"A SECURITIES REGULATORY PERSPECTIVE ON EC '92 AND THE SINGLE EUROPEAN MARKET"

ADDRESS OF JAMES R. DOTY,*
GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION,

TO THE
AMERICAN BAR ASSOCIATION
SECTION OF INTERNATIONAL LAW AND PRACTICE
AND
SECTION OF BUSINESS LAW

1990 ANNUAL MEETING
CHICAGO, ILLINOIS

SPECIAL PRESIDENTIAL SHOWCASE PROGRAM
* * *
1992 AND THE SINGLE EUROPEAN MARKET

PART I: MARKET ACCESS IN THE EUROPEAN COMMUNITY

AUGUST 5, 1990

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I. INTRODUCTION

I appreciate the opportunity to appear on this distinguished panel and to comment on the securities regulatory implications of recent developments in the international capital markets, particularly the evolution of the EC's internal market program. Inviting a securities lawyer into a discussion of international trade issues is a bit like installing lights at Wrigley Field: you may illuminate some arcane corners of the subject, but you also risk taking much of the romance out of the game.

Before beginning, I should remind the audience that my remarks reflect my views and not necessarily the views of the Commission or my colleagues on the staff of the Commission.

The securities regulatory perspective on EC '92 and the Single European Market, I believe, very largely turns upon the

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answers to two complex issues. First, there is the serious question of how much and how rapidly our regulatory system can or should change in response to the increasing importance of cross-border capital movements and the economic integration of Europe. Second, there is a related issue of whether, in regulating international capital movements and the transnational migration of financial services firms, the appropriate legal standard will be "national treatment", "reciprocal treatment", or something else.

In what follows, I will touch briefly on those two issues, and then talk about what the Commission has been doing to develop and implement positions on them. Then I will offer some thoughts on where the rules applicable to financial firms and markets in the U.S. seem to be intersecting with EC '92.

II. IMPORTANCE OF CROSS-BORDER CAPITAL MOVEMENTS

Impressive as it is, the EC's program to develop an internal market for industrial goods and services is no more important than its plan to facilitate the free flow of capital across national boundaries. This suggests that the planners of EC '92 believe that the development of a global market in goods and services will, in large part, depend upon more fluid cross-border capital movements. And, in our own country, there is a growing consensus that investors should have the opportunity to invest in securities that provide a greater rate of return than domestic securities, or that will allow investors to achieve greater portfolio diversification.

The quantification of this phenomenon of internationalization of the securities markets, seen over a ten-year period, is arresting. In the 1980's, foreign investors' purchases and sales of U.S. securities (predominantly government securities) grew from $198 billion to $4.7 trillion. U.S. investors' activity in foreign stocks increased by a multiple of eight. In 1980, the U.S. equity market was four times larger than its nearest competitor. By the end of 1989, the markets of the United States, Japan and the European Community were almost equivalent in size. As these comparisons indicate, the U.S. securities markets and U.S. securities exchanges no longer enjoy the position of competitive dominance they once did. Nevertheless, and of importance for the "national treatment" discussion which follows, it should be remembered that currently eleven of the largest 25 securities firms in the world are American.

These developments have not gone forward unnoticed by the Commission and its Congressional oversight committees and, in July 1987, there appeared a thick volume, Internationalization of the Securities Markets, 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). This was followed, in November 1988, with a Commission Policy Statement on "Regulation of International Securities Markets". 2/ The Policy Statement

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2/ Reprinted as International Rel. No. 1, 43 SEC Dkt. 128 (Mar. 28, 1989).

focused on three features of an effective regulatory structure for an international securities market system: (1) efficient market structures for pricing, clearance and settlement and strong capital adequacy standards; (2) sound disclosure systems and listing standards that provide investor protection yet balance costs and benefits; and (3) fair and honest markets (enforcement cooperation). The Policy Statement is both a manifesto and a concise statement of the problems which now confront us: that is, how to ease restraints and remove impediments to capital formation, while preserving adequate protection for investors. A number of the Commission's recent regulatory initiatives are foreshadowed there.

