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Remarks of
David S. Ruder
Chairman
Securities and Exchange Commission
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REGULATION OF INTERNATIONAL SECURITIES MARKETS

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

REMARKS TO
SEVENTH ANNUAL WASHINGTON BRIEFING
ON U.S. PERSPECTIVES

DAVID S. RUDER
CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

OCTOBER 19, 1987

REGULATION OF INTERNATIONAL SECURITIES MARKETS

It is a pleasure to be here. First may I thank the American Stock Exchange and its co-sponsors for providing me an opportunity to address this impressive gathering of chief executive officers and investment managers from around the world on the subject of Regulation of International Securities Markets.

Let me start with a fish story. In 1938, scientists discovered in the depths of the Indian Ocean the coelacanth, 1/ a species of fish that was believed to have been extinct for 60 million years. This prehistoric fish swims backwards, drifts upside down, and even performs underwater headstands. 2/ While the behavioral characteristics of this "living fossil" may seem bizarre, it is the evolutionary hardiness of the species -- its survival through adaptive characteristics -- that is of particular relevance to my central theme today.

Some commentators here in the United States seem to view internationalization as a threat to the survival of the primacy of U.S. markets and the integrity of the regulation of these

1/ Pronounced SEE la kanth.

2/ "'Living Fossils' Display Unusual Behavior," Science News, October 3, 1987, p. 213.

markets. An implicit assumption of this discussion seems to be that international competition among securities markets will inevitably lead to a deregulatory "race to the bottom." Much discussion seems to center on the ways in which our regulations need to be reduced in order to adapt to the new international environment.

While it is undeniable that favorable regulation will be a major factor in determining which financial centers will become dominant, the central question is "what is the most favorable regulatory climate?" My view is that sound regulation enhances rather than detracts from the vitality of markets. International competition among regulators, therefore, should concentrate with vigor on those regulatory concepts that contribute to the vitality of securities markets, while at the same time recognizing the need to adapt to market changes.

My underlying assumption is that the extraordinary fairness, efficiency, and competitiveness of our U.S. markets are in large part attributable to the sound regulatory premises of our federal securities laws and to the adaptive regulatory positions taken by the Securities and Exchange Commission. I suggest, therefore, that just as our prehistoric fish exhibits fundamental qualities that might be emulated by other species, the fundamental soundness of U.S. securities law policy, coupled with Commission regulatory adaptability, presents a model for adoption in the international arena. My remarks today will concentrate on several concepts that have such value in our markets that they merit incorporatio

with some adaptive change, into the developing corpus of common global regulatory principles. In making the suggestions that follow, I recognize that not all of them are appropriate for all markets. Factors such as the nature of the products, the identities of investors, and the stage of market development may well affect the desirability of application of some of these principles.

The primary task of securities regulators worldwide is to react to fast moving international market changes. To some extent, the application of regulatory concepts must wait until we have seen how these markets in fact evolve. Nevertheless, regulatory initiatives must begin now, and discussion of the appropriate regulation of international markets must take into account current market structures, trends, and trading mechanisms. Since we must start somewhere, an overview of the current markets is appropriate.

Between 1980 and 1986 offerings in the international bond markets, including the Eurobond markets, grew from \$38 billion to \$227.1 billion. International bond trading volume in 1986 was more than \$3.5 trillion. 3/ Although certain segments of the Eurobond market -- notably floating rate notes and fixed-rate Eurodollar bonds -- experienced liquidity difficulties in 1987, 4/

3/ See Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking Housing and Urban Affairs and the House Committee on Energy and Commerce (July 27, 1987), ("SEC Staff Study"), Chapter II.

4/ See "Hard Times for the Euromarkets," New York Times, September 20, 1987, at F-1.

total international bond offerings equalled \$102 billion in the first half of 1987, more than in any full year prior to 1984.

International equity markets, long the junior sibling to the debt markets, have also shown remarkable recent growth. Euroequity offerings grew from \$200 million in 1983 to almost \$12 billion in 1986, 5/ and in the first half of 1987 totalled \$7.5 billion. Trading between markets has also increased markedly. In 1986, foreign purchases of U.S. stocks reached \$148 billion, and U.S. purchases of foreign stocks totalled \$51 billion, as compared with \$82 and \$25 billion in 1985. 6/

While much attention is being focused on the trading volume growth in each of the world's 57 national stock markets, perhaps equally impressive is that the total value of equities now traded worldwide exceeds \$6 trillion. 7/ Not only is the amount of equity trading important, but it is also significant that this trading is occurring in an increasingly consolidated and automated global financial and communications network. For example, there is an increasing reliance upon automated quotation collection and dissemination systems within various domestic markets -- most notably in the U.S. and in the U.K. with its "SEAO" and "SEAO International" Systems. 8/ There also is an increasing trend

5/ SEC Staff Study, Chapter II.

