



Dodd-Frank Legislation: How the Law Might Really Impact the Capital Markets

The Dodd-Frank Wall Street Reform and Consumer Protection Act has now become law. Interestingly, a wide range of opinion still exists as to how the law will impact financial markets and, not surprisingly, there is still a great deal of spin coming from various parties that seem more intent on unsettling the public than explaining the law. Dodd-Frank proponents applaud new consumer protection measures and rules focused on reducing systemic risk. Opponents of the law assert the legislation is likely to result in less consumer and small-business credit availability and that it will lead to the export of financial services jobs.

In our view, the Dodd-Frank law has a good chance of meaningfully impacting the financial markets by enhancing oversight, reducing systemic risk, and improving consumer protection. We discuss the first two points and highlight potential forthcoming market changes below.

Improved Oversight

Dodd-Frank makes formidable strides in reducing regulatory oversight gaps. Some of the law's mandates are very straightforward and, we believe, can't help but improve regulators' ability to oversee market activity.

Some of the law's more notable elements in this vein include the creation of the Financial Stability Oversight Council (FSOC), placing of over-the-counter (OTC) derivatives under regulatory oversight, and reassigning particular responsibilities across various agencies within the oversight framework. Combined, these changes should go a long way to correcting various existing weaknesses and shortcomings.

Establishment of the FSOC should lead to better agency cohesion and improved coordination in implementing Dodd-Frank and new policy initiatives. One attractive aspect of the organization is that it will use resources already in place within the existing regulatory structure. Instead of creating yet another agency, this organization will unite talent from a range of existing organizations including the Treasury and Federal Reserve to identify and respond to issues pertaining to systemic risk in the financial system. The Council will also provide guidance to regulators in their respective markets.

OTC derivatives will be subject to regulatory oversight for the first time in history. While not reflecting the majority of transaction volume, OTC derivatives and highly structured products account for substantial market risk that, to this point, has not been monitored or measured on a market-wide level. Simply bringing visibility to this area of market activity is very likely to result in a clearer assessment of aggregate risk and leverage in the financial system.

Dodd-Frank also addresses certain deficiencies that exist in the current regulatory regime and redefines responsibility across a number of agencies. Without exploring those intricacies here, it

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suffices to say that the law reduces overlap and clarifies agency responsibilities rather than adding to or revamping the existing fragmented system.

Reduction in Systemic Risk

The new legislation is likely to lead to a notable reduction in systemic risk.

As we pointed out in our last Woodbine Opinion, the Volcker Rule will restrict bank investment in hedge funds to 3% of capital. An 11th hour compromise in Congress to pass the law diluted this aspect of the rule by changing the definition of 3% from "tangible" to "Tier 1" capital. Though slightly less stringent than the original provision, the measure still limits banks from potentially becoming heavily invested in risky hedge funds and indirectly putting the deposit base at risk.

In the same vein, the bank proprietary trading ban (which survived the legislative process intact) will substantially limit deposit-taking institutions from engaging in highly risky trading strategies for their own books. This will spell an end to large scale proprietary trading as it has existed at banks for the past 30 years and drive them to deposit services, extending credit, and client-oriented capital market business as their primary sources of revenue. Profits will decline as less glamorous but all-important commercial finance, retail lending, and account services become the central focus.

Impact on Markets

Equities

We expect the reduction in proprietary trading to have an adverse impact on equity market liquidity. However, the degree to which liquidity will be affected is unclear.

Proprietary trading formerly accounted for a significant portion of daily share volume. Although the trading landscape has changed in the past several years, the expansion of high frequency trading has caused a tremendous increase in trading volumes.

Accordingly, the adverse impact of declining liquidity due to the elimination of bank-related proprietary trading may well be offset by the benefits to market operations associated with high frequency trading. Recent data-based research we conducted (*"The Impact of High Frequency Trading Highly Liquid U.S. Equities"* April, 2010) supported assertions that high frequency trading is beneficial to the market in a majority of the 39 most liquid U.S. securities in that, on average, it improves execution quality and reduces volatility. We believe these favorable effects will "buffer" the impact of spread pressure resulting from the absence of bank proprietary trading in these 39 securities that, collectively, constitute approximately 20% of the daily market volume. However, the impact on spreads may be more keenly felt in smaller, more thinly traded securities. Without high-frequency

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trading to offset the decline in proprietary trading, the cost of raising equity capital through the public market could increase for smaller, less-established businesses.

Derivatives

Increased transparency in the derivatives markets resulting from Dodd-Frank should also be beneficial in terms of systemic risk reduction by placing specific controls around OTC derivatives. As has been previously noted, OTC derivatives contracts and most structured products are currently traded in a largely unregulated environment.

