Sustaining New York's and the US' Global Financial Services Leadership

THE CITY OF NEW YORK
OFFICE OF THE MAYOR
NEW YORK, NY 10007

UNITED STATES SENATE

Dear Fellow Americans,

The 20th Century was the American century in no small part because of our economic dominance in the financial services industry, which has always been centered in New York. Today, Wall Street is booming, and our nation's short-term economic outlook is strong. But to maintain our success over the long run, we must address a real and growing concern: in today's ultra-competitive global marketplace, more and more nations are challenging our position as the world's financial capital.

Traditionally, London was our chief competitor in the financial services industry. But as technology has virtually eliminated barriers to the flow of capital, it now freely flows to the most efficient markets, in all corners of the globe. Today, in addition to London, we're increasingly competing with cities like Dubai, Hong Kong, and Tokyo.

The good news is that we're still in the lead. Our financial markets generate more revenue than any other nation, and we continue to be home to the world's leading companies, which help form the backbone of our national economy. In fact, for every 100 Americans, five work in financial services – and these jobs are not just in New York and Chicago. In states as diverse as Connecticut, Delaware, South Dakota and North Carolina, the financial services industry employs major portions of the workforce.

All Americans have a vested interest in strengthening America's financial services industry, and the time has come to rally support for this effort. To stay ahead of our hard-charging and dynamic international competitors, and to ensure our nation's long-term economic strength, we can no longer take our preeminence in the financial services industry for granted. In fact, the report contains a chilling fact that if we do nothing, within ten years while we will remain a leading regional financial center; we will no longer be the financial capital of the world. We must take a cold, hard look at the industry, identifying our weaknesses, learning from the best practices of other nations, and drawing upon strategies that will allow us to adapt to the changing realities of the market. That is exactly why we commissioned this report.

The report provides detailed analyses of market conditions here and abroad, informed by interviews with more than 50 respected leaders drawn from the financial services industry, consumer groups, and other stakeholders. The findings are quite clear: First, our regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as is the case in the United Kingdom and elsewhere. The flawed implementation of the 2002 Sarbanes-Oxley Act (SOX), which produced far heavier costs than expected, has only aggravated the situation, as has the continued requirement that foreign companies conform to U.S. accounting standards rather than the widely accepted – many would say superior – international standards. The time has come not only to re-examine implementation of SOX, but also to undertake broader reforms, using a principles based approach to eliminate duplication and inefficiencies in our regulatory system. And we must do both while ensuring that we maintain our strong protections for investors and consumers.

Second, the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation. While nobody should attempt to discourage suits with merit, the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business – and driven away potential investors. In addition, the highly complex and fragmented nature of our legal system has led to a perception that penalties are arbitrary and unfair, a reputation that may be overblown, but nonetheless diminishes our attractiveness to international companies. To address this, we must consider legal reforms that will reduce spurious and meritless litigation and eliminate the perception of arbitrary justice, without eliminating meritorious actions.

Third, and finally, a highly skilled workforce is essential for the U.S. to remain dominant in financial services. Although New York is superior in terms of availability of talent, we are at risk of falling behind in attracting qualified American and foreign workers. While we undertake education reforms to address the fact that fewer American students are graduating with the deep quantitative skills necessary to drive innovation in financial services, we must also address U.S. immigration restrictions, which are shutting out highly-skilled workers who are ready to work but increasingly find other markets more inviting. The European Union's free movement of people, for instance, is attracting more and more talented people to their financial centers, particularly London. The United States has always been a beacon for the world's best and brightest. But to compete with the growing EU and Asian markets—in a way that grows our economy and creates jobs across the nation—we must ensure that we make it easier for talented people to move to the U.S. to pursue education and employment.

We know that addressing these challenges, and ensuring that we do so in a way that continues to offer strong protections to consumers and investors, will not be easy. But other nations have succeeded in this effort, and so too must we. The industry will continue to experience rapid growth in the 21st Century, which holds great promise for our nation – but only if we take seriously our competitors, who are rapidly gaining ground. Failing to do so would be devastating both for New York City and the entire nation.

In the weeks and months ahead, we will work together to implement the state and local reforms necessary to strengthen New York City's position as the world's financial capital. At the same time, we will work with Congress, the Administration, regulators industry leaders, and other stakeholders to take the necessary steps to ensure that America retains its dominant position in the financial services industry in the 21st Century. It is our hope that this report will call attention to the challenges we face in meeting this goal, and serve as a call to action for members of both political parties, and for leaders of every branch of government.

Sincerely,

Michael R. Bloomberg

Charles E. Schumer

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Executive Summary

Given the importance of the United States' financial markets to the national economy, their competitiveness has become a critical issue that merits a prominent place in the national policy agenda. US Treasury Secretary Henry M. Paulson focused on this issue in a recent speech, describing the US capital markets as the "lifeblood of our economy."[1] With financial services representing 8 percent of US GDP[2] and more than 5 percent of all US jobs,[3] the sector is too big and important to take for granted. New York City Mayor Michael R. Bloomberg and US Senator Charles E. Schumer also recently spoke out on the need for greater balance between innovation and regulation, stating, "Unless we improve our corporate climate, we risk allowing New York to lose its preeminence in the global financial services sector. This would be devastating for both our City and nation."[4] The most pressing issues affecting New York's leadership as a global financial hub, including regulation, enforcement, and litigation, are national issues that affect other US financial centers as well.

In this context, Mayor Bloomberg and Senator Schumer asked McKinsey & Company to work with the New York City Economic Development Corporation (NYCEDC) to develop a better understanding of the contribution that strong, innovative financial markets can make to a vibrant economy. The Mayor and the Senator sought a comprehensive perspective on the competitiveness of the overall US financial services sector, with particular emphasis on New York's contribution. While this report considers a broad definition of financial services – including retail and corporate banking, securities, and insurance – in understanding the sector's importance to the US and New York economies, it focuses primarily on US competitiveness in the securities and investment banking sectors, where competition among global financial centers is most intense and where New York has the most at stake.

To bring a fresh perspective to this topic, a McKinsey team personally interviewed more than 50 financial services industry CEOs and business leaders. The team also captured the views of more than 30 other leading financial services CEOs through a survey and those of more than 275 additional global financial services senior executives through a separate on-line survey. To balance this business perspective with that of other constituencies, the team interviewed numerous representatives of leading investor, labor, and consumer groups. McKinsey also interviewed and, in some cases, worked with leaders and other subject matter experts in the regulatory, legal, and accounting professions. McKinsey complemented this primary research with its own financial services industry knowledge base, as well as secondary research into topics including investment banking, employment, immigration, litigation and regulation.

The following report, *Sustaining New York's and the US' Global Financial Services Leadership*, is based on this research. It proposes recommendations, intended for policy makers and all interested parties, that strive to ensure the future competitiveness of US and New York financial services. This report, which touches on a broad range of legal, regulatory, accounting, and other issues, was developed within a short timeframe and does not purport to provide a comprehensive macro-economic analysis nor a thorough consideration of every relevant issue. As such, these recommendations should be viewed as a starting point for further reflection and debate by parties interested in enhancing the value of US financial services to all stakeholders. Other groups, including the Committee on Capital Markets Regulation and the bipartisan Commission on Regulation of US Capital Markets in the 21st Century, are also currently studying issues related to financial services competitiveness. Their findings and recommendations should help further inform the debate and serve to clarify and refine the recommendations in this report, which are by necessity limited in their level of specificity.

After this Executive Summary, the report contains four sections. Section I demonstrates why financial services leadership is an economic priority for the US, New York, and several other important US financial centers. Section II analyzes the extrinsic international trends that are stimulating the rise of other financial services centers and clearly defines where the problem lies for both the United States in general and for New York City in particular. Section III evaluates critical intrinsic factors for global financial services competitiveness, including how the United States is jeopardizing its lead in talent and falling behind in legal and regulatory competitiveness. Finally, Section IV proposes an integrated set of recommendations that holds the potential to address the negative intrinsic drivers of the current loss in financial services competitiveness and to re-affirm the global financial services preeminence of the US and New York.

GLOBAL FINANCIAL SERVICES LEADERSHIP: A NATIONAL PRIORITY

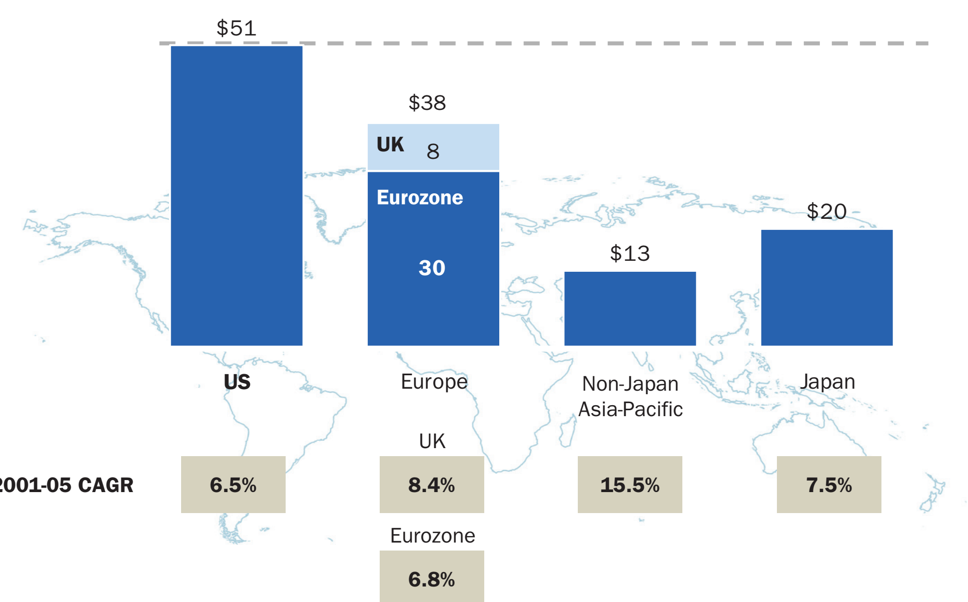
Leadership in global financial services is vitally important to the United States as a whole, as well as to the City and State of New York. Leadership in this large, high-growth sector translates into substantial economic activity, direct and indirect job creation, and tax revenues for the US, New York, and other financial services centers around the country. Further, because financial institutions provide invaluable intermediation and facilitation services to all businesses, a strong financial services sector is critical to the health of the overall economy.

The US financial markets, with New York at the center, are still the world's largest and are among the most important by many measures. The United States is home to more of the world's top financial services institutions than any other country: six of the top ten financial institutions by market capitalization are based in the New York area, and US-based firms still head the global investment banking revenue rankings. In terms of global financial stock,[5] the United States remains the largest market, well ahead of Europe, Japan, and the rest of Asia (Exhibit 1), although the financial stock in other

Exhibit 1

US FINANCIAL STOCK SIGNIFICANTLY LARGER THAN OTHER REGIONS, BUT GROWTH RATE IS LOWER

$ Trillions, 2005, Percent



Source: McKinsey Global Institute; Global Insight regions is now growing faster than it is in the United States. The US generates more revenues from financial services than any other region but, once again, the rest of the world is challenging that leadership in the hotly contested investment banking and sales and trading markets. Finally, as cross-border capital flows have accelerated, the United States, along with the United Kingdom, has benefited disproportionately.

Financial services is the third-largest sector of the US economy, contributing 8 percent of GDP – only manufacturing and real estate are more significant. Financial services is also among the three fastest-growing sectors with an average annual growth rate of 5 percent over the past decade, compared to a 3.2 percent average growth rate for the economy as a whole. Seven states, including New York (as well as Connecticut, Delaware, Massachusetts, North Carolina, Rhode Island, and South Dakota) count on financial services for 10 percent or more of their real gross product. In terms of employment, 1 in every 19 jobs in the country is in financial services. In states as diverse as Connecticut, Delaware, and South Dakota, financial sector employment accounts for 8 to 10 percent of non-farm private sector jobs.

The sector is particularly important to New York City, where it represents 15 percent of the gross city product (GCP), second only to real estate. It is also the City's fastest-growing sector, with average annual GCP growth of 6.6 percent[6] from 1995 to 2005, compared with the City's overall growth rate of 3.6 percent. Financial services are a vital component of the City's tax base, contributing over a third of business income tax revenues. One in every nine jobs in New York City is in the financial services industry and, according to a recent study by the New York State Comptroller, every securities job accounts for two additional jobs in other industries, in particular in retail and professional services.

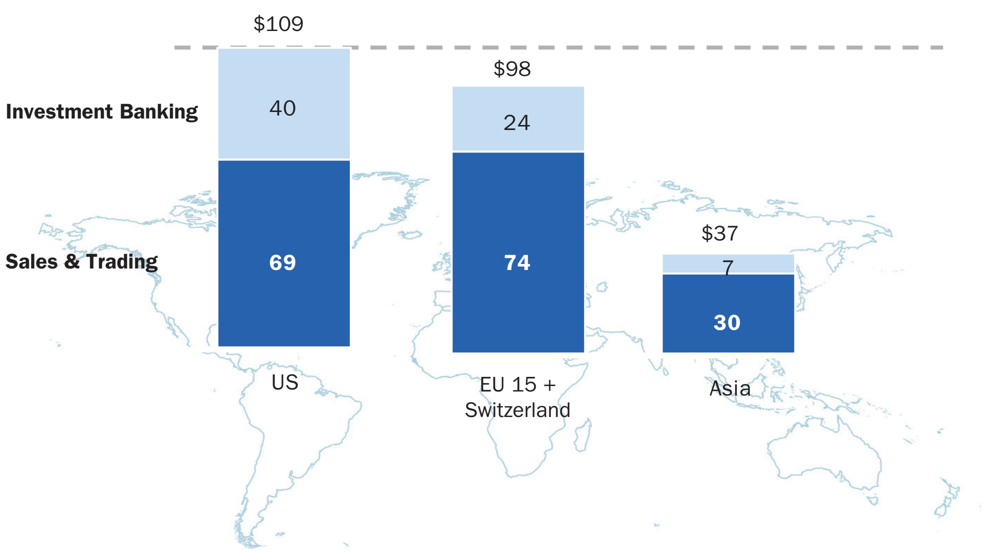
EXTERNAL FORCES UNDERMINING THE NATION'S AND NEW YORK'S FINANCIAL SERVICES PREEMINENCE

The threat to US and New York global financial services leadership is real: in the highly lucrative investment banking and sales and trading businesses, European revenues are now nearly equal to those in the US (Exhibit 2). It is clear that the country and the City need to take this threat seriously. In so doing, it is crucial to separate the effects of the natural maturing of foreign markets, which is an extrinsic phenomenon beyond the control of US policy makers, from the more intrinsically sourced practices and conditions that make the US and New York less competitive, and which are well within policy makers' power to influence.

Exhibit 2

EUROPE'S INVESTMENT BANKING AND SALES & TRADING REVENUES NOW NEARLY EQUAL TO US

Investment Banking and Sales & Trading Revenues, $ Billions, 2005



Source: McKinsey Corporate and Investment Banking Revenues Survey

At some level, it is inevitable that other national markets will become more attractive to industry participants as they grow faster than those in the US, albeit from a smaller base. Both European and Asian capital markets (i.e., the outstanding stock of equities and debt instruments) are smaller as a percentage of total financial stock and GDP than those in the United States, implying that these markets have more room to expand. Continued economic liberalization and the introduction of new market-oriented regulations are working to stimulate this growth. Moreover, technology, trading markets, and communication infrastructures are evolving to make real-time interactions and transactions possible and affordable from virtually anywhere, thus reducing some of the benefits of physical co-location in major financial centers such as New York.

However, in looking at several of the critical contested investment banking and sales and trading markets – initial public offerings (IPOs), over-the-counter (OTC) derivatives, and debt – it is clear that the declining position of the US goes beyond this natural market evolution to more controllable, intrinsic issues of US competitiveness. As market effectiveness, liquidity and safety become more prevalent in the world's financial markets, the competitive arena for financial services is shifting toward a new set of factors – like availability of skilled people and a balanced and effective legal and regulatory environment – where the US is moving in the wrong direction.

The choice of venue for IPOs offers the most dramatic illustration of the interplay between these factors. The world's corporations no longer turn primarily to stock exchanges in the United States, such as the NYSE or NASDAQ, to raise capital internationally. Over the first ten months of 2006, US exchanges attracted barely one-third of the share of IPOs measured by market value that they captured back in 2001, while European exchanges increased market share by 30 percent and Asian exchanges doubled their share. In part, this is because more European and Asian markets are now deep enough to meet large companies' capital needs locally. However, New York's decline in international capital raising is also due to non-US issuers' concerns about compliance with Sarbanes-Oxley Section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment. The IPO market offers other examples of jurisdictional arbitrage working against the United States, with very small-cap companies in the US increasingly favoring London's Alternative Investment Market (AIM) over NASDAQ and American private equity firms choosing to list on European exchanges.

While US-headquartered financial institutions do not feel the brunt of this relative decline in the preeminence of America's equity capital markets, due to their increasingly international stature and ability to compete against local financial institutions on transactions taking place in foreign markets, this trend is nevertheless significant because it entails a net loss of jobs and indirect revenues. As the international importance of America's capital markets recedes and the nation's leading financial institutions come to derive an increasing share of their revenues from foreign operations, more and more high value-added financial services jobs are likely to move abroad. Anecdotal evidence confirms that this shift is already under way. The trend in the equity capital markets is thus particularly worrisome not only because of the significant linkages that exist between IPOs and other parts of the financial services economy, but also because of the importance of financial services jobs to the US, New York, and other leading US financial centers in terms of both direct and indirect employment, as well as income and consumption tax revenues.

The rapidly growing derivatives market is another area where the US finds itself in a heated contest with international competitors. While Chicago leads in exchange-traded derivatives, Europe – and London in particular – is already ahead of the US and New York in OTC derivatives, which drive broader trading flows and help foster the kind of continuous innovation that contributes heavily to financial services leadership. Europe has a 56 percent share of the $52 billion global revenue pool from derivatives; it has a 60 percent or greater share of revenues in interest rate, foreign exchange, equity and fund-linked derivatives (the US leads only in commodity derivatives). Many of these businesses grew from nothing in the past 5 to 10 years and could be located anywhere. "The US is running the risk of being marginalized" in derivatives, to quote one business leader, because of its business climate, not its location. The more amenable and collaborative regulatory environment in London in particular makes businesses more comfortable about creating new derivative products and structures there than in the US. The more lenient immigration environment in London also makes it easier to recruit and retain international professionals with the requisite quantitative skills. Finally, the FSA's greater historical willingness to net outstanding derivatives positions before applying capital charges has also yielded a major competitive advantage for London.

While the US remains the center of innovation for leveraged lending (i.e., the lending of capital to companies with a rating below investment-grade) and securitization, it is facing challenges to its leadership in these markets as well. The US controlled over 60 percent of leveraged lending issuance by value and approximately 70 percent of revenues in 2005. America's leadership in securitization is even more striking, with the US market representing approximately 83 percent of global issuance by value and 87 percent of revenues in 2005. However, European lenders are beginning to embrace US-style credit terms, critical to the leveraged lending and sub-prime consumer finance markets. This should position Europe to enjoy explosive securitization growth in the near future, similar to what occurred in the US over the past decade. Further, European control of the credit derivatives markets is beginning to shape and drive the structure of the underlying cash lending markets. Whereas historically US markets and financial institutions often benefited from the ability to set market standards, this trend could lead to a deterioration in US competitiveness if markets and institutions fail to follow the pace increasingly set by their European competitors.

Compounding matters, US regulators' proposed amendments to the Basel II standards (i.e., the recommendations agreed upon by numerous international bank supervisors and central bankers to revise the international standards for measuring the adequacy of bank capital) could put US banks at a capital disadvantage relative to their international competitors. This could put a brake on US leadership in these markets and even reduce the likelihood that future innovations in the credit arena will occur in the US. Finally, London is transforming itself into an increasingly sizeable and attractive talent hub for people with the kind of structuring and pricing skills that used to be available only in New York, thereby reducing America's talent advantage and further increasing the likelihood that tomorrow's debt innovations will occur in London rather than New York.

In short, America's historical preeminence in financial services will face some natural erosion as extrinsic forces prompt foreign markets to grow faster in both established products, such as IPOs and traditional lending, and in newer and faster growing areas, such as derivatives and securitization. Nevertheless, America's current size and stature as a financial leader confers upon US markets and institutions a number of advantages which, if properly supported by an efficient and responsive regulatory and legal framework, should allow the US to remain the global financial services leader of tomorrow. However, time is of the essence for US policy makers to turn their attention to the factors of competitiveness they do control, as the global macroeconomic trends described above are steadily reducing the margin of error that the US historically enjoyed.

DOMESTIC DRIVERS OF COMPETITIVENESS THAT POLICYMAKERS CAN INFLUENCE

The attitudes of financial services leaders in the US and overseas, revealed in interviews and surveys, further elucidate the thinking that is shifting globally contestable business away from US markets. Despite positive sentiments about New York as a center for financial services and as a place to work and live, interviewees agreed that New York has become less attractive relative to London over the last three years. Looking ahead to the next three years, about two-fifths of CEOs surveyed expected that New York City would become less attractive as a place to do business, whereas less than one-fifth felt it would become more attractive absent some intervention by policy makers. By contrast, only a few CEOs surveyed expected that London would become less attractive as a place to do business, but over half expected it would become more attractive. Senior executives surveyed had similar, although less pronounced, views.

Perceptions, of course, are one thing, but these decision-makers' views are being played out in the job market: from 2002 to 2005, London's financial services workforce grew by 4.3 percent, while New York City's fell by 0.7 percent, a loss of more than

2,000 jobs. The size of the industry's workforce in both cities is now almost identical, with 328,400 jobs in New York in 2005, as compared with 318,000 jobs in London.

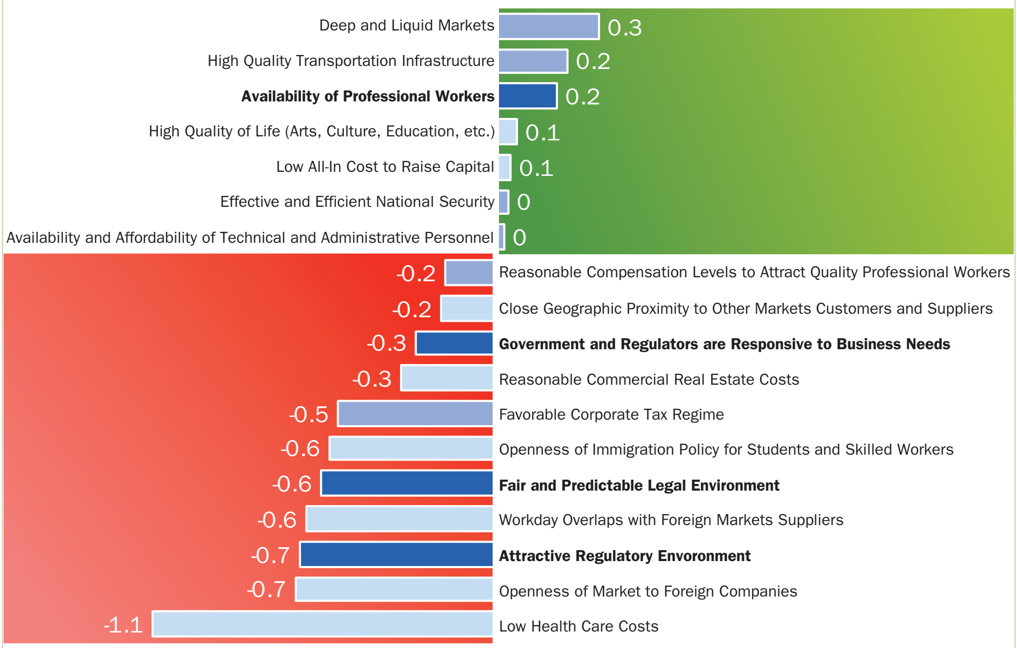
The research findings confirm the advantages of deep, liquid, transparent markets, supported by strong protection for consumers and investors. However, the findings also identify three factors that clearly dominate financial services leaders' views of New York – and by extension the United States – as a place to do business: skilled workers, the legal environment, and regulatory balance (including responsiveness by regulators and the overall regulatory environment). In each area, there are growing concerns that policy makers should consider in order to reverse the declining appeal and competitiveness of the financial markets in the United States and New York City (Exhibit 3).

Exhibit 3

AMONG HIGH IMPORTANCE FACTORS, NEW YORK EXCELS IN TALENT BUT UNDERPERFORMS IN LEGAL AND REGULATORY

Performance gap, rating scale

Importance*
High
Medium
Low



* High importance factors were rated between 5.5-6.0 on a 7-point scale; medium between 5.0-5.4; low were less than 5.0

Source: McKinsey Financial Services Senior Executive Survey

Skilled People. A high-quality workforce is essential for any financial center, and financial sector executives rated "talent" (highly skilled professional workers) as the most important factor among 18 elements that define the success of a financial center. They also perceived New York to be superior to London on that measure. According to the survey, one reason for New York's advantage is cost of living: respondents consider the two cities to be neck-and-neck in terms of quality of life, but they see London as markedly more expensive. Executives interviewed for this report also described a virtuous circle effect in New York, whereby innovative, dynamic skilled professionals attract others like them.

New York's lead over London, however, may be under threat. The problem facing New York appears to be more structural than cultural. US immigration policies are making it harder for non-US citizens to move to the country for education and employment, which works directly against New York's competitive advantage. The disparate outcomes resulting from the discretionary application of rules on visitor visas, caps on crucial H-1B work visas, and the lag between expiring student visas and work visa start dates are all encouraging talented people from around the world to turn elsewhere for work. By contrast, the free movement of people within the European Union is enabling the best people to concentrate in other financial centers – particularly London – where immigration practices are more accommodating.

Legal Environment. Survey respondents said that a fair and predictable legal environment was the second most important criterion determining a financial center's competitiveness. In this regard, they felt that the United States was at a competitive disadvantage to the United Kingdom. They attribute this US disadvantage to a propensity toward litigation and concerns that the US legal environment is less fair and less predictable than the UK environment. Empirical evidence certainly suggests that litigation has become an important issue: 2005 set a new high for the number of securities class-action settlements in the US, and for the overall value of these settlements. Of course, many of these cases addressed the legitimate claims of investors and consumers in situations of notable corporate wrongdoing. However, in aggregate, some of the unique characteristics of the US legal environment are driving growing international concerns about participating in US financial markets – concerns heightened by recent cases of perceived extraterritorial application of US law.

One particular challenge facing financial services companies operating in the United States is the multi-tiered and highly complex nature of the US legal system. Not only is it divided between state and federal courts, but it also uses a variety of enforcement mechanisms, including legal actions by regulators, state and federal attorneys general, plaintiff classes, and individuals. The efforts of this diverse set of actors have served American companies, investors and consumers well in the past. However, the lack of coordination and clarity on the ways and means of enforcement have led to a perception – voiced by participants in the surveys and interviews conducted for this report – that the US system is neither fair nor predictable. Respondents therefore uniformly indicated an interest in marrying strong enforcement backed by punitive penalties for corporate malfeasance with legal reform that would improve clarity and predictability for all parties.

Regulatory Balance. Regulatory responsiveness and the overall regulatory environment were the third and fourth most important issues for survey respondents and interviewees. They indicated that a very strong regulatory system was vital in giving all market participants confidence – and that the US clearly enjoys the benefits of such a system. However, the system also needs to adapt as markets and regulated institutions undergo constant change against a background of rapid globalization. Here again, survey respondents rated the United Kingdom more favorably than the United States, pointing to regulatory structure and other recent regulatory trends as damaging US competitiveness in financial markets.

Business leaders increasingly perceive the UK's single, principles-based financial sector regulator – the Financial Services Authority (FSA) – as superior to what they see as a less responsive, complex US system of multiple holding company and industry segment regulators at the federal and state levels. Regulatory enforcement style also matters, with the UK's measured approach to enforcement seen as more results-oriented and effective than a US approach sometimes described as punitive and overly public. Recent US legislative and regulatory action, such as the implementation of the 2002 Sarbanes-Oxley Act, the proposed US implementation of Basel II risk-based capital requirements, and the continued requirement for foreign companies to conform to US accounting standards, also put the United States at a competitive disadvantage according to the senior executives surveyed.

RECOMMENDATIONS TO SUSTAIN THE NATION'S AND NEW YORK'S GLOBAL FINANCIAL SERVICES LEADERSHIP

This report outlines three sets of integrated recommendations, based on the research conducted, that are aimed at making US financial markets more competitive. First among them are critical national legal and regulatory priorities that can and should be addressed quickly. These recommendations are already gaining acceptance with industry leaders and policy makers and, at least in some cases, solutions are forthcoming. Second are recommendations for leveling the competitive playing field between the US and other international markets, by re-examining several areas where US standards may be unnecessarily restrictive when compared to international alternatives. Third are national-level recommendations aimed at sustaining reinvigorated US financial market leadership over the longer term.

The report also outlines a set of specific recommendations for how New York City, working in partnership with the private sector, can continue to enhance its attractiveness as a center for financial services business activity. These include New York playing a more active role in the national financial services agenda and working with other states that also depend on the sector.

In addition to maintaining the safety and soundness of the financial system, a prime consideration in drawing up these proposals has been to strike a better balance between competition and innovation on the one hand, and strong financial regulation on the other. "If America's markets aren't competitive, investors lose," said SEC Chairman Christopher Cox. "If America's markets are not transparent and open, investors lose."[7] Although the competitiveness of the US financial services industry has declined, any recommendations to

NATIONAL AGENDA

Critically important near-term priorities

1. Provide clearer guidance for implementing the Sarbanes-Oxley Act
2. Implement securities litigation reform
3. Develop a shared vision for financial services and a set of supporting regulatory principles

Initiatives to level the playing field

4. Ease restrictions facing skilled non-US professional workers
5. Recognize IFRS without reconciliation and promote the convergence of accounting and auditing standards
6. Protect US global competitiveness in implementing Basel II

Important longer-term national priorities

7. Form a National Commission on Financial Market Competitiveness
8. Modernize financial services charters

improve that position must preserve the fundamental investor protections that have contributed to the US' global financial services leadership. "The lesson of competitiveness is critical but let's not forget the lessons of integrity," commented New York Governor Eliot Spitzer while he was the State's Attorney General.[8] These recommendations are meant to encourage regulators, Congress and the executive branch to continue to use powers already granted when possible, to pass new legislation when needed, and to work together to lead the world in best practices across all the factors that determine financial services competitiveness.

