Prop Trading: The People Moves

The 'Volcker Rule' spawns a shuffling of trading talent across The Street, out of big banks and into hedge funds and smaller prop shops

The Dodd-Frank Wall Street Reform and Consumer Protection Act holds many broad, big-picture implications, such as whether the financial system can avert another meltdown and how significantly financial companies' profits will be dented by more intrusive regulations. Yet for proprietary traders, the sweeping legislation also raises a more mundane, ground-level question: where will they work?

The so-called Volcker Rule, contained within Dodd-Frank, places restrictions on how much risk big banks can take with their own money. Depending on how the rule is implemented, this can effectively defang prop desks, whose *raison d'etre* is taking risks. While full implementation is years away and banks may yet end up with still-viable prop desks when the smoke clears, many traders want out, now.

"Prop traders of all stripes – equities, fixed income, commodities -- are deserting Wall Street," said George Stein, managing director at executive recruiter Commodity Talent LLC. "My Wall Street clients report it is almost impossible to retain prop talent, faced with the Volcker Rule coming in. Hedge fund clients say there is almost desperation among prop traders seeking refuge from Wall Street."

Wall Street banks are generally loath to talk about whether they are or are not divesting a business, nor do they readily discuss employee departures. But recent press reports chronicling compliance efforts explains why traders at bulge-bracket prop desks must feel as if they have targets on their backs.

Bank of America Merrill Lynch confirmed it would cut as many as 30 prop traders, or 30 percent of the group, as part of an effort to comply with the Volcker Rule. JPMorgan Chase is reportedly shifting its prop-trading group out of its investment bank and into its asset-management division; the bank is also said to be shutting down its commodities prop desk.

Goldman Sachs reportedly will wind down its Principal Strategies Group ahead of the implementation of the Volcker Rule, and traders from the unit have spoken with private equity concerns including Kohlberg Kravis Roberts and Carlyle Group about joining the firms. Citigroup has considered moving prop traders into a hedge-fund unit.

‘100 Percent Toast’

“No member of a prop trading or principal investment group at a bank or broker-dealer is feeling comfortable about future career prospects for themselves within the bank,” said Robert Olman, chief executive officer of Alpha Search Advisory Partners. “Over the past 10 years, banks have increased the size and scale of principal investing groups as business units completely separate from franchise activities (customer sales & trading). These groups are, as far as U.S.-based banks go, toast 100 percent.”

Senior prop traders who have left big-bank desks this year for greener pastures include Pablo Calderini, Deutsche Bank’s head of equity prop trading, who moved to hedge fund Graham Capital Management; Pierre-Henry Flamand and Ali Hedayat, who left Goldman to form hedge fund Edoma Capital Partners; and Matt Carpenter and Matt Newton, who quit Citigroup to join Moore Capital Management. Tim Jones was one of as many as five JP Morgan metals traders who left the firm in late August.

“The advantages of Wall Street, including the prestige and the compensation, no longer seem so attractive when faced with political exposure,” Commodity Talent’s Stein told Markets Media.

Prop traders’ compensation at banks generally has been at a discount compared with hedge funds, or 8 to 12 percent of trading profit at banks versus 15 to 20 percent at hedge funds. “But that was balanced by the greater security that came with working at a major firm on Wall Street,” Stein said. “That security has evaporated and the grass is looking a lot greener ‘over the hedge’.”

Indeed, as job security at big-bank desks melts away, the grass appears greener elsewhere. But in the post-financial crisis era of having to scratch and claw for every basis point of alpha and for every $1 million of raised capital, it is unclear whether the bulge-bracket expats will do any better for themselves -- or even as well -- in their new positions.

“The alternatives industry has rebounded nicely since 2008, in terms of new launches, new assets under management in, and returns,” Olman of Alpha Search told Markets Media. “Regardless, getting traction (gathering assets) for smaller hedge funds and for start-ups is, overall, very challenging.”

“Operating a hedge fund has become more complex than ever. Budgets for legal, operations/compliance, client relations, and marketing are multiples of pre-2008,” Olman continued. “The oft-heard phrase ‘two guys and a Bloomberg is not a hedge fund anymore’ is a generous understatement. Investor due diligence and skepticism is very intense and strong.

