SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 755-4846

DISCLOSURE BY FOREIGN COMPANIES IN U.S. MARKETS

An Address by

Ray Garrett, Jr., Chairman

U.S. Securities and Exchange Commission

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CONFERENCE ON RE-OPENING OF
U.S. CAPITAL MARKETS

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At this celebration of the demise of the Interest Equalization Tax, I have not been asked to speculate on the validity of the implication in the title to this conference that the U.S. markets will shortly become a source of capital for foreign companies - - and quite properly so. We commissioners at the SEC are instant experts, by Act of Congress, on many things but not on economic and financial forecasting even at home, much less abroad.

Our other speakers today are much better equipped to have worthwhile views in this area, and much freer to express them. I mention the question at the outset only because such projections as I have seen of the capital demands of our own industries in the coming years, measured against our present rate of savings, do not suggest that we will, on balance, be a capital exporting nation. Last November, for example, Hanover Bank in New York, undertook to project the capital demands of all of our industry through 1985 and, using 1971 dollars, they came to the figure - - which they thought conservative - - of $2.2 trillion. If one assumes an annual rate of inflation of 5%, this figure quickly becomes $3.3 trillion.

Again, assuming that something like half of this can come from retained earnings and other internal sources, it appears that outside capital in debt and equities will have to be raised at something like twice the rate of recent years. Barring some radical departure from the present trend of economic development, it rather looks as though we are entering a period of capital shortage for all of the free, industrial nations, even including the fabled Arab billions, and perhaps of some competition in attracting those billions.

This is not to say, as it might appear, that this conference is a useless exercise. Even if these unofficial projections are correct, that the U.S. will not on balance be a net

exporter of capital in the near future, there should be and will be successful efforts by individual foreign companies to raise capital in our markets. If one believes that the free flow of capital among nations contributes to the ultimate economic benefit of us all - - and this is certainly the position of our Administration - - then it is important that foreign companies seek U.S. capital whenever they appear to offer the prospect of superior return. This requires not only the elimination of unnecessary tax barriers but also the absence of unreasonable regulatory and other legal restrictions. This latter, of course, if my subject.

In discussing this subject, I assume that most of you have some familiarity with our laws and practices but that a little refresher might be in order.

I assume, for instance, that you know that we have a federalist system of government involving state as well as federal laws. In the area of our concern, the state laws are popularly known as "blue sky laws", with considerable variation amongst them. In a loose sense they get more stringent as one proceeds from east to west across the country. New York, for example, containing our largest financial center, has no truly regulatory blue sky law, except, curiously, for real estate financings. California, by contrast, has the most regulatory of all.

It would be inappropriate for me, this morning, to attempt to summarize these many laws and the even greater variations in their administration, even if I were prepared to do so. I mention these only to be sure that you bear their existence in mind. In any public financing that you undertake in the U.S., these state laws will be the concern of your managing underwriter and especially of his legal counsel. The technique for the simultaneous qualification of a public offering under the laws of the states in which the

underwriters plan to make distribution - - occasionally meaning all 50 of them - - are well developed. It is a marvelous procedure to behold, even though it might strike you as more than should be required. On the whole, for the kind of financing that most foreign companies may undertake in U.S. markets, our state blue sky laws should not pose a serious impediment once a company has found an exemption from, or complied with, our federal laws.

Turning now to the application of our federal securities laws upon efforts of foreign companies to raise capital in U.S. markets, a proper discussion must involve at least two phases - - the capital raising process itself and the consequences of having public ownership in the U.S.

The principal federal law governing the sale of securities by a company is the Securities Act of 1933, and a significant, relevant fact about the statute is that it does not, in terms, make important distinctions according to whether the issuing company is domestic or foreign or, curiously, whether or not the sales are to be made in the U.S. or to U.S. citizens. This stern equality does not necessarily result in beneficence. We all remember Anatol France's mordant observation that the law in its majestic impartiality forbids the rich and the poor alike from sleeping under bridges at night. Because of differences in national laws and business, and especially accounting, conventions, a failure to make distinctions may discriminate sharply against the foreign company.

Administratively, therefore, the SEC has for years made some concessions for foreign companies that are not made for our own. You may think these concessions a bit niggardly, but at least they reflect some effort to recognize the validity of other customers

where there does not appear to be a material departure from our standards of investor protection, and also to recognize the practical limitations on our jurisdiction.

