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INTERNATIONALIZATION OF THE SECURITIES MARKETS

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

INTERNATIONALIZATION OF THE SECURITIES MARKETS

I. INTRODUCTION

It is a pleasure to speak before this distinguished group of business leaders. I have had several opportunities during my tenure as Chairman of the Securities and Exchange Commission (the Commission) to speak on the subject of the internationalization of the securities markets.¹ The tenor of those speeches has been that the world's securities markets are increasingly linked and that we must seek coordinated international solutions to global market problems. That message was brought home during the October market break last year. Never before have events in one market so dramatically affected other world markets. Never before has it been so clear that international market regulators must pay increasing attention to the need to create coordinated market regulatory structures.

The challenges in creating a truly global marketplace fall into three categories. First, we must address the significant dissimilarities among the world's markets, ranging from differences in registration and reporting standards to differences in the structures of

¹ Those speeches include the following:

“The Role of Automation in the International Securities Markets,” delivered August 19, 1988 in Stockholm, Sweden;

“The U.S.-Canadian Relationship in Securities Regulation: a Model of Regulatory Cooperation,” delivered June 20, 1988 in St. John's, Newfoundland, Canada;

“The Challenges of Internationalization of the Securities Markets,” delivered May 19, 1988, before the World Affairs Council of Philadelphia;

“Critical Issues in the Regulation of Our Nation's Securities Markets,” delivered November 23, 1987, at the National Press Club in Washington, D.C.; and

“Regulation of International Securities Markets,” delivered October 19, 1987, at the Seventh Annual Washington Briefing on U.S. Perspectives hosted by the American Stock Exchange.

trading and settlement mechanisms. Second, more efficient trading and clearing linkages among all active markets must be developed. Third, world regulators must structure a level of information sharing and enforcement cooperation to deter international securities law violations.

We have a great deal of work to do to achieve compatibility among the world's regulatory structures. As I will discuss later in greater detail, the Commission has approached international regulation issues by encouraging and accommodating initiatives by U.S. market participants and by working with our foreign counterparts, both on a bilateral basis and in various international forums.

As we have participated in cooperative efforts with regulators from other countries, it has become increasingly clear that the decisions regulators make for their own markets can significantly affect other world markets. I believe that securities regulators worldwide must look to the future and must redouble efforts to develop a coherent and coordinated approach to market regulation.

II. INTERNATIONALIZATION ISSUES

A. Trading and Quotation Linkages

The effect of automation on the development of the world's securities markets is most clearly demonstrated by the increasing reliance on automated securities trading systems within national markets. Additionally, advances in technology have made possible a number of international linkages between markets for the exchange of quotation information and even for trading.

One example of an international linkage is a two-year pilot for the exchange of quotation information between the National Association of Securities Dealers' automated quotation system ("NASDAQ") and the International Stock Exchange in London.² This

² See Securities Exchange Act Release No. 24979 (October 2, 1987).

arrangement allows certain subscribers to NASDAQ in the United States to receive up-to-the-minute quotation information for selected securities from London and allows participants in the London market to receive similar quotation information for a group of NASDAQ stocks. The United States National Association of Securities Dealers also has a pilot underway for the exchange of end-of-day quotation information with the Stock Exchange of Singapore.³ In recent years trading linkages have also been established between U.S. and Canadian stock exchanges.⁴

In addition to these arrangements between markets, private vendors offer securities information on an international basis, and even international execution capabilities in certain world class equities.⁵ For instance, as you may be aware, Reuters is developing an extensive international quotation system, which already has in place over 4,000 terminals displaying quotations in the international bond market. Recently, Reuters and the Chicago Mercantile Exchange announced plans for an automated order entry and execution system that would allow trading in financial futures around the world during the hours that the Chicago exchange is closed.

An example of the kind of technological advances important to facilitate the development of global securities markets is the Stockholm Stock Exchange's proposed new "SAX" electronic trading system. SAX is essentially an electronic order book that

³ See Securities Exchange Act Release No. 25457 (March 14, 1988).

