another post from last year that i thought was relevant again:

What Business is Wall Street In ?

May 9th 2010 11:36AM

My last two posts were designed to stimulate discussion. But lets talk the real problem that regulators, public companies, investor/shareholders and traders face. The problem is that Wall Street doesn't know what business it is in. Regulators don't know what the business of Wall Street is. Investor/shareholders don't know what business Wall Street is in.

The only people who know what business Wall Street is in are the traders. They know what business Wall Street is in better than everyone else. To traders, whether day traders or high frequency or somewhere in between, Wall Street has nothing to do with creating capital for businesses, its original goal. Wall Street is a platform. It's a platform to be exploited by every technological and intellectual means possible.

The best analogy for traders ? They are hackers. Just as hackers search for and exploit operating system and application shortcomings, traders do the same thing. A hacker wants to jump in front of your shopping cart and grab your credit card and then sell it. A high frequency trader wants to jump in front of your trade and then sell that stock to you. A hacker will tell you that they are serving a purpose by identifying the weak links in your system. A trader will tell you they deserve the pennies they are making on the trade because they provide liquidity to the market.

I recognize that one is illegal, the other is not. That isn't the important issue.

The important issue is recognizing that Wall Street is no longer what it was designed to be. Wall Street was designed to be a market to which companies provide securities (stocks/bonds), from which they received capital that would help them start/grow/sell businesses. Investors made their money by recognizing value where others did not, or by simply committing to a company and growing with it as a shareholder, receiving dividends or appreciation in their holdings. What percentage of the market is driven by investors these days ?

I started actively trading stocks in 1992. I traded a lot. Over the years I've written quite a bit about the market. I have always thought I had a good handle on the market. Until recently.

Over just the past 3 years, the market has changed. It is getting increasingly difficult to just invest in companies you believe in. Discussion in the market place is not about the performance of specific companies and their returns. Discussion is about macro issues that impact all stocks. And those macro issues impact automated trading decisions, which impact any and every stock that is part of any and every index or ETF. Combine that with the leverage of derivatives tracking companies, indexes and other packages or the leveraged ETFs, and individual stocks become pawns in a much bigger game than I feel increasingly less comfortable playing. It is a game fraught with ever increasing risk.

The Pimco (who I think are the smartest guys on the Street) guys talk about a new normal as it applies to today's state of the world economy. I think just as important is the new normal as it applies to Wall Street. Wall Street is now a huge mathematical game of chess where individual companies are just pawns. This is money in the bank for the big players like Goldman, Morgan, etc. Why ? Because the game of chess is far too complicated for 99pct of the institutions out there investing money. So to keep up, they turn to Goldman, Morgan and the like to invent products for them. "You don't know how to play the housing boom, let us show you". "You think the housing boom is about to crash, let us show you how to play that". "You think that PIIGS are in trouble because they can't print money to pay debt holders, let us create a product to allow you to play that game" The big houses have the best hackers in the business and they put together the games and sell them to the many, many institutions managing Billions and Billions of dollars. They are the ultimate Hackers selling their attacks to the highest bidder, regardless of which side they are on. That is a new normal.

Again, I'm not passing judgement one or the other. I'm just recognizing what is going on in the financial world today.

It's rare for companies to go public these days. Just as rare for secondary offerings. The only thing that keeps me in the market is that most of the stocks (not all) pay dividends or some other sort of cash payout. For the first time in my life, I bought outside the United States. I bought Australia in a big way because it is becoming increasingly hard to find new domestic investments that are not influenced by the "hackers" and the games being played on a macro level. **It's hard to believe, but evaluating countries as an investment is now easier than evaluating companies** . Even with all the unrest in Europe. Or maybe because of it.

So back to the original question. What business is Wall Street in ?

Its primary business is no longer creating capital for business. Creating capital for business has to be less than 1pct of the volume on Wall Street in any given period. (I would be curious if anyone out there knows what percentage of transactions actually return money to a company for any reason). It wouldn't shock me that even in this environment that more money flows from companies to the market in the form of buybacks (which i think are always a mistake), then flows into companies in the form of equity.

