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Charles C. Cox

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INTERNATIONALIZATION OF THE CAPITAL MARKETS: THE EXPERIENCE OF THE SECURITIES AND EXCHANGE COMMISSION

CHARLES C. COX*

I. INTRODUCTION

International capital markets are developing rapidly. Orders, payments and securities can now be transmitted from one market to an-

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* Commissioner, Securities and Exchange Commission. This is an edited version of a paper presented to the XI Annual Conference of the International Organization of Securities Commissions in Paris, France, on July 16, 1986. The views expressed are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff. Douglas C. Michael and Andrew E. Feldman, of the Commission staff, provided research assistance for this article.

other almost instantaneously. These developments in capital markets are only one part of the free flow of goods and services over national borders. The free flow of international capital promotes a more efficient allocation of resources by increasing the depth and liquidity of capital markets and by providing improved opportunities for corporate planning and investment decision making.

International securities trading benefits all market participants, corporations, investors, brokers, dealers and marketplaces. Corporations and other issuers of securities benefit because they can broaden their ownership bases by entering foreign markets. This promotes market stability and liquidity. A broad ownership base also may increase interest in that issuer's products, and facilitate foreign acquisitions. International investors benefit because they have new opportunities to diversify investment risks and to seek higher returns. Brokers and dealers benefit because they can broaden product lines offered to domestic customers and can attract new foreign customers and better service the needs of existing foreign customers. Finally, marketplaces benefit because transnational trading and clearing linkages can result in increased order flow for both markets, increased price efficiency, availability of more capital for market-making, improved trade clearances and settlement processing, and increased visibility.

Notwithstanding the enormous potential benefits for the global economy from the internationalization of capital markets, there are obstacles to internationalization. In addition to the direct obstacles to the free flow of capital such as taxes, exchange controls and investment controls, perhaps greater obstacles result from the cultural and historic differences in various national approaches to capital formation. Disclosure, auditing and accounting principles, trade processing, trade and quote dissemination, market surveillance and enforcement are all affected by such differences.

This paper discusses the benefits of and obstacles to internationalization of capital markets in three specific areas, as experienced by the United States Securities and Exchange Commission (SEC).[1] Part II addresses disclosure requirements for public offerings of securities in more than one country, and the recent SEC proposal on reciprocal and common prospectuses. Part III discusses the development of the inter-

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1. Since this paper was presented, the SEC staff has completed a detailed statistical and policy review of the world markets. *See* STAFF OF U.S. SECURITIES & EXCHANGE COMMISSION, REPORT TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMMITTEE ON ENERGY AND COMMERCE, INTERNATIONALIZATION OF THE SECURITIES MARKETS (Jul. 27, 1987) (hereinafter SEC STAFF REPORT).

national securities marketplace and recent initiatives, both by private industry and the SEC, to develop trading, information, clearing and settlement linkages. Part IV discusses market surveillance and international investigations as well as the methods which the SEC has developed for obtaining information from other nations about securities law violations which result in domestic harm. Part V concludes by examining implementation of the recommended actions and the International Organization of Securities Commissions' potential role in ensuring smooth internationalization. Each section concludes with recommendations.

II. INTERNATIONAL OFFERINGS

Raising capital in international markets is no longer the novelty it was only a few years ago. Since 1985 there has been an "explosion" in the global capital markets.[2] The total volume of outstanding U.S. commercial paper, U.S. bonds, Eurobonds and Euronotes was up sharply over 1985 levels; some individual volume levels have more than doubled since 1984. New issues of Eurobonds totaled a record $187 billion during 1986.[3] Innovation and diversification have produced traditional financial instruments in new currency denominations and have increased trading levels in equity securities and swaps.[4] It is estimated that 27 percent of non-dollar-denominated Eurobond offerings in the first nine months of 1986 were linked to currency swap transactions.[5]

Innovation in the capital markets must be paralleled by innovation in disclosure requirements. The SEC has been developing its disclosure system for international issuers to continue that development.

A. *Present Registration Procedure*

In 1979, the SEC began developing a disclosure system specifically for foreign private issuers offering and trading securities in the United

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2. *See* Crabbe, Grant and French, *The Euronote Explosion*, EUROMONEY, Nov. 1985, at 40; *SEC Staff Report*, *supra* note 1, at II-1 ("explosive growth" in debt markets).

3. SEC STAFF REPORT, *supra* note 1, at II-35.

4. There are two basic types of swaps. Currency swaps are agreements to exchange specific amounts of one currency for another and to re-exchange the currencies at a specific time in the future. The swaps are designed to occur at a predetermined rate of exchange. Interest rate swaps are agreements to exchange interest payment flows of different characters from an underlying principal. *See SEC Staff Report*, *supra* note 1, at G-2, G-5.

