Impressions

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"If you have ten thousand regulations you destroy all respect for the law." Winston Churchill

" Whatever you have said in the dark will be heard in the light, and what you have whispered in the inner rooms will be proclaimed upon the housetops**" Luke 12:3**

INTRODUCTION

In our last newsletter we laid out what we thought would be themes for the financial markets for the next few years at least. To review we think that the next few years will bring a rise in nationalism around the world and in the US an increase in regulation in all areas of society, a deflationary period followed by inflation, movement to centralize healthcare and increases in taxation. We finished it off with a discussion of how these five would impact investment rates of return (we think it reduces them).

A number of readers asked if I could flesh out the five themes with ideas that would both prosper and decline under the conditions I foresee. The next few newsletters are going to deal with that last subject one theme at a time. This one will deal with regulation.

What is Regulation?

Regulation is a word derived from the Latin regulare and as you can see from the definition below the word and the concept have been around for a long time.

Function: *noun*
Date first used in English: 1665
1: the act of **regulating** **:** the state of being **regulated** **2 a:** an authoritative rule dealing with details or procedure **b:** a rule or order issued by an executive authority or **regulatory** agency of a government and having the force of law

There are two contexts for regulation. The first is the rules that allow laws to work and the second is a trope for idealists of all stripes to use selectively or constantly as a straw man to make a point.

No law, if it is to remain effective, can specify all the details and situations in which it could be invoked; to do so would create a document so burdensome as to be useless. Attempts to make law specific are the reason we still have laws on the books saying that if a horse drawn carriage will not pass a motorcar the driver of the car has to disassemble the car until the horse will pass (Indiana). It is necessary then to create regulations that take their force from the law and have the same effect. The presupposition behind regulations is that they can be changed with more alacrity than laws. Go to this web site www.gpoaccess.gov/cft to see that this is good theory but bad reality.

Regulations are written largely by the unelected infrastructure of government. The people who write them are hidden in the bowels of government unseen and largely unaccountable. If a regulation causes out-rage some elected official will pass the buck with the comment this is the work of the unaccountable beaurucrats. So to some extent regulations have the odium of the comment above from Luke.

Regulations prescribe the methods the police use in making arrests, they prescribe the reporting regime for land development and the sewer capacity of new plants. Other examples are health and safety provisions and parking regulations to facilitate road plowing and trash pickup. Like taxes, some regulation is necessary for the operation of a civilized society. The danger of regulation lies when it is captured by political interests of any stripe seeking to advance an agenda out of the harsh light of public debate.

Let's be clear about one thing. No regulation has even been enacted that did not have a cost associated with it. For a discussion of this effect see www.usgovinfo.about.com/b/2006/07/06/**cost-of-federal-regulations**-soaring.htm

These costs are why on the top of government forms is an estimate of how much time it will take to complete it. The cost might be direct because you have to purchase a license or permit or it can be indirect such as the time needed to fill out forms or install new equipment. If there is no cost to regulations why is that states, when selling themselves as sites for economic development, trumpet low regulatory burdens? If there is no cost why is it that when a company locates a plant they always ask for an abatement of taxes and regulatory costs as sort of a signing bonus? There is a very real regulatory burden in compliance.

One of the dangers of any representative political system is that certain groups can capture the attention of elected officials through money or pressure or both. When this happens unscrupulous politicians (I repeat myself) will often use regulatory methods to enact change or to maintain the status quo. The use of regulations shields the change from the harsh scrutiny of public debate that is part of legislation and provides plausible deniability. Regulations can be like the old metaphor of the frog in a pot of water whose temperature is gradually increasing.

When a society undergoes great and complex changes that are little understood but where action is demanded it is usually accompanied by the passage of great number of laws which are imperfectly formed, leaving the implementation in the hands of regulatory bodies. In times like this regulation can go wild and create preposterous situations like the country store in Tennessee that was fined by OSHA for having "water in contact with ice." I am not making that up.

The reason for this musing is that we are at one of those crisis points and action is being demanded and the politicians are of course reacting, creating a blizzard of laws aimed at everything that moves, flies or looks out of place. Some of this garbage will pass and as it passes it will engender more regulation which in turn means more costs which means less profit and so on.

