America's capital markets

Down on the street

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No longer can America take for granted its global superiority as a market for capital. Regulatory reform might let it keep up with the pack

DAVID CHAVERN has been looking at a photograph of hirsute twenty-somethings and fretting. The snap, from the late 1970s, shows a mop-topped Bill Gates and colleagues at what would become the world's biggest software company. Mr Chavern, a capital-markets expert at the US Chamber of Commerce, is concerned that America may no longer be very good at nurturing nascent Microsofts. "You can't help wondering about the hairy people you'll never hear of," he muses.

He is not alone. There has been much hand-wringing over the state of America's capital markets and their ability to help businesses grow. The main worry is that despite being big, they are no longer competitive compared with the leading financial centres of Europe and Asia. This month Michael Bloomberg, New York's mayor, and Charles Schumer, a senator, showed their concern in an article dramatically titled: "To save New York, learn from London." But some think it is already too late for Wall Street. "The days of financial hegemony are over," says one senior American official gloomily.

As arrogance gives way to angst, America is exploring what to do. The Chamber of Commerce has held a series of "town hall meetings" and will publish a report next spring. New York has hired consultants from McKinsey to develop a new strategy. But the initiative attracting most attention is the Committee on Capital Markets

Regulation (CCMR). This group of bankers, bosses, academics and investors, headed by Hal Scott, a Harvard Law School professor, is due to release its first set of recommendations on November 30th. These are likely to include scrapping or revising various regulations seen to be holding back American business.

Although the government insists it is not involved, the treasury secretary, Hank Paulson—a former head of Goldman Sachs—has offered encouragement. This week he said that the 2002 Sarbanes-Oxley act, which toughened up corporate regulation following Enron's collapse, is “being implemented in a way that may be...introducing new risks to our economy”, and forcing companies to spend more on accountants than research.

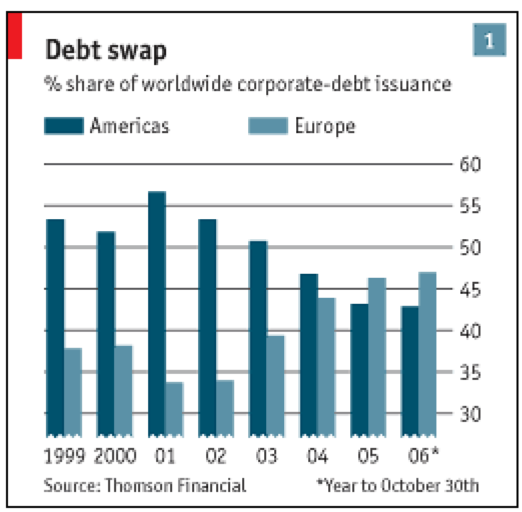
This might seem an odd time for such anxiety. After all, America's firms and banks, many of them world-class, are making record profits; Wall Street bonuses could be almost a third higher than last year's payout, itself a record; the Dow Jones Industrial Average recently hit a new high; the merger of two Chicago exchanges has cemented that city's dominance in derivatives-trading, while the New York Stock Exchange and Nasdaq are trying to buy their European rivals (see article).

At the right price

Are the fears misplaced? As capital becomes more mobile, investors worry less about where their trades take place, so long as the price is right. America's big investment banks can win business wherever in the world deals are made. And budding Microsofts can always list abroad if their local market cannot provide the financial support they need.

Yet it is not quite as simple as that. Although capital flows more easily, there are additional costs in raising money overseas. And successful financial markets create a “cluster” effect of businesses servicing them. Hence it is in America's interest to encourage a vibrant domestic capital market. And if it raises its game, other centres will have to do the same, which would benefit companies everywhere.