My 2 cents is that it is important for this country to push Wall Street back to the business of creating capital for business. Whether its through a use of taxes on trades, or changing the capital gains tax structure so that there is no capital gains tax on any shares of stock (private or public company) held for 5 years or more, and no tax on dividends paid to shareholders who have held stock in the company for more than 5 years. However we need to do it, we need to get the smart money on Wall Street back to thinking about ways to use their capital to help start and grow companies. That is what will create jobs. That is where we will find the next big thing that will accelerate the world economy. It won't come from traders trying to hack the financial system for a few pennies per trade.

And solutions won't come from bureaucrats trying to prevent the traders from hacking the system. The only certainty when bureaucrats step in is that the law of unintended consequences will smack us all in the head and the trader/hackers will find new ways to exploit the system that makes them big money and even more money for the big institutions that develop products for the other institutions that are desperate to play the game.

Regulators have got to start to recognize that traders are not investors and vice versa and treat them differently. Different regulations. Different tax structure. Different oversight. Individual investors and the funds that just invest in stocks and bonds are not going to crash the market. Big traders who are always leveraging up and maximizing the number of trades/hacks they make will always put the system at risk. We need to recognize that they do not serve much of a purpose other than to add substantial risk to the global economy. That their stated value add of liquidity does not compensate the US and World Economy nearly enough for the risk of collapse they introduce into the system.

Wall Street as a whole needs to be in the business of creating capital for companies and selling shares to investors who believe they are shareholders. The Government needs to create incentives for this business and extract compensation from the traders/hackers for the systemic failure level of risk they introduce.

There will be another crash, because there are too many players looking for the trillion dollar score. They can't all win, yet how many do you think wouldn't risk everything, even what is not theirs, for that remote chance to score big ? Put another way, *there is zero moral hazard attached to any trade. So why wouldn't traders take the biggest risk possible ?*

Update at 10pm 5.9.10

One more consideration. If there are traders of any kind that are unregulated or unmonitored, and trade for their own account, how do we know how big they are and how much of a threat they pose to the system, individually and in aggregate ?. For any High Frequency or big leverage derivative folks out there- is it possible there could be firms that have billions at risk with questionable ability to make a margin call or fulfill their side of the trade if things went against them ? Could there be hidden AIGs that few people know about or a bunch of AIG like situations ,which in aggregate fail and put the system at risk ? I have no idea. Just asking the question.

Update 8-9-2011

As a follow up from a comment, I found it interesting that Australia treats professional traders very differently than individual investors that invest in shares of companies. Traders pay regular income tax on their gains, investors pay capital gains and if held more than a year can even get a discount on the capital gains rate. Something that would make a ton of sense in the USA as well

From the site:

Carrying on a business of share trading

A 'business' for tax purposes includes 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee'. This definition would include a business of share trading.

The question of whether a person is a share trader or a share holder is determined in each individual case. This is done by considering the following factors that have been used in court cases:

1. the nature of the activities, particularly whether they have the purpose of profit making
2. the repetition, volume and regularity of the activities, and the similarity to other businesses in your industry
3. the keeping of books of accounts and records of trading stock, business premises, licences or qualifications, a registered business name and an Australian business number
4. the volume of the operations, and
5. the amount of capital employed.

1. Nature of activity and purpose of profit making

The intention to make a profit is not, on its own, sufficient to establish that a business is being carried on.

A **share trader** is someone who carries out business activities for the purpose of earning income from buying and selling shares.

Shares may be held for either investment or trading purposes, and profits on sale are earned in either case. A person who invests in shares as a **share holder** (rather than a share trader) does so with the intention of earning income from dividends and receipts, but is not carrying on business activities.

It is necessary for you to consider not only your intention to make a profit, but also the facts of your situation. This would include details of how the activity has actually been carried out or a business plan of how the activities will be conducted.

A business plan might show, for example:

- an analysis of each potential investment
- analysis of the current market and various segments of the market
- research to show when or where a profit may arise, and/or
- the basis of decisions by you as to when to hold or to sell shares.

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