S. HRG. 101-483

GLOBALIZATION OF THE SECURITIES MARKETS AND S. 646, THE INTERNATIONAL SECURITIES RCEMENT COOPERATION ACT OF 1989

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 646

TO AMEND THE FEDERAL SECURITIES LAWS IN ORDER TO FACILITATE COOPERATION BETWEEN THE UNITED STATES AND FOREIGN COUNTRIES IN SECURITIES LAW ENFORCEMENT

JUNE 14, 15, 1989

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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I am certain that Mr. Ruder agrees with this point and I hope his replacement as chairman, whoever it may be, proves to be his equal in vision and in vigorous enforcement.

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STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I want to again thank you for your efforts in putting these worthwhile hearings together. In addition, I'd like to welcome Chairman Ruder to the Securities Subcommittee.

Indeed, Mr. Ruder, while I have the opportunity I want to complement you on your work at the SEC and wish you well in your return to teaching.

We have not agreed on all the issues in the securities area, but I have always respected your point of view and your intellect.

Moreover, I think we share a concern about the growth of large institutions in the market and whether they may have too short-term a focus. It used to be that investors were largely individuals who took a long-term interest in their stock. Now some 70 percent of stock trades are by institutions that may only hold stock for a matter of hours —if that.

So I appreciate your concern in this area, Mr. Ruder. I think you were on the right track; I hope your successor continues your efforts.

As far as the globalization of securities markets, I am struck by the progress that the Japanese have made in financial services. The Tokyo Stock Exchange is now the largest in the world. The Japanese banks are dominant worldwide and their securities firms are giving ours a run for the money.

This is disturbing since America has always been the financial innovator. Our capital markets have always been the best run and most efficient in the world. Why has this happened? Are our markets too consumed with short term considerations, are they too concerned with merger mania rather than building new companies?

I look ferward to the witnesses answers to these and other questions. Thank you, Mr. Chairman.

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OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman. I would like to join my colleagues in adding our sincere thanks to Chairman Ruder for his dedicated service as chairman of the SEC. This may be the last time that you appear before this subcommittee, Chairman Ruder, and I know we all share in wishing you well as you return to academic life and in thanking you for serving the public and our markets and all its participants as head of the SEC.

I would also like to welcome our distinguished panel of witnesses, representing some of the world financial centers integral to the subject of today's hearing, the globalization of the securities markets.

The impact of this financial trend upon the relationship between government and business as well as its potential as an avenue for increased international cooperation, makes today's subject particularly intriguing.

After reviewing the testimonies presented at yesterday's hearings and the report prepared at the request of Senator Dodd by our Congressional Research Service it seems apparent that we must find a regulatory middle ground enabling our financial institutions to be competitive. Moreover, as I noted in my statement inserted into the record yesterday, we must look at the alarming statistical evaluations of our financial institutions' performance world wide, particularly figures showing that for the first time, in 1988, the Tokyo Stock Exchange exceeded volume trading on the New York Stock Exchange and determine what these numbers imply about our financial industry.

Second, it is important to recognize the emerging roles of Japan and a consolidated European market, as proposed beginning in 1992. We must examine how we might work with these entities to eradicate regulatory disparities among countries participating in the international financial markets and to develop the fairest international financial playing field possible.

The globalization of the monetary markets points to the need for greater regulatory coordination, and I am comforted that the committee is considering S.646, the International Securities Enforcement Cooperation Act of 1989.

Again, I commend you for holding this hearing, Mr. Chairman, and with the analogy offered by Mr. MacDonald during his testimony yesterday in mind, I rest assured that today's panel will offer significant insight into how we might best dis-

mantle the world's financial barriers enabling US financial water to integrate itself with other financial water most effectively.
Thank you, Mr. Chairman.

Senator DODD. Chairman Ruder, we welcome you here this morning. We are anxious to hear your testimony.

STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Thank you, Chairman Dodd and Members of the Subcommittee.

I thank you for this opportunity to discuss the globalization of the securities markets and S. 646, the International Securities Enforcement Cooperation Act of 1989. The Commission has submitted two written statements, one on internationalization issues generally and the other on the Enforcement Act, and I request that both be included in the record.

Senator DODD. Both will be included in their entirety in the record.

Mr. RUDER. As this Subcommittee knows, the securities markets are becoming increasingly internationalized. This internationalization affects the regulatory system administered by the Commission. As dramatically illustrated by the 1987 market break, events in one country's securities market may affect markets in other countries. As a result, we believe the Commission must be conversant with the operations of other markets and must seek to promote international cooperation. In this new environment, the Commission must consider the possible effects of its regulatory decisions upon foreign entry into our markets, upon the ability of U.S. financial service firms to compete abroad, and upon investor protection and opportunity concerns.

The Commission has undertaken important initiatives to further international coordination. In November 1988, the Commission issued a policy statement on the "Regulation of International Securities Markets." I delivered this policy statement at a meeting in Melbourne, Australia of the International Organization of Securities Commissions. In its policy statement, the Commission urged cooperation among the world's securities regulators, while recognizing cultural differences and national sovereignty concerns. The Commission suggested that an efficient regulatory structure for an international securities market system would have several elements. I'm going to read these elements, which are quite complicated, but, I think, are important to give a sense of the depth and breadth of the areas involved.

First, efficient structures for quotation, price, and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards;

Second, sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards, all of which provide investor protection yet balance costs and benefits for market participants; and

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE GLOBALIZATION
OF THE SECURITIES MARKETS

June 15, 1989

SUMMARY OF THE STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE GLOBALIZATION OF THE SECURITIES MARKETS

June 15, 1989

I. INTRODUCTION

During the 1980s, the world's securities markets expanded dramatically and became increasingly automated and interlinked. As illustrated by the October 1987 market break, events in one country's market affect those in other countries. When promulgating rules and making other regulatory decisions, the Commission must consider the effect its actions will have on the ability of foreign participants to enter our markets and the ability of U.S. financial services firms to compete in other markets.

Recognizing the importance of those issues, the Commission has taken a leadership role in promoting international coordination. The Commission's proposed structure for international cooperation is set forth in its November 1988 Policy Statement on the Regulation of International Securities Markets. The Commission is an active member of the International Organization of Securities Commissions ("IOSCO"), an organization of securities regulators from more than 40 countries. The Commission's staff actively participates in several working groups of IOSCO's Technical Committee. The Commission's staff assists the Committee on Banking Regulations and Supervisory Practices, formed under the auspices of the Bank for International Settlements, on capital adequacy issues, and attends meetings of the Wilton Park Group to discuss enforcement cooperation. The Commission has also worked on a bilateral basis with foreign securities authorities on enforcement and other matters.

