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Tempeting a Chill on Skittish Capital Markets: Illiquid Investments Investments in the Wake of Global Volatility

Christopher J. Mailander

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TEMPERING A CHILL ON SKITTISH CAPITAL MARKETS: ILLIQUID INVESTMENTS IN THE WAKE OF GLOBAL VOLATILITY

CHRISTOPHER J. MAILANDER^{*}

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I. OVERVIEW

The current financial market volatility of Southeast Asia and the corresponding anxiety it has fostered in other emerging markets, all of which has followed so closely on the heels of the chill on invest-

^{*} Christopher J. Mailander, Esq. is Managing Director of the Savile Group, a consultancy based in Washington, D.C., focused on finance and international trade. Mr. Mailander authored the initial piece in this dialogue on international private equity investment, *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment*, 13 AM. U. INT'L L. REV. 71 (1997). The author (mailander@earthlink.net) welcomes additional comments, questions, and critiques regarding this emerging area of finance.

ment which spread through Latin America following Mexico's peso devaluation in 1994, is calling on financiers and policymakers to explore the full implications of a more global world. The increasing interconnectedness of the world's markets raises a plethora of issues that are still not fully understood. One particularly important issue in this ongoing analysis turns on the means by which economies can realize foreign investment's beneficial attributes, yet mitigate their susceptibility to attenuated adversity when such investment capital is withdrawn. As expected, the solutions offered on how to "manage" capital flows are widely divergent and controversial. How they are ultimately addressed will have a significant impact on the shape of capital markets and economic development in both developed and emerging markets for the years to come.

In the most recent issue of the *American University International Law Review*, I explored a number of issues associated with international private equity investment,¹ one form of foreign investment that arguably fits within the definition of what some commentators refer to in a relatively pedestrian sense as "good" capital.² In *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment*, an analysis was set forth which reviewed the role of international private equity investment as a component of ever-increasing flows of capital, its promise to foreign companies and other countries as a tool for development, and one approach to overcoming the most significant challenge facing the international private equity investor—realizing a viable exit.

Searching for Liquidity was accompanied by three critiques from independent commentators with extensive experience in the international private equity field. These commentators offered additional comments, observations, and insights on this emerging form of financing. The product of *Searching for Liquidity* and these three cri-

1. Christopher J. Mailander, *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment*, 13 AM. U. INT'L L. REV. 71 (1997) [hereinafter *Searching for Liquidity*].

2. See Michael Howell, *A Question of Balance*, EUROMONEY, Sept. 1997, at 105 (describing the influence of varying types of foreign capital flows on emerging markets). The author characterizes foreign direct investment as a form of growth-creating capital, i.e. "good" capital for emerging markets. In contrast, he describes portfolio investment as volatility-creating capital, i.e. "bad" capital for emerging markets.

tiques is a valuable compendium of issues to be considered by the international private equity investor and the foreign company in need of external financing. This response both addresses these critiques and extends the analysis by reviewing the policy implications of the various approaches that will again be offered for managing increasing flows of foreign capital and, in particular, "bad" capital.³

II. CONTINUING THE DIALOGUE: EVALUATING EXIT STRATEGIES FOR INTERNATIONAL PRIVATE EQUITY INVESTMENT

Searching for Liquidity discusses both the broader attributes of international private equity investment and one strategy for enhancing the likelihood of that investment's success. That strategy, exiting through the United States public or private capital markets, implicates a number of issues for both the private equity investor as well as the host company. As such, the article reviews the disclosure requirements of, and potential legal liability imposed by, United States federal securities laws as well as various strategies for minimizing these burdens. The article discusses the use of American Depositary Receipts ("ADRs") as the preferred vehicle for a United States offering by a foreign company. Finally, the article reviews the role the investor plays as an advisor to the company in helping it employ the structures and strategies necessary to realize, as commentator Jerry Feigen phrases it, the "timely distribution of portfolio investment with maximum valuation potential,"⁴ or, in other words, the most successful investment opportunity possible.

In their analyses, the three commentators approached *Searching for Liquidity* from distinct perspectives. Before addressing the specific issues raised by these critiques, it is beneficial to explore the range of financing purposes and structures that fall under the umbrella known as "international private equity investment." A more developed context for understanding international private equity investment will aid a discussion of the commentator's critiques and their relationship to a United States exit strategy, particularly con-

3. See *id.*

4. Jerry Feigen, *Potential Exiting Through ADRs (and/or GDRs?) for International Private Equity Investors*, 13 AM. U. INT'L L. REV. 109 (1997).

cerning emerging market companies or exits made outside the United States.

