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Stephen J. Friedman
Pace Law School

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Capital Formation Alternatives: An Overview

*Stephen J. Friedman**

FRIEDMAN: I thought it would be interesting to discuss some of the major trends in financing in the American financial markets because they are a very good index of the direction in which financing is headed and of what practitioners can expect to be doing over the next five or ten years. I would like to talk about five principal currents in the financial market.

The first development, and by far the most important, is the volatility of interest rates. The second is the "dealerization" of the public securities markets, both for debt and equity. The third is the increasing internationalization of the capital market. A fourth trend is the significant growth and profusion of a very interesting development called "synthetic securities." The fifth trend is in the area of venture capital.

I will start with the volatility of interest rates. In this environment it is hard to imagine that for more than a quarter of a century after the bank crash of 1929 and the remedial legislation of the 1930s there was extraordinary stability of interest rates. Regulation Q[1] is the system of regulation that authorized the Federal Reserve Board and other regulators to impose ceilings on deposit interest rates. Regulation Q authority commenced in 1933, and until 1957, deposit interest rate ceilings were raised only once. The United States experienced a period of extraordinary stability during which a very effective financing device developed called the long-term bond market which was virtually unknown in other parts of the world at that time.

Beginning in 1966 and continuing through the Carter Administration, the United States began to experience a series of sharp interest rate increases, which had a devastating effect on the long-term bond markets. Investors began to shorten their time horizons and even insurance companies, which historically made loans of twenty and twenty-five years duration, began to shorten their maturities to fifteen, ten, and seven years. It became very difficult to finance in-

* Partner, Debevoise & Plimpton, New York, New York; former Commissioner, Securities and Exchange Commission. A.B. 1959, Princeton University; J.D. 1962, Harvard University.

[1] 12 C.F.R. § 217 (1984).

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dustrial plants on that basis. Of course, the most immediate and dramatic effect was on the mortgage market.

I remember when I was at the Treasury Department in 1978 reviewing the terms of the first variable rate mortgage, which was a device that the Federal Home Loan Bank Board approved to deal with the problem of interest rate volatility and to help thrift institutions withdraw from the uneconomic business of making long-term, fixed rate mortgages. The initial version of the variable rate mortgage was not an attractive instrument and was not used very widely.

That little trickle now has become a river with an incredible profusion of similar instruments. If you have tried recently to finance a house you know that it is almost impossible to comprehend the full range of alternatives. That same profusion of new instruments has developed in the public debt markets. Innovative investment bankers have created an ever-growing "kitbag" of securities designed to do two things. First, the securities give the issuer the protection of long-term maturities by enabling him to keep the money for a substantial period of time. Second, they give the investor protection against erosion of principal due to interest rate movements.

The following excerpt from Corporate Financing Week[2] captures the flavor of what is happening in this market:

> *Citicorp Person-to-Person* came to market last Tuesday with a $250 million floating rate note issue, a "substantial portion" of which was sitting with sole manager *First Boston* by Friday morning, according to Curt Welling, V.P. The frns float ⅛ of a point over the *Fed* CD composite, a market that was in turmoil last week with rumors and concerns about banks that are part of the run, and Welling said that First Boston had "pulled back from the market" in offering the notes and will "sit until a semblance of sanity comes back." Meanwhile, he said the firm was comfortable holding this paper in inventory, while declining to specify the amount unsold.
>
> Although the source of the trouble was the CD base, Welling said that First Boston had made the bid to Citicorp to do the deal because the widening spread between the CD rate and *Treasury* bills would offer investors better principle protection than bill-based floaters. The floaters have a weekly yield reset, a feature well-suited to a highly volatile market, Welling noted.[3]

Although this involved a Citicorp financing, it is relevant for those of us who do financing work for medium and small sized companies. All of these financing techniques trickle down, and what seems to be at the cutting edge of the market one year becomes a conventional financing technique five years later.

There is a range of attempts to cope with the effect of volatile interest rates. An interesting development in the public finance mar-

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[2] *Banking Turmoil Slows CD-Based Citicorp Deal*, Corporate Financing Week, vol. X, no. 21 (May 28, 1984).

