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THE SECURITIES AND EXCHANGE COMMISSION'S EXPERIENCE IN INTERNATIONAL CAPITAL MARKETS

Remarks to

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

THE SECURITIES AND EXCHANGE COMMISSION'S EXPERIENCE IN INTERNATIONAL CAPITAL MARKETS

It is an honor to address the Swiss-American Chamber of Commerce. When I was invited to speak to you, I was told -- quote -- "the tasks of the SEC are not always well understood over here." I was surprised to hear such an admission, but not because I am shocked that European business leaders aren't familiar with the Securities and Exchange Commission. I was surprised because that statement implies that the tasks of the SEC are well understood in other places. I can assure you that the tasks of the SEC are not well understood often times even in Washington, D.C., and sometimes not even inside the Commission building itself.

So if you are unfamiliar with the Commission's operations, rest assured you are in good company. Rather than detail the history and legal authority of the Commission and the various regulatory programs it administers, I'd like to focus on the Commission's tasks in relation to the international securities markets, as this is the area you are most likely to encounter. I think this will give you a flavor of the international complexities with which we deal.

Internationalization of the world's securities markets is as new to the SEC as it is to the world's markets. If you look back only three years, the comparisons are fantastic. Since 1984, the value of international borrowing by bond issues has doubled,[1] the value of international issues of equity-related bonds, such as convertible bonds and bonds with warrants, has tripled,[2] and the value of international issues of equities has

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1 The value has increased from $ 83 billion in 1984 to $ 156 billion in 1986. See Securities and Exchange Commission, Internationalization of the Securities Markets: Report of the Staff of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce II-7 (Jul. 27, 1987) (hereinafter "Staff Report").

2 The value has increased from $ 8 billion in 1983 to $ 22.3 billion in 1986. Id. at II-53.

increased sixty times.[3] At the end of 1984, the first international stock exchange linkage had just begun operating. The first international commodities exchange linkage had been made a couple of months earlier. Today, four different links provide trading and information connections among seven different stock exchanges or trading systems in the United States, Canada, and the United Kingdom, and negotiations for more are underway.[4] Other links have been created by futures exchanges.[5] In 1984, the Commission was in the midst of two protracted cases in the Swiss courts: the Santa Fe[6] and St. Joe[7] insider trading cases. The Memorandum of Understanding (MOU) between the Swiss and United States governments was two years old but still unused. Today identities of traders and trading information have been obtained in both

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3 The value has increased from $ 200 million in 1983 to $ 12 billion in 1986. Id. at II-7.

4 The four linkages are: the Boston and Montreal Stock Exchanges, the American and Toronto Stock Exchanges, the Midwest and Toronto Stock Exchanges, and the National Association of Securities Dealers (NASD) and the International Stock Exchange (formerly the London Stock Exchange) (quotations only). Two linkages have been agreed on by the parties but not implemented: the American Stock and European Options Exchanges (trading in options on the American Stock Exchange's Major Market Index), and NASD and the Singapore Stock Exchange (quotations only). Id. at V-49 to -55.

5 The two commodities linkages involving United States exchanges are the Chicago Mercantile Exchange-Singapore International Monetary Exchange and the Commodities Exchange-Sydney Futures Exchange. The Chicago Board of Trade and the London International Financial Futures Exchange have also agreed to link trading. Id. at V-49 n.103.

6 SEC v. Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Santa Fe Int'l Corp., No. 81 Civ. 6553 (S.D.N.Y. filed Nov. 13, 1981).

7 SEC v. Banca della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981).

the Santa Fe and St. Joe cases,[8] and the Memorandum of Understanding has been used successfully.[9]

I think this short review of history indicates that the regulators can be as shocked as traders by market developments, and it can be as difficult for us to keep abreast of changes. I'd like to review the tasks of the SEC in three particular areas concerning the growing internationalization of the securities markets: the sale of securities of foreign companies in the United States, the development of worldwide equity markets, and the impact of global trading on market surveillance and enforcement efforts.

In describing the SEC's tasks in these three areas, I'm relying on another recently-completed task of monumental proportion. In 1985, the Commission was directed by Congress to prepare a report on the internationalization of the securities markets. It was completed last month after diligent months of work by dozens of staff members. At over 900 pages, it is an excellent reference work for all areas of international securities trading and regulation, and should be an invaluable policy-making aid in the years ahead.

