

FOREIGN COMPANIES RAISING CAPITAL IN THE UNITED STATES

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1. INTERNATIONAL SECURITIES MARKETS

MR. HAWES: We have been talking about banking. In the fashion of Americans, we separate banking from securities; this is unlike the fashion in Europe where there are universal banks. We will first examine the raising of capital in the U.S. by companies from abroad and then we will discuss the raising of capital abroad by U.S. companies. Thus, we hope to get a clearer picture of the internationalization of the securities markets, particularly the primary markets. Turning next to an analysis of the law on investment by foreigners, we will use as illustrations the law of Japan, the law of Europe (if one may call it that), and the law of the U.S. We will be looking to see whether perhaps there is a need for greater coordination or harmonization of the law on foreign investments in the major countries.

Harmonization is already taking place, to a greater or lesser degree, in accounting and in disclosure rules. We will be examining those subjects as a possible precedent for harmonization and cooperation in other areas. We then take a look at the extent to which the natural forces in the market, especially the trading markets, have pressed beyond national borders without a concomitant extension of regulatory supervision. We will be looking at the barriers to international activity by brokers and, to some extent banks, which have been raised by national interests. First Michael Coles will speak on foreign companies raising capital in the U.S.

MR. COLES: I have been asked to talk about the use of the U.S. capital markets by foreign issuers. Much of the market that I will discuss is often referred to as the Yankee bond market. This is customarily defined as the U.S. domestic market for debt obligations, either non-convertible or convertible into equity, of non-U.S. issuers, which obligations have been registered with the SEC under the Securities Act of 1933. The Yankee bond market does not generally include debt issued here by Canadian issuers, and I will adhere to this convention. However, in addressing myself to the Yankee bond market, I do not wish in any way to neglect the small but growing market here for pure foreign equity issues.

2. HISTORICAL PERSPECTIVE

A. Development of the Yankee Bond Market

The Yankee bond market is often erroneously considered to be a recent phenomenon. However, if we go back into history we will find that, contrary to its position prior to World War I when the

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U.S. was a substantial debtor country and its growth was financed in large part by European capital, the U.S. found itself in the 1920s as the world's largest creditor nation, being owed significant amounts of money by most of the combatants involved in World War I. As a result, the U.S. became, and with some exceptions and in different degree has continued to be, an important supplier of capital to the rest of the world.

Much of the debt offered in this market during the 1920s and early 1930s lapsed into default during World War II; and much of it still remains subject to settlement plans whereby investors will receive only a small proportion of their original outlay. Most holders, for example, would probably prefer to forget the 1922 Bolivia Eight Percents, due 1947, or the Republic of Cuba four and one-half percent bonds due 1977, issued in 1937. The First Bohemian Glassworks located in Czechoslovakia must have been considered a good investment in 1927 when it issued its seven percent bonds due 1957. Purchasers of the City of Warsaw seven percent bonds issued in 1928 and due 30 years later could hardly have foreseen the destruction of that city in the early days of World War II, and the subsequent subjugation of Poland by the Soviets.

Most of the early Yankee bonds I have mentioned, and many others, are traded at nominal prices on the various stock exchanges. Probably they have greater value in the eyes of investors as the bases of lampshades or colorful bathroom wallpaper. One of the major points I wish to make today is to stress the significant differences between the market for foreign bonds in the U.S. now, compared to the market that existed prior to World War II. Later I will discuss what I perceive to be the much greater safety offered investors in today's Yankee bonds as opposed to their unfortunate predecessors.

Obviously, during most of the Depression and during World War II there was very little activity for foreign bond issuers in the New York market. However, the U.S. came out of World War II as a major creditor nation again, and during the period from 1945 until 1963 the Yankee bond market was the most important non-bank source of U.S. dollar borrowings for foreign issuers. Sales of foreign bonds to U.S. residents reached close to \$1 billion in 1962 and during 1963 were running at a rate almost double that amount.

As a result of rising concern about the increasing outflow of capital, the Kennedy Administration introduced in 1963 an interest equalization tax, designed to make it unattractive for most issuers to use the Yankee bond market. In addition, so-called voluntary guidelines severely limited the portfolio investments of U.S. non-bank financial institutions in the securities of foreign issuers.

In 1974 the controls on U.S. investments abroad were removed. Since that time eighty-six straight debt issues aggregating \$10.3 billion for twenty-nine non-U.S. borrowers, eight convertible bond issues totalling \$475 million for six non-U.S. corporations, and fourteen equity issues totalling \$565 million for eleven non-U.S. issuers have been successfully offered in this market.

The theme of this conference is the internationalization of the capital markets. The Yankee bond market now represents a quite significant portion of a global capital market which, over the last ten years, has demonstrated a considerable ability not only to finance the growing and continuing capital needs of the industrialized world but also to take care of the tremendous burden of capital flows resulting from OPEC surpluses and the corresponding deficits on the part of oil importing countries.

B. The Current Yankee Bond Market

Let us take a look at the Yankee bond market: first, the market for straight or non-convertible bonds. In 1974, after the interest equalization tax was removed, the market was opened by one issue on the part of the European Investment Bank, which raised \$100 million in this market. There followed seventeen issues in 1975, and twenty-eight in 1976; the volume peaked at twenty-nine in 1977. The volume since that time has tended to decline; only eight issues were offered in 1980.

There are a number of reasons for this apparent decline but the most logical explanation is the increasing depth and liquidity in the Eurobond market, both primary and secondary, which has enabled issuers to raise money there in large amounts and on terms which compare favorably with those available in New York. A further reason--which I will discuss more fully later on--is the fact that bond markets worldwide have become increasingly volatile and speed is essential if an issuer is to obtain the best possible conditions in the market. Whereas a Eurobond issue can be completed by a sovereign or supranational issuer in a matter of hours, the registration requirements of the SEC, until recently in any event, made the process of raising money in the U.S. market considerably slower. Dollar amounts have reflected the number of issues. In 1977, the peak year, there were \$2.3 billion of issues made here by foreigners; the amount in 1980 was less than half of that.