[3] Corporate Financing Week at 2. Citicorp Person-to-Person is a subsidiary bank holding company that does financing throughout the country for Citibank.

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ket is the so-called "put-bond," which has been used widely in connection with housing bonds. The housing bond is a long-term revenue bond that is supported by a flow of payments from home mortgages. The revenue bond investor is given the option of "putting" the bond back to the issuer after a period of time or when certain interest rate parameters have been exceeded. From the investor's point of view it is not necessarily a long-term investment, but rather a shorter-term investment which, of course, affects the return.

Typically a bank issues a letter of credit that backs up the issuer's obligation to purchase the bond and effectively promises the issuer and the market the availability of financing to make the purchase. The effect again is to convert the original long-term issue into a shorter-term floating rate if the letter of credit is taken down. An interesting sideline is that the importance of bank credit facilities has given banks larger roles as underwriters of revenue bonds. Housing revenue bonds are bank eligible, and because the letter of credit is such an essential element of financing, banks have been increasingly co-managing underwriters in many of these deals.

There are two other interesting consequences of the development of volatile interest rates that often are not identified with that trend because they are not instruments that are, strictly speaking, securities. The first is the advent of zero coupon securities, and the other is the interest-rate swap. Basically, a zero coupon security pays no current interest, rather it is issued at a discount from face value similar to old fashioned savings bonds or treasury bills today and it is paid only on maturity. The difference between the principal amount of the security and the issued amount represents the interest.

Unlike a treasury bill, however, zero coupons are generally of intermediate or long-term maturity. The advantage to the issuer is that there is no impact on cash flow during the period that the security is outstanding. With an ordinary investment such as a government bond, when interest coupons are paid on a semiannual basis, the investor has to reinvest that interest, and the rate at which that interest can be reinvested affects the yield-to-maturity of the total investment. Although there is a fixed interest rate on the bond, the total return from the investment is a function of the rates that are current at the time those interest payments are made.

Thus, there is considerable uncertainty as to the total yield from an ordinary long-term treasury bond or other long-term bond. A zero coupon, however, is sold at a discount which represents a fixed compound interest at the end of the term, so an investor knows precisely what the yield-to-maturity will be. It is a very convenient tool for financing children's education and other future events. The full

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rate of the investment is locked in at the outset. It is a very innovative way to cope with the problem of volatile interest rates.

The second development falls into a category of what has come to be known as "interest rate swaps." This is a market that is growing significantly and can be best described with an illustration. There are two borrowers. Let us call the first borrower "LT." LT is a company that has ready access to the long-term bond market. It can raise money on a long-term basis very cheaply and effectively. Assume that LT wants to use the proceeds from its borrowing for current transactions. LT would like to borrow in the short-term markets and pay current interest rates but does not have satisfactory access to those markets.

Let us call the second borrower "ST." ST has access to the short-term markets but has little access to the long-term markets. ST would like to finance a plant that will pay out only over a long period of time. In determining the economic viability of that plant, ST would like a fixed rate so it can compare the cost of capital to the returns that the plant will produce.

In the theoretical case ST and LT come together, and ST, who has access to the short-term market, agrees with LT to pay him an amount equal to a fixed, long-term rate on a notional amount of $100 million for the next fifteen years. LT uses that stream of payments to cover his obligations on a $100 million long-term borrowing that he makes in the long-term markets. In return, LT agrees to pay ST one percent above the prime rate or the LIBOR rate[4] on $100 million for the next fifteen years. ST, who is actually paying the long-term rate, uses that stream of payments to cover the interest on his short-term borrowing of $100 million over the fifteen-year period. ST has accomplished his objective of paying the long-term fixed rate, and LT is paying the short-term rate, yet no principal has changed hands.

Two problems may arise in this theoretical case. First, LT and ST may be unable to find each other. Second, if they found each other, each would worry about the credit of the other over this very long period of time. The result is that a bank acts as intermediary. LT deals with the bank as if the bank were the short-term borrower, ST deals with the bank as if it were the long-term borrower, and the bank runs a "matched book."