6/ See Department of Treasury Bulletin, various issues.

7/ See "Stock Exchanges Strong in Quarter," New York Times, October 5, 1987, p. D-12.

8/ See SEC Staff Study, Chapter V.

towards a greater amount of automated execution for smaller orders, with virtually every major market now having some such capability. Moreover, private vendors are now offering both competing international securities information dissemination systems, and even international execution capabilities in certain world class equities. 9/ Plans already exist for expanding these systems to include other securities, including certain futures products. 10/

As you know, the automation systems that I have just described can be used to support an auction market such as the market on the floor of the New York Stock Exchange, or a dealer market, such as the NASDAQ market. An upstairs market may also exist in conjunction with an exchange market, either during or after primary market hours. To an extent, internationalization of markets is increasing the competition between systems using auction market trading principles and those using dealer trading principles. 11/ The recent demise of the trading floor in London and its replacement in effect by the SEAQ System is

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- 9/ See the Instinet trading system, described in letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to Daniel T. Brooks, Cadwalader, Wickersham & Taft (Counsel for Instinet Corp.), dated August 8, 1986.
- 10/ See the planned Reuters/Chicago Merchantile Exchange ("CME") global order entry and automated transaction system for futures before and after CME hours described in "The Future of Futures, A Strategic Plan for the CME" (available from CME).
- 11/ See D. Unruh, "International Market Linkage" (Remarks at the SEC's February 17, 1987 Roundtable on Internationalization.)

perhaps the earliest evidence of this struggle. While it is not possible to predict which system or which variation of which system will prevail, or whether they will co-exist, regulators confronting internationalization must keep in mind that this market structure struggle is a part of the context in which they are operating.

Several factors, both institutional and economic, have contributed to the unprecedented growth of the international securities markets. As just suggested, among institutional factors technology enhancements have played a major role. In the economic area, the existence of reduced inflation seems to have increased the desire of investors to hold bonds rather than bank deposits, and the sharp decline in long-term interest rates during the middle 1980's has stimulated the refinancing of existing debt. In both debt and equity markets the elimination of competitive barriers, such as capital market restrictions, currency exchange controls, foreign ownership limitations, and fixed commission rates, 12/ has played a major part. The U.S., of course, has taken the lead in this regard, and other countries have followed. These countries also seem to be following our lead by adopting increased investor

12/ The U.K., Australia, Canada and Denmark have followed the U.S. lead in eliminating fixed commissions. See SEC Staff Study, Chapter II. Moreover, the Tokyo Stock Exchange has lowered its commission rates for institutional trades several times in recent years. See "Tokyo Stock Exchange's Broker-Fees Cut is Seen as Trimming Foreign Firms Profits," Wall Street Journal, October 2, 1987, p. 27.

protection measures such as restrictions on insider trading. 13/

These comments are not intended to argue that internationalization is being driven by foreign imitation of the United States. Rather, the point is that the growth of international markets is taking place in an arena containing a regulated U.S. securities market that is strongly and adaptively regulated. Most important, I believe that the continuing efficiency and fairness of the U.S. markets has made them healthy competitors in the international environment. I believe that our regulatory concepts not only contribute to this result, but offer a model that should be followed by other markets.

What are the attributes of these regulations and what are their purposes?

First, our federal statutes and regulations require full and fair disclosure of material information about publicly offered and traded securities. 14/ This information contributes directly

13/ See, e.g., the U.K.'s Financial Services Act of 1986 and the rules of the U.K. Securities and Investments Board creating, as a partial response to Big Bang "deregulation", a statutory self-regulatory apparatus together with greater investor protection measures (such as bans on cold calling). Several countries, including the U.K., Canada, Japan and Denmark also have either recently enacted insider trading restrictions or shown increased interest in enforcing existing laws.

