First there are the innovators. Then there are the imitators. Then there are the idiots.

Its starts off with “I have a great idea” that makes money. Then someone says “Thats a great idea, only XYZ is doing it. They made a ton of money. We should do it too”. Then it becomes have you seen what is happening with XYZ , ABC and DEF ? They are making a killing. We need to be there too”. Which in turn becomes, ” Everyone is doing it and making money. My relative and all of his friends are making a killing. We can get in on it with my broker or banker. ” Then its over.

It has happened time and time again for hundreds of years. It is exactly why there will always be bubbles. In the financial markets, the players realize that they can make enormouos amounts of money by copying what already works and applying bigger dollars. Because “the consistent track record” of the scheme is well documented, its an easy sell to bankers who will lend you money, or investors that will give you money. Each successive iteration of the scheme finds participants not only willing to take on a smaller return because of the consistency of returns in the presentation they just reviewed, but to lend or invest more and more money. After all, its worked for such a long time, what could go wrong ? Of course its all great, until its not.

What the administration and most people have not taken to heart and may not understand is that contrary to conventional wisdom, in the financial markets, CONSISTENCY DOESN”T REDUCE RISK, IT INCREASES RISK. How can this be ? Because of the laws of capitalism. The less the perceived risk, the less return participants are willing to take. The less return in percentage terms participants are willing to take, the more money they have to put at risk in order to “hit their numbers”.

If you work on wall street and want to make $500k with the least amount of perceived risk as possible, you copy what everyone else is doing , only you use bigger amounts then then person who only wants to make 200k. The same applies to companies. If a major investment bank wants to hit their quarterly earnings number for Wall Street, they do the exact same thing, only the numbers are much, much, much larger.

When multiple financial institutions on Wall Street get beyond big, the profits they are required to generate grow beyond anything we have seen before. They become institutions that are “too big to fail”. The amount of capital, in aggregate they are required to put at risk generates what is now referred to as “systemic risk”. When they fail, the entire economy is at risk.

But here is the scary part. In the minds of the management and boards of the banks, they thought they were “operating conservatively”. In their minds, all they were doing was applying more capital to business lines that had a long history of being successful for them. Again, in their minds, that is obviously far less risky than taking on or inventing new types of unproven businesses and services and deploying capital in that direction.

Remember, on Wall Street, there is no such thing as enough. There can only be more. It ALWAYS has to be more than last year. Always. Which in turn requires bigger numbers. Which in turn makes idiots out of otherwise very smart people who thought they were taking conservative business steps.

Call it Madoff’s Law. Where there are consistent returns, it doesn’t mean that the risk is reduced, it means you can’t see the risk.

In a world where public companies always have to make more money than last year, they have no choice but to convince themselves they are avoiding risk. Now with Madoff’s law, they can know that is not the case.

So how do we fix Wall Street ? Rather than limiting pay on Wall Street, I would do the exact opposite. I would ask the Obama administration to recognize where the real problems are. The problems are not with the innovators. The problem is less with the immitators. The problem is with the 3rd group, the idiots who think that by copying the others while accepting lower returns, they are making smart decisions.

I would create additional forms of licenses (outside the patent office, managed by the treasury ?) that any financial institution can apply for (with a signicant fee that makes this a government profit center and keeps out patent trolls) and receive for a new financial instrument. Once approved as original, with as many risks as can be having been documented, I would grant the financial institution some period of exclusivity to market and sell the product. It could be 3, 5, 10 years. I dont know what the exact right number is. What I do know is that while it will keep the price of that financial service artificially high for some period of time, it will also give the government a means of tracking what new financial instruments are being considered and marketed. The ones with the greatest upside will always try to get protection. It will also give the innovator and the markets a chance to see how the “law of unintended consequences” applies to the product. Before all the copycats get their shot at it.

In addition, because the companies that receive the “exclusive license” will always try to protect their license, the government will always be made aware of anyone trying to compete with their products. Which will make them a far more effective “regulator” than anything a government institution can do.

This approach would have made a whole lot more money for the company that created the CDS, but kept out the immitators and because it was offered by a single company and maybe its licensees, would have put a cap on the size of the market. The same could be applied to the low end mortgage industry as new products, which turned out to be toxic, would have been limited in their distribution and scale.

One caveat I would add is that these “financial licenses” cant be applied to products already in the market place. This shouldnt be a lawyer stimulus program . It should be for new products that are significantly different than those already in the marketplace. There are also international implications. But if this were to work here, I would guess that existing treaties could be applied to these as well.

Here is what it comes down to. The problems we have experienced did not come from the innovators, they came from the idiots who thought there was no risk for them if it worked for the imitators before them. That caused the market to inflate quickly and with the undesirable consequences we have all experienced. If you try to limit pay on wall street, the innovators will go outside the reach of regulators and do what they need to do to get paid. If instead you reward the innovators and make it easier to make money, you will be able to monitor, reform and understand the impact of the new financial products before they go “generic” and the imitators and idiots get a hold of them.