A. THE CONTINUUM OF INTERNATIONAL PRIVATE EQUITY INVESTMENT

The varying structures and purposes included within the field of private equity finance, which includes both venture and non-venture financing, unfortunately, do not fit within universally-defined categories.⁵ Due to its comprehensiveness and attempt at clear delineations, however, a useful model for purposes of this analysis is that set forth by the Federal Reserve System Board of Governors.⁶ The Federal Reserve's categorization of private equity investment generally refers to a range of financing: (1) early-stage new ventures, including those companies in need of seed capital to research and determine the feasibility of a concept or start-up capital to begin operations; (2) later-stage new ventures, including those companies seeking to expand their operations; (3) middle-market private firms that have an established track record, but cannot finance their efforts to expand their operations or effectuate a change in ownership through traditional bank lending; (4) firms in financial distress; (5) firms suitable for buy-outs (i.e., LBOs, MBOs); and (6) public companies which may already have access to public financing, but for reasons related to the cost, lack of confidentiality, or complexity in raising capital in the public market, choose to utilize private equity financing.⁷

As these categorizations relate to the commentators' critiques,

5. Compare GEORGE W. FENN ET AL., BOARD OF GOVERNORS OF THE FED. RESERVE, THE ECONOMICS OF THE PRIVATE EQUITY MARKET 1, 17-21 (1995) (providing six categories of private equity financing, but recognizing these categorizations may be overlapping or less than distinct), with *Venture Capital in OECD Countries*, FIN. MKT. TRENDS, Feb. 1996, at 15 (1996), available in LEXIS, News Library, Finmkt File [hereinafter *Venture Capital*] (providing five categories of venture capital financing, including seed capital, start-up capital, expansion capital, mezzanine financing, and buy-out/buy-in capital), and INT'L FIN. CORP., INVESTMENT FUNDS IN EMERGING MARKETS 10 (1996) (discussing two categories of venture capital financing: "early stage" financing, including seed, start-up, and other early stage capital; and "expansion stage" financing which includes working capital; expansion capital, or bridge/mezzanine financing).

6. See FENN ET AL., *supra* note 5, at 45-49 (discussing the categories of companies in need of private equity financing and the purposes for such financing).

7. See *id.*

much of their discussions focused specifically on companies in need of start-up and early stage financing—typically referred to in the United States as venture capital financing—and not those companies in need of non-venture financing, but which fall within the broader definition of private equity financing. For purposes of this response, the distinction is an important one to highlight in order to fully understand the relevance and applicability of a United States exit strategy. For example, in the international arena, private equity financing, more often than not, refers to non-venture financing.⁸ Furthermore, the most active investors in the private equity market are institutional investors from developed countries, scouting opportunities in both the venture and non-venture arena.⁹ For these reasons, private equity investment, as it is addressed in this response, includes the range of purposes and structures identified by the Federal Reserve, albeit with an international, rather than a domestic, dimension.

B. THE APPLICABILITY OF THE UNITED STATES EXIT STRATEGY

For a number of reasons, but largely due to the significant possibility of receiving a higher valuation for shares offered, the United States capital markets may be particularly attractive to a foreign issuer that received private equity investment during its formative stages and now seeks to raise additional capital. Among the exiting options available to a foreign company, however, an exit through the

8. See *Venture Capital*, *supra* note 5, ¶ 8. In the United States and Canada, venture capital financing is typically associated with firms in their start-up or early stages of development. In contrast, venture capital in other OECD countries is typically associated with later-stage investments, including funds dedicated to management buy-outs and buy-ins. See Peter Lee, *Barbarians at the Gate of Europe*, EUROMONEY, Nov. 1997, at 44 (describing various structures and approaches used in the European private equity market).

9. See Betsy McKay, *Russian Firms Continue to Lure Foreign Money*, WALL ST. J., Dec. 9, 1997, at A19 (describing international private equity investment in Russia); Danielle Robinson, *Wall Street's Latin Obsession: Will It Last?*, INVESTMENT DEALERS' DIGEST, June 2, 1997, at 16, available in LEXIS, News Library, IDD File (describing United States private equity activity in Latin America); Suzanne Miller, *Private Equity Needs Patience*, EUROMONEY, May 1997, at 21 (describing private equity activity in Eastern Europe); *Risks and Chances*, ECONOMIST, June 28, 1997, at 81 (describing venture capital developments in Germany); Jonathan Karp, *India Looks Abroad for Private Investors*, WALL ST. J., Aug. 19, 1997, at A12 (describing international private equity investment in India).

