GLOBAL FINANCIAL

Private Capital

COMPREHENSIVE WEALTH MANAGEMENT

Thought for the Week: Monday, May 7th, 2012

The Dodd-Frank Act: The Battle is On! – Part 2

Last week, we outlined the aims of the Dodd-Frank Act and the battle being waged against it by Wall Street's "too big to fail" banks. While we expect the final Act to be much delayed and watered down, we are hopeful that one of its most important components, The Volcker Rule, will have a more immediate effect in "leveling the playing field" between retail investors and big finance.

Of course, one way all investors can level their own playing field and get a fairer deal immediately is to vote with their feet:

- Research the Dodd-Frank Act and The Volcker Rule.
- Ask yourself, "is my financial advice provider really engaging in the activities this legislation intends bringing an end to? Are my personal accounts and investments affected in any way?"
- At the risk of bringing politics into the Weekly Thought, reach out to your own representatives and ask them if they support or oppose the legislation.

Dodd–Frank Wall Street Reform & Consumer Protection Act

An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system; to end "too big to fail"; to protect the American taxpayer by ending bailouts; to protect consumers from abusive financial services practices, and for other purposes.

The most comprehensive financial regulatory reform since the great depression

The Volcker Rule

Included in the Dodd-Frank Act at the suggestion of Paul Volcker Jr. (the former Chairman of the Federal Reserve under presidents Carter and Reagan), the Volcker Rule seeks to separate the investment banking, private equity and proprietary trading sections of financial institutions from their consumer lending operations. It should therefore protect the consumer by separating the people who make and rate financial products from the people who sell them to consumers.

The Rule was introduced following the recession of 2008, to control the risk associated with the financial sector. Wall Street banks were accused of accumulating an excessive amount of risk and engaging in unfair business practices due to the inability of regulators to properly monitor their complex instruments and activities.

The Volcker rule aims to protect individuals by creating a more transparent financial framework which can be regulated with greater ease.

For example, is it right that a company can build a financial product then tell its research department to issue positive ratings so its sales force can easily sell it?

Even if this is acceptable, surely it's wrong for the same company to profit by betting against the product it just sold to its clients, as Goldman Sachs allegedly did with a product called ABACUS 2007-AC1.

Paul Volcker Jr.

Paul Volcker ended the United States' stagflation (high inflation with little GDP growth) crisis of the 1970s. He successfully lowered inflation, which peaked at 13.5% in 1981, to 3.2% by 1983.

Volcker raised the federal funds rate, which had averaged 11.2% in 1979, to a peak of 20% in June 1981.

He remains one of our Financial Heroes

Proprietary Trading (Prop Trading)

The Volcker Rule seeks to limit the trading big banks and Wall Street do for their own accounts, a practice called Proprietary Trading which is widely held to incur significant conflicts of interest.

Prop trading occurs when a firm trades using their own money and therefore with the intention of making a profit for themselves, not their clients.

Famous prop traders include Robert Rubin and Steven A. Cohen. Infamous prop traders include Nick Leeson and Brian Hunter.

One obvious question: If your best traders focus on your own money as this makes you more profit, who looks after your clients' money?

Proprietary Trading was (and may still be) so profitable that many feel it was when these leveraged bets went against the big banks that liquidity froze and the financial system collapsed from 2007.

Although the most obvious form of prop trading conflict might be the temptation to trade stocks with your own money when using the knowledge of where your clients are betting, there are many, more complex forms of prop trading which may lead to many, much more complex temptations. It should also be noted that "front running", as described above, is illegal:

- If a prop desk loses money in a trade, can it ask the bank salesmen (aka brokers) to sell the investment to their clients, thereby recovering the trade?
- If one part of a bank profits from successfully taking companies public, can another part of the business help by selling the IPO shares owned by the bank to their clients?

The end result of these highly complex prop trading practices is that big banks end up acting like hedge funds - an especially secretive, complex and high risk area of finance. In fact, when the threat of the Volcker Rule first appeared, many banks shut down their "Prop Desks" and moved them to external hedge funds.

So, if most Proprietary Trading is now decommissioned, why bother writing about it? Well, if only big finance was that simple!

The Volcker War

Even though Wall Street et al claim they have shut down their prop desks and seem to have accepted the Volcker Rule, they are still battling hard to prevent the Rule being enforced.

In the opinion of Michael Lewis, one of our favorite financial writers who we had the privilege of meeting at a recent Fidelity Forum, proprietary trading has “gone undercover.” They have set up shop away from the big Wall Street banks and are looking to exploit the wording of the various rules seeking to outlaw them.

Which brings us to the latest battle in the Dodd-Frank Act: the date at which the Volcker Rule goes into effect.

- The date set by the Government is July 21, 2012.
- The banks want to say they want to push back the date by two years the date by which they need to comply.

The Fed’s response is to ask the banks to use “good faith” efforts to stop Prop Trading during this two year period. The Bank’s comeback is they will promise to stop trading by the END of the two year period.

Once again, if Wall Street really has stopped doing this, why are they still fighting?

Ask yourself:

If I can make more profit trading my own accounts and using my own money, what priority would I put on my clients’ money versus my own?

If the government is loaning taxpayer money to these banks to ensure their meltdown doesn’t affect taxpayer investments, is it right they use the money to self-trade for their own profit?