Comment

How Dodd-Frank fails to meet the test of our times

Alan Greenspan

The US regulatory agencies will in the coming months be bedevilled by unanticipated adverse outcomes as they translate the Dodd-Frank act's broad set of principles into a couple of hundred detailed regulations. The act's underlying premise is that much of what occurred in the market place leading up to the Lehman Brothers bankruptcy was excess (hardly controversial) and that its causes would be readily addressed by this wide-ranging statute (questionable).

The financial system on which Dodd-Frank is being imposed is far more complex than the lawmakers, and even most regulators, apparently contemplate. We will almost certainly end up with a number of regulatory inconsistencies whose consequences cannot be readily anticipated. Early returns on the restructuring do not bode well.

● Shortly after the act's passage in July 2010, Ford Motor Credit pulled its plans to issue a reported billion-dollar asset-backed security. It required a credit rating, which Ford could not obtain. One of the law's provisions had made credit-rating organisations legally liable for their opinions about risks. To ensure the issuance of the ABS, the Securities and Exchange Commission in effect suspended the need for a credit rating.

● In December, the Federal Reserve, as required by the act, in a preliminary finding, proposed to reduce banks' share of debit card fees associated with retail transactions, leading many lenders to contend they would no longer be able to afford to issue debit cards.

● More recently, concerns are growing that without immediate exemption from Dodd-Frank, a significant proportion of the foreign exchange derivatives market would leave the US. (The US Treasury is pondering an exemption but some bank regulators insist the statute be implemented as it is.)

● Many of the act's rules on proprietary trading, for example, apply to US banks globally. But competing US offices of foreign institutions can readily switch proprietary transactions to European and Asian banks, and if time zones are relevant, to Canadian banks.

● The act's most surprising failure to rein in supposed market-determined excess may be its stance towards the outsized (to some, egregious) bankers' pay packages. Small differences in the skill level of senior bankers tend to translate into large differences in the bank's bottom line. Competition for even the slightly more skilled is accordingly fierce. Senior bankers operate as largely independent entities whose "clients" are more theirs than the banks'; they leave with the "star" when he or she changes organisation. It is doubtful that legislation can work in such an arena.

These "tips of the iceberg" suggest a broader concern about the act: that it fails to capture the degree of global interconnectedness of recent decades which has not been substantially altered by the crisis of 2008. The act may create the largest regulatory-induced market distortion since America's ill-fated imposition of wage and price controls in 1971.

The problem is that regulators can never get more than a glimpse at the workings of the simplest financial system

In pressing forward, the regulators are being entrusted with forecasting, and presumably preventing, all undesirable repercussions that might happen to a market when its regulatory conditions are importantly altered. No one has such skills. Regulators were caught "flat-footed" by a breakdown we had erroneously thought was more than adequately reserved against. The Federal Deposit Insurance Corporation, for example, had noted as recently as the summer of 2006 that "more than 99 per cent of all insured institutions met or exceeded the requirements of the highest regulatory capital standards". Even the International Monetary Fund, in April 2007, had determined that global economic risks had declined in the previous six months.

The problem is that regulators, and for that matter everyone else, can never get more than a glimpse at the internal workings of the simplest of modern financial systems. Today's competitive markets, whether we seek to recognise it or not, are driven by an international version of Adam Smith's "invisible hand" that is unredeemably opaque. With notably rare exceptions (2008, for example), the global "invisible hand" has created relatively stable exchange rates, interest rates, prices, and wage rates.

In the most regulated financial markets, the overwhelming set of interactions is never visible. This is the reason that interpretation of contemporaneous financial market behaviour is subject to so wide a variety of "explanations", especially in contrast to the physical sciences where cause and effect is much more soundly grounded.

Is the answer to complex modern-day finance that we return to the simpler banking practices of a half century ago? That may not be possible if we wish to maintain today's levels of productivity and standards of living. During the postwar years, the degree of financial complexity has appeared to grow with the rising division of labour, globalisation, and the level of technology. One measure of that complexity, the share of gross domestic product devoted to finance and insurance, has increased dramatically. In America for example, it rose from 2.4 per cent in 1947 to 7.4 per cent in 2008, and to a still larger 7.9 per cent during the severe contraction of 2009.

