Russell

Karl J. Ege

Karl Ege is General Counsel and Secretary of Frank Russell Company, a position he has held since January 1992. At Russell he is responsible for managing the firm's legal, compliance, internal audit and governmental affairs functions, and is an active participant in its international operations and new business initiatives. Prior to joining Russell, Karl was with the Seattle-based law firm of Bogle & Gates for nearly 20 years, where he was most recently Chair of the firm's Securities and Corporate Finance Practice Group.

A native of New York City, Karl received his undergraduate degree with honors in Chemical Engineering from Princeton University in 1965, where he-attended on a Naval ROTC scholarship. After serving four years as an officer in the United States Marine Corps, attaining the rank of Captain, he entered Cornell Law School, where he received his law degree with distinction in 1972. At Cornell, Karl was Managing Editor of *The Cornell Law Review* and was a member of Order of the Coif. He also received his Masters in Business Administration from Syracuse University, attending classes during the evening while a Marine-recruiting officer in upstate New York.

Karl has been a contributor to a wide variety of national, state and local bar association activities during his career as an attorney and business executive. He is a former Chair of the Corporation, Business and Banking Law Section of the Washington State Bar Association, and served on the State Bar's Corporate Act Revision Committee for 12 years. He is a former Chair of the American Bar Association Section of Business Law's Committee on Negotiated Acquisitions, and was a member of that Section's governing Council for four years. He also served for six years on the ABA's Committee on Corporate Laws, drafters of the Model Business Corporation Act. Recently, he has been named co-chair of the ABA's newly formed *ad hoc* Committee on Financial Services Deregulation and Consolidation. Karl has also served on many of the ABA's committees and task forces dealing with regulatory, investment, corporate and international issues. In 1995 he was selected to the Conference Board's Council of Chief Legal Officers, a group of 75 of the nation's leading corporate counsel.

Karl is active in many civic and charitable activities, including service as a member of the Advisory Council of The Cornell Law School, a member of the Executive Committee and former Chair (1997-1998) of the Washington Council on International Trade, a member of the Board of Governors of the National Center for APEC, a member of the Board of Trustees of the Fred Hutchinson Cancer Research Center Foundation, a member of the Board of Trustees of the Japan-America Society, and Treasurer and a member of the Board of Trustees and Executive Committee of the Seattle Opera Association.

He has been a speaker at many local, regional, national and international conferences, seminars and institutes on issues pertaining to securities, investments, pensions, business financing, global trade and investment, and related topics. He has testified before Congress on a number of legislative topics, including those pertaining to regulatory reform, taxation of mutual funds, and reform of Social Security.

Karl and his wife, Carol, a Seattle real estate broker, have two grown children, Stephen, 25 and Kaarin, 2 1.

ANALYZING THE TRADE DEFICIT

"OTHER PRIVATE SERVICES"

A BRIGHT LIGHT IN AN OTHERWISE TROUBLING TRADE PICTURE

Karl Ege
General Counsel
Frank Russell Company

My name is Karl Ege, and I am General Counsel of Frank Russell Company, an investment management and advisory firm operating around the globe from our headquarters in Tacoma, Washington. We appreciate the opportunity to present our views on the nation's current trade deficit and to recommend a few specific issues our government might address to continue to enhance the ability of financial services firms based in the United States to operate on an equal footing with their global competitors.

Although Russell has been in business for 63 years, it did not become a truly global firm until 1979, when we opened our first international office in London. In addition to a thriving office in London, today we also provide services to an increasingly global client base from offices in Toronto, Paris, Amsterdam, Tokyo, Sydney, Singapore and Auckland. Currently we manage in excess of $55 billion in assets in investment funds domiciled in six countries, and we are strategic advisers to more than $1 trillion of assets held by some of the world's largest and most influential institutional investors, principally pension funds, located in more than 30 countries. We also trade securities representing approximately 1% of the volume of the New York Stock Exchange for our global institutional customers, and we have become one of the leading firms specializing in "transition trading", the transfer of investment portfolios among institutions in a manner that minimizes both cost and market impact.

In February 1995 I spoke to a gathering of state legislators in Washington on the topic of "Trade in Services", characterizing that segment of the trade picture as "The Export Tiger". To my knowledge that was the first time anyone in this most trade-dependent part of our nation had ever publicly focused on that portion of the trade picture that does not readily come into view – namely, trade in services. And until that time there was little visible effort from the "other Washington" to emphasize services as an important, and growing, part of our nation's economy, impacting positively not only our domestic workforce, but our global workforce as well.