Left unmanaged, today's trends in the US financial markets could have a significant negative impact on the economy: the United States would lose substantial market share in investment banking and sales and trading over the next five years. The 2004-05 revenue growth rates for Europe and Asia were approximately 25 percent and 19 percent, respectively, compared with a US growth rate of 6 percent. This implies a growth rate of 15 percent for the global revenue pool. Even if global growth rates slowed to a more sustainable rate of 8 to 10 percent, the US would stand to lose between 4 and 7 percent market share over the next five years. Stopping this loss of share would add approximately $15 billion to $30 billion in incremental financial services revenues to the US in 2011 alone. Assuming a constant relationship between revenues and jobs, that would translate into between 30,000 and 60,000 securities sector jobs; it would also stimulate indirect jobs in the other industries.

Section IV of this report outlines these recommendations in substantially more detail. A brief summary follows below.

Critically important near-term national priorities

- **Recommendation 1 – Provide clearer guidance for implementing the Sarbanes-Oxley Act.** The Securities and Exchange Commission (SEC) and the Public Companies Accounting Oversight Board (PCAOB), in consultation with business and public accounting firms, should follow through on their recently proposed revisions to the guidelines controlling the implementation of Section 404 of the Sarbanes-Oxley Act. Provided that, upon their adoption, they afford guidance beyond what is currently proposed with regard to the notion of "material weakness," these proposals should ensure that the audit of internal controls takes a top-down perspective, is risk-based, and is focused on the most critical issues. The guidance should also enable auditors and management to exercise more judgment and emphasize materiality. Taking full account of the constructive observations that will result from the notice and comment periods to which both proposals are currently subject, the SEC and PCAOB should seek to implement the proposed revisions quickly and effectively, resisting pressure to dilute the recommendations, as doing so would severely undermine the proposals' important signaling benefits.

Depending on the extent to which the revised guidelines empirically reduce the particularly significant compliance burden that Sarbanes-Oxley imposes on smaller companies, as explained in more detail in Recommendation 2, the SEC may want to consider giving such companies the opportunity to "opt out" of the more onerous requirements of Sarbanes-Oxley, provided that this choice is conspicuously disclosed to investors. The SEC should also consider exempting foreign companies from certain parts of Sarbanes-Oxley, provided they already comply with sophisticated, SEC-approved foreign regulators. This would make US capital markets more attractive to smaller companies and foreign corporations without unduly jeopardizing investor protection and the quality of corporate governance. It would also address international concerns about the extraterritorial application of US regulations by showing appropriate deference to foreign regulators.

These administrative measures will, without legislative change, address the unintended cost of implementing Sarbanes-Oxley while maintaining the intended deterrent to corporate malfeasance. They will at least partially address the concerns of small companies and non-US issuers regarding the Section 404 compliance costs involved in a US listing. Finally, these measures will send an important signal to the global financial community that regulators are appropriately balancing business and investor interests.

- **Recommendation 2 – Implement securities litigation reform.** The SEC should make use of its broad rulemaking and exemptive powers to deter the most problematic securities-related suits. For example, the SEC could invoke Section 36 of the Securities Exchange Act of 1934, which effectively allows it to exempt companies from certain onerous regulations where it deems such exemptions to be in the public interest. Within the confines of the SEC's authority under the 1934 Act, the Commission therefore could, pursuant to a thorough cost/benefit analysis, choose to: limit the liability of foreign companies with US listings to securities-related damages proportional to their degree of exposure to the US markets; impose a cap on auditors' damages that would maintain the deterrent effect of large financial penalties while also reducing the likelihood of the highly concentrated US auditing industry losing another major player; and give smaller public companies the ability to "opt out" of some portions of Sarbanes-Oxley (although only if they conspicuously disclose the fact to investors and provided that sufficient investor-protection safeguards are otherwise retained).

The SEC should also leverage the tacit influence it has over the securities industry to promote arbitration as a means of resolving securities-related disputes between public companies and investors. Historically, the SEC has been opposed to arbitration, but reversing this position would bring it more in line with broader enforcement trends. Arbitration would substantially reduce the costs that companies face in the course of protracted litigation and discovery, it would provide aggrieved plaintiffs with more timely and cost-effective remedies, yet it would not diminish the SEC's ability to initiate enforcement actions on investors' behalf.

Legislative reform is also needed to address the long-term, structural problems that underpin the trend toward increasing litigation in the securities industry. Congress should thus consider legislative means of addressing concerns around the quantity and unpredictability of litigation relative to other countries. Changes to consider could include limiting punitive damages and allowing litigating parties in federal securities actions to appeal interlocutory (non-final) judgments immediately to the Circuit Courts. The latter proposal would reduce the overall legal burden on listed companies by reducing the frequency of settlements based less on the merits of the case than on the prospect of protracted litigation.

Legislative and enforcement-level reform will require a careful balancing of interests: it should seek to eliminate suits filed to place unwarranted pressure on companies to settle, while maintaining the ability of plaintiffs with valid claims to recover appropriate damages. Arguably, the right reforms, supported by rigorous cost/benefit analyses, could benefit legitimate plaintiffs, investors, and corporations alike by providing greater predictability and making better use of judicial resources.

- **Recommendation 3 – Develop a shared vision for financial services and a set of supporting regulatory principles.** Under the leadership of the Secretary of the Treasury and the Presidential Working Group on Financial Markets, federal financial regulators should work together to develop, agree on, and pursue a shared vision for the importance and strategic direction of the financial sector and its impact on global competitiveness, innovation to meet customer needs, the management of systemic risks, the ethical conduct of business, the financing of a growing economy, and the creation of new jobs. This shared vision should be supported by a common set of principles for the regulation and supervision of financial institutions operating in the United States. These principles could include, for example, cost/benefit analysis, materiality tests, collaborative rulemaking and enforcement, and an escalation process for enforcement matters. Each regulator could then use these common principles to guide future rulemaking and enforcement actions.

Several precedents that exist today can serve as starting points for a set of new US financial regulatory principles. The UK's Financial Services Authority (FSA), for example, operates under six such principles for good regulation based on its statutory objectives. More recently, the Institute of International Finance (IIF) has issued a complementary set of seven principles based on its objectives for economic growth and competition, financial system stability and security, and customer safeguards. Both the FSA and the IIF also espouse principles for how private sector firms and their management teams ought to interact with their regulators.

Regardless of the details of the principles themselves, a common approach emphasizing collaboration and the open sharing of information between regulators and regulated entities would deliver more balanced, consistent and predictable outcomes for financial institutions, consumers, investors and other market participants. This would have the added benefit of allowing regulators to be more empirically effective in shaping the actions of market participants. It would also help non-US corporations comply with US regulations more easily, which in turn would make the US more appealing as a center for business operations.

Initiatives to level the playing field

- **Recommendation 4 – Ease restrictions facing skilled non-US professional workers.** Congress should re-examine and eliminate some of the barriers that deter or prevent skilled foreign professional workers both from coming to the United States to work, and from remaining in the country as part of the workforce. Specific actions, which may perhaps most effectively be implemented as part of a comprehensive immigration reform package similar to that introduced in the 109th Congress, could include raising the annual cap on H-1B visas, eliminating the time lag between student visas expiring and the granting of H-1B visas, and providing clearer guidelines on how to exercise discretion in granting business visitor visas.

Taken together, such reforms to US immigration policies would significantly ease the imbalance between supply and demand for talent in the financial services industry. This will allow the United States, and specifically New York, to retain its position as the world's largest pool of financial services talent, which in turn makes the United States more attractive to both domestic and foreign financial institutions. In light of the positive impact that a successful, high value-added financial services industry creates in terms of attracting other sophisticated businesses, this would also reinforce New York's position as a first-tier global business hub.

- **Recommendation 5 – Recognize IFRS without reconciliation and promote the convergence of accounting and auditing standards.** The SEC should consider recognizing International Financial Reporting Standards (IFRS) without requiring foreign companies listing in the US to reconcile to US Generally Accepted Accounting Principles (GAAP). Similarly, the PCAOB should work with other national and international bodies towards a single set of global audit standards. Meanwhile, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should continue – and, if possible, accelerate – current efforts towards the convergence of global accounting standards, aiming for a "best-of-both" approach that balances materiality with the need to inform investors and other users of publicly reported financial information.

  The accelerated convergence of two high-quality accounting standards will reduce regulatory compliance costs without undermining investor protection or impairing market information. The harmonization of auditing rules, provided that better standards win out, will similarly lower auditing costs for most public companies without reducing the quality of the statements produced.

- **Recommendation 6 – Protect US global competitiveness in implementing the Basel II Capital Accord.** US banking and thrift regulators should continue to consult with the banking industry and subject the Notice of Proposed Rulemaking (NPR) to further cost/benefit and competitiveness analyses. US banking regulators have proposed changes that would result in US banks holding higher capital levels than their non-US peers, which could put them at a competitive disadvantage. Ideally, US banking regulators will find a middle road that protects the structural integrity of the US financial system under adverse market conditions while preserving the global competitiveness of its banks. This has already taken many years of effort by regulators and financial institutions. An expeditious implementation of these new standards would bring to a close the lengthy debate over the approach employed in the US, and give greater clarity concerning the future regulatory landscape.

  A harmonized, balanced approach could place US banking institutions on a more equal footing with their international competitors in the important lending and fixed income markets. It could also make the US more appealing as a place to do business for foreign financial institutions, which would not then need to adjust their capital requirements in order to participate in the US markets. As a result of this enhanced competition, US corporations, consumers and investors would enjoy greater choice, enhanced protection and better pricing.

Important longer-term national priorities to preserve financial services preeminence

- **Recommendation 7 – Form an independent, bipartisan National Commission on Financial Market Competitiveness to resolve long-term structural issues.** Early in 2007, Congress should create a National Commission on Financial Market Competitiveness to assess long-term, structural issues that affect the health, competitiveness, and leadership of US financial markets and their contribution to the national economy. Guided by an overarching vision for the future of US financial services that is consistent with the regulatory framework proposed in Recommendation 3, this Commission should develop legislative recommendations with thoughtful private sector, investor, and regulator input, for a financial regulatory system that is simple, efficient, responsive to the competitive needs of financial institutions in serving their customers, and attentive to the systemic need for a strong, vibrant, well-managed financial sector with adequate investor protections. Potential areas of reform should include broad policy, legal, regulatory, and enforcement issues that the Commission deems important to a competitive financial marketplace and the US economy.

Among other things, this Commission should consider regulatory integration as well as the possibility of a single regulator for national and global financial services firms operating in the United States. Furthermore, with due deference to the separation of powers between executive and judicial enforcement agencies, as well as between state and federal officials, the Commission should also consider reforms that would improve the consistency and predictability of enforcement efforts nationwide. More generally, the Commission should review and make recommendations on the general strategic direction of the financial services industry and the balance of public-private sector cooperation best able to promote a vibrant and robust financial services sector in the context of increasing global competition.

- **Recommendation 8 – Modernize financial services charters.** Regulators and Congress should assess and, where appropriate, modernize US financial services charters, holding company models, and operating structures (such as international banking facilities under Regulation K of the Federal Reserve) to ensure that they are competitive by international standards. Where these charters and models prove to be cumbersome or inflexible, which would be unsurprising given that most have gone without scrutiny for decades, Congress should enact legislative changes that can promote responsiveness by US financial institutions to a rapidly changing, increasingly global competitive environment. One priority, in the context of enhancing competitiveness for the entire financial services sector and improving responsiveness and customer service, should be an optional federal charter for insurance, based on market principles for serving customers. This review should include full input from industry participants, customers, and other interest groups to ensure a balanced outcome.

New York agenda to promote financial services competitiveness

The national agenda described above is critical to preserving and enhancing New York's competitiveness as a financial services center. The City and State of New York have many strengths, and New York City continues to be seen very positively as a place to live and work. The quality of life is high, crime is low, arts and culture flourish, and traffic is better (at least when compared to London). Nevertheless, focusing on making New York more livable is only one part of the equation. The City and State can also take an integrated set of actions, centered around the creation of a new public/private joint venture dedicated to financial services, to support and complement this national agenda. New York has an important responsibility to the global financial services businesses centered in the area to promote US and New York competitiveness, and the joint venture described below should provide local authorities and market participants with an effective means of doing so.

Establish a public/private joint venture with highly visible leaders focused exclusively on financial services competitiveness.

The Mayor should work with the business community, particularly the Partnership for New York City, to form a public/private joint venture focused on strengthening the financial services competitiveness of the City, the State, and the nation. This joint venture should own and execute a City- and State-level agenda that balances the objectives of business competitiveness, consumer protection, and broad economic growth. More specifically, this agenda should include:

- **More actively managing attraction and retention for financial services.** Although the City and the State of New York already employ significant resources to maintain working relationships with leading financial institutions, this interaction could become more effective and forward looking. To do so, the financial services joint venture should seek to maintain an active dialog with the State's top financial services employers about their expansion and relocation agenda. It should also develop relationships with a short list of high-priority financial services institutions that might consider expanding what is a limited presence in New York today. The joint venture's leadership should reach out to corporate decision-makers at the highest levels and give them the focused attention they need as they make decisions of such magnitude, bringing in the Mayor, Deputy Mayor, and other high-level local and State officials as and when needed.

- **Establishing a world-class center for applied global finance.** Several New York-based educational institutions already provide excellent graduate programs in business, law, and accounting, but today's financial institutions need graduates with deep quantitative skills to drive innovation in high-growth, geographically mobile businesses, particularly derivatives and securitization. The financial services joint venture should take a leadership role in coordinating with financial services businesses and local educational institutions to design and finance the world's best graduate program in financial engineering and global capital markets – one that combines the academic strengths of local institutions with practical work experience at the leading financial institutions and that focuses on applying cutting-edge mathematics, statistics and economics to financial services.

- **Potentially creating a special international financial services zone.** The public/private joint venture, working with other interested stakeholders, should investigate the potential for further economic development that the creation of a special financial services zone could have. The creation of such a zone could leverage the inherent competitive advantage that New York's unparalleled clustering of financial services businesses bestows upon the State to a greater extent than would be possible for any other financial center. One possibility for a special financial services zone, relying primarily on tax incentives, would be to attract a new cluster of next-generation financial services businesses and support industries. Attracting such leading-edge companies would not only confer a direct benefit upon New York by virtue of their inherent economic output, but it would also enhance the sophistication of the region's overall business environment, thereby making the area as a whole more attractive to the well-established, traditional financial services firms that have historically been at the heart of the New York's economic success. While differential tax treatment is an economic policy tool that should be used with great care and only pursuant to a thorough cost/benefit analysis, its potential to build upon New York's existing advantages to attract new businesses should not be overlooked. By focusing on foreign firms without a significant US presence, as well as on startup firms, the tax incentives described above can achieve their purpose without materially harming the interests of other regions, and should thereby benefit the nation as a whole.

  A more ambitious alternative would be for the City, in collaboration with federal financial regulators, New York State authorities, and Congress, to develop a pilot program to expand and adapt the concept of an international banking zone, based in New York, to other financial sectors. This proposal would use both fiscal and regulatory policies to leverage New York's existing financial services base to attract or recapture businesses that are currently based abroad. Again, by focusing on attracting a net inflow of new businesses to the US, this proposal holds the potential to generate a net surplus for the nation without harming the economic interests of any of its constituent States.

- **Enhancing New York's ability to promote its financial services profile and its agenda as a leading financial center.** New York already engages in a variety of marketing activities to promote the benefits that the City and State of New York can deliver to the local, national and international business community. Considering the intensity of competition for global financial services preeminence, however, the financial services-focused public/private joint venture should complement ongoing activities by investing further in critical areas, including primary research into financial services topics, a fact-based public relations campaign, and advocacy at the state and national levels.

The new joint venture should be managed by a dedicated, full-time Chief Executive with significant experience in leading major financial services efforts. This individual would be tasked with furthering New York's local agenda in the most timely and collaborative manner possible. He or she would manage the joint venture's strategic and operational activities, including acting as the high-level liaison between individual industry participants and the City or State, as well as being the driving force behind the implementation of the joint venture's broader strategic plan for New York's financial services development.

To further raise the profile of New York's financial services industry at the national and international levels, the joint venture should also be led by a Chairman, appointed by the Mayor in consultation with financial services industry leaders, who will act as an ambassador for the area's financial services industry. This official would assume a wider-ranging mandate than the Chief Executive, helping New York's financial services industry communicate its vision for the region's economic future with a comprehensive and consistent voice that is heard at the national and international levels.

While the joint venture's Chairman and Chief executive will primarily concern themselves with furthering a New York-centric financial services agenda on the local, regional, national, and international levels, it is important to recognize that New York's economic interests in this regard are largely aligned with those of the broader Tri-State area. The joint venture and its leadership, along with the Mayor's office and other New York governmental authorities, should therefore seek to collaborate with Connecticut and New Jersey authorities to provide the most effective advocacy possible for a robust and efficient financial services industry regionally. Although some competition with regard to the attraction and retention of financial services businesses will always exist between local governments within the Tri-State area, the aggregate benefits to the region of a thriving US financial services sector are such as to demand that regional interest groups wanting to support the local economy present a common front on issues affecting financial services competitiveness.

* * *

There is an urgent need for concerted, balanced action at the national, State and City levels to enhance the competitiveness of the US financial markets and defend New York's role as a global financial center. Businesses cannot leave it up to public officials alone to refashion the nation's and New York's competitiveness. Nor should regulators, administrators, or legislators move forward without drawing on the insights of the private sector. Immediate action by both groups is required, not just to protect and expand jobs in a vital industry sector, but also to ensure that US financial institutions and markets are positioned competitively in the future to meet the needs of all customers and support sustained growth in the domestic economy.

The recommendations contained in this report are a contribution to the debate on the future of US financial services. They deserve discussion and further exploration, as do the recommendations being offered in other reports and by other interested stakeholders. The Secretary of the Treasury and the various financial regulators can take some actions now, while others will require legislative action by the Administration and Congress working together in a common, bipartisan effort. The private and public sectors – acting through the proposed bipartisan National Commission on Financial Market Competitiveness or New York's new public/private joint venture – should also come together at the national, State and City levels, to act now on the issues and economic priorities identified by this report as crucial to the United States and New York.

Global financial services leadership: A national priority

As the pace of globalization accelerates, a series of economic, political, cultural, and technological changes continues to increase the level of integration and interaction across geographic borders. With the cross-border flow of goods, services, ideas, and financial stock growing rapidly, the international competitiveness of all industry sectors becomes ever more important for countries and regions that want to maintain and grow their relevance in the larger global community. Like many other parts of the US economy, the financial services sector has become increasingly subject to the forces of globalization and international competition. Yet because financial institutions provide invaluable intermediation and facilitation services to businesses throughout the United States, a strong financial services sector is critical to the health of the national economy as a whole. Given its domestic and international importance, US financial services leadership should receive significant attention from policy makers.

A. THE UNITED STATES: A DOMINANT FORCE IN GLOBAL FINANCIAL SERVICES

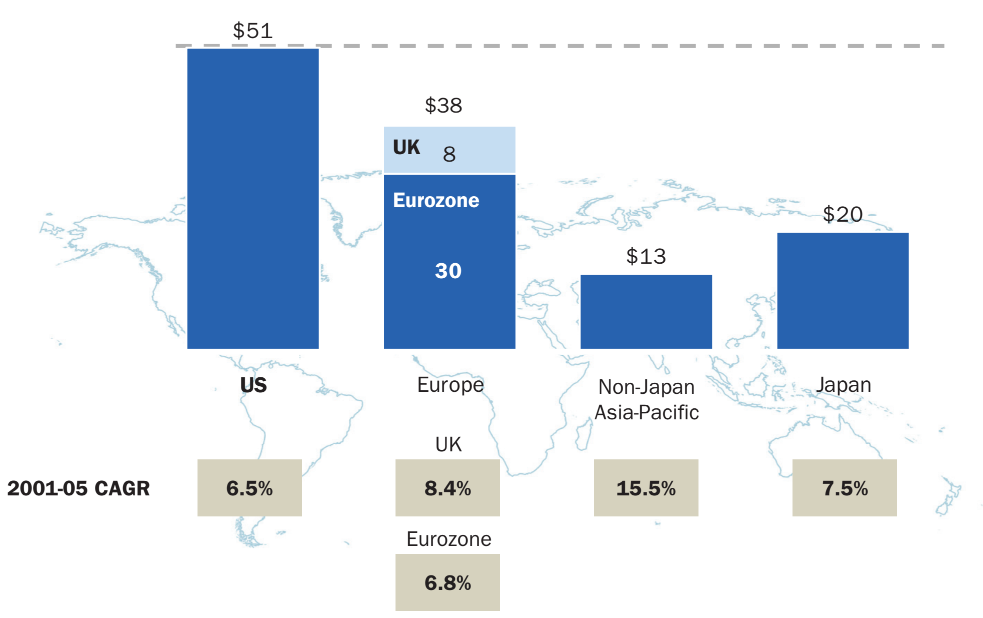
The US is undeniably one of the world's leading financial services centers. Its financial stock and insurance markets dwarf those of other countries and only the UK rivals it in terms of cross-border capital flows. The US is home to many of the world's leading financial services companies and generates significant revenues for domestic and international financial institutions.

With nearly $51 trillion as of 2005, US financial stock – including equities, bonds, loans and deposits – is more than twice that of Japan, the next largest country, which has just short of $20 trillion in financial stock. Combining the 12 Eurozone countries with the UK gives Europe $38 trillion in financial stock, but that is still only about three-quarters the size of US financial stock (Exhibit 4). [9] The US markets are also the most sophisticated: equity and private debt are the largest components of financial stock (approximately 34 percent and 35 percent, respectively), while in many less developed markets, bank deposits still account for the lion's share.

Exhibit 4

US FINANCIAL STOCK SIGNIFICANTLY LARGER THAN OTHER REGIONS, BUT GROWTH RATE IS LOWER

$ Trillions, 2005, Percent



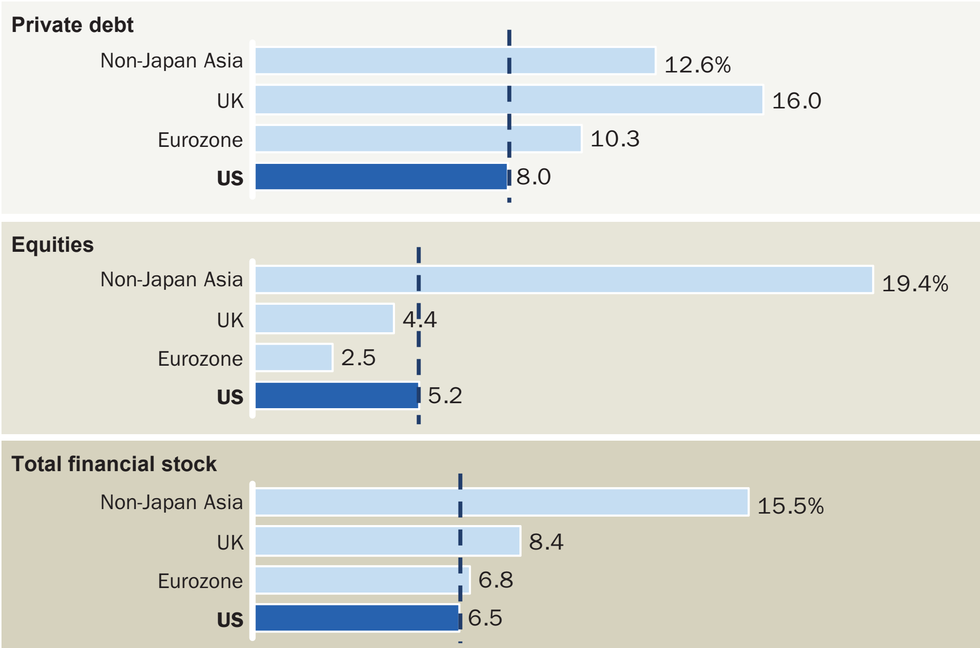
Source: McKinsey Global Institute; Global Insight

Although growing at a slower pace than other regions, the US, because of its significantly larger financial stock base, will remain the world's largest repository of financial assets for years to come. Nevertheless, it should be pointed out that, at constant exchange rates, the Eurozone, UK and Non-Japan Asia have all enjoyed faster financial stock growth rates in recent years than the US. While financial stock grew at 6.5 percent annually between 2001 and 2005 in the United States, the Eurozone grew 6.8 percent annually over the same period, the UK 8.4 percent, and Non-Japan Asia 15.5 percent (exhibits 4, 5). Very different dynamics are driving financial stock growth in developed and developing countries, as shown by the fact that private debt was the

Exhibit 5

US FINANCIAL STOCK GROWTH RATE HAS BEEN SLOWER THAN IN OTHER REGIONS

CAGRs (2001-05), Percent



* Total financial stock comprises equities, private debt, public debt, and bank deposits

Source: McKinsey Global Institute

main engine for financial stock growth in the US, Eurozone and UK (with 8.0, 10.3, and 16.0 percent annual growth, respectively), but growth in Non-Japan Asia was primarily linked to strong performance in the equity markets (19.4 percent annual growth).[10]

Moving from securities to insurance, the historically local life insurance and property-casualty insurance markets are now internationalizing, although not as fast as the securities industry. Issuers of life insurance (a market valued at $1.97 trillion in 2005) are increasingly participating in many different national markets throughout the world, and nearly all of the world's leading life insurance carriers compete globally. In the market for non-life insurance (valued at $1.45 trillion globally in 2005), the US remains served primarily by domestic insurance carriers, although some US carriers are increasingly expanding overseas. It is worth noting that many non-US carriers have recently withdrawn capital and capacity from US markets, and in some cases exited entirely, due to the perceived difficulty of coping with the unfamiliar US regulatory and legal environment.[11] The most globally competitive insurance market is the (much smaller) reinsurance business, with global net reinsurance premiums amounting to $149 billion. The US also has the largest share of this market, although it is less dominant than in non-life, with 24 percent of the global market, or $37 billion in net premiums in 2005. Germany follows closely behind, with premiums of $35 billion and a 23 percent share. London accounts for 7 percent of the market, whereas Bermuda has recently emerged to capture 11 percent of global premiums, or $16 billion in 2005, driven by a more flexible regulatory environment, tax benefits, and the ease of setting up insurance businesses.[12]

It should come as no surprise that in a rapidly integrating world, cross-border capital flows have accelerated, to the benefit of the US and the UK in particular. In 2005, cross-border flows totaled $6.2 trillion worldwide, up from $1.5 trillion in 1995.[13] Capital flows have grown across the board, with portfolio investment flows (equities and bonds) growing more rapidly than anything else. In 2005, total capital flows into and out of the US totaled $1.64 trillion, while the equivalent figure for the UK was $2.68 trillion.[14]

Turning from capital stocks and flows to capital markets revenue generation, the concentration of financial services industry leaders in the US tells a similar story about the country's leadership role. The United States is home to more of the world's top financial services institutions than any other country: six of the top 10 financial institutions by market capitalization are based in the New York area, with the other four found in Edinburgh, London, Tokyo, and Zurich. Firms headquartered in the United States top the league tables in mergers and acquisitions, as well as equity and debt capital-raising. US firms accounted for the top five spots in the combined rankings for capital markets and M&A for US-based companies in 2006; they also occupied three of the top five spots for European-based deals in 2006 (Exhibit 6).[15] Finally, the revenues generated by investment banking and sales and trading activities are still larger in the United States than anywhere else. US revenues totaled $109 billion (45 percent of the global total) versus Europe's $98 billion (40 percent).[16]

B. A VITAL SECTOR AT THE HEART OF THE ECONOMY

The financial services sector is a vital element of the US economy, and it is of particular importance to New York and a number of other states. It is a large industry, fast-growing, a major contributor to the tax base, and a major source of quality jobs

Exhibit 6

US BANKS CONTINUE TO DOMINATE THE US AND EUROPEAN INVESTMENT BANKING LEAGUE TABLES

2005 league tables for M&A, equity capital markets, and debt capital markets combined
$ Billions

■ US-headquartered investment banks

Revenue	US	Rank	EMEA*	Revenue
$2.1	Goldman Sachs	1	Deutsche Bank	$1.4
$1.9	Citigroup	2	J.P. Morgan	$1.3
$1.7	Merrill Lynch	3	Morgan Stanley	$1.1
$1.7	J.P. Morgan	4	UBS	$1.1
$1.7	Lehman Brothers	5	Citigroup	$1.1

* EMEA: Europe, Middle East and Africa
Source: Dealogic

nationwide. Ultimately, well-developed and thriving financial markets contribute to the nation's overall prosperity as they provide easy access to low-cost capital and promote economic stability. Given the sector's many important characteristics, supporting it must be high on the national agenda.

Financial services is the third-largest sector of the US economy, accounting for approximately 8 percent of GDP.[17] Only manufacturing (14 percent) and real estate (12 percent) are larger. Between 1995 and 2005, the industry grew at a compound annual growth rate of more than 5 percent, making it one of the three fastest-growing sectors. By contrast, manufacturing and real estate grew at around 3 percent and the overall economy posted 3.2 percent real GDP growth over the same period.[18]

Of course, the financial services sector is even more critical to the New York economy than to the country as a whole, although other states are also heavily reliant on it. The sector represents approximately 15 percent of real gross product for both New York City and New York State.[19] Six other states (Connecticut, Delaware, Massachusetts, North Carolina, Rhode Island, and South Dakota) all count on financial services for 10 percent or more of their real gross product.[20] In New York City, only real estate is larger (17 percent) with the next-largest sector, professional services, accounting for

9 percent. Financial services is also the City's fastest-growing sector, registering 6.6 percent growth from 1995 to 2005 compared with overall growth of 3.6 percent and real estate sector growth of 3.7 percent.[21] The financial services sector is also critical to the local tax base, accounting for approximately 36 percent of the City's business income tax revenues in fiscal year 2005.[22]

Financial services are important not only in terms of economic output, but also in terms of jobs. Nationally, the industry directly accounts for one in every 19 jobs.[23] Many states are highly dependent upon the sector: in Connecticut, Delaware, New York, and South Dakota, sector employment represents 8 to 10 percent of non-farm private sector jobs. In New York City, financial services employment represents 1 in every 9 private sector jobs. Other US cities are also heavily reliant on financial services, including Hartford (1 in every 8 private sector jobs), Charlotte (1 in 12), Boston (1 in 14), San Francisco (1 in 14), and Miami (1 in 18).[24]

The largest sector of financial services employment in New York is the securities industry. In 2005, the securities industry accounted for 171,000 of the 328,400 financial services jobs in New York City.[25] Direct jobs are one very visible contribution, but the sector also creates a large number of indirect jobs. A recent study by the Comptroller of the State of New York revealed that every securities industry job in the City creates two additional jobs in other industries.[26] Many of these jobs are related to financial professionals' consumption and employ lower and middle income workers, although other professional services sectors also benefit, albeit less significantly.

