INTERNATIONALIZATION OF THE CAPITAL MARKETS: THE EXPERIENCE OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

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SUMMARY

"Internationalization" of the securities markets refers to the increasing tendencies of issuers, investors, broker, dealers and marketplaces to cross borders in search of a transaction. This phenomenon is beneficial for all participants, including the nations involved, if they undertake to manage it efficiently.

This paper discusses the experience of the U.S. Securities and Exchange Commission in three areas which encompass many of the emerging issues of internationalization: initial offerings; trading markets; and enforcement and surveillance. In addition, a final section on implementation discusses participation by IASCO in the internationalization process. Each section concludes with recommendations which are reproduced below, and are to be discussed at the meeting.

International Offerings

Recommendation 1. Governments should recognize that a growing number of companies are raising capital in foreign markets, and should be flexible in applying their disclosure regulations to foreign offerings, when possible and consistent with their own objectives.

Recommendation 2. Government representatives should continue to meet and discuss ways of harmonizing disclosure standards and other regulations and practices dealing with the distribution of securities without foregoing what each country believes are necessary investor protections.

International Trading

Recommendation 3. Governments should recognize that securities are increasingly being traded in foreign markets and investors are seeking greater investment opportunities in foreign markets, and that this trend is driven by economic forces, 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 for market integrity and investor protection.

Recommendation 4. Government representatives should continue to facilitate the development of international market linkages.

International Surveillance and Investigation

Recommendation 5. Governments should recognize the need for international enforcement of national securities laws where violations in one country have harmed investors in another country. Cooperative arrangements should be developed to enhance international surveillance of market activity.

Recommendation 6. Governments should agree to develop mechanisms for access by foreign securities enforcement authorities to regulatory and investigative files.

Recommendation 7. Governments should consider negotiating bilateral and multilateral agreements which would provide mutual assistance in securities matters.

Implementation

Recommendation 8. Representatives to the IASCO meeting should report upon the consideration of these matters in writing to the IASCO Secretariat prior to the next annual meeting.

INTRODUCTION

International capital markets are developing rapidly. Orders, payments and securities can now be transmitted from one market to another almost instantaneously. These developments in capital markets are but 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 of the market participants: corporations, investors, brokers, dealers and marketplaces. Corporations and other issuers of securities benefit because they can broaden their ownership basis by entering foreign markets. This promotes market stability and liquidity, may increase interest in that issuer's products, and may 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 or better service the needs of existing foreign customers. And

marketplaces benefit because transnational trading and clearing linkages can result in increased potential order flow for both markets, increased price efficiency, more capital being available for market-making, improved trade clearances and settlement processing, and increased visibility.

Notwithstanding the enormous potential benefits of internationalization of capital markets for the global economy, there are obstacles to internationalization. In addition to direct obstacles to the free flow of capital such as taxes, exchange controls and investment controls, perhaps greater obstacles result from 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 these benefits of and obstacles to internationalization in three specific areas, as experienced by the U.S. Securities and Exchange Commission (SEC). Part I discusses disclosure requirements for public offerings of securities in more than one country, and the recent SEC proposal on reciprocal and common prospectuses. Part II discusses the development of the international securities marketplace and recent initiatives, both by the industry and the SEC, to develop trading, information, clearing and settlement linkages. Part III discusses market surveillance and international investigations, and the methods which the SEC has developed, and new suggestions which may result, for obtaining information from other nations about securities law violations which result in domestic harm. After these areas are discussed, Part IV examines implementation of the recommended actions and IASCO's potential role in ensuring smooth internationalization. Each section concludes with recommendations for discussion at this meeting.

