REMARKS ON THE MOVEMENT OF CAPITAL MARKETS TO THE INTERNET†

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The basic contradiction that Mr. Fleischman was alluding to is as follows. On the one hand, our regulatory regime for raising capital is driven by the notion of securities laws and reinforced by the fear of litigation. Under these laws, the distribution of information has to be carefully controlled, carefully channeled, and carefully choreographed. Information must be dribbled out in a very paternalistic way so that the buyer can make a decision. Standing in contrast, or even contradiction, to that concept is the reality of the opportunity of the Internet, which can provide all the information immediately—unfiltered, unchallenged, constantly available, and with no borders at all. The current regulatory regime is founded on the idea that you can corral and control information, but you have the reality of the Internet in the marketplace which says you cannot.

What I want to talk about is that paradox, because that is really what constrains the full realization of the potential of the Internet in transforming capital markets. I also want to take a brief look at a series of products that have moved—in the terminology of the Internet—from the bricks to the clicks, some that are part of the way through that transition, and some that I believe will go through that transition in the future.

First—and a lot of this just reinforces what Mr. Fleischman said—the markets, domestically and internationally, that have moved most completely to the Internet are those that truthfully are not regulated at all by our securities laws, such as various aspects of currency trading, derivatives, and commodities. These exchanges are not, for various reasons, captured by our regulation and therefore can proceed in a fairly unregulated way on to the Internet, driven by technology to the point where these markets have moved sixty to seventy percent of their trading and origination online.

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† The following is an edited transcript of remarks made on November 3, 2000, at the *New York University Journal of Legislation and Public Policy* Symposium.

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The next area of financial products that I expect will move to the Internet quickly are the categories of financial products that we view as exempt securities, which means that they are largely outside of the constrictions of the law. For instance, there is the commercial paper industry, which is really one of the largest in America. Exempt securities have gone from being traded the traditional way in 1999, to, in the fall of 2000, hitting the point where fifty or sixty percent of it is online, to the near future, when I expect most of the physical commercial trading desks will be closing down. It has happened that quickly. It has happened in the environment of a financial instrument that is, by and large, not captured by the registration processes of our law.

A similar thing has happened in the government and municipal bond arena. By the fall of 2000 there were already fifty or sixty Web sites set up to originate, market, and distribute municipal bonds. Goldman Sachs, a leader in the municipal bonds business, is moving their whole municipal bond business online, simply to allow them to maintain profitability. For them, seeing what has traditionally been a very inefficient, very costly distribution structure transformed into a broad-based retail product by bringing it online provides new opportunities to make profits.

Now after that, you start looking at other categories of finance on Wall Street, asking, "What types of financial products make sense to move online and will move there?" There has been a lot of publicity about various banks and companies attempting to do so-called "e-bond" offerings—bond offerings over the Internet—but there have only been ten or twelve of them depending upon how they are defined. The interesting thing with these is that, on one level, corporate bonds should be the next thing that is swept into the Internet, because they are evaluated by buyers not on the basis of a lot of research or concern about the issuer or anything else, but on the basis of things that can be summarized on a screen—their maturity date, their interest rate, their rating, and a few other numbers. They are commodities; they can trade as commodities; and they can originate as commodities. All the buyer needs to know is who the issuer and underwriter are and what the bond's rating is, and that is enough to make a decision about whether to purchase or sell a particular bond.

The problem has been this: if I am a buyer of a bond, there are four or five things that I will want to know. I want to know the rating and what the rating agency says about the bond. I want to know what the company's cash flow is going to be for the next two years so I can make sure they can pay their bonds off. I want to know about how this bond is trading in a similar market. Finally, I would want to know what analysts think of the industry. That is what buyers want to know, and that is how we sell bonds; it is usually about a thirty-five or forty-five-second discussion with our bond salesman on the phone.

Now, people want to move toward putting all that information up on the Internet, but they cannot because the law does not let you do it. At some point, there is the fundamental problem that what the market wants is disclosure-oriented. All they want is to do that disclosure over the Internet, and the law is not letting those who offer bonds do that.