Financial services are also of broader value to the national economy. In addition to being a significant source of economic growth, tax revenues, and employment, well-regulated and efficient financial markets fuel growth by optimizing capital allocation and allowing market participants to raise capital at lower cost.[27] Furthermore, capital markets also enhance financial stability through better risk management and diversification, which means lower overall systemic risk not only for large financial institutions, such as the banks and money managers with whom Americans invest their savings, but also for all US companies. Finally, capital markets provide an efficient link to the broader global economy, forcing domestic institutions to be more efficient, and therefore boosting the international economic competitiveness of the United States.

External forces undermining the nation's and New York's financial services preeminence

The United States' and New York's historically strong position in financial services is under threat from a number of challenges, both external and internal. Section II outlines the external challenges, created by developments in other markets, before moving to the internal, self-imposed challenges in Section III.

A. STRONG DYNAMICS OUTSIDE THE US DRIVING INTERNATIONAL GROWTH

Financial markets outside the United States are growing faster than domestic markets in terms of both depth and liquidity; international capital now has many competing locales into which it can flow. The dynamism and growth of some of these markets makes them inherently attractive, but capital flow decisions also reflect favorable developments in corporate competition and financial market regulation. Meanwhile, advances in technology and communications are freeing capital from the limitations of geographic boundaries and some of the need for financial services firms to locate their various businesses in the same place. Conditions are ripe for financing, risk management, and other financial services to shift from more mature and stable economies to emerging, more dynamic markets. As one business leader interviewed suggested, "New York and the US need to get comfortable with having a smaller share of a larger pie as globalization occurs." The challenge for US policy makers is to understand these changes and ensure that the country continues to be the world's preeminent global financial services center.

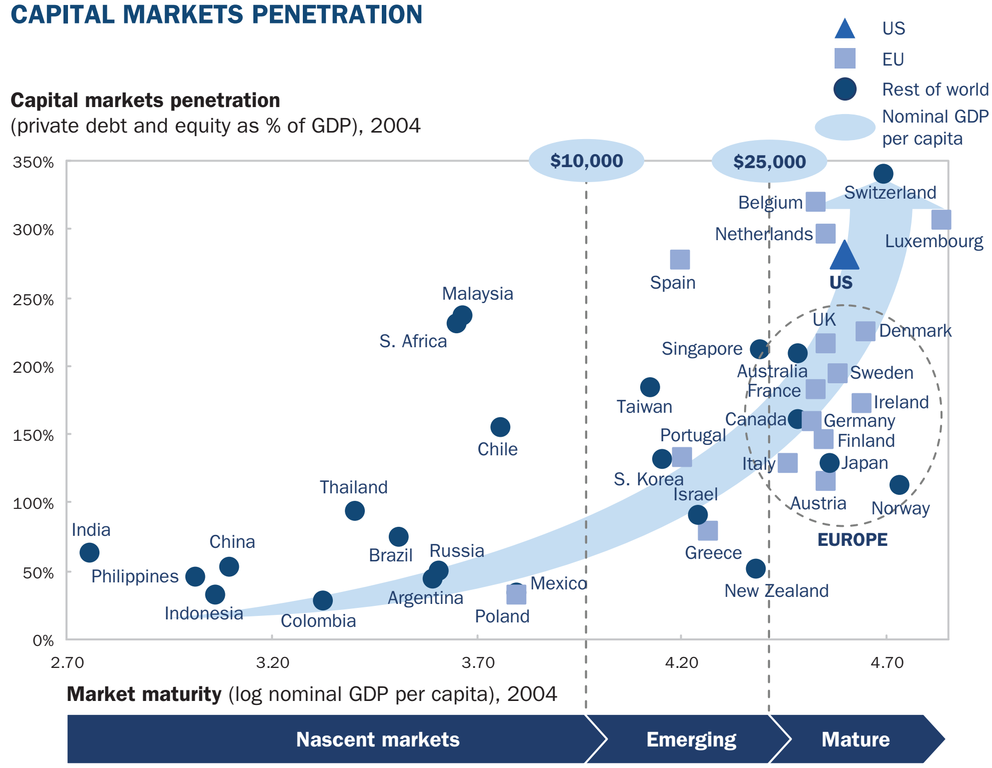
Economic growth. There is no doubt that the United States will continue to be a significant driver of the world economy, but it is also clear that it will not be alone as a global economic center. Even with less than 3 percent annual growth, the United States will create about $3.7 trillion in additional real GDP between 2005 and 2015.[28] Economic forecasts indicate that China, by comparison, will add approximately

$2.2 trillion to its GDP over the same period, which corresponds to approximately 7 percent compound annual growth. India is similarly expected to grow at 7 percent per year, albeit from a lower base, yielding just over $600 billion in additional GDP over the period.[29] Still, intra-Asian trade – rather than East-West trade – will increasingly fuel global economic growth. This is particularly true as the countries of the European Union (EU), still working through harmonization challenges, are expected to grow GDP by $1.9 trillion through 2015,[30] or approximately 2 percent annually, although economic development on Europe's eastern edges may yield some incremental growth.

Capital markets penetration. Most European and Asian economies have lower capital markets penetration – equity and bond financing compared with GDP – than the US economy,[31] suggesting that they have significantly more room to grow (Exhibit 7). However, despite having a smaller GDP than the US, the EU has almost caught up in terms of capital markets revenue. In 2005, US capital markets revenue was $92

Exhibit 7

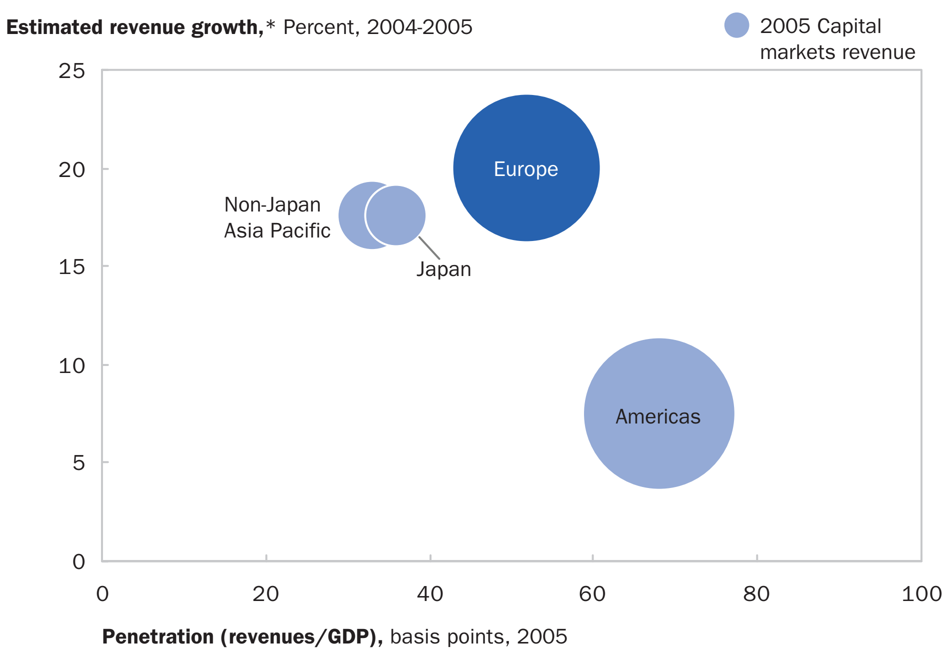
EU HAS HIGHER GROWTH POTENTIAL THAN US BECAUSE OF LOWER CURRENT CAPITAL MARKETS PENETRATION



Source: McKinsey analysis; UN Population Division billion, while the EU's was $85 billion.[32] The median growth rate for capital markets revenue is much higher in the EU (20 percent versus 7 percent in the US), while the penetration of revenue to GDP is lower,[33] which indicates more revenue potential and momentum in Europe (Exhibit 8). Overall, the figures suggest that Europe is steadily assuming a more dominant position in the world's financial markets.

Exhibit 8

EUROPEAN CAPITAL MARKETS REVENUE PENETRATION HAS ALMOST CAUGHT UP TO THAT OF THE AMERICAS; ASIA STILL LAGS



* Average of range is shown
Source: McKinsey analysis; UN Population Division

Corporate competition. Relatively open competition between domestic and foreign companies, a necessary stimulus for financial markets development, is becoming the norm in most countries – even for strategic industries such as financial services, energy, transportation, and telecommunications. The United States and the United Kingdom have virtually eliminated constraints on market entry and consolidation, although some might perceive the new US disclosure requirements for foreign acquirers as a step backward. Across the Atlantic, European Union regulators are pushing member states to relinquish control over large, long-nationalized institutions. Their pan-European approach to industry concentration and competitiveness has begun to dismantle the barriers that protected national champions, despite the persistent challenges of protective national labor laws. China, the latest major country to liberalize corporate ownership, has made real progress with over $100 billion in privatizations since 2000, although formidable limits on foreign control of strategic companies remain.[34]

Financial services regulation. Globally, financial services regulations generally promote efficient, transparent, market-oriented solutions that retain a high standard of investor protection. More recent regulations are diluting the anti-competitive protection once enjoyed by banks, broker-dealers, and insurance companies. In securities markets, both the Markets in Financial Instruments Directive (MiFID) in Europe and the SEC's new Regulation National Market System (NMS) in the United States will foster competition among exchanges, broker-dealers, and alternative trading venues to deliver the best execution to investors. In Asian securities markets, regulators are attracting foreign investment capital by enhancing market access and promoting good corporate governance. Similarly, in banking, the Basel II framework will stimulate loan and bond trading markets globally by harmonizing economic and regulatory capital levels.

Technology and communications. Amid all these regulatory changes, technology and trading infrastructures are evolving to make real-time interactions and transactions possible and affordable from virtually anywhere. Many markets already enjoy near-instantaneous electronic communication of trading intentions and market information, thanks to standard communications protocols like FIX, advances in routing technology to find the best price across multiple trading venues, and steady investments in the telecommunications backbone. Buyers and sellers of securities and financial contracts can meet virtually and anonymously by using electronic and algorithmic trading applications. Indeed, once the NYSE goes live with its Hybrid Market structure – under which investors can choose between floor-based and electronic trading – all the major global securities and futures exchanges will offer fully electronic trading. Market innovators are now pushing the frontier of electronic trading for liquid and less liquid instruments. Straight-through, fully electronic clearing and settlement is becoming the industry standard for futures, options, global bonds, and domestic equities, although it is still only an aspiration for cross-border European equities and most traded products in non-Japan Asia.

As most important limitations on cross-border capital flows have disappeared and other markets are becoming large and liquid enough to attract significant international investment, the US markets' traditional advantages are coming under pressure. Investors are establishing greater presences in London, Hong Kong, and other parts of Asia as they try to get close to new investment opportunities. For example, Fidelity and AIG have substantial in-house investment operations located outside the US. There is no reason to believe that capital will not continue to flow to new financial centers, and the competition between them for investment capital will only intensify.

B. GLOBAL IPO ACTIVITY MIGRATING AWAY FROM NEW YORK

Media headlines clearly indicate that the public equates recent challenges to America's market leadership in initial public offerings (IPOs) with larger concerns about financial market competitiveness. In truth, equity underwriting fees are not a major economic driver, even for a leading financial center. The importance of being a preferred listing destination should not, however, be underestimated.

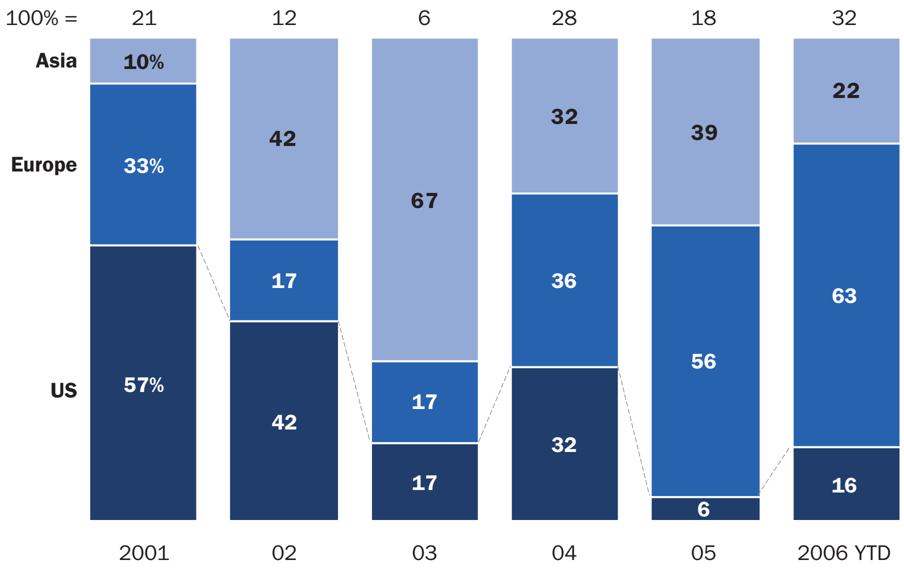
According to McKinsey estimates, equity underwriting revenues in the US amounted to approximately $6.8 billion in 2005, or about 3 percent of total US corporate and investment banking revenues; of that underwriting total, only one-third related to IPOs.[35] The numbers may not be large in and of themselves, but IPOs matter because they are the first in a series of events that generate substantial recurring revenues for the host market. After the IPO itself, income comes from secondary trading, secondary public offerings, and the ability to directly tie derivative instruments to the underlying equity security. Everything else being equal, new issuers will also look to raise equity in the markets they see as most vibrant. Thus, perceptions around IPO market competitiveness really do matter to exchanges, broker-dealers, and financial markets more broadly.

The IPO market also offers the most dramatic illustration of the change in capital-raising needs around the world, and US exchanges are rapidly losing ground to foreign rivals. When looking at all IPOs that took place globally in 2006, the share of IPO volume attracted by US exchanges is barely one-third of that captured in 2001. By contrast, the global share of IPO volume captured by European exchanges has expanded by more than 30 percent over the same period, while non-Japan Asian markets have doubled their equivalent market share since 2001.[36] When one considers mega-IPOs – those over $1 billion – US exchanges attracted 57 percent of such transactions in 2001, compared with just 16 percent during the first ten months of 2006 (Exhibit 9).[37]

Exhibit 9

US SHARE OF IPOs VALUED OVER $1 BILLION HAS DECLINED

Number of IPOs valued at over $1 billion



Source: Dealogic; year-to-date data compiled as of 11/02/2006.

To some extent, this decline is due to the fact that most issuers are not US companies. Only three of the world's 20 largest IPOs since the beginning of 2005 were linked to US issuers, and only one of those – MasterCard – took place on a US exchange.[38] European privatizations and the emergence of strong capital markets in developing countries have boosted foreign IPO growth. For instance, six of the world's top 10 IPOs in 2005 (representing a quarter of total deal flow) were either state-owned enterprises or companies from emerging markets with previously limited access to equity capital. The trend continued into 2006, with four of the 10 largest IPOs (including the top three) coming from developing countries. By contrast, in the United States, where most large companies are already public, the average size of the 10 largest IPOs in 2005 was $850 million – roughly one third of the $2.5 billion average in Europe.[39]

Interviews with several foreign issuers revealed that the motivation for some of these foreign listings was driven by both geography and market attractiveness. One indicated that, “Due to our national identity, it only makes sense to list on our home exchange; listing outside our country did not make sense at all.” Another commented that, “If we were to list outside of our home country we would probably consider the UK or Asia before the US, because regulatory issues, administrative hurdles, and legal risks have made the US’ reputation more and more negative.”

Another explanation put forward by some commentators as to why international issuers are staying away from US equity markets is the fact that the underwriting fees charged by investment banks are significantly higher for US listings than in competing markets. One study reveals that underwriting fees for non-domestic listings were 5.6 percent and 7.0 percent on the NYSE and NASDAQ, respectively, compared with just 3.5 percent on London’s main market.[40] But while such figures may seem significant when looked at in isolation, their importance relative to the overall value of an IPO is fairly low, and easily outweighed by the benefits of a more liquid market and superior execution. Surveys conducted for this report corroborate this thesis: when asked to rate the importance of underwriting fees in the overall process of listing a company on the public equity markets, survey respondents ranked underwriting fees last among seven factors, with just 4 percent judging the issue “very important.” This compares with 88 percent who felt that the depth and liquidity of the market is “very important.” In other words, the higher underwriting fees charged by investment banks in the US are not by themselves enough to explain why more and more international issuers are turning away from the US equity markets.

Whatever the underlying reasons, the apparent loss of US preeminence in equity issuance is the result of explicit choices that issuers are making. These are driven by the liquidity available elsewhere, less stringent reporting requirements for smaller companies, and the rise of private ownership within the US.

Large-scale international offerings can turn elsewhere

A listing on a US exchange was – up until relatively recently – considered *de rigueur* for a non-US company that wanted to capitalize on the deepest and most liquid market in the world. One investment banker characterized the change in equity markets with this description of IPO “pitches” that underwriters make to non-US clients today: “We keep New York in the pitch book and try to make a case for it, but it is a given that major issuers will choose London over New York.”

In 2003, 31 percent of the NYSE's IPO volume came from foreign issuers,[41] and the exchange's single largest IPO, representing 27 percent of total IPO volume for the year, came from China.[42] By 2004, foreign issuers accounted for only 19 percent of IPO volume, and by 2005 the figure was just 8 percent. A chief executive summed up his view on the deterioration of US financial markets competitiveness when he said, "Clients no longer need the US to raise money. The US markets are no longer so dominant that foreign issuers have to have access to them – luring them back will be no small task." This relative decline has three causes. First, some equity issuance has shifted to European countries with deep domestic markets. Second, some developing countries now have deep liquid markets that can accommodate even the biggest IPOs. Third, companies with capital needs that outstrip even that deeper domestic market capacity are not turning to US exchanges, preferring other markets, especially London.

Europe has historically had more IPOs than the United States, but lower overall deal value because of smaller transactions. Yet by 2005, the value of IPOs in Europe was approximately 75 percent larger than in the US, and for the first ten months of 2006, the value of IPO transactions was 270 percent higher in Europe than in the US.[43] Large privatizations are driving much of this change, as EU member states seek to maximize divestiture proceeds and are required to denationalize in a manner that complies with regulators' requirements for transparency. In 2005, for example, 4 of the top 10 European IPOs were the direct or indirect result of government privatization programs. These privatizations averaged $4.2 billion, nearly five times the size of the average US top 10 IPO for 2005.[44] The big western European IPOs do not, however, appear to be truly geographically mobile, due to a combination of political sensitivities and market depth: each of the 10 largest IPOs of 2005 involving western European companies took place on the issuer's home market.[45]

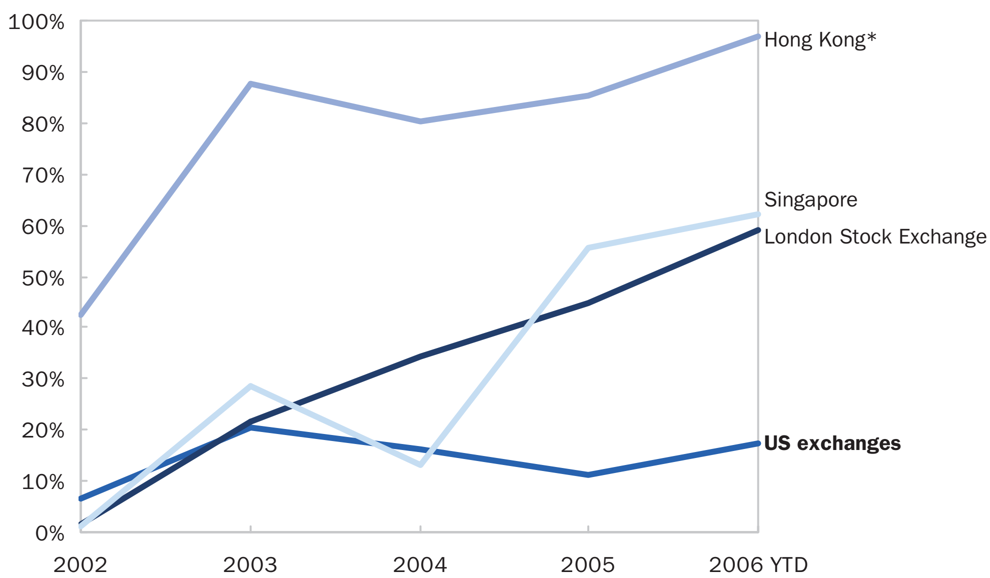
Developing markets have also been driving the shift away from the US equity markets. Turning first to Asia, five of the eight emerging market mega-IPOs of 2005 and 2006 came from China, fueled by strong economic growth and the Chinese government's decision to allow partial privatization of many state-owned enterprises.[46] A few years ago, deals of this size would have had to involve the US public equity markets, but these IPOs all took place in Hong Kong.[47] "Long term, Asia is a bigger threat [than Europe]. US institutional investors can access foreign markets, so issuers can access US capital without tapping US markets," points out one chief executive. More broadly, international IPOs have become in recent years increasingly important to the leading

Asian exchanges. On the Hong Kong stock exchange, 97 percent of the value of IPOs that took place during the first ten months of 2006 was related to mainland Chinese issuers, up from 43 percent in 2002. Similarly, 62 percent of the IPOs on the Singapore stock exchange for the same part of 2006 came from foreign issuers, compared with just 1 percent in 2002 (Exhibit 10).[48] The supply of Chinese IPOs has come at a time when Asian markets are seeking to increase their competitiveness and New York markets have come under pressure. The number of very large Chinese IPOs may not, however, be as substantial going forward, as more than three-quarters of the leading Chinese enterprises in the most important industry sectors are now publicly listed.

Exhibit 10

COMPETING FOREIGN EXCHANGES ARE INTERNATIONALIZING FASTER THAN THE US

IPOs by foreign companies
Percent of total IPO value



* Mainland Chinese IPOs considered "foreign" for Hong Kong purposes
Source: Dealogic; year-to-date data compiled as of 11/02/2006.

The other three emerging market mega-IPOs of 2005 and 2006 were from Russia and other former Soviet republics, which have also entered a privatization phase. Lacking the levels of investor confidence and market depth in their domestic markets that now exist in Hong Kong, these massive issuers have turned to foreign exchanges to raise capital. London has reigned supreme in capturing these transactions. Deal flow on the London Stock Exchange (LSE) related to international IPOs rose from 2 percent in 2002 to over 59 percent during the first ten months of 2006. Similarly, 6 of the 10 largest IPOs of 2005 on London's main exchange were by foreign issuers. This compares with just one such IPO on NASDAQ, and none on the NYSE.[49]

The economic impact of these large issuers' decision to stay out of the US capital markets is substantial. It is true that large-scale IPOs often benefit from discounted fees, but a single large IPO such as the Industrial and Commercial Bank of China's (ICBC) can generate as much as $500 million in underwriting fees alone (see sidebar: "ICBC Sets New Benchmarks," p. 49). Although US banks continue to command a significant portion of the underwriting revenues for many foreign IPOs, their share of the underwriting fee pot in Non-Japan Asia – one of the fastest-growing IPO markets – slipped from 41 percent in 2000 to 32 percent in 2005. This compares to a 73 percent underwriting market share for these banks in the US.[50]

US exchanges are aware of the economic risk that lies in the newfound ability of international issuers in Europe and Asia to reach US institutional investors without actually listing in the United States. This growing understanding of the other opportunities available to investors may be a driver behind the proposed NYSE/Euronext merger and NASDAQ's bid for the London Stock Exchange. By merging with foreign exchanges that have already succeeded in attracting US institutional investors, the US exchanges are effectively recapturing some of the institutional and public issuance business they recently lost. Furthermore, the combined international markets could create value for both investors and issuers by facilitating their access to the liquidity of US markets without requiring them to submit to US regulatory and legal standards. In other words, the new linkages between international exchanges will make it easier still for companies to steer clear of New York, with the attendant economic shortfall that this implies. Unless the US capital markets can become as appealing to issuers as their foreign counterparts, major international issuers are likely to elude them. The problem is particularly acute because foreign issuers have not only focused more of their attention on foreign exchanges, but have also increasingly relied on the private placement 144A market for capital when they chose to come to the United States. In 2005, for instance, foreign companies raised 16 times as much equity in Rule 144A transactions as they did on public US markets.[51]

ICBC SETS NEW BENCHMARKS

On October 27, 2006, the Industrial and Commercial Bank of China (ICBC), the third of China's Big Four banks to go public, began trading on the Hong Kong and Shanghai stock exchanges – a momentous event for many reasons. For starters, it was the largest initial public offering (IPO) ever, raising $21.9 billion for the issuer, and generating as much as $500 million in underwriting fees. ICBC was the first company to debut simultaneously on the rival Hong Kong and Shanghai stock exchanges, with approximately $16.1 billion raised in Hong Kong and about $5.8 billion in Shanghai. It was also the first time that underwriters exercised a "greenshoe" option (i.e., an over-allotment provision in the underwriting agreement allowing the underwriters to sell investors more shares than originally planned) for a mainland Chinese offering, which enabled them to increase the deal size by 15 percent.

ICBC's shares rose 15 percent in the first day of trading in Hong Kong, and 5 percent in Shanghai. Launched when Hong Kong's Hang Seng Index was at an all-time high, ICBC's IPO has been universally regarded as a success. It showcased the liquidity of the Asian markets and the newfound ability of local issuers to raise vast amounts of capital without listing in New York, London, or other Western exchanges.

The offering attracted $500 billion in orders worldwide, with Hong Kong accounting for about 80 percent of that total. Retail interest was extremely high in both locations, with the Hong Kong retail offering 78 times over-subscribed and the larger Shanghai retail offering 49 times over-subscribed. Retail interest in Hong Kong was in fact so strong that the retail allocation there was increased from 5 percent to 10 percent. Institutional investors represented about $375 billion of the order book, with about 90 percent of all institutional funds centered in Hong Kong. While US institutional investors probably accounted for the lion's share of the Hong Kong institutional interest, bankers also sought out international, government-backed institutional investors from Asia and the Middle East.

Western investment banks captured most of the fees from this transaction, but the mainland Chinese portion of the ICBC deal may also foreshadow a long-term shift in underwriting leadership. Assuming discounted fees of 2 to 2.5 percent (versus 3 to 4 percent for typical Hong Kong IPOs and 5.6 percent for foreign companies listing on the NYSE), ICBC's IPO may have generated up to a $500 million payday for investment banks – nearly as much as all other Chinese IPOs in 2006. Merrill Lynch, Deutsche Bank, and Credit Suisse took the bulk of the global offering fees but China International Capital Corp. and ICBC's own ICEA Capital Ltd. also participated. By contrast, global firms played no role in the domestic offering: fees there went exclusively to Chinese and Hong Kong firms, including China International, Citic Securities, Guotai Junan Securities, and Shenyin & Wanguo Securities. ■

As institutional investors have increasingly turned their attention to the 144A market, trading volumes for American Depository Receipts (ADR) – the principal means for companies with a primary listing abroad to list in the US – have deteriorated. This has encouraged foreign companies with US listings to withdraw from the US equity markets. Until recently, however, such efforts were stymied by the requirement that an ADR issuer maintain its US listing so long as more than 300 US residents held its securities. On December 13, 2006, the SEC proposed a modification to this rule to allow foreign companies to de-list if trading volume for their securities in the US falls below 5 percent of the trading volume on their home market(s). This modification removes a significant impediment to the free movement of capital in US markets, and is likely on the margin to encourage foreign companies to consider tapping US equity markets. However, in the near term, the SEC's new proposal may also yield a wave of de-listings by foreign companies whose US securities are no longer trading sufficiently to warrant the ongoing costs of US regulatory compliance.

In short, caught between a growing domestic private institutional market, thriving foreign exchanges, and increased capital mobility, the US public equity markets must evolve and improve if they want to remain a major source of international financing.

Many small-cap companies choose to list abroad

London's Alternative Investment Market, commonly known as AIM, has become the dominant small-cap listing venue in Europe and, in the eyes of some commentators, a viable alternative for US issuers. Since 2001, 870 companies have listed on AIM, compared with 526 on NASDAQ. The trend has recently accelerated: since the beginning of 2005, AIM has added more than twice as many companies (484) as its US counterpart (224).[52] In the past, NASDAQ listings raised more capital, but that is no longer true. In 2004 NASDAQ raised more than four times as much capital as AIM ($16.5 billion versus $4.0 billion), but during the first ten months of 2006, the volume of new issuances on the two exchanges was very similar: $10.4 billion on AIM versus $11.9 billion on NASDAQ.[53]

There are several reasons why small issuers now gravitate to AIM: companies enjoy less onerous reporting obligations, cheaper ongoing listing fees, and the research and market-making support of a dedicated broker-dealer. The main reason why companies choose to list on AIM, however, may be its less stringent initial listing requirements. For many AIM-listed companies, the US capital markets are never an option: thus far in 2006, for instance, fewer than half of the companies that listed on AIM would have met the lowest initial market capitalization requirements on NASDAQ.[54] Therefore, to a large extent, the two exchanges operate at different places along the IPO spectrum.

The fact that AIM has tailored its listing requirements to attract smaller companies has bolstered the number of new listings in London. This may, over time, provide additional benefits to the LSE, but the aggregate value of these small-cap listings is presently comparatively small. During the first ten months of 2006, for example, over 85 percent of London's new listings occurred on AIM, yet these represented less than 25 percent of the market capitalization of all London IPOs.[55] Worldwide, approximately half of all IPOs that took place during the first ten months of 2006 were valued at less than $50 million, but these transactions represented just 3 percent of the world's total IPO volume (see sidebar: "AIMing for Small-Caps," p. 52)[56].

With such small companies involved, the potential loss in financial revenues for the US from this shift to London is limited – at least in the short term. Total financial services revenues generated by AIM in 2005, for instance, were probably only around $700 million.[57] Furthermore, the low number of small-cap listings in the US does not necessarily indicate that small American companies are starved of capital: the venture capital market, which is arguably better equipped to deal with an uncertain payback environment than a market directly accessible to individual investors, is larger and more active in the US than anywhere else in the world. The dearth of very small company listings does, however, pose a risk that the next Microsoft or eBay could be listed abroad during its infancy, with the United States thus forgoing the associated future benefits.

Small-cap markets are clearly riskier than their more established counterparts, mainly because smaller companies are less diversified and generally have fewer means of surviving adversity. Yet it is precisely when adverse conditions arise that investor protection measures are most important. In their efforts to make listing easier and cheaper for fledgling companies, small-cap exchanges often relax some of the constraints on publicly listed companies that provide the most protection for investors. Before making the decision to change listing requirements to attract more small-cap companies, regulators and exchanges should look beyond recent experience and carefully consider the potential impact that a downturn in the equity markets might have on investors. This concern over the disproportionate impact that a bear market might have on small-cap markets and investors, along with the limited economic benefits associated with such markets, explains in part why this report does not recommend that US exchanges lower their listing requirements to attract more small issuers.