I. International Offerings

Raising capital in international markets is no longer the novelty it was only a few years ago. Commentators have titled 1985 a "boom year" in the global capital markets. The total volume outstanding of U.S. commercial paper, U.S. bonds, Eurobonds and Euronotes is up sharply over 1984 levels; some individual volume levels have more than doubled. New issues of Eurobonds totaled a record $133.4 billion during 1985. During 1985, foreign investors purchased $37.9 billion of United States Treasury Securities, and United States investors purchased roughly

$10 billion in foreign government bonds. Innovation and diversification has produced traditional financial instruments in new currency denominations and has increased trading levels in equity securities and "swaps." It is estimated that 50 percent of 1985 Eurobond offerings were linked to interest rate and currency swap transactions.

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

A. Present Registration Procedure

In 1977, the SEC began developing a disclosure system specifically for foreign private issuers offering and trading securities in the United States by adopting Form 20-F. This form lists the disclosure requirements for foreign companies whose securities are actively traded in this country and who are subject to our continuous disclosure requirements. Accommodations were made to foreign private issuers in an attempt to harmonize the disclosure requirements in the United States with the requirements most commonly found in foreign countries.

In 1982, an integrated disclosure system for foreign issuers was first adopted which is similar to the system for domestic issuers. 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, or "incorporation by reference."

B. The Multinational Offerings Release

In March 1985, the SEC issued a release entitled "Facilitation of Multinational Securities Offerings." The release requested public comments about 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 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. Under either approach, the same liability standards, discussed in Part III below, would apply to foreign issuers and domestic issuers.

The release asked questions about these approaches, their impact in other areas, and the SEC's role in facilitating such offerings. 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.

C. Response to the Release

There were seventy commentators on the release; some raised additional issues not mentioned in the release. The SEC's initiative was strongly endorsed by a significant majority of the commentators. 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 about the impact on the domestic regulatory schemes, or were concerned that this initiative would facilitate the spread of United States disclosure standards to their domicile. The major points raised are discussed in the following paragraphs.

The Reciprocal Approach. The majority of commentators favored the reciprocal approach. One of the major advantages of the reciprocal approach appeared to be the ease of implementation. It was also argued 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.

While there was some support for reciprocity without any additional disclosure, 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 meeting minimum disclosure standards.

The Common Prospectus Approach. Many persons believed the common prospectus may be the ideal approach, although they were skeptical about the prospects for achieving the necessary agreements in the near future.

Accounting Standards. The difference in accounting standards in the three countries was mentioned by many commentators. 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. In contrast, other commentators indicated that anything less than compliance with United States generally-accepted accounting principles and auditing standards could present various 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 other 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 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 out differences of the distribution system employed in the United Kingdom. United States "gun-jumping" rules inhibit pre-effective publicity in the United Kingdom, and it is 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 called for the SEC staff to pre-

review filings on a confidential basis, or to abstain from reviewing multinational filings by relying entirely on the review in the issuer's domicile. For periodic reporting, some commentators called for the SEC to 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, because United States standards are more strict and comprehensive. 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 competitively disadvantaged; others, however, believed there would be no such effect. At least one person projected that multinational issuers would tend to substantially comply with United States disclosure standards under a reciprocal approach, in order to avoid any comparative disadvantage to their offering which might result from 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 solicited comments on the possibility of incorporation by reference to 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 for incorporated documents, such as regulatory agencies or stock exchanges, should be required in each jurisdiction. Access to the EDGAR system was also enthusiastically endorsed, with further suggestions that reciprocal benefits for any foreign counterpart system be assured and that other countries given access be encouraged to contribute to 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 41 such funds at the end of 1985, ten more than in 1984 and nearly

twenty more than in 1983. In addition, United States funds are increasingly sold to foreign investors. The SEC is considering a recent suggestion by the Investment Company Institute that the United States seek an agreement with the EEC allowing reciprocal sales, similar to the existing arrangement among EEC members.

E. Recommendations

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

Recommendation 1. Governments should recognize that a growing number of companies are raising capital in foreign markets, and should be flexible in applying their disclosure regulations to foreign offerings, when possible and consistent with their own objectives.

Recommendation 2. Government representatives should continue to meet and discuss ways of harmonizing disclosure standards and other regulations and practices dealing with the distribution of securities without foregoing what each country believes are necessary investor protections.