In 1988, the Commission proposed legislation, the "International Securities Enforcement Cooperation Act of 1988," portions of which were adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. In 1989, the Commission proposed similar legislation designed to facilitate cooperation between the Commission and foreign securities authorities in the enforcement of securities laws. Chairman Dodd and Senator Heinz have introduced the Commission's 1989 proposal as S. 546.

II. MARKET STRUCTURE DEVELOPMENTS

In 1988, the Commission issued a release clarifying the U.S. broker-dealer registration requirements for foreign broker-dealers. Proposed Rule 15a-6, developed from previous staff interpretive positions, would provide a limited exemption from the broker-dealer registration requirements for foreign entities that deal with certain non-U.S. persons or with specified U.S. institutional investors.

In its November 1988 Policy Statement, the Commission stated that one of the most important goals in achieving a global securities market is to establish efficient, comparable, and automated clearance, settlement, and payments systems. The Commission generally supports recommendations made by the Group of Thirty, a private sector group that includes international businesspersons and bankers. These nine recommendations are designed to enhance creation of a compatible and efficient worldwide clearance and settlement system.

Other important issues for future coordination of international securities regulation include capital adequacy standards for market participants, information sharing among clearing entities about risk positions of joint members, and the interaction of the securities, options, and financial futures markets. The Commission has proposed legislation to improve coordination among clearing systems for these markets.

The Commission is monitoring developments in the area of after-hours and international automated trading markets and the growth of domestic automated proprietary trading systems. The Commission is also monitoring the program of the European Community to develop a single internal market for services and capital by 1992.

III. REGISTRATION AND DISCLOSURE ISSUES

The Commission is investigating the possibility of developing a multijurisdictional registration system under which issuers would be able to use their own jurisdiction's disclosure documents for offerings in other countries. In 1988, the Commission proposed for comment Regulation S, which would provide safe harbors intended to provide objective procedural standards which, if followed, would assure that offers and sales are outside the United States and therefore not subject to U.S. registration requirements.

The Commission has also proposed Rule 144A, which would provide a safe harbor from the registration requirements of the Securities Act of 1933 for the resale of restricted securities to institutional investors. Development of Rule 144A has been compelled not only by internationalization of the securities markets, but also by the tremendous growth of the private

placement market. This rule, as well as the resale safe harbor provisions of Regulation S, should provide increased liquidity in the secondary market for privately placed securities.

The Commission is engaged in cooperative efforts to revise and adjust international accounting and auditing standards in order to increase comparability and reduce costs. The Commission is working with international accounting organizations to develop and harmonize international accounting standards. The Commission's staff is also working with the International Federation of Accountants to revise international auditing guidelines and narrow the differences among auditing standards and procedures.

IV. INVESTMENT MANAGEMENT

In order to meet a growing demand for foreign investments, a number of publicly-offered U.S. registered investment companies recently have been organized to invest in foreign securities. Often the advisers, sub-advisers, and custodians of these funds are located abroad, and most of their portfolio transactions occur abroad. The Commission has entered into informal arrangements with foreign regulators under which information obtained by a foreign regulator through an inspection of investment company operations abroad would be shared with the Commission, and information obtained during a Commission inspection of an investment company's U.S. operations would be shared with the company's foreign regulator.

V. ENFORCEMENT

The Commission has worked both on a bilateral basis and within international organizations to improve coordination of enforcement efforts. The principal issue the Commission confronts in its efforts to police the internationalized securities markets is the need to obtain information located outside of the United States. The Commission has negotiated a number of memoranda of understandings with foreign countries to ensure international assistance and exchange of information. Last year, Congress passed legislation authorizing the Commission to use its subpoena power to obtain information on behalf of foreign securities authorities.

VI. CONCLUSION

In its efforts to promote cooperation on international securities matters, the Commission has been a leader among the world's securities regulators. In taking this role, the Commission has been motivated both by a desire to improve the operations of the world's securities markets and by its obligation to protect U.S. investors. The Commission stands ready to cooperate with other U.S. regulators, with Congress, and with foreign regulators to achieve honest and efficient worldwide capital markets.

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CONCERNING THE GLOBALIZATION
OF THE SECURITIES MARKETS

June 15, 1989

Chairman Dodd and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to discuss the globalization of the securities markets.

I. INTRODUCTION

During the 1980s, the world's securities markets expanded dramatically. In 1988, gross transactions by U.S. investors in foreign corporate stocks totalled over $151 billion, down from the record total of over $189 billion in 1987, but still representing almost 9 times the total of such transactions in 1980. Gross U.S. transactions in foreign debt securities totalled $445 billion in 1988, reflecting a more than twelve-fold increase since 1980. U.S. investors' net investment in foreign stocks in 1988 totalled $1.7 billion. Their net investment in foreign debt securities totalled $10 billion. 1/

International markets are increasingly automated and interlinked. For example, the National Association of Securities Dealers, Inc. ("NASD") and the International Stock Exchange in London have initiated a two-year pilot program to

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1/ Treasury Bulletin 141 (U.S. Department of the Treasury, March 1989).

exchange quotation information between the NASD's automated quotation system ("NASDAQ") and the ISE. The NASD and the Stock Exchange of Singapore also have initiated a pilot program to exchange quotation information, and trading linkages have been established between U.S. and Canadian exchanges.

The internationalization of the world's securities markets affects the regulatory system administered by the Commission. As dramatically illustrated by the October 1987 market break, events in one country's securities markets may affect those in other countries. As a result, the Commission must understand the operations of other securities markets and seek to promote cooperation among securities regulators in all countries. When promulgating rules and making other regulatory decisions, it must consider the effect its decisions will have upon the ability of foreign participants to enter our markets and the ability of U.S. financial service firms to compete in other markets. These judgments are often complex, and they require the Commission to accommodate competing policy concerns without sacrificing investor protection.