The basic proposition is that a foreign company seeking funds in the U.S. must do so according to the same rules that apply to our domestic companies, except for modest and limited administrative commission.

Unwritten rule number one is to look for an exemption so as to avoid the expense and other difficulties which registration under the Securities Act entails. The only exemption likely to be available is the provision that exempts offerings by an issuer "not involving any public offering" - - the so-called private placement exemption.

I understand that private placements in the U.S. will be discussed later this morning, so I will not dwell on them except to say that I hope our new Rule 146 will make the whole subject somewhat more comprehensible. The draftsmen of 1933 took the simple phrase, "not involving any public offering" from the English Companies Act, and over the years our judges and lawyers applied scholastic and Talmudic refinements until the whole business became a metaphysical quandary of ridiculous proportions. Rule 146 presents its own problems, but I hope it will be a clearer guide, with some closer relation to meaningful investor protection and practical realities. Bear in mind, however, that exemption from the registration requirements of the Securities Act does not carry with it exemption from the antifraud rules of that Act or the Securities Exchange Act of 1934.

Assuming no exemption is available, the offering must be registered with the SEC under the Securities Act and the registration must become effective before the sales can be made. The SEC has adopted rules and forms governing this process, and with certain exceptions, the rules and forms are the same whether the issuing company is foreign or

domestic. The Act provides rather severe civil liability to investors who lose money on securities sold pursuant to a Securities Act registration statement which is incomplete or false or misleading or otherwise deficient. This liability, essentially for rescission with a short statute of limitations, is imposed upon the issuing company, with respect to whom it is absolute, and upon each director of the company, each officer who signed the registration statement, each underwriter, and each independent accountant or other person who is named therein with his consent as an expert. In all of these cases, the defendant has available a so-called "due diligence" defense if he can show that in the exercise of reasonable care he did not and should not have known of the deficiency. Our few judicial decisions in point indicate that it is not easy for defendants to meet this standard.

To provide a basis for jurisdiction, in one of the few specific statutory provisions recognizing differences in nationality, Section 6(a) of the Act requires that the registration statement of a foreign issuer be signed by the issuing company's duly authorized representative in the U.S., in addition to the signatures of the managers of the company. This provides a means to enforce civil liabilities in U.S. courts and encourages careful preparation and what we generally refer to as full disclosure, either through the influence of the representative on the issuer, or through the representative's own investigation.

Saving all discussion of accounting matters until later, let me mention first, and in only a cursory way, offerings by foreign governments and subdivisions thereof, which receive somewhat different treatment under the securities laws than offerings by foreign companies. For example, debt securities issued or guaranteed by foreign governments or their subdivisions are exempt from the trust indenture qualification provisions of the

Trust Indenture Act of 1939. More important, such offerings are treated differently under the Securities Act with regard to both the form and content of registration statements, as specified in Section 6(a), Schedule B to the Act and Rules 490-495, adopted pursuant to Section 7 of the Act.

Section 6(a) of the Securities Act provides that registration statements for foreign government offerings need be signed only by the underwriter or by the issuer, not by both. Schedule B of the Securities Act lists the items of information that must be disclosed, which include the amount of funded and floating debt outstanding, the circumstances of any prior debt defaults, sources and uses of government receipts and disbursements, and the terms and conditions of the offering, but not financial statements conforming with our accounting Regulation SX. The Commission has not adopted any special forms for registration by foreign governmental entities, and has no present intention of doing so. Pursuant to the general catch-all provisions of Securities Act Rule 408, which requires the inclusion of any other material information not otherwise expressly required, foreign government issuers and their counsel usually have included in the registration statement additional information pertaining to the issuer country's resources, population, foreign trade figures, political and economic conditions and institutions, the balance of international payments, taxation provisions and exchange controls.

As to foreign companies, one principal accommodation under the Securities Act is to permit them to supply aggregate remuneration figures for management in lieu of the names and amounts paid to each director and each of the three highest paid officers, who received in excess of $40,000 in the previous fiscal years; such disclosure was practically

unheard of, at least until recently, outside the United States. There have been indications that foreign policies may be changing; our position likewise may change.