United States public markets could be the most difficult to achieve. The United States capital markets, therefore, are not a realistic option for all companies. The commentators were quick to make this point.¹⁰ Therefore, the more practical question, recognizing the early but encouraging state of development for international private equity finance, is what types of companies have a realistic opportunity to tap the United States markets?

While there are no hard and fast rules, foreign companies with certain characteristics do stand out. First, as institutional investors have become comfortable with offerings from large foreign issuers undergoing privatization, they are now scouting new foreign offerings which will boost the returns of their portfolios in exchange for the assumption of a higher level of risk. As a consequence, they are turning to the next tier of foreign companies that have a lower level of capitalization (medium-sized companies). As pointed out in *Searching for Liquidity*, initial public offerings of foreign companies ranging from about \$20 million to \$100 million were favorably received in 1996.¹¹ Given this interest in the lower tier companies, many of those companies which fall within the categories of non-venture private equity investing noted in the Federal Reserve categorizations above, may be suitable candidates for a United States offering rather than an offering in other capital markets.¹²

Second, United States investors are more comfortable with technology-oriented companies than with their foreign counterparts generally, and, therefore, companies with sound prospects in telecommunications, computer hardware and software, biotechnology, etc., are more likely to make a strong showing in a United States offering.¹³

Third, United States investors purchasing equity have proven to be more receptive to foreign offerings from companies based in developed countries as opposed to those from emerging markets.¹⁴ In light

10. As each of the commentators are significantly interested in the economic development of emerging markets, their perspectives perhaps underlie this point.

11. See *Searching for Liquidity*, *supra* note 1, at 100-01.

12. See *supra* notes 6-7 and accompanying text (discussing the categories of companies involved in private equity financing).

13. See *Searching for Liquidity*, *supra* note 1, at 102-03 (describing various types of technology companies that have employed United States exit strategies).

14. See *id.* at 103 n.217 (describing companies from developed countries that

of the recent currency crises in emerging markets, this preference for interests in foreign companies from developed countries is likely to continue for the foreseeable future. As another dimension to this predicament, to the extent that a foreign issuer seeks to conduct a public offering in the United States, the company's ability to achieve a transparent level of disclosure and compliance with international accounting standards, on par with that required of companies in the United States, will facilitate a United States offering.¹⁵

The other important issue for the foreign issuer in considering whether to approach the United States capital markets is the variability of the offering structure. While the issue was not discussed by the commentators, one of the primary points of *Searching for Liquidity* was to address the numerous structures that a foreign company can utilize to access the United States market, particularly under those circumstances in which a company cannot meet the legal, accounting, and market conditions necessary to conduct a public offering.¹⁶ These include, most notably, conducting a private placement, which is entitled to a safe harbor from the federal securities laws under Rule 144A, or seeking a listing on NASDAQ's over-the-counter market. Both options may prove beneficial to the foreign company's effort to gain a foothold in the United States market, with the later anticipation of raising capital in the public market.¹⁷ To date, companies from emerging markets have utilized these approaches to the United States market more consistently than they have utilized public offerings.¹⁸

C. OTHER EXIT STRATEGIES FOR THE INTERNATIONAL PRIVATE EQUITY INVESTMENT

In *Searching for Liquidity*, it was noted that the range of exit strategies available to a foreign company included not only taking the company public, but also making the company available for ac-

employ United States exit strategies).

15. See *id.* at 99-90. Obviously, companies which have been operating under financial regimes in countries which approximate the United States threshold are better prepared than companies from those emerging markets which have yet to liberalize their domestic capital markets or adopt appropriate regulatory reforms.

16. See *id.* at 91, 99.

17. See *id.* at 104, 107.

18. See *Searching for Liquidity*, *supra* note 1, at 105-107.

quisition by another, orchestrating a repurchase of the shares by the company, or arranging a secondary purchase of the equities by a third party.¹⁹ In his critique, Robert D. Stillman provides a succinct and valuable summary of these and other exit strategies.²⁰ Mr. Stillman correctly notes that while these exit strategies may not produce the highest valuation possible for the foreign company, such strategies are more likely routes to executing an exit from the international private equity investment, particularly for companies based in emerging markets.²¹

D. CONSIDERING OTHER OFFERING VEHICLES AND OTHER MARKETS

Mr. Feigen raises a number of the major issues associated with the use of depository receipts ("DRs"), particularly those used in other capital markets such as the Euromarket.²² While potentially useful to the foreign issuer, depository receipts other than American Depository Receipts ("ADRs") were not discussed in *Searching for Liquidity* since in most cases, due to market and legal considerations, such instruments would not be the preferred vehicle for an exit in the United States.²³ Mr. Feigen suggests that Global Depository Receipts

19. *See id.* at 78.

