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EURO-CAPITAL MARKETS AFTER THE REMOVAL OF AMERICAN RESTRICTIONS

An Address By

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Ladies and Gentlemen:

I am simply delighted to be here among you at this very impressive meeting of those most active in the Eurobond Market. It not only has given me a chance to meet many of you, but in addition to that it has given me a chance to renew an acquaintance which I commenced in Washington a couple of months ago when your Chairman, Peter Sorg, and Walter Koller and Max Studerus visited the Securities and Exchange Commission. At that time, I had the opportunity to sit next to Peter during luncheon and learned with genuine amazement of the tremendous achievements of your organization during a short six years. That so much could be done in such a short time, and with no regular paid staff, is a tremendous credit to your initiative and that of your leaders. Quite candidly, in the United States if someone had conceived the idea of organizing such a group, the very first thing that would have been done would have been to hire people to do the hard work! You have avoided that and, consequently, the measure of your achievement is even greater and more commendable.

You have done this without legislative authority, sanction or command. The organization most closely resembling yours that we have in the United States is the National Association of Securities Dealers, on the board of which I was honored to serve as a public governor prior to becoming a Commissioner. The NASD

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exists pursuant to statutory authority contained in the Securities Exchange Act of 1934 and derives considerable of its power from that source. It is, as many of you know, subject to the oversight of the Securities and Exchange Commission. Of course, I should also candidly mention that given the fairly stringent interpretations of our antitrust laws which are current today, probably if you had undertaken to do in the United States many of the things that you have done several of you might very well be in jail for violating these laws!

Be all that as it may, your achievement is one of which you may be proud. Certainly much of the strength of the Eurobond Market is the consequence of those farsighted men who conceived of this organization and of those who have been its members, made its rules and have then abided by them. This achievement magnifies my sense of satisfaction in being able to speak to you today.

Being a member of an agency which is concerned with developing and enforcing rather stringent rules with regard to "full disclosure" concerning corporate matters, it would be unseemly for me to go any further without disclosing that the competence of my agency -- and my own competence -- is not really directed toward the problems of the Eurobond Market; in fact, the SEC deals only tangentially with the substantive problems of capital markets. Many of you are familiar with the operations and responsibilities of the Securities and Exchange Commission. We are an independent regulatory agency -- that is, we answer neither to the President nor any of his executive departments nor, in the usual sense, Congress, nor anyone else in the government, although obviously, since Congress and the Administration are the source of our money, we must satisfy them annually that we are doing competently and well the tasks which the statutes under which we exist commanded us to do. We are concerned with the regulation of the securities markets, both exchange and over-the-counter, the integrity of those involved in the process, and in large measure this entails enforcement of our standards of disclosure. We do not make policy with regard to interest rates or credit or monetary policies at all, although quite obviously much of what we do may have an indirect impact upon monetary and economic matters and, in turn, we must in making our decisions take into account those policies as made by other agencies and by the Administration and Congress. To be very concrete, although the Commissioners as individuals may very well have ideas with respect to the Interest Equalization Tax and the foreign direct investment restraints, we have had no official influence or impact upon either the imposition of those restraints or their removal. But in our role as regulators of the securities markets obviously we must take into account the Administration and Congressional policies with regard to those matters. We are very concerned with other related matters, such as the access of foreign dealers to American exchanges, the conditions under which they may become such, and similar problems. In fact, we have recently published for comment by interested parties an extensive series of questions that relate to problems of foreign access, including membership on exchanges, exchange listings and the like.

Having made all these disclaimers, I am going to be bold enough to express some notions with regard to the topic listed in the program, "Euro-Capital Markets after the Removal of American Restrictions." I emphasize that these are indeed only my own opinions, they are not the expressions of the Commission, and they suffer from the infirmities that I have mentioned, absence of involvement in and direct responsibility for the matters to which these American capital controls relate.

The Interest Equalization Tax was imposed in 1963 and the foreign direct investment restrictions imposed in 1968 represented a repudiation by the United States of a longstanding conviction that all nations are well served, including the United States, when there is a free flow of capital throughout the world. That had been the historic stance of the United States. However, national concern over an ominous continuing and unprecedented unfavorable balance of trade led the government, with the utmost reluctance, to impose the most severe restraints on the movement of capital which we had ever known. While we never felt comfortable with these restraints, nonetheless Americans who felt their impact adapted to them and lived and conducted their business among them. However, there was a strong wish on the part of major parts of the American financial world that these be eliminated as quickly and expeditiously as possible. That has now been done. The authorizing legislation for the Interest Equalization Tax expires on June 30, 1974. There may be those who entertain the expectation or hope that this legislation will be extended, even though the Administration has evidenced no desire to reimpose the tax, but I know of no significant pressure to secure such an extension and, therefore, I would expect that the legislative authority will expire in mid-year. Thus, barring a most unusual set of circumstances, I would not foresee either the extension of authority or the utilization of any such authority down the road.