It is not altogether surprising that the Yankee bond market has been dominated by sovereign and supranational borrowers. The number of private sector corporations who have been prepared to undergo the rigors of registration with the SEC is relatively small. In the straight debt sector, European supranational organizations--in other words, the European Economic Community itself, the European Coal and Steel Community, the European Investment Bank, and Eurofima--have accounted for thirty-three issues or just under one-third of the total amount offered, with a total dollar amount of \$3.4 billion.

European countries have accounted for forty-three issues, with France being the single most frequent borrower with fourteen issues and Norway having the largest volume with total offerings of \$1.25 billion. Other issuers have been Austria, Finland, Sweden, and the United Kingdom. Non-European governments have accounted for twenty-seven issues, with Australia--having done eleven with just under \$1 billion--being far and away the most important. Others include Japan, Brazil, Mexico, New Zealand, and Venezuela.

Many of these governments have chosen to borrow indirectly through a state agency guaranteed by the government; others have borrowed in their own names. The credit distinction by investors between these two routes appears to be minimal. Some municipalities have come here, the City of Oslo and the City of Stockholm accounting for three issues between them.

In the straight debt private sector, on the other hand, only three issuers have appeared to date: ICI for two issues, British Petroleum and Ito Yokado, a Japanese retailer, one each.

Let us look now at the equity sector of the market which is, of course, confined to corporate issuers. Since 1974 there have been nine issues of convertible bonds made in this market by foreigners--all of the issuers being located in Japan. The total amount issued was \$535 million, and all the issues were made for maturities of fifteen years. There have also been eleven issues of pure equity

securities, all in the form of American Depository Receipts. Nine of these were for Japanese companies, two for British companies.

C. Changes and Improvements

Why should American investors, given the somewhat disastrous record of foreign borrowers in this market between World War I and World War II, be willing to buy foreign securities in substantial amounts today? I think there are a number of reasons why investors look upon the Yankee bond market today as being dramatically different from that which existed prior to World War II.

First we must remember that most of the issues prior to World War II took place before 1933 and were therefore not subject to the disclosure requirements of the 1933 Securities Act. We should not underestimate the importance of the clean nature of our securities markets. If you are going to invest in securities, you might as well choose a game where the deck is not stacked and the players keep their hands above the table.

Second, the world financial community has changed dramatically since World War II. There is a strong network of interrelating financial connections. Countries that qualify for entry into the U.S. market are among the world's leading industrial nations, and they are normally substantial borrowers in a number of different markets. It is arguable that if one of the major borrowers here--such as France, Norway or Japan--were by any remote possibility to run into problems in servicing its foreign debt, it would undertake emergency loans from the World Bank or the IMF, activate existing inter-governmental swap agreements, run down reserves, tighten belts, cut back imports, or even hold rescheduling discussions with its commercial bank creditors. A whole host of measures would be tried before acknowledging the severity of the crisis by incurring any kind of default in externally funded debt. Continual access to international credit is a country's life blood. To permit curtailment of this access because of an impaired record of debt service would be a national disaster. Corporate issuers are generally based in countries that are themselves well-accepted borrowers in the New York market. Many of these countries have substantial U.S. assets which, although not pledged to secure dollar debt, provide the reserves to service it in an emergency.

This brings me to what I think is the most important distinction between the market today and the market as it existed prior to World War II: that is the willingness of the independent rating agencies in New York to give bond ratings to indebtedness of foreign issuers. This is a relatively new development, but it has become nearly impossible for a foreign issuer to raise money in the New York market without having first obtained a rating--at least if its plan is to issue non-convertible debt.

Of the twenty-one issuers or guarantors that have come to the U.S. market in the last seven years, fifteen have obtained an AAA rating from both agencies; and their borrowings have accounted for \$9.6 billion or 87.5 percent of the total amount raised. Two have obtained an AAA from one agency and an AA from the other, accounting for 6.2 percent. One has an AA from both agencies, accounting for \$300 million or 2.7 percent, and one has an A from both agencies but borrowed only \$20 million. Therefore, borrowers with no rating at all accounted for only 3.4 percent or \$370 million of the \$10.9 billion raised since 1974.

The overwhelming majority of business done in this market by foreign borrowers is AAA rated. It is this quality aspect of the borrowings that most appeals to investors here--quality, that is, coupled with an appreciable premium in rate. A foreign sovereign borrower, today, will probably pay as much as one hundred basis points over the Treasury bills of a corresponding maturity; whereas an AAA domestic industrial borrower will pay only forty additional basis points. This differential of sixty basis points represents the so-called "foreign premium": the amount that a foreigner must pay in order to attract the investment interest of U.S. institutions. The investor is therefore able to have, on the one hand, an AAA name on his books while obtaining, on the other hand, a yield significantly higher than that available from comparable domestic credits.

Finally, as I mentioned earlier, bond markets today are volatile. Investors are sophisticated; the days when a bond was bought and held to maturity are now long gone. An advantage of the Yankee bond market is its liquidity. There is a significant and liquid secondary market for Yankee bonds maintained in New York by the principal bond dealing houses; and also, since the vast majority of Yankee bond issues are sovereign credits, these securities are completely fungible with their equivalent issues in the Eurobond market. There is frequent swapping between the two markets, aided by the fact that interest on Yankee bond issues--like interest on Eurobond issues--is paid free of all withholding tax. U.S. corporate and government issues, on the other hand, are subject to the U.S. withholding tax.

3. ADVANTAGES TO THE ISSUER OF THE YANKEE BOND MARKET

A. Characteristics of the Market

Why do foreign issuers use the Yankee bond market? Issuance of a Yankee bond provides entry into the world's largest and most sophisticated capital market. The process of registering with the SEC can be a painful and time consuming one. Nevertheless, once this bridge has been crossed, entities that are substantial users of capital then have access to the broad range of U.S. capital markets, which can frequently provide funds in greater size or on more favorable terms than alternative markets.

Although the use of the commercial paper and private-placement markets does not require long-term debt ratings or registration with the SEC, the completion of these demanding processes provides significant advantages. Continued access is gained to both the debt and equity markets; and access to the commercial paper and private-placement markets is made easier. Finally, the existence of favorable debt ratings and acceptance by U.S. capital markets can serve only to enhance the issuer's standing in other markets.