20. Robert D. Stillman, *Alternate Exit Strategies for International Private Equity*, 13 AM. U. INT'L L. REV. 133 (1997).

21. *See id.* Several comments about these alternative exit strategies outlined by Mr. Stillman are worth noting. First, Mr. Stillman explains that the institutional investor can realize a return on its foreign investment through securitization of a project's cash flow stream. *See id.* at 135. Project finance has proved to be one of the most successful means of foreign investment in emerging markets, and the development of asset-backed securities ("ABSs") holds significant potential. First, however, these structures are premised on an offering of debt rather than equity. Secondly, in the case of ABSs, the investor purchases an interest in the receivables of a company with a well-established cash flow rather than a new venture, firm in financial distress, or firm targeted for a non-public buy-out. Third, regarding the use of arrangements built into financing instruments at the initiation of an international private equity investment, such an approach is obviously very attractive to the investor as a means of lowering the risk assumed with the investment. The International Finance Corporation notes, however, that it has encountered problems of enforceability of put arrangements with several of its emerging market funds, and, therefore, the practitioner should use due caution. *See INT'L FIN. CORP., supra* note 5, at 29.

22. *See Feigen, supra* note 4, at 121.

23. First, ADRs are the commonly utilized vehicle in foreign offerings targeted

("GDRs") may become a preferred offering vehicle as a more global capital market emerges. In time, this may prove true, but only as the major capital markets achieve a level of uniformity by undertaking "globalization," not only in a financial sense, but also legally. Until that point, however, vehicles like ADRs, which are specifically aimed at overcoming the regulatory barriers between separate and distinct capital markets, will likely continue to be the preferred means by which investors in the United States acquire interests in foreign companies.

Perhaps the more interesting issue raised by Mr. Feigen relates to the transformations taking place within more regionally-focused capital markets which may increase their viability as an alternative venue to the United States for offerings by companies that have received private equity.²⁴ Specifically, Mr. Feigen asserts that "[g]overnments now realize that the flow of investment capital is correlated with investor friendly changes in laws, regulations, and standards that will bring comfort, rather than roadblocks, to potential investors."²⁵ In particular, the ongoing efforts by the European Union toward the harmonization of capital market standards on that continent as well as the establishment of monetary union, may ultimately prove to be one of the most significant developments in fostering the growth of international private equity investment.

The European Union has undertaken a number of initiatives in recent years to overcome its challenging environment for small and medium-sized enterprises and, quite expectedly, to better compete with the United States' job-creating entrepreneurs.²⁶ These initiatives have included helping to foster the creation of EASDAQ, an exchange specifically designed to improve liquidity for small and me-

toward United States investors, and, therefore, the comfort level with such instruments gives them an advantage in the marketplace. Secondly, a United States investor who purchases securities in a foreign issuer represented by GDRs could do so only pursuant to the limitations of Regulation S concerning off-shore securities offerings or pursuant to the safe harbor set out in Rule 144A concerning private placements. See *Searching for Liquidity*, *supra* note 1, at 91-96 (describing Rule 144A and Regulation S).

24. See Feigen, *supra* note 4, at 114.

25. *Id.*

26. See Communication from the Commission of the European Communities: Reporting on the Feasibility of the Creation of a European Capital Market for Smaller Entrepreneurially Managed Companies, COM(95)498 final at 3 (outlining the various initiatives taken by the European Union and the Commission).

dium-sized enterprises along the lines of the United States' NASDAQ, the adoption of the Investment Services Directive, the Prospectus Directive, and the Capital Adequacy Directive.²⁷ The European Union is now focusing on removing other barriers in an effort to foster the access of small and medium-sized enterprises ("SMEs") to long-term capital, including differences in national laws and practices concerning taxation, accounting standards, corporate governance, and restrictions on institutional investors.²⁸ Simultaneous with efforts to remove intra-European Union barriers to a freer flow of capital to SMEs, the European Union is also currently considering the establishment of a US\$470 million fund for venture capital support to SMEs.²⁹ As a consequence of these and other developments, there seems to be some indication that Europe is emerging as a more vibrant source of private equity.³⁰

E. RESHAPING ILLIQUID COMPANIES

Mr. Anderson offers useful insight into the practical perspectives of the various players involved in an international private equity investment from its inception to its exit.³¹ To illustrate the "round-trip" of the investment through its life cycle,³² he uses a hypothetical of a Kazakstan state-owned mineral company undergoing privatization. Assessing this hypothetical, which Mr. Anderson admits is an extreme case, against the above mentioned characteristics of companies

27. See Communication from the Commission of the European Communities: Reporting on the Obstacles to Financing for SMEs, COM(97)187 final at 1 [hereinafter *Obstacles*]; see also Maurice Anslow, *Europe's New Bourse Stresses It's Links with NASDAQ*, EUR. VENTURE CAP. J., May 1995, available in LEXIS, Mkt Library, lacnws File.