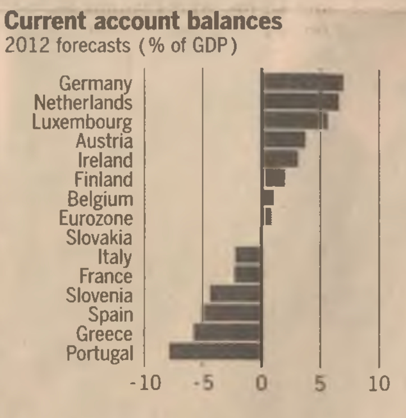
Increased financial shares are evident in the UK, the Netherlands, Japan, Korea, and Australia, among others. Even China has joined, its share rising from 1.6 per cent in 1981 to 5.2 per cent in 2009. Deregulation especially in America during the 1980s, clearly accounts for part, but certainly not all, of the share rise.

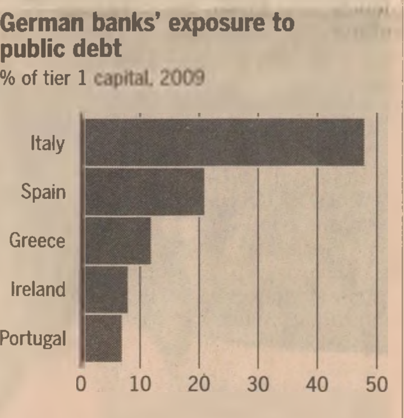
The vexing question confronting regulators is whether this rising share of finance has been a necessary condition of growth in the past half century, or coincidence. In moving forward with regulatory repair, we may have to address the as yet unproved tie between the degree of financial complexity and higher standards of living.

The writer is former chairman of the Federal Reserve

The 'grand bargain' is just a start

Martin Wolf





Sources: Thomson Reuters Datastream; OECD Economic Outlook; Nomura

Will the eurozone survive its crisis? That was the question I raised three weeks ago. My answer was: yes. My argument was that economic self-interest and political will would combine to preserve the common currency, in spite of the difficulties.

Yet that raises a further question: have leaders now done enough to put the eurozone on a sound footing? The answer is: no. Progress has indeed been made. But more will be needed, both intellectually and institutionally. Evidently, I am assuming that further shocks will compel further reforms. That is my judgment. It cannot be a certainty.

The euro is a unique project. For sovereign states to share a currency demands solidarity and discipline. The more diverse are the component economies and the more divergent is their performance, the greater is the need for solidarity and the smaller is its likely supply. So it has proved. I was one of the many who believed that a stronger political union and greater economic flexibility would be needed if the eurozone was to survive in the long run. Only in a crisis would it become clear whether the conditions for survival would be met. This crisis provides the test.

A fascinating speech by Lorenzo Bini Smaghi, a member of the executive board of the European Central Bank, makes the point. "Europe", notes Mr Bini Smaghi, "is evolving, growing, continuing on its path of integration. This is not happening, however, according to some pre-defined, agreed plan, but rather in response to the challenges it faces, which in some cases are likely to endanger the very existence of the Union." The current crisis is such a challenge. This might be called "the perils of Pauline" route to integration. It is hugely risky, but it has also worked, at least so far.

The response to the crisis is a superb example of the risks and rewards of this approach. The shock caught Europe unawares. Some had recognised the dangers created by huge internal imbalances and irresponsible lending to peripheral countries. Few realised this might interact with a global financial disaster to generate banking, sovereign debt and competitiveness crises inside the eurozone.

In response, leaders have innovated spectacularly. Within a year, they have approved a €110bn ($155bn) rescue package for Greece, in co-operation with the International Monetary Fund, endowed a new European financial stability facility with €440bn, decided to amend the treaty, to create a permanent rescue mechanism, amended the stability and growth pact, to enhance fiscal discipline, and created a new system of macroeconomic surveillance.

Germany has accepted ideas that its citizens abhor. Countries in difficulty have accepted austerity that their citizens abhor. We have seen much kicking and heard much screaming. But the show goes on.

Yet however far the eurozone may have come, it has not yet come far enough. There are three challenges.

First, the leaders have not created a regime capable of preventing and dealing with the potential crises.