Recognizing the growing importance of these issues, the Commission has taken initiatives to further international coordination. In November 1988, the Commission issued a policy statement on the "Regulation of International Securities Markets," 2/ in which it urged cooperation between the world's

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2/ Policy Statement of the U.S. Securities and Exchange Commission, "Regulation of the International Securities Markets," Securities Act Release No. 6807 (Nov. 21, 1988).

securities regulators, as well as the need to recognize cultural differences and national sovereignty concerns. The Commission suggested that an effective regulatory structure for an international securities market system would include:

1. Efficient structures for quotation, price, and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards;

2. Sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards that provide investor protection yet balance costs and benefits for market participants; and

3. Fair and honest markets, achieved through regulation of abusive sales practices, prohibitions against fraudulent conduct, and high levels of enforcement cooperation.

I presented the Commission's policy statement at the annual meeting of the International Organization of Securities Commissions ("IOSCO"), which is made up of securities regulators from more than 40 countries. The Commission is an active member of IOSCO, and will host the annual IOSCO conference in 1991. IOSCO's Technical Committee, which is composed of representatives from the most developed markets, reviews regulatory problems related to international securities transactions and proposes practical solutions to these problems. The Commission's staff has been particularly active in several of the Technical Committee's working groups. At a meeting later this month in Montreal, the working group on capital adequacy will consider a

report concerning capital adequacy standards for non-bank securities firms. Members of the Commission's staff also are participating in two other working groups. One is studying problems related to multinational offerings of equity securities and the other is attempting to harmonize accounting and auditing standards. The accounting working group and the International Accounting Standards Committee ("IASC"), a private organization supported by approximately 100 accounting bodies from approximately 70 countries, are examining problems in the completeness, specificity, and comparability of international accounting standards.

In the enforcement area, in February 1989, at the Commission's urging, the Technical Committee recommended to IOSCO's Executive Committee a resolution regarding international information sharing. The resolution calls for the negotiation of bilateral and multilateral understandings to facilitate mutual cooperation and assistance in securities law enforcement, and for improved sharing of information and documents between countries.

The Commission participates in a number of other multinational organizations. The Commission's staff is assisting the Committee on Banking Regulations and Supervisory Practices, formed under the auspices of the Bank for International Settlements located in Basel, Switzerland ("BIS"). That Committee is exploring issues related to a risk-based capital adequacy approach for the securities positions of banks. Commission staff also attend meetings of the Wilton Park Group,

an informal discussion group convened by the U.K. Department of Trade and Industry and consisting of representatives from ten countries, to discuss methods for improving the exchange of enforcement information among securities regulators.

In addition to the Commission's participation in these multilateral forums, individual Commissioners and staff regularly attend multinational conferences and meet with foreign regulators to discuss coordination efforts. For instance, representatives of the Division of Corporation Finance have been meeting regularly with Canadian authorities on the use of home country disclosure documents. Similarly, representatives of the Division of Investment Management have been discussing with foreign regulators approaches to the cross-border sale of investment company shares. Commissioner Charles Cox serves as the Commission's representative to IOSCO and has attended IOSCO Executive Committee meetings in Europe, Canada, South America, and Australia. During the past two years I have met with securities regulators in Great Britain, Japan, Germany, the Netherlands, Sweden, Canada, Brazil, and Australia, and I have met with regulators from those and other countries both in Washington, D.C., and at IOSCO meetings in Brazil and Australia. Other Commissioners have participated in conferences on international securities regulation in the United States and abroad.

The Commission often works directly with foreign regulators on a bilateral basis to address specific problems. For the past

two years the Commission has participated in quadrilateral meetings with the Federal Reserve Board, the Bank of England, and Britain's Securities Investments Board in London and New York, regarding matters of mutual interest, such as capital adequacy standards and information-sharing agreements.

During the last five years, the Commission has negotiated memoranda of understanding ("MOUs") with foreign securities authorities concerning mutual cooperation on enforcement matters. The Commission has entered into such MOUs with the Brazilian Securities Commission, Canadian securities regulators, the United Kingdom Department of Trade and Industry, the Japanese Ministry of Finance, and Switzerland. The Commission and the Securities Bureau of the Japanese Ministry of Finance have established a working group to develop further arrangements for mutual assistance in enforcement matters, as well as procedures for sharing transaction, clearance, and customer information under our MOU.

In 1988, the Commission proposed legislation, the "International Securities Enforcement Cooperation Act of 1988," portions of which were adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988. In 1989, the Commission proposed similar legislation designed to facilitate cooperation between the Commission and foreign securities authorities in the enforcement of securities laws. Chairman Dodd and Senator Heinz have introduced the Commission's 1989 proposal as S. 646.

The Commission has been developing internal procedures to coordinate and organize its international securities regulatory activities. In 1987 it submitted to Congress a staff report on the internationalization of the securities markets. In 1988 it named an Associate Director for International Affairs in the Commission's Division of Enforcement in order to enhance efforts to negotiate enforcement MOUs. Increased staff resources have also been committed to the Office of International Corporate Finance in the Division of Corporation Finance in order to deal effectively with international registration and disclosure issues and projects. Since March of 1988, the various Commission divisions have been participating in biweekly coordinating meetings to discuss international activities, and in March 1989 the Commission inaugurated the International Release series to publish Commission releases on international topics. 3/

II. MARKET STRUCTURE DEVELOPMENTS

A. Foreign Broker-Dealers

With the growing interest in international portfolio diversification, U.S. investors, and in particular large institutions, have sought efficient access to foreign securities markets. An important component of this access is the use of foreign broker-dealers to obtain analyses of foreign securities and to execute transactions in foreign exchange and dealer markets. In response to these developments, in 1988 the

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3/ International Series Release Nos. 1-94 (March 28, 1989).

Commission issued a release clarifying the U.S. broker-dealer registration requirements for foreign broker-dealers. 1/ The release included a staff interpretive statement regarding the applicability of U.S. broker-dealer registration requirements to foreign entities engaged in securities activities involving U.S. investors, and sought comments on this statement in anticipation of a final Commission interpretive statement. The release also included proposed Rule 15a-6, developed from previous staff interpretive positions, which, if adopted, would provide a limited exemption from the broker-dealer registration requirements for foreign entities that deal with certain non-U.S. persons or with specified U.S. institutional investors. In particular, this exemption would allow foreign broker-dealers to contact large U.S. institutional investors directly, without registration in the United States, so long as any resulting trades were executed through a U.S. registered broker-dealer.

The Commission subsequently published a comment letter from the American Bar Association that suggested incorporating major sections of the staff interpretive statement in the exemptive rule. These sections included an exemption for unsolicited trades, a limited exemption for research provided through registered broker-dealers, and an exemption for foreign broker-dealers contacting other U.S. institutions if a registered representative of a U.S. broker-dealer participated in and monitored those contacts. The Commission determined that this

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1/ Securities Exchange Act Release No. 25801 (June 14, 1988).

comment merited serious consideration. A final version of Rule 15a-6 will be considered by the Commission during the summer of 1989.

