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INTERNATIONAL SECURITY MARKETS

Robert L. Knauss*

I. EEC PROGRESS TOWARD ESTABLISHING EUROPEAN CAPITAL MARKETS

I would like to concentrate on what we might call the international aspects of the European securities markets and, if nothing else, to define a couple of terms. What I want to do first is to look at the question of integration of capital markets, and what we mean by that term. Is it really easier for a French company to raise capital in Belgium than a company from the United States? Has there been any integration in the Common Market? Do foreign issuers raise capital on national securities markets in the currency of that market? I think we have to answer that question, "No." If you will look at the statistics shown in Table IV of the Appendix, you will see that in 1966, in all of the EEC countries, aside from Germany, the only foreign insurers making use of the national securities markets were international organizations. For example, in 1967, a total of 14 million dollars was the only money raised by foreign issue in the Netherlands. I think that we can say that the situation still is that the EEC markets are basically national markets. Germany is somewhat of a special case. Table IV contains statistics on Germany and Switzerland. These indicate that foreign issurers raised in Germany 205 million in 1967, and over 800 million in 1968. Although these issues were made in Germany in Deutchmarks, many of these issues should be treated as Eurobond issues. What once was a relatively easy definition of a Eurobond has become more complex, as the German situation shows. You must look factually at each issue to determine whether it was underwritten and sold only within Germany, or whether it was sold by an international underwriting syndicate. Aside from Germany, Switzerland has traditionally been a source, though somewhat limited, of capital for foreign issuers. The Swiss Finance Minister has controlled this with a queue system where you line up and wait your turn, but nevertheless, the market has been present.

What has happened with the EEC? Why is there not more integration of capital markets of member countries? Without any question, the treaty calls for free movement of persons, services, and capital. Again, without any question, the founders of the Common Market anticipated complete unification

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and integration of the capital market. The problem is that there is an inherent weakness in the Treaty in that economic policy has been considered to be primarily the interest of the individual state. Thus at this first stage of development of the Common Market, a unanimous vote is necessary before any action can be taken on matters of economic policy. Very briefly, the structure of the Treaty in Article 67 does provide that member states shall progressively abolish restrictions on the movement of capital. Sections 69 and 70 relate to exchange controls, and there is the specific provision that the Commission shall propose to the Council measures for the progressive coordination of the exchange policies of member states in respect to the movement of capital between the states.

There have been two basic directives that provide for movement of capital in certain designated fields. These provide among other things for movement of current capital where there is immediate quid pro quo in return of services or goods. They also listed separate categories where capital could pass freely, including direct investments, real property investments, certain other private investments, and certain transfers of private funds, as in inheritance. For securities, the directives provided for the taking of progressive steps. The principal one provided that foreign securities that were listed on a stock exchange of a member country could be purchased by residents of that country. However, the ability of a foreign corporate issuer to come into the country and raise capital was left for further development. A third directive that is still in the draft stage attempts to deal with exchange control problems of new issues. One of the primary stumbling blocks is that we have a situation where three of the member countries, France, Italy, and the Netherlands, still have exchange controls and the other three basically have removed them. In this third directive there are provisions to remove all restrictions over the new issue of foreign securities. As you might suspect, Belgium, West Germany, and Luxembourg are reluctant to agree to this, because then they fear that if restrictions are removed the other three countries will fall back on their exchange control limitations. The current proposals which are still being negotiated, would eliminate all restrictions up to a certain percentage of the domestic securities markets. It provides for the removal of all restrictions and for the issuance of foreign securities up to 1.5 per cent of the average of domestic securities issued during 1963 and 1964. There are in addition provisions to keep raising the levels. As I said before, steps in this direction require unanimous agreement.

An important aspect of this problem is the importance of the national market to the national government. As pointed out in Table I, you will see that the total issues in the various EEC countries is in billions of dollars, and almost 50 per cent of the capital is raised by the government itself. The governments are obviously very jealous of maintaining and protecting this capital market. The governments want a source of funds at reasonable interest rates. I think, also, that before we become too critical about the lack of progress in the EEC, we might reflect that the three countries that have the most developed securities markets in the world -- the United States, the United Kingdom, and Japan -- all currently have limitations on the access of their domestic security markets to outsiders. These restrictions vary in kind. Some countries are very specific in saying what permission you need to enter the market, while others are not as clear. In the United States and United Kingdom the restriction is financial (interest equalization tax in the United States, and need to purchase investment dollars in the United Kingdom).

