PART V.

FOREIGN BOND REFORT

Conclusions and Recommendations

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Conclusions and Recommendations

As we have indicated, regulation and control of committees and other agencies representing holders of defaulted foreign governmental bonds are necessary in the public interest and for the protection of investors. At present no supervision exists, except the registration requirements of the Securities Act of 1933, as amended. These govern for the most part only committees seeking the deposit of bonds. Thus committees seeking only powers of attorney or proxies are by and large exempt. And no basis exists for regulation and control of agencies like the Foreign Bondholders Protective Council, Inc. Even in case of committees which are required to register under the Securities Act, they are forced only to disclose the truth as to their organization, their affiliations, and their plans. There is no power to refuse to qualify as committees those who have even palpably conflicting or adverse interests. There is no power to supervise the conduct and activities of these committees during their life. There is no power to curtail or delimit in the public interest and for protection of investors the powers which committees may take unto themselves. Thus more disclosure in these situations is hardly sufficient for protection of investors. On default investors, unorganized and largely helpless to help themselves, have little freedom of choice but to go along with those who, self-constituted and self-appointed, announce themselves as protectors of the investors. Disclosure of the facts regarding these protectors is of little practical utility to investors. Prospective purchasers of securities have by and large a real choice – to buy or not as their judgment dictates. To them disclosure of the pertinent facts surrounding the offering is of great value. But in case of these default situations the case is quite different. An investor with defaulted foreign bonds holds the securities; his investment has already been made; his choice is drastically limited. It will be of small comfort to know that those who control his destiny are incompetent or faithless fiduciaries.

In addition, disclosures in the registration statement present the facts as of the time of filing. That date is usually far in advance of the negotiation of a plan. When the committee subsequently negotiates a plan, the investor usually has no alternative but to go along with it regardless of the fact that it is unsound or unfair. The price of going along will be submission to such terms and conditions as the committee in its uncontrolled discretion may impose. As we have seen, committees may exact heavy tribute from depositors. But the latter are faced with a "Hobson's choice" of not depositing (or withdrawing their securities on payment of a penalty or assessment) with the result that they get little or nothing; or going along with the committee and paying the committee such toll as the committee may dictate. In other words, though the registration statement contains no misstatements or non-disclosures of material facts, committees may continue to operate under oppressive deposit agreements. The Commission is powerless to regulate or control their practices.

This means that the basis for regulation of committees must be broadened and that methods must be designed to bring within a system of regulation and control committees and other agencies presently exempt and immune from any supervision. In fashioning these regulatory measures, it will not be possible even to approximate the type of supervision and control which inheres in bankruptcy or receivership courts, since the assets of the debtor are not subject to process in this country and no power exists to subject them to such jurisdiction. By the same token there is no control over the debtor in any real or legalistic sense. Hence any system of control must fall short of assuring, to the degree possible in the domestic field, production of reorganization or readjustment plans which are fair and equitable. Assets cannot be collected; claims cannot be enforced; debtors cannot be restrained from wasteful or

unconscionable practices; leverage cannot be placed in the hands of creditors; priorities of creditors cannot be enforced as in domestic bankruptcies or receivership.

The domain for regulation and control is largely restricted to the actual or purported representatives of creditors. The control is accordingly for the most part unilateral, though we will suggest a few measures which might be taken to curb extravagant practices of debtors. For that reason it falls short of the desirable objectives. Nevertheless it can represent a forward advance over the chaotic and oppressive condition which exists today. That program of control should be designed to deal separately with (1) committees or similar representatives; (2) a central authoritative agency such as the Foreign Bondholders Protective Council, Inc.; and (3) certain practices of the debtors which can in a measure be restrained.