True, important areas of agreement have been reached. One is the intention to monitor and promote competitiveness, particularly in labour markets. Without flexible labour markets, such a currency cannot work. Another is the focus on long-term fiscal sustainability. Yet another is the decision to legislate for banking resolution. Another is the plan to monitor debt of banks, households and non-financial companies. Nevertheless, big holes remain. The most important hole in the plans for economic co-ordination is the unwillingness to recognise the link between the external surpluses of core countries and the financial fragility in the periphery. The focus remains overwhelmingly on fiscal indiscipline, which was not the cause of the crises in Ireland or Spain.

Meanwhile, the biggest failing in the plan for a permanent European stability mechanism is that its resources – a total of €500bn – would be insufficient to manage liquidity crises in larger countries. Moreover, as my colleague Wolfgang Münchau has also noted, even this depends on resources from countries that may themselves need to be rescued.

Second, it is unclear whether the countries now in difficulty will be able to escape from their crises at manageable political cost. They have barely begun what is surely going to prove a long and painful process of adjustment. At present, Greece, Ireland and Portugal find access to financial markets prohibitively expensive. It is unclear when or how they can regain it. Yet they have no easy alternative to the slog. The countries in difficulty have large structural primary fiscal deficits (that is, before interest payments). Thus, debt restructuring alone is no panacea. An additional question is whether those in trouble can regain competitiveness without making their euro-denominated debt yet more unmanageable. At present, the countries likely to adjust their way out of the mess seem to be Ireland and Spain. But further political and economic shocks are all too likely.

Third, the eurozone has failed to cut the Gordian knot connecting the fiscal to the financial crises. Today's dominant opinion is that the senior creditors of banks must be made whole, while governments must avoid restructuring their debts. This combination is a machine for loading the costs of past bad lending onto the taxpayers of countries whose private sectors borrowed excessively.

This is, alas, a "transfer union". But those transfers occurred years ago, when these loans were made. It would be helpful – and honest – for the German government and the governments of other creditor countries to tell their people that they are rescuing their own savings in the guise of rescuing peripheral countries. The alternative is to write off loans and recapitalise their banks directly. To admit this would be to admit their policies have been at fault. That would surely be helpful.

Indeed, we can go further. An admission that mistakes have been made by both the virtuous and the sinners may be a necessary condition for sustaining the political will to strengthen the system. Huge challenges remain ahead. It would be easier to believe they will be overcome if everybody confessed to their part in the mess. Those who lent so foolishly and those who borrowed so foolishly are implicated.

As Christine Lagarde, the French finance minister, has remarked, "it takes two to tango". So it does. The eurozone's tango is fiendishly complicated. But the dance goes on. It will continue to do so, provided the will to remain entwined survives.

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MORE COMMENT ONLINE

Financial 'strikes', including the freezing of state assets, can swiftly oust Muammar Gaddafi, writes Patrick Cronin **www.ft.com/comment**

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UK tarnished by bribery no more

Britain's new bribery act enters force in July, replacing laws that date back to 1889. It creates offences of offering or receiving a bribe, bribery of foreign public officials and of a failure to prevent a bribe being paid on an organisation's behalf. These are tough rules, certainly. But combating bribery is largely about common sense, not bureaucracy, ***writes Ken Clarke***

Bribery is a thing we all know when we see it. It is a cynical attempt to manipulate someone's judgment by financial or similar means. But it does not include reasonable hospitality, or improving relationships with customers. So under this law no one is going to try to stop businesses taking clients to Wimbledon, or a Grand Prix.

Some have suggested that certain overseas companies in London will be exempt from the rules. Here it will be up to the court to decide whether or not any organisation can be said to be "carrying on a business" in the UK. Mere listing on the London Stock Exchange, or just the fact of having a UK incorporated subsidiary, would not necessarily mean the act applies. But to be clear: this is not a "carve-out". Under the act, it has always been a decision for the courts.

The question of prosecutions is also important. Cases will be brought where they are in the public interest, which will require the personal agreement of the Director of Public Prosecutions, or the director of the Serious Fraud Office. I do not expect a large number of prosecutions, and certainly not for trivial cases based on overzealous literalism.

We are also not going it alone in pursuing this objective, but working with our partners, including in Europe and the US. I believe the act will create clarity and establish a level playing field, helping to align trading nations around decent standards. And it protects the reputation of British companies, particularly among institutional investors.

The ultimate aim of this legislation is to make life difficult for the minority of organisations responsible for corruption, not to burden the vast majority of decent and law-abiding businesses. Britain has a reputation for believing in fair play. But lately our halo has begun to tarnish, with the UK failing to show the zero tolerance lead it should have. In implementing this act, the UK government and British business is striking a blow for the rule of law and the operation of free markets.