5. *Id.* at II-43 to II-45.

States with the adoption of Form 20-F.[6] This form lists the disclosure requirements for foreign companies whose securities are actively traded in the United States and who are subject to continuous disclosure requirements. In an attempt to harmonize the disclosure requirements in the United States with the requirements most commonly found in foreign countries,[7] the SEC has made accommodations for foreign private issuers.

An integrated disclosure system for foreign issuers, similar to the system for domestic issuers, was first adopted in 1982.[8] This system — Forms F-1, F-2, F-3 and F-4 — generally requires the same information as Form 20-F, and permits issuers to meet some disclosure obligations by referring to previous filings, known as incorporation by reference.[9]

B. *The Multinational Offerings Release*

In March 1985 the SEC issued a release entitled "Facilitation of Multinational Securities Offerings."[10] The release requested public comment on ways to accommodate multinational offerings and to harmonize the prospectus disclosure standards and securities distribution systems of the United States, the United Kingdom and Canada.

The release discussed two possible ways to make multinational securities offerings: the reciprocal approach and the common prospectus approach. The reciprocal approach would result in an agreement by the three countries that a prospectus accepted in an issuer's domicile which meets certain standards would be accepted for offerings in each of the participating countries. The common prospectus approach would result in agreed disclosure standards for an offering document that could be used in two or more of the three countries.[11] Under either approach, the same liability standards would apply to foreign issuers and domestic issuers.

The release sought comment on these approaches, their impact in

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6. *See* Securities Exchange Act Release No. 16371, 44 Fed. Reg. 70,132 (1979).

7. In adopting Form 20-F, the Commission noted specific accommodations were made in disclosures on industry segments and management remuneration, filing schedules and translation of periodic reports. *Id.* at 70,133 & n.4.

8. Securities Act Release No. 6437, 47 Fed. Reg. 54,764 (1982)(Forms F-1, F-2 and F-3); Securities Act Release No. 6579, 50 Fed. Reg. 19,010 (1985) (Form F-4).

9. *See generally* SEC STAFF REPORT, *supra* note 1, at III-65 to III-71, for a discussion of disclosure requirements.

10. Securities Act Release No. 6568, 50 Fed. Reg. 9281 (1985).

11. *Id.* at 9283-84.

other areas, and the SEC's role in facilitating such offerings.[12] The United Kingdom and Canada were chosen for initial consideration in any possible experimental implementation because issuers from those countries frequently use the United States markets, and the disclosure and accounting requirements of those countries are more similar to United States requirements than those of other countries.[13]

C. *Response to the Release*

Seventy respondents commented on the release.[14] Some raised additional issues not mentioned in the release. A significant majority of the commentators strongly endorsed the SEC's initiative. Many indicated that the SEC was the logical entity to assume this leading role. Commentators stressed that the objective of removing barriers to multinational offerings should be balanced with the statutory mandate to protect United States investors. The opponents of the initiative were concerned with either the impact on domestic regulatory schemes, or the spread of United States disclosure standards to their domicile. The following paragraphs discuss the major points raised by the commentators.[15]

The Reciprocal Approach. The majority of respondents favored the reciprocal approach. One of the major advantages of the reciprocal approach appeared to be the ease of implementation. It was also suggested that the reciprocal system best respects the different customs, business conduct, and traditions of fairness and disclosure in each jurisdiction. Some believed the reciprocal system would result in lower costs by reducing United States printing fees, underwriters' "due diligence" expenses, and fees of experts such as lawyers and accountants.

There was some support for reciprocity without any additional disclosure. However, many respondents favored a modified reciprocal approach, based upon either a prospectus supplement to be used outside the issuer's domicile, or a domestic supplement to a foreign prospectus which would meet minimum disclosure standards.

The Common Prospectus Approach. Many respondents believed the common prospectus would be the ideal approach, although they

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12. *Id.* at 9284.

13. *Id.* at 9282-83.

14. The comments are available for public inspection in Commission Public File No. S7-9-85.

15. The following summary is drawn from DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION, SUMMARY OF COMMENTS ON CONCEPT RELEASE: FACILITATION OF MULTINATIONAL SECURITIES OFFERINGS (Jan. 10, 1986)(available in Commission Public File No. S7-9-85).

were skeptical about the prospects for achieving the necessary agreements in the near future.

Accounting Standards. Many commentators mentioned the difference in accounting standards in the three countries. Some asserted that compliance with international accounting standards would be an adequate safeguard, noting that present United States, United Kingdom and Canadian generally-accepted accounting principles are all in conformity with international accounting standards. Other commentators indicated that anything less than compliance with United States generally-accepted accounting principles and auditing standards could present problems with comparability and independence and could sanction the use of techniques such as hidden reserves. Many of these commentators recommended continuing the present requirement of reconciling statements to United States generally-accepted accounting principles.