In some areas, we require additional disclosure from foreign registrants - - such as various economic, political and legal considerations pertaining to taxation, expropriation risks, stockholder rights and the like, when and if appropriate in regard to the particular company, industry or country involved. We also require an opinion of counsel - - usually negative - - as to the ability of investors to enforce, in the foreign country, the civil liability provisions of the Act, either in original actions or on the basis of judgments of U.S. courts.

Except for accounting matters, these are the only significant differences between the Securities Act registration statements of domestic and foreign companies. We do not expect to make any additional concessions and may get more strict as to executive compensation.

The Securities Exchange Act of 1934 deals with post-distribution trading, extending the disclosure approach of the Securities Act to the trading market by requiring periodic disclosure of financial and other material information by most publicly-held companies. The purpose of the Exchange Act is to provide for fair and honest markets conducted by responsible persons. Like the Securities Act, it contains broad antifraud provisions which relate to the use of any manipulative or deceptive device or contrivance in connection with the purchase and sale of securities. Other provisions of this Act relate to take-over disclosures, to broker-dealers' registration and financial responsibility, and to regulation of the markets.

The Exchange Act, like the Securities Act, extends its jurisdiction over companies by requiring the registration of their securities in certain cases. Legal obligations are then imposed upon companies whose outstanding securities are thus registered. This legislative technique of using the registration of securities as the point of entry, so to speak, with dire penalties imposed for failure to register, had attractions under our Constitutional law as it existed in 1933 and 1934 - - the beginning of Roosevelt's New Deal - - but it confuses discourse to use it twice, with different consequences under different Acts.

The confusion is worse for companies subject to our Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, under both of which we also register the companies themselves, but I intend to stay away from those more specialized areas.

In 1933 our Congress dealt with the problem of the distribution of securities by requiring full disclosure, as we like to refer to it, bolstered by frightening potential liabilities. In 1934 it sought to establish a continuous disclosure system for companies whose securities were actively traded in the markets. For reasons of Constitutional timidity and, probably, political acceptability it imposed the obligations of continued disclosure only upon companies whose securities were listed on a stock exchange or who had registered an offering under the Securities Act. This enabled one to say that the obligations of continuous disclosure were voluntarily assumed as conditions to the acts of listing, or no de-listing, and of public offerings. And, of course, this tended to include the larger companies.

By 1964, these reasons for so limiting the Exchange Act had gone away or been forgotten, and the Act was amended to catch those unlisted, or over-the-counter, companies, in which there was thought to be a significant public interest. As then amended and now in effect, a company whose securities are listed on a stock exchange must also register them under Section 12(b) of that Act - - the process is well coordinated, especially when timed with a fresh Securities Act registration - - and a company whose securities are not listed but who has assets of at least $1,000,000 and an outstanding class of equity securities held by 500 or more persons must register that class under Section 12(g) - - with special provisions for banks and insurance companies. When the number of holders gets below 300, the company may terminate its registration.

Both types of Exchange Act registrants accomplish the registration by filing a Form 10, which resembles a Form S-1 Securities Act registration statement, and thereafter an annual Form 10-K, which is now the full Form 10 updated - - a sort of annual statutory prospectus - - plus quarterly reports on Form 10-Q and current reports on Form 8-K for significant interim events. Also, both types of registrants are subject to the proxy rules adopted under Section 14 of the Exchange Act and the insider reporting and trading provisions of Section 16. How do these provisions apply to foreign companies, bearing these propositions in mind? Even though a company might meet the registration requirements of Section 12, that portion of its securities held in the U.S. might be small. Section 12(g) may strike a company regardless of the desires of management. And our jurisdiction over foreign companies, especially on matters on internal management, is limited at best.

Although no specific exemption for foreign issuers is contained in either Section 14 or 16 of the Act, the Commission has broad exemptive authority pursuant to which it adopted Rule 3a12-3 in 1935 which, in effect, exempts from both Sections 14 and 16 those securities registered by foreign governments and by certain foreign private issuers. The only significant amendment to this rule occurred in 1966 when the exemption was removed for foreign companies that are essentially United States companies, that is, companies 50% owned, directly or indirectly, by U.S. residents <u>and</u> whose business is either administered principally in the U.S. <u>or</u> 50% of whose Board of Directors are U.S. residents.