The consequences of the imposition of these controls were clear. It became economically undesirable, although not impossible, for American investors to invest in foreign securities, including Eurobonds. As this Eurobond Market developed, it developed almost exclusively offshore and very little American money found its way into these securities. Thus, American investors could no longer become a part of the world securities market and foreign nations were, for the most part, particularly developed ones, denied American resources in their financings. As a part of that phenomenon American corporations could not export their surplus capital to further foreign operations and they could not engage in financings in the United States and then utilize the proceeds abroad. Thus, in order to maintain and expand their growing international activity, they had to have recourse to financing outside of the United States and this, of course, was one of the principal stimuli of the Eurobond Market. That these restraints did not significantly adversely affect the ability of American corporations to finance their overseas operations was evident in the testimony of the Deputy Director of the Office of Foreign Direct Investment who said in 1971:

> "So far there has been no significant change in the rate of accumulation of assets abroad that can be attributed to the imposition of the program. Indeed, the assets of foreign affiliates of U. S. parents have grown at a vigorous rate during the period of the mandatory program . . . .
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> "The reason that direct investors have been able to carry out their plans while meeting the restrictions of the program is because they have made substantial amounts of foreign borrowings, usually in place of domestic borrowings that would otherwise have taken place. The [program], therefore, should be considered primarily as a financing program."

Not only were American investors barred from foreign securities markets, but the restraints also made it difficult for non-Americans to penetrate American capital markets and offerings in the United States by foreign issuers declined markedly. Thus, the American securities markets became, in effect, domestic securities markets with its huge resources frozen inside the the borders and only a minimal flow out of it.

However, in one particular the market remained unrestrained and that related to the capacity of foreign interests to acquire American securities. This investment has continued unabated and, in fact, if anything increased. For instance, during 1973 some 20 tender offers were made for American companies by foreign interests, a much larger number I believe than had ever occurred before. In some measure, this obviously reflected both accumulations of resources abroad and the depressed state of American securities markets. Thus, the historic relationship was significantly reversed: America, instead of exporting capital, now became for the most part an importer.

One of the consequences of all this, of course, was the diminution of New York City as a world capital market. Not only did this adversely affect the economic prosperity of many New York firms which had historically been instrumental in channeling American funds overseas and in bringing foreign investment opportunities to American investors, but it was also damaging to the ego not only of New York City but of the nation, and a frequent argument heard for the removal of restrictions was the necessity of restoring New York to its position as the prime world capital market. Whether the removal of the restraints will bring about such a restoration is a question that remains open at the present time.

Largely, but, I think, not exclusively, as a consequence of these strictures, the Eurobond Market developed. As it developed, it was not confined to United States companies seeking financing for foreign operations, but it became the medium through which companies of other countries, as well as non-American public bodies, sought financing. It developed mechanisms and techniques and it engendered organizations like yours, as well as clearing systems, to do the business of the market efficiently and well. While the prime users of this market were American companies, nonetheless I think it is terribly important in analyzing the consequences of the removal of American restraints to realize that these were not the only ones who utilized this resource.

Something else to bear in mind is this. Many American companies sought financing in the Eurobond Market for reasons other than the difficulty of financing foreign subsidiaries with American originated capital. I know from my experience when I was practicing law prior to joining the Commission last August that many issuers sought out financing in the Eurobond Market for many reasons other than that. Frequently, lenders in the Eurobond Market provided American businesses with greater flexibility of terms than were procurable in the domestic market. Often the red tape, and therefore the cost of borrowing, was significantly less. I must admit that often this was a result of the lack of necessity for registration under the Federal securities laws which the Securities and Exchange Commission administer, a process which I must in all candor confess is frequently difficult, time consuming and expensive. Often restrictions in lending agreements entered into with American lenders explicitly allowed, or a waiver might be secured to allow, offshore borrowing.

As the Eurobond Market developed it became several things. First, it obviously became big. In 1972, it reached $6 million; since 1963, it represented $29 billion in 1,200 issues. Second, it began developing the characteristics of other markets, particularly a secondary market, although as all of us know this secondary market has had blemishes and weaknesses which will be the subject of discussion later in your meeting today. Third, it was increasingly utilized by non-American industrial companies seeking financing. Fourtn, the issuers in the Eurobond Market were for the most part characterized by high reputation and quality. Perhaps to some extent we may claim vicarious credit at the Securities and Exchange Commission for this characteristic. Manuel F. Cohen, a former Chairman of the Commission, has stated in this regard:

> "One reason [it has thrived] is the high quality of disclosure made by Euro-bond issuers, either because they are large international companies listed on the New York or London stock exchanges and, accordingly, accustomed to making adequate disclosure, or because the purchasers of Euro-bond obligations are sophisticated investors who demand such disclosure. Whatever the reason, adequate disclosure has played a significant role in the ability of issuers to gain the public's confidence and raise large amounts of capital through the Euro-bond vehicle."