⁴ The first international stock trading linkage was established between the Montreal and Boston Stock Exchanges in 1984 [Securities Exchange Act Release No. 21449 (November 1, 1984)]. Since then, trading linkages also have been established between the American and Toronto Stock Exchanges [Securities Exchange Act Release No. 22442 (September 20, 1985)], and the Midwest and Toronto Stock Exchanges [Securities Exchange Act Release No. 23075 (March 28, 1986)].

⁵ See the Instinet trading system, described in a letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to Daniel T. Brooks, Cadwalader, Wickersham & Taft, dated August 8, 1986.

will match the orders entered by exchange members, giving priority to those orders with the best price that were entered first.⁶

Another example is the Paris Bourse, which is using the technology from Toronto's Computer Assisted Trading System (CATS) for its order routing system. Further off on the horizon is the European Community's planned Interbourse Data Information System -- a network that would provide continuous price reporting and trading among the major European securities exchanges.

B. Clearance and Settlement Systems

In the internationalization of the world's securities markets is to proceed, one of the most important international goals must also be to establish efficient and compatible automated national and international clearance and settlement systems. One of the problems we face is that there are wide-ranging differences in settlement periods and degrees of automation among world markets. In the United States we have developed an automated depository and book entry clearance and settlement system. Many other mature markets such as the United Kingdom and Japan, however, are still in the developmental stages in clearing and settlement. Ultimately, we hope that all countries will establish fully automated clearance and settlement systems that permit paperless book entry movement of all broker-dealer and institutional securities positions. The current lack of coordination among clearance and settlement systems in major world markets increases the costs and risks of global securities trading.

Even if comparable systems are not in place, however, it is important to develop clearing linkages among the major international markets. Linkages provide a current viable means of establishing international clearance and settlement because they do not depend upon the existence of identical, or even similar, systems in each country. Linkages facilitate cross-border settlements without compromising the essential

⁶ SAX is patterned in part on the Toronto Stock Exchange's CATS system. International Securities Regulation Report (BNA) Vol. 1, No. 5, at 4 (Feb. 17, 1988).

soundness and integrity of each national clearance and settlement system. The Commission has relied upon the linkage concept to approve several systems for linking U.S. clearing agencies and foreign clearing entities in circumstances in which we have been satisfied that adequate safeguards exist to reduce the risks of default and to contain potential losses.⁷ In the near term, the Commission will continue to encourage sound linkages between U.S. and foreign clearing entities to facilitate cross-border settlements.

Notwithstanding the use of clearance and settlement linkages, reduction of differences between the various national clearance and settlement systems is necessary for creation of a truly global market. The Group of Thirty, a group of individuals representing international bankers, business people, academics, and government officials, concluded at its March symposium that the most feasible near-term solution is a network of linkages between individual market clearance and settlement mechanisms. The Group of Thirty cautioned, however, that the linkages are only as effective as the quality of the individual systems that comprise the linked network. Accordingly, all of the world's markets and their regulators should continue to work towards achieving efficient and compatible systems. For our part, the Commission staff is exploring the development of uniform time frames, central matching and settlement procedures, and multi-currency settlements on an international basis.

C. Disclosure and Distribution Issues

Of course, if a truly international equities market is to develop, it will depend upon an integrated disclosure system. Efforts are underway to ease registration and

⁷ See, e.g., Letters from Jonathan Kallman, Assistant Director, Division of Market Regulation, SEC, to Karen L. Saperstein, Assistant General Counsel, International Securities Clearing Corporation ("ISCC"), dated October 10, 1986; and to Robert J. Woldow, General Counsel, ISCC, dated December 10, 1986 (link between ISCC and International Stock Exchange); and letter from Jonathan Kallman to Michael Wise, Associate Counsel, Midwest Clearing Corporation/Midwest Securities Trust Company ("MCC/MSTC"), dated March 21, 1986 (link between MCC/MSTC and Canadian Depository for Securities).

reporting burdens resulting from differences in national disclosure standards, but much remains to be accomplished.

