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THE INTERNATIONALIZATION OF THE CAPITAL

MARKETS

An Address By

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It is a fact of economic life that the strength of the economy of a free enterprise society will parallel the health and vigor of its securities markets. Economic progress and the welfare and living standards of people throughout the world depend upon the efficiency of their public securities markets.

This contention requires a little elaboration. The maintenance and improvement of our standard of living demand a commitment of savings and capital to the building of the machinery and equipment, and the development and application of programs and services to apply modern technology to meet human needs. Our securities markets make possible and facilitate this transition of cash into productive channels. The raising of funds to exploit and apply new technology is achieved by the underwriting and sale of securities to investors throughout the world. This process requires market mechanisms for the distribution of securities. In addition, however, people could not be persuaded to commit their savings to the purchase of

securities to finance new capital ventures without the assurance that the capital thus committed could be readily reconverted into cash through a liquid trading market. This function is served by smoothly functioning markets for continuous trading in outstanding securities -- in the United States, our stock exchanges and over-the-counter markets -- and how well these markets satisfy that function is therefore critical for the application of new technologies to human need and to the whole range of economic progress.

It seems to me that what brings us together at this conference -- the first "World Congress on the Stock Exchange" -- is the increasing recognition that our capital markets are becoming international; that the viability and efficiency of domestic trading markets are becoming increasingly important to countries other than those in which they operate.

Domestic securities markets throughout the world are becoming international public markets -- they attract and are dependent upon the participation of large numbers of investors both local and foreign -- and in the broader sense, their performance directly affects the economy of

not only the host country but also of free enterprise countries throughout the world. Investors today do not recognize geographic or political boundaries. Indeed, in today's world of multinational business enterprises, such restraints have become outmoded and unrealistic. It is apparent that the securities markets of the world have become affected with an international public interest.

Like most important new developments, internationalization of the world's securities markets has had its failures and its false starts. We all know that over the last few years there were investment institutions which attracted public savings in Europe and subsequently disappointed expectations of investors. This perhaps will happen again -- there is no investment without risk. But, it is one thing for investors to accept the risk of economic adversity and miscalculation and quite another thing for those of us charged with a responsibility to provide or regulate these securities

markets to stand by and expect that the public will continue to commit their savings to markets which do not exhibit the kind of responsibility or adhere to the kind of public trust to which public savings are entitled. The threshold question today, then, is what must be done to protect this public interest -- to establish and maintain international public confidence in stock market investments.

Let me speak from my own experience. In the United States we have disclosure requirements, principles of fair dealing in the market, anti-fraud rules, and fiduciary obligations. The Securities Act of 1933 is our "truth in securities law." It is concerned with the initial distribution of securities -- the raising of capital -- rather than subsequent trading. Issuers of securities must register them before they are distributed and must disclose in a prospectus the important financial and other material information. The Securities Act also prohibits fraud and misrepresentation in the sale of

securities. The goal is to provide a prospective investor with adequate reliable information so that he can make an informed judgment of the merits of the security and the risks involved. The Securities Exchange Act of 1934, on the other hand, relates primarily to post-distribution trading. It extends the disclosure approach to the trading markets -- both exchanges and the over-the-counter market -- by prescribing reporting requirements for issuers of publicly traded securities, requiring adequate disclosures in proxy solicitations of the stockholders of such companies, and requiring disclosure and limiting profits of insider trading in order to curb corporate insiders from profiting from information known only to them. It also provides for the regulation of the securities markets themselves by a combination of two techniques -- direct requirements and prohibitions, and supervised self-regulation. The Exchange Act requires brokers and dealers to register with the Commission and authorizes the Commission to suspend or revoke their registrations

if they are found to have violated rules and regulations promulgated by the Commission to provide for fair treatment of the investing public. Rules define acts or practices which constitute a manipulative or deceptive device; regulate short selling and stabilization trading; prescribe safeguards to provide a degree of financial responsibility of broker-dealers; specify record keeping standards; and, in general seek to elevate the standard of dealing in the industry to an over-all level of fairness and professionalism. Persons in the business must pass an examination covering a broad range of subjects, they must recognize their obligation that recommendations to customers be suitable to their needs and investment goals and they must adhere to high standards of conduct and principles of fair trade.

The other major regulatory activities of the Commission arise under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Investment Company Act provides a regulatory framework

for an industry where more than disclosure was thought necessary. The Investment Company Act requires that investment companies register with the Commission and attempts, through various provisions, to provide honest and fair management; some measure of investor control over management; adequate but simple capital structures; full and fair disclosure to investors of business results; and outside limits on selling practices and commissions. The Advisers Act also requires registration with the Commission of investment advisers and authorizes the Commission to suspend or revoke a registration upon finding that an adviser violated provisions designed to assure fair dealing and protect against fraudulent or deceptive practices.