The real irony of the current financial crisis is that it is blamed on deregulation - which is true but not in the way most people think. There is no industry in the United States more heavily regulated than financial

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services. We act under the aegis of no less than six federal agencies, each state's agencies and three self-regulatory groups. Below is a table of the various agencies:

Federal	Self-regulatory	State Agencies
SEC www.sec.gov	FINRA *www.**finra**.org*	State banking Commissions
CFTC *www.**cftc.gov***	*Financial Planning Association www.**fpa**net.org*	Secretaries of State
OCC *www.**occ**.treas.gov*	*NAPFA www.napfa.org*	State Insurance Commissioners
Office of Thrift supervision www.ots.treas.gov		State Securitas Commissions
Homeland Security (Patriot Act) www.dhs.gov		
*IRS www.**irs**.gov*		

We are regulated down to the actual words we can use in a presentation. We are regulated as to the fees we can charge and the number of transactions we can make. We are regulated as to when and how we can swap one security for another. We are dictated to as to what we have to disclose and what we do not have to reveal. In every other industry if a client likes what you do for them you can use their testimonial- but not in financial services.

Regulations role in this mess is in the place of an overseer who was too tight in the wrong parts of the business. The most tightly regulated parts of the business (normal securities transactions and mutual fund investing) are the areas of greatest numbers of transactions and deal with individual investors. Most of the regulatory and compliance burden therefore falls in those areas. Supporting the regulatory overburden destroyed profit potential. So, the firms moved to areas less well regulated and more profitable. The current suite of regulations descends from the Depression Era and it was assumed that the individual required protection. It was assumed that if an individual lost their money they needed to have recourse if it happened as a result of misdealing and the regulators existed to ensure fair dealing. Institutional investors were assumed to know the risks they took and were able to bear the losses of poorly thoughtout actions.

Government regulation will always be slow to react and will be reactive rather than proactive. The regulatory structure did not have any concept of what was developing. The regulations might have protected the average person but they did not cover the rise of institutional investors who acted and traded like individuals. This market largely free of regulation, operating under favorable tax treatments and with enormous leverage was very profitable for all concerned because it was opaque and little understood.

The fact is and always will be that where markets are less efficient and transparent they tend to be more profitable due to the uncertainty of results. This ability to earn outsized returns drew Wall Street like flies to honey. It also drew clients.

So the natural argument is that the reptilian Bernie Madoff was able to rip off $50 billion in the midst of all this regulation so more regulation needs to be in place to stop it. Faulty logic. The current regulation was hamstrung in its enforcement actions because of political turf wars and self interest. FINRA (the successor to the NASD of which Madoff was once Chairman) had the authority to regulate Madoff but did not do so. Perhaps it might be because FINRA was started and is funded by the brokerage industry to create a favorable regulatory body for the industry (http://www.finra.org/AboutFINRA/Leadership/P009756). Part of Madoff's operation was a large brokerage firm. FINRA has an inherent conflict of interest, is not truly independent and is therefore less effective.

Even if FINRA had wanted to rein in Madoff it would have run into jurisdictional disputes with the SEC which had responsibility over some of Madoff's activities. Rather than work out the issues the two agencies did nothing. The fact is that the Madoff affair did not result from lack of regulation; it was the fault of regulations that did not work. Before new regulations are put in place we should make sure that the old ones work.

Here is a fact of brokerage firms and investment houses. They exist to fill or create a need. The firms would not have embraced the areas of operation that are currently causing problems if clients had not been demanding higher returns. This does not excuse the excesses of Wall Street it is merely a statement of uncomfortable truth that we are all partly to blame for this mess.

Most assuredly illegality will be discovered in the dissection of the mess. The irony is that all of this mess was created by actions and methods that were well within both the legal framework of the industry as well as the regulatory aegis. While some folks will certainly go to jail, it likely will not be for creating securitization of mortgages, but for violation of an obscure regulation.

I have been through a couple of these fall out situations (none this severe) and in the end all the regulations that are piled on ex post facto do nothing but make the next crisis more likely. The sad fact is that the more law and the more regulation that is piled on, the chance of violations is more likely not less. While it is hard to accept that less regulation may actually result in better outcomes, the fact of the matter is that unless innovation is outlawed the heavy and uneven hand of regulation will drive enterprising individuals to areas not so heavily regulated.