Disclosure Requirements for Foreign Issuers

The primary problem in the disclosure area is that disclosure standards and reporting requirements differ from country to country. In recognition of this fact, the Commission began in 1979 to develop a separate reporting system for foreign private issuers similar to the system for U.S. domestic companies, but recognizing differences in disclosure standards in other countries. At that time, accommodations were made in disclosure requirements for management remuneration, transactions with management, and segment reporting.⁸ In 1982 the Commission adopted an integrated disclosure system for foreign issuers enabling them to use periodic reports previously filed in the United States in connection with public offerings made there.⁹

In 1985, the Commission issued a concept release that requested public comment on ways to accommodate multinational securities offerings and to harmonize the prospectus disclosure standards and securities distribution systems of the United States and other countries.¹⁰ The United Kingdom and Canada were identified as the most likely partners in any initial effort because of their frequent use of our markets and the similarity of their accounting principles and disclosure requirements.¹¹

Comment was sought on two possible approaches -- a reciprocal approach and a common prospectus approach. Under the reciprocal approach, each of the jurisdictions would accept the disclosure documents prepared in the issuer's domicile. Under the

⁸ Securities Act Release No. 16371 (November 29, 1979).

⁹ Securities Act Release No. 6437 (November 19, 1982).

¹⁰ Securities Act Release No. 6568 (February 28, 1985).

¹¹ Id.

common prospectus approach, the jurisdictions would agree to use common disclosure standards.

The majority of commentators favored the reciprocal approach, primarily because of the ease of implementation. The Commission's staff is currently working with foreign regulators on an experimental first phase utilizing the reciprocal concept. The experiment will probably involve offerings of world-class issuers and initially will involve investment-grade debt offerings, and certain rights and exchange offerings.

Accounting and Auditing Standards

Since financial statements and related financial disclosure are critical to the integrity and credibility of a regulatory system, it is extremely important to concentrate on accounting matters. Accounting principles, auditing standards, and auditor independence are key factors in determining the feasibility of achieving mutually acceptable disclosure.

The problem faced in the accounting principles area is that different countries have different standards. In recognition of this fact the Commission permits financial statements to be prepared in accordance with generally accepted accounting principles in the home country, but requires that for U.S. reporting purposes they must be reconciled to U.S. Generally Accepted Accounting Principles (GAAP).¹² This approach has not been entirely satisfactory since it frequently requires foreign issuers to make additional disclosures if they wish to reach U.S. markets.

In an effort to address accounting differences, the Commission's staff is working with the International Organization of Securities Commissions (IOSC) to examine practical means of promoting the use of common standards in accounting. IOSC has formed a Technical Committee, which includes representatives from the United States, to determine accounting standards that would be acceptable to securities regulators in

¹² 17 C.F.R. 240.4-01(a) (2).

multinational offerings. A working group of the Technical Committee is cooperating with the International Accounting Standards Committee (IASC) to revise international accounting standards. This group is addressing problems of completeness and lack of specificity in some of the international accounting standards and hopes to reduce the number of free choice accounting options permitted under some of the standards. Where options cannot be eliminated, the group seeks to specify one method as the benchmark (or "preferred" method) for international filings. At its November 1988 meeting in Copenhagen, the IASC board is expected to consider publication of an Exposure Draft for public comment. This draft would represent the first phase of the project -- proposed changes to deal with the question of accounting options in existing international standards.

Although progress is being made in resolving differences in accounting standards, differences in auditing standards are not as susceptible to accommodation through reconciliation. Auditors around the world are subject to different independence standards, perform different procedures, gather varying amounts of evidence to support their conclusions, and report the results of their work differently. Efforts to establish mutually agreeable auditing standards have not yielded the same degree of progress found in the accounting area, in part because concerted effort thus far has not taken place. The Commission's staff, as part of an IOSC working group, recently began participating in a project by the International Federation of Accountants (IFA) to expand and revise international auditing standards. The joint IOSC/IFA working group held its first meeting in May 1988 to begin to deal with these issues.