The two principal quantitative advantages of the Yankee bond market are cost and maturities. The Yankee bond market can frequently provide funds at a lower cost than those available elsewhere. Although the initial costs of market entry are higher than in the case of a Eurobond issue, interest rates are often slightly lower. This fact, combined with the much lower U.S. commission structure, frequently results in a lower end-cost than is obtainable in other dollar markets. Issuers are increasingly cost sensitive. Frequent borrowers want to choose the most competitive market; and it is quite normal for a last minute switch to be made between the Euro-

market and the Yankee market to take advantage of marginally lower rates.

The second attraction of the U.S. market to foreign borrowers is the availability of long term maturities. Of the 114 issues made since 1974, forty-eight have been for ten years or longer, accounting for \$4.4 billion or forty percent of the total. The remainder have been for five, seven, or eight years. Under normal market circumstances the U.S. can provide longer maturities than have usually been available in other markets. Issues with maturities of twenty or even twenty-five years have been successfully offered in the U.S. while fifteen-year issues are considered about the longest maturities obtainable in the Eurobond market.

The main disadvantage of the Yankee bond market is the time, effort, and cost of registering with the SEC. However--as I will discuss in greater detail--these costs are far less for a sovereign issuer. This explains why the great majority of Yankee bond issues have been made by sovereign governments or supranational agencies.

B. Characteristics of the Issues

It is worthwhile pausing for a moment to look at the principal characteristics of Yankee bond issues. First, amounts. Amounts have varied from \$20 to \$200 million per tranche and up to \$350 million per issue (an issue may sometimes consist of two or more tranches of differing maturities). The size of straight Yankee bond issues has been increasing over the past five years. Convertible issues have also ranged in size from \$20 million to \$100 million. Since issues of less than \$75 million do not develop significant secondary market activity, we do not generally recommend offerings of less than that amount.

Yankee bond maturities, as I have already said, range from five to twenty-five years, but it is interesting to note that the two issues for twenty-five years have been for corporations. We have observed that, all other things being equal, American investors will usually prefer a corporate credit as opposed to a government credit of similar rank, particularly when the corporation has significant assets located within the U.S.

One of the reasons why the volume of Yankee bond issues has been declining is that the prevalence of inflation in the U.S. domestic markets has caused investors to seek to shorten the maturity of their exposures. As the overall average life of our domestic bonds goes down, so does the average life of Yankee bonds. The critical comparison between the medium-term Eurobond market and the increasingly medium-term Yankee bond market becomes, therefore, interest costs.

Most Yankee bond issues with maturities of fifteen years or more have typically had sinking funds which have reduced their average lives to around ten years (in the case of fifteen year bonds) or thirteen years (in the case of twenty year bonds). Convertible issues in the Yankee bond market have also had sinking funds, reducing the weighted average life of a fifteen year bond to approximately eight years. Yankee bonds have typically had call protection providing that the bonds will not be callable for a number of years, with the non-call period being as much as twelve years in the case of twenty year bonds. Convertible issues, on the other hand, are typically callable at any time.

Underwriting discounts and commissions (customarily known as the gross spread) are substantially less for straight debt issues in the Yankee bond market than they are in the Eurobond market. Gross spreads for fifteen to twenty-five year bonds are generally about one and one-quarter percent, and for five to ten year bonds they range from just under seven-eighths to one percent. The gross spread on convertible issues is typically two and one-half percent, about the same as in Europe.

The initial costs of structuring a Yankee bond issue can be quite high. This is particularly true for corporate issuers, since one of the major expenses is the fees for auditors who have to prepare the company's financial statements in a manner acceptable to the SEC. A first time corporate issuer undertaking an equity related offering could find its expenses running close to \$1 million. Major items in this expense list would include, for example, about \$150,000 for document printing, another \$50,000 for printing and engraving securities, anywhere from \$200,000 to \$300,000 in accountants' fees, probably around half that amount in legal fees, \$100,000 in reimbursement of the underwriters' expenses, and other miscellaneous fees including the SEC registration fee, listing fees, blue sky fees, fees of the trustee and paying agent, and fees of the rating agencies.

C. Characteristics of the Investors

Who are the investors in Yankee bonds? The major purchasers of straight Yankee bonds are U.S. institutions. However, the institutional market for Yankee bonds is quite significantly reduced in size by the fact that two key classes of investors are limited in their ability to purchase foreign bonds. Many public pension funds can buy no foreign securities at all. Insurance companies, which could be very substantial purchasers of such securities, are also limited in the amount of overseas investments they can make. This means that performance-oriented bank trust departments and investment advisors are critical to the success of new Yankee bond issues. This factor makes the job of the issuer and the manager in correctly fixing the terms of the issue much more difficult.

If a foreign company has significant operations in the U.S., it may be possible to structure the issue in the form of a domestic offering with a guarantee by the foreign parent. This technique substantially enlarges the potential universe of investors.

For obvious reasons, investment bankers are quite reluctant to reveal precisely where they sell each respective Yankee bond issue or any other bond issue. However, looking at our own retail sales over the last four years, we can see a distinct pattern of distribution emerging. Our own sales account for approximately seven percent of the total amount of Yankee bond issues made during the period under discussion. They are therefore probably a quite accurate reflection of the whole.

Close to eighty percent of our sales have been made domestically; the remaining twenty percent have gone to investors located outside the U.S. The breakdown of our domestic sales is approximately as follows: twenty percent to commercial bank trust departments, five percent to thrift institutions, ten percent to investment funds and investment advisors, six percent to charitable institutions, fourteen percent to insurance companies, twelve percent to pension funds, and thirteen percent to others, including individuals. The proportion of these issues placed within the U.S. will obviously vary according to maturity. For a twenty-year issue the domestically

placed proportion is considerably higher.

I have mentioned that one of the attractions of the Yankee bond market to borrowers is the possibility of obtaining funds at a somewhat lower cost than might be available in the Eurobond market. If this is true, the converse is also true: investors should be able to obtain a better yield on their money by putting it in Eurobonds. One reason for not putting all one's assets in the higher yielding securities is the desire to develop a reasonable spread of risk between the Yankee and Eurobond markets. In the event that there is a run against the dollar in Europe, the sale of unregistered Eurobonds to European investors may become extremely difficult. On the other hand, it is recognized that there will always exist within the U.S. a reasonably viable market at some price for dollar denominated securities that have been registered with the SEC.