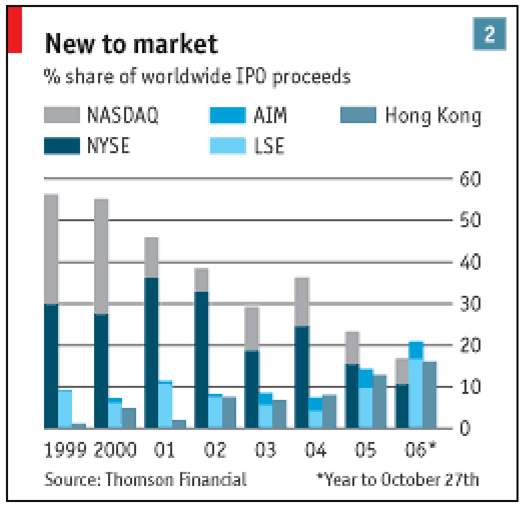
The advocates of reform see plenty of scope for improvement. The problem is not only Sarbanes-Oxley, they argue. Aggressive investigations by Eliot Spitzer forced the financial industry into settlements that curbed innovation as well as sharp practice. Federal regulators, desperate to keep up with the New York attorney-general (and now governor-elect), ran amok. Class-action lawyers have been allowed to wield too much power, and shareholders too little.



Whatever the causes, the numbers bear out America's slippage. It is still well ahead of Europe in hedge-fund and mutual-fund assets, securitisation, syndicated loans, and turnover in equities and exchange-traded derivatives. In all but one of these, however, the gap narrowed in 2005. Europe's corporate-debt market overtook America's last year (see chart 1), although America still leads in high-yield “junk” bonds, a distinction less dubious than it once was.

The loudest sucking sound has been in the market for initial public offerings, a crucial barometer of financial wellbeing. America's share (measured by proceeds) has collapsed since the late 1990s (see chart 2). Five years ago the New York Stock Exchange dwarfed London and Hong Kong.
This year it is being beaten by both.

Luigi Zingales, an economist who sits on the CCMR, says the figures suggest something fundamental has changed. He thinks the best guide to the competitiveness of America's markets is the behaviour of overseas firms that choose to list their shares at home and abroad. Even after stripping out factors that might skew the result, America's share of these “cross-listings” has fallen substantially in the past five years. Yet of the growing number of firms which are no longer cross-listing in America, more than 90% still choose to market their shares to investors in the United States under a rule known as 144A. This gives them access to the American market, but without the full registration and compliance costs.



Domestic firms are also fleeing the glare of public markets. According to Dealogic, more of corporate America was taken out of public ownership by private-equity firms (spending $178 billion) in the first ten months of this year than in the previous five years combined. Some cite Sarbanes-Oxley and other post-Enron costs as a reason, although, to be fair, private-equity is booming in the rest of the world, too.

Wall Street's rivals are fighting harder for business. London is now the world leader in the trading of foreign-exchange and over-the-counter (off-exchange) derivatives. It is seen as the natural home for firms from emerging markets: big Russian companies prefer to list there. Goldman Sachs is beefing up its London office, adding functions that it currently has only in New York. Hong Kong has benefited from the emergence of China and become an intra-Asian centre for capital-raising as well as trading. There is also fierce competition to lead regional financial markets, especially with a flashy bid from Dubai to dominate the Middle East and its oil money.

Open outcry

Technological innovation has made it easier for capital and those that need it to go where the best deals are available. As Messrs Bloomberg and Schumer see it, this has upset the “almost exquisite balance between regulation and entrepreneurial vigour” that helped America thrive in the last quarter of the 20th century. But Wall

Street's moneymen must take some of the blame: they were slower to embrace electronic trading than those in London.

Problems were compounded with tougher immigration controls after the 2001 terrorist attacks. With work visas harder to obtain, it can be extremely difficult for the managers of a global firm to gather in New York or Chicago at short notice. Meeting in London is much easier.

Aside from the visa question, which is hard to sort because it bumps up against security issues, there are four fundamental problems underlying America's declining competitiveness:

• **Section 404**. This is the most contentious part of Sarbanes-Oxley. It requires an annual "internal control report", which must be certified by auditors and personally signed off by two executives. It has concentrated minds, but raised costs considerably. Some say this is because it is being implemented too zealously.

Auditing expenses ballooned soon after the law was introduced. These have since fallen, but can still top several million dollars a year for a firm with a market capitalisation of $1 billion.

