REMARKS OF

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CROSS-BORDER ACCESS OF ELECTRONIC SYSTEMS: AN SEC PERSPECTIVE

FEDERATION INTERNATIONALE DES BOURSES DE VALEURS/
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We've come a long way since the days of Paul Reuter, who used carrier pigeons to send market data between Brussels and Aachen, across a gap in Europe's young telegraph system.[1] Two hundred years ago, the U.S. securities markets consisted of a group of men -- gathered under the shade of a buttonwood tree on Wall Street -- who traded face-to-face, recording their trades with pen and paper. The old buttonwood tree is gone now, and so are most of the pens and paper. Today's markets are highly automated, and participants no longer need to be present at a centralized location to effect trades.

Much of the change has come in the last 20 years, when enormous strides in telecommunications and computer technology have caused an upheaval as great as the Industrial Revolution caused in the last century. Advances in computer technology have made possible rapid information dissemination, which, in turn, has made possible increases in market efficiency, speed, and accuracy that were only dreamed of ten years ago.

Along with these truly remarkable benefits, however, have come some fairly tough questions for regulators, and, I suspect, for a market participant or two. Not least among them is how to regulate wholly automated trading systems for which domestic borders present only political -- and not physical -- limitations. Because these automated systems allow geographically dispersed participants to trade directly with one another, the time and space limitations that used to characterize markets have vanished. For these reasons, regulators constantly struggle with the question of how far and deep to cast their regulatory nets. Defining -- or more precisely, regulating -- a market within a computer network has been a challenge for several generations of regulators.

The debate over the appropriate regulatory scheme is first and foremost about investor protection, or perhaps more broadly, market integrity. All national regulators have a responsibility to maintain investor protection in their countries; however that may be defined under relevant law. But, the debate is also about investor opportunity.

Today, investors are increasingly searching to diversify their portfolios with investments in foreign companies. In many cases, they have little choice but to go to the foreign market to make such investments often at a much higher cost and inconvenience than home country transactions.

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1 The Soul of a Reuters Machine, Forbes (October 30, 1989) at 148.

Cross-border trading of financial instruments is now growing at a faster rate than domestic trading as the demand for foreign investments continues to grow exponentially. The evidence of that is irrefutable. Foreign companies from all over the world have raised more than $66 billion in capital in U.S. public and private markets in 1992, compared with $48 billion in 1991 and $34 billion in 1990. To date, 529 foreign companies have become reporting companies under the Securities Act of 1933.

And last year, U.S. investors purchased and sold a record high of $270.9 billion of foreign equities in markets throughout the world. Investors around the globe now trade $1.1 trillion in foreign equity markets. That's 11% of all equity trading around the world on a daily basis.

If U.S. investors are seeking out these investments, doesn't it make sense for U.S. regulators to find a way to allow them to make these investments within the borders of the United States, where they are accustomed to the regulatory scheme and where they understand the investor protections they are provided? Of course it does. Unfortunately, there is no clear path to achieving that goal. But I assure you that a healthy debate rages.

The SEC's historic position has been that any securities market or broker-dealer or proprietary trading system that wanted to operate in the United States could do so on a level playing field with U.S. participants -- in other words, national treatment. For example, a foreign exchange or automated quotation system similar to NASDAQ would have to register as an exchange, or conceivably as a securities association, to operate in the United States. Of course, the question arises as to what constitutes "operation" in the United States and I have no clear answer to that question. It's something we're very much struggling with right now.

Before we examine the appropriate regulatory structure for foreign electronic systems in the United States, however, I want to spend a little time on how we regulate domestic systems. Our current regulatory structure is based on three categories of systems: (1) exchanges and automated quotation systems such as NASDAQ; (2) proprietary trading systems; and (3) low-volume exchanges, which the SEC exempts from traditional exchange regulations.

As I mentioned earlier, entities in the first category -- exchanges and associations -- are subject to a comprehensive regulatory scheme that is designed to ensure the integrity of the markets and to ensure adequate investor protection. Exchange registration and its attendant self-regulatory responsibilities are some of the linchpins of the SEC's oversight of the trading markets. Whether an entity is an exchange and, if so, how it carries out its responsibilities are questions of paramount importance.