The writer is UK justice secretary. A longer version of this article is available at www.ft.com/comment

Wayne Rooney and Ricardo forge the ultimate dream team

John Kay

Wayne Rooney recently signed a new contract with Manchester United. The agreement guaranteed him £50m over its four-year life, equivalent to £250,000 a week. Mr Rooney is an exceptionally gifted footballer, but has few other evident talents. If he were not employed as a footballer, his earnings would probably be modest. And the life of a professional footballer is an exciting one, which attracts media attention and glamorous women. So it is likely that Mr Rooney would be willing to play professional football even if he were paid much less.

Many think of Sir Stanley Matthews as England's greatest footballer. His autobiography describes a rather different lifestyle. At the end of his career, in the early 1960s, he was receiving the then maximum wage of £20 a week. One of his greatest matches was a postwar celebration in which Scotland met England in 1948 at Hampden Park before a crowd of 150,000 people (England won). A letter from the Football Association encloses Matthews's match fee of £14 (about £500 at current prices) and his (second-class) rail fare from Stoke to Glasgow. But his claim for 6d (about £1 today) spent on a cup of tea in the station buffet at Carlisle was rejected: not a reimbursable expense.

The difference between what Rooney is paid and Matthews was paid is economic rent. Economic rent is the difference between actual earnings in an activity and the returns necessary to attract resources to that activity. The name seems misleading. The explanation is that early elaboration of the idea dates back to when agriculture was a principal form of economic activity. The concept is generally attributed to the English economist David Ricardo, but the idea was set out 50 years earlier by a Scottish gentleman farmer and scholar, James Anderson. Scotland won this one.

"Whence comes it, I [Anderson] may ask, that the price of grain is always higher on the west than on the east coast of Scotland? Are the proprietors in the Lothians more tender-hearted and less avaricious than those of Clydesdale?" No, he explains, "it is not the rent of the land that determines the price of its produce, but it is the price of that produce which determines the rent of the land. This seems to be a paradox that deserves to be explained".

The difference between what Mr Rooney is paid and what football stars in the 1960s were paid is economic rent

Mr Anderson's subsequent account of that paradox stands up well 250 years later. The demand for corn determined how much land had to be cultivated: the worst land that needed to be brought into production to satisfy that demand would earn only the cost of production, and better land would earn rents that measured the value of their superiority. Who benefited from these earnings was a political issue. Rooney's earnings are partly the result of the scale of revenues that football generates, and partly a result of the ability of his agent to bargain for them. Matthews' second-class ticket is not an unimportant detail – we can assume that the officers of the Football Association did not travel second class to Glasgow – but a demonstration of the social milieu within which Matthews worked. The lifestyle of the proprietors of Lothian was the result of a combination of the economic forces that determined the regional demand for corn and a feudal regime that enabled the local gentry to extract a substantial fraction of the benefits. The amount and distribution of economic rent is the product of the interplay of politics and economics.

As Mr Anderson was the first to argue, to comment on the amount and distribution of economic rent we must begin by understanding the mechanisms that gave rise to it. He might have been anticipating the furore on bankers' bonuses when he asked what might happen if "the gentlemen of Clydesdale, from an extraordinary exertion of patriotism and an inordinate desire to encourage manufactures, should resolve to lower the rents". Would the price of grain fall in consequence of this? By no means. "Readers of penetration will be able themselves to finish the sketch," he concluded. They must do so again today.

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Business Life

Partners should not always be equal

Luke Johnson
The entrepreneur

Perhaps the most painful part of any business relationship is dividing up the cake between partners. This usually happens in the very early days of a new project, when there is a handful of you in a room, a band of adventurers with big dreams out to conquer the world. So what shareholding does everyone get?

The easiest split is to give everyone an equal stake. This has a certain simple logic. Usually, first-time start-up teams, and friends or relatives who go into business together, do it this way. In my experience this tends to lead to fewer arguments initially but it rarely reflects relative contributions – more naivety and a spirit of fairness. It does not really work with more than three founders – and it can certainly lead to bitterness later, if some feel they were cheated or that others have not pulled their weight.

