

Regulation and Compliance—From Main Street to Wall Street: A Transactions Tax, Fiduciary Standards, and Restraints on Risk-Taking

Efforts to respond to public anger at Wall Street and reign in behaviors that some have blamed for the recent financial crisis continue on Capitol Hill. Three proposals advisors should be alert to concern:

- A recently proposed transactions tax;
- An imposition of fiduciary standards on broker-dealers; and
- The Obama administration's call for more restraint on risk-taking by investment banks and hedge funds.

Transactions Tax

It's hardly a new idea, but that's not stopping Democrat Pete DeFazio from proposing it. From 1914 to 1966 the US had, and Britain continues to have, a transactions tax on stock trades. DeFazio's proposal, encompassed in the "Let Wall Street Pay for the Restoration of Main Street Act," would impose a tax of .25 percent on trades involving stocks, swaps, credit default swaps, futures, and options.

Inasmuch as the proposed legislation is aimed at taxing Wall Street banks, which have apparently recovered from the financial downturn while individuals and small businesses continue to struggle, there are several exceptions to the tax. The tax would be refunded on \$100,000 of transactions annually as well as on transactions associated with tax-favored retirement accounts, education savings accounts, and health savings accounts.

Amounts collected from the tax would go toward reducing the deficit and creating jobs.

Those opposed to the tax have argued, among other things, that its burden would fall not only on big Wall Street banks, but also on mutual funds, which trade on behalf of small, middle-America investors.

In response, proponents of the tax have argued that it would fall more heavily on actively traded funds than index funds. Accordingly, small investors would be incentivized to invest in index funds, which over the long-term have performed better than actively traded funds.

Although it is too early to speculate on the outcome of the proposal, one thing is certain. There is a lot of “populist” anti-Wall Street sentiment among voters. Whatever the merits of the transactions tax, elected officials who fail to support it and other such measures, risk suffering the voters’ wrath at the polls.

Fiduciary Standards

Last month, this newsletter reported on proposed legislation that would impose a fiduciary standard on broker-dealers. Currently, broker-dealers who provide advice to retail customers that is merely incidental to the sale of securities must deal fairly with their customers and fully disclose conflicts of interest. The higher fiduciary standard would, among other things, require broker-dealers to abandon activities that result in a conflict of interest with their clients.

Senator Chris Dodd of Connecticut has been the primary architect of this legislation. His resignation along with the election of Republican Senator Scott Brown in Massachusetts has fueled speculation as to the possible outcome of the proposal.

For now, with many industry groups backing the legislation, populist sentiment running high, and everyone from Mary Shapiro at the SEC to Lloyd Blankfein at Goldman Sachs coming out in favor of the proposal, eventual passage seems about as likely as anything is Congress is considering.

Last week President Obama asked Congress for legislation aimed at limiting the investments banks could make. Backed by former Fed Chairman Paul Volcker, the proposal would limit the size of bank-holding companies as well as their ability to engage in proprietary trading and investment in hedge funds and private equity firms.

Obama Administration Proposals

As if large banks weren’t already under siege, last week President Obama asked Congress for legislation aimed at limiting the investments banks could make. Backed by former Fed Chairman Paul Volcker, the proposal would limit the size of bank-holding companies as well as their ability to engage in proprietary trading and investment in hedge funds and private equity firms.

Mr. Obama’s newest foray into bank regulation is in addition to a broad overhaul of financial services legislation currently working its way through Congress. The new proposal joins other proposals in a similar vein. Republican Senator John McCain of Arizona and Democrat Maria Cantwell want to reinstate Glass-Steagall and the SEC wants to regulate high frequency trading, in which professional investors execute orders in milliseconds to capture tiny price

discrepancies. These strategies are believed to make up more than 60 percent of all U.S. stock transactions.

Bottom Line

With politicians from both sides of the aisle hoping to woo voters angry at the financial services industry, the likelihood of some or all of these proposals becoming law is more likely than not. It's too soon to predict the final form any such legislation might take.

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