Several other significant accommodations have been granted to foreign companies. Most foreign companies with shares trading over-the-counter have been exempted from the registration requirements of the Act by Commission rule. For non-exempt foreign entities, the Commission having in mind that foreign companies at the most are exempt from the proxy rules and the insider reporting and trading provisions, let me first emphasixe that the latter does not refer to the consequences of the misuse of information that has not been made available to the public, but only to the mechanical reporting and recovery provisions of Section 16. Beyond this, what are the reporting requirements?

Section 15(a) of the Exchange Act requires that any company that registers securities for sale under the Securities Act must thereafter file periodic reports giving material information about the issuing company until the until the numer of holders of the class of securities thus registered is less than 300. Foreign companies are subject to this requirement, except that the forms on which this after-offering information must be

supplied are Form 20-K and 6-K. I will discuss these forms in companies with their counterparts for domestic companies later.

Foreign companies that cause their securities to be listed on a U.S. securities exchange are subject to the same filing requirements. In both cases, the seeking of capital from our public markets and the obtaining of listing on one of our exchanges, the foreign company has sought to utilize our markets to a degree that justifies its paying a price

However, a foreign company that has not voluntarily sought to make use of our capital markets but finds itself, willy-nilly, with public ownership of its securities in the U.S. is entitled to, and receives, more lenient treatment. Such a company is exempt, by our Securities Act Rule 12g3-2, from all formal periodic reporting requirements provided it furnishes (but does not have to file) the same information that it reports to its own government or otherwise makes public at home. Information fulfilling this requirement at present is more perfunctory than helpful to U.S. investors.

Finally, such a non-listed company that has not made a registered public offering in the U.S. is exempt altogether from Exchange Act reporting if the registered class of securityholders is less than 300.

Putting this all together, if you have raised capital in our markets by a registered public offering, or if you have sought the benefits of our stock exchanges through causing your securities to be listed, you are subject to periodic reporting requirements, but in the case of foreign companies the basic Exchange Act filing form is Form 20, rather than Form 10, the annual reporting form is Form 20-K, rather than 10-K, and the interim

reporting form is Form 6-K, rather than 10-Q or 8-K, and to be used only in extraordinary circumstances.

The Form 20 is the basic form available for registration of securities by most foreign companies under Section 12 of the Act who are not exempted by Rule 12g3-2. Form 20, even as amended in 1967, provides an interesting contrast to Form 10 required of domestic companies. It does not require disclosure of share ownership by management or 10 percent stockholders, but only the presence of direct control by a foreign government or another company. Only aggregate figures are required for direct remuneration, pensions, and stock options paid, accrued or issued to management. Information on interests of management in transactions, pending legal proceedings, indemnification provisions for management, trading markets and recent issuances of securities are not specifically required by any item in the form. The form specifies only a brief description of the "general character of the business and any substantial changes therein in the past five years" and "the general character and location of the principal plants and other units" respectively - - skimpy requirements compared with Form 10, especially in regard to required information on lines of business and competitive situations. Furthermore, all that is required by the Form 20K, which requires a full description, including contributions to sales and earnings by lines of business, in each annual report. A recent sample review by the staff indicates that the usual response to this item in the Form 20K is "None", that is no changes.

The Commission's continual efforts to improve disclosures to investors has resulted in important amendments to our registration and reporting forms in recent years. However, the forms used by foreign entities, especially Forms 20 and 20K, have not been

amended in a similar manner, presumably reflecting the relatively minor impact of foreign issuer filings in relation to the total number of all reports filed. It would appear that the information called for by Forms 20 and 20K could parallel more closely the Form 10 and 10K without creating unusual burdens for foreign issuers; in fact, many foreign countries require more extensive reporting by their local companies that we might.

Prior to 1967, most foreign issuers were not required to file interim reports; there were no foreign forms equivalent to the quarterly 10Q or the current 8K filed by domestic issuers. In 1967, in conjunction with the adoption of Rule 12g3-2 previously discussed, of the amended Forms 20 and 20K and of some related rules, the Commission also adopted Form 6K as a substitute for the interim 8K and 10Q reports. The 6K, in essence, provides for the furnishing, not filing, of interim information required by the issuer's country of domicile - - essentially the same information furnished by foreign issuers under the Rule 12g3-2 exemption with the same qualification as to nonliability. In other words, the only information required to be furnished is that made public abroad. The 6K is to be furnished "promptly" after such public release abroad.

