

# Woodbine *Opinion*

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



April 5, 2010

## Reform in the Capital Markets: How We Would Do It.

Without question, the top issue on everyone's mind in the capital markets is regulatory reform. Concerns are significant among practitioners. It is no secret that the institutional trading community has often been uneasy with impending regulation. Regardless of how well-intentioned, the results of Securities and Exchange Commission (SEC) initiatives generally complicate the environment for institutional traders. The involvement of career legislators drafting rules that may well have substantial yet undetermined impact on various aspects of market operations no doubt increases the anxiety factor.

We have been mindful of proposed legislation and regulatory reform. Clearly, all parties involved - broker/dealers, banks, exchanges, ECNs, ATSS, politicians, and regulators - are acting within the confines of political reality. This means that current reform efforts are likely to follow the path of many past actions and result in compromised solutions that do not achieve targeted ends and bring along with them a host of unanticipated side effects.

So, if it were up to us, what would we do?

The scope of proposed financial reform extends beyond the capital markets. However, in this piece, we will confine our discussion to the capital markets arena. It is clearly impossible to propose comprehensive legislation in three pages. However, we will put forth the high-level changes we think should be made to improve systemic risk control and improve market operations.

**Hedge Fund Oversight.** The current regulatory framework for the capital markets has a significant shortcoming: the lack of hedge fund oversight. Exempt from regulation as "investment companies" under the Investment Company Act of 1940, hedge funds are responsible for some of the industry's most creative and profitable trading. They are also increasingly responsible for the creation of systemic risk. While we don't see the need for a special set of rules that pertain to hedge fund activity at this time, we believe that comprehensive reform is not possible when the activities of such significant market participants remain outside the scope of regulatory authority and their activities cannot be brought into line with those of other market participants.

**Risk Capital / Permissible Leverage.** The magnitude and scope of institutional trading is the real basis of systemic risk. Using regulation to control specific trading, settlement, or investment operations as a way to manage systemic risk is like treating the symptoms of an illness instead of the illness itself.

Greater leverage constraints/risk capital requirements would facilitate systemic risk management by increasing the cost of conducting "risky" businesses. If less leverage is allowed or more capital is required, the hurdle for the marginal transaction or piece of business becomes greater. If sufficient return cannot be generated for a given level of risk, the marginal transaction is not done. Eventually, capital is reassigned to better use.

We believe that controls on leverage and/or more stringent risk capital requirements would be most effective in managing and controlling systemic risk. Leverage restrictions and risk capital requirements are favorable in that they are easy to implement, are minimally disruptive to normal business operations, generally have a uniform impact on market participants, and are easily modified or repealed as necessary. Unlike a patchwork of entity or function-specific regulations, such leverage/capital modifications would facilitate systemic risk management while not adversely impacting the environment or incentives necessary for financial innovation.

Obviously, restrictions on leverage and risk capital requirements would require some work for implementation at the level of individual businesses. No doubt, significant debate would arise around what should be considered "appropriate" capital requirements/leverage restrictions for certain businesses.

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**Change Compensation Practices.** The most difficult to implement and probably the most controversial aspect of our actions would involve altering the way practitioners are compensated.

In many cases, practitioner compensation is based on (or has a major component related to) revenue generation. In certain instances, it may be based on profits. Both methods provide a potentially unhealthy incentive for the practitioner to maximize revenue. Where revenue or profit is the predominant focus of compensation structure, business-related risk may be overlooked or underemphasized since there is no explicit incentive to do otherwise.

We would advocate broader use of compensation practices based on *profitability* (i.e., risk-adjusted return on capital). Pay on profitability incentives production staff to take risk into consideration because that element is built into compensation structure. Furthermore, a compensation structure that incorporates risk protects the business unit and firm as transactions that do not meet profitability targets are not done.

Compensation based on profitability sounds great in concept but is fairly difficult to implement in practice. Nevertheless, we believe the efforts to implement such structures are well worth the time and use of resources. Implementing such structures involves a fairly exhaustive process where the business costs must be clearly defined, and risks identified and quantified. Further complexity lies in the granular breakdown of business activities. How is capital allocated where a team of individuals is involved in business generation? How is relative contribution assessed and rewarded? And what about losses associated with start-up businesses? Though there are absolutely assumptions that must be made and imperfections associated with particular aspects of this type of compensation practice (as with *any* type of management process), we believe that the results achieved through these means are superior from a corporate perspective.

While we believe that compensation practices based on profitability are essential, we don't believe that is something that can or should be implemented through legislation or regulation. Such action would be just too much government intervention in private enterprise. However, we believe that implementing compensation based on profitability is just good business and we wonder why it isn't done more regularly. We expect that part of the reason has to do with – you guessed it – perceived risk. In this case, the risk of breaking ranks with tradition and concern that initiating compensation based on profitability in an industry that rewards largely on the basis of revenue generation is just too great for many senior executives.

**Shareholder Representation on Public Company Boards of Directors.** While we believe that too much government intervention directly into corporate policy would have a negative impact on the financial services and securities businesses, we believe it would be appropriate and beneficial to make changes to the corporate boards of financial services and broker/dealers. Specifically, we believe that placing a firm's largest shareholders in a majority position on corporate boards would have far-ranging impacts on how business is conducted.

Placing major shareholders on boards of directors would position key executives, well-trained in finance, risk, macro-level industry analysis, and corporate analysis in oversight positions for publicly held financial services companies and broker/dealers. Such directors would likely not have some of the affiliations with senior executives that exist at the current time and would have the incentive to do what is best for the company, as one of their objectives is to maximize shareholder value. We envision directorships held by professional portfolio managers/analysts who, on a daily basis, are involved in industry analysis and corporate operations with respect to banks and broker/dealers. Such experience is certainly acceptable for broad-based policy setting and oversight so long as the analyst is truly experienced. Implementing such changes would keep oversight in the private sector among experienced professionals who have experience and incentive to maximize shareholder value. Who better to watch out for the interests of shareholders than individuals charged with maximizing shareholder value?

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The challenge with implementing such changes is the extent to which legislators would need to go to change existing practice. Corporate board policies are usually set forth in a public company's by-laws, which are established at the time a firm goes public. It would certainly be far-reaching for legislators to make sweeping changes to corporate bylaws. However, we also point out that many financial institutions and broker/dealers became public at times when issues and concerns were different.

A quick review of directors at major public financial institutions and broker/dealers indicate a large presence of corporate chairmen mixed in with academics. We don't see academics strongly standing up to CEOs and we don't see directors who are chairmen at other companies voluntarily implementing policy for greater independent oversight to which, at some point, they may become subject.

We believe that current board arrangements are generally effective. However, when a debacle occurs, flaws can often be traced to the top of the management structure. Removing allegiance conflicts between directors and senior management and replacing it with greater independent oversight couched in financial experience with a built-in incentive to maximize shareholder value would go a long way, once again, to controlling systemic risk, enhancing public confidence, and increasing shareholder value.

In conclusion, corporate performance, oversight, and compensation are indeed sensitive issues. No doubt, that is why discussion of such topics is often contentious. However, we believe that the means by which broker/dealers and other financial institutions operate could definitely be improved. If legislators plan comprehensive financial reform, wouldn't changes that maintain the principles of private enterprise while removing incentives for action that may be contrary to those desired to control systemic risk or enhance shareholder value be most appropriate?

We recognize the impediments to effective comprehensive financial reform. Yet given a blank slate and a wish list, this is how we would do it.

## **For More Information Contact:**

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## **About Woodbine Associates:**

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