14/ In addition to direct disclosure regulation the federal securities laws also accommodate surrogates for mandated individual disclosure such as access to information.

to the economic efficiency of our markets, since investment decisions will be made on a fully informed basis. A fully informed market is likely to be a fair market, in turn encouraging greater investor confidence and market participation. 15/ I believe adequate disclosure is so basic to market fairness and to market efficiency that one of the initial international regulatory goals must be the development of minimum disclosure standards. Given the importance of financial disclosure a key element of international disclosure standards will be to develop

14/ (Footnote continued)

SEC v. Ralston Purina, 346 U.S. 119 (1953). Indeed, it has been suggested that the variety of analyses used to determine when there has been a public distribution all boil down to a consideration of whether in a particular case the persons to whom securities were sold needed the protections of the Securities Act. See Quinn, "Redefining 'Public Offering or Distribution' for Today" (November 22, 1986) (Address to the Federal Regulation of Securities Committee of the American Bar Association Section of Corporation, Banking, and Business Law). This notion underlies the accredited investor provisions of our laws and rules, see, e.g., Section 4(6) of the Securities Act and Regulation D under the Securities Act, 17 CFR 230.501 et seq. This concept also has been suggested as justification for ideas in the international context such as a free trade zone for institutional investors. See Summary of SEC, February 17, 1987, Roundtable on Internationalization; and Remarks of L. Quinn, Director, Division of Corporation Finance, SEC, at September Practising Law Institute seminar, reported in BNA Securities Regulation Law Report, Vol. 19, No. 37, p. 1444 (September 18, 1987).

15/ By relying principally upon disclosure, our federal statutory structure also easily accommodates new product development, as can most dramatically be seen in the successful introduction of new options products in the 1970s and early 1980s.

mutually acceptable international accounting and auditing standards. 16/

A second essential principle that underlies U.S. markets is an extensive antifraud system. Our laws prohibit fraud, including insider trading, market misrepresentations, 17/ and market manipulation. 18/ Development of international antifraud and manipulation standards should be an important near term goal. 19/

Third, the public availability of current price and quotation information for the major listed and over-the-counter equity securities has become an important part of our markets, a result in part due to regulatory requirements. 20/ The availability of

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- 16/ The International Organization of Securities Commissions ("IOSC") recently adopted recommendations calling for exchange among regulators of information on prospectus, interim reports and continuous disclosure requirements; an examination of practical means of promoting the use of common standards in accounting and auditing principles; and consideration of a study on responsibility for information disseminated in the prospectus or through other means in view of the increasing number of multi-national issues, within the framework of reciprocity. See BNA Securities Regulation and Law Report, Vol. 19, No. 37, at 1399 (September 18, 1987).
- 17/ See Rule 10b-5 and Rule 14e-3 under the Securities Exchange Act, 17 CFR §240.10b-5 and 14e-3.
- 18/ See, e.g., Sections 9 and 10(b) of the Securities Exchange Act.
- 19/ The IOSC recently resolved to "identify the main types of offenses against the principles of fair securities markets." See BNA Securities Regulation and Law Report, Vol. 19, No. 37, at 1400 (September 18, 1987).
- 20/ The national market system goals codified in 1975 established among other things the availability of composite (i.e. all markets) quotation and price information as an important

(Footnote continued)

price and quotation information has contributed directly to the depth and liquidity of our equity markets. 21/ Moreover, the availability of this information has produced at least one major additional benefit by helping to make prices in the options markets more reliable and efficient. 22/ Options markets in turn have contributed to the efficiency of our equity markets. 23/ Based upon this experience, the widespread availability of market information, like the disclosure and antifraud standards, seems to be an obvious candidate for global assimilation.

20/ (Footnote continued)

regulatory consideration. See Section 11A(a)(1)(C)(iii), 11A(b)(5) and 11A(c)(B) and (D) of the Securities Exchange Act. Commission rules and SRO plans have effectuated these goals. See, e.g., Rules 11Aa3-1 and 11Ac1-1 under the Securities Exchange Act, 17 CFR §240.11Aa3-1 and c1-1 (Transaction Reporting and Quote Rules); and the Consolidated Transaction Association, Consolidated Quotation System and NASDAQ/NMS Transaction Reporting Plans.