Application of Registration Requirements to Foreign Offerings

The Commission is also examining questions regarding application of U.S. registration requirements to securities offerings overseas. In this area we are moving toward the concept that overseas securities sales by either domestic or foreign companies should not be subject to U.S. registration requirements. While the registration provisions

of our Securities Act are broad enough to encompass any offering in which there is some contact with the United States, the Commission stated in 1964¹³ that it would not take enforcement action if United States companies offered securities outside the United States to non-United States investors in a manner that resulted in the offering coming to rest outside the United States.¹⁴ The concepts in this release have been applied to foreign issuers as well.

In June of this year, the Commission issued a release seeking public comment on a proposed regulation dealing with the extraterritorial application of the registration provisions of the Securities Act.¹⁵ Following a territorial approach, we proposed Regulation S, which would provide that Securities Act registration requirements would not apply to offers or sales of securities that occur outside the United States, even if those offers or sales are made to U.S. residents.

Organized Institutional Trading

It has long been true in the United States that detailed disclosures may not be necessary if offers are being made to sophisticated investors. In recognition of this principle, the American Stock Exchange and the National Association of Securities Dealers have recently requested Commission approval of proposed trading systems that would provide facilities for institutional trading of certain unregistered securities between sophisticated investors. If approved, the Amex's system, SITUS,¹⁶ and the NASD's

¹³ See Securities Act Release No. 4708 (July 9, 1964).

¹⁴ The Commission's staff has considered the term "coming to rest" in no-action letters. Such letters have indicated that if steps are taken to assure that the securities will not be sold in the United States or to United States persons for 90 days in debt offerings and for one year in equity offerings, the securities will be deemed to have come to rest.

¹⁵ Securities Act Release No. 6779 (June 10, 1988).

¹⁶ File No. SR-Amex-87-32 (December 23, 1987).

system, PORTAL,¹⁷ will provide organized marketplaces in the United States for certain sophisticated investors to trade unregistered securities of large, high-grade foreign issuers. Both debt and equity securities of qualified foreign private issuers and debt securities of qualified foreign government issuers would be eligible for trading in these systems. Under these proposals, sales and resales of these securities could take place without meeting extensive U.S. disclosure requirements.

EDGAR

The most dramatic change in the U.S. disclosure system will occur in 1990 or 1991 when the Commission's automated disclosure system becomes operational. The Commission's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) has been in a pilot stage since 1984, with approximately 250 industrial companies and approximately 1,000 investment companies now utilizing the system.

Eventually we expect all 14,000 companies required to file reports with the Commission to file information electronically. When that occurs, information about all of these companies will be immediately available for review and analysis by both the Commission and the public. We are very excited about EDGAR, and hopeful that the project may eventually point the way to a worldwide automated disclosure system.

D. Operations of Multinational Broker-Dealer Firms

The multinational character of many large U.S. brokerage firms and foreign financial institutions raises several regulatory concerns, perhaps the most important of which relates to the financial integrity of these firms. Varying degrees of regulation exist regarding broker-dealer capital. For instance, the Commission's net capital rule¹⁸ provides safeguards by requiring each broker-dealer to have liquid assets greater than its

¹⁷ File No. SR-NASD-88-23 (June 17, 1988).