And, finally, there developed efficient clearing systems which now are "bridged," and techniques and skills in the execution of transactions.

We are, if I might lightly paraphrase the words of a very great American, met to determine whether this market, conceived in the needs of the sixties to serve especially the demands of American industry, can survive in a world market from which the restraints which were largely instrumental in its creation have disappeared. And this question arises in a rapidly changing economic world. First, there is the tremendous world-wide need of capital, a need that has been aggravated and accentuated by the recent energy crisis. In the United States alone between now and 1985 it is estimated that somewhere between two and three trillion dollars of capital will be necessary, based on 1971 dollars; when the effects of a five percent rate of inflation are added in this the figure goes past three to four trillion dollars. A very large portion of this need, and an increasingly large one, is created by the President's determination that by 1980 the United States will have energy independence. The American needs for capital are paralleled in every nation, developed or undeveloped.

There is the specter of inflation, the bounds of which no man knows today. Confident predictions and expectations have perished and no one can say tomorrow whether those that we now have, even though more tentative than before, will be realized. We are witnessing massive shifts of currency and financial resources from the developed countries to the Middle Eastern countries and obviously the flow of those funds into investments will have a tremendous impact on securities markets throughout the world and upon economic values.

All of these economic circumstances have caused great fear concerning the capacity of the world capital markets to respond to the needs of the world. In the United States there is wide and deep concern with this problem. In the last couple of months I have attended innumerable meetings of people concerned with capital and securities problems and almost invariably it is suggested, in the most urgent terms, that this is the prime problem with which we must come to grips. In the United States we are witnessing a weakening of the financial structures of securities houses; in the last two years approximately 300 have gone out of existence. Most of them that have survived have suffered and are continuing to suffer severe losses as a consequence of the generally declining securities markets, the unavailability of underwritings, the aggravated withdrawal of individuals from the securities markets and other phenomena which are paralleled throughout the world. There is a great concern whether a securities industry, thus weakened, can be the instrumentality through which these enormous demands of United States industry for capital can be met.

Specifically, what does the removal of the Interest Equalization Tax and the other restraints on investment by Americans mean in economic terms? First, it means that American companies can now finance the needs of their overseas operations directly, either by taking accumulated earnings in the

United States and sending them abroad or by doing financing in the United States, either on a public or private basis, and sending the proceeds abroad. Thus, unquestionably the necessity of depending upon markets abroad is going to be far less compelling.

Another obvious result of this change in the restrictive complex will be the ability of non-Americans to tap the American capital markets and make offerings there and, thus, once more make available for their enterprises American capital resources.

Both of these consequences, of course, are adverse to the Eurobond Market. From your standpoint, on the other side of the balance sheet, United States investors will now be able to buy foreign offerings either in the United or abroad, and that of course includes Eurobond offerings. It would appear that through most of the history of the Eurobond Market the yields on those offerings have been somewhat above those on comparable offerings in the United States. If this situation were to continue -- and, of course, that possibility must be dealt with cautiously since the ability to move capital freely necessarily results in a leveling of yields -- it may well be that American investors will find the opportunities afforded by the Eurobond Market attractive. At worst, these changes will open up the potential of a vast number of additional investors, possessed of considerable resources, as likely candidates for Eurobond Market investments. Whether the advantages of this will overshadow the disadvantages to the Eurobond Market will depend upon a lot of circumstances that are presently highly unpredictable.

