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Internationalization of Securities Markets

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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. Washington, DC: Securities and Exchange Commission, 1987, xxv + 910 pp.

In the effort to comprehend what the phenomenon of "internationalization" is, and to determine what, if anything, should be done to regulate it, this staff report represents the first shoe dropping. It is a significant empirical study replete with useful information and data on global trading, and it also contains the practical basis for a constructive critique of the workings of the increasingly internationalized securities markets.

The realization of such a critique will be the second shoe to be dropped, if at all, by the Securities and Exchange Commission. The Commission staff "anticipate[s] that the Commission will utilize the staff report in formulating its views on policy and legislative initiatives in the internationalization area."[1] Hence, the report is noteworthy both for what it says about internationalization and for whatever indications it may afford of the future direction the Commission might take as a matter of policy.

In this regard, the staff report may be most profitably read in conjunction with the U.S. Department of the Treasury's "National Treatment" studies,[2] which review limitations on the entry and treatment of

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* Ed. Note: Volume 11:2 of the *Journal* is a symposium on the internationalization of the securities markets.

1. STAFF OF SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE INTERNATIONALIZATION OF THE SECURITIES MARKETS, I-1 n.1 (1987) [hereinafter SEC INTERNATIONALIZATION REPORT]. *See also id.* at I-19.

2. *See* DEP'T. OF TREAS., REPORT TO CONGRESS ON FOREIGN GOVERNMENT TREATMENT OF U.S. COMMERCIAL BANKING ORGANIZATIONS (1979) [hereinafter NATIONAL TREATMENT STUDY]. This study was mandated by section 9 of the International Banking Act of 1978, Pub. L. No. 95-369, 92 Stat. 623 (1978). *See generally* Korsvik, *Legal and Regulatory Constraints Within Other Countries, in* BAUGHN & MANDICH, INTERNATIONAL BANKING HANDBOOK 734 (1983). The most recent update of the National Treatment Study, issued in 1986, included a review of the treatment of U.S. securities firms in foreign countries. DEP'T. OF TREAS., NAT'L. TREATMENT STUDY: 1986 UPDATE, at 1 (1986). *See also* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at V-3 - V-4.

U.S. financial services firms in foreign markets. The 1986 update of the study[3] is particularly useful, since it includes a study of host country restrictions on entry and subsequent treatment of U.S. securities firms. Thus, between the two studies the reader will begin to get a fairly accurate picture of the movement towards internationalization of the securities markets and the current regulatory limits on such a seemingly inevitable movement.

The staff report begins with a brief introductory chapter, in which the staff takes the position that the current intimations of "internationalization" represent merely a more heightened pace to a long-standing situation in the securities markets. The report argues:

> Internationalization of the securities market is not a new phenomenon. Throughout much of history investors have assumed the risks attendant to investing in a foreign economy. The degree to which the world's securities markets have become internationalized, however, is unprecedented. These developments are a result both of technological advances and of the removal of restrictions on foreign participation by many of the world's securities markets.[4]

Even with its significance as an independent phenomenon minimized in this fashion, the pace of this increased internationalization appears to be creating new opportunities and new challenges. In large part, these new challenges concern regulatory policy: "The laws governing the securities markets of various countries are diverse. Indeed, there are significant differences among the regulations in different nations, in terms of nature, purpose, and degree of protection."[5]

In a less "internationalized" set of markets, such diversity in regulation might be no more than anecdotal. However, as the pace of the development of an internationalized market quickens, such diversity is both significant and dangerous. Issuers may face incompatible requirements in different markets. Investors may face confusing inconsistencies in disclosures under diverse regulatory regimes, as well as unperceived risks as among diverse markets. Exacerbating these difficulties is the fact that a diverse and mobile set of markets raises the stakes on the potential for fraud. These are some of the concerns that inform the staff report's study of the internationalization of the securities markets.

