- THE WALL STREET JOURNAL. WSJ.com

- CURRENT ACCOUNT
- FEBRUARY 21, 2012

'Short-Term' Problem of Volcker Rule

- **By FRANCESCO GUERRERA**

"If it doesn't fit, you must acquit."

Wall Street's defense against regulatory efforts to ban some of its trading practices is reminiscent of Johnnie Cochran's famous rhyme about ill-fitting gloves in the O.J. Simpson trial. (Mr. Simpson was found not guilty of the murders of his ex-wife and one of her friends).

I am exaggerating, of course. Banks' trading with their own capital, or "proprietary trading," isn't a criminal offense. But it is about to become illegal due to the "Volcker rule."

The rule—aimed at curbing risk-taking by financial groups—is the most controversial measure in the postcrisis regulatory overhaul. No conversation, cocktail party or casual encounter with a Wall Streeter these days is complete without an outpouring of venom on the rule, the brainchild of former Federal Reserve Chairman Paul Volcker.

Ex-Fed Chairman Paul Volcker's brainchild has caused much angst.

Banks, investors and other interested parties had until last week to comment on the proposal, and they certainly seized the opportunity. The regulators drafting "Volcker" were deluged with documents asking them to tighten, loosen, clarify, change or even scrap the rule.

The smorgasbord of submissions had a common thread: They mostly missed the point and overlooked the one fundamental weakness of the Volcker rule—it focuses on the wrong type of trading.

Before I reveal my simple solution to the tangle of angst, vested interest and political skulduggery that envelops the rule, let's look at the critics' arguments.

The tirades of Wall Street firms, some foreign governments and many investors can be summarized thusly: It is impossible to distinguish "prop" trading from its "legit" brethren—buying and selling securities for clients. As a result, the rule will (delete as appropriate): be impossible to enforce/choke off markets' liquidity/drive trading volumes away from the U.S. Put another way: "The rule doesn't fit, so you must acquit us."

These complaints are justified. The problem is that the proposed rule forces banks to prove that each and every trade isn't "proprietary," raising the risk that some customer-focused activity will be caught in the dragnet and banned.

There is a better way. The original sin here is that the Dodd-Frank Act, which turned the Volcker rule into law, bans "short-term" proprietary trading. The proposed rule defines short-term as positions held for 60 days or less.

That is nonsensical.

There is ample evidence to show that it is long-term, not short-term, proprietary trading that harms financial groups. Lehman Brothers Holdings Inc. was undone by top-of-the-market investments in real estate; banks like Citigroup Inc. and Merrill Lynch & Co. suffered huge losses on mortgage-backed securities that sat on their books for a long time; and MF Global Holdings Ltd. failed after a disastrous months long bet on European sovereign bonds.

The focus on the short-term, coupled with the burden of proofs on banks, will also oblige financial groups to second-guess the bulk of their trading activities, increasing the chances that proper trading will be banned alongside "prop" trading.

More than half the trades, excluding derivatives, carried out by Goldman Sachs & Co., for example, are completed in 45 days or less, according to a recent investor presentation. Not to mention the possibility that banks might try to get around the ban by designating speculative trades as longer than 60 days.

Here is my solution: Require banks to prove that any trade they hold for more than 60 (or 90 or any other number higher than that) days isn't proprietary trading and leave the short-term stuff alone.

The advantages would be threefold.

First, long-term trading is more likely to be speculative: If a bank claims to be holding securities on behalf of customers, why haven't they showed up for more than two months?

"The longer you hold it, the greater the probability that what you are doing is speculation," argues William Silber, a former trader who teaches finance at the Stern School of Business of New York University and has written a soon-to-be-published biography of Mr. Volcker.

Second, even if banks were to get away with short-term proprietary trading, any losses would be unlikely to break them.

And finally, it is much easier to police a relatively small number of long-term positions than myriad short-term ones. Many banks already do that. To monitor their risks, they compile daily lists of trades open for more than 90 days.

The only snag is that regulators can't change the word "short-term" that is enshrined in the law. Crucially though, Dodd-Frank doesn't define short-term, allowing regulators to extend its "duration" if they so wish.

After millions of dollars in lobbying, thousands of pages and vocal-cord-straining arguments, the solution to the Volcker conundrum may lie in the stroke of a regulatory pen by changing a "6" to a "9."

—*Francesco Guerrera is The Wall Street Journal's Money & Investing editor. Write to him at: currentaccount@wsj.com*