Smaller funds cannot successfully navigate the demands of institutional investors to the degree to receive an allocation.”

One logical question may be, if the Volcker Rule is a long way from being implemented and the path of implementation is not clear, why are traders so intent on leaving big banks now?

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“Although certain provisions of the Volcker rule won’t come into effect for several years, the overall thrust of the law is against the concept of prop trading backed up by government support, whether that be in the form of actual bailout money or deposit insurance,” Stein explained. “The political exposure to attacks that the banks are gambling with taxpayer money is what is leading some large investment banks to shed prop trading units. Within the units, traders know they are facing headwinds that are likely to get stronger—and they are seeking safe harbor in funds less subject to regulation and political scrutiny.”

New Opportunities

Independent prop shops are aware of the ‘brain drain’ from bulge-bracket desks; a lesser-known byproduct of the Volcker Rule also may be the chance for established players to sell products and services to new entrants in the space.

“We are looking to take advantage of talent that becomes available or to supply technology to potential spin-off or start-up firms if the opportunities present themselves,” said Craig Iseli, partner at Chicago-based SpiderRock Trading.

For prop traders who remain at big banks, “it’s an open question whether there will be enough seats and deployable capital at hedge funds to absorb the exodus from investment banks.” Stein said. The number of hedge funds has fallen by 9 percent since the start of the financial crisis to 6,982 as of mid-year, according to Hedge Fund Research; the absolute number suggests there are still plenty of opportunities for prop traders defecting from big banks, but not many funds are in expansion mode.

Aside from moving to hedge funds or independent prop shops, big-bank prop traders can also dodge the tentacles of the Volcker Rule by going to non-U.S.-based banks. This past May, star derivatives and currencies prop trader Jay Glasser left Citigroup for Nomura, Japan’s biggest brokerage.

“Prop traders are seeking harbor wherever they can find it” including low-tax locations Switzerland, Singapore, and Dubai, said Stein of Commodity Talent.

One trend in prop trading that may be counterintuitive for a contracting business under siege by regulators is steadily rising compensation, at least for top talent. Pay for prop traders “is going up and up and up,” said Joe Long, a quantitative-trading executive recruiter at I-NET Technologies.

"Comp has been increasing significantly over the past two years and the smaller shops are paying large bonuses and some are paid quarterly," Long told Markets Media. "The increase in comp at prop firms is for top technical talent (developers who build high speed trading systems), the top quants, and traders with large (profit and loss accounts). Obviously there's a lot of talent out there, but these small prop firms and hedge funds want the best talent on The Street and they are willing to pay for it."

"Basically, there's a small group of top quants, technologists, and traders on the street and everyone wants them, so they have to pay," Long added.

While any Volcker Rule-driven senior personnel move on Wall Street will generate headlines, it should be noted that the new regulations have not caused a seismic change in the financial industry, nor has it affected all corners of the prop trading space. At least not yet.

On a July 20 conference call to discuss second-quarter earnings, Goldman Sachs Chief Financial Officer David Viniar answered a question as to whether the firm had seen any material human capital shifts or outsized departures from regulation-sensitive areas such as derivatives and prop trading.

"No, but it's very early," Viniar said. "But no, there has really (been) nothing substantial that's happened."

Iseli of SpiderRock said he has not seen significant people moves ahead of the Volcker Rule.

"In our view there is currently a lot of talent moving but it is being driven more by mid-sized and smaller firms cutting back as a result of limited capital access and a generally lower level of market trading opportunity than pending regulation that will impact larger firms," he said.

"We think this has impacted the market generally more than firms specifically at this point," Iseli added. "Maybe the market impacts are an outcome of positioning, or maybe as a smaller firm in Chicago we just don't have the access to the undercurrent of information from larger New York-based firms. Time will tell."

University Perspective

U.S. universities with top-rated quantitative financial programs are seeing fewer graduates go into trading careers, but the swirling regulatory wind generally is not a factor in this dynamic.