I. Sales of Foreign Securities in the United States

The first "task" at hand is to make order out of current regulations on sales of securities by foreign companies. It is fitting to take up this subject first, as approximately one-third of the Staff Report on Internationalization is devoted to disclosure and distribution standards.

Accommodations need to be made for foreign issuers -- this is simply a fact of life in the international marketplace. The SEC recognized this in a request for comment issued two-and-a-half years ago.[10] The most

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8 See Staff Report, supra note 1, at VII-52 to -57.

9 See SEC v. Katz, No. 86 Civ. 6088 (S.D.N.Y. Aug. 7, 1986), Litigation Release No. 11,185, involving trading before the announcement of a merger. The MOU was used to discover one defendant's identity and his trading through a bank in Geneva. Staff Report, supra note 1, at VII-63 to -64.

10 Securities Act Release No. 6568, 50 Fed. Reg. 9231 (Feb. 28, 1985).

favorably-received SEC proposal was the so-called "reciprocal" prospectus: a registration statement form that would use the offering document of the issuer's home country as the prospectus for offerings in the United States. The United Kingdom and Canada were initially considered for this effort, because their disclosure and accounting practices are similar to those in the United States and because those countries are familiar with United States standards, as companies from those countries frequently file offering documents and other forms with the SEC.

Is the reciprocal prospectus feasible? That depends for the most part on the accounting and auditing standards of the country involved. The SEC has historically permitted financial statements to be prepared under different accounting standards, so long as the statements are reconciled to United States standards. The SEC has historically not permitted financial statements to be audited under different auditing standards, however. The staff is contemplating that the reciprocal prospectus arrangement will initially be limited to investment-grade debt, because those securities trade primarily on yield and rating, and thus reconciliation of accounting and auditing problems should not be a major roadblock.

As a broader effort, the SEC staff is generally re-thinking the way the boundaries of United States regulation are drawn. For over 20 years, the SEC position has been that the registration requirements extend to transactions which involve United States nationals, wherever they may be. Companies would not be liable for violating United States law if they took reasonable steps to assure that distributions would not be made in the United States or to U.S. citizens resident abroad.[11] More recently, the staff has indicated offerings made exclusively to foreigners resident in the United States need not be registered.[12]

This policy needs to be re-examined. It has created a convoluted practice of "lock-ups" in foreign offerings, to make sure that stock certificates are not distributed to United States citizens. It has excluded our citizens from international investment opportunities. In addition, this

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11 See Securities Act Release No. 4708, 29 Fed. Reg. 9828 (1964).

12 No-action letters have been given by the Division of Corporation Finance to this effect. See, e.g., Israel Discount Bank (letters publicly available Jul. 23 & Sept. 13, 1981).

policy regarding initial sales is not consistent with SEC regulation of secondary trading, and may leave companies with inconsistent obligations.

The staff is considering instead a "territorial" approach. This means that registration requirements of United States law would apply to any distribution of securities in the United States, whether to citizens or foreigners. Traders outside the U.S. would be bound by the law applicable law to that market.

This approach has several advantages. It is easier on issuers, who can sell to anyone without registering so long as they avoid the United States. It is easier on U.S. citizens, who can participate in unregistered foreign offerings, so long as they do so outside the United States. It squares registration obligations with periodic reporting obligations. Thus, an issuer who may not have initially sold securities in the United States may ultimately be obligated to file periodic reports with the SEC if enough United States residents purchase those securities in the secondary markets.[13] In addition, basing jurisdiction on "territorial" theories is more accepted as a matter of modern international law. The United States would be relying on comity and accommodation instead of the archaic notion that its law follows its nationals around the world.[14]

Although this is an approach with potential, certain problems need to be resolved. Most importantly, we must determine what is trading "in the United States." Does it include a person present in the U.S. but with a brokerage account with a London firm? Does it include an underwriter who distributes securities through a foreign exchange, only to have them purchased in the U.S. through a trading link? These questions indicate that the "territorial" approach still is in its infancy, but I believe it has a promising future.

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13 See generally Staff Report, supra note 1, at III-317 to -319.

14 Territoriality and nationality are both accepted bases of jurisdiction in international law, but territoriality is preferred, and is almost exclusively relied upon in regulation of transnational transactions. See American Law Institute, Restatement (Revised) of the Foreign Relations Law of the United States § 402, comment b (1986).