I think it is clear that nations which provide these pre-conditions of investor confidence will succeed in attracting capital to their securities markets while those which do not will fail. Throughout the history of the U.S. foreigners have consistently been investors in our economy. Recently, however, the interest in common stocks has heightened.

Why? No doubt because foreigners -- both individuals and institutions -- have become more aware of the investment opportunities in the U.S. securities market and the general long-term growth of our economy. But this development, which coincided with modifications in the U.S. tax laws eliminating tax impediments to foreign investment, was no doubt considerably fostered by the sharp contrast between the extensive scheme of investor protections provided in the American securities markets and the absence of comparable protections in a number of foreign securities markets.

The problems of regulating international investment companies is an actual case in point. We are all familiar with the financial vicissitudes of certain well-publicized investment companies which had previously thrived in a regulatory vacuum. As a result, investor confidence in these vehicles throughout the world was greatly shaken and we have experienced a period of substantial redemptions. Perhaps reflecting an over-reaction to this development,

a number of countries initiated laws to substantially restrict the activities of investment companies within their borders. Fortunately, the OECD was alert to this trend and recognizing as the Commission has said that "requirements for investor protection should serve to facilitate, rather than impede, the free flow of capital between countries," it commissioned a working group of experts from member countries to develop standard rules for the regulation of "collective investment institutions". Agreement on these standard rules and their adoption in member countries will at least insure that any investment company wishing to sell shares in the rich capital markets of the world will be required to meet minimum standards for investor protection. Adherence to such standards is vital, I believe, to restoration of investor confidence in such securities.

Similar efforts will be necessary to establish, improve or restore investor confidence in a number of other

areas if our international securities markets are to continue to grow and prosper. Americans today have a very substantial stake in other countries--both through direct corporate investment in foreign affiliates of U.S. corporations and through indirect investment in the securities of foreign corporations--and, with improved regulatory techniques and tools to eliminate existing disparities in regulation, the flow of capital across national boundaries should accelerate in both directions.

Thus, I predict that American money managers responsible for the increasing funds of institutions--like pension funds, investment companies and life insurance companies--and large individual investors will more and more consider investing in the securities of companies operating in the OECD member community. These companies comprise about 50% of the market value of comparable American companies in which investments are made. By a willingness to commit funds to all of the prime companies of the free world, American money managers can thereby

increase the potential outlets for their funds by 50%. I do not think that they will neglect this opportunity. I believe, however, that they will at least want to see improved standards of information and financial reporting for the companies in which they invest.

At the same time we will continue to see American corporations meet the financial needs of their foreign business activities by having recourse to the Eurodollar market -- offering high interest securities convertible into equity to European holders of American dollars. Between 1965 and 1970, U.S. corporations tapped the Eurodollar market for close to \$6 billion in straight debt and convertible issues. The total Eurodollar market is now estimated to aggregate \$50 billion, and with U.S. corporations continuing to be restricted in transferring U.S. funds abroad, their dependence upon the Eurodollar is not likely to diminish. In fact, in June 1971, a U.S. Department of Commerce survey indicated that foreign affiliates of U.S. corporations operating in continental Europe and South Africa project their spending needs for 1972 alone

at \$4.4 billion. Certainly a significant part of this capital will be raised by Eurobond borrowings -- both public and private.

The raising of huge capital funds from these sources will depend on the European banks, the American banks and the European and American investment bankers which have learned how to raise capital efficiently from these sources. However, their ability to continue to satisfy corporate financial needs may be directly dependant upon our ability to come to grips with a number of intriguing issues that have arisen.

As in the case of a domestic distribution of securities, the success of a Eurobond -- or Euroequity offering -- is dependant -- at least in part -- on the confidence of investors in the operation of a functioning aftermarket where they can, if necessary, reconvert the securities to cash. Thus, we have today a developing trading market for Eurodollar securities --

a market truly international in scope without even a geographic center for the delivery of securities or the settlement of transactions. This market has a long way to go -- its depth and liquidity is so questionable that in 1970 it is estimated that private Eurodollar financings were more than four times greater than public offerings. We must anticipate the needs in this area.

Even if private financings can satisfy the Eurodollar capital needs of American corporations doing business outside the United States, is this trend to be encouraged?