Commentators were sharply divided on whether to require the full segment reporting now required for most public offerings in the United States. Half supported full segment reporting and the other half supported modified segment reporting requiring only disclosure of segment revenues with narrative discussion of segment income in certain circumstances.

Supplemental Disclosure. Some commentators felt there should be minimum disclosure standards or supplemental information in areas such as the description of business, management's discussion and analysis and risk factors. Most commentators endorsed the inclusion of a legend stating that the offering is made by a foreign issuer which has met the disclosure requirements of its own country but that such requirements are not necessarily comparable to those of the United States.

Impact of the SEC Review Process. Some commentators warned that the potential benefits of a reciprocal prospectus approach may be negated if the timing and nature of the SEC's registration statement examination and continuous reporting requirements are not modified. With respect to the timing of initial offerings, commentators pointed toward differences in the distribution system employed in the United Kingdom. United States "gun-jumping" rules prohibit pre-effective publicity in the United Kingdom. It is also difficult to coordinate effectiveness in the United States with the United Kingdom issuer's position in the Government Brokers Queue which mandates the date of effectiveness in the United Kingdom. Some of the suggestions in these areas recommended that the SEC staff pre-review filings on a confidential basis, or abstain from reviewing multinational filings and rely entirely on the review in the issuer's domicile. For periodic reporting, some commentators recommended that the SEC accept periodic reports filed

in the issuer's domicile as meeting United States periodic reporting requirements and proxy and tender offer rules.

Disproportionate Benefits. Some commentators believed that foreign issuers would benefit more than United States issuers from a reciprocal approach, since United States standards are stricter and more comprehensive than those of other countries. Other commentators, however, did not expect such a disproportionate benefit. Similarly, some commentators believed that United States issuers offering securities only in the United States would be at a competitive disadvantage, while others believed there would be no such effect. At least one person projected that multinational issuers would tend to comply substantially with United States disclosure standards under a reciprocal approach, in order to avoid any comparative disadvantage to their offering due to more limited disclosure.

Gradual Implementation. Many commentators indicated that the reciprocal system should initially be limited to "world-class" or "seasoned" issuers of investment-grade debt. World-class issuers would be defined by their assets, revenues, records of profitability, trading markets, or exchange listings.

Incorporation by Reference. The release sought comment on the possibility of incorporation by reference for reciprocal registration statements and access to the SEC's Electronic Data Gathering Analysis and Retrieval System (EDGAR). Commentators favored incorporation by reference with the qualification that repositories, such as regulatory agencies or stock exchanges, be required to house incorporated documents in each jurisdiction. Access to the EDGAR system was also enthusiastically endorsed. Commentators further suggested that reciprocal benefits for any foreign counterpart system should be assured and that other countries given access should be encouraged to contribute to the development costs of the EDGAR system.

D. *Other Initiatives*

The SEC is considering similar approaches in disclosures by mutual funds. A growing number of mutual funds are providing individuals with the opportunity to invest indirectly in foreign stocks. There were fifty-nine such funds at the end of 1986, seventeen more than in 1984 and nearly thirty more than in 1983.[16] In addition, United States funds are increasingly being sold to foreign investors. The SEC is considering a recent suggestion that the United States seek an agreement with the European Economic Community allowing reciprocal sales,

16. *See* SEC STAFF REPORT, *supra* note 1, at II-79.

similar to the existing arrangement among EEC members.[17]

E. *Recommendations*

The SEC hopes that this release, the response generated by it, and other initiatives will result in concrete proposals in the near future. Successful implementation, even on an experimental basis, would be a significant step toward harmonization of international disclosure standards. Initial success is important. As indicated above, any reciprocal or common prospectus system should be gradually implemented.

Governments should recognize that a growing number of companies are raising capital in foreign markets. Hence, they should be flexible in applying their disclosure regulations to foreign offerings, when possible and consistent with their own objectives.

Government representatives should continue to discuss ways of harmonizing disclosure standards and other regulations and practices dealing with the distribution of securities while protecting what each country believes to be necessary investor protections.

III. INTERNATIONAL TRADING

International securities trading markets are developing in tandem with international public securities offerings. Debt instruments, particularly Eurobonds, have been the most prominent elements in the international markets. Annual trading volume has increased four-fold over the last five years to an estimated $3.6 trillion.[18] There are also strong international markets for sovereign debt, most notably United States Treasury securities.[19] While debt has been the foremost element of the internationalization process, equity securities also are being traded increasingly on international markets. The stock of at least 410 major companies, including over 85 United States corporations, is traded actively in both the issuers' home market and at least one foreign market.[20] Foreign demand for United States equities remained high in 1985, with overseas investors effecting more than $277 billion in transactions on United States markets; United States investors during the

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17. *Id.* at VI-17.