28. See *Obstacles*, *supra* note 27, at 6-12.

29. Emma Tucker, *EU Proposes Funding Plan for Companies*, FIN. TIMES, Nov. 7, 1997.

30. See Lee, *supra* note 8, at 44 (stating "Private equity, venture capital or merchant banking – whatever you call it – is a hot area that banks and investors are piling into in Europe, importing US-style aggression and leverage techniques"). Historically, Europe's private equity industry has lagged behind that of the United States due to its sensitivity to risk, lack of interest in equity, and adversity to new or complex financial structures. See *id.*

31. Kenneth Anderson, *Three Roles for the Private Equity Market in Foreign Investments: Comments on Mailander's "Searching for Liquidity"*, 13 AM. U. INT'L L. REV. 125 (1997).

32. See *id.* at 129.

that may be viable candidates for utilizing a United States exit strategy,³³ the Kazak company is probably not a viable candidate to utilize the structure or strategies outlined in *Searching for Liquidity*.

Of greater relevance to understanding international private equity investment, however, is Mr. Anderson's underlying point regarding the tension between the target company's interest in raising external financing juxtaposed against the investor's interest in ensuring the ultimate success of his investment. Particularly in emerging markets, many foreign companies lack the managerial expertise and culture conducive to structuring a later-stage exit that will result in a return on the investment that appropriately compensates the risk assumed.³⁴ This lack of managerial expertise and inability to relinquish a degree of control over a company is one of the largest pitfalls the International Finance Corporation has encountered in seeking to set up venture capital funds in developing markets.³⁵ Under more conducive conditions, the private equity investor should come to play an important role in advising, managing, and overseeing the company. In fact, the private equity investor should be vested with the ability to "influence the company's long-term objectives, strategies, and operations, thereby enhancing the company's attractiveness to other potential investors and that investor's ability to later liquidate its position."³⁶ In other words, during the early stages of the investment relationship, the investor should play a significant role in shaping the company to ultimately realize a condition of liquidity—a condition beneficial not only to the self-interested investor, but also to the company's long-term prospects.³⁷

33. See *supra* notes 11-18 and accompanying text.

34. See *Searching for Liquidity*, *supra* note 1, at 77.

35. See INT'L FIN. CORP., *supra* note 5, at 28.

36. *Searching for Liquidity*, *supra* note 1, at 77.

37. Mr. Anderson notes that the use of ADRs in a United States offering does not foster liquidity in the offering at the time of exit simply by virtue of their use. See Anderson, *supra* note 31, at 131. Certainly nothing suggested in *Searching for Liquidity* supported such a premise, and his characterization of ADRs as "financial alchemy" seems overstated. *Id.* On the other hand, while permissible if registered, a direct offering of foreign shares to United States investors without the use of ADRs, particularly for an emerging market company, is not likely to receive a warm reception in the United States. Such an offering would again face the very condition of illiquidity it is seeking to overcome through its intended capital-raising offering. See *Searching for Liquidity*, *supra* note 1, at 83-85.

III. AT A CROSSROADS: A RENEWED CALL FOR INTERNATIONAL PRIVATE EQUITY INVESTMENT

Due in large part to the tremendous economic liberalization that has taken place globally over the past decade,³⁸ international flows of capital have increased exponentially. One of the most interesting trends within this international financial development has been the increasing dedication of such capital flows to investments in emerging markets.³⁹ However, as evidenced by the market turmoil caused by Mexico's currency devaluation in 1994, the resulting "chill" on investment in Latin America, and the wave of devaluations that have spread through Asia in 1997, these increased flows of capital have come under closer scrutiny.

Many emerging economies, long protected from the influence of foreign investment but now experiencing the adverse impact of volatile markets,⁴⁰ are at a crossroads. Do they continue down a path of liberalization and openness or return to a system closed to foreign investment and, presumably, less susceptible to volatility?⁴¹ This issue

38. See U.N. CONF. ON TRADE AND DEV., WORLD INVESTMENT REPORT 1997: TRANSNATIONAL CORPORATIONS, MARKET STRUCTURE, AND COMPETITION POLICY, at xvii, U.N. Sales No. E.97.II.D.10 (1997) [hereinafter WORLD INVESTMENT] (noting that from 1991 to 1996, 95 percent of a total 599 changes in foreign direct investment regulatory regimes have been in the direction of liberalization).