B. Clearance and Settlement

One key international securities regulation problem is the wide disparity in settlement periods and degrees of automation among the world's markets. The current lack of coordination among clearance and settlement systems in major world markets increases the costs and risks of global securities trading. The United States has developed an automated depository and book entry clearance and settlement system which is efficient, but which can be improved in important ways. Other mature markets are in varying stages of developing automated clearing and settlement systems. Ultimately, the Commission hopes that all countries will establish fully automated clearance and settlement systems permitting paperless book entry movement of all broker-dealer and institutional securities positions.

1. Group of Thirty Report

In its November 1988 Policy Statement, the Commission stated that one of the most important goals in achieving a global securities market is to establish efficient, comparable, and automated clearance, settlement, and payments systems. In 1989, the Group of Thirty, a private sector group that includes international businesspersons and bankers, made nine recommendations designed to enhance creation of a compatible and efficient worldwide clearance and settlement system. The

Commission supports the Group of Thirty recommendations with some minor reservations. The Group of Thirty's recommendations would facilitate competition among markets and cross-border movements of capital and would enhance investor confidence in the securities markets.

The recommendations contained in the Group of Thirty's report are:

1. By 1990, all comparisons of trades between direct market participants (i.e., brokers, broker-dealers, and other exchange members) should be accomplished by T+1.

2. Indirect market participants (such as institutional investors, or any trading counterparties which are not broker-dealers) should, by 1992, be members of a trade comparison system which achieves positive affirmation of trade details.

3. Each country should have an effective and fully developed central securities depository, organized and managed to encourage the broadest possible industry participation (directly and indirectly), in place by 1992.

4. Each country should study its market volumes and participation to determine whether a trade netting system would be beneficial in terms of reducing risk and promoting efficiency. If a netting system would be appropriate, it should be implemented by 1992.

5. Delivery versus payment should (DVP) be employed as the method for settling all securities transactions. A DVP system should be in place by 1992.

6. Payments associated with the settlement of securities transactions and the servicing of securities portfolios should be made consistent across all instruments and markets by adopting the "same day" funds convention.

7. A "Rolling Settlement" system should be adopted by all markets. Final settlement should occur on T+3 by 1992. As an interim target, final settlement should occur on T+5 by 1990 at the latest, save only where it hinders the achievement of T+3 by 1992.

8. Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Existing regulatory and taxation barriers that inhibit the practice of lending securities should be removed by 1990.

9. Each country should adopt the standard for securities messages developed by the International Organization for Standardization [ISO Standard 7775]. In particular, countries should adopt the ISIN numbering system for securities issues as defined in the ISO Standard 6166, at least for cross-border transactions. These standards should be universally applied by 1992.

Current practices in the U.S. securities markets conform to, or are moving toward substantial conformity with, most of the Group of Thirty's recommendations. Central depositories permitting book-entry delivery, institutional participation in confirmation and affirmation systems, trade netting, delivery versus payment, rolling settlements, and securities lending to support settlement are all firmly established practices in the U.S. securities markets. Substantive progress toward earlier trade comparison also is being accomplished in the United States through the efforts of the New York Stock Exchange, the NASD, the National Securities Clearing Corporation, and other self-regulatory organizations. The Commission understands that, within nine to twelve months, a period that meets the Group of Thirty's target date, the substantial majority of inter-dealer transactions in over-the-counter, NASDAQ, New York Stock Exchange, and American Stock Exchange securities will be compared by T+1.

Moreover, due to this progress in earlier trade comparison, the question of earlier settlement already has been under active

consideration. Earlier trade comparison would require that the clearing agency guarantees of trade settlement occur sooner, and that clearing agencies be exposed to market risk for a longer period of time. For this reason, earlier trade comparison would necessitate earlier settlement or other means to protect the clearing agencies from increased market exposure, such as marking to the market or higher clearing fund contributions.

The question of standardized identification numbering systems also is under discussion among U.S. securities professionals. By recommending use of the International Securities Identification Number, or "ISIN," but limiting the recommendation to cross-border trades, the Group of Thirty implicitly has acknowledged that substantial investment has been made in the infrastructure of domestic systems. Nevertheless, an interim solution such as a conversion facility should *not* preclude discussion of whether outright adoption of ISIN is the best longer-term solution to the problem of inconsistent securities identification numbering systems.

Implementation in the United States of the Group of Thirty recommendation that all settlements be made in same day funds raises significant issues that the Commission believes warrant further study and discussion. Although market participants generally agree that conversion to same day funds settlement would create long-term advantages and efficiencies, the recommendation raises several significant concerns, including whether the Fedwire system and other electronic funds transfer

systems could handle an increased volume of large dollar transactions late in the day. In addition, same day funds settlement would reduce the amount of available time for clearing agencies and their participants to resolve temporary liquidity problems. Clearing agencies thus would be required to monitor more closely the financial condition of clearing members.

The Commission plans to assist in efforts to evaluate and implement the Group of Thirty recommendations. With regard to the three most far reaching aspects of the recommendations for U.S. securities markets, the Commission will continue to monitor progress toward next day comparison and earlier settlement periods for all stock markets, and will cooperate with banking regulatory agencies to address the same day funds settlement suggestion.

C. Other Areas for Coordination

Some of the most important items for future coordination of international securities regulation not contained in the Group of Thirty report include capital adequacy standards for market participants, information sharing among clearing entities about risk positions of joint members, and the interaction of the derivative markets.

1. Capital Adequacy Standards

Adequate capital requirements for market participants are basic to the safe functioning of all securities markets. A working group of IOSCO's Technical Committee has been studying

the issues related to capital adequacy for non-bank securities firms and is currently exploring the suggestion that international risk-based capital adequacy standards should be adopted. Additionally, the Committee on Banking Regulations and Supervisory Practices 5/ has designated a working group on position risk for traded securities. This working group is exploring various issues related to a risk-based capital approach for the securities positions of banks. At the group's request, the Commission has designated a representative to assist the group in its deliberations.

