Wall Street Reform – An Odyssey The Dodd-Frank Legislation

By Michael W. Masters, a presentation for the 2012 FTA Revenue Estimation and Tax Research Conference

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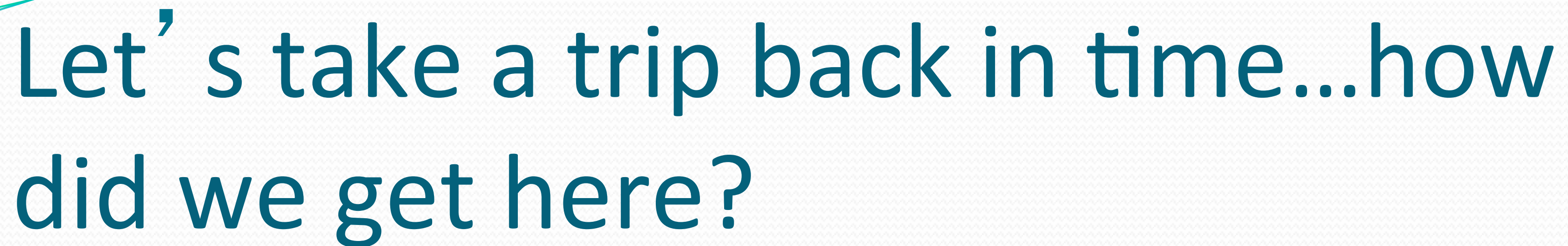
What is Better Markets?

- **Nonpartisan, nonprofit organization that promotes the public interest in the domestic and international capital and commodity markets**
  - **Transparency, accountability, and oversight**
  - **Often referred to as a "Wall Street Watchdog"**
  - **www.bettermarkets.com**

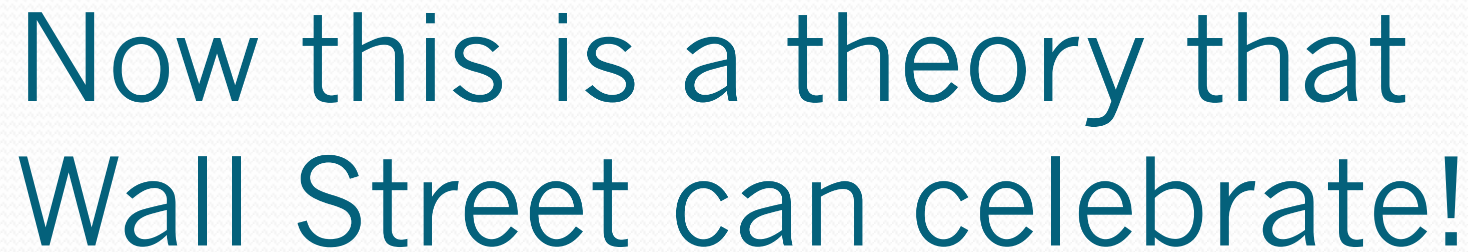
Let's take a trip back in time…how did we get here?



- The emergence of the "Efficient Market Hypothesis" (EMH) in economics…
- Ultimately presaging the passages of deregulatory financial legislation including the CFMA and the repeal of Glass Steagall…
- The philosophical emergence of "free market fundamentalism" and regulatory capture…
- The arrival of the 2008 Financial Crisis…

The Emerging Market Hypothesis Emerges

- Arises from Neo Classical economics and assumes that "market participants are fully informed agents with rational expectations"
- Which implies that market prices always reflect all known information
- Therefore efficient markets will naturally lead to maximally rational allocation because of their perfectly rational price formation.



Now this is a theory that Wall Street can celebrate!

- IF markets are efficient (in the sense of EMH), than governments ought to deregulate (the more the better) to let perfectly rational agents allocate optimally.
- Which gives politicians a good excuse to do Wall Street's bidding (and take lots of money from Wall Street in the process) by promoting deregulation.

So what's the purpose of regulators?