18. *Id.* at II-52.

19. The Public Securities Association estimates that $3-$5 billion in U.S. treasury securities are traded daily outside the United States, with $1-$3 billion of that trading occurring in the United Kingdom. *See* Glynn, *A Day—and Night—in the Life of the Global Market*, INST'L INVESTOR, Apr. 1986, at 293.

20. *See Tapping Overseas Investors*, EUROMONEY, Jan. 1986, at 114; *see also The Corporate List*, EUROMONEY, May 1985, at 122.

same period traded more than $102 billion worth of foreign stocks.[21] United States institutions now hold more than $16 billion in foreign stocks, compared to about $2 billion in the late 1970's.[22]

A. *Present Trading Development*

An active market is developing among dealers away from organized stock exchanges to meet investors' demand for international trading opportunities. This trading is primarily by institutional investors and dealers for their own accounts. It involves international securities firms passing orders among their worldwide offices. Brokerage firms and banks are making markets around-the-clock in sovereign debt instruments, particularly United States Treasury securities, and are using international markets to execute interest rate and currency swaps. Global trading of equity securities is also developing, although the market is not as active as that for debt securities. International broker-dealers trade certain foreign equities around-the-clock. Generally, trading in United States equities remains concentrated in the United States securities markets, although intermittent trading in some issues occurs in Japan and Europe before the trading day begins in the United States.[23]

1. *Trading and Quotation Linkages*

Securities markets are developing linkages to accommodate international trading of equity securities and options. The American Stock Exchange (Amex) and Toronto Stock Exchange, and the Boston and Montreal Stock Exchanges are currently operating electronic trading linkages and coordinated market information systems. The Amex-Toronto link is the first between primary markets inside and outside the United States.[24] Trading through the Amex-Toronto linkage began in

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21. *See* SEC STAFF REPORT, *supra* note 1, at II-103 (aggregating purchases and sales).

22. *See* Feder, *Foreign Equities Gain Favor*, N.Y. Times, Jan. 3, 1986, at D1, col. 3. (current holdings of U.S. institutions); Kristoff, *World Financial Curbs Eased by Technology and Ideology*, N.Y. Times, Jan. 26, 1985, at 1, col. 2. (earlier holdings).

23. *See* Putka, *supra* note 20, at 24 (estimating that $100-$150 million worth of stocks of United States companies are traded daily in the London "upstairs" market). *See also* Sterngold, *Redrawing the Financial Map*, N.Y. Times, Apr. 1, 1986, at D1, col. 3. *See generally*, SEC STAFF REPORT, *supra* note 1, at V-19 to V-26 (discussing international equity markets).

24. *See* Securities Exchange Act Release No. 34-22442, 50 Fed. Reg. 39,201 (1985).

late 1985 on a pilot basis in six dually-listed stocks and will later be expanded to include all dually-listed issues. Orders in linkage securities from the Amex and Toronto are transmitted between the two trading floors using existing automated routing systems. Trading volume has increased from 137,000 shares in the fourth quarter of 1985 to 239,000 shares in the fourth quarter of 1986.[25] The Midwest Stock Exchange and Toronto have developed a similar trading linkage, which began operating in April 1986.[26] Boston and Montreal have implemented a linkage that enables Montreal specialists to send orders for execution by Boston specialists in a small number of Canadian issues listed in the United States and in approximately 200 United States-listed securities.[27] Trading has grown from 161,000 shares in the third quarter of 1985 to 621,000 shares in the fourth quarter of 1986.[28] The two exchanges may later allow Boston member firms to send orders in Canadian national issues directly to Montreal for execution.[29]

In addition to the operating linkages described above, other market participants are finalizing arrangements to facilitate the growth of transnational trading. The National Association of Securities Dealers, Inc. (NASD) and the London Stock Exchange have agreed to a two-year stock quotation sharing pilot program. Under the pilot program, the NASD's automated quotation system (NASDAQ) will display price quotes from the 100 London Stocks included in the Financial Times-Stock Exchange index and for 180 non-United Kingdom stocks in which there is an active London market off the exchange floor. London's international Stock Exchange Association Quotation system will display firm quotes for 200 companies traded on NASDAQ and 75 non-United Kingdom companies whose American Depository Receipts (ADRs) are traded on NASDAQ.[30]

There are several other information or trading linkages under consideration by the world's securities exchanges and information processors. The Philadelphia and London Stock Exchanges have proposed trading fungible contracts on the six foreign currencies on which Philadelphia currently trades options. Under this proposal, quotations and

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25. Trading figures were compiled by staff in the Commission's Division of Market Regulation.