2. Information Monitoring and Sharing

Another important component of sound market linkages is a procedure whereby clearing agencies monitor information about the financial and operational condition of participants in multiple markets and share that information with clearing agencies in other markets. U.S. clearing agencies serving the equity and equity options markets have formed the Securities Clearing Group ("SCG") to accomplish this objective. The SCG members have agreed to work toward a system of sharing settlement, margin, and position information about joint members. As international clearing linkages develop and mature, a similar international initiative also should be undertaken.

In the international context, the provision of information may serve as a method for reconciling conflicting regulatory

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5/ The Committee was formed under the auspices of the BIS.

requirements, which can be unnecessarily burdensome. For example, the Commission has entered into an agreement with certain regulators in the United Kingdom which provides that they will waive their capital adequacy requirements for U.S. broker-dealers that have branches in the United Kingdom, if the Commission provides them with certain information. The Commission has agreed to notify U.K. regulators if it becomes aware that a particular broker-dealer's financial or operational condition is impaired, and U.K. regulators have agreed to notify the Commission if they become aware that a U.K. branch of a U.S. broker-dealer has a substantial problem. The Commission also is discussing with foreign securities authorities the exchange of information with respect to affiliates of regulated entities.

Coordination among stock markets and markets trading options and financial futures is important for the development of sound clearance, settlement, and payments systems. The Commission has proposed legislation to improve coordination among clearing systems for securities, options, and futures. The Commission's proposal was introduced by Chairman Dodd and Senator Heinz as S. 648. This legislation would also require the Commission and the Commodity Futures Trading Commission to report to Congress within two years on the progress toward linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, options, and futures. Finally, the legislation would encourage further private sector initiatives to resolve these problems. For example, the American Bar

Association's Advisory Committee on Settlement of Market Transactions already is reviewing the need for harmonization of state law concerning the transfer and pledge of securities.

D. After Hours Trading

Many multinational companies currently list their stock on major exchanges around the world even though the trading is normally concentrated in the company's home market. Because much of the overseas trading may occur after the domestic markets have closed, some domestic markets are exploring the possibility of extending their trading hours. For example, the Midwest Stock Exchange has proposed a late trading session so that members can execute portfolio trades which they now execute in London. 6/ The Chicago Mercantile Exchange and the Chicago Board of Trade also are developing electronic systems for trading products listed in their markets, in order to compete effectively with developing overseas markets. The Commission also understands that the New York Stock Exchange has considered the possibility of creating a system for after-hours trading, but that the exchange does not currently believe enough trading activity exists to justify such a system.

Finally, the Commission has encouraged the development of certain proprietary trading systems that provide quotation dissemination and, in some instances, trading across markets. For example, the Instinet system, owned by Reuters Holdings PLC,

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6/ Securities Exchange Act Release No. 26887 (June 2, 1989).

offers automated quotation dissemination and execution services to both domestic and international subscribers. 7/ One of Instinet's features is a "crossing network" that permits institutions to trade entire portfolios of securities with one another on an after-hours basis. In 1986, subject to certain enumerated conditions, the Commission staff issued a no-action letter to Instinet with respect to the non-registration of the Instinet system as a national securities exchange, registered securities association, and registered clearing agency. 8/

Related to the growth of after hours and international automated trading markets is the growth of domestic automated proprietary trading systems. The Commission has recently voted not to object to a staff no-action position regarding a proprietary system for trading options on U.S. Treasury notes, has temporarily registered a clearing agent for that system, and has proposed Rule 15c2-10 designed to provide a means of regulating such systems. 9/ Developments in this area presage

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7/ In addition, recent newspaper reports indicate that the NASD is considering implementation of a system that would permit pre-dawn trading of 200-300 of the most actively traded OTC stocks, including several dozen stocks that would be traded in direct competition with the International Stock Exchange. As yet, the Commission has not received a proposed rule change from the NASD with respect to the planned system.

8/ See letter from Richard G. Ketchum, Director, Division of Market Regulation, to Daniel T. Brooks, Cadwalader, Wickersham & Taft, counsel for Instinet Corporation (August 8, 1986).

9/ The Commission is in litigation with respect to its actions on the proprietary trading system. Board of Trade of the City of Chicago v. Securities and Exchange Commission, Nos. 89-1084 and 89-1449 (7th Cir.).

ultimate consideration of the proper means of regulating both proprietary and non-proprietary international automated trading systems.

E. Other Multinational Initiatives

The Commission is monitoring the program of the European Community ("EC") to develop a single internal market for the EC's services and capital by the end of 1992. The EC's Second Banking Directive has particularly interested financial regulators in this country. Moreover, this directive is important to the Commission because much of international securities trading is conducted by banks, and regulated by bank supervisory authorities. The directive is designed to establish criteria under which a member state may authorize the establishment of a bank, and would provide that once it is authorized by a member state, the bank may establish operations in any other member country. As originally drafted, the directive would have required that non-EC countries grant access to EC banks before banks in those countries could be eligible for a single banking license in the EC. A draft EC Investment Services Directive, which would apply to the establishment of securities firms in the EC, contains substantially similar reciprocity provisions. The United States opposed this reciprocal approach, and in April the Commission of the EC recommended, with respect to the Second Banking Directive, that the EC move to a scheme that closely approximates the "national treatment" standard favored by the United States. Under the EC's

revised approach, non-EC banks would be permitted to obtain a single license if the non-EC country treats EC banks in the same way as domestic banks, and if EC banks are given effective market access in the non-EC country. While the Commission is encouraged by the recent proposed modifications, it is not yet clear whether or how the new treatment is to be applied and whether similar proposals will be made for the directives affecting securities transactions.

The Commission also is monitoring the efforts of multinational organizations to study the international financial markets. For example, the Commission's staff has participated in a number of studies of the financial markets prepared by the Organization for Economic Cooperation and Development ("OECD").

III. REGISTRATION AND DISCLOSURE ISSUES

In the registration and disclosure area, three factors have driven the Commission's initiatives: (1) the desire of U.S. investors to diversify their portfolios on a global basis; (2) the desire of issuers to be able to choose to raise capital outside the United States without concern that they will violate U.S. securities registration requirements; and (3) the concern that unnecessary restrictions on the free flow of capital are increasing costs to issuers and investors, as well as impairing the efficient allocation of capital.

The Commission has accommodated foreign private issuers by developing a separate registration and reporting system for such issuers, and by making some adaptations in disclosure

requirements. 10/ However, the U.S. securities laws continue to discourage foreign issuers from directly entering the U.S. market. U.S. investors thus have been forced to purchase the securities of these foreign issuers offshore, generally in the secondary market, in which case they are denied the pricing advantage provided in the initial offering.