39. See Thomas J. McCool, *International Financial Crises—Efforts to Anticipate, Avoid, and Resolve Sovereign Crises*, Rep. to the Chairman, Committee on Banking and Fin. Services, GAO/GGD/NSIAD-97-168, GEN. REPORTS, July 7, 1997, available in LEXIS, Market Library, Iacnws File [hereinafter GAO REPORT] (referring to G-10 statistics reporting that total net capital flows—both public and private—to developing countries and countries in transition reached a high of US\$218 billion in 1995).

40. See WORLD INVESTMENT, *supra* note 38, at 114 (citing IFC data showing that in 1988, only three emerging stock markets were classified as "free" and 11 as "relatively free" with respect to foreign investment in stocks owned locally). By 1995, the IFC had classified 26 emerging markets as free, 11 as relatively free, and only one as closed to foreign investment. See *id.*

41. In the wake of severe volatility, many foreign governments have sought to pin blame for the situation on foreign investors and, more specifically, on "hot" money—liquid portfolio investment that can quickly enter and leave a market. See Steve Glain, *Asians Blame Foreigners for Their Woes*, WALL ST. J., Dec. 2, 1997, at A17; Roberto Salinas-Leon, *Market Mania*, WORLD PAPER, June 1, 1997, available in LEXIS, News Library, Wpapper File; Melito S. Salazar, Jr. *Opportunities in*

was raised in *Searching for Liquidity*,⁴² but warrants further analysis given the urgency facing many emerging markets.⁴³

A. CATEGORIZING FOREIGN CAPITAL

Most economies have subscribed to the view that foreign investment is essential to their development. But foreign investment has many forms, the characteristics of which have different implications for each host economy. As noted above, one commentator separates foreign investment into two categories: "good" and "bad."⁴⁴ He argues that flows of portfolio investment directed toward financial markets create volatility in emerging markets and that such capital is "bad." Conversely, foreign direct investment goes into the real economy and creates growth for that market and is therefore "good."⁴⁵

While this distinction is analytically useful to understanding the current economic state of various emerging markets and their susceptibility to devaluation, it may be overly simplistic for purposes of assessing how emerging markets may ultimately respond to the influence of foreign investment in the future. For example, the United Nation's World Investment Report 1997 attempts to distinguish foreign portfolio investment and foreign direct investment in order to gauge overall flows between developed countries and emerging mar-

the Regional Currency Turmoil, BUS. DAILY, Nov. 5, 1997.

42. See *Searching for Liquidity*, *supra* note 1, at 78-80.

43. Some emerging markets have, or at least have attempted to, reinstitute capital controls to mitigate the influence of external investment in their market. See Robert S. Greenberger & Helene Cooper, *Trade Barriers Signal Caution in Asian Crisis*, WALL ST. J., Dec. 2, 1997, at A16 (describing new barriers being imposed in Asia and Latin America); Jonathan Karp & Sumit Sharma, *India Alters Tactic on Rupee, But Market Remains Unimpressed*, WALL ST. J., Dec. 3, 1997, at A14.

44. See Howell, *supra* note 2, at 105.

45. See *id.* Howell argues that emerging markets should use as a barometer for their health a measure of "fundamental balance," which is defined as "the sum of a country's current account position plus its total net receipts of foreign direct investment, less any scheduled foreign debt repayments." *Id.* The fundamental balance is offered as a measure of the quality of the capital flowing into a country. Based on this model, economies which have channeled foreign portfolio investment into consumer spending have proven themselves able to mask underlying economic instability for a period of time, but eventually these economies experience currency devaluation. See *id.* (citing Thailand, Mexico, the Philippines and Pakistan as all exhibiting this characteristic).

kets.⁴⁶ The report recognizes that, in principal, foreign private equity investment does not result in managerial control over a foreign company, is premised on a relatively short time horizon, and is motivated primarily by the financial returns which can be gained on the investment.⁴⁷ In contrast, foreign direct investment does result in a degree of control, has a longer timeline, and is motivated with an intent toward facilitating the development of a productive and efficient unit in a multi-national corporation's overall operations.⁴⁸ The report also recognizes that these general principles do not adequately describe all types of investments. Most prominently, it states that although international venture capital investment is classified as portfolio investment, it operates in many respects like foreign direct investment.⁴⁹ Therefore, using the parlance set forth above, a form of international private equity investment, like venture capital, looks like "bad" capital, but behaves like "good" capital.

