Sleeping with the enemy: should investment banks be allowed to engage in prop trading?

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This paper investigates whether conflicts of interest exist between the research and proprietary (prop) rading departments of full-service investment banks. The prop trading incentive has captured regulator interest only recently when the Volcker rule which significantly restricts prop trading activities was passed as part of the Reform and Consumer Protection Act (also known as Dodd-Frank). In light of the ongoing controversy regarding the rules intended and unintended consequences, we examine whether investment banks exploit their research analyst reports to increase prop trading profits. Our results indicate that investment banks trade ahead of their own recommendations, and that this is the case for both upgrades and downgrades. We also find that even though stock affiliation with the investment banking department does not deter such trading activity, higher institutional ownership does. Interestingly, we find that investment banks
also trade against their upgrades (downgrades) by reducing (increasing) their holdings after the issuance of the recommendation. Banks trade against their upgrades for both unaffiliated stocks with low institutional ownership and affiliated stocks. In the case of downgrades, trading against the recommendation is increasing with the level of institutional ownership.
Further analysis indicates that banks trade against their downgrades for low visibility and affiliated stocks. More importantly, we find that the prop trading incentive is, at least partly, manifested through the issuance of biased recommendations to facilitate prop trading objectives. Additional analysis suggests that the Global Research Analyst Settlement (GRAS) which targeted the investment banking incentive has accentuated rather than eliminated the prop trading incentive. We argue that regulator attention to investment banking conflicts of interest served as a confirmation of their lack of attention to incentives related to prop trading. Overall, the evidence supports the recent concerns of regulators regarding conflicts of interest that can arise between bank proprietary trading and research departments, highlighting the need for stricter regulation.