Registration as an exchange or securities association brings with it benefits, such as the ability to sell quote and trade data, but it also entails significant costs in the form of a comprehensive regulatory scheme. Exchanges and associations are required to obtain SEC approval of any changes in their operations. In addition, our law requires that they provide equal access to and fair representation of anyone qualified to be a member. Finally, exchanges and associations have substantial market oversight and enforcement responsibilities.

The second category I mentioned earlier is proprietary trading systems, which are subject to more flexible regulatory requirements than exchanges and securities associations are. As a practical matter, the SEC has determined that proprietary trading systems are not "exchanges," as that term is used in our statute. That's primarily because they do not provide customers an expectation that they will be able to regularly execute transactions at the quotes displayed in the system.

Typically, theme trading systems seek an informal SEC staff blessing of their operations through what we call "no-action" letters. These are letters issued by the Division of Market Regulation that assure the recipient that the Division will not recommend enforcement action against the system if it operates without registering with the SEC.

The Commission struggled long and hard in determining how to regulate this new type of trading system. Trying to squeeze this round peg into the square regulatory hole of exchange or securities association registration was unsatisfying. Giving it carte blanche to operate with no SEC oversight was more unsatisfying.

Out of that grew the practice of issuing so-called "no-action" letters. The no-action process allows the staff to comprehensively review the proprietary trading systems' proposed operations, including the securities it will trade, how it will admit participants, and that the system has the adequate capacity and operational capabilities. After the no-action letter is issued, the SEC monitors the system's activity through periodic reports on volume and participant changes, and requires 30-day advance notice of any material changes to the system.

Although this process is flexible and more streamlined than filing a registration as an exchange or association, it also raises concerns about whether a level playing field exists between registered market operators and unregistered proprietary trading system operators.

Concerned observers raise three primary issues: first, that the approval process for systems or product changes that registered entities must adhere to is far slower and more expensive than the notice requirement that generally applies to proprietary trading systems; second, that proprietary trading systems have no market oversight and enforcement responsibilities, nor do they share in the costs incurred by the exchanges and NASDAQ; and third, that proprietary trading systems can choose their customers and the type of business they will conduct with them, allowing them to "skim the cream" and leave the more expensive trades to the exchanges and NASDAQ.

Recognizing the limitations of the no-action process, the SEC proposed a rule four years ago, Rule 15c2-10, to formalize the approval and oversight of proprietary trading systems. Among other things, the rule would require that proprietary trading systems file a description with the SEC, file periodic reports with the SEC, permit the SEC to conduct examinations of the system and supervise the system to ensure compliance with the federal securities laws.

The limited requirements of proposed Rule 15c2-10 are intended to provide the SEC with an effective means of monitoring the activities of proprietary trading systems to assure that they are complying with the federal securities laws, and that investors who use these systems are adequately protected. At the same time, the SEC recognized that subjecting proprietary trading systems to registration requirements along the lines of exchange regulation would substantially deter development of innovative trading systems. Proposed Rule 15c2-10 is intended to strike the middle ground by providing the SEC with an unobtrusive means of overseeing the activities of proprietary systems.

The SEC has not yet taken final action on the proposal. Because of the concern raised by the exchanges and the NASD that proprietary trading systems may enjoy an unfair competitive advantage over the exchanges and NASDAQ because of the regulatory scheme, the SEC incorporated these issues in the Division of Market Regulation's Market 2000 study.

The Market 2000 Study is intended to be a comprehensive study of numerous structural and competitive issues that currently face the equity markets. The purpose of Market 2000 is to resolve some of the nagging issues that have slowed progress in the markets over the last few years. The goal of the study is to position the U.S. markets to meet the international competitive battles of the next century.

Among other things, the study will look at whether regulatory burdens are fairly allocated among market and trading system operators. So, it provides a perfect opportunity to address the question of what regulatory burdens proprietary trading systems should bear.

Also as part of Market 2000, the SEC will re-examine the third category of regulated entity I referred to earlier: low-volume, exempt exchanges. Three years ago, Steve Wunsch approached the Commission for approval to operate a single-price auction system. The Wunsch Auction System, now the Arizona Stock Exchange, seemed to clearly fit the definition of "exchange," as the SEC has interpreted that term. Nevertheless, from Wunsch's perspective it was neither necessary nor appropriate to regulate the system as an exchange.

After preliminary discussions with SEC staff, Wunsch applied for an exemption from the exchange registration requirement on the basis that it was likely to attract limited volume, at least in its initial years. Under our law, low volume is the basis upon which the SEC can exempt an exchange from the registration requirements. The Commission granted the exemption but imposed a number of conditions, including continued low volume on the exchange.

