



2011: A Year of Rogues and Regulation

It is no secret: 2011 was another “annus horribilis” for the financial markets. We are pleased to leave it behind. Then again, many issues plaguing the capital markets are not behind us. They just never seem to go away, and they continually rear their ugly heads.

We dragged our feet through twelve months of new regulation and angst, with notable missteps, and controversy. Main Street continued to lose faith in financial services. Sentiment both within and beyond the industry cannot get much worse – or so we hope.

Like the angel and devil that sit on someone’s shoulder in the movies, the two most important themes from 2011 boil down to: “being rogue” and “being regulated.” Let us elaborate on these themes.

Being Rogue

We thought the industry would have been wary of wrongdoing since Bernie Madoff opened our eyes to the possibilities of massive malfeasance. Instead, the year was filled with more of the same. More highly publicized transgressions - from those at MF Global, to UBS, to tiny Pipeline Trading - highlighted the culpable behavior of a select few, but also served as a barometer for flawed corporate culture.

The MF Global bankruptcy was the piece de resistance of misguided corporate culture for 2011 and certainly one of the most egregious examples of such behavior we have experienced ([“*Why Are We So Irresponsible?*” - November 4, 2011](#)). The recurrent themes of senior management hubris, coupled with industry-wide practices that reward outrageous risk-taking with minimal personal downside, reminded all of us what is still wrong with today’s distorted incentives. While the details of the mess are still being sorted out, it is clear that the financial health of the enterprise was not paramount. Management likely confounded the very oversight, accountability, and controls that are put in place to avoid the specific breaches that took place.

This year’s UBS fiasco was a more classic example of senior management’s lack of support for oversight and controls than it was active malfeasance ([“*Why Banks don’t Listen to Their Risk Managers - and Risk Losing Billions*” - September 19, 2011](#)). In this instance, the all too common practice of overlooking a support function that “might” save the firm from a scandal took a back seat to allocating resources to pursuing outsized bottom-line results. We are among those who are still perplexed that a rogue trader on the delta-one trading desk in London could fraudulently trade undetected for nearly a year, racking up losses of nearly US\$ 2.3 billion. The answer should not surprise anyone: risk management too often takes a back seat to trading. The function is often regarded with second-class status, underfunded, and lacks the authority to prudently restrain the activities of line personnel, just when this is most needed.

Though a small player, the transgressions disclosed late in the year at Pipeline Trading highlighted the importance of trust ([“*Pipeline Trading: Rise Like a Phoenix or Crash and Burn?*” - November 21, 2011](#)) There is indeed a line that should not be crossed even when one’s intention is to provide value to clients: you can’t break the law! Many onlookers “missed the boat” on this scandal, expecting changes in the industry associated with a systemic problem. The SEC announcement of Pipeline’s transgressions brought a wave of industry commentary projecting everything from more stringent ATS regulatory and reporting requirements to amplifying the public rage against Wall Street. In truth, the Pipeline events do not highlight systemic weakness but show how simple breach-of-trust with clients can sink an otherwise productive venture.

Woodbine *Opinion*

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



December 20, 2011

Being Regulated

Government imposes regulation to “protect the public” in instances where self-regulation has failed. Sometimes regulators do the “right thing” – as they did in 2011.

The markets need more effective regulation. This was made most obvious in the near systemic failure of the entire financial system in 2008. In the U.S., many of the factors contributing to the crisis were addressed by Congress in the Dodd-Frank Act.

When Congress repealed the Glass-Steagall Act it removed constraints restricting the size, scope, and risk permissible for banks. It prompted an industry-wide consolidation of businesses that set the stage for the dislocation that occurred in 2008. Dodd-Frank effectively requires banks to – once again – focus on banking.

Proprietary risk taking was not the root cause of the 2008 crisis. Still, it played a significant role in the failure and receivership of several institutions. The Volker Rule within the Dodd-Frank Act aims to help curtail the opportunity for systemic failure by restricting banks’ ability to make risky investments and to trade for their own accounts.

While banks and their lobbying groups have espoused potential detriments of the rule (“the ‘end’ of liquidity in the fixed income markets,” and the “prohibitive’ cost of raising capital”), we see this simply as banks becoming banks again. We believe that non-banks will step in to fill the void created as bank-owned dealers redefine their role the markets.

As it is currently proposed, the Volcker Rule is likely to lead to a reallocation of risk capacity across market participants, as well as changes in the way participants’ source liquidity. Bank dealers will function as intermediaries, leaving non-bank dealers, asset managers, alternative investors and others to play an increasing role in providing liquidity to the markets. The rule was designed to move risk out of banks to those entities deemed to be more “appropriate,” and it looks like it will do just that.

One of the side-show issues raised by banks and certain industry watchers was the ‘impossibility’ of segregating agency business from proprietary activities. Our view was – and remains – that this would really not be difficult at all ([“To Catch a Proprietary Trader” - February 16, 2011](#)).

The Volcker Rule’s impact on market-making likely will affect trading and liquidity in multiple products in both the cash and derivative markets. These factors will be compounded by changes to the OTC derivative markets under Title VII, which were put in place to reduce the systemic counterparty risk that contributed to the crisis. These changes, which include central clearing, SEF execution and greater transparency, will have an impact that extends to trading in the underlying products in the cash markets ([“Corporates, Credit, and SEFs” - March 30, 2011](#)).

The requirements placed on banks should have a near term impact on liquidity and initially lead to wider bid-ask spreads. How participants respond to this will be a key consideration. In some cases we expect customers, asset managers and other non-bank entities to take on more execution risk going forward ([Woodbine Associates research report: “Buy-Side Corporate Bond Execution: Sourcing Liquidity under Dodd-Frank”](#)).

While most of the regulatory “fun” of 2011 was occurring in the fixed income derivatives markets, there was a little left over for equity players.

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Regulation is often inefficient, costly and burdensome. Yet In order for agencies to be effective and to minimize the adverse impact that their rules may have on markets, they need to have material and timely access to accurate information. With all the hubbub leading up to the Large Trader Rule this past summer, one might have thought a revolution was occurring. Yet, there hasn't been a hiccup since its finalization (["Large Trade Rule: Nay-Sayers All Hot Air?" - August 22, 2011](#)).

The regulatory blitzkrieg we have been trying digest over the last 12 months is our Government's response to the markets' inability to police themselves. It has never been more clear that we must regulate ourselves more effectively and adopt "best business practices," or it will be done for us. We think this is the most important lesson we must take from 2011.

Tomorrow

In many ways we don't feel as if we're leaving this year behind. There is so much still unsettled, and so much that will be resolved in the coming year. It would be foolish to assume the immediate and seamless integration of new regulation and practices, which means we should expect to experience continued growing pains in the year ahead.

We are cautiously optimistic that this year marked a near term low for our industry and that better times must lie ahead. Hopefully, 2012 will bring improved market structures, better regulation, and new perspectives that will permeate our culture and the way we do business.

Happy New Year!

About Woodbine Associates:

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