While the press and the uninformed rail against the supposedly egregious compensation on Wall Street the truth is as Shakespeare said "methinks the lady doth protest too much." All the current vocal critics of the securities industry benefited and lived better lives because of what happened on Wall Street. They bought houses, they financed luxury cars, they sent their kids to expensive colleges, and they vacationed in exotic places all because credit and money was made available via the innovation of Wall Street. Wall Street is guilty of excess but we are all guilty of taking advantage of the excess.

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Making Wall Street a pariah is going to make the next crises worse. When you make an industry or endeavor the object of calumny the only persons who will enter it are those who care little for reputation. If you can care little for reputation you will care little for law or morality. So we need to be careful of what we do to today's villain.

There is no doubt that there is going to be more regulation of the financial services industry, of health care, energy production, education, construction, and insurance. Added together that would be on about 50% of the US economy. (As we go to print the government has forced the Chairman of GM and most of its board of directors to quit.) There is also no doubt that as those regulations are emplaced the costs of compliance will rise. It is a statement of fact that the work of compliance is pushed down to the lowest level employee who can legally do the work. That is why many of recent compliance regimes (Sarbanes Oxley is an example) require information that can only come from higher level personnel or which has to be certified by them. As these highly placed and therefore (at least currently) highly compensated people spend more time completing forms the costs of compliance will increase and they will have less time to devote to the operation of the company.

Who are the industries and companies which will be most negatively affected by the increase in regulation?

Managed Care	**Pharmaceutical**	**Coal**	**Financial Services**	**Insurance and Annuities**
Humana	Merck	Massey Energy	Citicorp	Met Life
United Healthcare	Pfizer	Consol Coal	Morgan Stanley	Hartford
Well Point	Sanofi Aventis	Arch Coal	Goldman Sachs	Lincoln National
HCA Inc.	Johnson and Johnson	AEP Allegany Energy	Bank of America Wells Fargo	Allstate
Aetna	McKesson		J P Morgan	Progressive
Cigna	Cardinal Health			ING
	Stryker			AXA
				Allianz SE

How does one make money out of this concept? Increased regulation and increased costs will add to the pressure to outsource functions to hold down costs. So you will see contract manufactures getting more assembly business. Additionally, over the years of declining regulation and enforcement (and enforcement is really what has been lacking) many companies have reduced or eliminated their in-house regulatory compliance groups. This is particularly true in the commercial and investment banking industries. These functions are going to have to be rebuilt which will translate into hiring and human resource work. It is unlikely that failure to comply is simply going to be accepted. There will be penalties, perhaps severe ones. Therefore it will be important for companies to insure that their personnel are properly vetted.

Here are some companies that seem to be already aiming business units at the regulatory space:

Technology and IT consulting	Drug and Medical development	General Consulting	Human Resources	Failure Analysis	Contract Manufacturers	Information Providers
Cisco	Covance	Accenture	Hewitt First American Choice Point	Exponent Tetra Tech	Celestica Flextronics Jabil Plexus	Wolters Kluwer (Netherlands) Dun and Bradstreet
SAP	MDS Inc	BearingPoint		FTI Consulting	Elcoteq	Interactive Data Moody's
IBM **TCS (India)**	Charles River Labs	IBM CSC (computer services corporation) Lockheed Martin CA (Computer Associates)		Genpact LTD		Factset Dow Jones Standard and Poors
	Pharmaceutical Product Development Quest Labs Bio Reference			National Technical Systems		

As officers and directors are made more personally financially liable for their actions of the company the need for better insurance coverage will increase. As taxes rise both in terms of income tax but also social taxes such as social security, cost pressures will translate into a need to reduce headcount but maintain

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operational capacity. This argues for software/hardware solutions as opposed to people but it also argues for outsourcing the development and installation.

While what is happening is frightening and the future unclear there has never been a great crisis that did not hold within it great opportunity. What is lacking in times of great crisis is the ability to see past the negative onslaught of the news and the willingness to act.

I am not going to tell you that we have all the changes figured out and have the correct investment strategies to cope with all of them. There are many surprises to come. Who would have expected in January that the President of the United States would take to himself the power to reach out and fire the Chairman of the Board of Directors of a company still owned by its share holders. The justification was public interest but who is to say what is the public interest?

There are economic fixes to the problems facing us and there are political actions where the confusion will occur is at the junction of the economic fix and the political desire to benefit from the fix. That confusion will translate into increased risk premiums and lack of trust.

Good Luck
Dennis Gibb