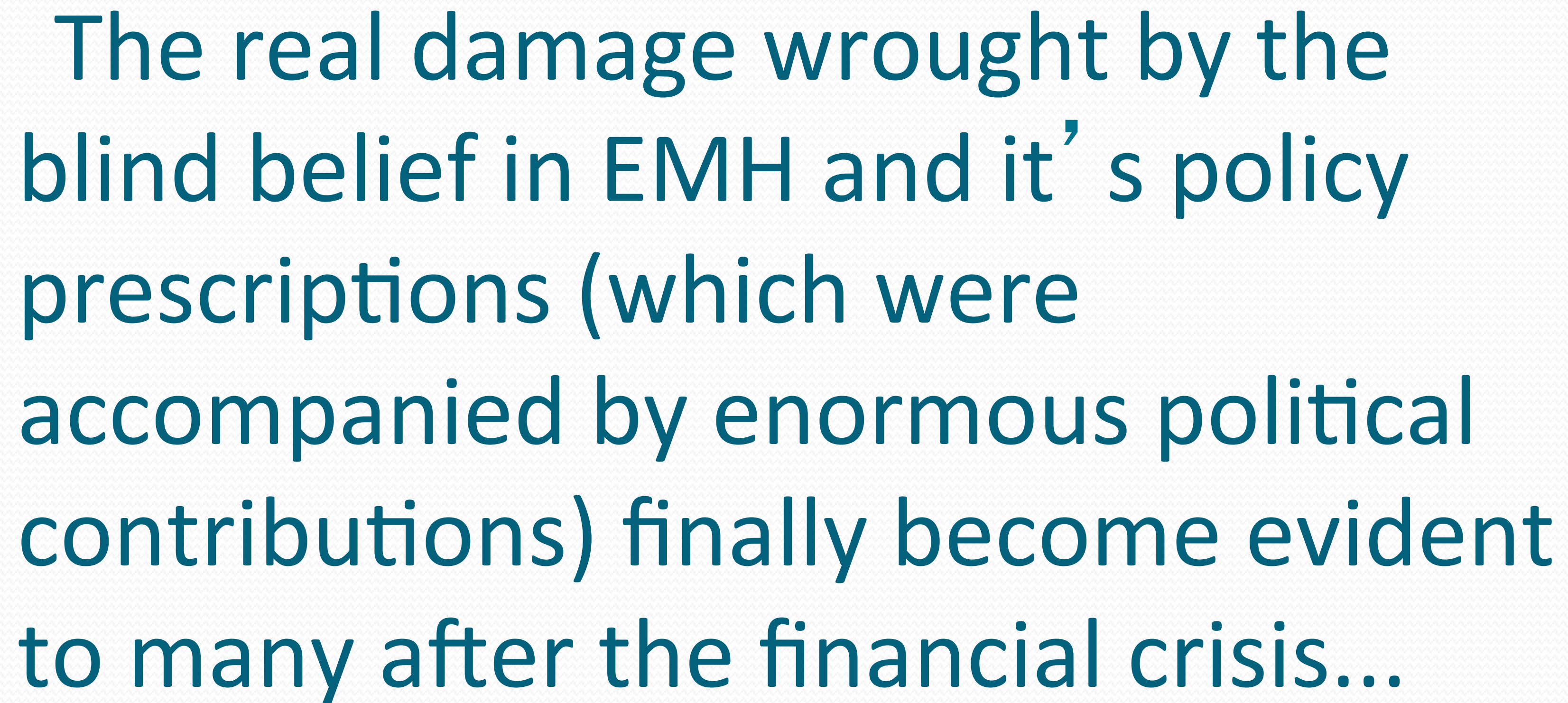
- In fact, why have regulators at all? OR, why not have them in name only-so that the public thinks they are "watching over things" but actually doing very little?
- Moreover, if markets are perfect, Wall Street can push the idea that ANY regulation in the markets is a bad idea.
- The view that markets are perfect ultimately becomes a widely accepted view-this is called **Market Fundamentalism**.

The Financial Crisis arrives…

- It turns out that market participants are a lot less rational than previously thought…
- Since regulation is absent from the vast swath of derivatives market, most don't realize the scale of what has been happening in these markets until too late…
- Many regulators, having been told "not to regulate", generally have no idea what is happening…

"The efficient market hypothesis is one of the most remarkable errors in the history of economic thought"

Robert Shiller, Yale University


The real damage wrought by the blind belief in EMH and it's policy prescriptions (which were accompanied by enormous political contributions) finally become evident to many after the financial crisis...