Although that is the way it began, the market is changing dramatically. Many banks no longer are running matched books. They are simply taking the interest rate risks on both sides and hedging their risks through interest rates futures and other devices. Other banks now are starting to offer arrangements called "floor/ceiling

[4] LIBOR rate is the London Inter-Bank Offered Rate. It is the interest rate that London banks charge preferred customers on loans of United States dollars.

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agreements." The bank will agree with a short-term borrower who is subject to fluctuations in interest rates that if the short-term rates rise above a certain percentage, the bank will pay the difference. If the rates fall below a certain percentage, the borrower will pay the difference. The borrower has a range in which it is prepared to take the risk, and the bank is compensated by fee income. Some banks now are issuing plain ceiling agreements in which the bank agrees with the short-term borrower that if the rate rises above a certain percentage, the bank will pay the difference.

I have called the second major trend in financing increasing "dealerization" of the market. This is related to rule 415, which provides for shelf registrations for qualified issuers.[5] In the old days, securities firms had two quite different departments. The corporate finance department handled new issues and dealt with the attorneys who did the prospectuses and the due diligence. The syndicate department would also deal with other investment banking firms and assemble a group of firms to underwrite securities. The other department consisted of the brokers and traders. Except in the case of those over-the-counter securities where the firm made a market and acted as dealer and trader, the firm acted as agent and not as principal. Twenty years ago, acting as dealer was by far the less important part of the firm's business.

One of the most extraordinary financial events of the post-World War II period has been the institutionalization of savings in this country and its profound effect on the financial markets. In 1948 there were approximately $3 billion in private pension plans. Today there are over $500 billion in private pension plans. Over seventy percent of the trading on the New York Stock Exchange is represented by financial institutions and that excludes mutual funds which are treated as individuals. This significant change in the nature of the investing community has had a dramatic effect on securities firms.

Institutions buy securities in very large quantities because it is expensive to monitor a large number of issues. Institutions have very large amounts of money to invest, they need liquidity, and they need companies that are widely followed. Because they buy in large quantities, they also sell in large quantities. The auction process on the floor of the stock exchanges, even the New York Stock Exchange which has a very effective auction process, is simply not capable of handling transactions of that size. During the 1970s many securities firms were forced to acquire larger and larger amounts of capital to position sales of blocks of securities. The positioning institutional broker agreed to buy the block at a fixed price and take the risk that the security could be distributed at that price or better.

[5] 17 C.F.R. § 230.415 (1984).

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Those were clearly secondary market transactions, yet they have had an impact on what is happening today in the capital raising market. The need to position securities forced a small number of firms to acquire very large amounts of capital, and those firms developed very sophisticated distribution mechanisms that were quite different from the syndicate process for selling large blocks of securities. The distribution of blocks involved direct dealings between the upstairs dealers at the firms and institutions through a variety of electronic means. They were wholly outside the auction process.

What does all this have to do with rule 415? Not long ago the Securities and Exchange Commission began to feel the effect of interest rate volatility. Companies began to complain that the volatility of interest rates resulted in very short "windows in the market," and that they could not wait fifteen days while the Commission processed their registration statements. In response, in the 1970s, the Commission progressively shortened the registration period applicable to very large issuers to approximately forty-eight hours.

As the Commission was shortening the processing period, interest rates were becoming more volatile and corporate treasurers continued complaining. In 1981 the Commission proposed to extend the availability of shelf registrations to primary offerings by larger issuers. I was a member of the Commission at that time, and I know that no one at the Commission recognized how significant this "small" change would be. Initially, there were virtually no comments. Finally, Morgan Stanley and a group of other firms looked at what the Commission was doing and recognized that it would have a profound effect.

Under rule 415, the registration statement is declared effective before the terms of the offering are fixed. The issuer has very limited discussions with a small number of underwriting firms that indicate an interest in participating. The treasurer or chief financial officer waits for one of these windows in the market to open. When the window is open, immediately the firms are called and invited to bid. The firms bid, the issuer picks a firm, and the offering is made that afternoon or the next day. There is obviously inadequate time to conduct any type of due diligence effort at that point. In a technical sense, the Commission has responded to that problem by integrating the 1933 Act and 1934 Act disclosure systems, but the underlying problem of the underwriter's obligation to learn enough about the company still exists.