21/ Our laws also require that the markets that collect this information from their members must make it available to vendors on fair and reasonable terms, thus promoting vendor competition both in the dissemination and display of information as well as in the development of execution systems. See e.g. Section 11A(c)(1)(C) of the Securities Exchange Act; and National Association of Securities Dealers v. Securities and Exchange Commission, 804 F. 2d. 1415 (D.C. Cir. 1986)[National Association of Securities Dealer's ("NASD") vendor subscriber fees must be cost-based].

22/ See Securities Exchange Act Release No. 22026 (May 8, 1985) 50 FR 20310.

23/ See A Study of the Effects on the Economy of Trading in Futures and Options, Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission and Securities and Exchange Commission (December 1984).

Fourth, an important corollary for a sound national market in the United States has been the development of a national system for clearance and settlement of securities. Our Congressional mandate in this area recognizes the need for prompt and accurate procedures for clearance and settlement of securities transactions. It recognizes that new data processing techniques create opportunities for more efficient clearance and settlement, as well as the desirability of linking clearance and settlement facilities. 24/ Although Congress has required regulation and supervision of clearing agencies, I believe strong economic forces would have moved the securities industry toward efficient clearance and settlement systems even without regulation. The back office problems in the United States in the late 1960's had severe repercussions for our securities industry. The lack of satisfactory international clearance and settlement systems presents a disturbing parallel to our experiences. The United States' systems offer another area in which our domestic regulation and current environment can serve as international models.

Fifth, our broker-dealers are regulated in many ways. They must register with the Commission, which enforces specified

24/ See Section 17A(a)(1)(A), (C) and (D) of the Securities Exchange Act.

statutory disqualifications 25/ and enacts rules guiding broker-dealer conduct. 26/ The stock exchanges and the National Association of Securities Dealers also regulate broker-dealers as members of their self-regulatory organizations. Their rules supplement and expand those of the Commission. 27/ Moreover, under our federal statutory structure the responsibility for enforcement of the federal securities laws requirements and those of the self-regulatory organizations falls first on the broker-dealers themselves, and then upon the self regulatory organizations with SEC oversight acting as the "shotgun behind the door." 28/ These provisions, too, merit review by all countries participating in the international markets.

Sixth, the financial integrity of firms is an important part of our regulations. Our securities laws provide for the financial soundness of broker-dealers by requiring, among other things, the segregation of customer funds and minimum levels of net capital. 29

25/ See Section 15(b)(4) of the Securities Exchange Act.

26/ See, e.g., the rules promulgated under Section 15(c)(1) and (2) of the Securities Exchange Act.

27/ Regarding customer protection, see NASD Rules of Fair Practice, Article III, Section (I), CCH ¶2151; and New York Stock Exchange Rule 476(a)(6); CCH ¶2476 (just and equitable principles of trade).

28/ W. Douglas, Democracy in Finance (Allen Ed.) (1940), at 82.

29/ See, e.g., Rules 15c3-1 and 3-3 under the Securities Exchange Act, 17 CFR §240.15c3-1 and 3-3.

These rules contribute in a fundamental way to the efficiency of our markets by increasing investor confidence and preventing disruptions in broker-dealer services. Such fundamental financial integrity protections are increasingly important in an international environment in light of the multinational operations of many firms and the potentially global domino effects of a firm failure. 30/

Seventh, a large and critical component of our system is a strong surveillance and enforcement system. 31/ Through cooperation between our exchanges, the NASD, and the Commission, our markets enjoy the most sophisticated, automated surveillance in the world. Coupled with a strong enforcement program, this surveillance has contributed to the vitality of our markets by increasing investor confidence and participation. As many have noted previously, 32/ strong surveillance and enforcement systems are also critical in an international environment.

30/ The recent joint proposal by the Bank of England, U.S. Office of the Comptroller of the Currency and Federal Reserve Board to create common minimum capital requirements for banks and bank holding companies, 52 FR 5119 and 18703 (February 19 and May 19, 1987), illustrates cooperation between governments that can enhance global regulation of financial markets.

31/ See, e.g., Sections 6(b)(2) and 15A(b)(2) of the Securities Exchange Act.

32/ See J. Shad, "International Securities Markets, Benefits and Challenges" (July 16, 1986) (Address to the XI Annual Conference of the International Organization of Securities Commissions).

We must continue to develop bilateral or multilateral surveillance and enforcement arrangements that are effective but are also sensitive to national sovereignty concerns. 33/ The agreements the United States has worked out with the United Kingdom, Japan, Switzerland, and others are good beginnings, but must be tested by actual use and must be expanded to include other markets. Ultimately it also may be desirable for the markets to create an International Intermarket Surveillance Group along the lines of the Intermarket Surveillance Group recently formed in the United States.