Some individuals believe that the lack of use of foreign markets is not all the fault of restrictions within the countries. The companies in Europe themselves have tended to be national minded. For example, Volkswagon had been negotiating for a period of time to raise capital in Belgium in order to build a plant there. The capital would be used within Belgium and the indication was that that kind of proposal would be approved without any question, but there has been reluctance to make stock offerings. One other item to keep in mind, when we think about how far the European security markets have to come is that, so far as I know, there have not been <u>any</u> equity offerings by foreign companies in any of the EEC markets. There have been two or three rights offerings by European companies that are very widely held in the various stock exchanges (for example, Royal Dutch had a rights offering which enabled current shareholders to buy shares), but as for straight equity offerings, they have not occurred.

There are a variety of things that need to be done to improve the European securities markets. Of these it is clear that free entry is critical. It is easy to sit back and compare our situation in the United States, and say that we have different corporate laws and different Blue Sky Laws, yet nevertheless we are able to have one capital market. The key is that in spite of different laws, we have free entry. If you have free entry, a single state like California can have a tough Blue Sky Law. What California is saying is that if any issuer wants to sell securities in California, it will treat you like any domestic issuer. California imposes tough restrictions on all companies, but it does not impose different standards on foreign corporations. Once you have a concept of free entry you can live with a certain lack of harmonization in the corporate laws and local security laws. There are, however, some areas where greater harmonization of laws is needed. One of these is mergers. There is great difficulty in

Europe with companies which merge with companies outside their own domestic areas. Simplification is needed.

II. EUROBOND MARKETS

We will turn now to the question of Eurobonds. What are we talking about? A Eurobond is an issue in a national market but that is denominated in a foreign currency and is sold through international underwriting syndicates in several countries. Typically, these are sold either in dollars or in Deutchmarks. In the first type of Eurobond, the dollar issues are sold in Belgium, France, and Switzerland, denominated in dollars and circulated by international syndicates, brokers, dealers and investment bankers. In Germany, there are issues in Deutchmarks that are considered Eurobonds. If either the market or the currency is reserved for foreigners, or the situation is such that because of the interest rates the domestics will not purchase the security, then the issue should be considered as a Eurobond issue rather than a domestic issue. In Germany's case, last year about 800 million dollars of Deutchmarks were sold by foreign issuers in the German market. Approximately 50 per cent of those were in fact issued by international syndicates of investment bankers. At least this amount should be designated as Eurobonds. Those that were issued and underwritten by German bankers and sold only in Germany should be considered as issues on the national market.

The background of the Eurobond issue can be divided into two parts. First, the United States market had been since World War II a very important source of capital for foreign issuers needing capital. Not all the money came from the United States, but the mechanism of the New York market was used. In 1963, because of the interest equalization taxes this source was basically cut off. Foreign issuers could not effectively use the New York market without forcing the United States investors to pay the 15 per cent tax. Thus foreign governments and companies were forced to find other markets for capital. At about the same time, in connection with the balance of payments problems, our government placed restrictions on American companies from exporting capital. This placed pressure on these companies to raise capital outside the country. This combination of factors led to the birth of the Eurobond market. This has grown astoundingly, particularly in the last two years.

One part of this that I find of particular significance, and again I refer to the tables in the Appendix, is the extent that in the last two years European companies and not just United States companies have been making use of the Eurobond market. Eurobonds have become a significant aspect of European companies' financing. This leads to the generalization that while attorneys sit and worry about legal restraints the financial community just does what is needed to develop an effective financing device to meet needs. The national European capital markets were not providing necessary access to new capital, so the financial community developed a new method. A large part of the initial pressure for development of the Eurobond market came from the United States balance of payments problem; but I think that Eurobonds now have a life of their own. The marketing techniques including the relatively full disclosure in the prospectus provided initially by American and English investment bankers have been followed in the European offerings. The United States effectively exported marketing talent. European investment bankers and European commercial bankers have taken an active role in many of the recent Eurobond offerings using similar underwriting agreements and similar marketing techniques that American underwriters were using in the initial offerings.