All foreign companies which have distributed or listed shares in the U.S. are subject to the Commission's accounting and auditing rules and regulations. As a practical matter, financial reporting has generally proved the most troublesome area of disclosure for foreigners, and I suspect this will remain the case, particularly in view of the expanded U.S. requirements in recent years.

While there is considerable appeal to insisting on strict adherence to one set of standards in these areas, the Commission has chosen the more practical route of accomodating some deviations from our standards where, in the estimation of the

Commission, the accommodations are compatible with our primary role of protecting investors. These accommodations have been made on a case-by-case basis and reflect determinations by the Commission's staff based on specific facts and the general financial reporting environment at the time of each case.

Accordingly, it would be unwise to draw many general conclusions about our practices by looking at past decisions. This is especially true given the rapid change which currently is occurring in financial statement disclosure practices throughout the world. And even though the Commission is currently attempting to develop more specific guidelines and requirements to assist and facilitate foreign issuer registrations, we are not there yet - - thus strongly suggesting for the present that the most practical course for such issuers is to approach the staff of the Commission for ad hoc consideration of problems relating to deviations from our disclosure and auditing standards.

Having given this rather formidable array of caveats, it appears to be useful nevertheless to look at some of the accommodations made by the Commission over the years in order to give some flavor of the types of considerations made and the degree of flexibility exercised in arriving at solutions.

One area where the Commission has accepted a number of presentations at variance with U.S. standards is depreciation accounting. For example, registrants have been permitted to present statements including depreciation expense based on reevaluation of assets which has occurred prior to registration and where the practice is sanctioned and controlled by the particular foreign government involved - - usually to establish a new depreciation base for tax purposes. Since such re-evaluations are

typically based on indices established by the government, this in effect allows foreign registrants to practice a limited form of price-level depreciation in their financial statements rather than historical cost depreciation as required by U.S. generally accepted accounting principles. However, even where this situation exists, the Commission has requested disclosure of the facts underlying such re-evaluations.

In the case of Dutch companies, various methods of replacement cost depreciation have been allowed in earnings presentations along with special additional disclosures, typically on the face of the summary of earnings or earnings statements, indicating the impact on reported income if U.S. principles were used. The Commission has allowed the reconciling amount to be estimated as long as that fact was disclosed. In most such cases, we have not required either a restatement or reconciliation of the balance sheet, although full disclosure of the nature of differences from U.S. standards typically has been required. Similar approaches have been allowed by the Commission for foreign registrants using replacement value inventory methods affecting both the balance sheet and the cost of goods sold.

In another area, the Commission has allowed foreign registrants to retain accounting established prior to registration which presents stock dividends capitalized at par value even though U.S. standards call for capitalization at fair market value. But such registrants have been expected to account on our basis in the future and to disclose the previous stock dividend accounting practices. In other instances, foreign registrants have been allowed to report gains on the resale of treasury stock as income or to deduct profit-sharing bonuses after reported net income if a note indicating adjustments reconciling such practices to U.S. standards was also included.

Some countries, especially Japan, have found their accounting and disclosure practices to be so divergent that practicality called for a complete conversion to U.S. standards in order to meet our requirements. In the case of Japan this occurred primarily because of their practice of presenting parent company financials only with no consolidated statements.

As practices change in each country our approach may have to be re-examined in light of such new practices.

Basically, then, we are willing to make some accomodations, in particular instances, where it has been demonstrated that departures from our practice cannot be practically rectified and are either not material or can be reconciled and disclosed in a manner which in our judgment provides sufficient information for a sound investment decision. Accordingly, it should be clear that any potential foreign registrant using accounting standards materially different from U.S. accounting standards should stand ready to identify such departures and to approach the Commission's staff to determine whether a solution other than complying with U.S. standards is satisfactory. In general, our staff has been responsive to the use of non-U.S. accounting standards if a reconciliation and supplemental disclosure resulted in a presentation understandable to U.S. investors.

Another area of concern to foreign registrants relates to our requirement for an independent audit. In the past, foreign registrants have handled this problem in various ways. Some have engaged American international public accounting firms. Others have used foreign auditors who in turn have brought in American public accounting firms to act as consultants in preparing registration statements.