¹⁸ Rule 15c3-1 under the Securities Exchange Act. Rule 15c3-1 specifies minimum levels of net capital to be maintained by a registered broker-dealer, based on the nature of the broker-dealer's business.

obligations to customers. The rule contains a number of safeguards aimed at preventing a broker-dealer's assets from being used to assist an affiliate in financial difficulty. Since the default of a major unregistered affiliate could dramatically affect a broker-dealer, our net capital rule was amended last year to require U.S. broker-dealers to make subtractions from net capital with respect to transactions with unregistered affiliates, including foreign affiliates, unless the affiliate opens its books and records to regulatory examiners.¹⁹

International cooperation is underway between regulators in efforts to improve capital adequacy standards in order to provide greater stability and liquidity in national and international markets. For example, the Commission and U.S. self-regulatory organizations have reached an agreement with the Securities and Investments Board of the United Kingdom for an information-sharing arrangement that would permit the Securities and Investments Board, the Bank of England, and British self-regulatory organizations to rely on financial oversight of U.S. firms by U.S. regulators. Under this agreement, the British Securities and Investments Board will rely on American regulatory oversight of U.S. firms with branches in the United Kingdom and will not require compliance with separate U.K. net capital standards. This agreement is an important first step toward achieving coordinated sharing of financial information on affiliated broker-dealers among regulators in major securities markets.

Of course, broker-dealers of one country wishing to participate in the markets of another country usually will be required to register under the host country's securities laws and be subject to various customer protection provisions. In the United States, we apply broker-dealer registration requirements to foreign broker-dealers, but we try to be flexible. For instance, we have taken the position that the mere provision of quotes by foreign brokers to U.S. customers through automated linkage arrangements between markets does not require registration. In addition, our staff has taken interpretive

¹⁹ See Securities Exchange Act Release No. 24553 (June 4, 1987).

positions allowing foreign broker-dealer affiliates to provide research and analysis to institutions if a U.S. broker-dealer is actively involved in any such conversations with the institution and if any resulting trade is consummated through the U.S. firm.²⁰

E. Investment Companies

In the investment company area, regulatory barriers between U.S. and foreign markets have significantly restricted cross-border sales of mutual funds and other investment company products.

We recognize that our investment company regulation is relatively strict, but we believe strict regulation is justified when professional money managers have control over large amounts of liquid assets. Section 7(d) of the Investment Company Act of 1940 prohibits a foreign investment company from publicly offering securities in the United States unless it first obtains a Commission order reciting, among other things, that the provisions of the Act can be effectively enforced against the foreign fund. This standard has been especially difficult for funds organized in European countries to meet.

Investment companies organized in the U.S. also have encountered problems in offering their shares abroad because of substantive restrictions imposed by some countries on foreign investment companies and because of currency, tax, and other restrictions that provide a disincentive for citizens of those countries to invest in foreign issuers.

If cross-border sales of investment company shares are to be facilitated, cooperative efforts by regulators and foreign governments are a necessity. The most

²⁰ See, e.g., letter from Amy Natterson Kroll, Attorney, Division of Market Regulation, SEC, to Frank Puleo, Esq., Milbank, Tweed, Hadley & McCloy (July 28, 1987). On June 14, 1988, the Commission issued a release requesting comment on its outstanding interpretive positions on foreign broker-dealer registration [Securities Exchange Act Release No. 25801 (June 14, 1988)]. The release also sought comment on whether the Commission should adopt a rule providing a limited exemption from broker-dealer registration for foreign entities dealing with certain U.S. institutions under limited conditions.

promising approach seems to be one based on notions of equal competitive opportunity. In 1984, the Commission recommended legislation to amend Section 7(d) to permit it to grant orders to foreign investment companies when strict compliance with our Investment Company Act requirements would be unduly burdensome and when investor protections comparable to those of the 1940 Act existed under foreign law.²¹ Although this legislation was not adopted, we continue to believe its underlying philosophy has merit.

Currently, our staff is considering recommending a renewed effort to amend Section 7(d) that emphasizes the benefits of equal competitive opportunity both in the U.S. and abroad. Additionally, we are exploring informally with Canada and members of the European Community the possibility of bilateral treaties for the reciprocal sale of investment company shares, a concept favored by the European Federation of Investment Companies and also of interest to the Japanese.