In summary, based in large part upon their soundness and success in U.S. markets, I believe the following regulatory principles will prove fundamental to the success of markets throughout the world as they seek to adapt to internationalization in the coming years:

- (1) Minimum disclosure, auditing and accounting standards;
- (2) Minimum market fairness, antifraud, and manipulation principles;
- (3) The widespread availability of current market information, especially regarding major world-class equities;

33/ The IOISC recently recommended adoption of bilateral or multilateral agreements that allow regulatory authorities to exchange information in a flexible manner and in a spirit of trust, understanding and reciprocity. BNA Securities Regulation & Law Report, Vol. 19, No. 37, at 1400 (September 18, 1987). To augment its ability to cooperate in this area, the Commission staff is drafting legislation that would empower the Commission to compel testimony or the production of documents on behalf of a foreign securities authority.

- (4) Safe and efficient international clearance and settlement systems;
- (5) Adequate broker-dealer registration, qualification, and conduct requirements;
- (6) The financial integrity of multi-national firms; and
- (7) International market surveillance and mutual assistance in conducting enforcement investigations.

My emphasis on a sound regulatory environment as a predicate for sound international markets does not reflect a lack of concern for creation of competitive markets. Indeed competition is a strong focus on our securities laws. In addition to imposing regulatory requirements our laws also mandate the consideration of the competitive impact of regulatory actions and proposals, 34/ as well as prohibiting fixed minimum commission rates. 35/ By seeking competition our laws reflect attitudes important to the international environment. I believe the institutional nature of international markets promotes negotiated commissions and that a fixed commission rate structure will be incompatible with survival in an international environment in which open and competitive markets are likely to be the most efficient. Additionally, as suggested earlier, the increasing international competition between dealer and exchange trading systems indicates that international regulatory structures most probably must countenance both systems and allow competition to determine market structure.

34/ See Sections 6(b)(8), 15A(b)(8) and 23(a) of the Securities Exchange Act.

35/ See Sections 6(e) and 15A(b)(6) of the Securities Exchange Act.

If our prehistoric fish had heard these remarks, that fish might accept the need for sound international market regulation, but it would also advocate the need for regulatory adaptation. I agree.

To compete in an international high-technology environment the Commission believes it must both maintain a sound regulatory system and be alert to the need for creative, adaptive change. Consistent with this approach, the Commission and its staff already have taken several forward-looking steps including, most recently: (1) the approval of international trading, quotation and clearance and settlement links; 36/ (2) no-action relief permitting U.S. institutional direct participation in certain unregistered foreign offerings; 37/ (3) the approval of waivers of certain listing standards for foreign issuers by the New York and American Stock Exchanges and the NASD; 38/ and (4) the grant of an exemption from Rule 10b-6 for U.S. affiliated U.K. market makers during international offerings conducted in part in the U.S. 39/ The Commission also has indicated its willingness to

36/ See SEC Staff Study, Chapter V.

37/ See letters from William E. Morley, Chief Counsel, Division of Corporation Finance, SEC, to College Retirement Equities Fund, February 18 and April 17, 1987.

38/ See Securities Exchange Act Release Nos. 24633 and 24634 (June 23, 1987) 52 FR 24230 and 24232.

39/ See letter from Richard Ketchum, Director, Division of Market Regulation, SEC, to Dan Sheridan, Assistant Director, Policy and Markets, International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, dated September 29, 1987.

consider other creative ideas, including reciprocal or common prospectuses for international offerings, 40/ and has entertained discussions of a marketplace for trading unregistered foreign securities by certain large sophisticated institutions under a so-called "Rule 144A" approach. 41/

In sum, the key to sound international capital markets is to adapt existing rules and policies to the environment without jettisoning the bedrock investor protections that continue to be essential to market fairness and efficiency. I believe the U.S. securities regulation system not only will survive but will also serve as a model for evolving global regulatory standards. Hopefully fair and strong international markets will continue to grow and will be adapted in a manner that will make our pre-historic fish extremely proud.

40/ See Securities Act Release No. 6568 (February 28, 1985). The staff of the Commission has indicated that the reciprocal prospectus approach is under active consideration.

41/ See supra, note 14.