Such large sums of private capital cannot come from the investment banker, whose traditional function is to supply the long term capital needs of industry. In the United States commercial banks are divorced by law from the investment banking business -- but not so in the unregulated Eurodollar arena. Similarly, I understand that in Switzerland, for example, there are very strict limitations on the activities of bankers, but these limitations do not seem to apply to Swiss banks outside of Switzerland. Thus, with a growing network of foreign affiliates and the advent and growth of consortium banking in alliance with

foreign institutions, the Swiss banks are able to play an active role in the Eurodollar market. Will the combination of banking with the traditional investment banking functions be good or bad in the Eurodollar market? Will it lead to unparalleled concentrations of financial power, unwanted anticompetitive alliances, and undesirable conflicts of interest? In the long run will investors gain or are they likely to lose? These difficult policy questions at least require broad discussion and careful consideration by all of us concerned with the welfare of our emerging international securities markets.

We in the United States must wrestle with some of these same issues as European banks and investment bankers come to Wall Street. Although a few European organizations have had securities market operations within the United States for some time, recently the pace of foreign interest has substantially quickened. Merchant bankers and commercial bankers desire access to our securities markets through domestic affiliates. In this context, we must consider the extent to which American firms are subject

to limitations and restrictions in foreign markets -- both as a legal matter and as a practical fact of competitive life. As the Commission indicated in our recent policy statement on the "Future Structure of the Securities Markets":

In view of the increasing internationalization of securities transactions, it is relevant to a discussion of exchange membership to consider whether brokers conducting a public business but controlled or owned by foreign entities should be permitted to become members of our exchanges. We believe that this question should be resolved in the context of reciprocal access to foreign securities exchanges, with the goal of open access under equivalent competitive conditions for all qualified brokers of all nations.

As part of this analysis, I believe we will also have to consider the extent to which these new developments raise policy issues in the light of our national legislation designed to achieve in the United States a separation of banking and investment banking or broker-dealer activity.

This analysis will also be necessary in reverse as American commercial banks and investment banking firms

establish foreign branches to seek foreign investments and commissions from developing them and I anticipate that this trend will accelerate. I expect that recent setbacks in foreign investment in United States securities were only temporary. We should see a reinforced foreign public confidence in our markets arising from our unique system of regulation -- which will be strengthened as the recommendations of our recent study of "Unsafe and Unsound Practices", and perhaps other changes, are adopted into law. As this renewed confidence firms up, I expect that our economy will continue to show expansion and investment opportunity. As these two factors coincide, we should see a continued growth of foreign interest in the United States securities markets.

To best participate in this growth and the opportunities it will bring, United States investment bankers will want to broaden their horizon beyond the Atlantic and Pacific coast lines, recognizing that the firm on the scene abroad will be most likely to develop and share

in this new business. Regardless of the advanced state of our communications system, there is no substitute in the securities business for personal contact. Branch offices abroad will likely bring other benefits in addition to participation in foreign commissions. They will be a handy and perhaps necessary facility to service United States customers abroad -- a population that is continuously increasing in this day of multinational corporations; they will provide a window in foreign countries for on-the-spot research of local investment opportunities; and they may afford an entree for participation in foreign underwritings. It is important to all of us concerned with developing international securities markets that this type of transnational interest not be impeded for artificial protectionist reasons.

In this same vein, it is important that the continuing emergence of new types of international investment companies competing for the savings dollars of individuals throughout the world be regulated but not stifled. In the

United States, for example, we are endeavoring to fashion a new type of offshore fund -- a vehicle that would offer foreign investors an opportunity to participate in the growth of our economy without any unfair tax impediments and without sacrificing investor protection. It is important to the development of our international markets that when these SEC-regulated offshore funds develop they be permitted to compete in foreign markets on their investment merits.

There are other areas too where planning and co-operation seem likely to be necessary. If our markets are to be truly international, we must have uniform minimum standards of disclosure; efforts to achieve this within the EEC and OECD communities should be continued and accelerated. We must also have improved and more uniform accounting standards. There is already an Accounting International Study Group, organized in 1966 and consisting of Canadian, United Kingdom and United States independent public accountants. Perhaps this is the vehicle to take on the formidable task of achieving some

acceptable level of accounting uniformity on an international basis. Similarly, thought should be given now to the proper role and responsibilities of a new emerging professional -- the multi-national lawyer. And, of course, a viable international securities marketplace can only exist when we achieve at least some level of comparability of securities regulation, in all of the areas I earlier mentioned -- disclosure, fair dealing in the markets, protections against fraudulent, deceptive or manipulative practices and the application of fiduciary obligations.

When all of this is achieved, we may begin to think in terms of integrated or combined markets. In theory at least, a unified international market is a natural development to achieve greater efficiency. What is a stock exchange after all but a place where people meet to offer and bid on securities? In the modern age this need no longer be a geographic location but can be a communications system.