26. *See* Securities Exchange Act Release No. 23075, 51 Fed. Reg. 11,854 (1986).

27. *See* Securities Exchange Act Release No. 21449, 49 Fed. Reg. 44,575 (1984).

28. *See supra* note 26.

29. *See* Securities Exchange Act Release No. 21925, 50 Fed. Reg. 14,480 (1985).

30. *See* Securities Exchange Act Release No. 23158, 51 Fed. Reg. 15,989 (1986). *See also* SEC STAFF REPORT, *supra* note 1, at V-55 (link between American Stock Exchange and European Options Exchange).

available trade information from each exchange would be disseminated on the floor of the other exchange, but no formal trading linkage is contemplated at this time.[31] The New York and London Stock Exchanges are discussing possible future joint ventures in securities trading and reporting of market data.[32] Instinet and Reuters have entered into an international marketing agreement granting Reuters exclusive rights to represent Instinet outside the United States. Reuters has agreed to purchase a large stake in Instinet in order to make Instinet's automated execution and negotiation services for United States equities, options, and ADRs available to Reuters' foreign customers.[33]

Even where no formal trading or information exchange is made, exchanges in different countries are using common technology. The Paris Exchange, for example, is using the technology from Toronto's Computer Assisted Trading System (CATS) for its order routing system.[34] The Zurich Exchange also is considering using CATS.[35]

2. *Clearance and Settlement Linkages*

Developers of these information and trade sharing arrangements have realized that a precondition to effective trading linkages is the development of efficient clearance and settlement arrangements. United States clearing agencies have been forming links with foreign clearing agencies and establishing clearing subsidiaries designed to process international securities transactions more efficiently and safely.

The Canadian Depository for Securities has become a member of the National Securities Clearing Corporation (NSCC). This permits processing of both exchange and over-the-counter transactions between United States and Canadian broker-dealers and facilitates the Boston-Montreal and Amex-Toronto exchange linkages.[36] NSCC's new subsid-

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31. *See* Securities Exchange Act Release No. 34-22343, 50 Fed. Reg. 34,955 (1985); *see also* Securities Exchange Act Release No. 34-22354, 50 Fed. Reg. 35,340 (1985). Philadelphia has since indicated it does not intend to pursue this linkage at this time. SEC STAFF REPORT, *supra* note 1, at V-55 n.117.

32. *See* McMurray and Anders, *Big Board, London Exchange Discuss Trading, Data-Reporting Joint Ventures*, Wall St. J., Jan. 7, 1985, at 3, col. 2.

33. *See* Putka, *Bid by Reuters for Instinet Underlines U.K. Firm's Goal of Global Stock Trading*, Wall St. J., June 11, 1985, at 35, col. 1.

34. *Paris Bourse to Test New Trading System in Bid to Modernize*, Wall St. J., Sept. 17, 1985, at 33, col. 1.

35. *Swiss Stock Exchanges Plan to Link Systems*, Wall St. J., Sept. 25, 1985, at 34, col. 2.

36. *See* Letters from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, Securities and Exchange Commission, to Karen L. Saperstein, Assistant General Counsel, National Securities Clearing Corporation (October 24, 1984

iary, International Securities Clearing Corporation (ISCC), was created to further international clearing by initially developing a clearing linkage with London's "Talisman" fortnightly settlement system. The ISCC-Talisman linkage will provide United States investors access to London's clearing facilities, and permit United Kingdom investors to clear trades through NSCC.[37]

The Options Clearing Corporation (OCC) is developing securities processing arrangements to enable it to clear trades in fungible foreign currency options from both London and Philadelphia. OCC proposes to establish a London office and a special membership category to enable London firms to clear foreign currency options trades through OCC's London office. Additionally OCC would establish a linkage with the International Commodities Clearing House (ICCH), which currently issues, guarantees, clears, and settles transactions in London options. This would help to process transactions by European firms that elect to continue to clear options trades through ICCH.[38]

3. *SEC Review of Current Linkages*

The SEC has been studying these developments in order to see what steps, if any, it should take to increase efficiency in the international securities markets while assuring appropriate investor protection. The SEC encourages international trading and clearing linkages, but recognizes that there are few surveillance mechanisms for this trading. In reviewing rule changes of United States national securities exchanges developing international linkages, therefore, the SEC has been careful to insure that adequate arrangements have been made for market surveillance. For the linkages involving Montreal and Toronto, for example, the SEC worked closely with the two exchanges and the provincial regulatory authorities to develop private agreements and other assurances of cooperation and information-sharing.[39]

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and November 26, 1984); *see generally* SEC STAFF REPORT, *supra* note 1, at V-66.