The implications of this analysis are important to understanding the legal and operational impact that various forms of capital controls could have on foreign investment, including international private equity investment.⁵⁰ The concern is that in a rush to impose capital controls, the result may be to unintentionally stem the flow of other forms of "good" capital, like private equity and venture capital.

B. MANAGING THE FLOWS OF FOREIGN INVESTMENT

In their article, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, Enrique Carrasco and Randall Thomas propose that to realize the benefits of foreign investment while mitigating the adversities of market volatility, emerging markets should encourage forms of "relational investment" such as venture capital investing and "restrict foreign capital inflows to manageable levels and insulate their domestic economies from these

46. See WORLD INVESTMENT, *supra* note 38, at 107-111.

47. See *id.* at 108-109.

48. See *id.* at 108-111.

49. See *id.*

50. See GAO REPORT, *supra* note 39, at 41 (defining capital controls as measures to "limit the types of flows that come into or out of a country as well as limit the speed at which funds can enter or exit a country").

movements.”⁵¹ While encouraging investors to take long-term, illiquid interests in emerging market companies (“relational investing”) offers a number of benefits toward economic development, as advocated in *Searching for Liquidity* and by its commentators, a reassertion of capital controls on foreign investment in emerging markets is disturbing.

First, the extreme market volatility experienced in recent years in some emerging markets is not the direct product of increasing flows of foreign capital. More accurately, it is the poor underlying economic fundamentals of the host country that are at the base of such volatility.⁵² The massive inflows of foreign capital have had, in some instances, the effect of masking these economic problems for a period of time.⁵³ Additionally, once the economic condition was no longer sustainable, massive outflows of foreign capital accentuated the volatility and adversity facing the emerging market during its wake.⁵⁴ Nonetheless, remedies to avoid further instances of market volatility rest more appropriately with correcting the macroeconomic

51. Enrique R. Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSNAT'L L. 539, 544-545 (1996). The authors also propose that guidelines be developed to regulate international portfolio fund managers' use of power in Latin America and other emerging markets. *See id.*

52. *See Informe Económico: Evaluación Mensual y Pronósticos de la Economía Mexicana* (Economic Report: Monthly Evaluation and Forecast for the Mexican Economy), GRUPO FINANCIERO BANCOMER, Sept. 1997, at 8 (describing the economic variables that contributed to the devaluations in Asia). Bancomer, with extensive first-hand experience in the implications of a currency crisis, notes that four elements aggravated the Asian situation. These include: (1) inconsistent monetary and foreign exchange policies (e.g., fixed or pegged exchange rates no longer sustainable under current economic conditions); (2) weaknesses in the financial sector; (3) a loss of competitiveness for the economy, as represented by a high and growing current account deficit; and (4) a pattern of investments that are speculative or channeled toward low profitability projects (like large government-financed projects). *See id.*

53. *See Howell, supra* note 2, at 105 (stating that the problem lies in the stability of the emerging financial systems). According to Howell: “When global capital pours in, its effects are magnified many times. The result is either a consumer boom and a swelling trade deficit, or a long period of overinvestment that culminates in severe debt and banking problems. But the outcome is always a currency crisis.” *Id.*

54. *See GAO REPORT, supra* note 39 (recognizing that “large fund flows into emerging market countries may amplify the magnitude of financial crises, contagion, and any effect on the international financial system”).

conditions of a country,⁵⁵ rather than on flows of foreign capital.⁵⁶

Second, while there may be a theoretical attraction to using capital controls to the flow of foreign investment, the practical evidence indicates otherwise. A comprehensive survey of economic studies on the effectiveness of capital controls, released by the International Monetary Fund in December of 1996, concludes that such controls may be effective in terms of influencing interest rate yield differentials.⁵⁷ There is, however, no evidence that suggests that they have enhanced economic welfare within a market. More specific to this analysis, there was no evidence that capital controls could be used to change the volume or composition of private capital flows (e.g., encouraging FDI and private equity while discouraging foreign portfolio investment).⁵⁸

Third, foreign portfolio investment and foreign direct investment are inherently linked—the benefits of one accentuate the prospects for the other.⁵⁹ Of particular significance to this discussion, the typically shorter-term portfolio investment is often an essential ingredient in the success of longer-term investments like foreign direct investment and private equity investment. The International Finance

55. See Martha M. Hamilton, *Don't Cry for Latin America*, WASH. POST, Mar. 16, 1997, at H2 (noting that foreign direct investment and foreign portfolio investment has continued to flow to Mexico due, in large part, to the necessary economic restructuring and privatizations, which have taken place both before and after its currency devaluation).