A. Committees.

It would be dubious wisdom to prevent or place undue restraint on the formation of all committees in this field. The vices and weaknesses of committees should be dealt with directly and thoroughly. But a place in the system should be reserved for them. Despite their obvious defects they have served and can continue to serve useful functions; certainly in this stage of development of techniques for handling these default situations. Feeble though their accomplishments have been and may be, they can usefully perform functions not presently undertaken or performed by the Foreign Bondholders Protective Council, Inc. Among these are affording investors some measure of protection against loss of their fraud and rescission rights against houses of issue; and supplying some vigilance against excessive practices by short term creditors in receiving preferences of their claims. The first of these is an important and valuable service to individual bondholders. The second is a general service to the entire class or classes of bondholders. Though no committee or other agency has any real sanction or power to prevent

preferential treatment to short term creditors, nevertheless the vigilance and determination of any such agency can carry weight and persuasion as deterrents to excessive practices. Admittedly a central authoritative agency if committeed to such programs and actually vigilant in pursuing them could be more effective in view of its greater resources, skill, prestige and standing. But absent that, committees can to some extent perform the desired functions. But the importance of committees transcends these matters of fraud and rescission claims and preferential treatment of short term creditors. If truly independent, they will supply to an extent a valuable conditioning influence on other agencies operating in the field, vis., houses of issue, fiscal agents, including trustees under indentures and any central authoritative agency such as the Council. No possible method exists for legislating competency, ability, honesty and integrity. The foreign field (like the domestic) abounds with examples of greed, overreaching and excessive practices. No matter how nicely adjusted is the system of control, it may be expected that many of these practices and conditions will recur. Whether it be a weakness in the central authoritative agency, excessive practices of fiscal agents or trustees, greed of houses of issue, an independent committee which exposes it will be serving a useful function. The inherent weakness in any complete monopoly in this field is that such matters would be unnoticed and unheralded. Investors would be helpless in face of such a condition, as there is no forum where their claims can be pressed and given sanction. Independent committees can thus serve as a balance in the system. Inferior though they undoubtedly will be in negotiating debt adjustments, they, like minorities in other reorganization situations, can supply a check on excesses of those in a dominant position. Their disappearance from the system would be less.

That is not to say that they have been or are above reproach. On the contrary, driven by the profit motive, they have frequently presented the sorry spectacle of entrepreneurial

fiduciaries bent more on personal gain than anything else. Likewise they have frequently been invested with powers which no fiduciaries should exercise unrestrained. And furthermore they have at times been in the extremely vulnerable position of representing materially adverse interests. Hence to make more certain that their proper functions will be adequately performed the following reform measures are essential for all committees undertaking to represent bondholders in these foreign default situations:

1. Houses of issue should be disqualified from being directly or indirectly represented on committees, not only by reason of their potential or actual liability for fraud or rescission claims but also because they frequently have other conflicting interests abroad or other relations with the debtor, (such as fiscal agent) which history and experience demonstrate will be served before the interests of bondholders.

2. Fiscal agents of the debtor should be disqualified from being represented, directly or indirectly, on committees.

3. All short term creditors and holders of commercial credits, and others with property or commercial interests in the debtor country which, by reason of their nature or amount, conflict or are likely to conflict with the interests of bondholders, should be disqualified from being represented, directly or indirectly, on committees.

4. The foregoing disqualifications should be sufficiently broad as to cover those who have been an officer or director, within the five years preceeding their membership on the committee, of any such person.

5. Attorneys, who, by reason of their prior or present connection with or relationship to the debtor, the fiscal agents, the houses of issue, the trustee, short term creditors, or others with property or commercial interests in the debtor country, have or

are likely to have conflicting loyalties, should be disqualified from representing committees for bondholders.

6. Fees and expenses of committees should be subject to independent scrutiny, review and determination.

7. Trading in the securities by committee members, secretaries, counsel, and their affiliated interests should be prohibited and outlawed.

8. Deposit agreements in the foreign field should be outlawed, except on a showing of conditions which make their use desirable or necessary in the interests of investors. Such conditions will be rare. If used, these agreements should be drastically limited in purpose and effect. Powers of committees over depositors would be vastly curtailed; pledge of securities would be barred; freedom of withdrawal would be permitted. In effect, ironclad deposit agreements would disappear and the extortionate and oppressive practices or committees made possible by the conventional deposit agreement would hereafter be eliminated.

9. Control over proxies and powers of attorney should be provided, so as to avoid oppressive powers and grants of authority both unnecessary and inappropriate in the public interest and for the protection of investors.

10. Control over deposit agreements and proxies should be sufficiently pervasive so as to provide independent review and determination of the time when and the conditions under which bondholders might obtain the benefit of plans of debt arrangement. This is essential in the interests of minorities who as we have seen are faced with a "Hobson's choice" of staying out and getting little or nothing, or coming in on terms dictated by the committees alone.