Investors in convertible Yankee bonds typically include a larger number of individuals than would be the case for a non-convertible issue. However, the major portion of the investor group is still institutional, albeit that the previously mentioned restrictions on purchases of foreign securities by pension funds and insurance companies are applicable.

4. REGISTRATION REQUIREMENTS

As I have mentioned several times during the course of my remarks, a major problem that foreign issuers face in the U.S. is in meeting the registration requirements of the SEC. As most of you know, the registration process in general has been considerably simplified over the past several years. A company of stature that has its securities broadly distributed in public hands will generally be what is known as a reporting company, which is a company required to file periodic reports with the SEC pursuant to the Securities Exchange Act of 1934. Such a company, if it meets certain size and other standards, will be able to issue debt securities by registering those securities on Form S-16. This is a short-form registration statement, and most of the information contained in it is incorporated by reference from other documents on file with the SEC. For foreign issuers, however, there is presently no alternative to the basic Form S-1 registration statement, which is a considerably longer and more burdensome document than the S-16.

A. Governmental Issuers

A governmental issuer is entitled to file an S-1 registration statement under what is known as schedule B, which gives the governmental issuer considerable leeway in the extent of its disclosure. For governments, therefore, the SEC problem is not actually the amount of required disclosure. Most of the statistical data that is contained in a governmental S-1 is reasonably available within the various economic and finance ministries. The task is really one of collecting the data and presenting it in a format that satisfies the SEC. Once prepared, however, subsequent registration statements for a sovereign issuer can be prepared with relatively little trouble.

The principal problem that governmental issuers encounter with respect to SEC registration requirements is the lack of flexibility as to timing. A registration statement must be prepared, filed with the SEC, and cleared before any sales of securities can take place. This may take days or weeks in a market that can move significantly in hours. In the Eurobond market, on the other hand, an issue can

take place in an extremely short time, often on the basis of only a simple offering telex.

Recently the SEC has moved to remedy this problem by means of a so-called shelf registration. A governmental issuer may file this at the beginning of a year and then make an offering by amending the registration statement to reflect, in general, any material developments, underwriting arrangements, and offering terms [1].

B. Corporate Issuers

The real SEC problem concerns corporate issuers who, in addition to filing the S-1 registration statement, will thereafter be required to file reports annually on Form 20-F, which is the foreign equivalent of a domestic issuer's Form 10-K. Despite the fact that the SEC has adopted a quite reasonable and flexible attitude toward the requirements of Forms S-1 and 20-F for foreign registrants, these requirements still present the most severe hurdle: one that keeps many prospective issuers out of our markets.

C. Problems

(i) Accounting

There are several key SEC reporting requirements that create problems for foreign issuers. First is the sheer magnitude and cost of the accounting requirements. This is especially true for companies located in countries whose accounting system differ quite radically from ours, particularly with regard to consolidation.

In those countries where both auditing standards and accounting practices are generally similar to our own--such as, for example, the United Kingdom and the Netherlands--the SEC will normally permit the inclusion of the company's existing financial statements followed by a schedule which reconciles in reasonable detail the financial statements presented with those which would have been required under U.S. generally accepted accounting principles. In practice, this relatively simple procedure can be extremely costly and time consuming. For a company whose existing accounts come nowhere near our own practices, the cost of meeting U.S. auditing standards can be enormous.

(ii) Segment accounting

Another area of dispute is segment accounting. Most U.S. issuers now report on a segment basis with very little difficulty; the outcome, so far as we can tell, has not caused anyone to suffer unduly. However, for a foreign issuer, which may have five or six domestic competitors that do not report on such a basis, the competitive burden of segment reporting can be quite considerable. In addition, we have found several cases of large foreign multinational companies where the requirements of segment reporting have meant a total reordering of their internal data processing systems in order to generate the required information in a timely manner. This, again, is something that represents a continuous burden which can be quite costly and which makes issuers think twice before committing themselves to meeting SEC requirements.

(iii) Executive compensation

One disclosure requirement that is totally accpeted domestically probably raises more questions in the minds of prospective foreign issuers than almost any other. That is the disclosure of executive compensation. As you know, a domestic registration statement requires disclosure of the names of and all remuneration paid

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to the five most highly compensated directors or executive officers whose remuneration exceeds \$50,000, as well as the total number of and remuneration to all officers as a group.

In most foreign countries, disclosure of this type is not required, and it is understandable that foreigners are extremely sensitive about this matter. The chairman of a major German or French company would find it both politically embarrassing and possibly--given today's environment--even personally dangerous to have his compensation disclosed in a public document. The SEC has recognized this concern and has shown a very flexible and pragmatic attitude. It has not objected to the disclosure of aggregate executive compensation, without revealing what individuals are paid, unless more detailed information is made public by the registrant in its own country. Nevertheless, we find prospective issuers are still concerned on this account. Once securities are outstanding in this country, they are subject to continuing reporting requirements; and there is concern that what is acceptable now may become more onerous in the future. You may recall that when Form 20-F was first proposed, its requirements were intended to be more consistent with those of Form 10-K than they now are. One proposed requirement, which was shelved after considerable opposition here and abroad, would have resulted in more detailed compensation disclosure.

(iv) Disclosure of foreign payments

One final problem which foreign issuers have with SEC disclosure requirements concerns foreign payments. Corrupt foreign payments which are material either in amount or as an indication of management integrity must be disclosed. However, what is considered to be a corrupt practice in the U.S. may be a normal method of doing business in a foreign country. Indeed, there are many countries that consider the payment of agents' fees or other similar transfers (which we might consider to be improper and therefore disclosable in a registration statement or other SEC report form) to be a part of the normal way of doing business and encourage them as a form of export promotion.

