



By Robert Pollin

ECONOMIC PROSPECTS

Field Notes on Wall Street Reform: The Battle Continues

PRESIDENT BARACK OBAMA SIGNED INTO LAW THE DODD-FRANK WALL STREET Reform and Consumer Protection Act in July 2010. Dodd-Frank is the most ambitious measure aimed at regulating U.S. financial markets since the Glass-Steagall Act was implemented in the midst of the 1930s Depression. However, it remains an open question as to whether Dodd-Frank is capable of controlling

the hyper-speculative practices that produced the near-total global financial collapse of 2008-2009, which in turn brought the global economy to its knees with the Great Recession.

Dodd-Frank is a massive piece of legislation, 875 pages in length, covering a wide range of issues. These include coordinating the efforts of the Federal Reserve, Treasury, Securities and Exchange Commission (SEC), and other financial regulatory agencies to control excessive speculation; creating a consumer financial protection bureau; establishing regulatory controls on the previously unregulated hedge funds and derivative markets; and placing restrictions on big banks, like Goldman Sachs,

trading on their own corporate accounts—a practice known as “proprietary trading”—when they are supposed to be focused on their clients’ interests only.

The prevailing view on the left is that Dodd-Frank was a major victory for Wall Street. There are valid reasons for progressives to reach that conclusion. The most important is that, despite its length, Dodd-Frank mostly lays out a broad regulatory framework, allowing the various regulatory agencies to settle on the details of implementation over the next few years. Both Wall Street lobbyists as well as advocates for strong regulation anticipate that the lobbyists will be able to dominate this process of detailed rulemaking. But the reality

is more complex. In fact, Dodd-Frank remains a contested terrain because there are lots of areas where strong regulations can emerge through this detailed rulemaking process.

TERMS OF ENGAGEMENT

THE VERY FACT THAT DODD-FRANK exists demonstrates that the glory days of financial deregulators are mercifully over for the foreseeable future. Yet Wall Street is clearly moving into the phase of regulatory rulemaking with a strong hand. The major Wall Street firms have huge budgets at their disposal to intervene at will during the process of detailed rule-setting. In addition, the regulators themselves understand that they can burnish their future private sector career prospects if they are solicitous to the concerns of Wall Street while still working for Uncle Sam.

These are unavoidable realities. But the ammunition on behalf of serious reform is also powerful. It begins with the overwhelming evidence, provided by the financial meltdown itself, that weakly regulated financial markets produce economic disasters. The final version of Dodd-Frank that was passed into law testifies to this. Despite the ambiguities included in the final law, many features of the measure were actually strengthened through the drafting process, as lobbying efforts by Americans for Financial Reform and other citizens' groups did end up exerting influence over many important issues.

An important example is the regulations that were established around derivative markets, including the markets for options and futures contracts, swap agreements, and other complex financial instruments. The version of the bill that passed in the Senate was much tougher than the House version in requiring, for example, derivatives to be traded on regulated exchanges, as opposed to being permitted to operate in unregulated, freewheeling, over-the-counter markets. Wall Street was quite

displeased when, despite its intensive lobbying efforts, the final version of Dodd-Frank that emerged out of the reconciliation conference between House and Senate members ended up much closer to what the Senate had drafted.

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There is another important consideration here. In fact, it is not necessary for the supporters of effective regulations to win victories on each and every rule that needs to be hammered out. Rather, reformers can achieve a great deal winning victories in a few key areas within the full expanse of Dodd-Frank. We can see this by considering one crucial case in point, the features of Dodd-Frank covering proprietary trading by the giant banks.

TAMING THE BANKS' PROPRIETARY TRADING THROUGH THE VOLCKER RULE

THE VOLCKER RULE IS NOT ACTUALLY one rule, but a series of measures, which were strongly supported by former Federal Reserve Chair Paul Volcker, to greatly limit proprietary trading and related highly risky and destabilizing activities by Goldman Sachs, J.P. Morgan, Citibank, and other mega-banks.

Proprietary trading and related activities by the big banks were a major cause of the financial bubble as well as the collapse of the bubble and near-total global meltdown in 2008-2009. The banks ran large trading books—inventories of securities that they themselves own—ostensibly so that this supply of securities would be readily available for their clients to purchase. But maintaining large trading books enabled the banks to operate with inside information on their clients' trading patterns. This allowed the banks to stay ahead of market movements, which could be quite profitable for them, sometimes even at the expense of their own clients. For example, J.P. Morgan traders could see which securities their clients wanted to buy. The Morgan traders could then buy those securities first, before prices rose as a result of their clients' increased demand. The Morgan traders would then have the option to sell these securities as soon as the prices rose, again staying crucial steps ahead of their clients in cashing out at a profit.

In addition, the banks' proprietary trading activities were closely intertwined with hedge funds and private equity funds which, unlike the banks themselves, were essentially unregulated financial firms. This allowed the banks' proprietary trades to be financed through mobilizing huge pools of money without worrying about regulatory restrictions in using these funds. This raised the level of risk exposure to all the parties involved. It was precisely interconnections such as these that fueled the credit market bubble, which in turn led to the crash.

Dodd-Frank includes measures that could prove effective in dramatically reducing the risks associated with the banks' proprietary trading. First, the legislation includes a blanket prohibition against banks engaging in transactions involving material conflicts of interest or highly risky trading activities. For example, the J.P. Morgan proprietary trading practice I described above would now be prohibited.

Dodd-Frank also establishes that regulators impose capital requirements or other quantitative limits on trading, such as margin requirements, on banks. Capital requirements entail that traders maintain a minimal investment of their cash relative to the overall asset holdings, including their stocks, bonds, buildings, land, and machinery. Margin requirements establish that traders use their own cash holdings, in addition to borrowed funds, to make new asset purchases. There are two interrelated purposes to both capital and margin requirements. The first is to discourage excessive trading by limiting the capacity of traders to finance their trades almost entirely with borrowed funds. The second is to force the banks to put a significant amount of their own money at risk—"putting skin in the game," as they say on Wall Street.

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At the same time—and here is where we run into trouble with Dodd-Frank—the law allows for exemptions from regulations as well as various ambiguities that could be readily exploited by the banks. Thus economics Nobel laureate Joseph Stiglitz laments that "unfortunately, a key part of the legislative strategy of the banks was to get exemptions so that the force of any regulation passed would be greatly attenuated. The result is a Swiss cheese bill—seemingly strong but with large holes." For example, Dodd-Frank permits some proprietary trading as long as such activities support "market-making activities" and "risk-mitigating hedging activities." Down in the bowels of the regulatory agencies, clever Wall Street lawyers could potentially earn lavish fees parsing the details of language on such issues in discussions with regulators.

OPTIMISM OF THE WILL

DODD-FRANK DOES, INDEED, include lots of holes. They can and will be filled. The question is, who will do the filling? I am not so naïve as to assume that regulatory standards, such as the Volcker Rule, will be enforced effectively simply because they are written down on paper within Dodd-Frank. But the fact that they are written down on

paper does offer real opportunities for serious political engagement and positive outcomes. As such, Dodd-Frank can be used as a framework for building effective regulations. Capturing these opportunities will require combining two things that do not often mesh well—insightful economic analysis along with effective political mobilizations. It will be a difficult, but by no means insurmountable, challenge.