Another development has been that the base of investors has grown. Initially, Eurobonds were sold to a relatively small market. There has been an intriguing mystery concerning ultimate buyers-- Mid-East oil barons, wealthy South Americans, and others through the Swiss banks, or whom? I think there is still a lot of money coming from these sources, but without any question there is now a broader base of purchasers of Eurobonds in Europe. In part, the interest in the investor in Europe in the United States equity market is responsible for this.

The offshore mutual funds, especially the larger ones, appear to be actively purchasing Eurobonds. Moreover, local European bankers, who knew nothing of the issues two years ago, are now considering that type of securities for small trust accounts.

The Eurobond market is valuable for us to look at in connection with the European national markets in order to study their characteristics, and help determine how they are going to develop. The Eurobond market is basically unregulated. The regulatory agencies in European countries, both the Finance Ministers and the agencies that would exercise some security regulations such as the Commission bancaire in Belgium, have ignored the issues. They have done this for two reasons. One is that Eurobonds have not been denominated in the currency of the national country. The other is because the national regulatory agencies have pretended that Eurobonds are really private offerings. The latter argument is becoming more difficult to justify. There is extensive marketing that goes into the selling of Eurobonds. As the market has broadened, selling pressure is being exerted on individual investors and not just on large institutional investors.

Eurobond issues have had a relatively high quality of disclosure. This has been true in the first instance because of the high quality of companies that have been involved in the initial offerings. These have been primarily international companies, many of them listed on the New York Stock Exchange, that were in the habit of making adequate disclosures. Many of the early offerings were registered under the 1933 Act. A larger number were listed on the London Stock Exchange, and I would agree that the pressure of the English investment banking community has been quite strong in maintaining the quality of disclosure. Another reason for the good disclosure was the make up, at least initially of the participants in the market place. The purchasers have been sophisticated investors who have been advised by sophisticated professionals. These men created a pressure to force continued good disclosure.

A third aspect of this Eurobond market, and this one I think is very significant, is that these bonds have been sold in Europe. One of the differences between the United States security market and every market that I have seen in Europe, including England, is the difference in marketing. It is so obvious that you do not see the difference until you have been looking at it for about six months. Securities in the United States are sold. We have brokerage houses with hundreds of branch offices and thousands of account representatives who are selling securities. There is more selling going on in England than any other European country, yet in comparison to the United States, it is small. Up until a year ago, the maximum number of partners in the largest brokerage house in the United Kingdom was twenty. In these houses they might have up to a half dozen individuals other than the partners who would deal with customers. There are no branch offices. In Europe the brokerage units are even smaller. Most purchasers make contact with securities through banks, and then on their own initiative. The concept of selling is something that is just not part of that European market.

There are obviously two sides to the lack of marketing. One of the representatives in the Commission bancaire commented about our hot issue market and our Special Study of the Security Markets that we had a short period of time ago: "Well, we might have some problems with our securities markets, but at least we don't have the problem of selling frauds and of the hot issue." My response to him was that like it or not this appears to be the price you have to pay if you want a good secondary market. I have become convinced that a significant part of the United States success in developing an active securities market has been the fact that securities are actively sold by salesmen. It is because of the fact that we sell securities in this country that much of our regulatory pattern including our direct regulation of broker-dealers has developed. This extensive regulation has not yet become necessary in Europe. But the need is developing to find ways of handling the new European phenomenon of mutual fund salesmen. It is expected that, as selling pressures increase in Eurobonds and other securities, more extensive regulation will follow.

The last characteristic I would mention about the Eurobond markets has been the significance of developing an active secondary trading market. This again was spearheaded by United States underwriting firms who recognized, more than the European firms, the need to have a good secondary market if you are going to have an active primary market. You may not make much money on your secondary market, but the fact that there is a market gives the liquidity that will help provide enthusiasm and a base for the later selling of new issues of securities.