In our country we have determined to move to a central market system. Our goal is to tie together the

exchanges in different parts of the country into a national market system in which information on transactions and all parts of the system will remain available to brokers in all parts of the country. We already have NASDAQ, a highly automated quotation system by which it is possible to electronically and instantaneously transmit quotations of more than 2,500 securities to dealers throughout the United States. NASDAQ has demonstrated that computer and instant communications techniques provide the ability to convey information, and store and record and display a record of all transactions to every corner of the country. Transactions can be closed by immediate written or verbal communications through wires. Looking further ahead, transactions so consummated will be completed -- including transfer of securities and payment -- by electronic impulses. My colleague, Commissioner Needham, has described how in the future this process can even become internationalized with a market based on electronic communications through Telstar functioning on a 24-hour day basis.

In all of this what is the role of the Securities and Exchange Commission likely to be? One thing is clear: the Commission's activities and resources must be strengthened to meet the needs of our emerging international securities markets. We are interested in cooperating with foreign regulatory authorities as to issuers' experience in selling securities both here and abroad. Such cooperation will help the Commission deal with such improper practices as the use of foreign nominees for trading and selling of securities, or hiding the illegal gains of organized crime. To facilitate this, we are hopeful that the United States will draft and sign treaties with a number of foreign governments over the next couple of years to establish reciprocity in enforcement actions involving securities. Inter-governmental enforcement cooperation will become more and more necessary as time goes on, and I think we all have a vested interest in encouraging it. The advantage of such an interchange is very clear. Take for example a very simple area -- the exchange of information about people. Isn't it reasonable to expect that the SEC would be interested in and have a use for such information as, for example, that an officer of a company now in registration spent time in jail in, say, Denmark

for misappropriation of someone's assets? Or, on the other hand, wouldn't it be interesting to the authorities in Belgium or Holland to know before a man begins operations in their country that he had been enjoined from selling exactly the same kind of security as a result of an action by the Attorney-General of the State of New York, or the State of Texas, or by the SEC?

In a less immediate and more general vein, I believe it is an important U.S. national policy to assist and encourage the development of foreign local capital markets. The rationale is relatively simple; to the extent such markets prosper, we would expect better international relations. Furthermore, as I have noted, healthy and vigorous foreign capital markets provide a source of capital to United States corporations to finance their operations outside of the United States. In this era of internationalization of capital movements and transnational business enterprises, United States companies require sound capital markets to finance their operations and it is obviously in the interests of our balance of payments position for them to raise capital outside the United States. Also, healthy foreign capital markets mean vigorous and expanding foreign corporations. To the

extent such corporations grow and ultimately enter the United States markets, such business expansion into the United States could produce significant potential dollar inflows which, again, can aid in reducing our balance of payments deficit. Finally, the resulting domestic production of what might otherwise be imported goods also strengthens our balance of payments situation.

President Nixon stressed the interrelation of our domestic and international goals this way:^{1/}

"Economic advancement will never approach its full potential if pursued solely within national boundaries. The interdependence of national economies in the 1970's gives all people a major stake in the effective functioning of the world economy. Economic relations have thus become centrally important in international affairs. An American policy which retreated from cooperation, or which moved toward increasing the barriers to fair and equitable economic intercourse among nationals, would threaten the foundations of the partnerships which are our central foreign policy objective."

In this context, I believe it is the responsibility of the SEC to direct its skills, knowledge and resources to the common goal of broadly based, viable, functioning international securities markets. Here too, there is a real need for close cooperation

^{1/} Report on U.S. Foreign Policy for the 1970's, February 25, 1971.

between the Commission's staff and international and foreign government regulatory authorities. Our securities markets and financial communities are diverse and unevenly regulated; while uniformity is not likely nor, perhaps, desirable, greater international cooperation, coordination and control will be needed. Stock exchange and market practices should be integrated, and corporate structures, financial analysis and disclosure practices, accounting and legal procedures, and disparate tax and fiscal policies require greater balance from country to country within our rapidly expanding international capital markets.

The strong forces of economic and technological change impinging on our capital markets challenge us to devise and absorb these changes in a way which will protect the investor and maintain his confidence, and which will enable the capital markets to meet the expanding requirements of the future and at the same time develop a coherence which will commend continuing public understanding. This is the task in which we must all cooperate.

It seems clear even now that local legislation on a country-by-country basis will not adequately deal with the problem of transnational securities markets. We cannot afford to be protectionist or parochial in concept -- the problems of

international securities markets will require solutions of international scope. What will be needed will be a larger, more global approach, perhaps even a type of multinational securities commission. For the more immediate future, the development of national securities markets and adequate securities regulatory structures, together with closer cooperation among those of us who are concerned with these emerging developments, should suffice and enable us to deal with the immediate challenges ahead. But the ultimate answer may be in an international system of securities regulation -- truly an uncharted route for us all.