56. See *Rates Decline 'Not Justified'*, FIN. TIMES, Dec. 3, 1997, at 6 (citing recently released report from the Institute of International Finance showing that spreads on emerging market bonds declined in recent years to a level lower than justified by the risks of the investments). It should be acknowledged that the market's perception that the risks in emerging market economies were lower than more objective assessments would dictate, may have contributed to the greater size of inflows and the significant impact of rapid outflows on those markets affected by currency crises. See Paul Blustein, *'Spread' the Bad Word in Emerging Markets' Downfall*, WASH. POST, Dec. 4, 1997, at E1.

57. See Michael P. Dooley, *A Survey of Literature on Controls Over International Capital*, INT'L MONETARY FUND STAFF PAPERS, Dec. 1996, at 639, available in LEXIS, News Library, Asapii File.

58. See *id.*

59. See WORLD INVESTMENT, *supra* note 38, at 107-11. The United Nations stresses that foreign portfolio investment plays an essential role in financing domestic companies, increasing the liquidity of local stock exchanges, strengthening domestic financial infrastructures, and facilitating the operations of the multinational corporations actively involved in providing foreign direct investment. See *id.*

Corporation notes that ten years ago most emerging country stock markets were characterized as having small capitalization, few listed stocks, low turnover, a weak regulatory and institutional environment for investors (e.g., accounting, disclosure, investor protection), and restrictions on foreign entry, capital and dividend repatriation.⁶⁰ The IFC's experience has shown that the entry of foreign portfolio investment fostered the development of the local market in two ways.⁶¹ First, foreign portfolio investment increased the regulation, transparency, and integrity of the local market. Second, foreign portfolio investment has both broadened and deepened the market by setting into motion a "virtuous circle of liquidity," which improves conditions for existing securities and encourages new offerings for companies previously not exposed to external capital.⁶² This evolution within local markets is essential to the ultimate success of the international private equity investment.⁶³ In the context of establishing capital controls, driving a wedge between the various types of foreign in-

60. See INT'L FIN. CORP., *supra* note 5, at 49-52.

61. The IFC also indicates that the primary beneficiaries of improved local stock markets have been local companies. According to the IFC, 90 percent of the stock market capitalization in emerging markets is held by local investors as opposed to international portfolio equity funds and direct investors. See *id.* at 48.

62. *Id.* at 51.

63. See Carrasco & Thomas, *supra* note 51, at 597 n.329. In their discussion of the underlying need to restrict foreign portfolio capital flows into emerging markets, Carrasco and Thomas correctly note that "large and sudden shifts of portfolio investments can create economic and political upheavals in these countries." *Id.* at 597. They attribute such volatility to two sources: (1) the thinness of the capital market and (2) inefficiencies in the market. See *id.* Regarding the challenge posed by the thinness of the capital market, the authors state that the only cure is to expand its size by increasing the amount of capital in the market. Regarding the challenges posed by inefficiencies being present in the market, their recommendation is that improvements be made toward the better dissemination of information through improved disclosure, enhanced investor protection, and expanded trading in a broader number of issues. See *id.* Several comments on their observations and recommendations are warranted. First, in the eyes of the IFC, these two remedies have been jump-started in local markets by the increased presence of foreign portfolio investment, the very type of investment the authors recommend restraining. See INT'L FIN. CORP., *supra* note 5, at 49-52. Second, given the importance of the liquidity of the local equities market to the successful exit from an international private equity investment (a form of "relational investment" the authors advocate), the recommended controls on portfolio investment may have an adverse, unintended consequence. See *id.* Finally, capital controls typically embed inefficiencies within a given market and, therefore, are not a constructive means of improving its long-term operation and stability. See Dooley, *supra* note 57, at 639.

vestment as a means of encouraging one and discouraging the other is likely to be counterproductive to the overall economic development of a country.

IV. CONCLUSION

In the wake of the volatility experienced in a number of emerging markets in the past several years, the temptation will be to return to protectionist measures, which shield an economy from external influence. Unfortunately, such measures act to preserve market inefficiencies and structural deficiencies. In terms of foreign investment, long-term, illiquid investments like foreign direct investment and international private equity investment can play an essential role in enhancing the welfare of both developed and emerging markets. Efforts to foster these forms of financing should be encouraged. The path of such encouragement should not be marked by new barriers to foreign investment, regardless of their form. Rather, the path of economic development should be marked by continued efforts to remove remaining legal barriers, strengthen local financial systems and market structures, and implement sound macroeconomic policies.