Because many of the costs of compliance are fixed, big companies find them easier to swallow. Some small firms cite this as a reason for listing on London's AIM market for young stocks; 50 American firms have done so, most of them since 2004. Hundreds of others are said to be considering it. Another spur has been the decline in coverage of smaller stocks since banks were forced by Mr Spitzer to tighten up their research procedures.

But Sarbanes-Oxley is not just about costs. In theory, a higher standard of corporate-governance should result in a higher valuation, since listing in a well-regulated market shows a commitment from a company that it will not abuse investors. If this premium is high enough, it will offset the costs of compliance. One study, conducted post-Sarbanes-Oxley, found that the premium placed on the value of an emerging-market firm listing in New York can reach 37%; preliminary research suggests the value of a London listing is not as high. Mr Zingales's calculations suggest that the New York premium outweighs costs for companies with a market value of more than $230m.

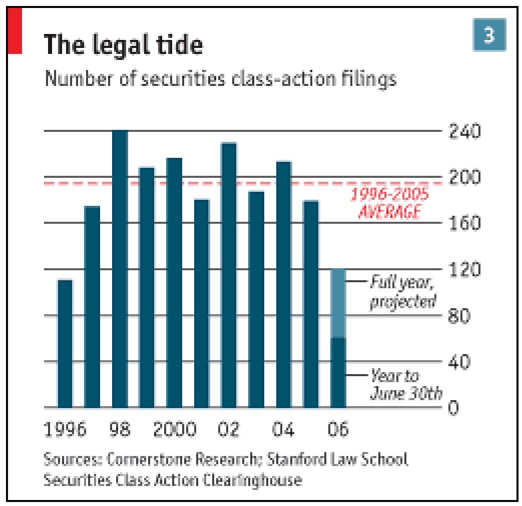
For the most part, reformers insist they are not out to gut Sarbanes-Oxley, but to make it more "risk-based". This means keeping the goals largely the same but giving firms and their auditors more leeway in achieving them. That battle may already be won: the Securities and Exchange Commission (SEC), America's chief market-regulator, and the Public Company Accounting Oversight Board, which was created by Sarbanes-Oxley, have both announced reviews of Section 404, hinting strongly that the burden will be eased, especially for smaller firms. On November 16th Christopher Cox, the SEC's chairman, promised "significant changes" in coming weeks.

A more radical recommendation, unlikely to be among the changes, would be to limit prosecutions to individuals rather than companies. This would avoid a repeat of the Arthur Andersen debacle, in which the accounting firm was driven out of business after being convicted of obstructing justice in the Enron case, only for the ruling to be overturned last year by the Supreme Court.

Some believe a wide-ranging rethink is needed on accounting standards. America continues to believe that its accounting rules are better than internationally accepted standards, even though studies suggest there is not a lot to choose between them. Foreign firms would be keener to list their shares in New York if they did not have to reconcile their accounts.

• **Litigation**. Many businessmen regard America's legal system, with its punitive jail terms and class-action lotteries, even less favourably than they view Sarbanes-Oxley. "For foreign companies we're a jungle," says a senior regulator. Asian firms, for instance, are still reluctant to risk being sued three years after China Life, an insurer, listed in New York and within days fell victim to a shareholder lawsuit. Most firms involved in mergers in America have to factor possible legal troubles into the costs of the deal, says Dick Langan of Nixon Peabody, a law firm.

Infographics



By some measures, the worst may have passed—though nobody is betting on it. The tide of post-Enron cases is ebbing. Cornerstone Research reckons there will be some 120 class-action filings this year, down from 179 last year (see chart 3). Aggressive law firms have also come under scrutiny. However, damages have continued to rise, from $1.1 billion in 1999 to $3.5 billion last year (excluding the $6 billion-plus WorldCom settlement).

Doesn't this merely show the legal system is doing its job in a country in which big rewards mean big incentives to cheat? Sensitive to such doubts—and painfully aware of the large political contributions of trial lawyers, predominantly to the resurgent Democrats—those pushing for change are, for now, eschewing a radical approach. The boldest suggestion is that damages should be agreed through arbitration, rather than awarded by juries.