As noted in its November 1988 Policy Statement, the Commission believes that its goal in addressing international disclosure and registration problems should be to minimize regulatory impediments without compromising investor protection. The Commission also believes that it must seek to accommodate foreign law and practice, but avoid compromises that would give foreign issuers an undue advantage over domestic issuers in the U.S. markets. Consistent with these views, the Commission has responded to the foregoing concerns with three major initiatives: multijurisdictional registration, Regulation S, and Rule 144A.

A. Multijurisdictional Registration

Differences in disclosure requirements, accounting principles, and auditing standards are impediments to multijurisdictional offerings. As discussed above, the Commission's staff is participating in multinational efforts to

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10/ See Securities Act Release No. 16371 (Nov. 29, 1979). Accommodations were made in disclosure requirements for management remuneration, transactions with management, and segment reporting. Additionally, 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 here. Securities Act Release No. 6437 (Nov. 19, 1982).

achieve international agreements on internationally acceptable principles and standards in these areas. Such agreements would make possible the establishment of a mutually acceptable worldwide disclosure regime.

In the interim, the Commission is developing a multijurisdictional registration system whereby issuers can use their own jurisdiction's disclosure documents for offerings in other countries. The Commission first addressed the multijurisdictional registration concept in 1985, when it 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 with those of other countries. 11/ 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. 12/

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 common prospectus approach, the jurisdictions would agree to use common disclosure standards. The majority of commentators favored the

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11/ Securities Act Release No. 6568 (Feb. 28, 1985).

12/ Id.

reciprocal approach, primarily because of the ease of implementation.

The Commission's staff subsequently discussed with the staffs of the Ontario and Quebec Securities Commissions establishment of a system of multijurisdictional disclosure. Substantial progress has been made, and, during the summer of 1989, the Commission expects to consider an initial multijurisdictional registration experiment with Canada. If adopted by the Commission, the experiment likely will cover offerings by substantial issuers, rights and exchange offerings by a larger class of issuers, and some cash tender offers. The regulations and forms developed in this experiment would provide a foundation for a multijurisdictional disclosure system that could be expanded to encompass a wider class of issuers and additional jurisdictions. This effort will be directed to those jurisdictions whose different disclosure systems apply similar accounting principles and auditing standards and provide similar basic disclosure to investors. The problem is to provide a means of protecting U.S. investors and permitting the sale of foreign securities in U.S. markets without giving foreign issuers an undue advantage over U.S. companies in U.S. markets.

B. Regulation S

The Commission also is examining questions regarding the application of U.S. registration requirements to overseas securities offerings. While the registration provisions of Section 5 of the Securities Act 13/ are broad enough to require

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13/ 15 U.S.C. 77e.

registration of any securities offering in which there is some contact with the United States, the Commission recognized in 1964 that the law need not be applied to the offer and sale of securities outside the United States to non-U.S. investors in a manner that resulted in the offering coming to rest outside the United States. 14/ However, under that articulation, application of the registration requirements depended on whether the purchasers were U.S. persons. As a result, U.S. investors have been precluded from participation in many primary overseas securities offerings by foreign companies. In addition, the demarcation of the appropriate reach of the registration provisions has been developed on a case-by-case basis, resulting in a lack of clear standards for determining which transactions require registration. While these problems have existed for years, they have become more critical with the development and maturity of major markets offshore and the huge growth of transnational investment.

In 1988, the Commission proposed Regulation S for comment. 15/ Regulation S states the general principle that the U.S. securities laws are intended to protect the U.S. capital markets, so that offers and sales in the United States, whether to foreign or domestic persons, should be registered unless otherwise exempt. In contrast, offers and sales outside the

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

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

ited States should not be subject to U.S. registration quirements.

Regulation S would provide safe harbors intended to provide jective procedural standards which, if followed, will assure at the offers and sales are outside the United States and erefore not subject to U.S. registration requirements. The ocedures set forth are those deemed necessary to protect ainst an indirect public offering in the United States through e mechanism of offshore transactions.

The Commission received 95 comment letters regarding oposed Regulation S. The staff is revising the proposal in sponse to the comments received. In light of the number of visions being made, the staff plans to recommend that the mmission repropose Regulation S early in the summer of 1989.

C. Rule 144A

On October 25, 1988, the Commission published for comment le 144A, which would provide a safe harbor exemption from the gistration requirements of the Securities Act for the resale of stricted securities to institutional investors. 16/ velopment of Rule 144A has been compelled not only by ternationalization of the securities markets, but also by the emendous growth of the private placement market. In 1981, $18 llion worth of securities were privately placed in the United

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/ Securities Act Release No. 6806 (Oct. 25, 1988).

States. In 1987, such placements totalled approximately $139 billion. 17/ In 1988, approximately $202 billion were raised in this private placement market, representing approximately 43 percent of total corporate financing in the United States that year. 18/

Rule 144A is intended to provide a framework in which qualifying institutional resales can be freely undertaken. This rule, as well as the resale safe harbor provisions of proposed Regulation S, should provide increased liquidity in the secondary market for privately placed securities. The potential increase in liquidity could significantly lower the discount commonly associated with private placements, which could in turn attract an increasing number of issuers, including foreign issuers, into the private placement market.

Foreign issuers that previously may have been concerned about compliance costs and liability exposure associated with registered public offerings in the United States or that may have been concerned about the financing costs inherent in placing restricted securities may find U.S. private placements more financially attractive under Rule 144A. Direct participation by foreign issuers in the U.S. capital market would reduce the costs borne by U.S. institutional investors by enabling them to invest

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17/ IDD Information Services. This is a conservative figure because it only includes private placements involving intermediaries. Accordingly, it includes neither direct placements by issuers nor swaps.

18/ Id.

in a diversified worldwide portfolio without leaving the U.S. securities markets. The staff is revising the rule proposal in response to the significant number of public comments received. Due to the substantial nature of the revisions, the staff plans to recommend that the Commission repropose Rule 144A early in the summer of 1989.

D. Accounting and Auditing Standards

The continuing trend toward internationalization will increase the need for, and the benefits to be derived from, mutually agreeable international accounting principles and auditing guidelines. Such standards would reduce the regulatory burdens resulting from current disparities among the various national standards. Accordingly, the Commission, along with securities regulators and members of the accounting profession throughout the world, is engaged in efforts to revise and adjust international accounting and auditing standards in order to increase comparability and reduce costs.

