

Distinguishing between proprietary trading and market-making -- a cheat sheet

Mar 16 2012 George Michaels

How can you distinguish proprietary trading from market-making and steer clear of violating the restrictions contained in the proposed Volcker rule?

The proposed rule, section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), contains prohibitions and restrictions on the ability of a banking entity and non-bank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

In this article, we offer compliance officers this comment on defining and creating criteria for identifying market-making versus proprietary trading activity. If firms better understand and readily identify proprietary trading activity, they can effectively abide by the Volcker Rule and minimize banking risk, enabling banks to become more focused in their business operations.

We discuss the need to develop a litmus test, focusing on compensation and bonus-pool allocations, for firms to use to determine and easily ascertain whether or not they are conducting market-making or proprietary trading. We explain how this test can be applied to facilitate the successful implementation of the Volcker rule, if sanctioned by the regulatory agencies as a suitable solution.

Differentiating between proprietary trading and market-making

Identifying what is proprietary trading as opposed to legitimate market-making can be quite complex. There is a valid reason for market-making to remain with banks and brokerages. For example, in the case of derivatives trading, when a client wishes to place an order, there might not be an immediate, natural counterparty, nor might there be one for an extended period of time. This forces the market-maker to take a position in the derivative to facilitate the client order. These positions are both necessary and valuable because, on the whole, they help the markets operate in an orderly fashion.

If everyone was forced to wait for a natural counterparty before they were allowed to trade, market swings would be greatly magnified and panics more commonplace. The problem is that these market-making positions make it incredibly difficult for an outsider to distinguish between legitimate, client-related activity and proprietary trading for the firm's own profit.

The real goal of the Dodd-Frank Act and the Volcker Rule is for proprietary-trading risk to be held by hedge funds. This means that both the financial institutions and the agencies that regulate them need a simple, yet effective metric to help separate market making from proprietary trading.

To determine if the firm primarily is doing market-making or proprietary trading, instead of looking at positions, we suggest that financial institutions look at how the bonus pool for the front office is allocated.

In the world of proprietary trading, traders are compensated purely on their profits and losses. For a proprietary trader, customer activity is, at best, irrelevant. In the world of legitimate market-making, the compensation is based on commissions, and keeping customers happy – the trader's entire focus. Every trader knows what drives his or her bonus. If the driver is profit and loss, then they can be said to execute proprietary trades. If the driver is commissions, then they will generate customer flow and be labeled market-making. You simply need to ask each trader how they get paid, and then the compliance officer will know whether the firm is doing proprietary trading or market-making.

Use this simple, two-step process:

1. The sell-side will need to classify personnel as back office and front office. Then, they need to categorize all compensation paid to the front-office personnel as either commission-based or profit and loss-based.
2. If the amount of money that is paid based on profit and loss is greater than the amount of money paid based on customer flow (commissions), then you are looking at a proprietary trading operation, and the firm should be held in violation of the Volcker Rule.

With this simple process to ascertain whether a firm is doing market-making or proprietary trading, firms and regulators will have greater clarity and be able to comply with the Volcker Rule.



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