37. *See* National Securities Corporation News Release, *NSCC Sets International Sub for Two-Way Links Overseas, Proposes Reciprocal Clearing with Stock Exchange of London* (Oct. 30, 1985); SEC STAFF REPORT, *supra* note 1, at V-68.

38. *See* Securities Exchange Act Release No. 22354, 50 Fed. Reg. 35,340 (1985). The London Stock Exchange clears trades in options on Exchange-listed stocks.

39. *See, e.g.*, Securities Exchange Act Release No. 22442, 50 Fed. Reg. 39,201, 39,204 (1985) (discussing SEC-Ontario Securities Commission cooperative efforts in approving link between American and Toronto Stock Exchanges).

B. *The Global Trading Release*

In addition to assisting with the specific development of trading, information, clearing and settlement linkages, the SEC is studying the growth of transnational trading markets and encouraging further development. In April 1985, the SEC solicited comment on a broad range of issues concerning the increasing internationalization of the securities markets, including conditions and structures of international trading markets, international consolidated reporting, quotation and trading linkages.[40] The purpose of the SEC survey was to encourage United States and foreign securities industries, markets and regulators to consider ways of attaining the fairest and most efficient global trading markets possible.[41]

C. *Response to the Release*

In response the SEC received thirty letters from commentators in six countries.[42] Commentators believe that international trading is a positive development, and that it will continue to grow in size and importance. Commentators also recognize that the SEC plays an important role in internationalization, but most feel that the SEC should permit international trading markets to develop further on their own before taking any action in this area.

Although commentators agreed that international trading would increase, they disagreed about the future structure of the international securities markets. Several commentators predicted that future global trading of world-class securities would occur around-the-clock through a network of interconnected exchanges, while others believed that such trading was more likely to be done off the exchange floors by large securities firms. Commentators believed that greater dissemination of quotation and trade information would facilitate the growth of global trading markets although some expressed reservations about the practicability of immediate development of international consolidated quotation and transaction reporting systems. They also strongly supported additional links between central clearing and depository organizations, but felt that the incremental development of links between existing institutions was preferable to trying to create a central international clearing or depository entity.

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40. *See* Securities Exchange Act Release No. 21958, 50 Fed. Reg. 16,302 (1985).

41. *Id.* at 16,302.

42. The following is drawn from a staff summary of comment letters. Both the summary and the letters are available in SEC Public File No. S7-16-85.

D. *SEC Implementation*

The SEC addressed these responses in a public meeting on May 23, 1986. The SEC staff recommended that the Commission informally suggest to the New York Stock Exchange and the National Association of Securities Dealers that they loosen trading restrictions and increase reporting requirements for so-called "after hours" trading. The Commission determined instead that the issues needed further study and discussion before any recommendations could be made. The SEC staff was directed to prepare a memorandum on the necessary elements for developing an international market structure, looking at characteristics such as fairness, efficiency and flexibility. In particular the staff was directed to consult with members of the stock exchanges, self-regulatory organizations, and securities firms.[43]

E. *Recommendations*

International securities markets develop in response to international economic forces. That development should be encouraged and channeled into organized markets in order to maintain and increase market efficiency.

Governments should recognize that securities are being traded increasingly in foreign markets and investors are seeking greater investment opportunities in foreign markets. This trend is driven by economic forces; it promotes competition, and increases the depth and liquidity of existing capital markets. Accordingly, governments should ascertain what steps can be taken to enhance the efficiency of the growing international trading markets while providing market integrity and adequate investor protections.

IV. INTERNATIONAL SURVEILLANCE AND INVESTIGATION

The development of linked world markets combined with dual listing and registration of securities will create new challenges for enforcement agencies seeking to police individual securities markets. The United States securities laws prohibit all market participants from deceit, manipulation or fraud in connection with purchases and sales of securities. The cornerstone of the United States securities laws is disclosure of all information material to investment decisions. These laws apply to all investors and issuers whose transactions are aimed at the United States market.

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43. *See* SEC STAFF REPORT, *supra* note 1, at V-86 to V-87.

A. *The Present Enforcement Environment*

The SEC enforces the laws by identifying where violations have occurred, developing evidence of the violation, and instituting appropriate administrative or judicial proceedings against the violators. Where all the evidence is located in or controlled from the United States, the SEC has the jurisdiction to compel its production.[44] However, where the evidence is located abroad, the SEC's investigative power is greatly limited. The SEC's subpoena authority is limited to persons within the United States.[45] Foreign law often does not allow any investigative or pretrial discovery, and may frustrate SEC efforts to develop facts where only suspicious circumstances are apparent. The SEC has been required to engage in lengthy proceedings and negotiations to obtain information regarding transactions through foreign banks or securities firms located outside the United States.[46] No comprehensive agreements exist for assistance in such international investigative efforts.