There have been cases where the disclosures required under our securities laws have attracted a considerable degree of unfavorable publicity in the company's domestic country--not because the company did something and was caught at it, but because it was the only company operating out of that country required to make a disclosure of that kind. The possibility of disclosure of agents' fees and other similar payments is something that worries an issuer not only at the time of registration but also in connection with its continuing reporting requirements.

(v) Proposals for change

The SEC, as part of its continuing monitoring of the reporting requirements, has recently circulated a draft proposal requesting comments on the concept of permitting foreign registrants who have securities outstanding in the U.S. market and are already using Form 20-F to report on a regular basis to file for subsequent issues using a much shorter form [2]. One possible system which could be adopted would be very similar to S-16, incorporating by reference information already filed on 20-F. We believe that this could represent a major step forward for foreign issuers and, if adopted, would open up our market. It would not produce an avalanche of new issues, but at least it would make our market more acceptable to those who, while prepared to accept the need to register once under S-1, are reluctant to do so if they have to repeat the same process over and over again for future issues. I urge those of you who have an interest in the future internationalization of our securities markets to write to

the SEC supporting the kind of liberalization contemplated in this draft.

5. YANKEE EQUITIES

A. Characteristics of the Market

I would like to examine for a moment what we refer to as the Yankee equity: the issuance here of ordinary shares by foreign companies, as opposed to convertible debt or straight debt. Despite the fact that the costs of entering this market are probably higher for Japanese companies than for almost any other type of company--due principally to the substantial expenditure on auditors' fees--Japanese companies have accounted for by far the largest portion, in terms of numbers, of foreign equity issuers here. Over the last seven years there have been share issues by Kyoto Ceramics, Pioneer Electronics, Honda Motors, Waco, Mekita Electric, Kubota, and Trio Kenwood.

The only other country that has provided equity issuers here is the United Kingdom with British Petroleum and Tricentrol, both companies engaged in the oil business. The largest issue was that made by British Petroleum in June 1977, when the Bank of England disposed of part of its holdings in that company. The issue amounted to \$215 million--substantially more than any other foreign equity issue in this market, before or since. The size of other issues has tended to be in the \$20-30 million range, although Tricentrol, which was the next largest and which I will discuss further in a minute, amounted to \$56 million.

Investors in equity issues, as demonstrated by our own retail sales, are very largely the trust departments of commercial banks, accounting for over one quarter of our sales. Investment funds and investment advisors and insurance companies represent the next largest group, followed closely by pension funds. Individuals account for a relatively small proportion of the sales, and sales to overseas investors represent a somewhat larger proportion than is true in the case of straight Yankee bonds.

We find that investors in foreign equity securities are knowledgeable and are making these investments for a number of reasons: (1) obviously, diversification of assets; (2) the opportunity to buy into a market, particularly the Japanese market, which appears to be growing somewhat faster than our own; (3) a diversification of currency risk; (4) at times, the opportunity to buy the growth segment of a particular industry.

For example, Matsushita may today represent the best way of penetrating the healthiest segment of the home entertainment business. At the time of its offering here in 1977, British Petroleum attracted considerable investment interest, since it was then the major international oil company that had the least Arab exposure, its reserves being heavily engaged in both the North Sea and the North Slope.

Yankee equities are typically offered in the form of American Depository Receipts, or ADRs. These receipts evidence ownership of foreign securities, are designed to facilitate the transfer of ownership, and are usually administered by major international banks operating in New York under a depository agreement. They may represent stock on a share-for-share basis. However, where the value of the underlying stock would make the value of one ADR lower than the

most commonly traded unit values (i.e., between \$10 and \$30), the ADR may represent a multiple of underlying shares: for example, around ten in the case of Japanese corporations.

The depository agreement is entered into by the issuer and the depository. It empowers the latter to issue receipts and to transfer ownership of the ADRs on its own books and records, while it continues as the official holder of record of the underlying stock on the issuer's books. The ADRs are exchangeable into the respective underlying stock; ADR holders enjoy the same rights, duties, and privileges as holders of stock of the issuer. The ADRs must also be registered under the Securities Act, but if the underlying stock has been registered, registration of the ADR is relatively uncomplicated.

B. Tricentrol: A Case History

I shall relate to you, briefly, a case history of the sale in this market of shares of an important foreign company, tracing it from the moment this company first thought of entering the U.S. market until the time the marketing was successfully completed.

On July 2, 1980, Goldman Sachs was sole U.S. manager on a three million ADR offering for Tricentrol Ltd. with a total value of \$55.5 million. Of those three million ADRs, 2.25 million were sold in the U.S. and 750,000 in Canada. This was the first primary offering by a British company--or, indeed, any European company--in the U.S. equity market and only the second equity offering by a European company since the removal of the interest equalization tax. Subsequent to the offering, the ADRs were listed on the New York and Toronto Stock Exchanges.

Goldman Sachs had been advising Tricentrol for a period of two years prior to the offering. Initial discussions with the company had centered on their need--as they perceived it--as an oil and gas company to increase their representation in the U.S., from both a business point of view and a financial point of view, given that the U.S. represented the world's largest capital market with particular sophistication in financing oil and gas companies.

Early discussions with the company had focused on ways to help them develop their business base in the U.S., either through acquisition of companies or through the financing of acquisitions of U.S. reserves to be developed by Tricentrol. Tricentrol viewed the energy business as a multinational one where it is important to have a significant stake in the U.S.; for the U.S. operates as a relatively free market economy in a business where governments increasingly tend to dominate and control the development of natural energy resources.

After looking at various alternatives, the decision was made to forgo trying to achieve both a U.S. shareholder base and an expanded business base in the U.S. in one step through an exchange of stock. It seemed more prudent to achieve the shareholder base first. Then this shareholder base could be used for further acquisitions.

For Tricentrol's stock to be acceptable as an acquisition currency to a U.S. company, it seemed that a registration with the SEC and, preferably, a listing on the New York Stock Exchange after a public offering of stock in the U.S. would be by far the most effective means of achieving this objective. In addition, the funds raised through the offering would be available for additional U.S. acquisition purposes. Tricentrol also decided to take the opportu-

nity to register the stock in Canada and to have a simultaneous offering in the Canadian market. This offering represents a unique situation in that stock was simultaneously offered in the U.S. and in Canada as an initial public offering in both markets. The prospectus and registration documents met the requirements of the securities laws not only of the U.S. and Canada, but also of the United Kingdom, where the prospectus was also registered.

