The US rules that shaped today's capital markets - opinion

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Milbank Tweed Hadley & McCloy's Phillip Fletcher outlines how the Naughty Nineties expanded access to capital markets

Phillip Fletcher

1990 brought in what many have termed, from a regulatory perspective, as the Naughty Nineties, but the constructive highlights of the year were the expanded access to capital markets provided by two major legal innovations.

Brady Bonds

The 1980s debt crisis left many developing countries with major sovereign debt problems. The original tonic featured *ad hoc* programmes of fresh loans and commitments from debtors to structural adjustments. By 1989, with the debt overhang still immovable, the IMF and World Bank endorsed the Brady Plan, which called for debt reduction by way of risk-compensated forgiveness. Debtor countries' loans were restructured into a menu of publicly-traded US dollar-denominated 'Brady Bonds' collateralised with US Treasury securities.

Multilateral institutions had earmarked over $30 billion under the plan by June 1989. To this carrot, two sticks were added: first, the IMF agreed to "lend in arrears", meaning it lent directly to debtor countries only shortly before they came unstuck with repayments, effectively forcing the banks to engage with the plan. Second, the largest creditors agreed to novate over to new agreements in which cross-default protection for each syndicate bank was removed – forcing creditors to look at the menu or find themselves adrift on their own.

The first Brady Bond deal was completed in 1990 for Mexico; Venezuela's deal came later in the year. For each portion of debt, the choice was binary - exit or non-exit. Exit meant accepting a Brady Bond priced just above the secondary market price of Mexico's bank debt. Non-exit required a bank to subscribe for a 'new-money' call expressed as a percentage of its outstanding exposure to prevent a free ride on the rise in the price of Mexican debt in the secondary-market. As the options applied to portions of debt, creditors often ended up with a blend of bonds and new-money calls in connection with their original exposures.

The Mexican Brady deal became the archetype for the other Brady deals that followed over the next seven years.

Rule 144A and Regulation S

Finance in the 1980s will forever be memoralised by the Wall Street scandals that affected retail investors, so it is particularly noteworthy that the US Securities and Exchange Commission's

adoption of Regulation S and Rule 144A in 1990 presaged the evolution of markets to institutional investors and away from retail.

Through the adoption of these rules, the SEC clarified when it would not exercise extra-territorial reach in regulating securities offerings and what types of offerings could be made within the US without requiring registration with the SEC. This provided clarification to issuers and underwriters accustomed to relying on 'no action' letters to determine when an offering would require SEC registration.

It took the markets time to understand how the new rules worked in practice. However, as the developed world came out of the slump of the early 1990s, these rules were instrumental in funding the growth of private enterprise. We are now 22 years on and the international capital markets still rely on these rules as a matter of routine.

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