The second chapter of the report, prepared by the Commission's

3. *See supra* note 2.
4. SEC INTERNATIONALIZATION REPORT, *supra* note 1, at I-1. *Cf. id.* at II-5.
5. *Id.* at I-2.

directorate of Economic and Policy Analysis, develops the basic empirical data concerning the trend toward internationalization. The factors affecting this trend — economic, institutional and regulatory — are examined in considerable detail. In particular, the chapter includes an extremely useful analysis of the international bond and equity markets.[6] The view of the staff in terms of the trend toward internationalization is explicitly stated: "The securities markets are likely to maintain their global character in the years ahead."[7] Indeed, the defining characteristic of these markets for the future would seem to be further interdependence and integration, and the corresponding need to "develop a global regulatory framework that preserves the efficiencies associated with international capital mobility."[8]

The third chapter of the staff report, prepared by the Division of Corporation Finance, analyzes the disclosure and distribution standards applicable to the multinational or international related issuance of securities. It includes not only a very thorough and useful discussion of U.S. requirements in this regard, but also a selective but nonetheless noteworthy survey of the requirements of other major jurisdictions.[9] Given the importance of international acquisitions in the trend toward internationalization,[10] the chapter also includes an extensive comparative study of the regulation of tender offers.[11] The chapter concludes with a discussion of the problems raised by the potentially broad extraterritorial application of the registration requirements of section 5 of the Securities Act of 1933,[12] which can result "in complex and costly offering procedures to assure that [the] registration provisions do not apply, as well as the exclusion of United States persons from various offshore investment opportunities."[13]

The chapter recognizes the importance of reexamining the juris-

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6. *See id.* at II-35 - II-70.

7. *Id.* at II-88.

8. *Id.* at II-90.

9. This survey includes discussion of the directives of the European Economic Community ("EEC") and the requirements of the United Kingdom, Japan, Canada, West Germany, France, Australia, Switzerland and the Netherlands. *See id.* at III-74 - III-245.

10. *See id.* at II-86 & II-87, table II-23. *Cf. id.* at III-247 (internationalization and compliance with various regulatory requirements particularly in exchange offers).

11. *See id.* at III-246 - III-298. Given the relatively developed state of U.S. tender offer regulation, the chapter also includes a section dealing specifically with compliance issues encountered by foreign bidders under U.S. regulations. *See id.* at III-298 - III-310.

12. 15 U.S.C. § 77e (1982).

13. SEC INTERNATIONALIZATION REPORT, *supra* note 1, at III-311.

dictional scope of section 5 as applied, in light of the "recent development of active international trading markets and the significant increase in offshore offerings of securities."[14] It reaffirms an essentially "territorial" approach to application of the registration requirements of the Securities Act of 1933 as consistent both "with the regulatory ambit of the Securities Exchange Act[15] and with comity principles."[16]

This territorial approach, limiting the potentially broad scope of the Securities Act of 1933 to transactions involving U.S. persons and markets, has not as yet been definitively determined. Such a situation becomes increasingly less tolerable as securities markets become more interrelated. The chapter clearly urges more precise definition in this regard:

> In defining a territorial approach, the concept of an "offer or sale within the United States" must be developed, taking into account advancing technology and worldwide telecommunications. Clear, simple guidelines designed to assure that investors in United States capital markets have appropriate information available to them must be established, taking into account the differences in debt and equity offerings as well as the differences in the types of purchasers that may be involved.[17]

This is neither easily said nor done. The continuing coalescence of national markets and the mobility of trading may make the line of demarcation a shifting boundary. Further, if the intended goal is, as it appears to be, to balance the disclosure objectives on U.S. securities laws[18] against the opening of foreign-based issuances to U.S. investors, such value-laden terms as "appropriate information" may be difficult to fix. Reciprocal agreements between nations with relevant securities markets may assist in the establishment of such an approach.[19]

As formidable as varying disclosure requirements may be as an impediment to internationalization, accounting and auditing standards in particular have raised considerable difficulties for the process. The fourth chapter of the staff report, prepared by the Office of the Chief

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14. *Id.* at III-315.