Some Massachusetts Institute of Technology students who would have gone into trading jobs three or four years ago are now hedging their bets and considering opportunities in consulting and technology, said Melanie Parker, director of MIT's career center. Of MIT undergraduates in the class of 2009, 15 percent went into financial careers, down from 31 percent in 2006.

"I am hearing two concerns. One, are there enough opportunities, and two, the overall reputation of the industry," Parker told Markets Media. "There is a challenge there. Students are asking themselves what they think about the ethics of the industry and whether that's where they want to work."

On the positive side, Parker reported that representatives of Wall Street firms who have recently visited MIT said they expect to increase hiring over the next couple years. Looming changes in financial regulation do not seem to be a specific concern among MIT students, Parker said, but it could turn off some grads who enter the profession if new rules prove overly burdensome and detract from the challenge of being a successful trader.

Among students at Baruch College's Zicklin School of Business, interest in trading careers is decidedly lower compared with several years ago, according to Richard Holowczak, director of Baruch's Subotnick Financial Services Center, which operates a 7,000-square-foot simulated trading floor designed for students to learn how to gather market data and information and apply risk-management techniques.

"If you are coming out of college and looking for an entry-level job, I would say since the financial crisis a lot of this has been shut down. There are a lot of folks with three to five years of experience out there who got downsized and are willing to take entry-level jobs," Holowczak told Markets Media. "If I were someone who's just starting school and thinking things will turn around in four years, this may be something to count on. But right now things

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are definitely on the wane in terms of people saying they want to do something in trading or front-office work."

Aside from the ongoing changes to the trading landscape such as regulation and tepid financial markets, Holowczak noted that the increasing prevalence of algorithmic trading has lowered the staffing requirements of Wall Street trading desks in a structural sense, especially on the equities side.

"There may be more activity in over-the-counter, fixed income, and currencies, but is a student coming out of college going to get a job on a desk doing those things? Probably not," Holowczak said.

Holowczak said recruitment activity for trading and finance positions has picked up a little bit this year, after "pretty dismal" activity levels in the summers of 2008 and 2009. "By and large, things are starting to pick up a little bit, but for the most part it has been muted over the past couple years."

"Companies overall are hesitant to bring on new folks," Holowczak said. "Some things are freeing up a little bit but certainly it is not like it was in 2004 and 2005, when people were going into front-office jobs pretty regularly."

Dodd-Frank and the Volcker Rule are part of the toned-down backdrop for Wall Street trading, and Holowczak noted that "we do have students in seats who are hearing about regulation" as part of financial coursework. Still, the administrator indicated that it is the perceived lack of opportunity, rather than regulatory specifics, that is front-center in the minds of students who may be having second thoughts about going into trading.

Comes Down to People

In the end, initiatives to rein in big-bank prop trading—often conducted at "30,000 feet up," with primary regard for systemic implications—come down to how it will affect banks' human capital, or what goes down the elevator every night.

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"The obvious benefit with prop trading is profits—that's why banks got into (the business) to begin with," said Heath Tarbert of law firm Weil, Gotshal & Manges. "But in large part, it's also about people. Historically, the top people at firms have been attracted to the prop trading operations. Banks have gotten a lot of talent from their prop operations, and have used these operations as a recruiting tool. Banks have to deal with the human element to make sure they don't lose their top talent."

"If they spin it off, obviously the top talent goes," Tarbert continued. "I'm also not sure to what extent prop trading operations can be spun off—in a lot of banks the prop desks are not really separate legal entities like hedge funds or private equity arms." He said potentially viable solution is for a bank to put prop trading under hedge-fund operations, as Citigroup has considered.

Private equity concern Blackstone is said to be launching a fund of funds with the intent of luring prop traders from banks. Blackstone Alternative Asset Management will also help seed hedge funds started by former traders. Blackstone declined to comment when contacted by Markets Media.

"Hedge funds and other asset management firms will fill some of the void (from the Volcker Rule) but not all of it," said Matt Russ of consultancy Hewitt Associates. "Competition in the hedge fund business is going to change because traders will go to hedge funds and create competition. . . Institutional investors will take an interest in these former prop traders who are managing external client assets. As a result, the hedge fund industry will probably become more competitive."

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