AIMING FOR SMALL-CAPS

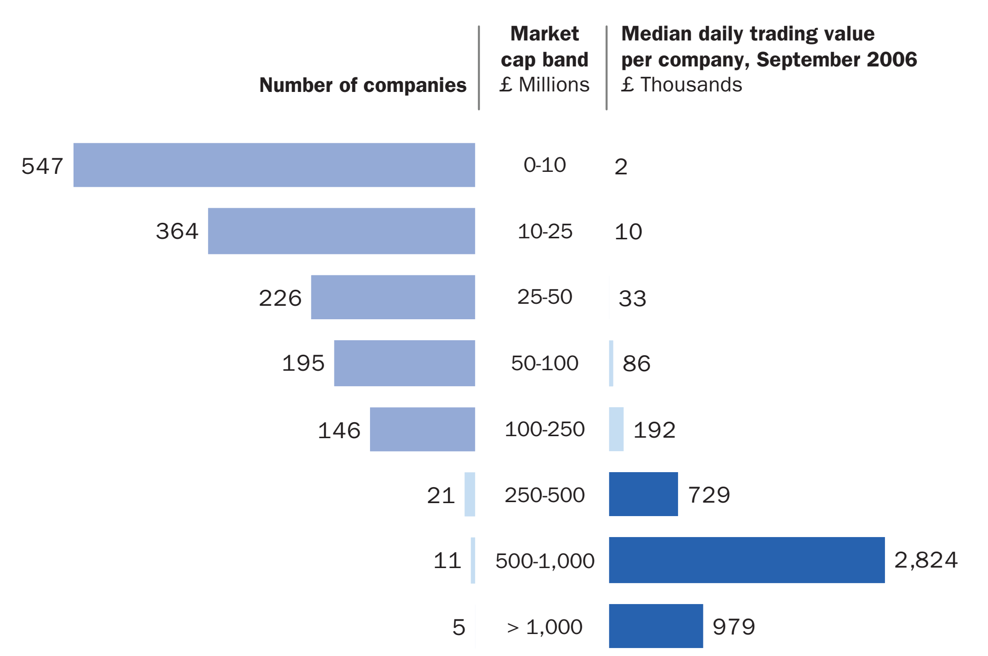
A subsidiary of the London Stock Exchange, the Alternative Investment Market (AIM) has attracted more small-cap listings in recent years than any other exchange in the world. AIM's success stems from the development of listing and reporting rules that make it as easy and economical as possible for small companies to tap the public equity markets. For instance, AIM has no minimum listing criteria; it does not require the filing of an LSE- or FSA-vetted prospectus; there is no need to convert financial reports if existing ones already comply with one of the world's major accounting regimes; companies need file only half-yearly accounts; and the initial and ongoing listing fees are minimal (£4,340, regardless of the size of the company).

The only significant condition to listing on AIM is approval by a nominated advisor, or "Nomad." The Nomad is usually a firm of financial professionals approved by the LSE, which deems the candidate company to be suitable for the market, and often acts as its AIM-mandated broker. In this capacity, the Nomad will raise funds for the company, usually by placing the shares with institutional investors (hence the lack of a public prospectus requirement). The Nomad also acts as a market-maker for the new issuer by participating in the secondary market and providing research on the company.

There is no doubt that AIM has been very successful in attracting large numbers of small-cap companies. The economic impact for financial services firms of this success, however, is less apparent. Although IPO volumes on AIM have grown as the number of companies on the exchange increased, this masks the large and increasing number of de-listings (480 since the beginning of 2003)[58] and low liquidity of most AIM stocks. Not only is the average daily traded volume per company on AIM a mere 2 percent of that on NASDAQ, but even that limited liquidity is highly concentrated in the few companies at the very top end of AIM's market capitalization range (Exhibit 11).[59] Furthermore, because AIM adopted low listing fees in a bid to attract more small-cap companies, this source of revenue is also relatively negligible. ■

Exhibit 11

AIM'S LIQUIDITY IS CONCENTRATED IN THE FEW LARGER-CAP COMPANIES



Source: London Stock Exchange; AIM statistics, September 2006

Alternatives exist to US public listings

Arguments in favor of private over public equity ownership are increasingly common in both business and academic circles in the United States. Private equity assets under management are now nearing $400 billion in the United States versus just under $200 billion in Europe.[60] The largest financial sponsor firms, such as Blackstone, the Texas Pacific Group, or Kohlberg Kravis Roberts & Co., each control companies with combined net revenues surpassing all but the very largest US companies.[61] These firms' war chests of committed investor capital and their borrowing capacity with banks allow them to consider and execute deals that until recently would not have been possible, such as Blackstone's recent $36 billion purchase of office building owner Equity Office, the largest leveraged buyout ever.

Private equity momentum is strong: aggregate deal value grew 51 percent annually from 2001 to 2005 in North America,[62] with the volume of public-to-private deals valued at over $500 million more than doubling annually in the US over the same period.[63] This momentum is related – according to a number of business leaders interviewed – to the regulatory and legal environment in the United States, which is driving companies to consider private alternatives. The extent of private equity acquisition activity has begun to make a meaningful dent in US public company listings.

Potentially more worrisome for US public equity markets than the rise of private equity ownership is the fact that some of the major US-headquartered private equity issuers are going outside the country for new listings. Most notably, KKR and Ripplewood have listed private equity funds on Euronext. Industry commentators have suggested this is to avoid the regulatory requirements associated with a US listing (namely, compliance with the US Investment Company Act of 1940). This form of regulatory arbitrage is particularly important to private equity funds: the 1940 Act imposes significant restrictions on sponsors' compensation and their ability to implement transactions between affiliates. After an initial flurry of interest, however, the reaction to such offerings in Europe became very cautious. Nevertheless, the recent secondary listing of Investcorp on the London Stock Exchange suggests there may be a revival in demand.

Looking ahead, these transactions may have several potential implications for the US public equity markets. First, foreign listings by the dominant US private equity players could mean that foreign financial services markets capture more of the attendant benefits of the growth in the private equity industry. Second, a European listing of the parent fund may make it more likely that portfolio companies (those companies in which a private equity fund invests) choose to list abroad in the future. Were this to occur, some portion of the just over $2 billion in US IPO revenue, as well as the $25 billion US equity secondary trading revenue pool, could be in jeopardy.[64] Lastly, private equity transactions tend to attract significant media attention and therefore act as trendsetters that other US companies might be inclined to emulate.

C. COMPETITION INTENSIFYING IN TWO KEY MARKETS: DERIVATIVES AND DEBT

As cross-border competition intensifies with regard to financial markets opportunities, two cities in particular – New York and London – are contesting two key battlegrounds: 1) the dynamic and innovative derivatives market and 2) the large, well-established debt financing market. Both of these markets are important because they account for a substantial share of revenues and because the cities' market positions are reasonably close to one another. However, superior conditions for innovation, capital formation, risk management and investment in these markets are beginning to emerge (or have already done so) in London, which is building momentum relative to New York. One business leader, referring to these businesses in particular, commented that "The US is running the risk of becoming marginalized. New York City might become a domestic market only – albeit a very large one."

London's lead in derivatives

London already enjoys clear leadership in the fast-growing and innovative over-the-counter (OTC) derivatives market. This is significant because of the trading flow that surrounds derivatives markets and because of the innovation these markets drive, both of which are key competitive factors for financial centers. Dealers and investors increasingly see derivatives and cash markets as interchangeable and are therefore combining trading operations for both products. Indeed, the derivatives markets can be more liquid than the underlying cash markets. Therefore, as London takes the global lead in derivatives, America's competitiveness in both cash and derivatives flow trading is at risk, as is its position as a center for financial innovation.

The derivatives market is comprised of both exchange-traded and OTC derivatives. Exchange-traded derivatives are governed by very standardized contracts and trading practices; OTC derivatives, which are not traded on an exchange, can be more highly customized. Recently, however, market standards have evolved so that many "flow" OTC derivatives markets are now at least as liquid as exchange-traded comparables. Although a variety of derivative products enjoy significant trading volumes on US and foreign exchanges, revenue generated by OTC-traded instruments far surpasses that produced by exchange-traded derivatives. For instance, the revenue generated in 2005 by exchange-traded fixed income and equity securities was approximately $6.5 billion, compared with revenue for the OTC derivatives markets of slightly over $52 billion.[65]

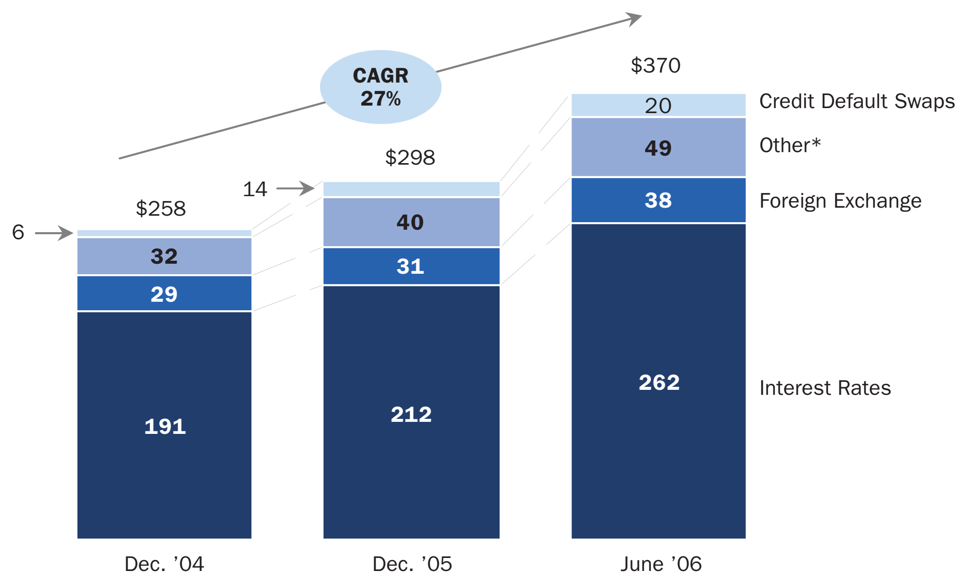
Notional amounts outstanding in the OTC derivatives market have grown at slightly under 30 percent per annum in recent years, as more and more issuers and investors use these products for both investment and risk management purposes (Exhibit 12).

Exhibit 12

OTC DERIVATIVES MARKET HAS EXPERIENCED EXPLOSIVE GROWTH

Global OTC derivatives market

Notional amounts outstanding, $ Trillions



* "Other" consists of equity, commodities, and other unallocated derivatives contracts

Source: BIS

In the two most mature derivatives markets, foreign exchange and interest rates, average daily trading volumes in 2004 were $1.3 trillion and $1.1 trillion, respectively, and the combined trading volume grew at an annual rate of over 11 percent from 1998 to 2004.[66] Other markets are smaller but growing even faster: the equity derivatives market grew 28 percent annually from 2001 to 2005; the credit derivatives market, which had just $1 trillion in outstanding notional in 2001, is now estimated to be as large as $20 trillion.[67] This growth should continue as clients increasingly turn to derivatives for risk management and investment purposes, as operations and settlement procedures improve, and as products continue to evolve. This also means that the already sizeable revenues from derivatives will continue to grow despite inevitable future pressure on trading spreads.

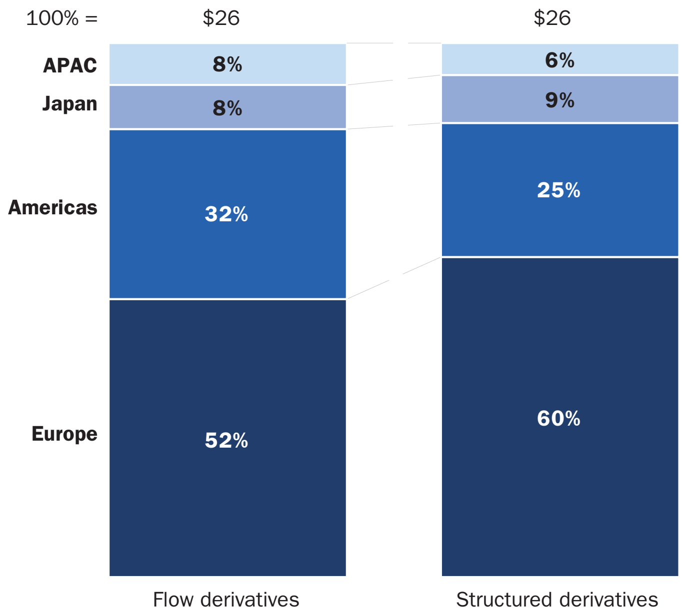
Europe has the largest share of global derivative revenues and London is the main trading center for most of these markets. Based on average monthly trading turnover, London has a 49 percent market share in foreign exchange derivatives and a 34 percent share in interest rate derivatives[68] (the US has 16 percent and 24 percent of those markets, respectively). Europe's revenue leadership across all product categories is even more striking: the region has a 60 percent or greater revenue share in interest rate, foreign exchange, equity and fund-linked derivatives.[69] The only derivative product where Europe trails the US is commodities, which accounts for the lowest overall revenue among major product categories.

Europe is also the center for derivatives innovation. "People feel less encumbered overseas by the threat of regulation and so are more likely to think outside of the box," notes one US-based business leader. The UK and France in particular have well-established structured equity derivatives businesses that benefit from significant retail distribution. Non-US markets can also benefit from advantageous capital treatment. For example, in the United Kingdom the FSA has historically permitted a more expansive netting of offsetting positions before application of capital requirements, as compared with the US. Looking at the mix of business between flow and structured derivatives, Europe has a greater lead over the United States in the structured derivatives revenue market (60 percent versus 25 percent) than it does in flow derivatives (52 versus 32 percent) (Exhibit 13).[70] These revenue pools are likely to grow rapidly given the underlying market growth, with Europe the main beneficiary as London solidifies its position as the center for derivatives trading.

Exhibit 13

EUROPE CAPTURES MOST OF THE FLOW AND STRUCTURED DERIVATIVES REVENUE

2005 REVENUES, $ Billions, Percent



Source: McKinsey Global Capital Markets Survey

"Americanization" of overseas debt markets

New York still leads the world in debt financing (both lending and bond issuance), but London is rapidly emerging as an effective alternative for non-US corporations. This is important because the corporate issuance and trading markets are large, profitable, and central to customer relationships for commercial and investment banks. Together, these markets account for over half of wholesale banking revenues[71] – easily more than any other wholesale business activity. New York's preeminence in the debt markets makes it a global magnet for many investors: several central banks have satellite locations in New York in order to buy and trade US dollar-denominated debt. Further, debt financing is often the key to banks' broader relationships with their corporate clients, particularly as companies mature and their need for equity financing and M&A advice wanes.

Within debt markets, two key activities are the most dynamic and important for borrowers, investors and banks. The first is leveraged lending – lending to companies with a rating below investment-grade. Issuance volumes have grown fivefold in this market since 1995,[72] fueled by record-setting deals such as the $16.8 billion leveraged buyout of HCA, and led by private equity firms whose portfolios of companies now rival the world's largest corporations in terms of size. Although leveraged lending accounts for only about 20 percent of all corporate lending and bond issuance,[73] it generates 45 percent of revenues.[74]

The second key activity is securitization – packaging pools of similar debt obligations such as residential mortgages into public securities, often with differentiated risk/return characteristics. This business has grown by over 20 percent annually in the United States since 1995, almost twice as fast as the corporate debt market.[75] In 2005, global securitized issuance reached $3.6 trillion[76] and accounted for over half the revenues from all debt issuance.[77]

The United States remains the center of innovation for both leveraged lending and securitization. It continues to drive development of the leveraged lending market, with just over 60 percent of global issuance and approximately 70 percent of revenues in 2005, versus 32 percent and 27 percent, respectively, for Europe.[78] The high-yield bond market was invented in the United States in the 1980s, and enabled the takeover and restructuring of many of the largest companies of the time. In the 1990s, innovation again altered the makeup of the market as borrowers, banks, and institutional investors concluded that the bank loan market was superior to the bond market for rapid deal execution, risk diversification, and restructuring in case of borrower default. While the US non-investment-grade debt market flourished, the European market stagnated, hampered by terms and conditions that protected senior bank lenders to the exclusion of other creditors. As a result, non-investment-grade European borrowers routinely went to New York for their debt financing.

The United States still accounts for 83 percent of securitization issuance volume[79] and 87 percent of securitization revenues,[80] dwarfing both Europe and Asia. Today's dramatic US leadership in securitization was initially born of necessity: government-sponsored enterprises (GSEs) such as Freddie Mac and Fannie Mae received favorable capital and funding treatment in exchange for securitizing mortgages originated by institutions whose size, skills and geographic concentration made diversification difficult. Historically, the United States led the world in fostering all the necessary conditions for a robust and dynamic securitization market: competitive charters for private non-bank financial institutions, a healthy commercial paper market, and the financial engineering skills necessary to price, structure and hedge risks inherent to securitized products.

Despite these relatively healthy market positions for the US, looking ahead, the days of its dominance in leveraged lending and securitization may be numbered. Thus far in 2006, European loans to non-investment-grade companies have accounted for 33 percent of the market ($353 billion), up from just 18 percent in 2000.[81] It seems that US-headquartered investment banks and law firms have worked with European non-investment-grade companies, investors, and banks to export US-style terms and conditions to London. According to the head of credit markets at one of the top leveraged lenders on Wall Street, “All of our growth will come from London and Asia; we’re already doing everything we can do here in the US.” For US banks, proposed changes to the US implementation of Basel II, as described in Section III below, could accelerate this shift of lending away from the US.

US securitization leadership is likely to continue for some time, but the seeds of change are already germinating. Residential and other consumer finance markets are already very mature, with 69 percent of US households owning homes as of the third quarter of 2006,[82] and the financial obligations ratio (the percentage of income required for debt service and rent) reaching a record 19.2 percent in the second quarter of 2006.[83] US-headquartered investment banks are now looking to other less developed markets for the next wave of income growth from securitization. For instance, several investment banks are already betting that, over the longer term, rising income levels, massive urbanization, and much-needed improvements in investor disclosures and protections will make the Chinese residential mortgage-backed securitization market one of the largest in the world.

Domestic drivers of competitiveness that policymakers can influence

An assessment of New York City's competitiveness in financial services, particularly relative to London, is central to the recommendations for how to ensure that it remains a preeminent global financial center. As discussed in this section, many of the factors driving the City's competitiveness are actually *national* policies and issues, and addressing them will benefit financial services institutions, consumers, and investors across the United States. As a result, in many respects a comparison between New York and London becomes a comparison between the US and the UK. McKinsey's primary research has highlighted three critically important factors that determine the competitiveness of a global financial services center: the availability of talent, the legal environment, and regulation (more specifically, government and regulatory responsiveness, as well as the more general regulatory environment). From the perspective of financial services CEOs and other leading decision-makers, New York is doing well as a center for talent, but it lags behind London on the legal and regulatory fronts.

A. FINANCIAL SERVICES LEADERS PERCEIVE NEW YORK CITY AS WEAKENING

In building the assessment, McKinsey carried out a large number of interviews and surveys with industry leaders and others whose views will shape the future of New York City as a financial center (see sidebar: "Understanding Attitudes," p.62). The surveys show that, generally speaking, these decision-makers see London as having more momentum, but feel confident about New York's long-term viability. The research identified a trend in staff migration, with many new, high-value jobs destined for London. Finally, critical gaps were noted in New York's performance that must be addressed to reassert its preeminence.

UNDERSTANDING ATTITUDES

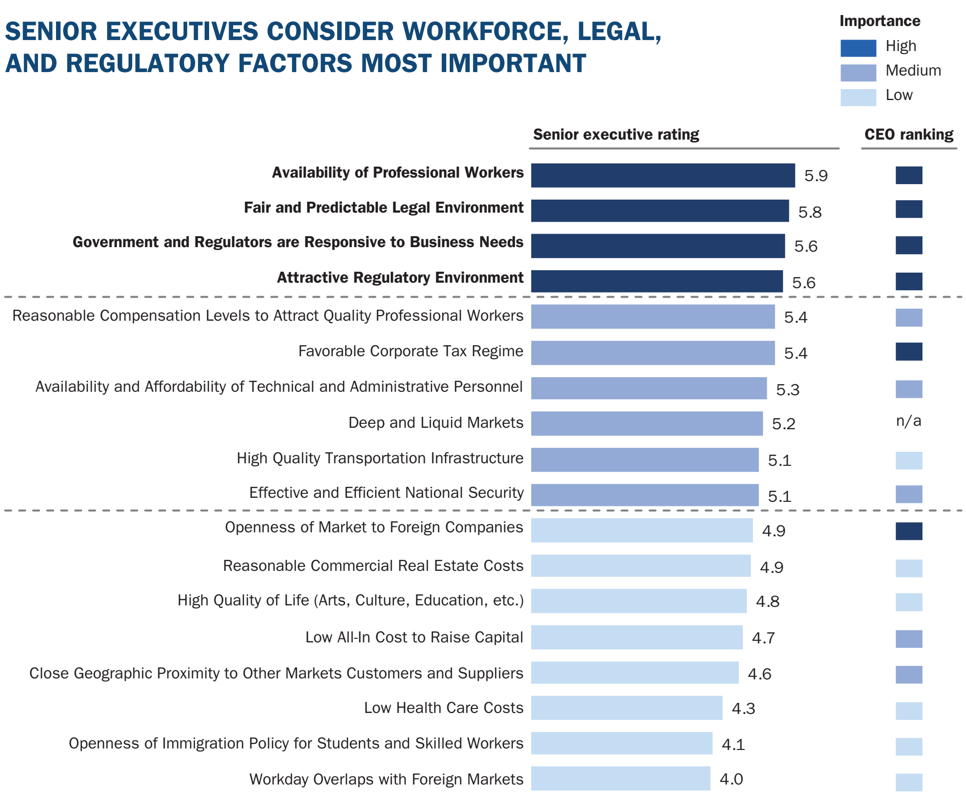
In attempting to understand the priorities and attitudes of executives in the financial services sector, McKinsey & Company conducted a series of primary research efforts. These included: 1) in-depth interviews with over 50 industry CEOs, senior executives, regulators, lawyers, politicians, and other interest groups; 2) a paper-based survey sent to CEOs of other leading financial services institutions around the world, which provided more than 30 top management perspectives *(CEO survey)*; and 3) an on-line survey of senior executives in financial services firms around the world that elicited 275 responses *(senior executive survey)*.

The interviews provided insights into industry leaders' attitudes and beliefs, concerns, and suggested remedies. The CEO survey provided further depth with regard to the concerns of the industry's top decision-makers. Finally, the senior executive survey offered significantly more statistical data, which was used to refine the trends identified using the first two sources. These survey responses were weighted to obtain a target geographical distribution that mirrored that of the world's top 1,000 financial services firms by market capitalization as between the United States, United Kingdom, France and Germany (fewer responses did not permit a weighting of Asian countries).

The most significant section of the senior executive survey measured the relative importance of 18 different factors of competitiveness on a 7-point scale (Exhibit 14). Four factors rated above 5.5 and are deemed the most critical elements of competitiveness: a professional workforce, the legal environment, government and regulatory responsiveness, and the regulatory environment. The next six factors, rated between 5.0 and 5.5, are of moderate importance; these include the cost of doing business (including compensation levels and corporate taxes), the availability of technical and administrative talent, market depth and liquidity, and safe, effective, and efficient infrastructure (including quality transportation and national security). Other factors, with ratings below 5.0, are less important to senior executives in financial services. These factors had to do with market openness (to foreign firms, immigration), other cost elements (commercial real estate, cost of raising capital, and health care), quality of life, and geographic issues (proximity to customers and suppliers and time zone overlap). ■

Exhibit 14

SENIOR EXECUTIVES CONSIDER WORKFORCE, LEGAL, AND REGULATORY FACTORS MOST IMPORTANT



Source: McKinsey Financial Services Senior Executive Survey

London's superior momentum

CEOs and other senior executives around the world were asked to compare New York City with London in terms of each city's overall desirability as a place from which to conduct financial services business. In interviews, most US-based respondents expressed strong loyalty toward New York. As one CEO put it, "New York has the largest pool of best-qualified talent, which in turn attracts the next generation of great talent. New York's culture of accepting, assimilating and learning from diversity is unmatched anywhere else in the world, and it is a pure form of meritocracy. As a result, New York City has an unparalleled ability to draw on the strengths of its population to foster superior innovation." Interviewees from elsewhere also expressed respect for New York; for example, a senior executive in the UK indicated that "New York has the best raw talent, a rich history of banking, and a culture more accepting of financial services professionals."

Despite the positive sentiments about New York as a center for financial services, there was a broad consensus, irrespective of respondents' country of origin, that New York has become *less* attractive relative to London over the last three years. Nearly half of respondents in the CEO survey said they believed New York had become less attractive, compared with just one person who felt that London had become less attractive. Conversely, one in two felt that London had become more attractive, compared with only about one in every five who felt the same way about New York. The other set of senior executives surveyed agreed with the trend, but were less pronounced in their opinions. The latter group, however, also exercises less control over business location decisions than respondents to the CEO survey.

Survey respondents had more mixed expectations about the future for the two cities over the next three years. Only about a fifth of senior executives surveyed expected New York City to become less attractive as a place to do business, while CEOs were more negative, with just over two-fifths sharing this perspective. London fared better than New York on the same question; just under 10 percent of CEOs believe that London will deteriorate as a place to do financial services business, while over half expect that London will improve.

In interviews, executives from both cities agreed that London's momentum is currently stronger than New York's. One suggested that "it would take a lot of bad management by government to derail London's success." The effects of this momentum have yet to fully take hold, but decision-makers' faith in London's progress could become a self-fulfilling prophecy if things remain the same. Nevertheless, there is also an expectation that New York City can regain momentum through a concerted effort. Senior executives indeed had little doubt that New York City would persist as a global financial hub: 88 percent anticipated that the City would be a global financial hub in 10 years (81 percent felt that London would have the same status).

London attracts new jobs

There may be a positive consensus about New York City's long-term prospects as a global financial hub, but neither the City nor the United States as a whole can be complacent given the discontent evident today: the opinions highlighted above come from the people who decide where to locate and conduct business. In fact, the views expressed in the surveys on financial services attractiveness are already borne out on the ground. From 2002 to 2005, London's financial services workforce expanded by 4.3 percent, or 13,000 jobs, to 318,000.[84] By contrast, over the same period, New York City's financial services employment fell by 0.7 percent to 328,400, a net loss of more than 2,000 jobs.[85] It is also worth noting that the respondents to the CEO survey reported, on average, that they were increasing employment levels in London while keeping their New York employment levels relatively stable. Given how crucial financial services are to the local economy, these trends should be of the utmost concern for New York City and State policy makers.

Anecdotal evidence also demonstrates a trend toward US-headquartered firms shifting leadership of certain corporate and investment banking businesses from New York to London. As the *Financial Times* in London reported recently, Goldman Sachs' CEO has just taken the unprecedented step of setting up a duplicate office of the CEO in London, where he now spends nearly half his time.[86] A number of other big competitors on Wall Street have also been shifting more high-level decision-making power to London. These are meaningful changes for US-headquartered firms that have traditionally concentrated leadership in the United States.

Identifying what drives the difference

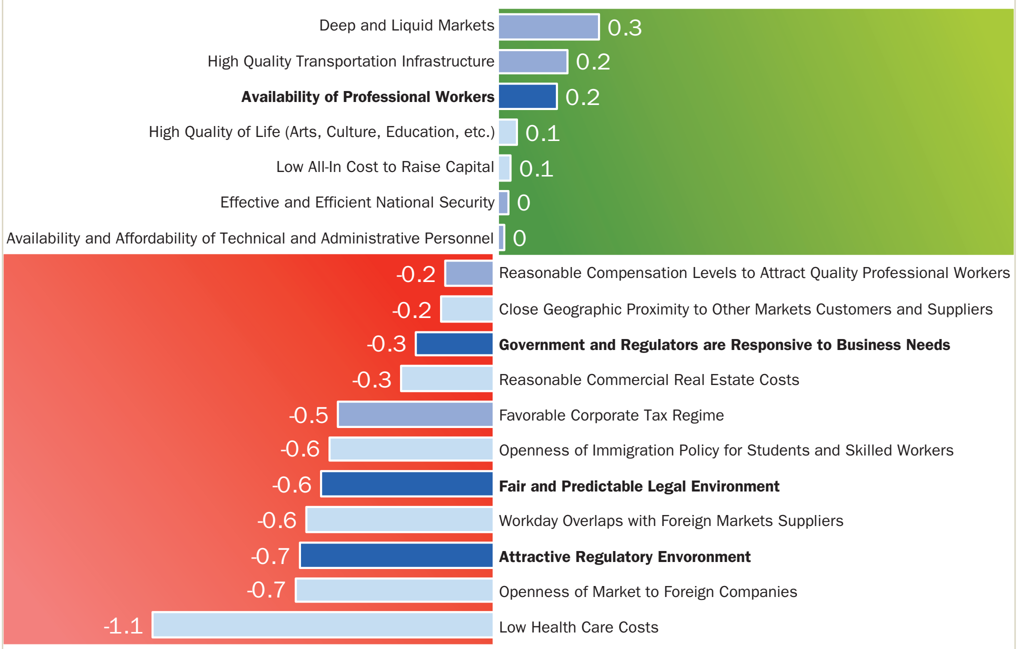
Beyond each city's relative attractiveness and the shifting employment situation, the surveys also sought to identify how each city performed on what respondents believed to be the key factors of competitiveness for financial markets. As previously mentioned, the four factors that mattered most to financial services respondents in the senior executive survey were the availability of professional workers, a fair and predictable legal environment, government and regulatory responsiveness to business needs, and attractive regulatory conditions. Of those four critical factors, according to the survey, New York outperforms London only on talent; on the other three factors, London has the edge (Exhibit 15). The sources of these differences are explored in greater detail later in this section.

Exhibit 15

AMONG HIGH IMPORTANCE FACTORS, NEW YORK EXCELS IN TALENT BUT UNDERPERFORMS IN LEGAL AND REGULATORY

Performance gap, rating scale

Importance*
High
Medium
Low



* High importance factors were rated between 5.5-6.0 on a 7-point scale; medium between 5.0-5.4; low were less than 5.0

Source: McKinsey Financial Services Senior Executive Survey

The next six factors of competitiveness are more evenly balanced: New York is ahead on two (depth and liquidity of markets and transportation infrastructure), London is ahead on two others (corporate tax regime, compensation levels), and the two cities are essentially tied on the last two (national security and the availability of administrative and technical personnel). Other factors of lesser importance, including cost of capital-raising and health care, tended on balance to favor London, although these factors do not strongly influence senior executives' decisions about where to locate global businesses or raise money.