15. 15 U.S.C. §§ 78a-78kk (1982 & Supp. IV 1986).

16. SEC INTERNATIONALIZATION REPORT, *supra* note 1, at III-317.

17. *Id.* at III-319 (footnotes omitted).

18. Individual state blue sky law requirements may also be an impediment to full integration of the international securities markets. *See id.* at III-327.

19. *See, e.g., id.* at III-324 - III-325 (discussion of experimental reciprocal proposals).

Accountant, examines in detail the impact of current accounting and auditing standards upon the trend toward internationalization. The discussion focuses upon the concepts and standards applicable in the United States, Canada, Japan and the EEC member countries.

The chapter highlights the differences in accounting principles and auditing standards in these countries, and in particular the differences arising as a result of the method by which standards are promulgated. Differences between principles generated by the accounting profession (typically, where there is broad dispersal of corporate ownership) and principles generated by the government (typically, where such ownership is relatively more concentrated) appear to be pronounced.[20] These differences tend to create considerable difficulty in terms of adequate transborder disclosure, which may artificially restrict markets.[21] Despite these difficulties, efforts have been made toward harmonization of principles and standards, and the chapter describes these in detail.[22]

The chapter also discusses potential accountants' liability, a problem not limited to the U.S. markets.[23] The chapter discusses in turn the liability problems in each of the selected jurisdictions which are the focus of the chapter.

The fifth chapter of the staff report, prepared by the Division of Market Regulation, focuses upon issues with respect to international trading and the emergence of global securities markets.[24] The secondary securities markets have been one of the more rapid achievers of internationalized, or at least broadly regionalized, status.[25] In general, the chapter finds the process of internationalization to have proceeded in a manner that is both "safe and efficient."[26]

The staff finds that trading linkages are developing, but that some significant barriers to entry and participation remain. The chapter examines in some detail the character and operation of certain emerging integrated secondary markets, such as the Eurobond markets,[27] and the efforts of such markets to develop centralized and efficient clearance

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20. *See id.* at IV-1.

21. *See, e.g., id.* at IV-8 - IV-11 (example of Japanese issuers).

22. *See id.* at IV-21 - IV-26, IV-31 - 37. On the Commission's initiatives toward harmonization in the specific context of internationalization, *see id.* at IV-48 - IV-54.

23. *Id.* at IV-40.

24. *Cf.* Exchange Act Rel. No. 34-21958, 50 Fed. Reg. 16,302 (1985) ("Global Trading" release).

25. For example, the Eurobond markets, "the leading example of an integrated multinational secondary market." *Id.* at V-1.

26. *Id.*

27. *See id.* at V-4 *et seq.*

and settlement mechanisms.[28] The chapter also examines the more recent emergence of 24-hour trading markets in equity securities.[29]

Whatever the eventual character and significance of an internationalized trading market,[30] even the current level of international secondary market trading "raises a host of questions regarding the operations of multinational firms, the trading, clearance and settlement of international transactions and the ability of regulatory bodies to enforce their laws and regulations."[31] Since the secondary trading markets have exhibited some of the most significant movement towards internationalization, efforts to rationalize the effects of this movement in this context should be particularly noteworthy. The remainder of the chapter surveys the operations of these firms and the impact of regulatory requirements upon them and reviews some recent initiatives to establish linkages among the national markets.[32]

In this context, "improved international clearance and settlement . . . [is] the critical issue."[33] The problems encountered in this regard may exemplify the difficulties that the trend toward internationalization faces in general: the lack of truly international links to facilitate transborder transactions and the wide variance among the systems that do exist from one capital market to the next. The chapter discusses the current situation and various attempts at transborder linkage.[34] To date these attempts appear to be rather episodic and disjointed; the lack of coordination and uniformity remain as serious concerns for the internationalizing markets. The staff report does evidence the very serious concern of the Commission and its staff in this regard, and one may hope that the staff report will contribute at least a concentration of purpose on the resolution of this difficult impediment to the continuing process of internationalization.