Most recently, nations with emerging economies, such as those in Central Europe, also have recognized that economic growth depends upon the development of efficient capital markets. Hungary has reopened the Budapest Stock Exchange, which had been closed for 48 years, and the other nations of Central and Eastern Europe may soon follow. To respond to the requests for technical assistance that are coming in from these developing capital markets, Chairman Breeden has formed an Emerging Markets Advisory Committee, composed of leading figures in the U.S. financial industry, to assist the Commission in helping in the task of structuring efficient, safe systems in countries with emerging markets. It is indicative of the significance of the times in which we live that our country is called upon to do this and, at

the same time, devise the financial services structures that will maintain our own competitiveness.

III. NATIONAL TREATMENT

National treatment, I suggest, is a kind of benchmark, from which we can measure the steps taken to remove impediments to the flow of capital to our own markets and exchanges, while protecting the goals of our regulatory system -- i.e., structural efficiency and stability, adequacy of disclosure, and integrity and honesty in market practices. In terms of preserving these purposes, a position full of controversy, but one held firmly in this quarter, is that international capital movements can best be regulated by a system of national treatment. Each country should treat foreign financial firms on no worse terms than domestic firms. Indeed, as I will discuss below, the United States may really provide "national treatment plus" in our securities regulation with accommodations we make for foreign participants. This system of national treatment or "national treatment plus" generally ensures that firms are not subject to U.S. regulation that discriminates unnecessarily. As a rule of law, or governing principle, the national treatment standard permits regulators to promulgate their rules without undue consideration of unrelated issues, such as the treatment domestic firms receive abroad.

Reciprocal treatment, on the other hand, by which I mean the regulation of foreign firms in a manner that is principally intended to afford parity with the foreign treatment of domestic firms, is apt to impose artificial barriers that discriminate

against foreign service providers and discourage international competition. Reciprocal treatment requires that regulators divert their attention from the goals of the Policy Statement -- market efficiency and stability, disclosure and integrity -- to matters of international reciprocity. Reciprocal treatment tends to discriminate against foreign firms without necessarily providing adequate prudential regulation.

National treatment is, therefore, a principled position, by which the priorities of securities regulation are correctly ordered and from which we should proceed in disciplined and cohesive fashion to consider the ways in which we can harmonize our laws in the interest of removing impediments to capital formation. 3/

IV. NATIONAL TREATMENT AND THE FEDERAL SECURITIES LAWS

As I mentioned before, the U.S. securities laws may be described as providing "national treatment plus". Those laws generally treat foreign firms at least as well as domestic firms and, in some important respects, provide special accommodations to foreign firms.

These accommodations have involved both some highly technical adjustments in the operation of our rules, and some fairly fundamental decisions about what should be required of foreign persons. The techniques employed by the Commission have

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3/ This does, of course, mean that what results should be truly "national treatment", and should not be impaired by unnecessary internal legal barriers.

all been designed to assure both foreign participants and domestic investors that our markets are fair and efficient.

A. Foreign Broker-Dealers: Rule 15a-6

The regulation of foreign broker-dealers is an excellent example of how "national treatment plus" has worked. Last year, the Commission adopted Rule 15a-6 under the Securities Exchange Act of 1934, which exempts certain foreign broker-dealers that engage in U.S. securities activities from the Exchange Act's registration requirements. 4/

Rule 15a-6 reflects a territorial approach to broker-dealer regulation. The Rule creates conditional exemptions from registration for foreign broker-dealers engaging in certain activities in the U.S.

The exemptions provided by Rule 15a-6 fall into three categories: (1) unsolicited transactions by a foreign broker-dealer with U.S. persons; (2) the provision of research to, and transactions arranged by a foreign broker-dealer with, a U.S. institutional investor or a major institutional investor where the trades are booked by a registered U.S. broker-dealer; and (3) trades effected by foreign broker-dealers with or for certain non-U.S. persons.