Thus, with this elimination of artificial restraints the capital market will become more truly international and each portion of this increasingly unitary market will compete with the other portions without the benefit or the detriment derived from now defunct United States capital restraints. The terms of this competition will be those that have characterized competiton in free markets for ages. Efficiency will be one basis upon which this competition will be carried out. Thus, the market which can offer the best in the way of clearance and settlement facilities, ease and speed of execution, and the general overall service to the investor will be an advantageous market in this new competition. Furthermore, it seems to me that the existence and the liquidity of the secondary market for securities will become even more important. It is a text book axiom that efficient markets are characterized by ease of transferring ownership of securities at prices enjoying reasonable stability and relationship to preceding prices. Obviously any strengthening of these characteristics of the Eurobond Market will be of tremendous significance. In that particular, it may well be that the proposals to be considered this afternoon will be of enormous importance in determining liquidity in-depth of the Eurobond Market in the future. Another factor that should not be minimized is the confidence of investors in the integrity of the market. If a market is characterized by confidence that all material information about the issuers of securities in the market is available and disseminated, that it is reliable, that it is correct, then it seems to me that that market has an advantage. I think it is well accepted by many people, perhaps most commentators, that one of the commendable characteristics of the American securities markets has been the beneficial presence of high disclosure standards, although recent debacles have probably to some extent impaired that confidence. Thus far, as I indicated earlier, it may well be that the Eurobond Market has been the indirect beneficiary of American disclosure standards. Many of the American companies offering securities in that market have been substantial issuers about whom huge amounts of information are available, information which has been utilized by investors in the Eurobond Market as well as in other classes of securities of such issuers in the American market. If the Eurobond Market becomes the market for securities of other issuers who are not subject to such rigid disclosure requirements and which do not choose voluntarily to comply with such requirements, then it seems to me that the Eurobond market may be at a disadvantage as compared with the American capital markets.

This brings us, of course, to the final question: Can the Eurobond Market survive in this new climate? I would suggest that it can. During the period when American capital controls have existed, the Eurobond Market has expanded and built a position of considerable strength. During that time the professionals involved in it have developed efficiencies and skills, as witnessed by the work of this Association. Too, high caliber clearance systems which now have erected a "bridge" between each other have come into existence. Vigorous efforts are being made to strengthen the secondary market for these securities. In addition to that, I think that probably most of those who are involved in this market have learned a good deal about the American system of disclosure and have realized the benefits to be secured from it. In addition to that, the market has been characterized by the absence of the procedural problems that characterize the American market in which the necessities of registration are often a significant factor in management decisions as to financing plans. Thus, I think it would be grossly premature to suggest that this sturdy giant, less than ten years ago a rather struggling infant, can be washed away or will be washed away by change in American capital export policies. Thus, I would caution you against an unworthy and unnecessary pessimism. Among other circumstances which I think should give you encouragement is the fact that in recent years only one-third of the issuers, expressed in terms of total value of offerings, have been American companies, a clear indication that significant numbers of other issuers have found the advantages of the Eurobond Market. And as I indicated earlier, in many instances American entrepreneurs sought money in the Eurobond Market not because of the capital restraints, but for other reasons which I have suggested. Furthermore, there is as I have mentioned considerable concern as to whether the capital markets in the United States can meet the tremendous demands of the future, and it may well be that the dollar resources accumulated in the European market, in some measure as a consequence of the shifts occasioned by the energy crisis, may provide relief from the tightness of American markets. Non-Americans seeking financing will not, in my estimation, quickly flee the Eurobond Market and seek capital in the United States, again one of the principal reasons being the necessity of compliance with the rigorous registration and disclosure standards which prevail there. They will, I imagine, continue to find in the Eurobond Market many advantages which will continue to make that market appealing.

It is true that many institutions are subject to additional restraints of long standing which might tend to impede investment in Eurobonds. Banks, of course, are very rigidly controlled as to investments they can make for their own account. They and other fiduciaries are likewise restrained by such rules as the so-called "prudent man rule" from exercising uncontrolled discretion with regard to their investments as fiduciaries. Those who administer pension funds, which are the largest accumulation of investable resources in the United States and which are also the most rapidly growing, are usually afforded by the trust instruments extensive flexibility and, thus, would be prime candidates for investments in markets outside the United States. If anything may be said about these additional restraints, it is that there is presently a greater willingness to expand the latitude for such professional investors. As an example, Senator Bentsen has introduced legislation which would immunize from the "prudent man rule" up to one percent of institutional portfolios, thus permitting considerably greater freedom for fiduciaries in their investments.

A story is told that there was a widespread rumor at one time that Samuel L. Clemens, more popularly known as Mark Twain, the distinguished American writer of the late 1800's and early 20th Century, had died. Mr. Clemens being reached by a reporter and asked about the rumor stated, "The rumors of my death are grossly exaggerated." I think the same can be said about rumors about the death or demise of the Eurobond Market. I think it is very true that changes will have to be made and greater attention given to those characteristics of the market which limit its competitive ability and greater exploitation of the strengths which make it a formidable competitor.

In short, then, the disappearance of United States restraints of direct foreign investment by its citizens marks the beginning of a new stage in the development of truly international capital markets. These markets, I believe, will be increasingly efficient in meeting the world's capital needs as programs of international co-operation by the participants in the market develop compatible mechanisms for securities transactions guided by policies designed to insure investor confidence and interest in the markets by full and fair disclosure of the relevant material information required to make informed investment decisions. As I learn of the tremendous growth of this Association and the work it has done, I have no doubt of the ability of this market to survive and more than survive, thrive in the newly competitive international capital markets.