The sixth chapter of the staff report, prepared by the Division of Investment Management, rounds out the tour of the regulatory concerns raised by internationalization. The focus here is upon the effects of internationalization on investment companies and investment advisors. These groups "have participated actively in the internationalization process,"[35] and their experience exemplifies the experience of U.S.

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28. *See, e.g., id.* at V-12 *et seq.*
29. *See id.* at V-19 - V-26.
30. *Cf. infra* note 50.
31. SEC INTERNATIONALIZATION REPORT, *supra* note 1, at V-26.
32. *See generally id.* at V-26 - V-60.
33. *Id.* at V-61.
34. *See id.* at V-61 - V-77.
35. *Id.* at VI-1.

market participants generally. There has been a dramatic increase, for example, in the number of U.S. open-end investment companies that concentrate their portfolio investments in foreign securities, yet foreign participation in the U.S. investment company market has been very slow.[36] However, the problem is not simply a practical reluctance on the part of foreign participants to enter the market, but the statutory limitations on the Commission's authority to approve entry of foreign investment companies.[37]

The chapter reviews recent initiatives to respond to and to facilitate investment company participation in the process of internationalization. These include bilateral reciprocal arrangements between the United States and foreign countries, as well as broader and potentially more effective reciprocal arrangements with international organizations such as the European Economic Community or the OECD.[38] The latter approach has received the support of industry representatives and received considerable play in the staff report.[39]

The seventh and final chapter of the staff report, prepared by the Division of Enforcement and the Office of the General Counsel, considers the impact of the internationalization of the securities markets on the enforcement of U.S. securities laws. Here the trend toward internationalization is essentially a complicating practical concern:

> The accelerating internationalization of the securities markets has . . . afforded the unscrupulous new opportunities [to] exploit others and to violate the federal securities laws. In particular, those who seek to engage in illegal trading while in possession of nonpublic information have attempted to conceal their activities by conducting their trading through foreign entities.[40]

As the process of internationalization proceeds apace, fresh opportunities for illegal trading will undoubtedly present themselves. Even with the gradual "demystification" of, for example, Swiss bank secrecy law,[41] enforcement of U.S. securities laws in the international context

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36. *See id.*

37. *See, e.g.*, 15 U.S.C. § 80a-7(d) (1982) (prohibition on foreign investment companies absent Commission order). *See generally* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VI-9 - VI-13.

38. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VI-9 - VI-13.

39. *See, e.g.*, *id.* at VI-17 - VI-24.

40. *Id.* at VII-1.

41. *See* Honegger, *Demystification of the Swiss Banking Secrecy and Illumination of the United States-Swiss Memorandum of Understanding*, 9 N.C.J. INT'L L. & COMM. REG. 1 (1983).

is a delicate and formidable undertaking for federal authorities.

The chapter traces the course of this undertaking through recent case law on the subject, with particular attention to, *inter alia*, the perennially sensitive issue of extraterritorial jurisdiction.[42] The discussion shows a continued, and quite justifiable, adherence to basic concepts of the "conduct"[43] and "effects" tests[44] of jurisdiction to apply and enforce the federal securities laws.[45]

The chapter also includes a very useful and informative discussion of the practices and problems surrounding the investigation of possible securities laws violations in the internationalized context.[46] This section of the chapter considers both various methods available for obtaining information and the use of both private and public (informal and formal) agreements for the production of evidence. While there is little here that will be new or unfamiliar to the experienced practitioner, the discussion is organized and extensive and warrants a careful review.

Considering the staff report overall, one conceptual problem never directly addressed, let alone resolved, is the meaning of the term "internationalization," a term with so much cachet in today's commentary on the markets. Much is made of the significance of "the trend toward internationalization,"[47] but what is it that this "trend" is heading towards? The answer to be inferred from the staff report is neither clear

42. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VII-5 - VII-26.