We believe the law will increase transparency and reduce credit exposure without significantly affecting the transfer of risk in the market. The new mandates will require large derivative trading firms to execute transactions electronically in an exchange or swap execution facility, clear through a clearinghouse, and report to a trade repository. Trades that are exempt from these requirements will face a higher capital charge, reflecting their additional risk. The resulting reduction in counterparty credit risk among trading partners is a significant element of the law's goal to reduce the inter-connectivity among major securities dealers.

The law also requires insured banks to spin off or “push out” non-hedging related derivative trading to separate affiliates. As this area becomes clarified by regulators, the ultimate impact on the market can be better discerned. As it stands, we expect that the impact will be largely organizational, with associated capital implications. We do not expect this provision to significantly affect trading.

The combination of electronic markets, clearing, and reporting will add significantly to market depth and liquidity. This will level the playing field for less creditworthy counterparties and foster greater price competition among a larger group of market makers. Less liquid products, such as some of the more esoteric credit default swaps (CDSs) and collateralized debt obligations (CDOs), stand the most to gain in terms of price discovery and spread compression.

Fixed Income

Almost nothing in the law, outside of the ban on bank-related proprietary trading, will directly affect overall operation of the U.S. fixed income market. Specific areas will be impacted, such as asset backed securitization where underwriters are required to retain 5% of the credit risk in originated securities. A similar risk retention requirement will exist for certain types of non-exempt residential mortgage backed securities as well; however, the securities that will be affected have yet to be determined. We believe that this will be positive for the markets as underwriters will now have some “skin in the game,” increasing their due diligence.

New accountability facing credit rating firms (including legal liability to investors for their ratings) should bolster their accuracy and independence and restore some confidence in their assessment of

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creditworthiness. This should be a welcomed change since credit rating arbitrage, coupled with insufficient investor due diligence, played a significant role leading up to the structured credit market meltdown.

Perhaps the most interesting part of the law with respect to the fixed income market will be the effect that electronic trading of fixed income derivatives has on the underlying cash markets. We believe movement toward more robust electronic trading is inevitable for most fixed income securities as the efficiencies derived from current technology are too overwhelming to be ignored. More advanced electronic trading is currently conducted almost exclusively among the major market participants. Forthcoming changes to the derivatives market may well provide the catalyst for more widespread adoption of electronic trading.

Reduction in Bank Lending Largely Hype

We are not clear how opponents to the Dodd-Frank law purport that reform will lead to a decline in the availability of business and retail credit. The best we can determine is that they believe that greater regulation will raise business cost for smaller lending institutions, driving some out of business, and resulting in less available, more expensive credit for small businesses and less creditworthy individuals, from fewer banks.

The business cost argument is not new. In our experience, it has been one of the most widely used arguments against regulation when opponents lack reasonable or rational grounds upon which to object. We have yet to see any bank, broker, exchange, ECN, or ATS be truly hurt through compliance-oriented spending in connection with new regulation.

We think the cost argument is largely hype that could be traced to banks intent on protecting their bottom line. In other words, the cost argument is really an indirect objection to impending revenue reductions likely to result from the new legislation. In fact, once the legislation is implemented, bank operating models may very well resemble those at banks between the 1930s and 1990s while the Glass-Steagall Act was in place.

Glass-Steagall prohibited deposit-taking institutions from underwriting and trading in equity securities. During this period, widespread derivatives trading, for the most part, was non-existent. Banks focused their business efforts on account services and lending. Guess what? Business was just fine.

Job Export

We agree with Dodd-Frank opponents that the new legislation is likely to result in firms shifting certain financial services positions overseas. A more restrictive business environment may well result in so-called "regulatory arbitrage," in which firms move business activities to less restrictive markets. Some trading will, no doubt, find its way to such geographies.

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In regard to the potential export of jobs, we ask the fundamental question: Does it make sense to forgo beneficial legislation in the interest of repatriating a limited number of financial services positions?

We believe the answer is a resounding “no.”

We are not insensitive to those who have or may lose employment. However, it is what is natural and necessary during periods of structural economic change. Changes short of those mandated by the law would simply preserve a flawed business environment to protect the interests of a few. Preserving a flawed system to retain a relatively small number of jobs potentially places our nation’s economic engine and standard of living at risk.

In all, we believe that the Dodd-Frank Wall Street Reform and Consumer Protection Act is a remarkable piece of legislation that is bound to bring about beneficial changes to the financial markets. While no legislation is perfect and, no doubt, there are certain to be meaningful issues surrounding the law, we are impressed that legislators held their ground and retained important substance necessary to correct flaws in financial market operations. It is always easier to repeal rules than to implement them. Let’s hope this law helps achieve the best balance of our free market engine and social objectives.

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