And many legislators and regulators finally opened their eyes to Wall Street's self serving justification of financial deregulation.

- Some large financial institutions had to be run by regulators in order to continue to exist…
- The primary reason many large financial intermediaries survived the crisis was due to massive government intervention…
- This market failure showed policy makers the true hypocrisy of the financial industry's push for deregulated markets while requesting bailouts for themselves!

Paul Volker, Gary Gensler and other "new" faces show up in the Obama Administration

- Dismissing recent innovation in derivatives, Volker says **"The most important financial innovation I've seen in the last 25 years is the automatic teller machine."**
- **"First we must explicitly regulate the financial groups that deal in derivatives.**" a quote by CFTC Chairman Gary Gensler

The Dodd-Frank Wall Street Reform and Consumer Protection Act

- Passes the U.S. House on Dec. 11, 2009
- Passes the U.S. Senate with amendments on May 20, 2010
- Passes joint conference committee on June 29,2010
- Signed into law by the President on July 21,2010

Dodd-Frank is considered the most sweeping change to financial regulation in the US since the Great Depression

- 16 titles
- 243 Rules to be created
- Promulgated 67 Studies
- 22 new periodic reports
- 3 major new agencies created, including the Bureau of Consumer Financial Protection

4 Sections (titles) of significant interest:

- Title IV: Regulation of Advisors to Hedge Funds and Others
- Title VI: Improvements to Regulation (Includes "Volker rule")
- Title VII: Wall Street Transparency and Accountability*
- Title IX: Investor Protection and Improvements to the Regulation of Securities

Title IV

- Increases number of investment advisors
- Some groups (VCs, family offices) under $150 million in assets excluded
- Accredited investors now have to exclude residences from calculations, other changes
- Several studies required, including one on short selling, accreditation, and possible Self Regulatory organizations for private funds

Title VI

- "Volker rule" limits banking entities from owning hedge funds and/or private equity with more than 3% of total ownership interest
- Further limits bank interests to less than 3% of tier one capital
- All bank and hedge fund arrangements and possible conflicts must be disclosed to regulators
- Other rules include limits on proprietary trading by banks and counter cyclical bank capital requirements

Title VII*

- Major changes for the OTC derivatives markets.
- Standard is "if it can clear it must clear, if it can trade it must trade" regarding OTC swaps
- Depending on the ongoing rulemaking process, this title should greatly increase transparency in these markets, ultimately LOWERING transaction costs.
- Additionally, OTC derivative reporting should be greatly enhanced.
- Position limits for speculators in commodity markets "shall be set".
- Not surprisingly, Swap Dealers fought this section most aggressively, this fight continues today...

Title IX

- Increases investor protections, authorizes an "Office of the Investor Advocate" at the SEC
- SEC is mandated to issue "point of sale disclosure" rules to investors including concise information on costs, risks, and conflicts
- Authorizes, but does NOT mandate, an initial fiduciary duty standard on broker dealers and investment advisors to their customers
- Numerous new rules dealing with Credit Rating Agencies
- New executive compensation and accountability rules for shareholders

But what about the “costs
of regulation”?

MAYBE we should be asking about the costs of not regulating?

- Estimate of what the US government and Federal Reserve have spent, lent, or committed from beginning of financial crisis to December 2009 is $8.2 trillion (Bloomberg)-and it's over a trillion dollars more today…
- 15 million new unemployed
- According to a recent Better Market's analysis, the financial crisis cost the U.S. Economy more than $12.8 trillion dollars.

"I think we all could use a little regulation"

A statement made by an unnamed Fed official in a conversation in 2009

- According to the BIS there were 647 trillion US dollars in notional amount of OTC derivative contracts outstanding as of 2011 (27.3 trillion gross).
- IF Dodd Frank and other financial regulations help force these OTC derivatives to be cleared with novation, provide public transparency, and push higher levels of capital reserves, systemic risk can be reduced in financial markets.

This means less financial sector driven volatility…

- A more stable, transparent, and reserved OTC derivatives market means less intermediary driven financial market volatility!

Thus allowing more stable future economic conditions…

And better tax revenue forecasts for Federal, State, and Local forecasters.

Questions?