The Internationalization of the Securities Markets

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As already indicated, in February of this year, the Administration announced that the investment controls in the form of the Interest Equalization Tax and the Foreign Direct Investment Regulations will be phased out in 1974. Hopefully, this will be feasible. In any event, these controls, imposed beginning in 1963, sparked certainly what can be called the revolutionary development of international securities markets. The first stage of this development took the form of the so-called Euro-market, or more commonly and more appropriately, the Euro-bond market. I think a little background on the development of this market is in order.

First of all, conditions were right for the creation of an European capital or securities market. By the late fifties and early sixties, external currency convertibility had been accomplished; the Western European economics were maturing and generating capital; massive amounts of United States dollars had been accumulated as a result of the United States deficit spending programs, outright grants, and the substantial direct foreign investment of United States multi-national corporations.

Although New York prior to 1963 could be called the only real international capital market, increasingly the investment capital for such offerings was coming from outside the United States—mainly Europe. When the IET, in 1963, as practical matter, closed the New York market for international offerings for dollars, the natural swing was to Europe. The real take-off point came in 1968 when the mandatory foreign direct investment controls were established. This added the necessary fuel as the United States multi-national corporations, revealing such controls as only a financing program, merely shifted their capital-raising activities to the overseas markets in Europe.

To reach the available capital in Europe, however, a vehicle was needed to by-pass the diverse fiscal and political regulations and controls on capital existing in the various countries. This vehicle emerged as the Euro-market

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mechanism, an international phenomenon, which is essentially unregulated. By denominating issues in currencies other than that of the countries in which the offerings are made, the individual countries have been able to acquiesce in the fiction that such offerings are either "restricted," i.e., "private placements" or only pass through transactions and thus not subject to national securities regulations. Other factors of importance in the development of the Euro-market have been the high quality of the issues and issuers, the practice of providing full disclosure by the international corporations who are accustomed to providing such disclosures, the addition of the United States marketing techniques to distributions, and the fact—one of the most important facts—that the market is essentially a debt and not an equity market.

The removal of the United States investment capital controls, if and when feasible, should make the United States markets more internationally competitive, but the international Euro-market, or certainly some form of an integrated or unified European market, should remain, but probably on a much reduced scale. The Euro-market has proved viable despite an apparent lack of an efficient secondary market, at least in its initial years. Nor is it likely that the huge overseas investment in Europe of United States and other international financial institutions, banks and brokerage houses will just wither away. Additionally, Japan, which has the third most developed securities market in the world, has and is opening her domestic capital markets to outside borrowers and investors, and should emerge in a short time as another major international market. The conversion of Arab countries' oil reserves into currency reserves—the so-called petro-dollars—is likely to stimulate all international markets in yet unascertainable ways. More and more, companies are seeking international stock exchange listings for their securities. Investment capital, both direct and portfolio, is crossing national boundaries in increasing amounts in all directions.

It is clear, then, that viable competitive alternatives to New York do and will exist unlike pre-1963, even though certainly they will lack the overall efficiency and capability of the United States market. However, the cornerstones for truly international markets have been and are being laid. Moreover, as the practicable as well as desirable limitations on the level of world debt capital are reached, more resort will have to be made to equity capital financing to meet the anticipated vast world capital requirements in the future. This, realistically, will require more direct access to all capital markets of the world. Is this more feasible now than in the sixties? How do these overseas securities markets and their regulation differ from ours in terms of regulations? The answers to these questions could have a bearing on our present and future policies regarding foreign issuers and foreign participation in the United States markets and our market structure.

The Office of International Corporation Finance established in the Commission's Division of Corporation Finance early this year is presently engaged, with the voluntary aid of outside professional bodies, including the ABA,

in just such a study of a select few of the more representative European countries as well as Japan and Mexico. This study is only in its very initial stages but I would like to share some observations based on the very limited study input to date and on other available information which, unfortunately, may be somewhat dated. These observations of necessity are very general, pertain essentially to the countries in Europe, especially Continental Europe, and do not relate necessarily in all respects to each and every individual country.

The systems of securities regulation in Europe, of course, reflect the development of the legal and economic systems as well as the customs of the individual countries. In my opinion, three basic differences are notable in any comparison of foreign securities regulation to the federal regulation here in the United States. First, except perhaps in the area of mutual funds, there are no separate national securities laws as such. The laws pertaining to securities regulations are found in various commercial, corporation and penal laws and codes, in banking laws and in the private rules of the various stock exchanges. This helps to explain, perhaps, the dearth of readily available information on such regulations and on administrative determinations and court decisions relating thereto. Second, European countries do not, as a rule, have a single governmental agency like the SEC with the direct authority and responsibility for enforcing securities regulations and which actively uses that authority especially in the areas of establishing and enforcing required disclosures to investors and in the trading practices of those in the industry. Third, there does not appear to be any counterpart to the highly developed system of both the direct regulation by the SEC and the supervised cooperative self-regulation by the various segments in the market structure.