Now, Rule 15a-6 was not greeted with cheers and "huzzahs" all around. In fact, a lot of foreign firms and their counsel thought the Rule did not go nearly as far as it should have in

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4/ Securities Exchange Act Release No. 27017, 54 Fed. Reg. 30087 (July 11, 1989).

exempting such activities. Bear in mind, however, that this Rule permits substantial U.S. sales activities by the foreign broker, without the U.S. broker-participant having to obtain positive assurances that the foreign broker is operating in accordance with U.S. requirements -- such as the net capital rule, 15c3-1. The adopting release was accompanied by a concept release discussing an exemption from broker-dealer registration based on recognition of foreign regulation, among other things. 5/ Moreover, the rules of our two principal exchanges permit foreign-owned members. Although the number is unconfirmed, there may be 150 U.S. brokerage firms with substantial foreign ownership, with foreign persons owning controlling interests in approximately 80.

B. Foreign Investment Advisers

Foreign investment advisers also are subject to the same registration requirements as domestic investment advisers. Anyone who pays the $150 fee, completes a Form ADV, and is not disqualified by reason of prior convictions, injunctions, violations, or misstatements in Commission filings, generally may be registered with the Commission. 6/

C. Foreign Investment Companies

The area in which special regulatory action is necessary in order to provide national treatment is in the offer and sale of

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5/ Securities Exchange Act Release No. 27018, 54 Fed. Reg. 30087 (July 11, 1989).

6/ Investment Advisers Act Section 203; Investment Advisers Act Rule 203-1; Investment Advisers Act Rule 203-3.

investment company shares. In this area there will probably have to be either legislative change or treaty making to permit automatic national treatment.

1. Section 7(d)

Section 7(d) of the Investment Company Act of 1940 prohibits the offer and sale of foreign investment company shares. Section 7(d) does authorize the Commission to permit a foreign investment company to register and make a public offering of its securities "if the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company" and that the exemption is consistent with the public interest and the protection of investors. Rule 7d-1 under the Investment Company Act establishes minimum conditions for a Canadian company to obtain an exemptive order under Section 7(d).

Section 7(d) has been a difficult law to live with, and the undertakings, covenants and charter and by-law changes which have been employed under Rule 7d-1 have led to charges that we have tried to turn foreign firms into U.S. model firms. Of the 19 exemptive orders issued under Rule 7d-1, I understand that only about 4 of these foreign funds are still active. In effect, the Commission must find that investors in foreign investment companies have the same protections as investors in domestic investment companies. Most investment companies organized in

foreign jurisdictions do not provide the same protection to investors, even though they may provide comparable protection.

2. Mirror Funds

Despite Section 7(d), however, foreign money managers still can enter the U.S. investment company market. Section 7(d) does not prevent a foreign money manager from offering its services in the United States. A money manager may establish in the United States a "mirror fund", which maintains the same investment portfolio as its foreign counterpart. These mirror funds are subject to the same investment company regulation as funds established by domestic money managers. The Commission has commenced a study of investment company regulation. In connection with this study, the Commission has issued a release requesting comment on, among other things, the offer and sale of foreign investment company shares in the U.S. 7/

D. Other Commission Initiatives to Facilitate Cross-Border Capital Movements

The Commission has taken other regulatory initiatives that will facilitate the cross-border movement of securities while providing necessary prudential safeguards.

E. Regulation S and Rule 144A: Disclosure Adequacy

The Commission's regulatory initiatives over the past couple of years represent efforts both to implement general principles of disclosure adequacy and to harmonize national differences. In

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7/ Investment Company Act Release No. 17534, 55 Fed. Reg. 25322 (June 15, 1990).

April of this year, the Commission adopted Regulation S and Rule 144A under the Securities Act of 1933. 8/ Both of these initiatives should help facilitate the efforts of foreign issuers by providing greater guidance as to when the U.S. registration requirements will or will not apply.