Some of these factors explain why the Eurobond market has been able to continue unregulated. The nature of the participants in that market to date is paramount. There have been good companies involved, professional investors involved, and professional advisors involved, so you have somewhat of an equality of bargaining power. Now there may be many stages where regulation becomes necessary, but I think clearly one of them is when the participants do not have approximately equal bargaining power. In securities regulations this can occur when the individuals to whom the securities are being sold are not in a position to force disclosures on their own. It is at this time that there is the need for regulated disclosure.

III. INFLUENCE OF SECURITIES REGULATION

One of the things that happens in looking at regulation, or the lack of regulation, in the European market is that we Americans tend to try to compare aspect by aspect what we are doing here with what the Europeans are doing. We must recognize, as we comment on the differences of these markets and the differences of selling practices, that there are many aspects of United States regulation that have no significance at all in Europe.

There are some areas of comparison, however, and let me focus on two. The first has to do with the recognition that good disclosure by issuers acts as a basis for promoting active securities markets. This can be related to the Eurobond market as well as the security markets in the United States. One of the reasons that these markets have been successful is because there has been good disclosure. Disclosures create an open and free market and encourage investors and promote investor confidence. This in turn increases trading in the secondary trading market as well as purchases at the time of initial distribution. Improved liquidity is a direct result. Other forms of regulation may produce different results. For example, Belgium has prospectus requirements, but relies on direct regulation in addition to disclosure as a method of protecting investors. In Belgium the Commission bancaire requires the company to submit a separate dossier of information for the Commission's exclusive use. The extent of public disclosure is limited. The Commission bancaire frequently demands that a company make certain internal changes in their corporate structure before allowing securities to be sold. They will restrict sales unless they determine whether the security issue is economically sound. Protections such as preemptive rights, restrictions against illegal dividend payments, and requirements for maintenance of stated capital are subject to the Commission bancaire's examination. This emphasis on direct regulation is as good if not better than the approach that we use in the United States for protecting investors against fraud. I question, however, if direct regulation is as effective as forcing greater disclosures in encouraging investors on promoting the markets. In contrast I think you can argue that direct regulation may act as a depressant on the securities market. This is not to say that in the United States we do not have many aspects of direct regulation, but most of our direct regulation is related to the trading markets: regulation of broker-dealers, regulation of manipulation, and regulation of specialists. We do not use direct regulation in connection with requirements on an issurer. The ability of the issuer to sell securities depends primarily on disclosure rather than aspects of direct regulation.

A related aspect concerns the marketing of securities. While the extensive selling and marketing of securities creates problems in the United States, it is important in creating liquid markets. In most European countries right now there are prohibitions against advertising, and prohibitions against the broker-dealer making direct contact with someone who is not already a client. I think these blanket prohibitions are detrimental to the creation of viable securities markets. But there needs to be more of a change here than just changing the law. In talking to various broker-dealers in England and in Europe it is evident that it is a change in attitude that is needed as well as a change in the law. Some of the larger brokerage houses are marketing to a much greater extent particularly in respect to Eurobonds, and with institutional clients. At the other end of the spectrum there is an increased amount of unregulated high pressure selling of mutual funds. This suggests that the complete prohibition against advertising and the uneven restrictions on selling that currently exists in many of the European countries are unwarranted. An approach is needed that will recognize the value in advertising, and marketing, yet control the abuses.

In conclusion, the importance of the Eurobond market is in two directions. First, it is the beginning of an integrated European capital market. It cuts across national boundaries and is providing a new source of capital to European companies as well as to United States corporations and foreign governments. Second, the development of the Eurobond market is providing valuable lessons to the financial community which will assist in improvement of the various national security markets.

APPENDIX

Statistics on European Securities Markets

TABLE I -- National Issues E.E.C. Countries (in billion dollars).[1]

	1964	1965	1966	1967
Shares	2,88	3,02	2,59	2,24
Government bonds	2,53	3,34	4,02	5,41
Corporate bonds	4,95	5,31	4,37	5,16
Total E.E.C.	10,36	11,67	10,98	12,81

TABLE II -- Eurobond issues (in billion dollars).[1]

	1964	1965	1966	1967	1968[2]
European Institutions		0,058	0,095	0,115	0,025
E.E.C. Corporations	0,149	0,147	0,171	0,414	0,390
U.S. Corporations		0,297	0,454	0,527	2,170
Other OECD countries, etc.	0,547	0,452	0,376	0,756	1,215*
Totals	0,696	0,954	1,096	1,812	3,950

TABLE III -- Comparison of National Bond Issues with Eurobond Issues by E.E.C. Corporations (in billion dollars).