Once a strategic decision had been made to do a registered offering in the U.S. the process of achieving that registration was both lengthy and complex. The meeting to start work on this process took place in early February and the offering was completed in July: a period of five months. Requirements of the SEC are particularly complex in the case of an oil and gas company, and extensive work was performed by the company's accountants, both internal and external. Added complications were caused by the need to have a firm of independent geologists estimate the reserves of the company in both North America and the North Sea. Furthermore, during the period they were working on the transaction, Tricentrol made an acquisition in the United Kingdom which was so significant that the target company's financial statements had to be included in the registration statement.

As a result of these complications the prospectus contains seventy pages of text and sixty-two pages of financial statements for a total of 132 pages. In addition to the prospectus, almost 3,000 pages of additional material had to be filed with the SEC, some of which involved confidential contracts between Tricentrol and the British government about the development of their North Sea fields. The British government required Tricentrol to negotiate with the SEC to obtain confidential treatment for these documents. As mentioned earlier, the offering was also to be registered in Canada. This called for additional disclosure required by the Canadian Securities Law. Finally, the whole prospectus had to be translated into French in order to meet the requirements of the Quebec Securities Law and thus to be eligible for offering in that province.

In addition to the difficulty of preparing documentation to conform to both U.S. and Canadian requirements, the marketing effort posed similar problems. There are significant differences in the procedures used in the Canadian new-issue distribution process from those that are normal in the U.S. Much time was spent by Goldman Sachs (lead manager of this offering) coordinating with Wood Gundy (the Canadian manager) to ensure that the two different distribution processes were indeed coordinated, so that an offering could be completed on the same day and effectively at the same price.

The Canadian investors were offered shares in Canadian dollars based on a translation of the U.S. dollar offering price. The company and the investors were protected against movements in the foreign exchange market between the time of pricing and the time of payment. The underwriters took out, on behalf of the company, a forward foreign-exchange contract. This covered the difference between the price in Canadian dollars that Canadian investors were to pay for their shares and the price in U.S. dollars that the company was to receive at the time of the closing. Additional discussions took place, particularly with the New York Stock Exchange and the blue sky authorities in the various states in the U.S., for it seems it is common practice in the U.K. for companies to make loans to their officers and this is frowned upon in the various state jurisdictions.

Clearly, this offering by Tricentrol represented a substantial investment in money and in management time. Nevertheless, substantial benefit resulted from the offering, both in terms of the offering itself and in terms of the company's positioning itself for the future. This is particularly notable because Tricentrol is not the sort of company you would expect to be using the U.S. capital market. It is not in the top tier of international British companies. It is relatively small; and up to this point, it has relied primarily on the U.K. market as a source of capital. At the time of the offering, the company had a total market capitalization of approximately \$460 million; and the offering represented more than eleven percent of the number of shares then outstanding. Nevertheless, as this offering indicates, it may turn out that it is the second-tier foreign companies which can obtain the greatest benefit from an equity offering in the U.S.

In Tricentrol's case, some of these benefits are as follows:

- (1) An offering of \$55.5 million represents a substantial new source of equity capital and reduces the risk that the London market, which had provided equity to the company as recently as 1979, might be unable to meet the company's quite substantial needs.
- (2) An offering in the U.S. represents the first step in a program to obtain access to all aspects of the U.S. capital market. The U.S. market is the largest in the world and can be expected to provide additional sources of funds at all times. Reliance on the political and economic status of a single smaller economy is avoided, and registration with the SEC acclimates Tricentrol to the U.S. disclosure requirements in a way that should allow it to meet subsequent obligations relatively easily.
- (3) Tricentrol is now in a position to use its stock in connection with the acquisition of a U.S. company. With a New York Stock Exchange listing and a successful U.S. offering behind it, Tricentrol will have a market acceptance with shareholders of potential target companies, which it would not have had without such an offering.
- (4) Tricentrol's business strategy calls for increased exposure in the U.S. The publicity associated with the offering and the presentation of Tricentrol in a format familiar to the U.S. business community will facilitate that exposure. It will increase knowledge of Tricentrol among U.S. companies in the oil industry.
- (5) In addition to providing sources of funds, the U.S. capital market will be a source of support to Tricentrol in the future. Up to the time of the offering, the company was dependent upon the U.K. equity market--a market that is relatively unsophisticated in evaluating oil and gas companies, particularly those whose assets are located outside the U.K. continental shelf. It is to be expected that at various times in the future U.S. investors will value Tricentrol's assets and earnings more highly than will the U.K. market. This will provide buying support for the stock and thereby facilitate additional equity financing or acquisition through the use of common shares.

6. OTHER MARKETS

In conclusion, I shall touch briefly on two other major capital markets that are of importance to foreign issuers. The first is our commercial paper market. This is a market that really does not exist anywhere else in the world.

A. Commercial Paper

Commercial paper is unsecured short-term promissory notes, typically used by well-capitalized industrial, commercial, public utility, finance, and bank holding companies. It is sold in the open market, usually on a discounted basis.

Commercial paper has provided a means of short-term financing for over a century and a half, but it has experienced its most rapid growth in recent years. The total value of commercial paper outstanding in the market place has risen from \$260 million in the period just after World War II to approximately \$125 billion today. At the present time, approximately one thousand major corporations maintain commercial paper ratings from one or more of the three rating agencies. While not all the rated companies are active in the market at the same time, a substantial majority have occasion to come to the market at some time during any given year.

The market is divided into two segments. The first--comprising just over half of the total amount outstanding--is made up of issuers selling their paper directly to investors. These are mainly finance companies, such as GMAC, Ford Motor Credit, and G.E. Credit. The other segment represents issuers whose paper is marketed by a dealer.