Regulation S is designed to provide additional clarity and certainty as to the extraterritorial application of Section 5 of the Securities Act. It is based on a territorial approach to Section 5, and the principle that the registration requirements are intended to protect the U.S. markets and investors purchasing in U.S. markets, whether U.S. or foreign nationals. It provides generally that offers and sales that occur outside the U.S. are not subject to these requirements. The Regulation also provides two safe harbors for specified transactions.

Rule 144A provides a non-exclusive safe harbor exemption from Securities Act registration for resales of certain restricted securities to qualified institutional buyers. It is designed to achieve a more liquid and efficient institutional resale market for unregistered securities. While it is not directed solely at foreign issuers, the Rule may have significant implications for them. Foreign issuers who wish to participate in our markets, but have been reluctant to undertake the

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8/ Securities Act Release No. 6863, 55 Fed. Reg. 18306 (April 24, 1990) (Regulation S); Securities Act Release No. 6862, 55 Fed. Reg. 17933 (April 23, 1990) (Rule 144A).

registration process, may now be encouraged to make greater use of the private placement market because of Rule 144A.

Another very important initiative involves the efforts of the U.S. and Canada to implement a multijurisdictional disclosure system. 9/ The Commission has proposed a multijurisdictional disclosure system that would permit certain Canadian issuers to register securities in the U.S. using disclosure documents prepared according to the requirements of Canadian authorities. At the same time, Canada has proposed a multijurisdictional disclosure system that would permit U.S. issuers to make offerings in Canada using disclosure documents prepared according to Commission requirements. This project directly responds to one of the major impediments to multinational offerings -- the need to comply with the disclosure requirements of two or more jurisdictions. It represents a first step towards meeting the needs of transnational securities offerings.

The Commission's proposed system would permit single-jurisdiction regulation of certain offerings and continuous reporting obligations, to encourage and allow cross-border offerings by large issuers to be made more efficiently and at less expense. The disclosure document for an offering would be prepared in accordance with the requirements of the issuer's home jurisdiction. The system would also be available for certain rights or exchange offers by a broader class of issuers, on the

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9/ See Securities Act Release No. 6841, 54 Fed. Reg. 32226 (July 24, 1989).

theory that it is in the interest of domestic investors to facilitate the registration of such offers to encourage foreign issuers to extend them to U.S. investors. In addition, the system would allow tender offer bidders to comply with the provisions of the Canadian tender offer laws, rather than the Williams Act, where a limited proportion of the target securities is held in the U.S.

And just recently, in June, the Commission issued a release seeking public comment generally on the concept of allowing the use of foreign tender offer documents in the U.S. where U.S. shareholders of a foreign target own only a small percentage of the target's shares. 10/ While foreign regulation might not provide all the protections of U.S. law, the release notes that in the absence of such an approach, foreign tender offerors might choose to exclude U.S. shareholders from the offer rather than submit to U.S. requirements. Therefore, it may be preferable to adopt a regulatory approach that allows U.S. shareholders to share in such investment opportunities. The release also seeks suggestions for other approaches to facilitate extension of cross-border tender and exchange offers into the U.S.

A fair amount has already been written about the complexity of those rules, and questioning whether the 144A market will achieve "lift-off." That, I suggest, misses the point. We do not yet know what the private placement secondary market that

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10/ Securities Act Release No. 6866, 55 Fed. Reg. 23751 (June 6, 1990).

develops under Rule 144A will look like, what its appetites or its physiognomy will be. It may take time for these to appear. These rules, in the meantime, are initiatives which move cautiously and prudently to extend the perimeter of "national treatment plus" -- that is, by preserving an information requirement for investor protection while, at the same time, accustoming foreign issuers and market participants to use our market system. The multijurisdictional disclosure release and tender offer concept release are also part of the process whereby we may determine how comfortable we can get with extending "national treatment plus" by recognizing the protections afforded our investors by foreign regulation and foreign securities laws.