More sophisticated entrepreneurs know that equity can mean a great deal. Typically, those who demand a bigger piece of the pie are the inventor/founders who put up more seed capital, and serial entrepreneurs who bring a track record. Often it makes sense to vest equity over time, rather than granting it all up front – this ensures that only those who last the distance enjoy the prize.

Felix Dennis, the maverick publisher of The Week, is obsessed with avoiding dilution. An executive team working for him demanded he give them 20 per cent of the company – otherwise they would leave. He claims to have fired them on the spot. Of course, in the beginning, shares in any enterprise have just hope value, so it can seem petty to squabble too much. But never forget that equity has infinite upside – if you are to devote your life for years to a new venture, you want appropriate rewards if it succeeds thanks to your efforts.

There are absolutely no hard and fast rules about who should get what in an early-stage undertaking – it depends entirely on the circumstances. For pre-revenue businesses I balk at valuations much over a few hundred thousand pounds – even for spectacular ideas. Similarly, I think management's free equity in a buy-out should never be more than 15 per cent combined, and usually materially less than that. But every investor will have their own benchmarks, and will treat each situation on its merits. Management who are so greedy that they judge investors exclusively on how much equity they receive often regret their choice.

Human nature being what it is, the team at the top normally seizes all the sweet equity, barely leaving crumbs for those outside the boardroom. While this approach can deliver results, it also feels very selfish. No doubt less educated, more junior staff are mostly focused on short-term, cash bonuses. But concentrating all the gains in a tiny number of hands is not exactly motivating the broad workforce. The startling achievements in recent years of the John Lewis Partnership demonstrate the advantages of distributing participation widely.

"Equity has infinite upside – if you are to devote your life for years to a venture, you want appropriate rewards if it succeeds"

We live in an era where many executives want a job in a private equity-backed business because they think they will then be entitled to a juicy slice of ownership just for turning up to work – without stumping up any cash. They don't always realise that life in a leveraged smaller company is very different to the comfy world of big corporates. Long hours, personal risk and real talent are necessary ingredients – and even then a bonanza is far from guaranteed. There is nowhere to hide if things go wrong.

Equity is about both value and control, but wise founders realise that outside stakeholders will compromise the latter: subscription agreements, loan documents and board structures do mean sharing power and decision-making. The way to avoid that is never to raise external capital; but few companies are capable of substantial growth without any outside funding.

In negotiations over shareholdings, most partners think they deserve more than they actually get. If the bartering goes well, everyone is likely to emerge feeling a little disappointed – but able to live with the consequences. It is a fine line, juggling competing interests and keeping the show on the road – but it matters.

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Dear Lucy
Work problems answered

Can we hire a CEO whose reputation with PAs is dire?

I am on the board of a company that is looking for a new chief executive. We have found someone who seems very promising: he has a great record, a high profile and is dynamic and charismatic.

Some of the background we have done on him suggests that he has a short fuse and can be a bit difficult to work with, but the positives seem to outweigh the negatives. We were just about to offer it to him when we discovered that his PAs evidently find him impossible: he has been through 12 in two years. Should this rule him out?
Director, male, 52

Lucy's answer

I know a man who sounds just like the "very promising" one you describe. He gets through half a dozen PAs a year – and almost as many wives and girlfriends. He is charming when he feels like it but is also given to mammoth temper tantrums. He has, however, made a vast amount of money for his shareholders – and a vast amount for himself, much of which he has given away to good causes. The world would have been poorer if his PA habit had barred his advance.

But what makes his beastly behaviour just about OK is the line of business he is in. This man is a hedge fund chief. He runs a small operation and is paid to be a dazzling star. If he makes outstanding returns, everything else can be forgiven. There aren't many other lines of business where one can get away with being a truly awful person. There is some tolerance for it among film directors, pop stars, possibly editors, but on the whole it's unacceptable.

If your company makes steel ball bearings or sells groceries, I wouldn't even consider him. The job of a regular chief executive isn't just to be the things you say this man is – dynamic and charismatic and high profile. It is to set a tone in the organisation. It is to recruit the right people and make them stay. The revolving door to his PA's office suggests he has no idea how to begin.

