Justin Golden
Lake Hill Capital

24 July 2012

Why the Listed Options Market Doesn’t Need the Volcker Rule

As the finance industry prepares for the Dodd-Frank Wall Street Reform and Consumer Protection Act, “derivatives” remain in the spotlight for areas that need improvement. While derivatives encompass a variety of business activities within the financial services space, “equity derivatives” will experience limited impact and frankly, little change is needed.

In 2002, when Warren Buffett told the world that “derivatives are financial weapons of mass destruction,” which derivatives was he referring to? According to Buffet’s widely read annual report, the culprits were over-the-counter products that come loaded with hazards ranging from counterparty risk, illiquidity, and non-standard pricing methodology. To Buffett’s credit, many of these products became infamous for nearly collapsing the global banking system in 2008.

However, Buffett’s warnings, if taken out of context, could be confused with all derivatives.

Technically, the word “derivatives” also describes products that actually helped reduce risk during the crisis, but products like exchange-traded equity and index options unfairly get thrown into Warren’s bucket of WMD’s.

Using Buffet’s colorful language, we can provide a better analogy: in the wrong hands, radioactive material has the potential to be devastating if used to create weapons of mass destruction. But if harnessed correctly, safely, and with the right intentions, it can provide extremely valuable and highly efficient energy to billions of people.

Derivatives do in fact have a similar payoff-profile – the wrong instruments in the wrong hands have recently proven fatal for some global institutions including now well-known British-based aquatic mammalia. Yet listed equity options are an area of the derivatives world that continues to thrive despite being unfairly associated with products that nearly took down the system just few years ago.

Paul Volcker heeded warnings like the one from Buffett, which contributed to a law buried inside of the 849 page Dodd-Frank Act: The Volcker Rule. While the law has a place in regulating or even prohibiting a variety of proprietary and speculative trading activities, its protections are less necessary in the equity options space.

Most of the trading in equity derivatives happens on an exchange where transactions are posted in real-time making it difficult for “whales” to accrue large positions without being noticed. Equity derivatives desks at banks may be punished by the Volcker Rule even though they have already experienced their own “right-sizing” that requires little additional interference:

- Since 2008, banks and their customers have de-levered and gravitated towards highly liquid, exchange-traded products that are executed through a central clearinghouse
- Low barriers allow for healthy competition, and liquidity providers benefit from technology advancements in electronic execution and risk management
- Listed Index and ETF option trading is a critical hedging tool for investors across a variety of asset classes

The evolution of equity derivatives may serve as a blueprint for helping list other derivative products on an exchange. While there are certainly limitations to consider (for example, I don’t see the need for my mortgage or car loan to be listed on an exchange), an exchange helps alleviate counterparty risk and transparency issues, the crux of the Buffett argument.

The intention of the Volcker rule is to limit systematic risk, promote safety and soundness of banking and non-banking entities while hindering institutions from undue speculation. These have little to do with the listed options market, particularly S&P 500 options, which were relied on as a key source for hedging in 2008 at the peak of the crisis.

When hedge funds and banks alike were stung by illiquid and “esoteric” OTC products (the real WMDs) in the derivatives space, the trend shifted toward products that mark-to-market daily and are easier to understand. One can still lose money, but at least one has a better sense of why.

The basic principles of economics suggest that profitable businesses will eventually become more competitive, as pricing is driven lower due to enhanced technologies and innovation. These principles have had a profoundly positive impact on the option space that benefits end-users. In a report recently published by TABB Group, options traders mentioned “availability of new products, greater adoption, and more electronic trading” when asked what the biggest industry changes were for 2012.

A number of option sales and trading personnel have used the crisis as an opportunity to start their own broker dealers, market-making firms, and hedge funds. The proliferation of new market participants has garnered significant market-share on both sales and trading fronts.

The increased competition and accessibility of listed options have driven commissions down allowing low overhead agency brokerages to compete with the largest firms.

In addition, remote market making, high-speed FIX connections and advanced risk management technology on the buy-side are driving bid-offer spreads tighter. Clearly these are good things for markets that were realized without any intervention.

Within the options space, index and ETF products continue an upward trajectory of volume and liquidity. In 2006 index option and ETF trading made up roughly 25 percent of the overall volume compared with 75 percent for single stock options. Today over 40 percent of option trades are index and ETF options.

Particularly in periods of high asset price correlation, investors have found solace in highly reliable index products like the S&P 500 that have existed since the early 1980s. Index option trading has had a critical role in helping investors manage portfolio risk through turbulent times. If Volcker is set on reducing systemic risk, it would not be ideal to handcuff participants in this segment of the market.

Dodd-Frank will likely put additional constraints on banks but it should be careful not to infringe on activities that are working well, particularly those in the equity derivatives markets. Systemic risk is not generally thought of as being impacted by equity derivatives and thus an important distinction should be made. There is no disagreement here that the world needs less “whales” but you will find few of them in the waters of the equity options market.

We believe free markets have a funny way of correcting themselves through natural evolution and equity derivatives are no exception to the rule, thus they don’t need one from Mr. Volcker.