	1964	1965	1966	1967
National Issues	4,95	5,31	4,37	5,16
Eurobond Issues	0,149	0,147	0,171	0,414
Ratio:	3%	3%	4%	8%

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*OECD Countries and Corporations 0,980; Non-OECD Countries and Corporation 370; International Organizations 0,015.

[1] EUROPEAN INVESTMENT BANK, ANNUAL REP. (1964-67).

[2] The figures of Eurobond-issues in 1968 are not official as yet. The figures given are compiled from unofficial OECD sources; Morgan Guaranty Trust Co., Economist's Dep't, World Financial Markets, Dec. 27, 1968; and Neue Zürcher Zeitung, Dec. 19, 1968, No. 787/3.

TABLE IV -- Foreign Issues in Member Countries (in million dollars).

A. E.E.C. Countries Without Germany[1]

	1964	1965	1966	1967
Belgium:	--	10	10	21
--European Investment Bank	-	10	--	15
--European Coal & Steel Com.	-	0	--	-
--Others	-	0	0	-
(Inter-American Development Bank)	-	-	-	6
France:	30	25	41	41
--European Investment Bank	-	-	-	-
--European Coal & Steel Com.	-	-	-	41
--Others	-	-	-	-
Italy:	--	24	48	24
--European Investment Bank	-	24	-	24
--European Coal & Steel Com.	-	-	24	-
--Others	-	-	-	-
(Inter-American Development Bank)	-	-	24	-
Netherlands:	15	29	--	14
--European Investment Bank	-	11	-	-
--European Coal & Steel Com.	-	-	-	-
--Others (Netherlands Antilles)	-	-	-	14
Luxemburg:	-	1	-	-
Total foreign issues E.E.C. Countries without Germany:	45	89	99	100
--European Investment Bank	8	45	75	39
--European Steel & Coal Community	37	11	24	41

[1] EUROPEAN INVESTMENT BANK, ANNUAL REP. (1964-67).

Table IV contd

	1964	1965	1966	1967
--Others				
i) borrowers from member countries	-	33	-	-
ii) Inter-American Development Bank (raised in Belgium)	-	-	-	6
iii) Netherlands Antilles (raised in the Netherlands)	-	-	-	14
Totals	45	89	99	100

B. Germany[3]

	1964	1965	1966	1967	1968
Germany:	249	384	348	205	800*

The figures include DM and optional DM issues. Non-resident issues in Germany between March 1964 and the end of 1967 are statistically treated as international issues.

TABLE V -- Foreign Issues in Switzerland (in million dollars).[4]

1964	1965	1966	1967	1968
85	75	100	209**	287**

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*The 1968 figures are not official. The estimated breakdown is:

Total $ 1.68 billion of foreign issues
$ 800 million (internationally syndicated) (Eurobond-issues)
$ 800 million (nationally syndicated)

**Includes Eurobond-issues (Swiss tranche) underwritten by Swiss underwriting syndicates ($ 70 resp. 75 million).

[3]BANK FOR INTERNATIONAL SETTLEMENT, 38th ANNUAL REP. 58 (1968); EUROPEAN INVESTMENT BANK, ANNUAL REP. (1965-67).

[4]SWISS CREDIT BANK, THE SWISS ECONOMY IN 1967; OECD COMM. FOR INVISIBLE TRANSACTIONS, CAPITAL MARKET STUDY-STATISTICAL ANNEX (1967); EEC COMM. REP., THE DEVELOPMENT OF A EUROPEAN CAPITAL MARKET 360 (November, 1966). GÜNTHER BRÖKER, DIE MÄRKTE FÜR AUSLANDSANLEIHEN IN JAHRE 1967-1968; BANK-BETRIEB, July-August, 1968, at 186. All figures are rounded and give approximate magnitude only.