43. *See id.* at VII-9 - VII-14. *See generally* Leasco Data Processing Corp. v. Maxwell, 468 F.2d 1326 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); Grunenthal GmbH v. Hotz, 712 F.2d 421 (9th Cir. 1983).

44. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VII-15 - VII-26. *See generally* Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

45. The chapter's discussion and critique of the approach to such issues reflected in the American Law Institute's ("ALI") RESTATEMENT (REVISED) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 403, 416, 437 (1986) is remarkably restrained. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VII-21 - VII-26, VII-42 - VII-46. The simple fact of the matter is that the Revised RESTATEMENT, particularly in its discussion of discovery practices in section 437, is marred by a gratuitous and unwarranted departure from current case law which has generally followed the approach suggested by the ALI's RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 40 (1965). *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VII-45 - VII-46. *See generally* Trade Development Bank v. Continental Insurance Co., 469 F.2d 35 (2d Cir. 1972); In re Grand Jury Proceedings, 532 F.2d 404 (5th Cir. 1976); United States v. First National Bank of Chicago, 699 F.2d 341 (7th Cir. 1983); Garpeg, Ltd. v. United States, 583 F. Supp. 789 (S.D.N.Y. 1984); S.E.C. v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981).

46. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VII-27 - VII-77.

47. *Id.* at I-3.

nor entirely satisfactory.

Can it be that so much ink is being spilled these days merely over an increase in the degree of issuance and trading that happens to take place between national markets or across national borders? This appears to be the opening position of the report, which notes that, historically, investors have on occasion assumed the risk of investing transborder.[48] What distinguishes today's trend toward internationalization would apparently be only the amount of such investing.[49] Yet, surely this is a rather misleading use of the term "internationalization," which would seem to suggest a process whereby national markets are, in some significant case, becoming an interrelated, *inter*national securities market, not just a *trans*national one.

To be fair to the staff report, one must admit that whatever this internationalized market may be, it is still very much in the process of development. Therefore, it may as yet be too early to delimit the meaning of the term in any definitive fashion.[50] The report does, at various points, identify what appear to be marked features of this market. Among other things, the internationalized market is, or will be, marked by the following features:

> (i) In absolute terms, and as compared with the growth within the U.S. securities market, there is "increasing competition among the world's [national] securities markets."[51] Further, the marked growth in transactions by investors outside their home country would appear to be part of the definition of "[t]he global character of the securities markets"[52] today.
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> (ii) In the international distribution market, it appears that "the mechanisms that have for many years been utilized in offering debt instruments . . . are now being mobilized for the purpose of placing shares of major corporations through an international net-

48. *See id.* at I-1.

49. Indeed, the fifth chapter, concerning the effects of internationalization on the secondary market, goes so far as to say that "there is no clear indication that the basic structure of trading in U.S. securities, focused on home market trading as the pricing mechanism, will change." *Id.* at V-26.

50. The obvious model of an "integrated multinational securities market" would appear to be the secondary trading market in Eurobonds, now of long standing. *See id.* at ch. V. Still, a major limitation on the emergence of an integrated, truly internationalized market remains "[t]he lack of international clearance and settlement links to facilitate cross border settlements, and the existence of widely varying clearance and settlement systems within national markets . . . ." *Id.* at I-13.

51. *Id.* at I-3.

52. *Id.* at II-2.

work."[53] Related to this development, transborder markets (and, presumably, eventually an internationalized market) are beginning to ". . . play a much larger role in international capital formation than they did just a few years ago."[54]

(iii) A related and very recent development has been the increased "use of international securities markets as a means of capital formation [as opposed to] reliance on international bank loans,"[55] the so-called "securitization" phenomenon.

