As we move into earnings season, we believe the two key drivers to financial market direction today are the problems in Europe and their inability to deal with Greece's debt burden and the outlook for the U.S. economy. Soon, investor attention will turn to next year's election campaign and what that means for entitlement programs, debt reduction, spending, and tax policy. However, a quiet cancer creeping through the capital markets is the disconnected process of financial regulatory reform. The combined effects of inadequate regulation of the financial industry will likely perpetuate many of the inadequacies that lead to the Financial Crisis, and ultimately may lead to further severe capital market turmoil.

Financial Regulatory Reform

One of our main tenants for analyzing the capital markets and developing investment strategies after the financial crisis is that we need to see financial regulatory reform. More specifically, we need financial regulatory reform that has teeth and provides a set of rules that everyone in the financial services industry follows, and can deal with the complex securities and transactions that are prevalent in the markets. As capital markets and securities have become more complex over the past 15 years, the regulatory framework has remained largely untouched since the securities laws that were implemented following the market crash of 1929. After the Financial Crisis, Congress passed the Dodd-Frank Act, which provides a framework for regulatory reform; however, it requires that roughly 100 rules be written which will address some of the gaps in the financial regulatory framework. *We are growing more discouraged by the slow progress toward financial regulatory reform.*

The incremental changes in the capital markets that have occurred over the past decade which include the repeal of Glass-Steagall, the unchecked growth in the use of derivatives, the rapid electronic trading systems that now account for over 60% of the volume on the exchanges, and the pervasive misrepresentation within the industry of structured securities (which are not registered with SEC) to individual investors, in the aggregate have shifted the stability of our capital markets and financial system resulting in a "buyer beware" oriented market. Last month Reebok settled with the Justice Department for $25 million over false claims advertising its athletic shoes that tone your legs better. While the company has no proof of the claim, the company paid the fine, yet continues to stand by their assertions. Unfortunately, that illustrates the American business culture today – see if you can get away with it and deny it if you get caught. We believe that investors need the Consumer Protection Agency which was formed as a result of the Dodd-Frank Act to better protect us from the predatory practices that are still pervasive in the investment industry. Also, we believe that investors would benefit from all securities, regardless of their offering status, being registered with the Securities & Exchange Commission.

The Fiduciary Standard Initiative is De-Railed

Last month, the Department of Labor withdrew its recommendation for a consistent *Fiduciary standard* over the entire investment industry casting a cloud over the progress toward a higher standard of responsibility and accountability for the industry. Fiduciary duty is considered the highest standard of care at either equity or law. A fiduciary is expected to be extremely loyal to the person to whom he owes the duty, must not put his personal interests before the duty, must take responsibility for his actions and must not profit from his position as a fiduciary, unless the principal consents.

Right now, only Registered Investment Advisors are held to a fiduciary standard. All brokerage firms are held to a *suitability standard*, which only requires that what ever security be considered suitable for the individual client that it is sold too. So, for example, when the $200 billion Auction Rate Preferred securities seized up in early 2008 and investors couldn't get their money out, many of the brokers that sold the securities and represented them as substitutes for cash landed in arbitration over whether the preferred stock was considered suitable for the client that utilized them as a cash vehicle based on the representations of the financial advisor. While the original proposal was aimed at returning to the original intent of the Employee Retirement Income Security Act (ERISA), the issues are complex. Raising the industry to a fiduciary standard could increase the costs and reduce access to investment advice. So, it appears that we are no further along.

The Volker Rule Gets Watered Down

Another area for concern is what has become known as “The Volker Rule”, named after retired Federal Reserve Chairman Paul Volker who assisted in the development of the rules following the Financial Crisis. A hotly contested part of the Dodd-Frank Act, the Volker Rule is designed to restrain banks from proprietary trading and curtail the abusive risk taking and conflicts of interest that resulted from trading for their own account. It is widely believed that a contributing factor to the Financial Crisis was the trading activities by banks for their own profit, and at the expense of their clients, by encouraging the bank to take excessive risks. However, with the help of financial service industry lobbyists, it has now become a political football. It is expected that the draft proposal to be released this month could allow banks to trade for their own account for “hedging purposes”. However, containing trading by defining the word “hedging” has been impossible for regulators since hedging a portfolio can pretty much allow for any type of trading activity by the bank. Also contributing to the delay in the release of the Volker Rule has been the turf war between the Commodities Futures Trading Commission and the SEC over whole should be governing derivatives trading. We believe that the passion for reform in this area is being diluted over time.

The Growth in Structured Products Raises Concerns

The growing use of structured securities in the wealth management industry is a significant concern since these securities are not registered with SEC, offer no transparency and have lock up clauses that restrict the distribution of funds at maturity under certain market conditions. As these securities are only offered to accredited investors, the sales practices surrounding these complex securities can appear dubious given the conflicts of interests.

A *structured product*, also known as a market linked investment, is generally a pre-packaged investment strategy that is based on derivatives transactions which are designed to replicate the movement of a single security, a basket of securities, options, indices, commodities, debt issuance and/or foreign currencies, and to a lesser extent, swaps. These structured products are underwritten predominantly by major banks, without any uniform standards and have no single, uniform definition. A feature of some structured products is a "principal guarantee" function, which offers “protection of principal” if held to maturity. But, be careful because the guarantee is often from the bank holding company, not the bank itself which puts the security in a subordinate position during any restructuring. Lehman Brothers, once considered a top tier investment bank, filed for bankruptcy three years ago. As a result, their structured products are effectively worthless.

Structured products are a huge source of profits for the banks because they take an asset management fee in addition to the profits earned on the derivative transactions. With the large profits and the promise of returns linked to an index with little downside, many of the major banks, including JP Morgan, Morgan Stanley and Goldman Sachs are selling these securities into their wealth management client base.