In an effort to address accounting differences, the Commission's staff is working with international accounting organizations such as IOSCO and IASC 19/ to review international accounting standards. IASC is addressing international accounting standards that are incomplete or lack sufficient specificity, and it seeks to reduce the number of accounting options permitted under some of the standards. Where options

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19/ See discussion of IASC, supra, p.4.

cannot be eliminated, IASC plans to specify one method as the benchmark (or "preferred") method for international filings.

At its November 1988 meeting in Copenhagen, IASC approved publication of an Exposure Draft of proposed amendments to the international accounting standards for public comment. 20/ This proposal represents the first phase of IASC's project to address the question of accounting options. The Exposure Draft addresses issues concerning revenue recognition, business combinations, investments, retirement benefits, and foreign currency. The Exposure Draft was released on January 1, 1989, and has an exposure period of nine months.

In addition to the Commission staff's participation in IASC and IOSCO initiatives, the Financial Accounting Standards Board ("FASB"), under the oversight and with the encouragement of the Commission, also has indicated a desire to participate in the development and harmonization of international standards. A Board member acts as the Board's representative to the IASC and is a member of the IASC consultative group, which meets regularly with the IASC to discuss IASC's projects. 21/

The Commission staff also is working with the International Federation of Accountants ("IFAC") to revise international

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20/ International Accounting Standards Committee, "Comparability of Financial Statements, Proposed Amendments to International Accounting Standards 2, 5, 8, 9, 11, 16, 17, 18, 19, 21, 22, 23, and 25" (Jan. 1, 1989).

21/ Address by Dennis R. Beresford, Chairman of the Financial Accounting Standards Board, Meeting of the International Accounting Standards Committee (June 23, 1988).

auditing guidelines. Auditors in different countries 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. The Commission staff, as part of an IOSCO working group, is participating in a project by IFAC to revise international auditing guidelines and to narrow these differences.

With the increased internationalization of the securities markets, there will be a need to minimize the differences in accounting principles and auditing guidelines. The Commission, the FASB, and the accounting profession, therefore, will continue to devote substantial attention to international accounting and auditing issues.

IV. INVESTMENT MANAGEMENT

An increasing number of investors, both individual and institutional, are developing an interest in foreign investments. In order to meet the growing demand, a number of publicly-offered U.S. registered investment companies recently have been organized to invest in foreign securities. These so-called international funds are organized in the United States and registered under the Investment Company Act of 1940. Often their advisers, sub-advisers, and custodians are located abroad, and most of their portfolio transactions occur abroad.

As of December 1988, there were 126 mutual funds registered with the Commission that invest their assets, in whole or in part, in foreign securities. The net asset values of these funds

totalled $20.7 billion. These figures do not include closed-end funds, mutual funds that concentrate their investments in the securities of companies that mine precious metals, or unit investment trusts. If these other types of investment companies were included, assets of investment companies investing abroad would exceed $47.6 billion as of December 1988.

While the Commission supports increased foreign investment opportunities for U.S. citizens, it has been concerned about the difficulties in monitoring the activities of U.S. funds investing abroad. At issue is the Commission's ability to inspect funds with operations abroad to determine whether they are in compliance with the federal securities laws. To alleviate this concern, the Commission has encouraged foreign regulators to enter into informal information sharing arrangements with the Commission. Under these arrangements, information obtained by a foreign regulator through an inspection of investment company operations abroad would be shared with the Commission, and information obtained during a Commission inspection of an investment company's U.S. operations would be shared with the company's foreign regulator. The Commission also has explored the possibility of conducting joint inspections with foreign regulators. The Commission's Memorandum of Understanding with the Brazilian Securities Commission provides for such an arrangement.

In spite of the growing interest in foreign securities, regulatory barriers in the United States and foreign markets have

limited the extent to which investment company products can be sold across national borders. Section 7(d) of the Investment Company Act of 1940 22/ prohibits an investment company that is not organized under the laws of the United States from publicly offering securities in the United States unless it obtains a Commission exemptive order. Section 7(d) further requires that the Commission make certain findings before an order can be granted. In particular, the Commission must find that it is both legally and practically feasible to enforce effectively the provisions of the Act. This standard has proven very difficult to meet. By contrast, a foreign money manager can freely enter the U.S. market simply by registering with the Commission as an investment adviser and paying a $150 fee. While a foreign adviser is required to furnish a consent to service of process with the Commission, it need not maintain an office or staff in the United States. The approximately 200 foreign advisers currently registered with the Commission are free to establish and manage mutual funds in the United States on the same terms and conditions as U.S. advisers. Many foreign money managers act as advisers or sub-advisers to U.S. investment companies that invest all or part of their portfolios in foreign securities.

U.S. funds have had difficulty selling their shares abroad because of restrictions imposed in certain countries (which in some cases are stricter than those applied to domestic funds in those countries). Moreover, in order to reach a sufficiently

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22/ 15 U.S.C. 80a-7(d).

large market abroad, it is necessary to comply with the different requirements of various countries. Also, some countries have imposed currency and other restrictions that provide a disincentive to foreign securities investments by citizens of those countries.

In 1985, the European Community took a major step toward the creation of a common market for investment company products when it adopted a directive for certain "undertakings for collective investment in transferable securities" ("UCITS"). The directive establishes a minimum regulatory standard and requires mutual treatment of these products. Member countries are permitted to regulate these products in areas not covered by the directive. The twelve member nations are required to conform their laws by October 1989 to the UCITS Directive. Once the UCITS Directive is implemented, the European Community may seek to negotiate bilateral agreements with non-member countries, such as the United States, along the same lines. The Commission is currently studying the UCITS Directive and its implementation by the member states to determine its potential impact on investors and the investment company industry.

V. ENFORCEMENT

The internationalization of the securities markets has prompted the Commission to develop initiatives in the enforcement area which are consistent with its mandate to preserve fair and honest markets in the United States, while maintaining the United States as a major securities trading center. The Commission has

taken a leadership role in developing international understandings to enhance cooperation among regulators. The Commission has worked both on a bilateral basis and within international organizations to develop a systematic approach for coordinating enforcement procedures to address complex frauds when they arise.

The principal issue which the Commission confronts in its efforts to police the internationalized U.S. securities markets is the need to obtain information that is located outside the United States. The Commission has faced significant hurdles in obtaining overseas information.