But, our statutes, in fact, do not preclude foreign auditors from certifying financial statements of foreign registrants without assistance from American auditors, and, over the years, the Commission has accepted many registration statements audited solely by foreign auditors. In this regard, foreign auditors are expected to make a showing of familiarity with, and competence in applying, U.S. auditing standards. This has typically been accomplished on a "registration-by-registration" basis although the Commission is willing to entertain proposals by foreign auditors leading to a general privilege to practice before the Commission on all accounting matters for all possible registrants.

The principal difficulty in the past, however, for foreign auditors desiring to practice before the Commission, has not been their inability to show competence in applying U.S. standards, but rather in their inability to meet our standards of independence.

In addition, because foreign auditors cannot be expected to plan their examinations to meet our requirements unless they are instructed to that effect, and because they frequently are not so instructed, they may not employ certain procedures necessary for compliance with U.S. standards. Accordingly, in the past, the Commission has adapted its requirements in some instances to allow foreign auditors to disclose deviations from U.S. practice, as, for example, when accounts receivable were not confirmed or physical inventory-taking was not observed. In such instances auditors have been expected to satisfy themselves about accounts receivable or inventory balances by following appropriate alternative procedures to meet their audit obligations, and frequently the use of such alternative procedures has been indicated in the opinion rendered. These instances do constitute relaxations in an area considered critically

important by the Commission. We do not like granting them and will make efforts to avoid them in the future. Because of this, potential foreign registrants should confer with their auditors well in advance so that, if feasible, they may appropriately modify their examination and avoid difficulties in this area.

Another reason for potential foreign registrants to confer with auditors early is to assure that the auditors meet our independence standards. We have made a few accommodations, but once again - - and especially in this area - - we are reluctant to do so.

We have accepted the opinion of foreign auditors who had stock ownership in the registrant during the audit period covered, when the ownership no longer existed at the date of the audit and the facts were disclosed.

We expressed willingness to accept the opinion of an auditing firm owned by a bank where both the auditing firm and the bank did not continue to have any other business relationships with the particular registrant at the time of the audit, including any banking or accounting service apart from the audit engagement itself.

Some of you may be surprised to hear that these examples constitute accommodations in our view. I can only suggest that this emphasizes the need to plan well in advance - - and to approach the Commission early - - with problems in this area.

After this brief review of our practices, you may wonder whether we are sincere in our expressed intent to accommodate foreign companies desiring to tap our capital markets. I can assure you that we are. On the other hand, you must recognize in turn that the nature of our securities markets, with their broad classes of participating investors, requires strict standards in order to assure reasonable investor protection. We do not like

to grant many concessions, but we are more than willing to sit down with you to find practical solutions for meeting the basic intent of our requirements where your circumstances do not reasonably permit strict compliance. We believe that this approach will not effectively preclude you from our capital markets as long as you are prepared to do your share in accommodating us, that U.S. investors in this manner will be given an opportunity to invest in your offerings, and that we will fulfill our statutory obligation to protect U.S. investors.

To conclude, let me summarize the regulatory environment faced by foreign entities. First, as you know, there are a number of methods for raising capital which do not directly affect public investors, such as bank loans and private placements, which are therefore exempt from the securities acts. Secondly, the federal securities laws provide broad exemptions from our more burdensome requirements for foreign governments and their political subdivisions. Finally, we have attempted to aid those foreign companies which are subject to our acts by rules, special forms and case-by-case accommodations.

We have had little need in recent years to review our position on foreign offerings, but I believe the Commission will attempt to avoid erecting unreasonable barriers to the likely increased flow of such offerings and the internationalization of our capital markets. I do not, however, expect a significant lowering of disclosure requirements. In fact, the foreign reporting forms may be brought more up-to-date to conform with those forms used by domestic companies, and we should direct attention to the possible need for such new information as "convenience" conversion of foreign currency financial statements, additional supplementary information reconciling net

income and other financial data reported to foreign shareholders with that to U.S. shareholders, and a statement as to which country's accounting principles are used.

We must, in general, recognize the past and current efforts of the many individual countries, the Common Market and the O.E.C.D. to improve world-wide disclosure. The goal of free, international capital markets will best be achieved by more uniform standards governing the process by which capital is sought from public investors. We are ready to accept the undoubted fact that our system is not perfect, and we look forward to the day when other nations rival or exceed us in the width and depth of participation in capital investment.