Foreign borrowers like the U.S. commercial paper market for a number of reasons. First, it offers a source of funds that has historically been cheaper than alternative borrowing sources such as the London interbank market and the U.S. domestic commercial bank market. Second, it provides a diversification in a company's or a bank's source of dollar funds. Third, it is a flexible instrument in terms of tailoring maturities to the borrower's needs, since paper can be issued in maturities of anything from 5 to 270 days. Last, the issuance of commercial paper is an attractive and relatively easy-to-manage method of gaining access to the U.S. capital markets. Commercial paper is exempt from registration under the Securities Acts. On the other hand, commercial paper does require the issuance of a rating. The highest commercial paper rating generally indicates that the borrower would have a bond rating of at least an AA or possibly a very strong A. Obtaining a commercial paper rating paves the way for ultimately obtaining a long term bond rating. The institutional buyers of commercial paper parallel in many respects those who will ultimately buy a long-term debt issue.

As of the end of last year, approximately eighty-two foreign corporations, government agencies, and banks were using the U.S. commercial paper market. The average reported quarterly value of outstanding commercial paper of these issuers totalled just under \$10 billion. The issuers included entities located in Australia, the United Kingdom, France, Switzerland, New Zealand, Japan, Belgium, Finland, Sweden, Germany, Holland, and Denmark. There were major programs by such issuers as British Petroleum, which had close to \$1 billion outstanding; Electricité de France, with \$1.7 billion; Caisse Nationale de Télécommunication, the French telephone company with \$500 million; and the state-owned British Gas Corporation and British National Oil Co., each with just under \$250 million.

A recent development in the commercial paper market has been the growing interest of foreign banks in tapping this market. These banks see commercial paper as a method of diversifying their dollar funding, of tapping a broad segment of investors in the U.S., and of obtaining funds at a lower cost than in the European interbank market. Banks such as Barclay's, BNP, Swiss Bank Corp., Union Bank

of Switzerland, *Crédit Lyonnais*, and *Amsterdam-Rotterdam Bank* have chosen to adopt this method of financing within the last year or so. Our experience as the leading commercial paper dealer in the U.S. leads us to believe that this method will continue to prove attractive to top-rated foreign borrowers. From the investors' point of view, it represents a convenient and easy method of getting better acquainted with these major companies located outside the U.S.

B. Private-Placement Market

The other market I want to touch on briefly is our domestic private-placement market. This, again, is somewhat unique. Until recently there was really no other place in the world where major borrowers could negotiate directly with lenders and obtain large sums of long-term money on a totally private basis without any after-market listing or broad distribution. This private-placement market has not proved to be a very significant source of funds for truly foreign borrowers, since in many cases--as I described in greater detail earlier--the lenders were precluded from lending more than a small proportion of their assets to such borrowers. I strongly believe there is a case to be made for liberalizing these constraints and I am pleased to note that this is already happening in the case of investments in Mexico.

Where the foreign borrower has substantial assets in the U.S., however, his U.S. operations can be treated as a domestic entity for the purpose of meeting the various state legality tests. Through the medium of a guarantee or some other method of support, the parent ensures that the U.S. affiliate has the best possible credit rating and can obtain funds on the most attractive terms. The private-placement market has therefore been popular with foreign companies that are making acquisitions here or are expanding their assets base within the U.S.

The U.S. private-placement market is also a major source of funds for complex projects. Project financing typically relies for credit support on contracts between the project, users of output, suppliers of raw materials, and other sponsors. By fitting together the various components, a viable credit can be created, but one which is complex and therefore difficult to sell in public markets. Accordingly, most project financing in the U.S. is undertaken on a private-placement basis. In addition, where project equipment is to be leased, the U.S. tax laws provide substantial advantages to domestic owners of equipment that may be located in a foreign country. The lessor is still permitted to obtain accelerated depreciation and certain other fiscal advantages, but probably not investment-tax credit. Because of this, sponsors of major projects around the world tend to look toward the U.S. private-placement market if there is any possibility of obtaining funds here on a long-term basis.

Typically, the main constraint is sovereign risk when the project is located in a developing country. However, projects in Australia, New Zealand, the North Sea, Canada, and, more recently, Mexico, have found advantageous financing by using our private-placement market. *Goldman Sachs* has been responsible, for example, for financing drilling rigs constructed for *Pemex* to use in offshore oil exploration and development by the Mexican state oil company. These rigs are owned by U.S. lessors. They are leased to *Pemex* under long term leases, with the related financing being placed with U.S. institutions. *Pemex* has obtained U.S. financing for substantial capital expenditures by this route.

In summary, I believe the U.S. capital market represents a sophisticated and vital component of the world capital markets. We hope that issuers will increasingly use the U.S. markets, particularly as regulatory constraints are gradually reduced.

MR. HAWES: Steve Friedman, would you like to make some comments and raise some questions?

7. DISCLOSURE STANDARDS FOR FOREIGNERS

MR. FRIEDMAN: I think the SEC is clearly moving in the direction of integration in the use of shelf registrations and is increasingly confronting the question of differential disclosure for foreign issuers. But in evaluating those judgments, it is useful to keep in mind why we are doing this. Accordingly, my first question for Michael is, why do you think it is in the interest of the U.S. to encourage the use of our capital markets by foreign issuers?

MR. COLES: I think that the flow of capital, like the flow of goods and services, should be a two way street. If we create barriers to the use of our markets by others, it is quite possible that, when we need them most, others might create barriers to our use of their markets.

MR. FRIEDMAN: Michael, excuse me, but disclosure requirements are not barriers. They are inefficiencies in our market as compared to the Eurobond markets. They impose additional costs on raising capital in U.S. markets, but there are no discriminatory barriers against foreigners.

For example, consider the accounting issues. Differential accounting and auditing standards are a very serious problem, although I think it is interesting that the companies for which the accounting issue is probably the most difficult--the Japanese companies--are the ones that have been willing to face up to it and pay for access to our markets. In thinking about how far we ought to go to accommodate other accounting systems, it is important to keep in mind why we are doing so and why it is important to our national interest. Why is it useful for the U.S. to have foreign companies raising capital here?