B. NEW YORK STILL WINNING THE WAR FOR TALENT

A high-quality professional workforce stands at the forefront of any battle for global competitiveness. New York City excels on this dimension, according to the senior executive survey, scoring higher than London for the availability of such talent. In fact, this factor received the second-highest performance score for New York out of the 18 factors examined, second only to quality of life, which is itself a major driver for attracting professionals. Interviews confirmed that most financial services CEOs and senior executives still view New York as the best place to build a professional workforce. As one interviewee put it, “New York remains the most appealing city for the world’s best talent.”

To better understand New York’s professional workforce advantage, three key themes that emerged from the interviews are examined below: A high quality of life at reasonable cost, an open flow of talent through immigration, and an innovative culture fuelled by the clustering of talent. New York offers an equivalent quality of life to London, but at a lower cost. However, restrictive immigration policies are making it harder for non-US citizens to move into the country, which is slowly eroding the City’s hard-earned advantage. Moreover, a culture of litigation (discussed in more detail later in this chapter) may have begun to undermine America’s entrepreneurial culture, damaging innovation. Overall, New York still holds a tangible advantage over London in the global war for talent, but it must pay heed to those issues that threaten this position.

Cost and quality of life favor New York

There is no doubt that a key factor in attracting talent is the quality and cost of living. New York and London scored similarly in terms of quality of life in the senior executive survey: 30 percent of respondents thought New York was a better place to live, 32 percent considered London superior, and 38 percent considered them equal (Exhibit 16). CEOs surveyed had a similar perspective.

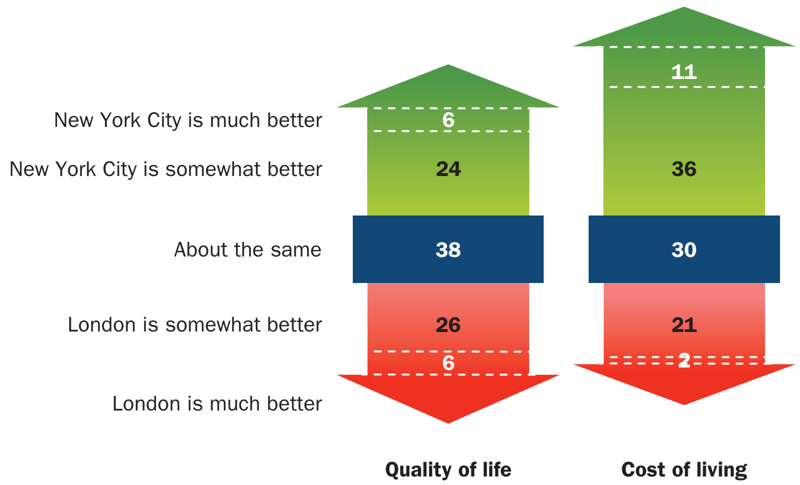
Although both locations performed equally well on quality of life, different factors drove each city’s strong performance. Respondents to the senior executive survey deemed housing, education, and crime rates the most important elements of quality of life, followed very closely by personal taxes, safety from terrorism, commuting options, and cultural activities. London scored slightly more favorably on housing, education, and

Exhibit 16

RESPONDENTS FEEL NEW YORK CITY IS LESS EXPENSIVE TO LIVE IN THAN LONDON, BUT PROVIDES AN EQUAL QUALITY OF LIFE

Ranking by response, Percent

Overall how would you rate New York City and London for quality of life and cost of living?



Source: McKinsey Financial Services Senior Executive Survey

crime rates; New York on personal taxes and commuting options. There was a virtual tie on safety from terrorism and cultural activities.

Interviewees provided additional color on the specific factors that drove their appreciation for New York City. One commented on the strides the City has made in recent years saying, “The City has never looked better.” Another noted, “New York has come a long way since the 1980s – remember how much crime we used to have here?” Empirical evidence supports many of New York’s strengths: four of every five rush-hour commuters avoid traffic congestion by taking advantage of some form of mass-transit service, there are more than 60 arts institutions, and 1,700 parks, playgrounds, and recreation facilities are spread across the five boroughs.

The similarity between the two cities on the high quality of life measure disappeared quickly when respondents were asked about cost of living. The majority of CEOs placed New York in the "moderate cost" or "high cost" category, with fewer than half placing it in the "very high cost" bracket. By contrast, nearly 80 percent of CEOs considered London to be "very high cost;" senior executives surveyed agreed with this assessment. Mercer's 2006 cost of living study confirms this, with New York ranked eleventh, and London ranked fifth in a ranking of the most expensive places to live. Moreover, Cushman & Wakefield's 2005 study on office rents confirms that New York's midtown and downtown neighborhoods are substantially less expensive for commercial tenants, at $64 and $41 per square foot versus $84 for London's City, and $138 in the West End, $73 in Midtown London, and $60 in Canary Wharf.

Immigration restrictions present a challenge

Despite New York's perceived advantage in attracting quality professional talent, which is driven in part by its lower cost of living, there are concerns that restrictive US immigration policies, a key factor in creating a talented workforce, are undermining this advantage by making it harder to get talented employees into the City, and thus into the sector. For a start, visa application processes and immigration procedures at point of entry to the United States are off-putting for business people coming to the country. In addition, caps on H-1B visas (which allow US companies to temporarily employ foreign workers with an undergraduate degree or higher) and the so-called "Cap Gap" (the period between when certain student and exchange visitor practical training permits expire and when an H-1B visa is officially granted) have made it harder for businesses to hire talented foreign workers.

A recent study undertaken by the Discover America Partnership revealed that almost 40 percent of foreigners consider the US the worst place to travel to in terms of obtaining documents and having respectful immigration officials. This is more than double the next most inconvenient place, the Middle East, which only 16 percent of respondents selected, and far worse than Europe, as only 7 percent of respondents decried European immigration policies. Travelers' negative experiences specifically focused on obtaining visas and getting through customs, with 36 percent of interviewees indicating they would not come to the US for fear of being detained by customs officials for "hours or worse" while at the airport. Moreover, 40 percent indicated that they had given up trying to obtain visas over the last two years and over half said that it was "unreasonably inconvenient" to obtain a US visa in their home country.[87]

Business leaders interviewed also expressed concern that the unpredictable outcomes associated with the discretionary approach to B1 (business visitors) and B2 (leisure visitors) visa issuance made the United States unwelcoming. Although foreigners can request a B1 visa valid for up to six months, consular and immigration officers have sole authority to determine the actual length of the stay, based on the circumstances presented – clearly a problem if the visa's duration is too short for the purposes of the business trip. Several interviewees also related stories about how immigration officials would not allow them to bring important foreign executives into the United States for critical business meetings. Others described how visiting delegations of foreign VIPs went through difficult and at times humiliating interview processes in order to enter the country. As one put it, "It's no surprise that foreign CEOs now actively avoid the US." Despite having hired 570 consular officials over the last five years, mostly to reduce the waiting times for people from large and high-demand countries such as India and China, visa wait times remain highly variable, from several days in Paris to nearly a month in Shanghai.[88] Increased border security has also made it more challenging for employment-seeking foreign professionals using these visas to enter the country. These issues have collectively damaged the ability of financial services employers to attract foreign talent to the United States.

The cap on H-1B visas also presents an impediment to talent mobility. It affects not only the financial services industry, but also engineering, technology, and venture capital employers, many of whom have expressed significant concern about the caps. In 1999, the US began a series of increases in the number of H-1B visas it issued, first to 115,000 and then to 195,000. However, following the 9/11 attacks, the cap was lowered back to the original 65,000 for 2002-03, resulting in a shortage of visas for degree-holding foreigners wishing to work in the United States. In 2006, the H-1B cap was reached at the end of May, only two months after applications began to be accepted, and four months before visa issuance. Significantly, visas ran out before many students could receive their diplomas – itself a requirement in the visa application process. Although Congress has recently made permanent a change that issues an additional 20,000 visas for graduate-level degree holders, the extension appears unlikely to satisfy either the supply of or demand for talented workers, and it has not addressed the problem for foreign workers with only an undergraduate degree. One global equities executive said, "It is much easier to hire talented people in the UK. There are plenty of great people and I never have trouble getting them in because of immigration restrictions; I couldn't hire the team I need in the US today and I wouldn't bother trying." The effect of the H-1B visa cap has thus been to force highly qualified foreign students to start their careers in other countries, increasing the likelihood that they will remain there for the long-term. Moreover, it is preventing US firms from hiring talented foreign workers, which could ultimately harm their international competitiveness.

Finally, the "cap gap" makes it hard for non-US students to remain in the United States. A student with a 12- to 18-month F1 (academic student visa) or J1 (exchange visitor visa) practical training permit could use it as a way to further his or her education while applying for an H-1B visa, which allows for a more permanent employment period of three years (with the opportunity to renew for another three). However, even if the student has been approved for an H-1B, he or she still has to leave the country if the practical training permit expires before the H-1B is officially issued in October. This potential "gap" in legal residency is undesirable and leads many talented students to believe that their continued presence in the US is unwelcome. One immigration expert commented, "It's so hard to work in the US nowadays that many international students are choosing to attend schools in London and elsewhere because they don't think they will be able to work in the US after getting their degrees."

In the EU, and more specifically the UK, talent flows more easily across borders. Any EU citizen (with some limits for countries due to join in 2007) can travel to and work in the UK without a special visa for any period of time. This open immigration policy enables the best and brightest people to move into the workforce easily and facilitates a clustering effect in the European labor pool. Non EU-nationals also find it easy to get a work permit in the UK since there are no quotas in place and it typically takes a few days (and a maximum of two weeks) to obtain a work visa. The ability to move freely across labor markets is in and of itself attractive to talented workers who might otherwise have come to the United States if policies there were less restrictive and cumbersome.

Is New York's innovation culture under threat?

Talented people are attracted to – and perpetuate – an innovative environment, and the United States has historically been a center for innovation. In the words of one interviewee, “Clustering is very important to idea generation, and the talent that is clustered in New York is the main reason for its track record of innovation.” But while innovation has historically thrived in the US, the surge in litigation in the country runs the risk of cooling the innovative spirit.

The senior executives surveyed felt that, broadly speaking, New York was significantly more innovative than London. Considering innovation across *all industries*, 47 percent of respondents thought New York was more innovative than London, whereas only 15 percent viewed London more favorably (Exhibit 17). Clearly, innovation is a key advantage for New York in attracting a talented workforce.

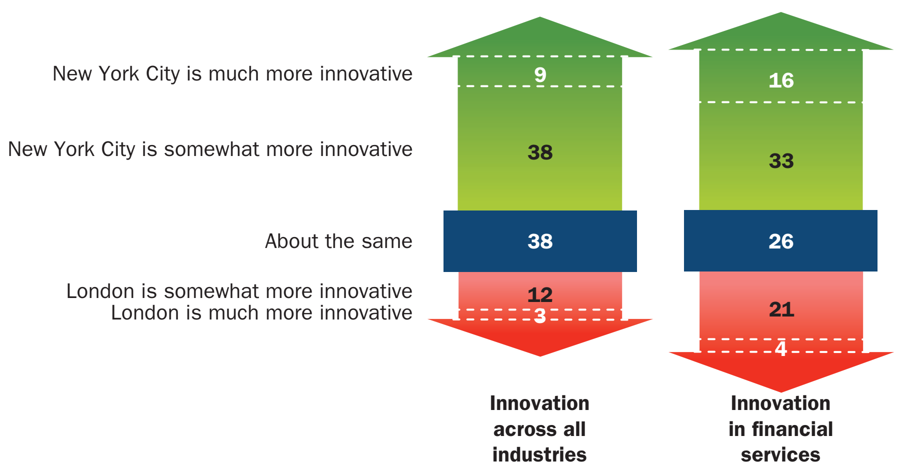
However, as addressed in the previous chapter, London’s leadership in derivatives has helped promote innovation there and, when combined with the ease with which talent can move to the UK, it is easy to see why London might be catching up to New York

Exhibit 17

NEW YORK CITY IS CONSIDERED MORE INNOVATIVE THAN LONDON, ALTHOUGH THE ADVANTAGE IS NOT AS STRONG IN FINANCIAL SERVICES

Ranking by response, Percent

Which is a more innovative environment?



Source: McKinsey Financial Services Senior Executive Survey

in this area. Survey data support this supposition: when asked about innovation in *financial services* specifically, 49 percent of respondents thought New York was more innovative, but 25 percent put London ahead, suggesting that London might be closing the gap with New York in this sector. Some interviewees suggested another important reason why London might be catching up: the legal risks associated with being a business trailblazer are starting to undermine America's entrepreneurial culture, which in turn damages its traditional leadership in innovation. Given the risks associated with experimentation in financial services, it would make sense for some of the more cutting-edge activity to move overseas.

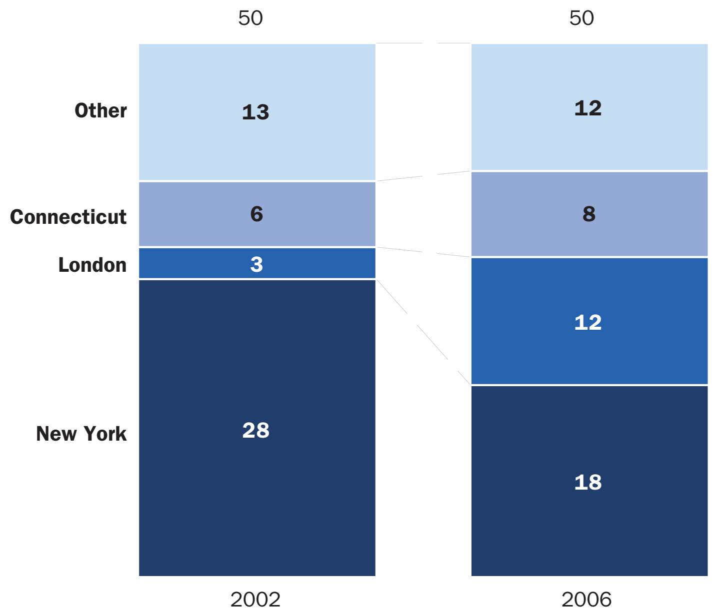
One example of the impact that the clustering of talent and innovation can have is the dramatic increase in the number of hedge funds located very close together in London. "Hedge funds started in the US," notes one executive, and hedge fund assets under management remain significantly larger in the United States with $715 billion under management at the end of 2005 (compared with assets under management in the UK of $244 billion). However, over the last three years, assets in the UK have been growing at an astounding average annual rate of 63 percent, compared with 13 percent in the United States. Twelve of the world's 50 largest hedge funds are now located in London, up from just three only four years ago (Exhibit 18). Although it is unclear whether this is part of the natural evolution of a high-growth industry that started later overseas, or whether the industry is expressing a specific preference for London over New York (perhaps due to greater regulatory certainty for hedge funds in the UK, as compared with the US), the attraction of a highly concentrated hedge fund talent pool, and the trading volumes they control, is a strong magnet for the kind of talent that drives innovation.

Overall, New York is still the winner in the war for talent. It is seen as having a superior stock of professional workers who are attracted by the City's work ethic, elevated compensation levels, high quality of life at a relatively lower cost, and clustering of talent. However, restrictive immigration policies and a threat to innovation may be causing these advantages to erode. With foreign students increasingly choosing European schools and international talent being drawn to London, New York needs to consider how to reinvigorate itself to maintain its competitive edge.

Exhibit 18

LARGE HEDGE FUNDS ARE INCREASINGLY LOCATED IN LONDON

Top 50 hedge funds globally



Source: Institutional Investor

C. A LEGAL ENVIRONMENT SEEN AS EXPENSIVE AND UNPREDICTABLE

The second most important factor of competitiveness revealed by the surveys and interviews was the quality of the legal system. Here, New York City is seen as being significantly behind London. Most critically, interviewees often cited America's general propensity for litigation as the biggest driver behind New York City's problems in this area. Beyond societal litigiousness, they also indicated that the increasing extraterritorial reach of US law and the unpredictable nature of the legal system were also significant factors that caused New York to be viewed negatively on this dimension.

A high propensity toward legal action

Regardless of one's view of the US tort system, the fact is that civil liability has experienced dramatic growth in recent years. Some estimates put the cost of the US tort system at $260 billion in 2004, approximately double 1990 levels.[89] Of greater concern, the trend appears to have recently accelerated: whereas tort system costs grew at approximately 3 percent per year between 1990 and 2000, growth reached 10 percent annually for the period from 2000 to 2004.

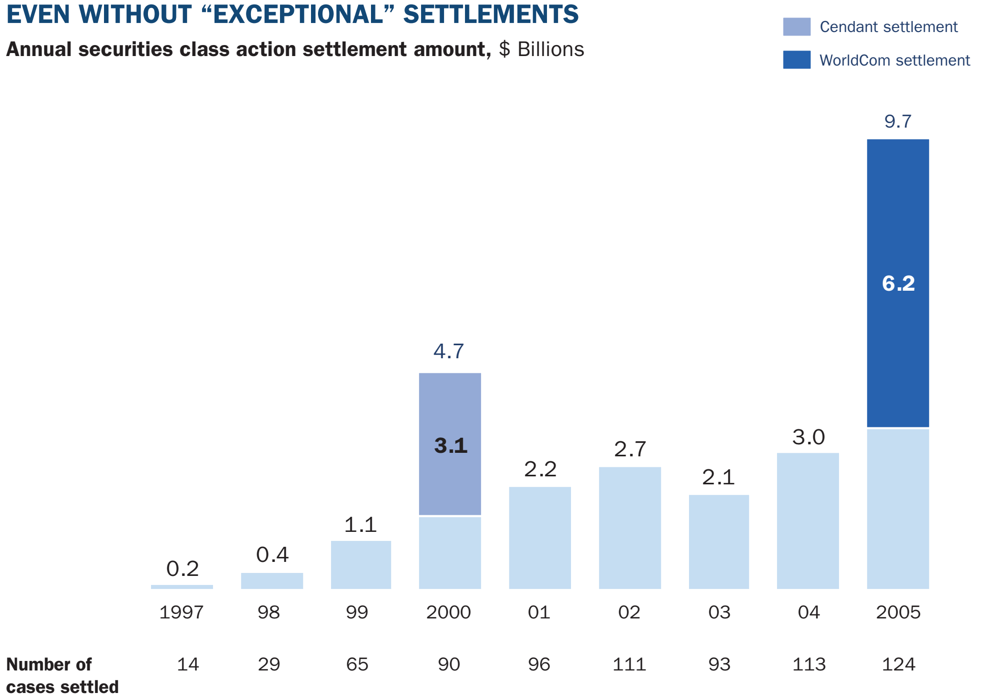
The propensity toward litigation, a significant issue for society as a whole, is of particular importance to the securities industry, which in recent years has borne a disproportionate share of the overall cost. Not only did 2005 set a new record for the highest-ever number of securities class-action settlements, but the overall value of these settlements overshadowed every prior year. The total bill for securities settlements in 2005 was $3.5 billion (omitting WorldCom-related settlements of approximately $6.2 billion), up more than 15 percent over 2004, and nearly 70 percent over 2003. 2006 is expected have been another expensive year for the industry, albeit largely because more than $7 billion in Enron-related settlements have been reached.[90] Of course, many of the claims underlying these settlements – including those associated with the largest payments (e.g., Cendant, WorldCom and Enron) – are legitimate and have allowed investors to recoup warranted damages. Nevertheless, the sheer size of the aggregate settlement amounts emphasizes the growing importance that the tort system has assumed in the US economy (Exhibit 19).

Recent evidence indicates that, while the number of securities settlements climbed to new heights in 2005, the number of securities class action filings decreased in both 2005 and 2006.[91] Several factors likely contributed to this decline, including such positive reasons as the enactment of the Sarbanes-Oxley Act in 2002, more diligent enforcement by the SEC and Department of Justice (DOJ), and the recent attacks on "pay to play" practices allegedly employed by some plaintiffs' attorneys. Unfortunately, other less hopeful reasons may also explain much of the recent decline in new class action filings: US stock prices have exhibited relatively little volatility in 2005 and 2006 (changes in stock prices that negatively affect the economic welfare of investors being a principal determinant for how many securities actions are filed), and the fact that the boom and bust cycle of the beginning of the decade is now receding into the past – along with the attendant windfalls, investor losses, and class action suits this created. It is thus likely that the recent decrease in securities class action filings is due at least as much to a change in the economic conjuncture as to

Exhibit 19

VALUE OF US CLASS-ACTION SETTLEMENTS REACHING RECORD HIGHS, EVEN WITHOUT "EXCEPTIONAL" SETTLEMENTS

Annual securities class action settlement amount, $ Billions



Source: Cornerstone Research

structural improvements in America's legal and regulatory framework. A significant level of apprehension therefore remains: if economic conditions were to decline in the future, then a strong resurgence in lawsuits would likely follow.

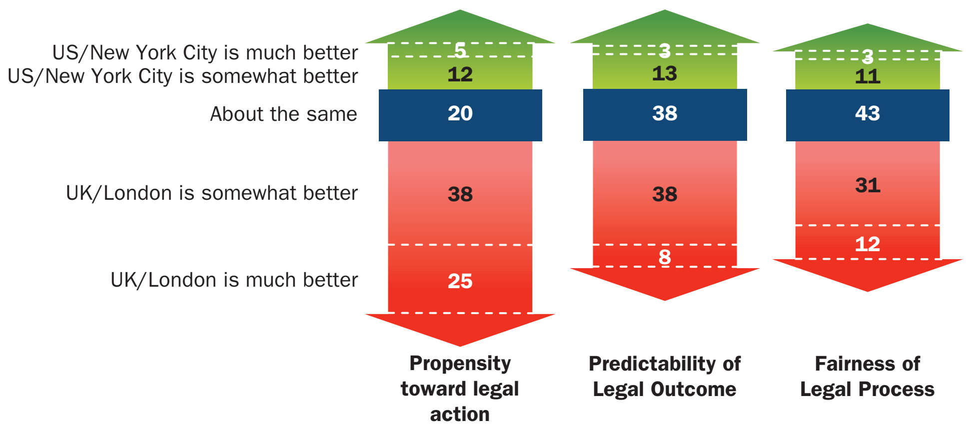
Not surprisingly then, the high legal cost of doing business in the US financial services industry is of real concern to corporate executives. When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem. Worryingly for New York, the city fares far worse than London in this regard: 63 percent of respondents thought the UK (and by extension London) had a less litigious culture than the United States, while only 17 percent felt the US (and by extension New York) was a less litigious place than the United Kingdom (Exhibit 20). This is a dramatic result, and it is echoed even more strongly by the CEOs surveyed: 85 percent indicated that London was preferable, and not a single one chose New York.

Exhibit 20

LONDON IS SEEN AS A DRAMATICALLY BETTER LEGAL ENVIRONMENT, ESPECIALLY AS IT RELATES TO PROPENSITY TOWARD LEGAL ACTION

Ranking by response, Percent

Which legal environment is more business-friendly?



Source: McKinsey Financial Services Senior Executive Survey

International concerns over the severity of America's legal system and the extraterritorial application of US law

Above and beyond the costs associated with a litigious society, recent legal developments have further added to the negative reputation of America's legal system abroad. First, it has become increasingly clear that, rather than being just an incremental cost of doing business, the mere threat of legal action can seriously – and sometimes irrevocably – damage a company. Over the past several years, the number of US companies that have been forced into bankruptcy or liquidated because of the threat of securities-related litigation (e.g., Adelphia, Arthur Andersen, WorldCom) has reinforced the perception that the US legal system is particularly punitive in this regard.

Second, liability is not limited to corporate entities but also extends to individuals, even if they are only remotely involved in the US markets. For example, Section 302 of the Sarbanes-Oxley Act specifically imposes personal liability on corporate executives for failing to comply with the Act. The recent extraterritorial application of other US statutes has made even clearer the personal threat that US laws can present. The level of foreign media attention around some of these cases is indicative of the place in the public consciousness that the threat of litigation now occupies outside the US.

Another source of international concern with the extraterritorial application of US laws relates to the increasing likelihood of mergers between US and European exchanges. With NASDAQ acquiring a substantial stake in the LSE and the NYSE and EuronextLiffe obtaining shareholder approval of their intent to merge in December 2006, the possibility of US regulators enforcing the more stringent US regulatory standards internationally has acquired real immediacy for both corporate executives and financial services participants, including European investors and regulators. This concern is evidenced by the Investment, Exchanges and Clearing Houses Act recently proposed by the UK government in an effort to provide the Financial Services Authority with veto power over new rules from foreign regulators if they have a “disproportionate” impact on UK exchanges. Importantly, the NYSE has been very clear about maintaining and defending European regulatory sovereignty for all Euronext activities.

US legal system’s perceived unpredictability is causing concern

Relative to most other countries, the US legal system is multi-tiered and highly complex. Not only is it divided between state and federal courts, but it also uses a variety of enforcement mechanisms, including legal actions by regulators, state and federal attorneys general, plaintiff classes, and individuals. As a result, and despite a high level of proficiency in most courtrooms (especially at the federal level), the system’s inherent complexity has the unfortunate side effect of making it harder to manage legal risk in the US than in many other jurisdictions. The senior executives surveyed certainly concur. Only about 15 percent felt that the US system was better than the UK’s in terms of predictability and fairness, while over 40 percent favored the UK in both these regards. The CEOs interviewed also shared this sentiment, although they felt that London’s advantage was particularly strong in terms of the predictability. Legal experts indicated that this is a major reason why many corporations now choose English law to govern their international commercial contracts.

Making matters worse, the relative importance of litigation risk has increased in recent years as a variety of enforcement efforts and subsequent rulings in the financial services industry have appeared to effectively criminalize conduct that had until then been assumed to be permissible. This caused many market participants to question their understanding of the scope of existing law, which in turn led them to adopt costly risk-averse behavior and bear the associated opportunity costs. Although those costs are difficult to quantify, as they encompass the opportunity cost of many foregone business opportunities, there is little doubt that such unnecessarily conservative risk avoidance practices have contributed to the decrease in New York's competitiveness revealed by the surveys.

Recent efforts to enhance the predictability of enforcement efforts, at least at the federal level, should go some way toward alleviating these concerns. For instance, the Department of Justice's McNulty Memorandum, released on December 12, 2006, should ensure greater consistency in the pursuit of future federal criminal indictments, as it requires that federal prosecutors get approval from the Attorney General's office before they can request that companies disclose privileged information. This should ensure that only those cases where a minimum level of evidence exists, and where enforcement is otherwise appropriate, will receive such forceful scrutiny. The McNulty Memorandum thereby provides a valuable blueprint for enhancing the consistency of goals and means of legal enforcement in the future.

D. RECENT US REGULATORY TRENDS DAMAGING COMPETITIVENESS

Striking the right regulatory balance is crucial for any financial center, yet the research indicates that regulatory trends in the United States are actually starting to damage the competitiveness of financial institutions doing business domestically. America's financial services regulatory regime has served the country well in the past, but the system's complexity, cost, and perceived lack of responsiveness, if left unchanged, are likely to make the United States less attractive going forward. Business leaders increasingly see the UK's regulatory model as better suited to a global financial center – both because they consider the overall regulatory environment to be superior, and because they feel regulators are more responsive and efficient. This is not to say that the UK model does not have problems of its own, but the perception is that its approach is more relevant in today's business environment.

Good regulation is critical for financial centers

If there are any doubts as to the importance of regulation to the business community, one need only look at the survey responses to dispel them. The third and fourth most important factors of competitiveness in the senior executive survey are "government and regulators who are responsive to business needs," and "an attractive regulatory environment," Respondents to the CEO survey were even more emphatic, ranking attractiveness of the regulatory environment as the single most important issue determining the international competitiveness of a financial market.

Balanced and effective regulation is considered a positive influence on financial market competitiveness, productivity, the ability to innovate, and it can contribute to greater investor and market confidence. When asked to discuss the relative impact of a variety of regulations, respondents in the senior executive survey saw some in a positive light. For example, SEC disclosure rules on insider transactions were thought to have had a positive impact by 48 percent of respondents, while only 11 percent of respondents felt they adversely affected their business. Similarly, 52 percent of respondents reacted positively to "know your customer" rules. One interviewee stated, "Strong regulation is a critical part of a financial system, and has historically been one of the biggest reasons for doing business in New York versus other locations." More generally, factors such as the presence of strong institutions competing freely, prudent risk management based on market principles, performance-based supervision, full transparency, accurate accounting statements, an effective market for corporate control, and incentives for good governance were broadly regarded as being strongly determinative of a financial market's attractiveness. Regulation can positively or negatively impact each of these elements, with significant consequences for the financial system and subsequent repercussions on economic activity.

UK regulatory climate seen as more attractive than that in the US

The historical success of the United States as the leading global financial center is at least partly attributable to the underlying regulatory framework. Skilled, experienced regulatory bodies exist at both the national and state levels for the various financial industry sub-segments, and US-regulated financial institutions have traditionally been at the forefront of innovation in both retail and institutional business across all product categories.

Investors have also been well served by the combined efforts of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD), enjoying reasonable protection and the benefits of accurate financial statements. Since 1913, the Board of Governors of the Federal Reserve System, working hand in hand with other federal banking regulators such as the Comptroller of the Currency and the various state regulators, has worked relentlessly to create a stable, safe, and sound banking system that meets the needs of consumers, corporations, and governments alike, while managing risk and potential conflicts of interest. It has done so, for the most part, prudently and effectively. Since the creation of the Federal Deposit Insurance Corporation in 1933, no insured depositor has lost any savings beyond prescribed limits. More generally, US regulations – and the regulators implementing them – have contributed to the overall competitiveness of US financial institutions. Historically, new laws and regulations have been written and supervisory guidance has been adapted to permit new organizational structures, new products and services, and new ways of serving customers.

Lately, however, the regulatory environment that has served the United States so well in the past has begun to work against itself. The increasing pace of innovation and new product development in financial services has meant that responsiveness and flexibility have become ever-more important features of regulation. Yet against this need for speed comes regulators' obligation to protect investors and customers, which has hampered efforts to respond quickly to the ever-changing needs of business and the rapidly evolving nature of risk in the markets. While the United States has struggled to balance rapid innovation with consumer and investor protection, other financial markets – most notably London – have grown faster and been nimble enough to adapt their own regulatory regimes to be responsive to businesses, while still safeguarding customers and investors.