The vast majority of issuers and traders comply with the United States securities laws. Yet securities law violators can conceal evidence of their activities from enforcement authorities by engaging in multinational transactions.[47] As these multinational transactions become more common, each nation seeking to enforce its securities laws will need access to information outside its borders. The SEC believes that the time has come to discuss ways to improve the gathering of relevant information for the enforcement of securities laws.

B. *Developments in Market Surveillance*

Electronic linkage between securities markets complicates the surveillance and oversight of market activity. Without enhanced surveillance techniques, internationally-linked markets will be more susceptible to fraud.

The SEC has encouraged the development of transnational trading, and further encourages international participation in the Intermarket Surveillance Group, an organization through which many of

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44. SEC v. Minas de Artemisa, S.A., 150 F.2d 215 (9th Cir. 1945).

45. *See* CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984); FTC v. Compagnie de Saint-Gobain-Pont-A-Mousson, 636 F.2d 1300 (D.C. Cir. 1980).

46. For a discussion including hypothetical examples, *see* Fedders, Wade, Mann and Beizer, *Waiver by Conduct—A Possible Response to the Internationalization of the Securities Markets*, 6 J. COMP. BUS. & CAP. MKT. L. 1, 4-8 (1984) [hereinafter Fedders].

47. *See id.* at 3 (secrecy laws "open the way for wrongdoers to threaten the fairness of the U.S. capital markets").

the United States securities exchanges share surveillance information. International participation would allow regulators and stock exchange managers to adequately oversee an internationally linked market.

The SEC already has approved several linkages between United States and foreign markets, and is satisfied that adequate arrangements have been made for market surveillance and information sharing regarding these linkages. For example, the SEC has worked closely with Canadian provincial authorities and the Montreal and Toronto Securities Exchanges to assure, in writing, that they will cooperate in enforcement investigations. The arrangements developed for the Amex-Toronto and Boston-Montreal linkages are possible models for future linkages. Toronto and Montreal have both agreed to cooperate in the investigation of any questioned trades and to transfer information to their counterparts in the United States. Amex and Boston have made corresponding agreements. Audit trails will be maintained by all exchanges. The Ontario Securities Commission has told the SEC staff that "it is difficult to conceive of an insider trading, market manipulation or other case of improper trading" in which the recently-enacted Canadian blocking statute might be exercised to prohibit exchange of information. This assurance was especially important to the SEC, as it has been frustrated by foreign blocking statutes in previous investigations.[48]

C. *Developments in Investigations*

Beyond market surveillance, the SEC's enforcement program may generate multinational investigations into alleged violations of the United States securities laws. The SEC has developed good informal relationships with foreign countries, but has otherwise found that resort to formal mechanisms — bilateral and multilateral treaties and letters rogatory — often does not bring satisfactory results. The SEC is seeking to develop a dialogue with other countries to find effective and efficient methods to assist investigations.

1. *Informal Methods*

The SEC has developed excellent informal working relationships with its counterparts in other foreign countries. On May 23, 1986, the SEC and the Securities Bureau of the Japanese Ministry of Finance signed a memorandum recognizing the need for international surveillance and investigative assistance, and agreeing "to facilitate each

48. *See supra* note 39.

agency's respective requests for surveillance and investigatory information on a case-by-case basis." Access to SEC files is available upon request by foreign authorities, and some foreign securities commissions have been able to provide reciprocal or even greater assistance. For example, the SEC has joined with its Canadian counterparts in investigating some cases which involve both United States and Canadian violations.[49]

2. *Formal Methods*

The only formal methods available for gathering evidence abroad are multinational agreements and letters rogatory. Neither has proven adequate for evidence gathering prior to litigation. New methods for international assistance in securities investigations need to be developed to ensure that all nations can obtain the information necessary to enforce their securities laws and to maintain the integrity of their securities markets.

The Hague Convention/Letters Rogatory. Both the Hague Convention on Evidence Gathering[50] and letters rogatory[51] provide useful mechanisms for obtaining evidence from neutral witnesses. They generally are available to the SEC only after a lawsuit has been filed in a United States District Court. Most often, however, the SEC needs foreign cooperation in obtaining evidence and completing an investigation before commencing such a lawsuit.[52] Many nations have agreed to the Hague Convention on the condition that no "pretrial" discovery may take place pursuant to Convention procedures.[53] The usefulness of the Hague Convention is further limited by the requirement that litigants follow the procedural rules of the country in which the evidence is sought, rather than the rules of the country attempting to enforce its laws.[54] In addition, it is often difficult to obtain evidence pursuant to the Hague Convention where those in possession of the evidence oppose its production. It is also difficult to obtain evidence pursuant to letters

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49. *See* SEC STAFF REPORT, *supra* note 1, at VII-60 to VII-68 (discussing other memoranda of understanding).

50. Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, *opened for signature* June 1, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444 (*entered into force* October 7, 1972) [hereinafter *Hague Convention*].

51. *See* 28 U.S.C. § 1781 (1982) (authority to transmit letters rogatory); 22 C.F.R. §§ 92.54, 92.66 (1987) (definition and procedures for using letters rogatory).

52. *See* Fedders, *supra* note 46, at 9 (discussing unusual case where the SEC was able to proceed with litigation against unknown defendants).

53. *See Hague Convention, supra* note 50, at art. 23.

54. *Id.* at arts. 9-11.

rogatory with either speed or certainty.[55]

Bilateral Agreements. The United States has treaties with several countries for mutual assistance in criminal matters[56] and is negotiating with others. Although the United States securities laws provide criminal penalties, the SEC generally seeks information for use in a civil or administrative rather than a criminal proceeding. Thus, these treaties, while technically available to the SEC, have limited practical value. Although they provide important assistance, they are not optimal models for future agreements in the securities enforcement area.

3. *New Constructive Alternatives*

The SEC sought public comment in 1985 on the "waiver by conduct" concept, which would provide that the purchase or sale of securities on a United States market would constitute a waiver of the protection that would otherwise be afforded by foreign secrecy laws.[57] The SEC also invited public consideration of the broader factual, legal and policy issues implicated by the increasingly international securities markets.[58]

Sixty-five comments were received, most of them opposed to a legislative enactment of the "waiver by conduct" concept.[59] The SEC recognizes that this idea was poorly received and is committed to exploring different alternatives.[60] However, no commentator proposed a comprehensive alternative to "waiver by conduct" other than the negotiation of bilateral and multilateral agreements that expressly provide the necessary assistance. The SEC believes that there are other viable non-confrontational alternatives. Many countries are understandably reluctant to allow foreign evidence-gathering rules to be applied within their borders. Flexible arrangements for gathering evidence are necessary to maintain the integrity of the securities markets and protect investors from fraud. Without such arrangements, securities law violators will be able to prey on the securities markets of many nations from

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55. *See* SEC STAFF REPORT, *supra* note 1, at VII-68 to VII-74, reviewing SEC experience under the Hague Convention and concluding that "while [it] has proven useful, its procedures are costly and time-consuming." *Id.* at VII-74.

56. *See id.* at VII-49 to VII-60.

57. Securities Exchange Act Release No. 21186, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,648 (July 30, 1984).

58. *Id.* at 86,977.

59. The letters are available in SEC Public File No. S7-27-84.

60. Michael D. Mann, Chief, Office of International Enforcement Assistance, Division of Enforcement, Securities and Exchange Commission, Remarks to Seminar, "Swiss Capital Market Law: Status and Perspectives," (Nov. 12, 1985).

outside the borders of those nations with virtual immunity.

Any arrangement for assistance in evidence gathering must allow participating nations access to information necessary to protect their securities markets against foreign-based fraud. At the same time, such an arrangement must not jeopardize the sovereign interests of participating nations in activities occurring within their borders. For example, a foreign law enforcement agency's request for evidence might be required to meet a relevancy standard applied by a court in the country where the evidence or witness is located. This standard would guard against unwarranted "fishing expeditions." The assistance might also be limited to governmental investigations and litigation, excluding private lawsuits. This would reduce fears that the process might be abused. Finally, the arrangement might limit assistance to matters arising under specified statutes, which would ensure that a participating nation would not be forced to assist in the enforcement of a foreign law which is contrary to its policies. The SEC is not committed to any one method for providing assistance, but rather believes that this subject should be explored in detail by all trading nations in an effort to develop a cooperative agreement among members.

D. *Recommendations*

As the securities markets become more international, law enforcement problems will become more severe and more widespread. All nations with securities markets may face the dilemma of deciding whether to act unilaterally to protect their markets from foreign-based fraud, or to live with markets where some participants can defraud others with impunity. Neither alternative is acceptable. The acceptable alternative is to develop ways of sharing surveillance and investigating information, and to formalize these arrangements in bilateral or multilateral understandings.

Governments should recognize the need for international enforcement of national securities laws where violations in their country have harmed investors in a foreign country. Cooperative arrangements should be developed to enhance international surveillance of market activity.

Governments should agree to develop mechanisms for access by foreign securities enforcement authorities to regulatory and investigative files.

Governments should also consider negotiating bilateral and multilateral agreements which would provide mutual assistance in securities matters.

V. IMPLEMENTATION

Each of the three areas discussed above raises new, emerging issues in the development of the international securities markets. Coordinated and trouble-free development of these markets requires continuing and rigorous dialogue among participant nations. The International Organization of Securities Commissions can play a leading role in developing and advancing this dialogue.