When I spoke in 1995 the United States enjoyed a healthy and growing trade surplus in services, offsetting in part the significant trade deficit in goods. Based on 1993 data (the latest available when I spoke), the trade surplus in services of $56.9 billion offset approximately 43% of the trade deficit in goods, resulting in an overall trade deficit that year of approximately $75 billion. In the five years since then our trade surplus in services has continued to grow, reaching $82.6 billion in 1998. But although the trade surplus in services has increased 45% during the last five years, our overall trade deficit has more than doubled, to $164 billion in 1998, since the trade deficit in goods ballooned to more than $246 billion that year, an 86% increase over 1993. Through August' 1999 the picture is more bleak. The trade surplus in services seems to have reached a plateau, while the trade deficit in goods has continued to rise unchecked, increasing over 35% over the comparable period in 1998 to more than $220 billion for the first eight months of the year.

Trade in services has been increasing steadily each year, but not equally across all industries in this segment. If one carefully analyzes the trade data that are presented, it is clear that travel-related services (airline passenger fares, travel expenditures by foreign visitors to the United States, and "other transportation services" (essentially payments associated with the shipment of goods to and from the United States)) represent the largest portion of trade in services in absolute dollars, amounting to nearly $115 billion in exports and $105 billion in imports in 1998, a $10 billion surplus. Nearly all of that surplus is represented by "travel" expenses; essentially foreign visitors in the United States spend more in the aggregate than do U.S. citizens traveling abroad. The data for air travel show relatively comparable export and import figures, and there is a small trade deficit in "other transportation services".

The bulk of the $82.6 billion trade surplus in the services sector is generated by two segments -- royalties and license fees (a trade surplus of $25.5 billion in 1998) and "other private services" (a trade surplus of $44.5 billion in the same year). Combined, royalties and licensing fees and other private services generated nearly 85% of the total trade surplus in services in 1998.

The economic impact of "other private services" on our domestic economy cannot be overemphasized. Much is made of the importance of the export of agricultural products from the United States. In fact, the export of "other professional services" from the United States in 1998 ($92.1 billion) was more than double the total export of all "foods, feeds and beverages" from the United States in that year ($41.2 billion). And the trade surplus in this "catchall" services segment in 1998 ($44.5 billion) was three and a half times the trade surplus from food and agricultural products in that year ($12.5 billion).

I would like to take a moment to focus on "other private services", since that is the segment of the services sector in which Frank Russell Company operates; it is also a segment that has experienced continuing growth and where we believe there remains considerable potential for expanding further an already healthy trade surplus.

"Other private services" includes services as diverse as tuition and charges to foreign students studying at universities and graduate schools in the United States; financial services offered to the global marketplace by institutions based in the United States, including banking, investment banking, investment management and securities trading; professional legal, accounting, and consulting services; engineering and environmental services; and architectural, advertising and design services. Unfortunately the trade data published by the Bureau of Economic Analysis aggregate these varied service offerings into a single "other" category. By comparison, the trade statistics for goods dissect that sector first into broad segments, such as industrial supplies, capital goods and consumer goods, and further into dozens of separate categories, ranging from civilian aircraft to numismatic coins. As a consequence it is difficult to determine from the available data precisely which components of "other private services" have an increasing surplus, which are holding ground in the global marketplan, and which suffer from a competitive disadvantage. Therefore one has to rely solely on one's intuition; and intuition seems to say that the financial services segment of the U.S. economy is adding significantly to the trade surplus in services our nation enjoys today. What is interesting is that until the 1990s that segment did so without much in the way of support or guidance from Washington.

Recent years have seen increasing initiatives by American financial services firms to tap into the vast need for quality 21st century services emanating from the market that dominates this category – the United States. Most heartening, our government, both Congress and the Administration, has been working diligently to address the barriers to the competitiveness of the services industry. In recent years Treasury and USTR officials have been instrumental in easing barriers to entry for U.S. financial institutions seeking to operate in foreign countries, particularly in Japan. Last week's historic signing of Gramm-Leach-Bliley, at long last repealing Glass-Steagall, was an historic step forward in recognizing the need to invest U.S. financial services firms with the same resources available to their global competitors. And Monday's signing of a new trade agreement with China, opening that nation's vast markets to U.S. entertainment, financial services and communications firms, represents a critical step to building a bridge from our extraordinary capable 2 1st century services industry to consumers and businesses world-wide.

These recent events mark important first steps, but much remains to be done. Some of the challenges remain here at home; others require focus abroad. I will highlight a few that we have encountered as Russell has pursued its global financial services strategy.

- U.S. tax laws contain provisions that discourage investment in U.S. domiciled mutual funds by foreign investors.