Not surprisingly, the vast majority of interviewees and survey respondents strongly believe that the pendulum of regulation in the United States has swung too far in recent years. An increasingly heavy regulatory burden and a complex, cumbersome regulatory structure with overlaps at the state and national levels is causing an increasing number of businesses to conduct more and more transactions outside the country. For many executives, London has a better regulatory model: it is easier to conduct business there, there is a more open dialogue with practitioners, and the market benefits from high-level, principles-based standards set by a single regulator for all financial markets.

The research for this report highlighted three themes that help explain the growing differences between the US and UK regulatory environments and reveal why the balance may be tipping in favor of London: the regulatory structure, the regulatory and supervisory approach, and regulatory enforcement.

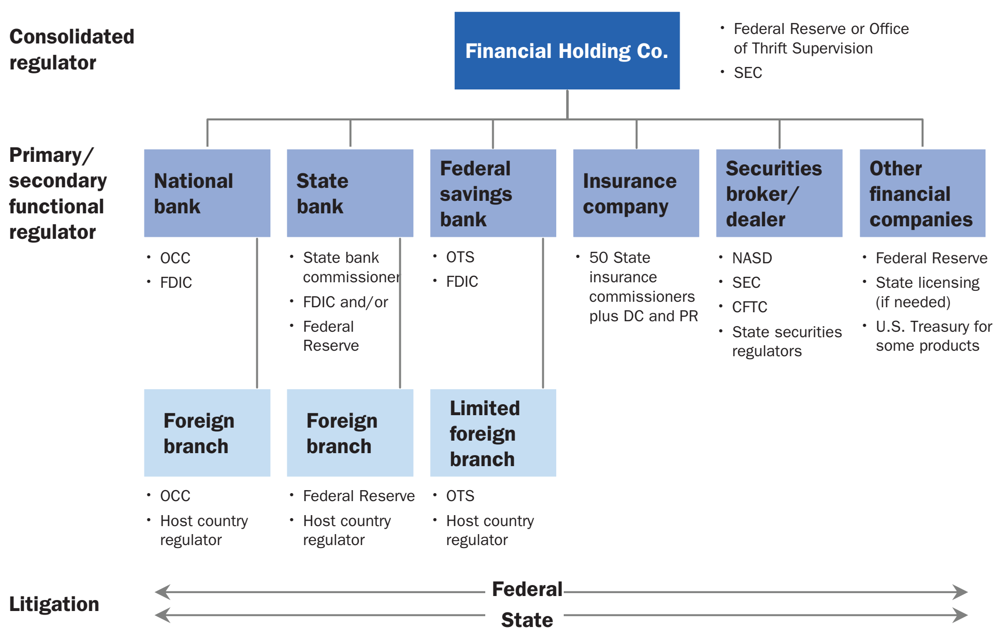
Regulatory structure. The Financial Services Authority (FSA) is the sole regulator for the entire UK financial services industry. Many of the executives interviewed find a single regulator easier to deal with – there is a single point of contact and a single institution to whom regulated parties are held accountable. Increasingly, they prefer to operate under a single, expansive universal banking license, as opposed to working through multiple chartering regimes and a variety of licenses and legal entities. They also favor a regulator that supervises fairly but is responsive to their business needs, and a regulator that can make decisions and take actions relatively quickly, since speed-to-market is an important factor in the highly competitive world of financial services.

The US regulatory system comprises a variety of regulators at the national and state level for the various silos of the financial services industry: commercial banks, savings and loan associations, credit unions, industrial banks, investment banks, insurance companies, finance companies, money brokers, and others (Exhibit 21). For the

Exhibit 21

THE UNITED STATES' REGULATORY REGIME IS COMPLEX AND FRAGMENTED

ILLUSTRATIVE



purposes of consolidated supervision globally, multiple regulators also exist in the United States at the parent holding company level with different sets of rules regarding organizational structures, capital, and risk management (the Federal Reserve, Office of Thrift Supervision, and the SEC). It is not uncommon to find different regulators of the same activities at odds with one another on particular issues, and such conflicts can take months to resolve. Financial holding companies' securities activities, for example, are regulated by the Federal Reserve, the SEC or NASD, and state securities regulators. Meanwhile, insurance sales activities by banks or bank holding companies are governed by both banking laws and the (often different) insurance laws of each state.

The result is that the US financial regulatory system is frequently seen as unresponsive by financial institutions trying to innovate and be at the forefront of effective customer service. Although respondents did not see the FSA as perfect, its theory of regulatory consolidation seems to offer greater hope of enhancing simplicity and responsiveness.

Regulatory and supervisory approach. The UK system is now largely principles-based and guided by outcomes – e.g., Treating Customers Fairly – in contrast with the US rules-based system, which is more input-driven – e.g., dictating what products a company may or may not offer to customers under certain conditions through specified channels.

The UK's FSA implements principles-based regulation via a two-tiered set of regulatory principles. First, in an effort to provide greater clarity and predictability to regulated entities, the FSA has issued a set of eleven high-level principles that embody the essence of what is expected of regulated firms. This set of principles includes, among others, the requirement that firms conduct themselves with integrity, and that they maintain adequate financial resources. Although applying these principles to real-life situations is not always a straightforward process, the principles have the benefit of setting forth clear, high-level guidelines that regulated firms should follow in their day-to-day affairs. The second set of principles relates to the FSA itself. Here, six over-arching policies guide the FSA's approach to regulation, supervision, enforcement, the approval of acquisitions, and the sanctioning of new products and services (see sidebar: "FSA Origin and Principles," p.90). This second set of principles provides the market with greater certainty about the regulator's future course of action and ensures that all new regulations will be subject to a rigorous analysis weighing the costs and benefits to the market.

By contrast, the US approach relies more on rules and compliance. Individual financial regulators at both the national and state levels obviously have their own unique missions to follow as mandated by law, but the overall national financial regulatory system is not guided by a common and universally accepted set of consistent principles that directs the approach to regulation, supervision, enforcement, and approvals. Certainly, the US has nothing comparable to the FSA's two-tiered principles-based system.

Without the benefit of accepted principles to guide them, US regulators default to imposing regulations required by various legislative mandates, many of which date back several decades. These mandates are not subject to major reviews or revisions and therefore tend to fall behind day-to-day practice. This failure to keep pace with the times has made it hard for business leaders to understand how the missions of different regulators relate to their business, and this in turn means that regulators have come to be viewed as unpredictable in their actions toward business. The cost of compliance has also risen dramatically over the last several years. Securities firms reported on average almost one regulatory inquiry per trading day, and large firms experienced more than three times that level. The cost of compliance estimated in an Securities Industry Association report had reached $25 billion in the securities industry alone in 2005 (up from $13 billion in 2002).[92] This increase is equivalent to almost 5 percent of the industry's annual net revenues. Although there are benefits from an increase in compliance-related expenditures, the report found that "a substantial portion of these increased costs were avoidable, reflecting, among other things: duplication of examinations, regulations and supervisory actions; inconsistencies/ lack of harmonization in rules and regulations; ambiguity; and delays in obtaining clear guidance."

Although their mandates have not been updated, regulators have tried to adapt by independently layering on a variety of new rules. A recent study by the Federal Financial Institutions Examination Council, the coordinating group of US banking and thrift regulators, revealed that more than 800 different regulations have been imposed on banks and other deposit-gathering institutions since 1989.[93] Regulations to implement the legislative requirements of the Sarbanes-Oxley Act of 2002 (SOX) are a good example. They are universally viewed by CEOs and other executives surveyed as being too expensive for the benefits of good governance they confer. Consequently, SOX is viewed both domestically and internationally as stifling innovation. "The Sarbanes-Oxley Act and the litigious environment are creating a more risk-averse culture in the United States," one former senior investment banker stated. "We are simply pushing people to do more business overseas rather than addressing the real issues head on."

In the United States, emphasis is placed on uniform compliance with all rules and regulations, albeit with some differentiation based on the size of the institution. There is, however, much less emphasis on the materiality of risk to the financial system or to large groups of customers. Cost/benefit tests are supposed to be applied to new rules and regulation, but regulators could do more analysis alongside the lengthy public review and comment period that takes place before any major regulation is introduced.

“Partly as a result of the rapid globalization and evolution of the financial sector, regulatory requirements have become highly complicated,” the CEO of a large European bank stated. “There is a need to ensure that regulations are developed so that they can keep pace with the rapid change in the market and accurately reflect the global character of the financial services business.” Certainly the rules-based system has served the United States well in the past, and replacing it wholesale with a principles-based approach, such as the FSA’s, is probably not necessary. However, developing a clearly articulated vision, strategy, and mandate that is similar to the FSA’s two-tiered, principles-based system may be a path to the greater flexibility and predictability that financial services business leaders increasingly seem to favor.

Regulatory enforcement. Perhaps the most emotive reactions from executives interviewed for this report came when discussing enforcement. There was growing appreciation for the UK’s more measured approach and escalation process. It is seen as being more results-oriented and more effective, compared with the fragmented US approach, which is seen as being more punitive, more public, and more costly, with multiple enforcement actions by national and state regulators and litigators. The US also holds the possibility of both criminal and civil penalties in different jurisdictions.

Many interviewees felt that they had a receptive audience at the FSA, and that they would receive fair treatment without fear of reprisals or subsequent legal actions. “The FSA is open to discussing issues constructively and resolving problems quietly, without penalizing you for coming forward when you see a potential problem,” said the CEO of one US securities firm. “The multiple US regulators and enforcers, by contrast, play a different game entirely.” Executives in the US were similarly complimentary of the New York Federal Reserve’s approach to addressing problems such as the credit derivatives documentation backlog, namely bringing all the parties together in a collaborative fashion to resolve the issues jointly.

Sadly, the majority of stories are less positive. Executives are by and large hesitant to raise even minor problems with regulators for fear that simply broaching the subject will lead to immediate enforcement action or, worse yet, a highly charged public prosecution. This view was, in the wake of the accounting scandals of the early part of the decade, strengthened by the Department of Justice's Thompson Memorandum, which allowed prosecutors to consider a company's failure to waive the attorney-client privilege as a factor in deciding whether to seek a federal criminal indictment. Many executives and legal academics viewed this as coercive and a violation of the constitutional right to counsel. It was also yet another motivation for executives to channel business to less litigious foreign markets, including London. Although the DOJ's recently released McNulty Memorandum largely reversed the stance taken in the Thompson Memorandum, as it restricts the circumstances under which federal prosecutors can ask a corporation to waive its attorney-client privilege, the fact remains that there is still no safe harbor or self-evaluation privilege allowing companies to conduct a self-assessment and share their findings with the appropriate regulators without fear of unnecessary regulatory or legal reprisals. "Regulators should be supportive of financial services without losing sight of safety and soundness issues," said a top executive of a large financial services holding company, "but there is a real need for a better sense of what matters and what is material and what is not."

The surveys carried out certainly support these themes, but more importantly they indicate that the United Kingdom has a competitive advantage over the United States in terms of being the preferred regulatory regime with internationally recognized high standards for doing business. When asked to compare New York and London on regulatory attractiveness and responsiveness, both CEOs and other senior executives viewed New York as having a worse regulatory environment than London by a statistically significant margin.

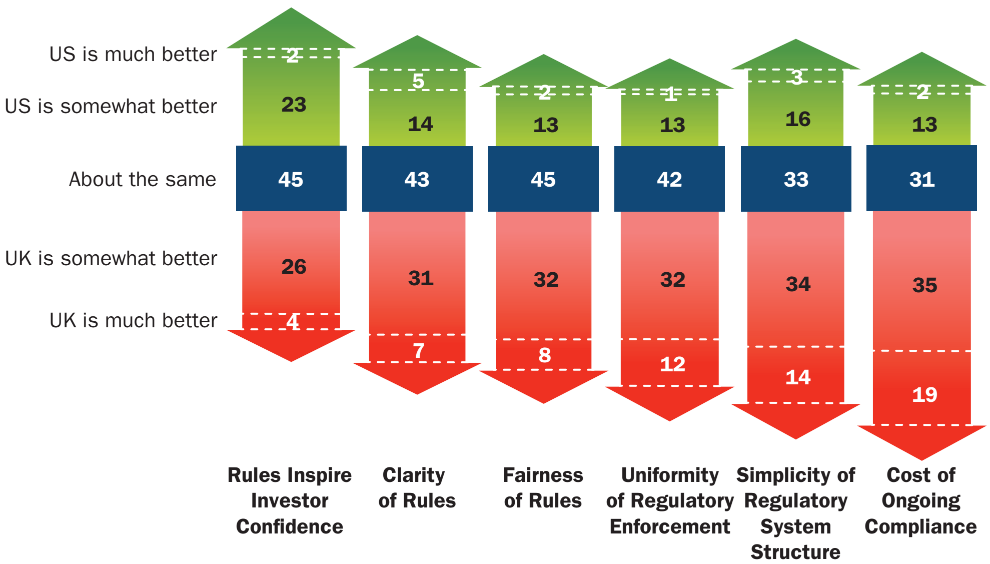
Looking more closely at the drivers behind respondents' preference for London's regulatory regime, surveys asked senior executives to evaluate six different dimensions of the regulatory system. Across all six factors identified, respondents indicated that they preferred the UK's system, although views were more closely balanced with regard to the regulatory system's ability to inspire investor confidence (Exhibit 22). Ranked from highest to lowest degree of UK advantage, the six factors were: cost of ongoing compliance, regulatory simplicity, uniformity, fairness, clarity, and investor confidence. Judged by these measures alone, the United States regulatory regime is at a distinct competitive disadvantage and has significant room for improvement.

Exhibit 22

UK IS PREFERRED ACROSS MANY REGULATORY DIMENSIONS BUT IS MOST DISTINGUISHED IN COST AND SIMPLICITY OF REGULATIONS

Ranking by response, Percent

Which regulatory environment is more business-friendly?



Source: McKinsey Financial Services Senior Executive Survey

Recent legislative and regulatory actions are hurting America's financial competitiveness

The United States is also perceived as being at a disadvantage when it comes to the individual and collective impact of its financial regulation. By far the most often mentioned regulation in interviews was the Sarbanes-Oxley Act (SOX), which was also heavily criticized in the surveys. However, two other areas were also frequently cited: the proposed US-specific modifications to the Basel II framework, and the need for foreign companies to reconcile accounting procedures to US accounting standards. Interviewees generally commented that the differences between international and US standards put the United States at a competitive disadvantage but, more positively, that there was also an opportunity to improve in these areas without major legislative action, while still balancing financial competitiveness with substantial investor protection.

Sarbanes-Oxley. The regulations imposed by the Sarbanes-Oxley Act drew some of the most negative reactions in the surveys: 55 percent of respondents to the senior executive survey believe that the Act will have "strong" or "somewhat negative" impact on their institutions. The interviews reveal a slightly more nuanced view of the Act; most executives strongly agree on the value of good corporate governance, transparency, and auditing standards and, as such, they think that SOX has done much good for corporate America. One CEO even said, "The transparency I have into my business is now much greater than it was previously; I have a deeper understanding of everything that is going on due to the corporate controls we have implemented." But many also believe that the costs of implementing the new SOX requirements outweigh the benefits. A few interviewees went so far as to suggest that the cost involved in SOX is one of the most important reasons why many non-US companies that meet US listing requirements nevertheless choose to stay out of the US equity markets.

Section 404 of Sarbanes-Oxley is only two paragraphs and fewer than 200 words long, but of all the components of the Act, it seems to have the most powerful implications for US financial institutions. Section 404 requires management to include in its annual report an internal control report that states management's responsibility "for establishing and maintaining an adequate internal control structure and procedures for financial reporting," and contains an assessment "of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Section 404 also requires the company's auditors "to attest to, and report on, the assessment made by management." For both companies and audit firms, the consequences of attesting to structure and procedures that later prove to be inadequate are severe: under such circumstances, chief executives, chief financial officers, audit partners and others can face criminal prosecution in the United States, regardless of where the company is headquartered or where the individuals involved reside.

Basel II. Generally, the senior executive surveys revealed positive sentiment regarding Basel II, although there were some subtle and more negative undercurrents from US and commercial banking respondents. Overall, 38 percent of respondents indicated that Basel II rules would have a "strong" or "somewhat positive" impact, versus 27 percent saying they would have a "strong" or "somewhat negative" impact. However, looking more specifically at US respondents, especially at senior-level commercial bankers, the picture becomes much more negative. Within that subset, 57 percent thought Basel II would have a negative impact on their business, whereas only 35 percent felt it would have a positive impact.

US banking regulators have issued for comment the Notice of Proposed Rulemaking (NPR) for Basel II implementation in the US. Interviews with CEOs and other thought leaders anecdotally suggest that the differences between this proposed regime and the implementation chosen by most other counties may put the US banking system at a competitive disadvantage. The purpose of the Basel II accord is to provide a consistent international risk-based capital standard. Basel I was no longer appropriate as a capital adequacy regime given the complexity of larger institutions. Basel II allows for the Advanced Approach where larger institutions can implement a risk-based model to determine capital requirements.

Banking regulators in the United States have proposed that the largest banks implement the Advanced Approach with several additional requirements. For example, the NPR provides for a leverage ratio, which could require banks to hold more capital than would be required under a risk-based system. Banking regulators also propose to adjust capital rules if the aggregate capital under the new regime falls by 10 percent for the industry as a whole. This applies a standard to the entire industry rather than using the ability under Basel II to impose different standards for specific banks as necessary. This application also ignores some of the changes in capital requirements that occur as a result of economic cycles. In a strong economic environment, for instance, capital requirements in a risk-based system should actually decline. The NPR includes other add-ons that also result in increased capital requirements beyond what would be mandated by the internationally agreed-upon implementation of Basel II.

Although these regulations are not yet final, comments from the banking industry suggest that they would result in significant differences in the international competitiveness of the largest banks. Unfortunately, these banks are precisely those most likely to compete internationally. Citigroup, JP Morgan Chase, Wachovia, and Washington Mutual have therefore come together to suggest a regulatory alternative that would give US banks a choice of options for meeting risk-based capital requirements.[94] These choices would include Basel I standards as well as the Standardized Approach under Basel II and Basel I-A that regulators developed to provide smaller banks with more risk-sensitive capital requirements without the full implementation of Basel II rules (the latter being more complicated and costly to implement). The American Bankers Association, the Independent Community Bankers of America and the Financial Services Roundtable have all endorsed this recommendation.

IFRS and GAAP. In face-to-face interviews, business leaders mentioned the need to make more rapid progress on the convergence of international accounting standards and to eliminate unintended consequences of the rules-based approach characterizing the US Generally Accepted Accounting Principles (GAAP), which can cause financial reporting to differ from economic reality. The SEC requires foreign companies that report under International Financial Reporting Standards (IFRS) to provide a reconciliation to US GAAP. The US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) both expressed their commitment to working toward high-quality, compatible accounting standards in their Norwalk Agreement of 2002. In February 2006, they reconfirmed their commitment to convergence, outlining short-term convergence goals for 2008 as well as longer-term objectives. The goal of the process is to allow foreign issuers in the US to report using IFRS without reconciliation starting in 2009. Business executives felt that the need to reconcile IFRS, which are accepted by every other major country, was unnecessary given the quality of those standards and their widespread adoption.

In November 2006, the leaders of the six largest global auditor networks published *Serving Global Capital Markets and the Global Economy,* which echoed the need for global accounting convergence. In addition, they pointed out the need for accounting standards to be principles-based and the need for an effort to promote the convergence of auditing standards. There is no effort currently under way that is focused on auditing standards convergence as there is for accounting standards convergence. Nevertheless, reliance on principles and judgment over rules and the elimination of unnecessary differences in standards (provided that the integrity of the standards is not diminished) are two of the themes that should underpin the call for change for many aspects of the US regulatory environment.

It is imperative that these issues be addressed through real, substantive regulatory reforms, or else US business hubs that are heavily reliant on financial services, such as Delaware, Chicago, Charlotte, San Francisco, Miami and, of course, New York City, will not be able to compete with London’s attractive and responsive regulatory environment. Consumers and investors across the United States will also benefit. If the financial competitiveness of US-based institutions is as important a national priority as research indicates, then the financial regulatory system must be thoroughly reassessed and improved along multiple dimensions in the near to medium term. Section IV contains a series of balanced and integrated recommendations along these lines.

THE FSA: ORIGINS AND PRINCIPLES

In 1997, the UK's newly elected Labour government tackled financial regulatory reform head on. Gordon Brown, the new Chancellor of the Exchequer, wanted to do away with the many self-regulatory organizations (SROs), which were widely regarded as bureaucratic, interventionist and rules-based, as well as insufficiently independent and objective in their protection of consumer interests. The reform proposal proved far more radical than expected – allegedly catching even the Governor of the Bank of England by surprise. Many had predicted the unification of the SROs, but few expected the creation of a single regulator for banking, securities, and insurance with extensive powers of investigation and enforcement.

Prior to the reforms, there was broad support for the simplicity and clarity that would come with a single regulator, and an acceptance that a statutory body would be more effective than self-regulation. However, concerns also existed with regard to the breadth of the enforcement powers, a possible lack of sufficient checks and balances, potential conflicts with human rights legislation, governance, and cost of implementation. Some even argued that moving to a single regulator would increase systemic risk, as a multiplicity of regulators reduced the likelihood that any single regulatory failure would undermine the credibility of the system as a whole.

Gordon Brown announced his decision to merge banking, securities, insurance, and investment services supervision in May 1997 under what would become the Financial Services Authority (FSA). The Bank of England transferred banking supervision authority to the FSA in June 1998 and, in May 2000, the FSA assumed the role of UK Listing Authority from the London Stock Exchange. The roles of several other organizations were later incorporated into the FSA's mandate under the Financial Services Markets Act (FSMA), which took effect at the end of 2001. In October 2004, the FSA assumed responsibility for the mortgage industry and, in January 2005, for the general insurance industry.

The FSMA outlined four statutory objectives: 1) maintaining market confidence; 2) promoting public understanding of the financial system; 3) securing an appropriate degree of protection for consumers; and 4) fighting financial crime. Lawmakers recognized that it was impossible to write rules addressing every conceivable situation that might arise in a rapidly changing financial services environment. To remedy this deficiency, the FSA adopted a set of eleven principles embodying the highest-level requirements with which all firms must comply.

More specifically, these principles require that a firm: 1) conduct its business with integrity; 2) conduct its business with due skill, care, and diligence; 3) take reasonable care to organize and control its affairs responsibly with adequate risk management systems; 4) maintain adequate financial resources; 5) observe proper standards of market conduct; 6) treat customers fairly; 7) communicate appropriate information to clients in a clear and fair manner; 8) manage conflicts of interest fairly; 9) take reasonable care to ensure the suitability of its advice to customer entitled to rely on its judgment; 10) adequately protect clients' assets when responsible for them; and 11) deal with regulators in an open and cooperative way.

In addition to providing regulated entities with this clear empirical guidance, the FSMA also set out a second tier of principles to ensure that the regulator will systematically act to further the market's best interest. These six "principles of good regulation," which the FSA must consider while pursuing statutory objectives are:

- **Efficiency and Economy.** The FSA must report to the Treasury every year; the Treasury may also commission reviews of the FSA's value for the money.

- **Role of management.** Senior management is responsible for taking reasonable steps to ensure that a firm's business complies with regulatory requirements and that adequate risk management controls are in place.
- **Proportionality.** The FSA must take a cost/benefits approach to any restrictions imposed on industry.
- **Innovation.** The FSMA allowed for different methods of compliance so as to not unduly discourage the launch of new financial products and services.
- **International character.** The FSA must consider the impact on UK markets and consumers of developments occurring abroad, consider the international mobility of financial businesses, and avoid damaging the UK's competitiveness.
- **Competition.** The FSA must avoid unnecessarily distorting or impeding competition, including via regulatory barriers to entry or business expansion.

Equally as important as the comprehensive two-tiered, principles-based regulatory framework highlighted above is the regulator's enforcement strategy. In this regard, the FSA has adopted a collaborative model of enforcement that has encouraged regulated entities to be more forthcoming about potential problems than is generally the case with more "enforcement-driven" regulators. In addition, the FSA has also implemented a risk-based approach to enforcement, wherein the level of regulatory resources allocated to a given issue depends on the scale of the future problems that this issue may potentially create.

Although the FSA is generally well regarded, it is not free of criticism. And it takes such criticism seriously, as shown by its December 2005 implementation of the Better Regulation Action Plan. This report summarized more than 30 recent or proposed changes to the way the FSA regulates, including such improvements as simplifying listing rules, removing barriers restricting access to retail financial advice, introducing more flexible rules for collective investment schemes, simplifying conduct of business rules relating to dealing with retail customers, and lifting audit requirements for smaller regulated firms. The self-evaluation process that yielded these recommendations may help explain, in part, why the FSA has been able to remain well-regarded over time by both investors and regulated entities.

If the FSA has been able to retain a positive public image, it is also largely because the debate over regulation in London today centers on the impact of EU directives such as MiFID. Although subject to the proportionality principle, the EU is not governed by the "principles of good regulation" that the FSA is, and so is not required to conduct cost/benefit analyses of its regulatory proposals. Regarding MiFID in particular, Sir Callum McCarthy, Chairman of the FSA, stated in 2005 that: "It is deeply unsatisfactory that UK financial services firms face major changes, with the associated costs, for an initiative which has been subject to no comprehensive EU cost/benefit analysis . . . . That kind of approach to policy-making cannot be sensible."[95] Many commentators have similarly questioned whether several new EU directives sufficiently enhance investor protection and market efficiency to warrant the costs entailed. So while the FSA may, within its own area of competency, provide UK firms with an effective regulatory environment, the limits to its authority implied by the EU's supranational jurisdiction means that the overall regulatory environment confronting regulated entities in the UK may not be as positive as would otherwise be expected under "principles of good regulation." ■

IIF PROPOSAL FOR A STRATEGIC DIALOGUE ON EFFECTIVE REGULATION

On December 13, 2006, the Institute of International Finance (IIF), a global association of leading financial institutions representing more than 360 member companies, announced its objectives and principles for more effective national and global regulation.[96] Supported by a set of seven guiding principles, the IIF's Proposal for a Strategic Dialogue on Effective Regulation highlights a set of common objectives and an agenda for action for both firms and regulators, intended to:

- **Support economic growth and competition**

  Regulation should support the health of the global financial system and world economy, as well as encourage the development of competitive financial markets.

  Healthy, innovative, and profitable financial firms. Successful institutions invest in innovations that benefit customers and improve the efficiency of the financial system. Such firms are less likely to develop the solvency or liquidity problems that cause financial disturbances. They are also more likely to devote an appropriate level of institutional resources to issues with broader social benefits.

  Open and competitive financial markets. Entry to markets should depend upon prudential standards regarding fitness and proper conduct, not protections intended to satisfy special interests. Although regulation should recognize and protect legitimate public interests, it should do so without favoring specific organizational or ownership structures. Open competition will in turn promote the regulatory goal of enhanced responsiveness to customer needs.

- **Ensure institutional safety and soundness**

  Regulation and supervisory oversight should foster an optimal level of structural soundness, financial prudence, and risk control in all participants. More specifically, *prudential regulatory capital requirements* should ensure the soundness of the financial system without unduly restricting business activity. *Sound regulatory risk management* should reflect and heavily rely on the governance and risk control systems of institutions, regardless of their legal structure. Regulation encouraging *counterparty transparency* should require meaningful disclosure to enable market participants to assess counterparty and investment risks. *Prevention of financial crime* should be implemented via regulation assisting financial institutions in efficiently combating money laundering and terrorism finance, and by ensuring that the substantial resources devoted by the private sector to this priority are used effectively. Finally, regulation should promote effective *crisis prevention and management* at the institutional and industry levels without creating moral hazard.

- **Foster customer service, protection, and care**

  Regulation should foster appropriate levels of customer service, protection, and care. More particularly, regulation should protect *customer privacy*, supporting legitimate law enforcement efforts without unduly burdening legitimate business activity. Regulation should also promote *customer choice* by respecting customers' ability to control their own affairs, albeit recognizing the differing needs and capabilities of different customer segments and markets. Regulation should similarly seek to enhance *customer awareness* by promoting the disclosure of information to customers as appropriate given the individual's sophistication, and by promoting public financial education efforts. Regulators should also foster *effective dispute resolution processes*, so as to promote consumer rights without creating excessive litigation exposures. Finally, regulators should beware of restricting *product availability* without a compelling justification and should therefore rely on fair, timely, and useful disclosure wherever possible.

Guiding Principles

The IIF believes that the interactions between regulators and the financial industry should be shaped by a set of guiding principles. These can be stated simply as follows:

- *Mutual trust and respect for judgment* are the foundations of effective regulation
- *Collective market-based solutions* should be preferred whenever possible
- *Global coordination of regulation* is an essential part of any jurisdiction's regulatory process for firms conducting cross-border business
- *A meaningful legislative dialogue* is essential for both industry and regulators
- *Effective regulation* requires a dynamic assessment of new initiatives and policies
- *Contingency planning* is an ongoing, joint obligation of the public and private sectors
- *Proportionate enforcement* must be a part of efficient and effective regulation

The IIF also proposes a set of regulatory responsibilities for firms, such as ethical leadership, effective governance, and effective risk management. Furthermore, it supports a similar set of responsibilities for regulators, such as the articulation of clear goals for regulation, periodic assessments to judge regulatory effectiveness, early consideration of implementation issues, and performance-based regulation. ■

Recommendations to sustain the nation’s and New York’s global financial services leadership

Based on the analysis and findings in this report, there is an urgent need for balanced action to maintain and enhance the competitive position of the US financial markets in the global economy. Section IV outlines three categories of recommendations aimed at the US financial markets and a separate set of specific recommendations for New York in its role as a leading financial center.

The recommendations at the national level include:

- **Critically important, near-term national priorities.** These include issues that are either already being considered or have broad acceptance within the financial services community and elsewhere. Importantly, these proposals would not only directly help the US financial services industry, but they would also signal the advent of a more balanced approach to regulation and litigation in the United States.

- **Initiatives to level the playing field.** These are important because they will not only make it easier for international companies to conduct financial business here, but they will also give US companies a chance to attract the best people and compete according to internationally accepted standards. Once adopted, these initiatives would clearly demonstrate that the United States is open to all globally competitive businesses and that everyone will be treated equally for important basic drivers of competitiveness such as capital treatment and accounting.

- **Important longer-term national issues.** Designed to begin now, these initiatives will take longer to implement, but they are important for the longer term competitive interests of the United States. The proposals here are likely to restore a better position relative to other major financial markets like London.

In addition to these recommendations at the national level, this section also includes an integrated set of City- and State-level recommendations aimed at enhancing New York's competitiveness as a financial center by better focusing the energy and capabilities of local authorities and businesses on the requirements of the financial services sector.