F. Enforcement Issues

As access to international markets by brokers, issuers, and securities traders from all countries has increased, the needs of regulators for access to information about foreign trading activity and the capital raising operations of foreign companies has expanded. The goal of international securities regulators should be to promote market fairness, including prohibitions against insider trading, market manipulation, and misrepresentations to the marketplace. Pertinent information and evidence regarding such activities frequently is located outside the host country and may not be subject to the host country's jurisdiction. The Commission's response has been to develop international surveillance and information sharing arrangements that are effective from an enforcement standpoint while sensitive to national sovereignty concerns.

²¹ See Memorandum of the Securities and Exchange Commission in Support of the Operating Foreign Investment Company Amendments Act of 1984, submitted to Congress with the approval of the Commission in conjunction with the issuance of Investment Company Act Release No. 13691 (December 23, 1983).

During the past five years, we have negotiated Memoranda of Understanding (MOUs) with the Brazil Comissao de Valores Mobiliarios, Canadian securities regulators, the United Kingdom Department of Trade and Industry, the Japanese Ministry of Finance, and Switzerland.²²

As the present time, the Brazilian and Canadian MOUs are the most comprehensive agreements negotiated by the Commission on cooperation in enforcement matters between securities regulators. Each party to the Brazilian and Canadian MOUs has agreed to provide the fullest assistance possible for investigations of cases where information needed by one authority is located in the territory of the other. Under the MOUs, the parties have agreed to investigate on behalf of one another to obtain the necessary information, and to use compulsory process (subpoena power) where necessary.

Currently, the Commission does not have the authority to conduct investigations on behalf of a foreign agency absent a possible violation of U.S. law. However, on June 3, 1988, the Commission proposed to Congress the adoption of legislative amendments which would provide us with such authority.²³ If enacted, the proposed legislation would also clarify the Commission's ability to share information with both domestic and foreign regulatory authorities. Additionally, it would allow the Commission to maintain the confidentiality of documents received from foreign authorities. Passage of this proposal

²² Additionally, the United States and Switzerland exchanged Diplomatic Notes on November 10, 1987, in which they agreed that under certain circumstances, the 1977 Treaty on Mutual Assistance in Criminal Matters between the Swiss Confederation and the United States, could be used to provide assistance in Commission investigations relating to serious violations of U.S. securities laws. The Diplomatic Notes ensure that, because insider trading has been made expressly illegal in Switzerland as of July 1 of this year, the Commission can obtain and use information under the Swiss Treaty in insider trading cases.

²³ On September 14, 1988, the House of Representatives passed H.R. 5133, the "Insider Trading and Securities Fraud Enforcement Act of 1988," which contained a provision that would give the Commission such authority.

would facilitate the negotiation of new MOUs and enhance international cooperation and coordination among securities regulators around the world.

III. NEED FOR INTERNATIONAL COORDINATION

The ability of securities regulators throughout the world to address the issues raised by automation and internationalization of the securities markets will depend greatly upon cooperation between regulators. There can be no doubt, particularly since the October 1987 market break, that all securities regulators must work together diligently to create sound international regulatory frameworks that will enhance the vitality of capital markets.

Regulators around the world have already made strides in developing coordinated responses to important issues. International forums such as IOSC and the Organization for Economic Cooperation and Development (OECD) provide regulators with the opportunity to meet with their international counterparts to work toward achieving greater uniformity in areas of particular concern.

Although some progress toward the goal of reaching common understandings has been made, the tasks ahead are difficult. Major differences remain among world market regulatory structures, even among the most mature markets. While we are seeking common solutions to the issues that face us internationally, we must be mindful and respectful of our existing regulatory frameworks.

If these national frameworks are to be respected, resolution of international securities regulation issues requires special effort by all concerned. For my part, I believe the United States Securities and Exchange Commission must be a leader in world securities regulation. Our Commission will continue its active efforts to meet the many challenges presented by securities market automation and internationalization.