The only way to address executive compensation and the inevitable boom and bust cycles that will happen in perpetuity in this country is to finally recognize the difference between financial engineering and investing. For some reason no one in any of our regulatory agencies seems to want to admit or deal with the differences. Too much pressure from Wall Street ?

In any event, the following is a post from a year ago. I thought it was worth republishing.

Let me get this straight. In **2008**, funds trying to squeeze out another basis point or two thought they were being conservative **buying insurance** on heavily leveraged portfolios of sub prime loans and other debt. Once those loans started to default, it created a cascading deleveraging event which lead to major financial institutions failing and the "smartest" minds on Wall Street being forced to dump everything to raise cash, which in turn lead to a crisis of confidence and deleveraging that created the worst week in the history of the stock markets. Did I get this right ?

In 1987, funds, trying to squeeze out another basis point or two thought they were being conservative **buying insurance** on leveraged stock portfolios. Once the stock prices on those portfolios started to drop, their insurance programs pushed them to dump everything AND sell stock index futures to raise cash, which in turn lead to a crisis of confidence and deleveraging that created the worst single day melt down in the history of the stock markets. Did I get this right ?

Think it wont happen again ? Of course it will. Whatever money the Fed makes available to entrepreneurs and businesspeople will be used as intended, to create and grow businesses.

Unfortunately, it will also be used by financial engineers to try to find a way to make HUGE profits from highly leveraged,risk laden financial packaging. Why wouldnt they ?

If you can borrow cheap money , invest in some asset that can be marked to an increasing market, borrow against the gain and buy something else and do it as many times as possible, wouldnt you ? Its exactly how homeowners In a bull market drove up real estate prices with a few making huge money.

If you could do the same thing, but instead of with houses, with stocks or asset backed securities, and instead of with thousands, do it with billions so you could profits in the 10s of millions or more, wouldnt you ?

Hell yes you would. You certaintly arent going to tell yourself that you could be creating the next big bubble that could rival 1929, or for future generations, would rival 2008, so dont do it. You would go for the money.

Which is the genesis of our problem in the US. Its not wrong to run with bull markets and leverage to the hilt. That can be a very good thing. But we have to make the upside based on investments, rather than financial engineering. Which is exactly why we have to change our tax code. We want to encourage investment, not financial engineering.

The financial markets were originally defined as markets that created capital for businesses to start and grow.

Today, that is rarely the case. Sure companies do come to the markets for cash for growth and that should be encouraged. But those examples are a tiny percentage of the market. When a stock turns over its float multiple times in a day, those are not investors buying and selling the stock. Those are traders or financial engineers.

The ONLY WAY WE ARE GOING TO END THIS BOOM AND BUST CYCLE IS IF WE DIFFERENTIATE BETWEEN INVESTORS AND EVERYONE ELSE.

Investors should be rewarded for actually owning companies and gaining returns on their investments. **Financial engineers should have to pay a premium for the risk they introduce to the entire financial system. It was not investors that brought on the last 2 crashes. It was the financial engineers.**

The beautiful thing about this country is that we like to work hard, and we like to take chances. **Unfortunately, over the last 15 years, the incentives have been to take chances as a financial engineer rather than as an entrepreneur. We give far more money to people who play games with financial instruments than we give to people who come up with ideas for the next big thing. That needs to change if we want to remain a leader in this world.**

Here is what I would do to change things

I would change to zero the taxes on any gains from the sale of stock or bonds purchased during an IPO and held for 5 or more years. All dividends/interest paid by that stock/bond would be tax free. If you sell it prior to the 5 years, you are taxed at your personal regular income tax rate.

In addition, I would not allow the stock to be borrowed against in any way. If it was, it would be considered an effective sale. Which means you couldnt borrow on it tax free until you have held it 5 years. Bottom line, if you hold the stock/bond , like a real investor would, you are rewarded for it.

For purchases post IPO, in the open market, the same rules apply, except I would tax a personal income rates the dividends/interest for the first 5 years of ownership.

For all other transactions, whether they are options, derivatives, stocks, bonds, whatever, all gains and losses would be taxed at personal income rates.

If you are a great financial engineer and make tons of money at what you are doing, more power to you.If you are good at what you do, you pay more to Uncle Sam, but you still make a boatload of money.

I would keep taxes on private transactions, just where they are. Private transactions are less liquid and harder to value, which in turn makes them harder to borrow against. Which reduces leverage in the system and encourages investment. Its hard to financial engineers a private company. I would tax gains and losses in private companies at capital gains levels, but I would extend to 3 years the marker to not be considered a short term investment. I would keep the active vs passive rules.

Next there is the issue of leveraging. No one ever complains when cheap cost of funds creates leverage and drives a market up. And no one ever will. So we have to set strict leverage limits. We set margin/leverage limits on day traders as the tech bubble burst. The only difference between the day traders of the tech bubble and the Investment Banks and AIGs of the world that cratered in this bubble is that the big guys started with more chips at the table. And they picked their own credit lines and there was no pit boss to watch over them. I would limit to 2x the leverage available on any asset that is insured by the government or is offered by any organization that is elgible for government insurance or tax incentives of any kind.

Of course, I would still levy a fee of anywhere from 1c to 10c on every transaction of stocks or bonds which would go into a general fund, that I will call the “Oh Shit We Missed It Fund”. It will be there to fund the inevitable situation where someone figures out how to work around whatever regulations and tax code that is created.

As an entrepreneur, I can tell you that this would not change how I ever started or invested in any business. As someone who trades stocks, It would impact my investment decisions. I would only trade out of necessity. I would be willing to take lower yields on my investments, making it cheaper for companies to raise funding.

I also recognize that it would mean that the chances of the Dow ever hitting 14k in 2008 dollars is about as likely as my catching my elbow on the rim playing basketball. I dont think thats a bad thing.