  We are all familiar with the phenomenal success of our domestic mutual fund industry, which now represents nearly $6 trillion in assets held by over 50 million U.S. citizens. It is agreed world-wide that U.S. mutual funds represent the most sophisticated and cost-effective vehicle available to individual investors who wish to gain access to broad segments of the global equity and debt markets. Yet non-U.S. citizens who might wish to invest in these vehicles face a barrier that virtually ensures that no investments are forthcoming. A 19 13 law that remains in force today imposes a withholding tax of up to 30% on all distributions of short-term trading gains and portfolio interest from U.S. mutual funds to non-U.S. citizens. U.S. citizens who invest in domestic mutual funds are not subject to this withholding tax. Although it is possible for an individual foreign investor to pursue a time-consuming and costly reclaim procedure to recover the withholding tax, the process is so daunting (it can take as much as two years for the Internal Revenue Service to process reclaim applications) foreign investors simply ignore U.S. mutual funds.

However, U.S. mutual fund firms have not been deterred in their efforts to seek market share from investors located outside the U.S. Rather than attempting to sell existing funds domiciled in the United States (and managed and serviced by a largely U.S.-based workforce) to potential foreign investors, many U.S. mutual fund firms have opted to create new fund complexes in offshore jurisdictions to avoid the U.S. withholding tax requirement altogether. Luxembourg, Bermuda, Dublin and other tax-efficient jurisdictions are among the most popular locations for these funds, thus providing foreign investors with investments that are in many cases tax efficient investment vehicles structured as virtual clones of the funds sold in the United States. Each of these offshore jurisdictions requires a certain amount of local content for the funds to qualify for favorable tax treatment; therefore local jobs are created outside the U.S. to support these parallel investment vehicles. As a consequence high-paying 21st century jobs are denied U.S. workers in part because of an outdated U.S. tax provision. To our knowledge, this provision does not generate significant revenue for the Treasury since few foreign investors incur the withholding tax by investing directly in U.S funds.

The existence of this tax provision is one of the principal reasons Russell currently operates separate and distinct fund complexes in Ireland, Canada, the Cayman Islands, Australia, Japan and Singapore. These additional fund complexes employ hundreds of individuals, both at Russell's non-U.S. offices as well as at the service provider firms in those locations with whom we contract.

- Local content requirements in non-U.S. jurisdictions place an unfair competitive burden on service firms seeking to provide low-cost, high-quality services in foreign markets.

  Often U.S.-based firms who wish to offer services in foreign countries encounter onerous local content requirements that adversely affect their ability to compete on a level playing field with their domestic counterparts. These non-tariff requirements come in several varieties, the most common being the need to employ a specific number of local individuals to provide the service, often under the guise of "required licensing or qualifications".

  For example, a foreign investment firm wishing to provide services in a non-U.S. market may often encounter a requirement that the services can only be rendered by a person possessing the necessary licenses in that country, and those licenses are available only to citizens of that country. Even though the essential services (in Russell's case strategic investment advice) is derived from intellectual capital generated in the United States, it must be conveyed through a local professional. This adds costs to the service and decreases the competitive edge the U.S. firm might otherwise enjoy. In addition, jobs are created abroad rather than in the United States.

Further, this practice results in a technology transfer of U.S. expertise to professionals in other countries.

There are many other situations in which local content restrictions place U.S. firms at a competitive disadvantage in foreign markets. For example, in the United States and Britain, large institutional investors, such as pension funds, are permitted to invest in the global markets free from government allocation restrictions. They are essentially required to invest in a "prudent" manner without regard to national boundaries. This is not the case in many foreign jurisdictions, where there are mandated government investment allocations that require a substantial portion of the fund's assets to be invested in domestic securities. These requirements bolster the domestic investment market and amount to a *de facto* government subsidy of both local financial institutions and publicly-traded domestic industrial corporations. To my knowledge, there has been no study of the impact of these requirements on the free flow of capital to what would otherwise be its highest and best use in the global marketplace.

The examples set forth above represent areas of potential focus for Congress, the USTR and other agencies of the U.S. Government that could enhance the ability of U.S.-based service firms to compete aggressively in the global marketplace. Implementing changes in these and other areas where non-tariff barriers exist will have a twofold impact. First, it will continue to increase the already substantial trade surplus enjoyed by the United States from the services sector. Second, it will enable the workforce in the United States to reap the full benefit of the intellectual capital it creates, in the process increasing jobs for workers in our domestic service sector, as well as avoiding an unnecessary transfer to foreign countries of the product of our intellectual efforts.

I thank you for the opportunity to present the views of Frank Russell Company on these matters.