(iv) Relative deregulation, at least as to ease of entry, appears to presage an increase in "the degree of worldwide competition in equity securities."[56] It may indeed be more accurate to speak of the structural realignment of the regulatory system, rather than "deregulation," intended to "facilitate competition and greater mobility of capital across national boundaries."[57]

(v) Following upon the increase in multinational stock listings and transborder trading of equity securities, there is increased interest among professionals "in the development of a 24-hour global stock market . . . . Many [U.S. and foreign securities firms] now have the ability to trade at any time of the day by having offices in New York, London, Tokyo and in other major financial centers."[58]

The staff report also contains a number of intriguing hints concerning peripheral issues that are not fully developed or followed up, due no doubt to the natural limitations dictated by the focus of the study itself. Nevertheless, the reader cannot help but be tantalized by the implied arguments concerning the separation of commercial and investment banking under the Glass-Steagall Act[59] suggested by discussion in the report such as the following:

> The separation of the investment and commercial banking sectors . . . may have given some impetus to the development of the U.S. securities market. It is interesting to note that the two largest securities markets, the U.S. and Japan, which account for nearly

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53. *Id.* at I-5. *See also id.* at II-2.

54. *Id.* at II-1.

55. *Id.* at II-6.

56. *Id.* at I-11.

57. *Id.* at II-25.

58. *Id.* at II-68. *See also id.* at II-70 (transnational trading linkages).

59. 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.). On the scope and impact of the Glass-Steagall Act, *see generally* 2 M. P. MALLOY, THE CORPORATE LAW OF BANKS 551-75 (1988).

> three-quarters of the world's equity markets capitalization generally have maintained a separation of commercial banking from investment banking.[60]

This passing remark would seem to imply that the staff takes a generally favorable view of the separation imposed by the Glass-Steagall, but the remark is not followed up.[61] Nevertheless, it is clear that the staff takes the position that "[t]he regulatory climate in the U.S. has permitted our securities markets to become a leader in financial innovation,"[62] and presumably it was not dissatisfied overall with the general contours of current U.S. regulation.

Furthermore, there is at least some suggestion that the scope of the Glass-Steagall restrictions, limited territorially, may have been a factor in fostering the trend toward internationalization. As the fifth chapter of the staff report observes:

> [T]he absence of extraterritorial application of the Glass-Steagall Act permits U.S. and foreign banks to engage in dealer activities for U.S. securities in Europe that would be prohibited in the U.S. In particular, foreign banks may find it tempting to effect directly transactions with their advisory clients rather than to route those orders through U.S. broker-dealers to a U.S. exchange.[63]

This would appear to indicate that the artificial geographic limitations, indirectly resulting from the jurisdictional scope of the Glass-Steagall Act restrictions, have had some unexpected consequences for the trend toward internationalization. One may question, though the staff report does not, whether these consequences were desirable or not, and whether the current situation in the internationalized securities markets counsels a removal of the Glass-Steagall restrictions.[64]

There can be little doubt, however, that this staff report represents a major contribution to our understanding of the character and impli-

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60. SEC INTERNATIONALIZATION REPORT, *supra* note 1, at II-16 - II-17 (footnote omitted).

61. *But cf. id.* at II-21, table II-4 (development of capital market instruments in the world's major securities markets).

62. *Id.* at II-19.

63. *Id.* at V-23.

64. This problem should be compared with the discussion elsewhere in the staff report of the Commission's initiatives with respect to easing restrictions on the ability of foreign banks to issue securities in the United States without registration as an investment company under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 - 80a-64. *See* SEC INTERNATIONALIZATION REPORT, *supra* note 1, at VI-24 - VI-27.

cations of the ongoing process of internationalization of the securities markets. As with the best work of the Commission's staff, it reflects both intellectual rigor and great practical sensibility. Whether the process of internationalization eventually achieves something like an integrated, coordinated and truly "internationalized" securities market or remains, as it began, an episodic and transnational phenomenon, this report will remain an important document for both scholar and practitioner alike.

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