II. 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. Total issues of Eurobonds outstanding exceed $300 billion, and annual trading volume has increased sevenfold over the last five years to an estimated $1.5 trillion. International markets also flourish for sovereign debt, most notably United States Treasury securities, British Gilt instruments, and Japanese Yen bonds. While debt has been the foremost element of the internationalization process, equity securities also are being traded increasingly on an international basis. The stock of approximately 410 major companies, including over 85 United States corporations, is traded actively in both the issuers' home market and at least one foreign market. Foreign demand for United States equities remained high in 1985, with overseas investors effecting more than $108 billion in transactions on United States markets in the

first nine months of 1985, and additional trading in United States equities occurred on foreign markets. United States investors during the same period traded over $30 billion worth of foreign stocks, and United States institutions now hold over $16 billion in foreign stocks, compared to about $2 billion in the late 1970s.

A. Present Trading Development

An active market is developing among dealers away from organized stock exchanges to meet the demand of investors for international trading opportunities. This trading is primarily by institutional investors or by dealers for their own accounts, and 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. For the most part, trading in United States equities remains concentrated in the United States securities markets, although intermittent trading in some issues occurs in Europe before the trading day begins in the United States, and some blocks are placed in Japan.

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. Trading through the Amex-Toronto linkage began in 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. Trades routed from Toronto to the Amex have increased from fourteen trades totaling 18,500 shares when the program began in October 1985 to 78 trades totaling 292,000 shares in January 1986. Trades routed from the Amex to Toronto have been less frequent, with six trades totaling 9,000 shares in January 1986. The Midwest Stock Exchange and Toronto have developed a similar trading linkage, which

began operating in April 1986. 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. Trading has grown from 150 trades totaling 41,000 shares in June 1985 to 530 trades totaling 423,000 shares in January 1986. The two exchanges also may later allow Boston member firms to send orders in Canadian national issues directly to Montreal for execution.

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, 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 SEAQ 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.

The Paris, London, Brussels, and Amsterdam Stock Exchanges are scheduled to establish the Interbourse Data Interchange System (Idis) in 1986. Idis will provide a common means for reporting historical non-current prices among the linked markets. Idis later will also include the Copenhagen, Madrid, and Milan Stock Exchanges.

There are several other information or trading linkages under consideration by the world's securities exchanges and information processors. The Philadelphia Stock Exchange and London have proposed trading fungible contracts on the six foreign currencies on which Philadelphia currently trades options. Under this proposal, quotation and 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. The New York and London Stock Exchanges are discussing possible future joint ventures in securities trading and reporting of market data. The Amex and European Options Exchange (EOE) in Amsterdam have announced a proposal for the EOE to trade fungible options on Amex's Major Market Index. And 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.

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. The Zurich Exchange also is considering using CATS.

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.

National Securities Clearing Corporation (NSCC) has admitted the Canadian Depository for Securities to its membership. This addition 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 described above. NSCC's new subsidiary, International Securities Clearing Corporation (ISCC), was created to further international clearing, initially to develop a clearing linkage with London's "Talisman" fortnightly settlement system. The ISCC-Talisman linkage will provide United States investors with access to London's clearing facilities, and permit United Kingdom investors to clear trades through NSCC.

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. OCC also would establish a linkage with the International Commodities Clearing House (ICCH), which currently issues, guarantees, clears, and settles transactions in London options, to process transactions by European firms that elect to continue to clear options trades through ICCH.

3. SEC Review of Current Linkages

The SEC has been studying these developments with a view towards seeing 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 parties and the provincial regulatory authorities to develop private agreements and other assurances of cooperation and information-sharing.

B. The Global Trading Release

In addition to assisting with specific development of trading, information, clearing and settlement linkages, the SEC is studying generally the growth of transnational trading markets to encourage 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. 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.