Not only is there insufficient time for due diligence, but there is inadequate time to form a large syndicate. Consequently, the major underwriters find themselves taking larger and larger positions that could lose substantial value if the credit markets turn against them before the positions are sold. Only a handful of firms have the capital

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necessary for these transactions, which has resulted in a large concentration of investment banking business. The securities industry, and in particular, the underwriting capital raising process, are even more concentrated than the banking industry.

Because there is inadequate time to form a syndicate, the distribution process tends to be undertaken through the trading desk rather than through the syndicate process. This results in an increasing institutionalization of the markets. If a securities firm is holding $100 million worth of a security in inventory, it wants to dispose of it very quickly. Retail distribution can be slow. Therefore, firms tend to solicit the people who can buy in the largest quantity, the large financial institutions. There is a fair amount of empirical evidence that a higher percentage of rule 415 offerings are sold to institutions than any other kind of offerings.[6] If the trend continues, one can envision large financial institutions engaging in the kind of sub-underwriting role, with attendant Glass-Steagall[7] implications, that insurance companies and banks play in Great Britain, where they are an intermediate stage in the public distribution process.

Although legally and practically only very large companies are involved, small issuers also should be interested in this trend. If rule 415 is combined with the integrated disclosure system, the lines between the public and private securities markets are progressively blurred. There are many small and medium sized companies that are in a continuous disclosure mode and have access to Form S-2, for example.[8] Registration has become a very easy process, and the question whether to sell securities in a registered offering or as a private placement is now much less important. If you distribute to a small number of people and you are unsure whether you qualify for the private placement exemption, it is easy to register. I think we will see increasing numbers of distributions into ongoing trading markets by companies of all sizes and shapes as long as there is enough liquidity in the market to handle the distribution. There is certainly no legal reason why a company that can file a Form S-2 registration statement cannot finance through the ordinary trading market. There is no need for rule 415 as long as the distribution commences at the time of effectiveness of the registration statement. There is no

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[6] *See* H. BLOOMENTHAL, 1983 SECURITIES LAW HANDBOOK § 6.17(4) (1983). Bloomenthal expresses the Commission's concern that rule 415 will be used to bypass traditional distribution techniques and place large blocks directly with institutional investors. *See also* SEC Securities Act Release No. 6391, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,108 (1982).

[7] Glass-Steagall Act, 12 U.S.C. §§ 347a-347b, 412 (1982).

[8] 17 C.F.R. § 239.12 (1984). Form S-2 provides an abbreviated registration process under the 1933 Act for qualified issuers which have been reporting companies for three years and have filed all reports timely during the past twelve months and the portion of the month in which the registration is filed.

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need to have a fixed price underwriting in which the underwriter takes the risk of distribution.

Briefly, I will discuss the internationalization of the securities market. Although it has a small impact on our lives today, in the long run, this trend toward a single, if not worldwide, international capital market will have the most profound impact on the financial regulatory system and ultimately on financing techniques.

In the primary markets, which includes the capital-raising process, it has become routine for the larger companies to decide whether to finance in the Eurodollar market or the United States market. The interest rate windows open up at different times in each market.

More interesting is the growth of the integration of secondary trading. If a financial institution wants an instrument to achieve a certain financial objective for its portfolio, it carefully examines Eurodollar securities of all types, including Eurodollar certificates of deposit and Eurodollar bonds. Ten years ago the Commission issued an elaborate release dealing with the problem of flowback and the steps that should be taken to avoid securities sold in Europe from being traded in the United States markets without registration.[9] The practices of market participants have advanced miles beyond the conditions of that release. The Commission either does not know what is happening or does not know how to deal with it. More significantly though, when the market is broader than the regulatory system, regulations do not work. Why bother to subject yourself to United States disclosure rules when you can access the same investors by selling in Europe? Why worry about United States insider trading rules when you can buy the same securities in Europe?

