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The Wall Street Slide

BY GERARD BAKER

Why New York is losing out as the world's financial center.

Wall Street people are supposed to be go-getting, hard-charging, can-do types. Optimistic to a fault, masters of the universe aren't meant to spend a lot of time complaining about how unfair life is and how difficult it is to make a decent living these days.

But New York seems to have lost its mojo. You can't open a newspaper or turn on a financial news channel without hearing that the United States is losing its edge in global financial markets and that it's all the fault of an unfair system. The complaint is that burdensome regulations, most notably the Sarbanes-Oxley legislation passed by Congress in 2002 in the wake of the Enron and other financial scandals, has driven business away from New York, enriching other financial centers around the world such as London and Hong Kong.

The Wall Street whining has become so loud that politicians have got in on the act. At the end of last year Michael Bloomberg, the mayor of New York, and Chuck Schumer (D), the senior senator from the state, sponsored a report by McKinsey that documented New York's loss of competitiveness. In March this year Treasury Secretary Henry Paulson and Securities and Exchange Commission head Chris Cox assembled a glittering crowd of Wall Street and Washington mavens that included Warren Buffett, Robert Rubin, and Alan Greenspan for a therapy session at Georgetown University to discuss their problems. Mr. Paulson promised action to revive the competitiveness of American capital markets. Mr. Cox is working to loosen some of the offending rules.

But how serious is all this? Are U.S. financial markets really losing out to more nimble, less tightly regulated markets in Europe and Asia? And if they are, is it really the fault of Sarbanes-Oxley and other aspects of America's regulatory regime?

There is certainly solid evidence that New York is losing its status as the world's preeminent financial center. In that McKinsey report sponsored by Bloomberg and Schumer, the researchers

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concluded that the United States was still the world's number-one financial market, but that its lead had dropped sharply in recent years.

The report noted that while America still holds a lead, investment banking revenues in Europe were closing in on those of the United States in 2006. Further, last year the U.S. share of global initial public offerings was one-third what it had been in 2001 (symbolically, the last year before Sarbox). Europe's combined share was up by 30 percent. Asia's doubled. It then cited survey and anecdotal evidence that suggested people really did believe it was the regulatory environment that had been a key factor in America's declining share.

Further evidence for New York's loss of competitiveness comes from a study this year by the City of London. In March it published its latest "Global Financial Centres Index," an occasional survey of capital markets participants on the appeal of different cities around the world.

As it had in November 2005, the survey found that London was the world's favorite money center, with New York second and Hong Kong third. But London had increased its lead over Wall Street and Hong Kong was closing the gap. What's more, as with the McKinsey report, there was qualitative evidence that New York's burdensome regulations were to blame. In the November 2005 survey, people and skills were regarded as the most important factor determining the competitiveness of a financial center. But in March 2007 it was the regulatory and tax environment that was ranked highest.

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So the jury's in. Sarbox, with all its onerous requirements on accounting and corporate governance rules and its eye-wateringly large compliance costs, is driving companies out of U.S. markets and into the welcoming arms of light-touch regulatory regimes in London and Hong Kong.

Not so fast.

That the United States has lost market share is not in question. But is it really so clear that this is because of regulation and not simply the result of the globalization of economies and financial markets in the last decade?

Confining the focus to the post-Sarbox period, as these reports do, conveniently ignores the fact that New York has been losing market share for at least decade.

As European financial markets have integrated in the last decade, London—despite the United Kingdom being outside the eurozone—has emerged as the consolidated financial market for the continent. That says much more. In the first quarter of this year, the combined market capitalization of companies quoted on European exchanges actually outstripped that of American companies for the first time since the First World War. That isn't really because of regulatory differences, but is simply a reflection of a more balanced global capital system.

In London, the head of the Financial Services Authority, Sir Callum McCarthy, bristles at the idea that the City is engaged in a kind of regulatory arbitrage, offering a soft-touch for companies looking to hide from tough American regulators. He points out that the FSA has a lengthy rule book running to a thousand or more pages, and that the agency has a more active role in some important financial sectors—such as hedge funds—than do U.S. regulators. What's more, many of the corporate governance rules in London and Hong Kong are much more rigorous than they are in the United States. The rights of shareholders, for example, to challenge management are much better entrenched in London than they are in New York—one reason that private equity has been such

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Anglo-American Common Law

The most striking thing thrown up by the changes in the relative merits of global financial centers in the last few years is this: As the global economy integrates, its financial markets are being steadily dominated by a few of the world's great cities—New York included. According to that City of London survey, the top eight financial markets in the world now include London, New York, Hong Kong, Singapore, Sydney, and Chicago.

What do these great financial centers have in common? Most obviously, a corporate legal framework that rests on the foundation of the distinctive common law system, the most efficient and equitable framework ever devised to ensure the smooth running of free capitalism. This Anglo-American common law approach differs fundamentally from the legal systems of Europe and most of Asia in its flexibility and reliability. It is no accident that, as capitalism has gone truly global in the last ten years, financial centers steeped in that tradition have moved to pre-eminence.

—G. Baker

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an attractive option for many companies based in the United Kingdom in the last couple of years.

Rep. Barney Frank (D-MA), the new chairman of the House Financial Services Authority who is looking into these claims that Sarbox has overreached, greeted a recent visitor, a senior official from London's regulatory bodies, with a simple question: "Are we in the United States not overselling the virtues of the FSA?"

Similarly, the growth of Hong Kong's equity markets is directly proportionate to the explosive growth of China as a major economy in the last decade. The former British colony last year hosted the world's single largest IPO and did indeed rank second in total IPOs. But that was because all of its big issues were mainland Chinese companies seeking to tap international financial markets.

"I know of no Chinese companies that have seriously thought about New York versus Hong Kong and opted for Hong Kong because of its regulatory regime," Ron Arculli, the chief executive of the Hong Kong Stock Exchange, told me earlier this year.

In any case, as Warren Buffett pointed out at that meeting Treasury Secretary Paulson arranged in Washington, if U.S. capital markets are so badly damaged, why are these such great times financially for U.S. companies?

"Profits as a share of GDP have never been higher. Return on tangible equity has never been higher," he told his querulous Wall Street friends.

None of this is to say that America's financial system is currently perfect, or couldn't be improved with the lubrication of somewhat less onerous regulation. The SEC recently relaxed one of the most notorious of Sarbox's provisions—the Section 404 rules on delisting.

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But many of America's regulatory problems go beyond Sarbox.

The United States is surely also losing some global business because of the ease with which litigants can sue American companies in the courts for all kinds of trivial reasons. The United States presumably suffers too because of its multi-layered and overlapping regulatory agencies—the alphabet soup of SEC, CFTC, FDIC, and others, as well as the Fed, and countless state regulators.

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As capitalism advances further it is what unites London, New York and Hong Kong that truly matters, not what divides them. ◆