This man is the sort who is charming to those above and foul to those below. When he was starting out this may not have mattered as everyone was above him. But as a potential CEO, when everyone is below him, it's a disaster. At the least, I suggest you do a bit more digging. Lots of readers suggest you ask him about it directly. I don't think there is much point in this. I can guarantee that he will say that he's a perfectionist and he doesn't suffer fools – which is what all CEOs say. Instead, you should ask some of the PAs themselves. Not why they quit, though that would be interesting. Ask them to give you advice on whether you ought to hire him. PAs are closer to their bosses than anyone; indeed if they were given a voice in selection processes, better decisions might result.

Your advice

Numbers speak
He has hit all the right numbers – no PA will ever be able to do that for you. Numbers speak for themselves; if he was truly an unreasonable bully then he wouldn't have been able to achieve what he has. The problem here lies with the agency in charge of supplying the staff in the first place – personality fit and a nice cup of tea should be top of the list.
Board-level PA, female

Look elsewhere
You bet it does. To lose one PA is unfortunate, to lose 12 is beyond carelessness. This man must be insufferable. Find another.
Director, male

He's the man
Hire him. He's tailor-made. That you should even ask the question suggests your company (especially its enabling board) already tolerates an abusive corporate culture masked by the occasional pious concern. Nice touch even raising the issue.
Former corporate, male, 48

Tie salary to PAs
Hire him, but stipulate in his contract that for each new PA he hires each year, he loses 10 per cent of his variable income. You'll find the next PA lasts as long as he does.
Retired, anon

Pick me
He needs someone adaptable, intelligent, who is able to cope with someone's challenging behaviour and who is rewarded handsomely. Can I send you my CV?
PA, female

Legal time-bomb
Twelve PAs in 24 months smacks of harassment to me. If you would like to be the employer of the lucky number 13 PA who files a big lawsuit, go ahead and hire him.
Director, female, 40

Hire a heavy
If Napoleon, Montgomery or Churchill had been judged on their abilities to control their temper, they would have never become leaders.

If he's good, hire him and hire an ex-Marine or ex-professional rugby player as a PA.

If he chews up a big tasty lad like that, then, well, that's what temp agencies are for.
Anon, male

Am I too beautiful for the City?

I know that you will think this problem is mad, but I fear I'm too good looking for corporate life. As a student I used my looks to make money modelling, but now that I'm in the City I feel they are holding me back. Female colleagues distrust me, while male colleagues are drawn to me, but don't take me very seriously.

My boss has told me that I need to network more. But I find networking events are ghastly, with all the eager men dribbling over me. What can I do, short of turning up to work in a bin liner?
Banker, female, 27

Please send answers and new problems to problems@ft.com. This column appears fortnightly.

Financiers of new frontiers

Entrepreneurship

An unlikely pair has capitalised on building knowledge of emerging markets, writes **Philip Delves Broughton**

Old-fashioned operators: Jonathan Auerbach (left) and David Grayson, co-founders of Auerbach Grayson, have targeted markets that were initially overlooked by bigger banks, such as Zambia (below)
Pascal Perich

Emerging markets now sit squarely in the centre of the investment universe. Even the most humdrum pension plan will have money riding on the Brics (Brazil, Russia, India and China) and, if they are feeling frisky, maybe Mexico or Indonesia. But how about Rwanda? Or the Democratic Republic of Congo? Or Iraq? Where would you even begin to find equity investments in these still nascent capital markets?

A good start might be a call to a loft-like office in midtown Manhattan, where two American entrepreneurs have built a global network of brokerage and research partners that now reaches 127 countries. In a city where financial innovation has come to be defined by hedge funds and ever faster trading platforms, Jonathan Auerbach, 68, and David Grayson, 57, are a throwback to a time when banking meant boots-on-the-ground relationship building and fact-finding missions.

When in New York, they start the day facing each other at a partner's desk in their shared office with brick walls covered with contemporary art and industrial pipes snaking across the ceiling. Mr Grayson looks very much the international banker, 6ft 6in tall in a navy blue suit and monogrammed shirt, and sporting a rich tan even at the end of a bleak New York winter. Mr Auerbach resembles a retired humanities professor, slightly dishevelled, with a wrestler's build, a gaudy gold and red plastic digital watch on his wrist, and seemingly perpetually amused by life's absurdity.

'We're discreet. We're never seen in the marketplace. When we buy, it's through our local partner, under the radar'

For much of the year, though, Mr Grayson is on the road, while Mr Auerbach sits at the trading desk with most of the company's 70 employees, pitching research and ideas to clients and executing trades.