Taken together, these recommendations could help reinvigorate and sustain financial market competitiveness at the national and City level. This would have a positive impact on the US economy, as well as on the local economy wherever major financial markets are located across the country. Some recommendations can be undertaken directly by regulators or through administrative actions, while others will require legislative action.

In addition to maintaining the safety and soundness of the financial system, a prime consideration in drawing up these proposals has been to strike a better balance between competition and innovation on the one hand and investor protection on the other. As described earlier, the potential cost of not taking remedial action would be significant: were current market growth rates and competitive trends to persist, the US would lose substantial market share in investment banking and sales and trading over the next five years. The 2004 – 05 revenue growth rates for Europe and Asia were approximately 25 percent and 19 percent, respectively, compared with the US growth rate of 6 percent. This implies a growth rate of 15 percent for the global revenue pool. Even if global growth rates slowed to a more sustainable rate of 8 to 10 percent, the US would stand to lose between 4 and 7 percent market share over the next five years. Stopping this share loss would add approximately $15 billion to $30 billion in incremental revenue to the US in 2011 alone. Assuming a constant relationship between revenues and jobs, that would translate into between 30,000 to 60,000 securities sector jobs, in addition to stimulating indirect jobs in other industries.

A. CRITICALLY IMPORTANT, NEAR-TERM NATIONAL PRIORITIES

These should be a first priority for policy makers, as they will significantly and immediately improve the international competitiveness of America's financial services industry, and thereby provide substantial benefits to the US economy as a whole.

Recommendation 1 – Provide clearer guidance for implementing the Sarbanes-Oxley Act

The Securities & Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), in continuing consultation with business, investor protection groups, and public accounting firms, should follow through on many of their recently proposed revisions to the guidelines controlling the implementation of Section 404 of Sarbanes-Oxley. They should also provide further guidance with regard to what represents a "material weakness" and, depending on the effectiveness of these revisions, they could consider separate requirements for smaller public companies, for which compliance costs pose an undue burden. Finally, the regulators should consider exempting foreign companies that comply with SEC-approved foreign regulatory schemes from the added cost of Sarbanes-Oxley compliance.

Congress passed the Sarbanes-Oxley Act in 2002 in direct response to significant cases of corporate malfeasance, which occurred despite the legal and market requirements for corporate governance oversight in place at that time. The CEOs and business leaders interviewed for this report generally recognized the need for enhanced corporate governance regulation and accepted Sarbanes-Oxley's effectiveness in this regard. However, in interviews and surveys they emphasized that one section – Section 404 – posed unintended negative consequences for US competitiveness (see Section III.D for more detail on Sarbanes-Oxley and Section 404).

Many interviewees attribute the burden of 404 not to the legislation itself, but to the SEC and PCAOB's interpretive guidelines for management and audit firms, as well as to the supplementary training the Big Four public accounting firms initially gave to their auditors on how to protect the firms and their partners from 404-related litigation. The most pertinent issue for financial services competitiveness is that foreign companies otherwise interested in listing in the United States have found Section 404 prohibitive. It is also expensive for large companies, and can be overwhelming for smaller companies that lack the infrastructure necessary to comply efficiently.[97]

Appropriate efforts are already well under way, led by SEC Chairman Christopher Cox and PCAOB Chairman Mark Olson, to provide clearer administrative guidance to auditors and the industry. In terms of addressing the most immediate needs of market participants, this approach is preferable to further legislative change to Section 404. From a financial services business perspective, these efforts should result in revised, simplified guidance to auditors and companies that ensures, in the words of Treasury

Secretary Henry Paulson, "that the internal control audit is top-down, risk-based and focused on what truly matters to the integrity of a company's financial statement."[98] To reach this goal, new guidance should enable auditors and management to exercise more judgment rather than rely on specific rules. It should also emphasize materiality – i.e., what is really important to investors and management – rather than comprehensiveness, and recognize and mitigate the excessive implementation costs imposed upon small companies. The SEC and PCAOB have each already taken significant steps in this direction by voting in December 2006 to propose improved interpretive guidance to management and auditors on the implementation of Section 404. The clear common intent underlying both of these new sets of guidelines, developed by the two agencies working in concert, is to simplify and reduce the cost of 404-related compliance. The proposals do so mainly by encouraging more risk-based analysis of internal financial controls, especially for smaller firms, which would enjoy greater discretion to "scale and tailor their evaluation methods and procedures to fit their own facts and circumstances."[99]

While the agencies' adoption of a more risk-based assessment standard should improve efficiency in auditors' and management's evaluation of internal financial controls, the empirical impact of this modification will be constrained if a clear standard is not also articulated to separate breaches in controls that are material – with the attendant need for disclosure and potential regulatory liability that this implies – and those that are not. While the PCAOB's recent proposal for guidance on the issue shifts the standard for "material weakness" from one of "more than remote" likelihood to one of "reasonable possibility," it still leaves significant room for interpretive uncertainty. In the highly visible and litigious environment in which audit firms operate, such uncertainty is likely to lead to costly risk-averse behavior, undermining the benefits of the regulators' adoption of a risk-based standard. Therefore, to the extent that there is still room to provide additional practical guidance with regard to the definition of "materiality," the SEC and PCAOB should, after analyzing the input received during the notice and comment period, provide such further direction.

Time will tell whether the flexible approach now proposed by regulators will sufficiently alleviate the burden of 404-related compliance on smaller companies. The SEC and PCAOB should continue to monitor the situation and, if compliance costs for smaller public companies fail to come down sufficiently, they should consider additional means of addressing these companies' needs. One possible avenue for relief would be to give smaller companies the possibility of opting out of the more onerous provisions of Sarbanes-Oxley, provided that they conspicuously disclose that choice to investors. This alternative would have the virtue of effectively providing smaller companies and their investors with the ability to determine whether the lower cost of capital stemming from incremental investor confidence, which is itself tied to the safeguards of Sarbanes-Oxley, outweighs the associated compliance costs.

If properly implemented, the new guidance proposed by the SEC and PCAOB holds the potential to reduce compliance costs without reducing the quality of financial reporting, thereby benefiting both businesses and investors, and thus enhancing the US' financial competitiveness. However, although each proposal received unanimous support within its respective agency, the road to implementation remains long and fraught with difficulties. Most commentators expect that it will be several months before these proposals become binding rules. During this time, companies doing business in the US will continue to face many unnecessary compliance costs. Although the notice and comment periods to which both proposals are currently subject are highly valuable and will likely elicit constructive comments leading to substantive improvements, the SEC and PCAOB should, once the notice and comment periods expire, hasten to implement the proposed guidance. The agencies should also resist pressure to water down the proposals, as such dilution would not only undermine the benefits that will result from the new guidance, but also weaken the strong signal that the proposals in their current form send to the international business community – that US regulators, in carrying their investor- and consumer-protection mandate, are nevertheless attentive and responsive to the needs of the market.

Eliminating unnecessary compliance costs via the introduction of risk-based evaluation standards is a laudable goal that should greatly benefit all companies participating in the US capital markets. Nevertheless, the compliance process could be improved further for foreign companies merely by showing greater deference to foreign regulators. Complying with US corporate governance standards entails significant redundant costs for foreign companies that already operate under similarly stringent standards in their domestic markets. While US regulators have fostered a corporate governance system that is broadly recognized as highly effective, other developed countries have adopted different approaches aimed at achieving similar outcomes that have also been very successful. For instance, the Financial Services Authority (FSA) in the UK or the Autorité des marchés financiers in France, as well as others, are widely regarded as having created regulatory regimes with strong corporate governance standards. US regulators should recognize that fact and exempt foreign companies that comply with the corporate governance standards of SEC-approved foreign regulators from also having to comply with the requirements of Sarbanes-Oxley. Such a step would make the US capital markets more attractive to foreign corporations by removing the burden of redundant compliance costs without jeopardizing the high levels of corporate governance, and thereby ensuring continued investor protection. More detail with regard to this proposal is provided in Recommendation 2.

Implementing new standards will not be painless and will take time, but the message sent to the global financial services and corporate community by introducing them will be powerful and immediate. Revised standards will not only reduce the direct and indirect financial costs to companies that now comply with Sarbanes-Oxley, but also remedy the fact that compliance with Sarbanes-Oxley was a significant reason behind companies turning away from US listings. These new guidelines should provide important signaling from regulators to the global financial community that they are willing to adapt implementation of new rules to the requirements of the market, while still preserving a high level of investor protection. New guidelines would not only increase the issuance of debt and equity by foreign companies, but also attract capital to the public markets that would have otherwise gone to the 144A or private equity markets. Finally, recognizing foreign corporate governance standards will not only enhance the appeal of the US capital markets to foreign issuers and thereby increase the number of new issues in the US, but also signal to the international community that US regulators are willing to accommodate foreign peers, and alleviate concerns about extraterritorial enforcement of US regulatory standards.

Recommendation 2 – Implement securities litigation reform that has a significant short-term impact

The SEC should provide immediate relief by making further use of its rulemaking power and tacit influence to address the most pressing litigation-related problems confronting US financial services, while preserving current high levels of investor protection. In addition, Congress should bolster America's long-term competitiveness by enacting legislative reforms to securities law that will eliminate inappropriate lawsuits without undermining relevant substantive rights.

The legal system governing financial services seeks to limit the actions of some in order to preserve the rights of others; ideally, it would do so in a way that minimizes market distortions. Primary research conducted for this report confirms what many recent news articles, particularly in the financial press, have suggested: business professionals believe that the pendulum has swung toward excessive litigiousness, imposing unreasonable costs on market participants. As outlined in Section III.C, not only are foreign companies staying away from US capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital, but a number of interviewees also suggested that the legal environment is detrimental to America's spirit of entrepreneurialism and innovation. As one interviewee put it, "Our CEOs have become indexers – they are as afraid to outperform as to underperform." Of course, the threat of litigation has benefits, as it provides a deterrent for wrongdoing. Unfortunately, the same threat is also proving to be a significant deterrent for legitimate foreign companies that want to list or just do business in the United States. Findings from primary research strongly indicate that, unless significant changes are made to America's litigation system, financial services businesses will likely continue to shift an increasing share of their activities to less litigious jurisdictions.

The rising cost of the US legal system is well-documented and extends far beyond financial services and the scope of this report. Any comprehensive legal reform effort would require long-term energy and attention by policy makers at the highest level, as well as significant legislative change. It would also require careful balancing of the respective interests of investors, consumers, businesses, and other parties. The outcome of any legal reform should not be to undermine the ability of plaintiffs with valid claims to recover appropriate damages. Instead, such reform should seek to eliminate those suits filed to pressure companies into settlement rather than to redress legitimate wrongs, as these suits dampen the business environment without providing a commensurate social benefit.

While it is clear that coordinated legislative and enforcement-level efforts will be required to bring about many of the desired improvements in the legal environment surrounding financial services, regulatory agencies are well positioned to have a positive impact in the near-term. The SEC, in particular, has broad powers that it could proactively use to deter the most problematic securities-related suits. For example, Section 36 of the Securities Exchange Act of 1934 effectively allows the SEC to conditionally or unconditionally exempt persons or transactions from most provisions of the Act, so long as doing so is in the public interest and consistent with investor protection requirements. In using Section 36 to improve market conditions for both companies and investors, the SEC would merely be invoking authority that Congress has already bestowed upon it. Furthermore, the agency would be doing so within a clear statutory cost/benefit framework, in harmony with the principles of good regulation proposed in Recommendation 3 below, and with investor protection remaining a paramount consideration.[100]

Among proactive enforcement strategies that regulators could consider, pursuant to a thorough cost/benefit analysis, as they seek to improve the legal climate in the securities industry, three in particular need to be considered. First, limiting the liability of foreign companies with US listings to securities-related damages that are proportional to their degree of exposure to the US markets would serve to more adequately align the costs and benefits to foreign issuers of a US listing. Second, imposing a cap on auditors' damages for securities-related infractions that is sufficient to deter wrongdoing in accounting would also lessen unnecessary and costly risk-averse behavior on the part of auditing firms. It would do so by making auditing firms once again insurable, which would have the added benefit of reducing the likelihood that the highly concentrated US auditing industry will lose another major player. Finally, granting smaller public companies the ability to "opt-out" of particularly onerous regulatory requirements, provided that they conspicuously disclose the fact to investors and assuming the SEC is satisfied that shareholders will remain adequately protected, would help increase the appeal of a US listing to small companies both domestically and abroad.

Generally speaking, these reforms would make the US capital markets more appealing to foreign and domestic companies of all sizes, as they would greatly reduce the frictional costs associated with a US listing. More broadly, they would also enhance auditors' ability to employ materiality principles and cost/benefit analyses in their oversight of US companies, thereby reducing auditing costs for all US-listed companies. Furthermore, these SEC-driven exemptions would be limited in nature, and thus should broadly maintain investor protection standards and preserve the ability of aggrieved plaintiffs to recover warranted damages.

In addition to the SEC's statutorily defined rulemaking powers, the agency also possesses significant tacit influence over participants in the securities industry. The Commission's ability to affect actions of market participants by providing guidance on future enforcement goals enables it to exert significant influence over the securities market even without resorting to "official" rulemaking. The SEC should wield this influence to improve the legal climate in financial services by following recent enforcement trends and reversing its historical opposition to the arbitration of disputes between investors and publicly traded companies.[101] Although arbitration as an alternative dispute resolution system is not without flaws, it has grown dramatically in recent years in terms of both scale and sophistication, and it is now well established under US law that federal policy favors arbitration.[102] Thus, provided that present and future investors receive proper notice (for instance, by requiring that broker-dealers unambiguously notify their customers of the arbitration terms), shareholders should have the opportunity before the fact to determine whether submitting future securities grievances to arbitration is in their own and the company's best interest. At the pre-IPO stage, this could be done by conspicuously including in the private company's charter a provision for submitting future securities claims to arbitration. For companies that are already public, a general shareholder vote ratifying such a charter amendment could achieve a similar outcome, although the question of how such a vote would affect the rights of dissenting shareholders is an important issue that should be considered in greater detail by regulators. Arbitration would benefit all parties involved: it would substantially reduce the costs that companies face in the course of protracted litigation and discovery; it would provide aggrieved plaintiffs with more timely and cost-effective remedies (which would be of greatest benefit to small investors); yet it would not diminish the SEC's ability to initiate enforcement actions on investors' behalf.

If the SEC has significant leeway to improve market conditions under its legislative mandate, there is no doubt that additional support from Congress would both help that effort and significantly enhance the prospects for long term improvement. Obviously, Congress should not concern itself solely with the needs of the business community – it should weigh these interests against those of investors and consumers to ensure maximum benefits to national interests overall. Nevertheless, this study would be remiss if it did not point out avenues for reform that the research suggests could significantly improve the business community's sentiment with regard to America's legal environment. A bipartisan effort aimed at investigating effective reform proposals should be initiated as soon as possible. This effort would ideally focus on the securities industry, where issues of global competitiveness are most acute. Within a robust cost/benefit framework, Congress may choose to consider:

- Legislatively limiting punitive (non-economic) damages to a finite multiple of actual damages, or alternatively enhancing judges' ability to limit exorbitant awards.

This would not only directly reduce the overall legal burden on companies doing business in the United States, but the greater degree of predictability that would ensue would also allow companies to engage in far more efficient legal risk management.

- Allowing litigating parties in federal securities actions to appeal interlocutory judgments immediately to the Circuit Courts. This will reduce the overall burden of litigation on US-listed companies by making it less likely that they will settle lawsuits even in the absence of wrongdoing, merely to avoid the significant discovery and other litigation costs that an unfavorable interlocutory judgment entails. Furthermore, allowing the immediate appeal of interlocutory judgments will also provide broader benefits to the securities industry and to the judicial system by enhancing the likelihood of obtaining valuable precedent-setting judgments on the merits.

Implemented in concert, the legislative and enforcement-level reforms highlighted above should greatly enhance the attractiveness of America's public markets in the eyes of both private US companies and foreign corporations looking to access equity capital. This is crucial for the US capital markets, as they find themselves in increasing competition with foreign venues offering legal and regulatory regimes that many businesses find more attractive. Critically, creating a more business-friendly legal environment need not entail any deterioration in investor protection. In fact, it stands to reason that legitimate tort plaintiffs, shareholders, and corporations would all be better off in a legal system that provides greater predictability and makes better use of judicial resources. Indeed, each of the reforms proposed above, if examined and implemented following a rigorous cost/benefit analysis weighing business interests, investor protection, and other important societal interests, could benefit every relevant constituency.

Recommendation 3 – Develop a shared vision for financial services and a set of supporting regulatory principles

Under the leadership of the Secretary of the Treasury and the Presidential Working Group on Financial Markets,[103] *federal financial regulators should work together to develop, agree on, and pursue a shared vision for the importance and strategic direction of the financial sector and its impact on global competitiveness, innovation* *to meet customer needs, the management of systemic risks, the ethical conduct of business, the financing of a growing economy, and the creation of new jobs. This shared vision should be supported by a common set of principles: 1) establishing norms for good regulation in financial markets, and 2) providing enhanced guidance to financial institutions operating in the United States, so as to deliver more balanced and predictable outcomes for financial institutions, investors, consumers and other market participants.*

As described in Section III.D, interviews and surveys indicate that the separate missions and legislative mandates of the numerous federal and state financial regulators can make the system appear complex, cumbersome, and unpredictable to both domestic and foreign institutions operating in the United States. Many US regulators, such as the SEC and the National Association of Securities Dealers, have sets of principles that guide their internal rulemaking and enforcement activities. However, both the principles and their application differ between regulators. US financial regulators could bring more harmony to the system by adopting a common vision for what financial services are to represent in the future, both to investors and to the business community, within the context of a US economy that is evolving in an increasingly globalized marketplace. This common vision should then be articulated via a shared set of principles governing both the process of regulatory rulemaking and the conduct of regulated entities. Such principles should transcend regulatory responsibilities and ensure that regulators act within clearly set guidelines for effective rulemaking. Regulators would then use the discretionary powers already within their statutory mandates to deliver outcomes that promote a globally competitive financial services marketplace while still protecting the interests of all market participants.

There are clear precedents for such an approach. In addition to the principles that already guide some US regulators, the UK's Financial Services Authority, as discussed earlier, operates under a set of six principles that guide its dealings with the institutions it regulates. More recently, the Institute of International Finance has proposed its own set of governing principles for how it believes regulators and financial institutions should interact to their mutual benefit. These principles cover three dimensions of financial regulation: economic growth and competition, institutional safety and soundness, and customer service, protection, and care (for a more detailed discussion or the FSA and IIF principles, please see the sidebars at the end of Section III). Such precedents could serve as a starting point for developing a comparable set of common US regulatory principles conducive to competing with regulatory regimes that are perceived as more responsive.

One way forward would be for the Secretary of the Treasury to make adopting a shared regulatory vision and common rulemaking principles a high priority for the President's Working Group on Financial Markets. Aided by input from the private sector, developing a common view as to what would represent regulatory success and a supporting set of principles should be relatively straightforward, given how much work has already been done in this field in both the public and private sector. The end result would be a set of regulatory principles geared towards the competitive and consumer needs of US financial institutions and markets.

Whatever shared goals and principles are ultimately adopted, they would guide future regulatory actions and outcomes. For example, if regulators agreed to principles requiring a rigorous cost/benefit analysis or materiality tests guided by sound economic analysis conducted by a proficient and dedicated staff, then all future regulations would be subject to such thorough assessments before being adopted. Similarly, enforcement action would be taken only if there was material impact on either the specific institution or the financial system in general. More broadly, enforcement policies should favor the open sharing of information between regulated entities and regulators, for example by moving from a regulatory environment emphasizing retributive punishment to one that favors collaborative rulemaking and enforcement. Doing so would not only alleviate the perceived risk associated with entering the US financial markets, but would also alleviate the likelihood that problems posing a significant systemic risk could grow unnoticed and unchecked due to a failure to adequately share relevant information between market participants and regulators.

By providing greater certainty around enforcement, regardless of the details of the principles themselves, a common approach would have the virtue of enhancing the overall consistency and predictability of the US regulatory system. This would provide market participants with greater clarity regarding the corporate actions that are permissible under existing regulation which, in turn, should allow regulators to be more effective. The newfound regulatory clarity and enhanced predictability will also help foreign corporations entering the US markets manage regulatory risk more effectively, making the United States more appealing for them. A consistent and predictable regulatory environment that preserves high standards affects all markets, both primary and secondary, and participants, both current and potential. Recommendations 7 and 8 below represent two of the many means of implementing a common regulatory vision, with the enhanced regulatory clarity and predictability that this implies, which regulators may consider in the future as they seek to fulfill their respective mandates in a consistent and collaborative fashion.

B. INITIATIVES TO LEVEL THE PLAYING FIELD

These initiatives are important to level the global playing field and signal that the US is open to all globally competitive businesses.

Recommendation 4 – Ease restrictions facing skilled professional workers

Congress should re-examine and eliminate some of the barriers that deter or prevent skilled foreign workers from visiting the United States for business, coming to the United States to work, and remaining in the country as part of the workforce.

Maintaining a talented, dynamic workforce should be the number one priority for sustaining and enhancing US competitiveness in financial services (as in many industries), according to the research conducted in conjunction with this report. US citizens will continue to be the most significant source of talent for US financial services jobs, but highly skilled non-US citizens educated both here and abroad are a vital complement to such homegrown talent. As outlined in Section III.B, some US immigration policies tend to make it difficult for financial institutions and other businesses to hire foreign talent. Anecdotal evidence suggests that many of those skilled workers who are unable to enter the United States end up in the UK instead, thanks to that country's relatively welcoming approach to skilled-labor immigration, both from the EU (within which there is freedom of movement) but also outside it.

Congress, working with the administration, has the power to restore the balance in supply and demand for talent in financial services and other industry sectors by instituting immigration reform targeting skilled workers and students. The fastest and most effective approach that Congress could take would be to revisit and pass the Comprehensive Immigration Reform Act introduced in the 109th Congress. Of greatest interest to the financial services industry are legislative proposals to:

- **Raise the annual cap on H-1B visas and incorporate a market-based mechanism for future increases.** Each year, the US issues H-1B visas valid for up to six years to applicants in specialty occupations[104] with US employer sponsorship, under Section 214(g) of the Immigration and Nationality Act. The maximum number of H-1B visas issued today is 65,000, but applications typically greatly exceed supply, and the visa allocation this past year was met before non-US graduates from US schools even qualified to apply. When Congress temporarily raised the maximum number of visas to 195,000 between 2001 and 2003, demand for and supply of skilled non-US citizens were balanced. The Senate's Comprehensive Immigration Reform Act of 2006 (S. 2611) proposed to increase the H-1B visa cap to 115,000 for the fiscal year after enactment, and if the cap was reached in any given year then it would be increased by 20 percent the following year. This or a similar change to the cap would address the H-1B visa issue identified in the research that underpins this report.

- **Eliminate the time lag between expiration of practical training permits issued to F-1 and J-1 student visa holders and the granting of H-1B work visas.** Students graduating without H-1B visas either wait outside the United States for employers to secure them a position, or seek employment in other countries. Recently, the Secretary of Homeland Security exercised discretionary authority to extend F-1 and J-1 visa holders' practical training permits to bridge the time lag between their expiration and the issuance of H-1B visas; however, it has since been determined that the law does not provide for this discretion. One option to solving these issues would be to extend such authority to the Secretary of Homeland Security. Alternatively, Congress could institute a standard, formal extension process for student visas until such time as limitations on H-1B visas are no longer a constraint.

- **Define standards for granting B1 visitor visas.** The decision on whether, or for how long, a business visitor may stay in the United States is at the discretion of individual immigration officers. Regular travelers report inconsistent decisions as a result. This means that many business travelers actively avoid traveling to the United States. To address this issue, the State Department (working with Consular officials) and the Department of Homeland Security (working with immigration officers) could set out clear guidelines regarding the exercise of discretion both on acceptable reasons for visiting the United States, and on the duration of any visit. These departments could also request tracking and monitoring of related data to ensure the consistent application of these guidelines and to ensure that visas are issued to foreign business visitors in the most expedient way possible. Moreover, these departments could make their policies clearer to applicants, educating them *early* in the process, by describing the high-level criteria used to judge their application. Examples would be a simplified version of the State Department's Foreign Affairs Manual or the Operating Instructions of the US Citizenship and Immigration Services.

- **Take other actions that ease visa and other access restrictions.** The Senate bill mentioned above included other measures that Congress could consider that would have a positive impact on financial services and other industries. Some of the most salient include an uncapped exemption for professionals who have earned a US master's degree or higher, and modifications to employment-based visas. Additionally, Congress and the administration should work together to facilitate the entry of business visitors into the country, including by reviewing the procedures for access to the US in place at embassies and airports.

Taken together, such reforms to US immigration policies would significantly ease the imbalance between supply and demand for talent in the financial services industry. This will allow the United States, and specifically New York, to retain its position as the world's largest pool of financial services talent, which in turn makes the United States more attractive to both domestic and foreign financial institutions. The benefits of a larger pool of highly skilled workers are all the more important because they will not only benefit financial services activities, but also many other industries in the US.

Recommendation 5 – Recognize IFRS without reconciliation and promote convergence of accounting and auditing standards

In addition to encouraging the convergence of global accounting standards, the SEC should consider recognizing the International Financial Reporting Standards (IFRS) without requiring foreign companies listing in the United States to reconcile to the US Generally Accepted Accounting Principles (GAAP). The PCAOB, meanwhile, should work with other national and international bodies towards a single set of global audit standards.

The International Financial Reporting Standards are robust accounting principles accepted by every major country in the world except the United States. Companies operating and listing in the United States must instead conform to US GAAP. The two standards are similar in many respects, but they differ meaningfully in their treatment of several complex items, particularly derivatives, leases, and pension obligations. Although neither regime requires interim financial reporting, practically speaking, SEC registrants following US GAAP must comply with a series of other regulations that push for quarterly reporting. On the other hand, most regulators implementing IFRS do not require public companies to provide quarterly statements, even though IFRS itself encourages interim reporting.

The US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have outlined short-term convergence goals for 2008 as well as longer-term objectives. Their target is to allow foreign issuers in the United States to report using IFRS without reconciliation starting in 2009.

According to research conducted for this report, convergence will tend to promote global financial market competitiveness while improving the information available to investors. It appears that the FASB and IASB are focusing on addressing major differences and replacing weaker standards with stronger ones. Ideally, they will also encourage balance and judgment over rules as these standards come together, since many of the interviewees highlighted the unintended negative consequence of the rules-based orientation of US GAAP. Both the FASB and the IASB are continuing this process in consultation with representatives of the European Commission and the SEC. The cooperation is important not only to identify areas of difference but also to develop the highest quality standards going forward.

While the world waits for accounting standards to converge, the SEC should allow foreign companies to report under IFRS without reconciliation to US GAAP. This would eliminate unnecessary costs and remove a barrier for foreign issuers seeking to list in the United States. It would also send a powerful signal to the global financial services community that the country is willing to respect and honor approaches invented outside its shores.

The convergence of two accounting standards and the continued efforts to improve upon them will benefit the global capital markets. However, ensuring that there is a single set of global audit standards is also important, as it will allow the world's accounting firms to standardize guidelines and processes across countries. Apart from making these organizations more efficient, it will also lead to lower audit costs for the business community at large. The standardization of world-wide auditing standards is unfortunately not as advanced as the convergence of US GAAP and IFRS. The PCAOB should take a world leadership role in establishing this as a priority for the relevant national bodies. Convergence in auditing standards will by necessity come after convergence in accounting standards. But efforts to bring it about should be initiated now, so that the convergence in auditing standards may occur as rapidly and efficiently as possible once the necessary conditions are in place.

As with all enforcement actions, regulators should act only following a rigorous cost/benefit analysis. Yet for both of the proposals in this Recommendation, effective enforcement of the proposed reform would yield significant benefits with few discernible offsetting costs. The accelerated convergence of two high-quality accounting standards will make it significantly less expensive for foreign companies to tap US capital markets, thereby improving the international competitiveness of the country as a financial center. Moreover, the reduction in regulatory compliance costs will be achieved without undermining investor protection or market information. Similarly, harmonizing auditing rules, provided that better standards win out, will lower auditing costs for most public companies without reducing the quality of the statements produced. This will in turn result in incremental value for shareholders and generally more cost-efficient capital markets, with all the attendant benefits that this represents for the broader US economy. In short, the reforms proposed in this Recommendation hold the potential to improve US markets overall and to encourage access to them by foreign companies subject to IFRS.

Recommendation 6 – Protect US global competitiveness in implementing the Basel II Capital Accord

US banking and thrift regulators should take a speedy and pragmatic approach to the implementation of the Basel II Capital Accord while also considering the impact on global financial services competitiveness.

The Basel II framework aims to give regulators and the market as a whole a better sense of a bank's risk by providing a risk-based capital regime. It has been developed to replace Basel I, which many believe had become ineffective given the complexity and size of many of today's banks.

While other major countries all plan to implement Basel II in a consistent fashion, US banking regulators have proposed several substantial modifications to implementation in a recent Notice of Proposed Rulemaking (NPR). These modifications include differences in leverage ratios, transitional floors and timing, definitions of default, and limitations on aggregate reduction of capital for the industry. The proposals, which are yet to be approved in final form, aim to protect the safety and soundness of the US banking system, with its mix of very large global institutions and thousands of smaller, often less sophisticated institutions. Analyzing the differences between the

NPR and the Basel II Capital Accord in detail is beyond the scope of this project, but variations in international implementation could affect the competitiveness of US banks. Four banks, Citigroup, JP Morgan Chase, Wachovia, and Washington Mutual, have responded by forming an alternative approach endorsed by the ABA, ICBA, and the Financial Services Roundtable

Regulatory bodies involved in overseeing the banking industry should continue to consult with the industry and subject the NPR to cost/benefit analyses, so as to avoid putting US financial institutions at a disadvantage in the global battlegrounds that are the lending and fixed-income markets. In an October 2006 speech to the Annual Convention of America's Community Bankers, Federal Reserve Chairman Ben Bernanke said that, despite efforts to promote a level playing field internationally, "Some significant differences do exist.... Before we issue a final rule, we intend to review all international differences to assess whether the benefits of rules specific to the United States outweigh the costs. In particular, we will look carefully at differences in the implementation of Basel II that may adversely affect the international competitiveness of us banks."[105] Based on the evidence gathered for this report, it is clear that a thorough review of what might otherwise appear to be purely technical issues may in fact be necessary to redress the balance between US financial institutions and their foreign competitors.

