal banking regulators, the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) to sort out specifics centered around differentiating market making and customer related hedging from outright proprietary trading and positioning within regulated financial firms.

The Volcker Rule in its (near) final form has two main components affecting banks and regulated financial entities: it curtails investment in and ownership of hedge funds and private equity investment and it eliminates proprietary trading by covered financial institutions.

The restrictions on private equity and hedge fund investment are relatively uncomplicated. Banks will be restricted from investing more than 3% of Tier I capital in such entities and must limit ownership interest to a maximum of 3% in these funds. As the rules will likely be phased in over a period of several years to allow for treatment of illiquid positions, institutions will gradually reduce their exposure to and investment in these vehicles until they are in compliance with the new law. Regulatory oversight should be relatively straightforward and should have little notable day-to-day impact on market operations.

The ban on proprietary trading is likely to be altogether different.

In the bill, proprietary trading is defined as “engaging as a principal for the trading account of the banking entity or nonbank financial institution ... in any transaction to purchase or sell or otherwise acquire or dispose of, any security, any derivative” or other financial instrument. The rule is crystal clear in the case of outright speculation for the bank’s own account via internal proprietary trading desks – it will not be permitted. Proprietary trading books will need to be closed. The closing of proprietary books is already underway at numerous institutions. Firms are already redeploying top traders to various other areas including customer driven trading desks.

Along with these trader redeployments will come the oversight challenge of differentiating between proprietary trading and positioning, market making, and customer related hedging that will be far less than straightforward. On a stand-alone basis, a proprietary trade and a customer trade can appear

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identical. The real distinction between the two is the intent behind the trades: taking a position solely for internal profit would be proprietary while assuming the identical position in anticipation of a client-related transaction would be considered facilitation. Since differentiating between these two instances is virtually impossible, the bill affords firms some latitude, stating that that market making related hedging is permitted so long as it is “not to exceed the reasonably expected near term demands of clients, customers or counterparties.”

So – at a granular level – how will regulators differentiate between truly proprietary and client oriented transactions? Most likely, they won’t. However, there are viable alternatives to transaction-by-transaction evaluation that can help shine a light on whether firms are complying with the “spirit” of the rule, i.e., not engaging in excessive speculative risk taking.

At Woodbine Associates, we believe a straightforward, practical approach to regulatory oversight might involve the adoption of a risk-based framework to monitor and enforce what could be deemed excessive risk taking by regulated firms. By excessive risk taking, we mean risk beyond what is necessary to conduct customer related business.

Instead of attempting to trace speculative risk-taking to particular strategies, traders, or positions, regulators could instead focus on book or portfolio-level market risk using a Value-at-Risk (VAR) or unit of risk measurement. The objective would be to ensure that aggregate assumed risk falls within limits that are appropriate for the facilitation of customer business. Certainly, differences of opinion will exist in what will constitute “appropriate” risk limits. And getting it right is important: risk limits for market making and hedging that are too restrictive will unnecessarily restrict trading and liquidity; risk limits that are too loose will be meaningless. However, once completed, the cost, resources, and efforts needed to examine risk and intent at the transaction level will be alleviated. Books with “excessive” risk (or, regardless of the actual figure, simply the most risky books at particular institutions) can be examined. Positions exceeding the limit can be flagged, monitored and evaluated.

The advantages to such a monitoring approach are clear cut. Methodology, workflow, and technology already exist. Accordingly, monitoring should be able to be easily implemented at relatively little cost. Risk managers at covered institutions already monitor internal risk in great detail. Risk limits can be scaled to the amount of customer risk passing through a book or desk. Furthermore, this approach has the added benefit of being flexible for broad application across different products and markets (e.g., equity, fixed income, and derivatives to name a few). The overall impact on individual firm and market operations should be minimal.

Some might argue that the elimination of proprietary trading under the Volcker Rule is an exercise in futility. The difficulty in distinguishing and classifying transactions in regard to the impending financial reform legislation to restrict assumption of speculative risk make it impractical. However, by looking

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for unwarranted risk assumption at the book level using established risk management practices, methodology, workflow, and technology, we can't help but disagree. Such an approach to monitoring provides the best of all worlds: it is easy to implement, it is "old hat," and it affords traders charged with hedging the greatest degree of latitude in hedging their books. In all, it is very reasonable.

When all is said and done, the Volcker Rule might actually function as intended: markets will operate efficiently and firms will enjoy the widest possible latitude in facilitating client business, while at the same time firm-specific and systemic risk will be greatly curtailed.

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