Memorandum for the Record

Telephone interview with Walter Payne, former US Treasuries trader for JP Morgan

36CFR1256.56: Privac

FCIC: Randall Dodd

Bruce McWilliams, (MFR reporter)

Here is link to audio tape:

https://vault.netvoyage.com/neWeb2/goId.aspx?id=4843-0971-6231&open=Y

This is not a transcript and should not be quoted directly.

Summary: Mr. Payne contacted us through the whistleblower section of our website. Tucker Warren corresponded with him. His concern is that primary dealers such as JP Morgan take advantage of clients through "front running" on US treasury transactions. He contends that since there is such little money to be made in US Treasury transactions in and of themselves, that primary dealers have undertaken other kinds of transactions such as swaps. The information provided through the swap transaction enables dealers to know of huge transactions about to be undertaken, and the dealer can buy the securities in advance of the big deal with the knowledge that he can sell it to the customer a short time later.

Mr. Payne earned his undergraduate degree and subsequent Master's degree from University of Chicago. He went to work in JP Morgan's commercial bank in 1985 in a management training program.

He traded US Treasuries until 1998. He left Morgan in 1999 for reasons he did not say.

He subsequently sent a letter to former SEC Commissioner Steve Wolman, who had told him to write a thorough description

In 2004, the SEC interviewed him for "a few hours." At this interview, SEC employee John McCarthy said to him, "Why should the SEC protect big companies, such as Proctor and Gamble, from big dealers, such as JP Morgan?"

Payne said, "Our swap dealers spent the day trying to front run clients."

Conclusion: Randall and I communicated afterwards, that we did not feel this warranted further investigation as a source of the financial crisis.

Here is his email to Tucker Warren:

Dear Mr. Warren,

Thanks for hearing me out during our phone conversation two weeks ago. I would welcome the chance to describe to your Commission the inefficiency and corruption endemic to dealer-based financial markets, based on my experience trading Treasuries for J.P. Morgan. Knowledge of how a trading floor actually works is a prerequisite to understanding the financial crisis--and how to prevent another one. Unfortunately, most people with such knowledge have strong incentives not to share it with outsiders.

As I mentioned today, I can stick to the technical issue of how to prevent front-running (please find below a condensed version of the information I've posted at http://www.ustreasurymarket.com/) or, if you'd like, offer a broader analysis of how to reduce the financial sector's share of our national income (please see http://www.efficientmarkets.com/wallstreet1997.html for a sample of these views). I can meet with your staff anywhere and anytime it is convenient for them.

Thanks for your help. Please hit 'reply' so that I know this message got through your spam filters.

Sincerely,

Walter Payne

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Front-running in the U.S. Treasury and other dealer markets

The bank dealers that dominate trading in U.S. Treasury bonds routinely use information from customers about their impending transactions to illegally profit by trading ahead of them. Although this allegation is based on my experience trading Treasuries for J.P. Morgan for a dozen years, front-running should be equally common in any market with the same conflicts of interest and lack of regulation and oversight, such as those for many derivatives. This is one reason banks oppose moving derivatives trading from dealers to exchanges—it would significantly reduce their opportunities to front-run.

How banks front-run

Banks, in their roles of dealer, adviser, and underwriter, regularly receive advance notice of their customers' transactions. When these trades are large enough to move the market, even temporarily, a bank can profit by buying the designated securities for its own account and then selling them to its customer a short time later at a higher price. For example, if J.P. Morgan learns that an underwriting client needs to purchase a billion dollars of ten-year Treasuries (perhaps to unwind an interest-rate hedge) when Morgan prices its bond issue, the bank's traders can aggressively buy ten-year Treasuries for the hour or two leading up to the pricing. If such buying pushes the ten-year's price one-eighth of a point above Morgan's average purchase price—reducing its yield from 3.50% to 3.485%, say—the bank makes $1.25 million on reselling the Treasuries to its client. Derivatives markets are even more prone to front-running since dealers know of a higher percentage of customer trades beforehand and less transparent pricing makes detection harder. This is consistent with what I observed of Morgan's interest-rate-swap desk. (Note that front-running does not require a proprietary trading desk so the Volcker Rule would not prevent it.)

Why banks front-run

Dealers make money from the bid-offer spread on trades with customers and by positioning securities correctly. But dealing spreads in mature, standardized markets such as Treasuries are very small, especially when trading with knowledgeable counterparties (that is why banks concoct new "products" and seek out unsophisticated customers). Nor can dealers consistently predict the longer-term movement of securities prices. Skilled front-running, however, has a very high success rate. It accounts for, conservatively, well over a hundred million dollars of Treasury dealer profits annually and many times that for derivatives dealers.

How to stop front-running

Front-running has been prosecuted many times on stock and commodity exchanges but never in dealer markets for bonds or derivatives. The possibility of punishment would reduce front-running, but moving trading from dealers to anonymous, electronic exchanges, directly accessible by customers, would be a better way to lower issuers' and investors' transaction costs. The loss of dealing spreads and chances to front-run would also remove banks' incentives to create and peddle unsuitable financial instruments.

I have posted a more complete description of front-running in the Treasury market, as well as an account of my attempts to interest regulators in it and a sample front-run transaction, at http://www.ustreasurymarket.com/. Please call me if you would like to discuss this issue.

Walter Payne

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