IV. EUROPEAN RESPONSE

A. The Outlines of the Single Market

It is also the case that we can begin to see some of the implications of our approach. In Europe this most clearly can be found in the EC's insider trading directive. 11/ The Directive on Public Offer Prospectuses is the basis for a potential "single review" system for securities offerings. 12/ Another promising development is the EC's directive relating to undertakings for

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11/ Directive 89/592, Council Directive Coordinating Regulations on Insider Trading, O.J. Eur. Comm. (No. L 334/30) (Nov. 18, 1989).

12/ Directive 89/298, Council Directive Co-ordinating the Requirements for the Drawing-Up, Scrutiny and Distribution of the Prospectus to be Published When Transferable Securities are Offered to the Public, O.J. Eur. Comm. (No. L 124/8) (April 17, 1989).

collective investments in transferable securities ("UCITS"). 13/ Nevertheless, it is not clear that U.S. fund managers will find it easy to get a "European passport" to set up an EC-based UCIT since member states may retain some power to adopt rules governing advertising, selling and promotions.

B. Reciprocity or National Treatment in Investment Services

At the same time, we should be concerned about the possibility that, under these or similar directives, the EC will move toward a system of reciprocity rather than national treatment in investment services. The EC's Second Banking Directive, in the initial draft, would have required that the Commission "examine whether all credit institutions of the Community enjoy reciprocal treatment * * *." 14/ A draft EC Investment Services Directive, which would apply to the establishment of securities firms in the EC, similarly would require that the Commission "examine whether all Community investment firms enjoy reciprocal treatment * * *." 15/ If the U.S. suspends the license of a brokerage firm from a member

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13/ Directive 85/611, Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), O.J. Eur. Comm. (No. L 375/3) (Dec. 20, 1985).

14/ Proposed Directive 88/C84/01, Proposal for a Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, O.J. Eur. Comm. (No. C84/1) (submitted Feb. 23, 1988).

15/ Proposed Directive 89/C43/10, Proposal for a Council Directive on Investment Services in the Securities Field, O.J. Eur. Comm. (No. C43/7) (submitted Jan. 3, 1989).

state, there is potential for allegations of "non-reciprocal" treatment in challenging the U.S. standard employed by the Commission in its enforcement role.

The United States has, as I understand, opposed this reciprocal approach and, in April of last year, the EC Commission recommended, with respect to the Second Banking Directive, that the EC move to a scheme that closely approximates the national treatment standard favored by the United States. The Second Banking Directive, as amended, was adopted last December. 16/

We are encouraged by the decision to modify the Second Banking Directive, and we hope that the EC will continue to provide national treatment of non-EC firms.

C. Accounting Standards for Foreign Issuers

A continuing problem, and one that will tax the creativity of regulators for some time, is the difficulty of accommodating foreign issuers to our accounting standards. As you may know, the balance sheets of many of the largest publicly-held companies in Europe do not disclose large reserves. One problem which these so-called hidden reserves pose is, of course, in the case of a "reserve reversal", when capital is taken out of the reserve and put back into the income statement. I know of no issue which more dramatically illustrates the complexity of the problem of

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16/ Directive 89/646, Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, O.J. Eur. Comm. (No. L/386/1) (Dec. 15, 1989).

national treatment, and the tension between the regulatory requirements of our own system and the desire to facilitate the efficient cross-border movements of capital.

V. CONCLUSION

Our markets are both a practical and regulatory model to the world. In the timely delivery of information, in the efficient operation of markets in which well-capitalized firms intermediate, in the integrity and bounty of our markets, national treatment works. There is no "quality" edge in the European state of mind where our financial products and services are concerned. We must, in the attempt to harmonize our rules, take care to preserve the features of our financial services system which have made it the model of the world. In this endeavor the staff of the Commission will continue, as it always has, to seek a workable approach to the harmonization of law and practice.

Thank you.