The virtues of this approach do not extend to fraud, however. I have been speaking only of the laws governing registration. The laws preventing fraud, deceit, manipulation and other wrongs have historically applied on a broader basis. This difference is also consistent with principles of international comity, which presume that the U.S. interest in preventing fraud in transnational transactions is greater than the interest in requiring registration of those transactions.[15]

An area related to registration generally is tender offer regulation, where the SEC is also re-thinking the bounds of its regulation. If securities of a foreign company are owned by U.S. residents, the U.S. residents may find themselves either cashed out or left out of an exchange or merger deal. The staff is considering extending reciprocal prospectus treatment to limited rights offers and exchange offers. I believe this may be an equitable response. Disparate treatment of U.S. residents seems unfortunate. It doesn't seem to further investor protection if these investors were willing to make the investment initially and were permitted to do so without the benefit of registration under the Securities Act. However, they are making a new investment decision, they are now in the U.S., and registration of the new securities would clearly be required. The reciprocal prospectus may represent the best compromise in a situation with no easy solution.

The regulation of tender offers is an example of a broader conflict of mission. In internationalization of disclosure and distribution requirements, we should have two goals: first, to avoid any disadvantage to U.S. shareholders, so that they can participate in world markets; and second, to avoid any disadvantage to U.S. issuers, which can be a problem if we are too accommodating to foreign issuers. I think it's obvious that these two goals don't always suggest the same solution in each case. The challenge to the SEC and its staff is to skillfully design regulation to maximize benefits and minimize the conflicts.

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15 See Federal Securities Code § 1905, comment b (1980). The Code, endorsed by the SEC, urges that the antifraud provisions should apply under more circumstances in transnational transactions than should the registration provisions.

II. Development of Worldwide Markets

With the problems of international offerings taken care of, we can turn to the second "task:" keeping order in the development and regulation in the U.S. portion of what is becoming the one-world securities market. Twenty-four hour markets are well developed for trading foreign currencies and U.S. Treasury securities. Some professionals believe the Eurobond market will be the next to make this leap. By any estimate, the equity markets are far behind. Investors do indeed purchase foreign equities, but they do so in their home markets.[16] Since 1984, the value of all foreign equity trading has increased two-and-a-half times, but the value of all foreign debt trading has quadrupled.[17]

As I indicated at the beginning of my remarks, we are witnessing a flurry of coordinated activities by the world's stock exchanges. Many have developed linkages, but little trading has resulted. Even the busiest international linkages account for far less than one percent of volume.[18] This apparent contradiction led me to examine the possible economic motivations behind international stock market linkages. In general, economic theory suggests that stock exchange specialists can lower trading costs and thus increase profits if they increase transaction volume. Linked trading could concentrate trading at one place and thus could lower costs. The lower costs would narrow spreads, which could then prompt more trading, lowering costs still further. It is thus feasible that linkages can be profitable, but only if they are active. I believe it is far more likely that the linkages

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16 See generally Staff Report, supra note 1, at II-68 to -69.

17 "Foreign trading" refers to any purchase by an investor outside his country of residence. Foreign trading in equities increased from $ 153 billion in 1984 to $ 379 billion in 1986. Foreign trading in debt increased from $ 633 billion in 1984 to $ 2,613 billion in 1986. Id. at II-71.

18 The total securities linkage volume for 1986 as a percentage of total 1985 stock trading volume was:

Boston-Montreal	0.42 %
Amex-Toronto	0.04 %
Midwest-Toronto	0.01 %.

Source: Boston Stock Exchange, American Stock Exchange, Midwest Stock Exchange, Securities and Exchange Commission Annual Reports.

as they currently operate represent posturing by the exchanges in preparation for competition with upstairs firms in offering round-the-clock equity trading.

Of course, trading linkages are but the first step in completing a securities transaction. The work has only begun once the trade is agreed upon. When the Commission requested comments on certain problems in this area in a 1985 release,[19] the main consensus was the need for improved international clearance and settlement. The staff has identified two areas for progress: linked clearance and settlement systems and uniform clearance and settlement standards. Currently, most linkages are "inbound" systems, which allow foreign broker-dealers indirect access to U.S. clearing agencies.[20] The first "outbound" linkage was approved late last year, allowing U.S. broker-dealers to clear and settle trades made on the International Stock Exchange in London using that Exchange's clearing facilities.[21]

These arrangements improve the mechanics of settling trades, but they do not coordinate settlements among clearing agents with different settlement cycles, system capabilities, and operational standards. Settlement times and settlement methods vary dramatically around the world. The U.S. is familiar with the wrenching conversion from one-by-one settling to an automated, standardized system. It was done in the U.S. by necessity in the 1960s as high volume overwhelmed old-fashioned settlement procedures. Similarly, necessity may be the motivation in the 1980s in the international markets as well. Developments in London suggest that a "back office crunch" may not be far off, and traders may begin demanding procedures which make settlement of trades easier and faster.