The Arizona Stock Exchange is currently the only exchange that is exempt from the registration requirements. And the usefulness of the exemption -- for both domestic and foreign exchanges -- may be limited because the volume threshold is very low. One possible approach the Commission may consider is to base a low-volume exemption on U.S. volume only.

Those are the issues that we are struggling with domestically in terms of regulating electronic markets. Fitting systems into our current regulatory structure is getting increasingly difficult. The fit is even more difficult for foreign electronic systems.

As I mentioned at the outset, the SEC's current approach is to apply national treatment to any foreign system that seeks to do business in the United States. In other words, a foreign exchange or a foreign proprietary trading system may enter U.S. markets on an equal footing with its U.S. counterparts.

This has significant limitations for the foreign operator, however, and may not be entirely necessary to protect U.S. investors. The SEC acknowledged as much in a paper presented to IOSCO in 1991.[2]

Registration is an expensive and time consuming process and the costs could very easily outweigh the benefits of tapping into the U.S. capital base. At the very least, requiring U.S. registration for an entity already regulated in its home country could result in overlapping requirements. After all, even the most ideologically attuned regulatory schemes often impose duplicative or conflicting requirements. If the foreign exchange is regulated under a regulatory scheme that affords protection similar to that provided by the U.S., and if there is an effective information sharing and investigative assistance agreement, then it may not be necessary to require the same form of registration as is required for a domestic exchange.

Some of my co-panelists this afternoon have suggested that the SEC should adopt the opposite approach and rely entirely on home country regulation of foreign systems.

I think that the answer lies somewhere between these two extremes. In the SEC's request for comment on proposed Rule 15c2-10 there are references to the unsatisfactory situation that the current regulatory structure presents for foreign exchanges. It is possible that the SEC may adapt the proprietary trading system model for foreign exchanges.

The difficulty with that approach is that it is premised on the fact that proprietary trading systems are not "exchanges," as defined in our law. Many, if not all, foreign exchanges, however, would probably meet the definition and, as I mentioned earlier, our law offers us only a little flexibility in exempting an exchange from registration.

That leaves one other option: a rule applicable specifically to foreign exchanges, perhaps similar to the U.K.'s recognized investment exchange, which relies on home country regulation. Such a rule would require legislation from the U.S. Congress, however.

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[2] Division of Market Regulation, Automated Securities Trading: A Discussion of Selected Critical Issues, (Sep. 26, 1991), at 8.

With respect to foreign proprietary trading systems, again the U.S. approach is one of national treatment. Of course, because the requirements imposed on proprietary trading systems are far less burdensome than exchange registration, that's not as problematic. Nevertheless, we have not resolved the issue on the domestic front, so it's hard to predict today what the outcome will be for foreign systems.

IOSCO's Technical Committee Working Party No. 2 has been discussing regulation of cross-border proprietary trading systems for the last few years. In addition to the approach reflected in the SEC's proposed proprietary trading system rule, two other approaches have emerged.

It's too early to predict what the final outcome of the IOSCO debate will be. The SEC's Market 2000 study will shed light on some of these issues. I suspect that the SEC, as a next step after Market 2000, will seek more specific comment on how to address these issues, particularly on how to deal with foreign exchanges that wish to operate in the United States.

Before we can resolve the question of foreign trading system registration, however, there are significant collateral issues that must be resolved. The first is the issue of broker-dealer registration of foreign broker-dealers whose quotations are displayed in the United States through the foreign system.

Except under some limited circumstances, current law would generally require such a registration. In addition, there's the thorny issue of foreign security registration. The U.S. exchanges see this as one of the most important competitive issues they face today. And few issues have been as incendiary as this one has been in the last few years. Any resolution of how to regulate cross-border trading systems will require a resolution of foreign security registration first.

Conclusion

Cross-border trading and access to international investments is increasingly an important priority for American investors. My goal is to see that the SEC does everything in its power to allow them to fill that demand in the United States. To meet this goal, It seems that we must find workable solutions to the access issues that I have raised this afternoon.

There are no clear answers at this time, primarily because our domestic regulatory scheme is under review with regard to these issues. I fully expect the Commission to come to some resolution of these issues in the near future. To maintain U.S. competitiveness, we must find answers.