The idea for the company came to Mr Auerbach while working in London for Dillon Read, the US bank. His job was to find Europeans to invest in the bank's domestic market. The cold war had yet to thaw. It was, as Mr Auerbach describes it, as if "America [was] the lifeboat and [the Europeans were] just hanging on to the side". But rather than finding Europeans to invest in the US, he kept finding opportunities for Americans willing to invest in Europe.

The harder he looked at the world, the more he became convinced there would be a great levelling of the global economic playing field. "This was long before Tom Friedman," Mr Auerbach points out, referring to the journalist who popularised the phrase "the world is flat".

Mr Auerbach envisaged capital flowing into every corner of the planet, a massive rise in living standards and, with that, greater political freedoms. But how could a US investor take advantage?

Dillon Read did not share his hunch, so Mr Auerbach quit to set up his own firm to trade in European securities for US investors. "It took me a week to get my licence and set up in an office on the corner of Old Bond Street and Piccadilly," he says.

Working alone, he began building a network of European brokerage and research partners who could provide ideas and execution services for Americans with an appetite for European markets.

After several profitable years in London, he returned to New York. But, after a brief break, Mr Auerbach rented a small office near Wall Street to see if he could replicate his experience in London on a larger scale.

Serving on the New York Stock Exchange's Specialty Firms Advisory Committee, he met David Grayson, a capital markets banker at ABN Amro, who offered to clear his trades. Mr Grayson began taking refuge in Mr Auerbach's office to escape the office politics. There, the two men would discuss the changes in brokerage, trading and capital markets and, after Mr Auerbach returned from one of his overseas trips, Mr Grayson suggested he needed a partner.

"He was right," says Mr Auerbach. "I was trying to do everything – get clients, run operations, develop research." They drew up a five-page business plan and went 50/50 in the company. Their employees consisted of a salesman, a secretary and someone to handle settlements. When asked how they funded their early operations, both men reach for their back pockets – each put in several hundred thousand dollars.

Today, Auerbach Grayson executes $100m-$150m of trades a day, taking anywhere between a few basis points to several per cent on each trade. By the standards of many modern financial institutions, Auerbach Grayson's activities are simple. It has exclusive relationships with partner brokerages in 127 countries, one per country. These provide English-language research into local equities that Auerbach Grayson then pitches to US clients, institutions such as mutual funds and hedge funds with over $100m in assets under management. When those clients make trades based on that research, they do so through Auerbach Grayson, which can then execute through its local partner brokers.

Their selling point is local expertise. While a global investment bank might parachute an analyst into a smaller market – say, Cambodia – Auerbach Grayson can tap research assembled by locals.

Mr Grayson notes: "We were initially concerned this might be an easy model to copy. But, having been around the world, we realised how difficult this is."

The company's first successes came in South Africa, after the release of Nelson Mandela, and in post-communist Russia. They were also quick to establish partnerships in countries overlooked by the larger banks, such as Slovakia, Slovenia, Croatia and Montenegro. They had a partnership in Sri Lanka during the country's civil war. Now the war is over, investors are pouring in. They are all over Africa, with partners from Rwanda and the Democratic Republic of Congo to Egypt. In 2009, they became the first non-Iraqi firm since the toppling of Saddam Hussein to offer research and delivery in Iraq.

The brokerage business has been transformed in recent years by new electronic and high-frequency trading platforms. Maintaining commission levels, Mr Auerbach concedes, is a constant battle. But, after a week in which clients were requesting specialised information on the situation in Japan, Mr Auerbach says his business provides an edge.

"Also, we're discreet. We're never seen in the marketplace," he says. "When we buy, it's through our local partner, under the radar."

In a business where stealth, as well as knowledge and timing, matters, it helps keep this most old-fashioned of modern financial firms in business.

Tips for start-ups

● **Have a clear purpose**
Auerbach and Grayson say their firm came together almost exactly as they envisaged in their original plan. They did not load the plan with mission statements. It was based on the simple idea that capital markets would expand around the world and American investors would want brokers who could access them.

● **50/50 can work**
Many investors prefer to see a single person in charge of a start-up venture. But Auerbach and Grayson have always shared the responsibilities and financial rewards of the firm.

● **Do not confuse your clients**
Auerbach Grayson does not engage in proprietary trading or pursue investment banking deals. From their clients' perspective, its motives are clear.