III. International Surveillance and Enforcement

Having solved the problems of worldwide trading, our third "task" is to police this world market, both in new issues and secondary trading. It is important to guard against misconduct abroad harming U.S. investors or

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19 Securities Exchange Act Release No. 21,958, 50 Fed. Reg. 16,302 (1985).

20 See the Staff Report, supra note 1, at V-64 to -69, for a description of these linkages.

21 See Securities Exchange Act Release No. 23,154, 51 Fed. Reg. 29,184 (1986).

markets. It is equally important to prevent the U.S. from being used as a base of fraudulent activity directed abroad. A U.S. Court of Appeals noted in a 1975 international securities fraud case: "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners."[22] It is important to keep this reciprocity in mind when discussing surveillance and information-sharing arrangements.

An effective program to prevent fraud requires effective surveillance of the market and its individual participants. Before the SEC authorized two-way trading with the Toronto Stock Exchange, the staff obtained assurances that Toronto has surveillance capabilities comparable to U.S. exchanges, and that surveillance information would be routinely shared by the exchanges.[23] Similar arrangements have been made regarding the NASD's quotation link with the International Stock Exchange in London.[24]

More difficult than exchange surveillance is regulatory oversight of large firms with active securities businesses in several different countries. The Commission and the self-regulatory organizations do not have the authority to examine unregistered overseas affiliates of U.S. firms, nor can the Commission apply its rules governing operational and financial condition. There are ways around this problem, however. If the U.S. firm guarantees obligations of its subsidiary, then it must be consolidated, and SEC rules would prohibit a U.S. firm from withdrawing capital to assist an ailing subsidiary at the expense of a safe level of equity in the U.S. In addition, the staff has negotiated with bank and securities regulators in the U.K. to establish capital requirements that are largely equivalent to the Commission's.

Besides surveillance, the other part of this task is the pursuit of securities law violators, both at home and abroad. Although the Commission still faces the challenges of foreign secrecy and blocking statutes, we've made great

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22 IIT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975).

23 See Securities Exchange Act Release No. 22,442, 50 Fed. Reg. 39,201, 39,204 (1985).

24 See Securities Exchange Act Release No. 23,158, 51 Fed. Reg. 15,989, 15,990 (1986).

progress in mutual information-sharing agreements, and continue to do so. Not surprisingly, the Swiss have been leaders in this area, with the 1977 Mutual Assistance Treaty and the 1982 Memorandum of Understanding. As I indicated at the outset, these agreements have been instrumental in stripping the cover of international secrecy from individuals suspected of flagrant violations of U.S. antifraud statutes and rules. The Commission has also negotiated Memoranda of Understanding with Japan and the United Kingdom. Fourteen countries, including the U.S., have signed a Commission-sponsored resolution before the International Organization of Securities Commissions, stating that each member should provide reciprocal assistance to the others, to the extent permitted by law.

I emphasized that this must be a two-way process. The Commission has received requests for information from foreign governments. The staff is limited to providing information that is already in our files or can be voluntarily obtained. By law, the SEC cannot compel testimony or production of evidence if it is not investigating a violation of U.S. securities laws. The staff is considering asking Congress for authority to investigate -- with a subpoena -- violations of foreign law, if requested by that country, and if that country agrees to provide the same assistance to the Commission.

Conclusion

And now you have, in a nutshell, the Commission's tasks. Really, they are simple to understand -- the SEC must merely coordinate, develop, survey and police the world's securities markets. There are two things about this "simple" task of internationalization that make it truly exciting. First, no one is really opposed to it, and even if anyone was, it wouldn't matter, because the change is inevitable. Second, internationalization is not an event, but a process, which means as regulators we'll never know when or if the job is truly done. The process may prove to be glacial -- slow, but with great force, and changing the face of securities trading in ways yet unfathomed. I look forward, as I'm sure you do, to being a part of it.