Capital requirements affect many different markets. As these capital requirements change, banks can be encouraged to adjust their holdings of a specific asset class, which can have a very large market impact given the size of bank holdings. Although protecting the structural integrity of the US financial system should be paramount in determining how to implement Basel II, harmonizing the relevant US regulations with those adopted by much of the rest of the world would have two clear benefits. First, it would place US financial institutions on an equal footing with their international competitors. Second, it would make the United States more appealing to foreign financial institutions, which would not then need to adjust their capital requirements in order to participate in the US markets. This would in turn benefit US consumers who would enjoy greater choice and better pricing as a result of enhanced competition. Banking regulators should carefully consider these benefits when deciding how to implement Basel II in the United States.

C. IMPORTANT LONGER-TERM NATIONAL ISSUES

Looking ahead to a world of multiple deep, liquid markets and to companies exploiting the differences between national jurisdictions, the United States simply will not be able to afford some of the more cumbersome and costly aspects of its regulatory and legal system if it is to remain competitive in international financial services. Having addressed some of the immediate actions that could be taken to make the United States more attractive, sustaining a leadership position will come only if there is a longer-term commitment to financial competitiveness that addresses the need for fundamental regulatory and legal reform. Even though the following recommendations are designed to address longer-term structural issues, the ground work must be laid immediately for these recommendations if they are to provide the intended benefits in a timely fashion.

Recommendation 7 – Form an independent, bipartisan National Commission on Financial Market Competitiveness to resolve long-term structural issues

Early in 2007, Congress should create a National Commission on Financial Market Competitiveness to assess long-term, structural issues that affect the health, competitiveness, and leadership of US financial markets and their impact on the national economy. Guided by a clear long-term vision for the future of financial services competitiveness, this Commission should develop legislative recommendations, with thoughtful private sector, investor, and regulator input, for a financial regulatory system that is simple, efficient, responsive to the competitive needs of financial institutions in serving their customers, and attentive to the systemic need for a strong, vibrant, well-managed financial sector with adequate investor protections. Structural reform recommendations should address the broad policy, legal, regulatory, and enforcement issues that the Commission deems important to a competitive financial marketplace and the US economy. Given the urgency of the topic, these recommendations should be presented to the respective Congressional committees and the Secretary of the Treasury within one year from the start of the Commission.

There are a number of long-term issues affecting the health and structure of the US financial services industry that have for years been raised by industry participants and commentators, yet there has never been a comprehensive review by a dispassionate panel of experts from both the public and private sector. While recent efforts by private sector committees and commissions have been useful, they are not a substitute for a government-sanctioned, national effort with a mission to review long-term, structural issues affecting the performance and competitiveness of US financial markets in a global setting over time.

Such an effort by the proposed Commission should be consistent with the shared vision for the future of America's financial services described in Recommendation 3 above, and should thus also both influence and be in harmony with the proposed shared regulatory principles. The Commission's strategic direction, embodying the efforts of both the public and private sectors working in effective collaboration, should demonstrate to foreign and domestic participants that US policy makers understand the importance of US leadership in high value-added financial services markets for the health of the overall US economy.

Policy issues to review could include: barriers to efficient capital market flows (both foreign direct investment in financial services as well as portfolio flows); the tax treatment of wealth accumulation vehicles (savings, investment, and inheritance products and services) offered in the United States by all financial intermediaries; intellectual property rights in financial services; potential anti-trust reforms in recognition of increasingly global markets; the continuing need for separate holding company regulation in light of current laws governing all facets of financial intermediaries; and long-term immigration reforms beyond those addressed in Recommendation 4 of this report.

Legal and regulatory issues to address more systematically could include recommendations geared to designing a financial regulatory system that is simple, efficient, and responsive to both the competitive needs of all financial institutions to serve their customers and the systemic need for a strong, vibrant, well-managed financial sector. Regulatory rationalization and consolidation options to be explored range from the creation of a new, modern financial services charter with a single financial regulator based on the UK model, to other less dramatic forms of regulatory integration that would reduce unnecessary complexity, duplication, and cost. This would make the legal and regulatory environment more market-oriented and responsive to changing customer demands at both the wholesale and retail levels. Rethinking the mission of such a future single regulator or a more consolidated regulatory regime to take into account explicitly financial market competitiveness, the need for innovation, enhanced customer service, and safety and risk management issues may also be desirable.

The Commission should also conduct an assessment of the enforcement mechanisms used by federal and state regulators today, along with state and federal judiciary agencies, to improve the consistency and predictability of enforcement efforts. The Commission can undertake a broad, coordinated review of such efforts that would cut across industries and enforcement levels. The separation of powers and enforcement duties between the judiciary and executive branches, as well as between state and federal enforcement agencies, is a valuable means of ensuring that the public is adequately protected, and should of course be preserved. Nevertheless, a better balance could be struck that would yield greater uniformity and proportionality in enforcement across jurisdictions, to the benefit of the US economy as a whole. On one hand, state and federal policy makers seeking to implement newly harmonized and simplified regulatory strategies could then expect more effective execution, allowing laws and regulations to have the full impact intended by their drafters. On the other hand, financial intermediaries, investors, and other market participants would enjoy an environment less rife with uncertainty. Such reforms would not necessarily seek to alter substantive or procedural rights, but could instead simply look to improve consistency in enforcement by ensuring that state and federal regulators, along with state and federal prosecutors, are all using appropriate and proportionate means, along with proper communication and coordination with each other, when pursuing clearly defined common goals to enhance financial sector competitiveness and encourage greater economic activity in US markets.

In a rapidly changing and increasingly global financial marketplace, the private sector can provide information and insights on market trends, customer needs, and market impact that are valuable contributions to the decision-making process at both the local and national levels. The Commission should therefore encourage ways to enhance thoughtful private sector input to any policy or regulatory decision as a means of helping to ensure better implementation and execution over time.

Several ad hoc commissions and committees exist today and are focused on many of these same issues,[106] but none has a direct and dedicated link to either policy makers or financial regulators, and none has been sanctioned as an explicit US policy initiative. In contrast, this Commission can play an important role as the public policy debate continues on the competitiveness of US financial markets and the institutions that choose to operate here. Such a Commission could also play an especially helpful role in advancing the recommendations contained in this report and acting as a clearinghouse for others that will emerge and should be discussed in the future.

Recommendation 8 – Modernize financial services charters

Regulators and Congress should assess and, where appropriate, modernize US financial services charters, holding company models, and operating structures to ensure that they are competitive by international standards. One priority, in the context of enhancing competitiveness for the entire financial services sector and improving responsiveness and customer service, should be an optional federal charter for insurance, based on market principles for serving customers.

One product of the diverse regulatory system in the United States is that financial institutions serve their customers under a variety of regulatory charters, holding company models, and operating structures. Some of these, such as the national bank charter, date as far back as 1863; several have archaic features, such as the need to maintain multiple licenses to serve customers with different products or the need to have multiple supervisory reviews of the same issue at both the national and state level regardless of charter type. Other than the 1999 Gramm-Leach-Bliley Act, which included a new financial holding company structure under the supervision of the Federal Reserve, Congress has enacted no major changes to charters in the past few decades despite dramatic changes in financial services. Even Gramm-Leach-Bliley may merit re-examination given the time elapsed since its enactment as well as the competing holding company models and other structures that are available.

On balance, US financial regulators have interpreted their charters and structures in a broad manner that has allowed regulated institutions to keep pace with market developments and serve customers with new products and services through new channels. This has been true even when regulators' decisions have been challenged in the courts, as has happened in recent years – with some notable cases dealing with securities and insurance sales, nationwide banking, and the federal preemption of the national bank charter even reaching the Supreme Court. The problem is that the regulatory clarification process can take years to complete, during which time customers are not able to take advantage of new products and services.

A thorough review of federal charters, holding company models, and operating structures (such as international banking facilities under Regulation K of the Federal Reserve), and subsequent changes, could ensure that financial services companies operating in the United States are fully competitive in today's rapidly changing world. The process should include full input from industry, customers and other interest groups to ensure a balanced outcome. The most natural approach for this effort would be for each individual regulator to start its own review process, inviting public comments and holding hearings to gather constructive private sector input. Each regulator could then make any administrative corrections needed while submitting its preferred legislative changes to the Administration and Congress for their support. Alternatively, as part of the normal legislative process, the President's Working Group on Financial Markets could take on this review as part of its 2007 agenda, and make the necessary recommendations to the President for review and submission to Congress and/or the regulators. Finally, the pertinent Congressional committees could initiate a comprehensive set of oversight hearings to build the legislative base for modernizing financial services structures in line with the competitive needs of the financial system as a whole.

In a related development, Senators John E. Sununu of New Hampshire and Tim Johnson of South Dakota introduced legislation in the 109th Congress to provide for an optional federal charter for insurance. They, and others, are likely to introduce similar legislation in the 110th Congress in 2007. The interviews indicated that a modern national insurance charter – in the context of enhancing the competitiveness of the entire financial services sector and allowing insurance companies to serve their customers more effectively and efficiently – merits early and attentive consideration by the House Financial Services Committee and Senate Banking Committee in light of broader concerns about US financial services competitiveness.

An optional national insurance charter would benefit the competitiveness of both domestic and international firms doing business in the United States. A single charter would give US companies a uniform regulatory platform from which to operate and serve their customers more efficiently nationwide as well as globally. It would remove arbitrary pricing and product constraints that exist in many of the 50 state regimes, lower their duplicated regulatory costs, and ensure faster speed to market for new products under a uniform set of standards for serving customers effectively and efficiently. Moreover, it would give these companies a common regulatory regime more in line with their major competitors, especially in Europe. Foreign companies doing business here would have a single regulatory platform more comparable to what they enjoy in most of their home markets, which would make it easier for them to do business and establish operations across the United States, rather than continuing to meet the varying and often inconsistent regulations found in the current state-based system.

More broadly, creating and revising industry-specific charters would benefit both businesses and consumers. It will alleviate much of the compliance burden stemming from the regulatory patchwork that confronts many financial services participants, yet it will also benefit consumers by giving them access to innovative products and services that would otherwise be unnecessarily delayed. Furthermore, the suggested charters would not undermine consumer or investor protection as best-in-breed regulations would be allowed to "rise to the top" to become national standards. Properly implemented following a thorough cost/benefit analysis, these charters should therefore provide a significant improvement to both the international competitiveness of the relevant US financial services markets and to consumer welfare.

D. NEW YORK AGENDA TO PROMOTE FINANCIAL SERVICES COMPETITIVENESS

New York City's competitiveness as a global financial services center depends heavily on the success of the national agenda described above. In general, most executives interviewed for this report agreed with the executive who said that, "City for city, New York is doing a better job than London on many fronts: the traffic is better, quality of life is great, and crime is low; the real issues are at the national level." Over the past several years, the City has focused intensely on making New York more livable, in order to attract and retain employers and employees. The City also provides a relatively comprehensive array of services and initiatives, managed by the New York City Economic Development Corporation (NYCEDC), aimed at making New York an attractive and efficient place to do business.

That being the case, the City could take further action to support and complement the national financial services competitiveness agenda. Given the size and importance of financial services in New York, the sector merits focused, senior attention and resources aimed at maximizing long-term vitality and competitiveness. New York City has an opportunity, and an important responsibility, to work with global financial services businesses based in the City to promote US competitiveness. In so doing, the City and State of New York should actively cooperate with Connecticut and New Jersey, given the common interest in financial services that extends across the Tri-State area.

Establish a public/private joint venture with highly visible leaders focused exclusively on financial services competitiveness

The Mayor should work with the business community, particularly the Partnership for New York City, to form a public/private joint venture exclusively focused on strengthening the State's and the City's financial services competitiveness. This joint venture and its leaders would act both as a high-level liaison between major financial services institutions and local authorities, and as a highly visible driving force shaping New York's future financial competitiveness, by providing a single voice and agenda for the financial services industry, investors, and shareholders, at all levels from city to international. The joint venture should be managed by a dedicated, full-time Chief Executive with significant experience in leading major financial services efforts. The joint venture should also be led by a Chairman, appointed by the Mayor in consultation with financial services industry leaders, who will act as a national and international ambassador for New York's financial services industry.

This public/private joint venture for financial services should own and execute a City- and State-wide agenda that balances the objectives of business competitiveness, consumer protection, and broad economic growth. More specifically, this agenda should include:

- **More actively managing attraction and retention for financial services.** Several interviewees indicated that New York City is fortunate to have a Mayor and a Deputy Mayor who are well-attuned to the needs of business leaders, in large part due to their past experience in the private sector. However, their numerous obligations make it hard for them to give financial services business leaders the kind of focused attention they seek, particularly at this critical juncture in the industry's evolution. As one CEO interviewed put it, "Top officials from other cities where we do (or might do) business constantly reach out to us to see what they can do to be helpful; New York typically doesn't do that." The NYCEDC works with existing and prospective New York businesses at the operational level to assist with real estate, infrastructure, utilities, financing, and other matters underlying major expansions and relocations. In many instances, the NYCEDC has helped companies navigate the zoning process, expedited infrastructure improvements, provided financings, and otherwise helped financial services businesses make the most of what New York has to offer. It also provides a focused set of corporate incentives and uses client coverage and roadshows to communicate New York City's merits to domestic and foreign businesses. However, evidence collected for this report indicates that financial services businesses require a deeper, more senior and more comprehensive level of interaction with the City, going beyond the scope of the NYCEDC's mandate. Furthermore, to maximize the City's ability to retain important businesses over the long-term, the City should anticipate these companies' relocation plans years in advance and become a more active early contributor to the relocation decision-making process.

The financial services joint venture should seek to fill the current void by initiating and maintaining an active dialog with the City and State's top financial services employers about their expansion and relocation agenda. In addition, it should develop relationships with a short list of high-priority financial services institutions that might consider expanding what is a limited presence in New York today. The joint venture's leadership should reach out to decision-makers at the highest levels within organizations and give them the focused attention they need as they make decisions of this magnitude. In addition to serving as the focal point for negotiations, the joint venture's Chief Executive should bring in the Mayor, Deputy Mayor, and other high-level City and State officials as and when they are needed. The joint venture should also work closely with the NYCEDC and other City and State agencies to ensure that administrative efforts aimed at the financial services community are well coordinated to most effectively deliver New York's significant advantages as a global financial services center.

- **Establishing a world-class center for applied global finance.** Several New York-based educational institutions already provide excellent graduate programs in business, law, and accounting; but today's financial institutions need graduates with deep quantitative skills to drive innovation in high-growth, geographically mobile businesses, particularly derivatives and securitization. The financial services joint venture group should take a leadership role in coordinating with financial services businesses and local educational institutions to design and finance the world's best graduate program in financial engineering and global capital markets – one that combines the academic strengths of local institutions with practical work experience at the leading financial institutions and that focuses on applying cutting-edge mathematics, statistics and economics to financial services. Several successful programs already in existence in the US (e.g., the University of Chicago's financial mathematics curriculum) could provide a valuable starting point for any future New York City-based effort in this area.

- **Potentially creating a special international financial services zone.** The public/private joint venture, working with other interested stakeholders, should investigate the benefits of creating a special enterprise zone to enhance the international competitiveness of US financial institutions as well as other ancillary, supporting services. Similar initiatives in foreign jurisdictions (e.g., Luxembourg, Ireland, Bermuda) and in competing cities (e.g., Canary Wharf in London) have achieved significant success and may provide a valuable blueprint for New York City.

  The financial services sector still exhibits a natural clustering effect despite advancement in remote work. Once a certain critical concentration of financial services businesses exists in a given area, the value to other financial services businesses of co-location begins to outweigh some of the potential drawbacks associated with that location, such as high occupancy costs. A high concentration of financial services businesses tends to be correlated with a similarly high concentration of clients and providers of support services, which creates the potential for additional business opportunities and more efficient operation. Furthermore, as discussed earlier in this report, this clustering of business has the additional benefit of creating a large pool of highly-qualified workers, which is a key differentiator in financial services.

  As the largest financial services center in the world, New York benefits from the positive clustering effect described above to a greater extent than any of its direct competitors. As the economic and employment trends described in this report indicate, however, that advantage alone is not sufficient to ensure the City and State's indefinite leadership. Other factors affecting the general environment in which financial services businesses evolve must also combine to create a framework that is internationally competitive. But New York would nevertheless miss out on an important competitive advantage if it did not leverage its current critical mass in financial services. Local authorities can do so through three primary means: development incentives, differential taxation, and differential regulation. The creation of a special financial services zone drawing on one or a combination of these levers could be an effective way for New York to capitalize on its current leadership position.

  At a minimum, New York could actively direct development incentives toward one or more areas targeted for financial services. New York City already offers development incentives for Lower Manhattan, the Bronx, and other areas. The State has similar priority locations for economic development, such as Buffalo and Dutchess County. The City and State could earmark selected locations for financial services, enhance industry-specific incentives, and actively market them to relevant companies. This approach largely mirrors what the City has already done in life sciences with the soon-to-be-developed East River Science Park.

While evidence from the surveys and interviews conducted for this report suggested that taxes did not rise to the same level of importance as litigation, regulation, or talent in the minds of global financial services business leaders, it also revealed that respondents were far from insensitive to tax issues, and that the potential impact of an effective, targeted differential tax policy should not be underestimated. The success of Luxembourg, Ireland and the Isle of Dogs in London, where Canary Wharf is located, was not exclusively based on attractive tax treatment for foreign entities. Nevertheless, favorable tax treatment did represent a clear centerpiece of the business attraction programs implemented with great success by these financial centers and should not now be overlooked as a policy instrument to enhance competitiveness. Any tax treatment, however, must be adequately targeted either to promote the creation of new businesses or lure foreign institutions to New York, so as to alleviate the risk of a regional or national fiscal race to the bottom. Active collaboration between local authorities in New York and the rest of the Tri-State area would be critical in ensuring that any new tax program would not have unnecessarily deleterious effects on neighboring areas. Furthermore, the tax program must be properly backed by flexible, responsive regulators and local authorities, and supported by a sophisticated business infrastructure. Given these conditions, the effect of a tax concession, as past experience has proven, would be a net benefit to the broader region and the nation as a whole.

One option to leverage the potential of development incentives and tax rate reductions via a special financial services zone would be to encourage a cluster of financial services businesses and financial industry support industries. The public/private joint venture could take the lead in attracting high-tech suppliers to the financial services industry to New York. Firms that produce risk monitoring and trading systems software, computer hardware providers, front- to back-office solutions experts, and other industries that are increasingly important to financial services firms would be more particularly targeted. New York would become a natural hub for this type of high-tech cluster, which could be centered in one of New York City's high-priority developable central business districts, such as lower Manhattan, Hudson Yards, or downtown Brooklyn, or in other attractive locations within the State, such as Buffalo or Syracuse.

Another, more ambitious option would be for the joint venture to combine fiscal and regulatory incentives and, working with federal financial regulators, New York State authorities, and Congress, to create a pilot program to expand and adapt the concept of an international banking zone to other financial sectors, so as to create a particularly attractive new financial services zone centered in New York. With its potential for hosting significant new business development, Governors Island may be one potential location for such a special financial services zone. International banking facilities already exist for US and foreign commercial banks operating here under the regulatory authority of the Federal Reserve. This existing platform could be a starting point to redesign a new US-based international financial zone with the specific goal of attracting back on-shore legitimate businesses (e.g., reinsurance) and financial transactions (e.g., some OTC derivatives) that have moved off-shore in recent years as a reaction to a combination of US-specific legal, regulatory, and/or tax considerations. This pilot program would have the advantage of attracting more financial and related business to the United States within a controlled environment and under the watchful eye of the appropriate authorities. Once the program is established, the joint venture could take the lead in producing regular reports to the relevant authorities and detailing progress made in enhancing the competitiveness of US markets and institutions under this controlled experiment.

- **Enhancing the ability of the City and State of New York to promote their financial services profile and agenda as a leading financial center.** New York City already engages in a variety of marketing activities to promote the City's benefits to the local, national and international business community. For example, the NYCEDC produces a monthly *Economic Snapshot*, periodically publishes promotional reports including *Biosciences in New York City* and *New York City, A City of Neighborhoods*, sponsors a Web site, and has representatives focused on client outreach who travel extensively. The State of New York runs a number of similar initiatives, including the highly comprehensive I Love New York online Web portal, which provides large corporations, small businesses, high tech companies, and other actors with detailed information about the many economic opportunities that exist in New York. Considering the intensity of competition for global financial services preeminence, however, the financial services-focused public/private joint venture should complement ongoing activities by investing further in three critical areas:

- **Primary research into financial services topics.** The financial services joint venture group should fund and promote a program of research on issues relating to financial services competitiveness. Some topics, such as the cost of capital-raising in the United States versus other countries, will be of national or international relevance and will lend themselves to formal academic research, potentially with support from trade associations or other national bodies. In these areas, the joint venture group will not seek to set an independent national policy agenda for financial services, but will instead build support for emerging national policies that could benefit New York-based financial services. Other topics, particularly those of local interest like business sentiment and detailed analysis of job creation and mobility, are more suitable for in-house research direction and execution. As appropriate, the financial services joint venture group would draw on its own research to recommend policies at the New York State and City levels.

- **Public relations.** A targeted, fact-based public relations campaign can be a powerful tool in promoting New York's competitiveness as a financial center. Many other financial centers have public relations campaigns, but few, if any, can sell as many advantages as New York. The financial services joint venture group could assume the leadership role in designing and implementing a stronger, more visible public relations campaign that promotes New York as a destination of choice for the financial industry. In addition to a traditional media campaign, public relations should include annual reporting on the City and State's financial sector.

- **Advocacy at the State and national level.** The State and national agenda for financial services and the health of the City's and the State's financial services sector are inextricably linked. As further detailed below, the financial services joint venture's Chief Executive and Chairman can be effective voices for the City and State's financial services industry, integrating common perspectives across banking, securities, insurance, and other sub-sectors. These individuals can also be advocates for the financial services community at the national level and provide input to government officials on national issues pertinent to financial services by regularly meeting with lawmakers, regulators and other stakeholders. In addition, they can coordinate with other city and regional groups, as well as industry and trade associations, on national issues that affect financial services more broadly.

Many of the CEOs and executives from the US' top banking, securities and insurance institutions stated in interviews conducted for this report that they are looking for the right way to shape and contribute to the US and New York financial services agenda. There are several trade associations addressing various aspects of financial services, such as the Financial Services Roundtable, the Financial Services Forum, and the Securities Industry Association, to name only a few. However, none of these groups is specifically dedicated to identifying and resolving issues of financial services competitiveness. A new organization that would give New York's financial services executives an effective means of channeling their desire to help shape the future of the State and City would therefore complement the efforts of other groups already in existence rather than compete with them. Bringing together executives from banking, securities and insurance, and focusing specifically on the financial services competitiveness issues that are key to New York's long-term vitality, such a group would significantly contribute to ensuring that the State and City are continuously aware of, and responsive to, the critical issues affecting one of the local economy's most important sectors.

To accomplish the agenda described above, the City and State of New York need an institution that is capable of providing both the high-level strategic interaction that financial services businesses require in their dealings with host cities, and an avenue for financial services actors to partner with the City in crafting New York's future as a global financial services hub. A collaborative effort involving both the public and private sectors, for instance through the creation of a public/private joint venture such as the one described in this Recommendation, could satisfy both of these needs. Although the Partnership for New York City already fulfills a similar mandate, its efforts span many industry groups, and therefore it necessarily lacks the sustained focus on financial services that the industry deserves. Nevertheless, the Partnership already has the kind of convening power, capabilities and infrastructure that the proposed joint venture would require. Active collaboration with the Partnership may therefore be a logical means of ensuring that the new joint venture can begin to fulfill its mandate as early and efficiently as possible. Although the joint venture would be exclusively focused on financial services, its development could also provide a model for other industry sectors for which such a focused effort would be beneficial and justified.

The joint venture could bring together executives of major financial institutions (many of them already members of the Partnership for New York City), as well as representatives from shareholder advocacy and consumer interest groups, law firms, and accountancies. The joint venture's high-profile Chief Executive position would be filled by a dedicated full-time officer who should be well respected within the community and the industry. He or she would bring broad experience across financial services sub-sectors and a successful track record of leading industry working groups. This individual would manage the joint venture's strategic and operational activities, including acting as the high-level liaison between individual industry participants and the City or State, as well as being the driving force behind the implementation of the joint venture's broader strategic plan for New York's financial services development. Within this mandate, the Chief Executive would represent the local financial community in meetings with other city and state financial services authorities and interest groups, and would be a spokesperson at relevant trade and industry association events. In short, the new joint venture's Chief Executive would be tasked with furthering New York's local agenda in the most timely and collaborative manner possible.

To further raise the profile of New York's financial services industry at the national and international levels, the Mayor should also, in consultation with financial services industry leaders, appoint as Chairman of the new public/private joint venture a high-profile former senior executive for one of the leading financial services institutions based in New York. Adopting a more ambassadorial role, this official would assume a broader mandate than the Chief Executive, helping New York's financial services industry communicate its vision for the area's economic future with a comprehensive and consistent voice that is heard at the national and international levels. The Chairman would travel extensively, domestically and internationally, to meet government officials and business leaders and to promote the capabilities and advantages that the City and State of New York offer as a financial services center.

While the joint venture's Chairman and Chief executive will primarily concern themselves with furthering a New York-centric financial services agenda on the local, regional, national and international levels, it is important to recognize that New York's economic interests in this regard are largely aligned with those of the broader Tri-State area. The joint venture and its leadership, along with the Mayor's office and other New York governmental authorities, should therefore seek to collaborate with Connecticut and New Jersey authorities so as to provide the most effective advocacy possible for a robust and efficient financial services industry regionally. Although some competition with regard to the attraction and retention of financial services businesses will always exist between local governments within the Tri-State area, the aggregate benefits to the region of a thriving US financial services sector are such as to demand that regional interest groups wanting to support the local economy present a common front on issues affecting financial services competitiveness.

Conclusion

There is an urgent need for concerted but balanced action at the national, State and City levels to enhance the competitiveness of the US financial markets and defend New York's role as a global financial center. All players with a stake in the financial services sector need to take action now. Businesses cannot leave it up to public officials alone to refashion the nation's, the State's, and the City's competitiveness. Nor should regulators, administrators, or legislators move forward without drawing on the insights of the private sector. Both groups must work together, as one thing is certain: real action is required now, not just to protect and expand jobs in a vital industry sector, but also to ensure that US financial institutions and markets are positioned competitively to meet future customer needs and to support sustained growth in the domestic economy.

The collective recommendations contained in this report are another important contribution to the debate on the future of US financial services. They deserve to be discussed and explored more fully, together with recommendations that are being offered in other reports and by other interested stakeholders. Some recommendations can be acted upon now by the Secretary of the Treasury and the various financial regulators, while others will require legislative action by the Administration and Congress working together through a common, bipartisan effort. The most effective way forward is to ensure that the private and public sectors join forces. At the national level, this could be through the proposed bipartisan National Commission on Financial Market Competitiveness; at the State and City levels, New York's public/private joint venture may be the best vehicle. Whatever the forum, the private and public sectors must strive to improve the situation for their mutual benefit, and they must take decisive action on the issues and economic priorities identified in this report as crucial to the United States and New York.

Endnotes

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11. A.M. Best.
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13. McKinsey Global Institute Capital Flows Database.
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28. Global Insight, *World Market Monitor*.

29. Ibid.

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32. McKinsey Global Capital Markets Survey.

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34. Dealogic; data includes Class A and B shares – equivalent figure for Class B shares only would be $56 billion.

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43. Dealogic; Bahamas-based issuers are not considered “foreign” for purposes of this comparative analysis.

44. Ibid.

45. Ibid.

46. Ibid.

47. The Industrial and Commercial Bank of China’s (“ICBC”) 2006 IPO was a joint listing in Hong Kong and Shanghai.

48. Dealogic.

49. Ibid.

50. Ibid.

51. Ibid.

52. Ibid.

53. Ibid.

54. AIM statistics; Nasdaq Listing Standards & Fees August 2006.

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56. Ibid.

57. McKinsey estimates; includes underwriting fees, trading revenues, and listing fees.

58. AIM statistics.

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94. "Meeting with Citigroup, Inc., J.P. Morgan Chase & Co., Wachovia Corporation, and Washington Mutual, Inc.," August 11, 2006, Basel II NPR Public File.

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96. *IIF Proposal for a Strategic Dialogue on Effective Regulation*, for the full text, see the IIF Web site at www.iif.com.

97. Financial Executives International, *Sarbanes-Oxley Compliance Costs Exceed Estimates*, March 21, 2005; *Sarbanes-Oxley Compliance Costs are Dropping*, April 17, 2006. Surveys have revealed that 404-related compliance costs for public companies with an average of $5-6 billion in revenues amounted to approximately $4.4 million per company during the first -year of implementation, as compared with $3.8 million during the second year, when Sarbanes-Oxley compliance costs failed to fall as much as expected; anecdotally, several global financial services firms interviewed for this report, with particularly intricate or complex financial reporting systems, estimated that their overall compliance costs ranged between $40 million and $60 million annually.

98. "Competitiveness of the US Capital Markets," remarks by Treasury Secretary Henry M. Paulson, Economic Club of New York, November 20, 2006.

99. "SEC Votes to Propose Interpretive Guidance for Management to Improve Sarbanes-Oxley 404 Implementation," SEC press release, December 13, 2006.

100. See John C. Coffee, Jr., *Capital Market Competitiveness And Securities Litigation, November 16, 2006.*

101. See Joseph W. Bartlett, *Tort Reform in the Securities Sector,* 2006.

102. See, e.g., Federal Arbitration Act, 9 USC Sections 1 et seq.

103. The Working Group includes the Treasury Secretary as Chair, the Chairman of the Securities and Exchange Commission, the Chairman of the Commodities Future Trading Commission, and the Chairman of Board of Governors of the Federal Reserve System, with the Comptroller of the Currency and the Director of the Office of Thrift Supervision as ex-officio members.

104. According to the US Citizenship and Immigration Services, "a specialty occupation is an occupation that requires theoretical and practical application of a body of specialized knowledge and attainment of a bachelor's or higher degree in the specific specialty." Specialty occupations include engineering, medicine, business specialties, accounting and law, among others.

105. Remarks by Chairman Ben S. Bernanke before the Annual Convention of America's Community Bankers Association, Phoenix, Ariz., and the Annual Convention of America's Community Bankers, San Diego, Calif., October 16, 2006; (via satellite).

106. In early 2006, the US Chamber of Commerce created the bipartisan Commission on the Regulation of US Capital Markets in the 21st Century that is looking at many of the same issues as this report (www.capitalmarketscommission.com) and the bipartisan Committee on Capital Markets Regulation was formed in September 2006 to examine the impact of the Sarbanes-Oxley Act and other laws that affect the competitiveness of the financial markets (see R. Glenn Hubbard and John L. Thornton, "Commentary: Is the US Losing Ground," *Wall Street Journal*, October 30, p. A12.)

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