•**Shareholder rights**. America may be the land of the free float, but its shareholders lack certain basic rights. For instance, they have only a limited say in electing company boards, unlike investors in Britain, and they have to contend with staggered boards (where only a fraction of the directors stands for re-election in a given year, making it impossible for a majority of shareholders to sack the board in one go). Add to that a proliferation of poison-pill takeover defences and the fact that it is boards, not shareholders, who vote on executive pay (again, unlike Britain).

• **Regulation**. There are three main areas of concern: how financial supervisors interact with the private sector; how they arrive at their decisions; and the fragmented nature of the rules. At the centre of all three sits the SEC. Once accused of being too slow to act, these days its perceived problem is hyperactivity, caused by what a senior regulator caustically calls the “Spitzerisation” of the agency.

This tough-guy approach is not entirely misplaced. The SEC has unparalleled numbers of retail investors to protect and it does not want to be outflanked by aggressive state prosecutors. But in striving to be tough, it may be losing sight of the need for markets to be efficient as well as clean.

Among the SEC's most vocal critics is Harvey Pitt, a former chairman. Most of its employees, he said recently, see it as an enforcement agency with regulatory powers, rather than the other way round. This shows up in salaries: the pay of its enforcement lawyers has shot up relative to other departments; by one estimate, over 700 of them now earn more than their chairman.

Part of the problem, says Peter Wallison of the American Enterprise Institute, is that the hard line sometimes takes on a life of its own. When wrongdoing is suspected or alleged, for instance, the SEC will open a so-called “matter under inquiry”. If this is not actively terminated within 60 days, it automatically becomes an informal investigation. Sometimes, says Mr Wallison, investigations open, and the companies involved suffer negative publicity, simply because nobody bothered to close the file.

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Blowing a bigger bonus

Some would like to see the SEC become more like Britain's super-regulator, the Financial Services Authority. The FSA has won plaudits for an approach based more on principles than hard rules. It prefers to nudge rather than bully. Moreover, it is widely considered to be better at analysing the potential costs and benefits of proposed regulatory changes. That may be because it employs a higher proportion of economists to lawyers.

The SEC, however, operates in a regulatory regime that is much more fragmented than in Europe. The number of federal and state bodies scrutinising a particular bit of the financial markets in America can lead to duplication and then to turf wars.

Rick Ketchum, head of regulation at the New York Stock Exchange, (and a former president of Nasdaq) says America's various regulatory bodies are now better at working with each other. But in some cases, he thinks, they might want to merge. A merger of the SEC and the Commodity Futures Trading Commission, for instance, would provide one agency to regulate the cash and derivatives markets, where boundaries are already becoming blurred.

All eyes on Capitol Hill

Whether these concerns are acted upon will depend largely, as ever, on politicians in Washington, DC. The Democrats, who retook control of Congress in the recent elections, are less likely to want to loosen financial-market laws than Republicans, and slightly more inclined to toughen up hedge-fund regulation.

That said, leading Democrats portray Sarbanes-Oxley as the other party's doing (even though it was a bipartisan bill) and may be prepared to see it tweaked. Barney Frank, a Democrat in line to run the House Financial Services Committee in the new Congress, has said he does not want to rewrite the law but would be willing to see regulatory agencies adjust their rules so that it is not applied so stringently. The CCMR also favours this milder type of non-legislative reform, because it would not require congressional approval.

But reformers must be careful not to appear to be pushing changes through the back door. Even before the CCMR's report is out, it has been denounced by some on the left as a self-interested attempt by big business and its Republican supporters to claw back lost ground now that the big post-Enron trials are largely over. Some in Washington refer to it as “the 7% committee”—a reference to the underwriting fees charged on Wall Street. Mr Scott, the committee's leader, denies any such bias.

Even if the angst is overdone, the competitive threat to America is real—as the Big Apple's hoarier financiers know only too well. They still sigh when recalling restrictions introduced in the 1960s that drove lenders and borrowers to London, where the Eurobond market promptly took off. The American government loosened the rules a decade later, but by then it was too late and London ran off with the business. This time they hope it will be different.