C. Response to the Release

In response, the SEC received thirty letters from commentators in six countries. Commentators believed that international trading is a positive development, and that it would continue to grow in size and importance. Commentators also recognized that the SEC plays an important role in internationalization, but most commentators opined that the SEC should refrain from premature action in this area, and should permit international trading markets to develop further on their own.

Although commentators agreed that international trading would increase, they disagreed about the future structure of the international securities markets. Several exchanges predicted that future global trading of world class securities would occur around-the-clock through a

network of interconnected exchanges, while other commentators asserted that such trading would be more likely 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, and indicated that the incremental development of links between existing institutions was preferable to trying to create a central international clearing or depository entity.

D. SEC Implementation

The SEC discussed these responses in a public meeting on May 23, 1986. The SEC staff recommended that the SEC 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 SEC 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 general 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. Many of the principles developed in this process will be discussed at this conference.

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.

Recommendation 3. Governments should recognize that securities are increasingly being traded in foreign markets and investors are seeking greater investment opportunities in foreign markets, and that this trend is driven by economic forces, 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 for market integrity and investor protections.

Recommendation 4. Government representatives should continue to facilitate the development of international market linkages.

III. 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 market participants, be they issuers or traders of securities, from deceit, manipulation or fraud in connection with purchases and sales of securities. Disclosure to investors of all information material to their investment decisions is the cornerstone of the United States securities laws. These laws apply to all investors and issuers whose transactions are directed toward the United States market.

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. In a case where all of the evidence is located in or controlled from the United States, the SEC has the jurisdiction to compel its production. 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. Foreign law often does not allow for 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. No comprehensive agreements exist for assistance in such international investigative efforts.

While the vast majority of issuers and traders comply with the United States securities laws, multinational transactions can be advantageous to securities law violators desiring to conceal evidence of their activities from enforcement authorities. As these multinational transactions become more common, each nation seeking to enforce its securities laws will need access to information from 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 will complicate the surveillance and oversight of market activity. Without enhanced surveillance techniques, internationally-linked markets will be more susceptible to fraud.

As discussed in Part II above, the SEC has encouraged the development of transnational trading. The SEC encourages international participation in the Intermarket Surveillance Group, an organization through which many of 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 has already 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 securities exchanges involved to assure, in writing, that cooperation in enforcement investigations will be available. 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 opined to 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.

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. Most recently, 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 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.

2. Formal Methods

The only formal methods for gathering evidence abroad are multinational agreements such as the Hague Convention, bilateral agreements specifically governing assistance in criminal matters, and letters rogatory. None of these is adequate for evidence gathering prior to litigation. New arrangements for assistance 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 and letters rogatory provide useful mechanisms for obtaining evidence from neutral witnesses. However, they generally are available to the SEC only after a lawsuit has been filed in a United States District Court. Most often, the SEC needs foreign cooperation to obtain evidence and complete an investigation before commencing such a lawsuit. Many nations have agreed to the Hague Convention on the condition that no "pretrial" discovery may take place pursuant to Convention procedures. 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. 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 rogatory with either speed or certainty.

Bilateral Agreements. The United States has treaties with three countries for mutual assistance in criminal matters 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 last year 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. The SEC also invited public consideration of the broader factual, legal and policy issues implicated by the increasingly international securities markets.

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

Any arrangement for assistance in evidence gathering must allow participating nations all the 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 vehicle for providing assistance, but rather believes that this subject should be explored in detail by all trading nations to develop an agreement enhancing cooperation 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.

Recommendation 5. 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.

Recommendation 6. Governments should agree to develop mechanisms for access by foreign securities enforcement authorities to regulatory and investigative files.

Recommendation 7. Governments should consider negotiating bilateral and multilateral agreements which would provide mutual assistance in securities matters.

IV. 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 Association of Securities Commissions can play a leading role in developing and advancing this dialogue.

Recommendation 8. Representatives at the IASCO meeting should report upon consideration of these matters in writing to the Secretariat prior to the next annual meeting.