In Europe, the concept of full and widespread corporate disclosures has been late in developing. Traditionally, corporations there have been willing to disclose only the barest details on operations for competitive reasons and because of the possible impairment of negotiations with trade unions. In addition, corporations traditionally were small, often family owned and debt rather than equity financing was the rule. As a result, full disclosures were limited to creditors and management. The slow development of disclosures in turn also delayed the full development of independent bodies of professional accountants and financial analysts—essential ingredients in any capital investment system based on full and open disclosure to investors. Substantial progress in these areas, however, has been and is being made, prompted probably by the need of European companies to resort to equity financing for expansion purposes to meet foreign competition coupled with the increased sophistication of foreign investors who want and demand not only increased but more accurate disclosures.

Notwithstanding this continued progress, however, generally the corporate laws in Europe are still not premised on the belief that investors are best protected by full disclosure as in our system. Rights offerings and secondary offerings of securities which are outstanding and trading usually are not sub-

ject to registration or regulation nor are other noncash offerings. A prospectus as such is required usually only in connection with listings which may occur, in some instances, after a public offering, as we know it, has been made. Important stockholder rights such as the receipt of a detailed proxy statement, one of the most informative and widely disseminated documents we have, are not provided for; in fact, in some countries management cannot solicit or vote proxies. The use of bearer shares, prevalent in Europe, further retards such full dissemination of information. A continuous disclosure system, other than perhaps for annual reports, if one exists, apparently is not always strictly enforced. The disclosures required by corporate laws and the exchanges, although covering essentially the same areas as those in the United States, are not as demanding or detailed. This has been especially true in the areas of line of business reporting, competitive conditions and comparisons, productive capacity and utilization of resources and transactions with and including management and other insiders.

In the area of accounting or financial reporting, there is no strict requirement in many countries that the auditor be financially independent and in others, the audits may be performed by internal accountants. Important auditing standards of accounts receivable and verification and observation of physical inventories are not always required. Important investment tools such as consolidated financial statements, sales *and* gross profit figures, reserves composition and analyses and the inclusion of detailed explanatory notes are still not all that common. Statements of source and application of funds usually are not required, and rarely are disclosed.

Regulation-wise, in contrast to the United States, the securities markets in Europe are almost completely self regulated, if not in theory, in fact. In the United Kingdom, the London Stock Exchange is the dominant regulatory factor; in Continental Europe, the banks and other financial institutions, directly or indirectly, control the securities markets. With few exceptions, these institutions decide what securities are traded, how much gets traded, how they are traded and by whom they are traded. Since banks in Europe engage in both commercial and investment banking, including brokerage, the potential for conflicts of interest is obvious, especially when coupled with the general proscription in Europe against the marketing of securities as we know it.

The concept of misuse of inside information which the SEC and the courts here have been pushing hard is a concept that is just now developing in Europe. Even in England, admittedly one of the most sophisticated capital markets in the world, the government is only now proposing legislation to provide not only more clearly defined civil but also penal sanctions for the misuse of confidential price sensitive information by insiders. Whether because of the lack of specific securities laws defining or establishing the rights of investors and/or the obligations of issuers and others in the market structure, the lack of effective enforcement by direct governmental authorities and

by the self-regulatory bodies or otherwise, there is a decided paucity of public information available in Europe regarding formal administrative proceedings or civil suits involving registration and reporting violations or insider frauds. There is evidence, however, that chinks are beginning to show in the armor of what has been characterized in some countries as "the tradition of discrete self-policing by tightly knit financial communities." It is beginning to be realized that complete self regulation by the market industry is not always in the best interests of all investors.

In recognition of the differences existing in regulation among the world capital markets and the classic economic theory that effective mobilization of the world's resources will require also an effective mobilization of the world's capital, there have been suggestions and recommendations made over the years, and with increasing frequency lately, for the establishment of an international SEC type body with authority to establish and enforce uniform worldwide rules and standards for disclosures, practices and over-all control of all securities markets. This may be a worthwhile long-term goal but one which, I think, may be more illusive than the attainment of a common world currency. Control of local capital market institutions and enforcement under local legal systems are sacred cows of national sovereignty. Even if obtainable, international uniformity in all respects in the world markets may not be practicable or even desirable.