11. Committees should be barred from being financed by those who would be disqualified from serving on committees.

B. Central Authoritative Agency.

As we have indicated, there is a necessary and appropriate place in the foreign field for a central authoritative agency. The necessity for one not only finds support in the experience of other countries; it is amply borne out by the record of the last decade in this country. And, as we have stated, such an agency may be expected to carry the brunt of the burden of protecting American investors in these default situations. Its prestige and standing will at times give it a virtual monopoly in negotiation of debt settlements. Eventually it may even preempt the entire field. The necessities of that situation make insistent that such an agency be above reproach, be freed from all likely conflicting loyalties, and be wholly and truly independent of those influences which would retard or deter it in being vigilant and aggressive in protection of the interests of American bondholders.

In our judgment, the corporation of Foreign Security Holders, envisioned by Title 11 of the Securities Act of 1933 would not be the most appropriate central authoritative agency. The reasons therefore are set forth above and need not be repeated here. In our opinion the Foreign Bondholders Protective Council, Inc., has in it the needs of an appropriate permanent agency. But it is likewise our judgment that rather basic and fundamental changes in the constitution and operation of the Council must be effected if it is to serve well the interests of American investors. It is important that these changes be made before the Council by reason of increasing dominance and prestige substantially preempts the field.

1. One of the basic problems of the Council is its financing. It originally accepted contributions principally from houses of issue and short term creditors. About

three-fifths of its funds have come from houses of issue. This is unhealthy and undesirable, for the reasons we have listed. Accordingly methods should be found for immediate financing of the Council from wholly disinterested sources. Absent other ready sources, funds from some governmental agency should be made available. These funds should not be contributed as donations or gifts, they should be loaned on easy and convenient terms with the full expectation, as seems reasonable, that they will be repaid over a term of years. The most appropriate medium for this financing seems to be the Reconstruction Finance Corporation. The annual budget of the Council approximates $100,000. The Reconstruction Finance Corporation should be authorized to advance to the Council, as a loan, a maximum of $100,000 a year for the balance of the life of the Reconstruction Finance Corporation but in any event not to exceed ten years. These funds would make the Council financially independent of houses of issue, short term creditors and other similar influences. The Council would thus be freed from any actual or ostensible entangling alliances with those whose interests do not lie with the bondholders. Given a term of years not exceeding ten, the Council by virtue of contributions from bondholders under debt readjustment plans and of contributions by foreign debtors, should be able to accumulate a reserve fund adequate for its purposes and perhaps begin repayment of the loan.

2. But these funds should not be advanced until and unless the government is satisfied that the Council by virtue of its policies, its organization, and its membership is properly equipped and manned to measure up to the exacting standards which those in such a monopolistic position should meet. That entails specifying certain terms and conditions to the loans, which will fall short of governmental control but which will be

sufficiently pervasive as to give further assurance to American investors that the Council is adequately and properly equipped to fulfill the onerous duties of its stewardship. These terms and conditions should embrace the following matters: The Council should amend its certificate of incorporation (or the Council should be reincorporated) so that its charter would contain the following restrictions or limitations:

a. The Board of Directors should be reconstituted so as to provide a small working body of men who could act truly as an advisory group to the Executive Committee and could supervise its activities. Individuals unable or unwilling to assume an active role in the life of the Council should not be elected to its directorate.

b. Fiscal agents, houses of issue, short term creditors, holders of commercial credits or property interests abroad, and brokers and dealers, together with attorneys for these interests, should be disqualified from being, or from being represented directly or indirectly, on the Board of Executive Committee or from being members of the Council. This would include disqualification of members, directors, or members of the Executive Committee who were employees, officers, directors, nominees or agents of anyone who had any such adverse or conflicting interests at any time. The disqualification should be sufficiently broad as to cover those who had been an officer or director, within the five years preceding their election, of any such person.

c. Maximum salaries or fees payable to directors or officers of the Council should be set.

d. The Council should be required to publish at least annual financial statements disclosing its receipts, disbursements, assets and liabilities, in such form or forms as may be prescribed by the Reconstruction Finance Corporation.

e. Any funds received by the Council from foreign countries or from bondholders should be subjected to independent scrutiny and review.