In spite of these obstacles, there have been a couple of bond auctions over the Internet. The first offering is one that I was personally involved in. It was a marvelous thing, even though it took eight months of talking with the SEC, trying to explain what the rules of the auction were and how they could be presented. That first auction happened in the Summer of 2000, and then the first offering was launched with a lot of hoopla.

Since that first auction, there has not been a lot of additional enthusiasm because the people doing it decided that they did not get as good a deal as if they had conducted the auction in a more traditional manner. They felt it was great to do that offering online and to get a lot of publicity for doing the auction that way, but instead of paying an expected interest rate of 6% had they gone the traditional route, they wound up paying about 6.2% instead. One of the interesting reasons why that happened is when we were trying to set up the auction, we were dealing with people that trade on Wall Street—trying to show them how to make bids over the Internet—and they simply found it too difficult.

None of those traders came to the auction, and the issuers ended up paying about twenty basis points more than they thought they could have gotten. Therefore, they are not doing more auctions on the Internet, because, ultimately, the whole choreography that we had to go through was so burdensome and complex for the customers that they said, "Forget it. This is too hard, and I just don't have the time to do it."

The next area is that of markets that have not gone online, and, in my own view, probably will not go online for a while in a successful way. Things that could be viewed as commodities and could be summarized on screen are ultimately the best things to be traded using the Internet; e.g. securities issued by highly rated issuers—securities that buyers have confidence in. But there are other types of securities that do not fall into that category, such as equities and junk bonds—two of the principal ways Wall Street still makes money. There may be parts of them that will make their way to the Internet. Obviously, they will be able to distribute prospectuses online, but will there be a point where things cross over just as they will in the bond business?

I do not think there will be such a point, because you cannot quite summarize all of the information on a screen. The best shot at trying to do that would be to broadcast a so-called "electronic roadshow." This format would give a party offering the securities an opportunity to have a freeform video for forty-five minutes, participate in a question and answer session, and find out what is going on through the eyes of the executives. But the problem is, you cannot do it now, under our current law, without it being an illegal prospectus.

The SEC is looking at this issue and will come up with something in the near future addressing "electronic roadshows." But at the end of the day, I think everyone's expectation is that nothing much will change. Things that require a story, things that require an understanding, are not going to move to the Internet. It will be the world of bonds, the world of debt securities and the like, that makes the move to the Internet rather than those other types of securities.

Now, I want to turn to the question of which specific markets will move to the Internet and when they will do so. One of the common pieces of wisdom in the land of Internet exchanges is that things go slowly until you get to a tipping point or an inflection point, and then, when you get a critical mass, everything moves over. I think that is the way people view a lot of technology development. That is something that will clearly happen in the markets. There is no doubt in my mind that in the near future you will start to see a lot of the various debt and capital markets that can trade more as commodities move online. Soon we will get to the point where there is critical mass, and it will be a very quick transition to the Internet.

The other thing I found interesting in this regard is talking to the CFOs of the two largest banks in the country, who have substantial consumer franchises and have been trying to move their institutions into the online world. They both made similar observations that online banking customers are typically very loyal to a bank, as compared to people that are customers of a physical bank. Ironically, it seems the customers of an electronic bank, once they become customers, do not shop and do not go looking around for the best price. This is in sharp contrast to the old banking industry, where customers would walk into a bank, find out the rate, and then walk into another bank down the road to find out its rate. It is a remarkable phenomenon that while the Internet supposedly enables you to comparison shop and is supposedly used by the most sophisticated consumers, it is actually being used by the most loyal customers.

Ultimately, the point of this discussion is that once an inflection point is reached, people stay and they will not go back. When that tipping point happens, and more and more of the debt business in particular is guided by the online market, there is no reason for it to be here in New York, or even in the United States at all. Instead, where securities markets operate will be largely a function of where the regulatory structures relax a little bit to permit the markets to breathe and grow.