"Synthetic securities" is one of the most interesting and quickly developing areas in the financial markets. The underlying idea is that an investment banker takes existing securities that have certain financial attributes and then recombines those attributes in different ways that investors will find more attractive. For example, zero coupon securities are attractive because they lock in yields. Some clever bankers found that it would be possible to combine zero coupon securities with the security and long-term maturity of the treasury credit. The only problem is that while the Treasury issues treasury bills at a discount, it does not issue bonds at a discount. That did not deter the people who ultimately created a zoological garden of synthetic securities called "cats," "tigers," and "cougars."

Basically, these synthetic securities involve the purchase and resale of a very large treasury bond. The coupons are stripped from the bond. There is a stream of semiannual payments, which the cou-

[9] SEC Release No. 33-4908, 1 FED. SEC. L. REP. (CCH) ¶ 1363 (July 9, 1964).

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pons represent, and then a large payment at maturity. The right to each payment is sold on original issue discount basis. In other words, the right to receive each interest payment is sold for a price less than its face amount. The discount represents an agreed upon interest rate that is attractive to an investor looking for a locked-in yield. The treasury bond is divided into many little pieces. Through the magic of compound interest a small investment will triple by the maturity date.

How is the bond split? Typically it is placed in a bank custody arrangement, and the bank sells receipts that represent the right to receive each payment. "Tigers," for example, stands for treasury growth receipts. "Cougars" and "cats" are similar arrangements. The receipts have a federal credit, and a locked-in rate, they trade in the secondary market, and some are listed on the New York Stock Exchange.

There is a host of legal questions related to synthetic securities, including those arising under the Investment Company Act[10] and the Securities Act of 1933. The Commission has issued a series of no-action letters,[11] indicating that if it is possible to give investors what the Commission calls direct rights in the underlying securities held in custody, then the arrangement is legitimate.[12] Lawyers have thus created legal structures designed to give investors direct rights to the securities. For example, investors are given the right to sue on the security in the unlikely event that the federal government defaults on its payments. This is the same approach that has been used in the development of a family of new mortgage-based securities. The traditional "Ginnie Mae" (GNMA) arrangement involves taking mortgages, putting them in a pool, and selling a pass-through interest to investors.[13] Investors are entitled to a pro rata share of the return. Their interest and principal is a function of the aggregate interest and principal payments by all the underlying mortgagors.

These new instruments are called CMOs, or Collateralized Mortgage Obligations. They are not pass-through vehicles. The mortgages are put in a pool, and then the bonds are issued as debt obligations of the entity that maintains the pool. The bond can be issued at an original issue discount or otherwise. Different series of bonds represent the right to receive different payments anticipated by the mortgagors. Short-term investors, for example, are given the

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[10] 15 U.S.C. §§ 80a-1 to -64 (1982).

[11] Blyth, Eastman, Dillon & Son Co. (December 16, 1974) (SEC No-Action Letter, on WESTLAW, Fsec Library, Nal File); First & Merchants Corp. (September 5, 1975) (SEC No-Action Letter, on WESTLAW, Fsec Library, Nal File).

[12] Direct rights in securities include, for example, the right to return on investment and the right to sue on the security in case of default.

[13] GNMA is the commonly accepted abbreviation for Guaranteed National Mortgage Association.

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first three years of payments, which are priced to produce a yield that is appropriate for a three-year maturity. Later payments would go to pay the longer maturity bonds. It is also possible to use this technique to convert old, low-yield mortgages into short-term instruments through the addition of "put" rights.

One last trend that is particularly interesting is that of pooling and selling interests in financial instruments. Recently, banks have increasingly sought to syndicate, or sell participations in, loans as a way of sharing the credit risk and the need for capital. Banks have now started selling participations in loans to nonbank institutional investors. This practice raises questions as to whether the pool is an investment company and whether the participation interest is a security. Nonbank institutions, especially retailers and companies with finance company subsidiaries that have large amounts of financial assets, such as receivables, are considering pooling these assets and selling the interests. The utility of this idea is growing at a great rate, and like all the recent changes in the world of financing, it is worth understanding.

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