MR. COLES: With respect to equity issues, if I may answer that first, the question would be, are U.S. investors better served by having an enormous amount of information about a very, very few companies? Or, would they not be better served by having a vastly expanded horizon of companies in which to invest, with a somewhat reduced level of disclosure? It could be argued that it is like--if I may use an analogy--pollution control. Getting the last five percent of dirt out of the air is what costs you the most. I doubt that general conformity to our requirements is the thing that worries foreign issuers the most. The problem is with some of our more marginal requirements, for example, the U.S. existed happily for many, many years without segment reporting being required to meet the disclosure obligations of the securities acts. Now, that is a major problem. We have discussed the disclosure of foreign payments. Again, I believe that the SEC did not necessarily feel this information was essential for investors to know. This disclosure requirement was used more, in our view, as an enforcement technique.

I think we would not propose that the overall standards of disclosure required for coming to the U.S. market should be lowered in any significant way. U.S. investors are entitled to a level of disclosure superior to that of the rest of the world; as I said early in my remarks, this is the market where you play with a clean deck. On the other hand, anything we can do to simplify disclosure, to make it easier for companies to meet our requirements without removing the basic premises on which the securities acts were built, would be a positive step.

MR. FRIEDMAN: I find it curious that so few foreign companies are using our market. As I listened to you talk, it became obvious that the problem of regulatory requirements creating undue delays is clearly a very serious one. On the other hand, the volatility of the bond markets is a relatively recent phenomenon, and there was a period of relative interest rate stability after the IET was lifted during which there was not much activity in our markets. You talked about an interest rate differential and a commission differential and I believe you concluded that the net cost of financing in this market for an appropriate company ought to be lower, even granting the higher front-end costs because of regulation.

If we were able to deal with the timing problem through a continuous disclosure system and if we dealt with some of what I will call the irritants in the disclosure system, do you think it is likely that there would be a substantially greater use of our markets by foreign companies?

MR. COLES: I think that the use of our bond markets by foreign companies would not increase dramatically except for companies that deem it necessary to come to the market every year. That is one of the reasons why governmental issues predominate. You swallow the first front-end costs, and from that point onwards that cost is already sunk. You do subsequent issues all the time, and it becomes relatively easy. For a corporation that is going to issue on a one-time-only basis, the Eurobond market will always be more attractive.

MR. FRIEDMAN: In spite of the cost differential?

MR. COLES: The cost on a one-time issue, if you figure in the front-end out-of-pocket costs, will always be higher here than in the Eurobond market. How many European non-governmentally owned companies come to the market for a bond issue every year? Relatively few.

I believe my firm is engaged at the moment in preparing for registration a major foreign company which sees the U.S. market as an insurance policy. As a continuous user of dollars, the company is concerned that somewhere down the road this may be the only game in town for dollars, and it wants to have access to this market. It turned out to be a very expensive insurance policy.

MR. FRIEDMAN: Problems of this nature impose an important discipline because they make us think anew about whether some of the disclosures that we require are really so essential. There is a useful fallout effect for our domestic disclosure system. Nevertheless, I think it is a fair question to ask whether it is worth going through this process for foreign issuers if there are not going to be substantial numbers of them in our markets.

MR. COLES: I think that the greatest expansion would be in

equity securities, and this is the area that would benefit U.S. investors the most.

MR. FRIEDMAN: I agree with you.

MR. COLES: There are major companies--for example, natural resource companies or companies with unique positions--that are not available in U.S. markets, and it would be very useful to have such exposure here. Again, I go back to my question, do you have a lot of disclosure from very few, or do you lower the standards somewhat --I would not want to see them abolished altogether--and admit many more issuers here?

MR. HAWES: Michael, what are the weights given to the particular concerns expressed by foreign issuers, for example, accounting standards and the disclosure of foreign payments? To what extent are these issuers frightened of the SEC, or are they simply frightened that regulations will change every week or every few months?

MR. COLES: The proposal to amend 20-F, even though it was shelved, did cause an enormous amount of concern.

MR. HAWES: The original proposal. . .

MR. COLES: The original proposal was to amend 20-F, to bring it much more in line with 10-K. The reaction of many of our prospective clients was, "They tried it once, they might try it again. Once we have the securities out here, there is no way we can pull them back. We issue a twenty year bond in the U.S., and it has ten years of call protection; then somebody suddenly says that they want this or this or this in the way of disclosure, and we are stuck with it." That is still a concern.

The other question of great importance to foreign issuers is based on the problems of preparing the first registration. Having lived through it ourselves three times with European companies and several times with Japanese companies, we can tell you that the work involved is incredible. It involves bringing in new management in some cases and new data processing systems. Our clients ask the question: "We understand the general principle under which you are operating; but when you get down to that last five percent which accounts for fifty percent of the cost, is it really necessary?"

MR. FRIEDMAN: Let us assume the Commission were prepared to do something about that. What kind of a process would one adopt to identify that last five percent? The last five percent may vary from company to company and management to management as their sensitivities shift, and it may be difficult to deal with it in a generic way.

MR. HAWES: What are the major segments of the five percent?

MR. COLES: Your proposal for the--I will call it the S-16-- goes along the right way because, as a U.S. company knows, it is much easier to prepare a 10-K than it is to prepare an S-1, even though much of the information is the same. If a company has to report to the SEC on a regular basis, I think the ability to submit a short-form registration statement later on will make the initial burden much more palatable. Anything we could do to cut down the minutiae that is required in notes to the financial statement would

help. The length and bulk of our financial statements are incredible.

Many times the question we are asked is, does anybody read it?

MR. HAWES: One possible answer to the concern of foreign issuers about becoming a reporting company and then having the SEC increase or drastically change the disclosure requirements would be a kind of moratorium. The SEC could provide that it would give foreign issuers the choice of accepting a change in disclosure requirements or of continuing under the old rules for a period, say five years, which would be adequate to allow the foreign issuer to withdraw from the market in an orderly way (e.g., through a tender offer program or redemption).

NOTES:

- [1] See The Kingdom of Sweden release, named after the government involved. Securities Act Release No. 6240, 45 Fed. Reg. 61,609 (1980).
- [2] Securities Act Release No. 6235, 45 Fed. Reg. 63,693 (1980). The International Securities Matters Committee of the American Bar Association wrote a letter commenting very favorably on the possibility of using the concept of world-class companies to categorize those who might be permitted to use simplified registration forms.