3. The standards for qualification of members of the Council's committees should, of course, conform to those which from time to time may be required of all other committees in the foreign field. The prohibitions, limitations, and restrictions on the use of deposit agreements or proxies should likewise be applicable to the Council's committees, if these committees employ them at any time. In other words, the Council's committees should be subject to the same supervision and control as other committees in the foreign field.

4. In order to measure up to the exacting standards of a central authoritative agency, which is vigilant and aggressive in its representation of the interests of American bondholders, the Council should broaden its program of policy and action so as to bring within its sphere of activity and concern preservation to bondholders of all their rights, including fraud and rescission claims and protection of bondholders against preferences commonly obtained by short term creditors. Elimination from the Council of houses of issue and short term creditors is a first (and necessary) step in this direction.

The foregoing matters do no more than to provide certain necessary safeguards against abuse by the Council of its monopolistic position. They are no guarantee of future efficiency, honesty and vigilance. The Council will remain in self-perpetuating body with all the inherent weaknesses which that implies. But these conditions will serve as some check or brake on

excessive practices in the future and will provide some assurance that the Council will develop in the strong tradition of vigorous and loyal prosecution of the interests of American bondholders. This course will avoid indulgence by the Government of the United States in the business of debt collection. At the same time it will provide necessary minimum assurance to the government (always an interested party) that the fate of its nationals is in proper hands. The Council under these safeguards and subject to the indirect and informal conditioning of the State Department can develop a tradition of loyal and efficient service which will bring deep respect and confidence at home and abroad.

C. The Debtor.

As we have indicated, no jurisdiction over the debtor is available. Nevertheless certain practices of the debtor can be substantially curtailed.

1. Some measures can be taken to curb repatriation of defaulted bonds. As we have seen, the practice of repatriation has been vicious from the viewpoint of American investors. No perfect system of prevention can probably be designed. But criminal sanctions can be imposed on brokers, dealers and others who purchase or participate in the purchase, as principal, agent, delivering or forwarding agent, or otherwise, knowing or having reasonable cause to believe that such defaulted security is acquired, directly or indirectly by the foreign government, its agent, or any person domiciled or residing in its territory.

This will supply some sanction against a practice which has been unconscionable and disastrous to American investors. It will make it less likely that a foreign debtor can default and use funds, otherwise available for debt service, to purchase the bonds at prices depressed as a consequence of its default.

2. The unilateral plan, with all of its unconscionable characteristics, cannot readily be outlawed or controlled at present. It may be feasible at a future time to apply sanctions against solicitation of assents to plans except and unless those plans are approved by duly qualified agencies in this country. But such a control necessarily awaits among other things the development of the comprehensive program recommended above.

D. Future Foreign Loans

The national policy regarding the sale in this country of securities of foreign governmental issuers, the restrictions and conditions on such sales, and the provisions of loan contracts, which are necessary and appropriate in the public interest and for protection of investors are not within the purview of this report. One aspect of that matter, however, has a rather direct bearing on the functioning and financing of a central authoritative agency which acts for American investors when these foreign loans default. It deserves special notice here.

No matter how free from fraud and overreaching foreign loans may be it is to be expected that there will be a certain percentage of defaults in years to come. That is but a normal consequence of depressions and of selfish interests of foreign debtors. Since that is predictable, adequate provision should be made in future loans for financing the cost of protecting American investors in the event of default. That is to say, the issuer should be required in case of future loans to deduct from the proceeds of the loan and to pay over to the reserve fund of the central authoritative agency a sum which would help defray the cost to the central authoritative agency in protecting that or other similar loans in periods of default. The amount to be paid by each issuer cannot be accurately adjusted to the probable risk of default. But a step in that direction can be taken by fixing the amount at a stated percentage of the gross fees or commissions which

the issuer pays to the underwriters of the loan. Accordingly, it is recommended that in all future foreign loans the issuer be required to deduct from the proceeds of sale a sum which is equal to 2% of the gross fees and commissions paid to underwriters and to pay that sum into the reserve fund of the central authoritative agency. The amounts so paid into this reserve fund would be pooled for use in case of a default on the issue in question or on any other foreign issue. In a realistic sense foreign borrowers would be providing in advance money to cover the direct costs of their own or other future defaults. From the viewpoint of American investors this seems just and equitable. From the long range point of view it will provide the central authoritative agency with the funds necessary for its efficient and effective activity and will make it financially independent.