The more realistic and plausible approach in the short term lies in increased cooperation, coordination and accommodation among the world securities markets in the areas of establishing uniform minimum standards of disclosures and replacing present informal international cooperation in regulatory and enforcement activities with more specific reciprocal legal assistance agreements. In this latter respect, the United States just recently has negotiated such a treaty with Switzerland. Although perhaps we may not have gotten all we wanted in the treaty, as proposed for adoption, it's at least a start and a very important one. Countries are recognizing, and must recognize, that they can no longer act in isolation in securities markets which are not bound by national borders.

Notable in the efforts to establish multi-national uniform standards of minimum disclosure have been the Organization for Economic Coordination and Development and the European Economic Community. Both are presently engaged in attempting to establish for their member countries minimum standards for the issuance of securities, the listing of securities and the periodic reporting of financial and other information to investors. Similar efforts have been and are being made by the International Federation of Stock Exchanges. The EEC also has been working for years on the establishment of a European company law—one corporation law for all of the states in the EEC. Despite the perhaps limited success of the efforts of these organizations to date because of the difficulties of harmonizing political and economic differences and problems, they should be encouraged in the interest

of internationalization. The SEC has, should and will continue to support such activities. Incidentally, Alan Levenson, the Director of the SEC's Division of Corporation Finance, is a member of the Working Party under the OECD Committee engaged in activities in this area. More recently, in June, 1973, as an outgrowth of the Congress of Accountants held in Australia in 1972, a new international accounting standards committee was established to promote worldwide accounting standards. The committee consists of nine of the leading capital market countries in the free world, and it is expected that forty to fifty other countries will join as associate members. At the Commission, we will continue to accommodate the ever increasing number of foreign study groups that are coming to study our system of regulation.

In a more direct role in the international area, although I do not believe it is the direct responsibility of the SEC to encourage or discourage international investment capital movements, I do believe it has a responsibility, in line with national policies, to facilitate the flow of investment capital and the exchange of investment opportunities within our framework of fair and equitable practices. We must consider, as we have in the past, the flexible application of our securities laws, consistent with the protection of investors, in order to encourage all issuers and investors, foreign or domestic, to operate within the framework of our regulation system.

In this connection, we have made accommodations to foreign or international issuers and issues under both the 1933 and 1934 Acts, or basic securities laws. Under the Securities Act, proceeding on a case-by-case basis, we do accept less prospectus disclosures in such areas as management remuneration. We have accepted foreign accountants' certificates where no material question of independence is involved, and we have accepted financial statements prepared under different accounting principles when any material differences that exist can be disclosed and reconciled to ensure readability, comparability and reliability. To facilitate the trading in foreign securities by United States investors, we have adopted a short form registration statement for American Depositary receipts. Finally, we have attempted to isolate bona fide foreign placements of offerings by either U. S. or foreign issuers in order to avoid the requirement of registration with the Commission.

Under the Securities Exchange Act of 1934, because the Commission has been given greater latitude in dealing with outstanding securities, even greater concessions have been made to accommodate the practices and customs of foreign issuers on the one hand as balanced against the interests of United States investors on the other. These concessions are premised on the basis that eventually, as a practical matter, foreign companies will meet our requirements on a voluntary basis. We have separate registration and reporting forms for most foreign issuers which are somewhat less demanding in disclosures, although the gap is and should be narrowing. Foreign issuers, with exceptions, are exempt from the proxy and short-term trading provisions of the Act. Foreign issuers generally are exempt from the over-the-

counter registration requirements provided they furnish, without liability under Section 18, whatever material investment information is made or is required to be made public abroad. Short of prohibiting the trading of foreign securities or somehow isolating such securities to only the most sophisticated of investors, the accommodation made appear to be both reasonable and practicable. But, perhaps, we have gone as far as we can under present statutory mandates.

Clearly, then, the SEC has not and need not apply blindly all the technical requirements of our Acts, nor should we apply blindly United States securities laws extraterritorially. This could tend to restrict the flow of capital internationally, continue the competitive disadvantages of the United States securities markets and, in the long run, perhaps operate to the detriment of United States investors. However, neither can we pretend that national securities markets can be conveniently isolated to conform to neat legal jurisdictions. We must seek to broaden our direct role and responsibilities to foster the establishment of international disclosure standards and means of effective international regulation and enforcement.

Manny Cohen, in a recent article, I think summed up this revolutionary trend toward the internationalization of securities markets very well when he said the concept is quite simply one whose time has come. Only when this apparently inevitable concept, and perhaps necessity, of internationalization of the world's securities markets is recognized and accepted will we be able to deal effectively on both a national and international basis with the obvious problems that are already present and those surely to come.