In the early 1980's, in an attempt to secure foreign-based evidence that was withheld on the basis of foreign bank secrecy laws, the Commission sometimes resorted to the federal courts to compel the production of this information. Although effective in particular cases, this unilateral approach was time consuming and expensive, and occasionally strained international relations. In part due to success in U.S. courts, the Commission was able to begin a dialogue with foreign securities and other law enforcement authorities and to develop informal case-by-case understandings which facilitated the production of foreign-based information. The ad hoc nature of this approach highlighted the need for more formal mechanisms that would guarantee the availability of assistance and foster cooperation.

A 1982 Memorandum of Understanding between the United States and Switzerland was the first such formal mechanism. The

Swiss MOU provided the Commission with unprecedented access to Swiss bank trading records. Of equal importance, the MOU provided a new formula for approaching evidence-gathering issues: bilateral understandings negotiated by the Commission, tailored to meet urgent enforcement problems and to address the foreign country's particular concerns.

After the Swiss MOU, the Commission negotiated increasingly complex MOUs with other countries. In 1986, the Commission entered into MOUs with the United Kingdom's Department of Trade and Industry and the Japanese Ministry of Finance. These MOUs provide assistance for a wide range of cases, but limit that assistance to that which can be provided through the "best efforts" of the regulators. In other words, each authority has agreed to provide the other with information already in its possession or which can be obtained from third parties without the exercise of compulsory process. This limitation was, in part, a consequence of restrictions on the Commission's ability to use its subpoena power to assist foreign authorities at the time the understandings were negotiated.

Based upon Commission proposals, Congress passed legislation last year 23/ authorizing the Commission to use its subpoena power to obtain information on behalf of foreign securities authorities. This legislation permits the Commission to implement more comprehensive agreements. Indeed, the Commission

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23/ Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

has entered into MOUs that cover virtually the entire range of cases that could arise under the federal securities laws, and provide for a full range of assistance, including the use of subpoena power. The Commission has signed two such agreements, one with the Brazilian Securities Commission, and the other with the British Columbia, Ontario, and Quebec Securities Commissions, securities regulators of the three largest Canadian provinces. Additional MOUs similar to these agreements are under negotiation.

While Commission efforts have been primarily directed to the negotiation of bilateral agreements, the Commission also has been an active participant in multilateral settings. In 1986, for example, the IOSCO Executive Committee adopted a Commission sponsored resolution on cooperation which mandated that members who thereafter ratified the resolution should agree to exchange information relating to securities matters. This resolution has been ratified by twenty-three securities regulators, including the Commission. In 1989, the Commission proposed another resolution, calling for members to negotiate comprehensive MOUs on information sharing similar to those the Commission has negotiated with the Canadian securities regulators and the Brazilian Securities Commission. This resolution, which was endorsed by the members of IOSCO's Technical Committee, will now be submitted to the entire IOSCO membership for consideration.

The Commission also has organized and participated in international meetings concerning cooperative efforts to combat

international fraud. In October 1988, the Commission sponsored a meeting to discuss various foreign and U.S. investigations of boiler room operations in Europe that allegedly are related to Thomas C. Quinn, a subject of several prior Commission actions who has been under arrest in France. The two-day meeting, attended by representatives of eleven countries and numerous agencies from the U.S. government, resulted in a framework for cooperation among the participants. Earlier this month, as part of the Commission's efforts to address fraud in the penny stock market, the Commission sponsored a training program for both domestic and foreign regulators and prosecutors at which strategies for investigating and prosecuting such cases were discussed.

The Commission also has developed a dialogue with the major participants in the international securities markets through its interaction with the Organization for Economic Cooperation and Development. The Working Group on International Investment Policies of the OECD Committee on International Investment and Multinational Enterprises is undertaking, at the Commission's initiative, a program to explore extraterritorial evidence gathering in the securities field.

The Commission believes that its efforts to facilitate information sharing have laid the groundwork for more effective regulation of international securities markets. The Commission's information sharing agreements, which were stimulated by problems encountered in insider trading cases, now

provide assistance in all types of securities cases. While insider trading cases have gained more publicity in recent years, the Commission's efforts are directed toward comprehensive agreements for assistance in the full range of cases that will be confronted as the markets continue to internationalize.

The Commission plans to continue to negotiate bilateral understandings on the exchange of information and to develop cooperative working arrangements with securities regulators abroad. The Commission also plans to work within multilateral organizations such as IOSCO and the OECD to foster additional cooperative enforcement efforts.

VI. CONCLUSION

In its efforts to promote cooperation on international securities matters, the Commission has been a leader among the world's securities regulators. In taking this prominent role, the Commission has been motivated both by a desire to maintain the importance of the United States as a financial center and by its obligation to protect U.S. investors. It believes that the high level of investor protection in the United States has contributed to the strength of U.S. capital markets. The Commission believes its efforts to achieve international regulatory cooperation will play a major role in larger U.S. efforts to eliminate overseas trade barriers. It stands ready to cooperate with other U.S. regulators, with Congress, and with foreign regulators to achieve honest and efficient worldwide capital markets.

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE U.S. SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING S. 646, THE INTERNATIONAL SECURITIES
ENFORCEMENT COOPERATION ACT OF 1989

June 15, 1989

SUMMARY

The internationalization of the world's securities markets is one of the most significant developments in modern finance. This development requires international cooperation to prevent securities fraud. Last year Congress passed an important piece of legislation intended to promote international cooperation. Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988 authorized the Commission to provide investigative assistance to foreign securities authorities. That provision had been introduced as part of the proposed "International Securities Enforcement Cooperation Act of 1988," submitted to Congress by the Commission on June 3, 1988.

The Commission believes that additional statutory authority would further its efforts to promote international cooperation in enforcement of the securities laws. Accordingly, it supports S. 646, the proposed International Securities Enforcement Cooperation Act of 1989, introduced by Chairman Dodd and Senator Heinz on March 17, 1989.

This legislation contains the three provisions of the Commission's June 1988 proposal that were not enacted. The Commission continues to strongly support these three provisions. They are:

(1) a provision exempting confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act or other laws;

(2) a provision making explicit the Commission's rulemaking authority to provide nonpublic documents and other information to domestic and foreign authorities; and

(3) a provision granting the Commission explicit authority to bar, suspend, or place limitations on securities professionals based upon the findings of a foreign court or foreign securities authority.

In addition, the Commission is seeking the enactment of two provisions that were not included in the June 1988 proposal. These provisions would:

(1) authorize the Commission and self-regulatory organizations, after an opportunity for a hearing, to deny any person who has been convicted of a felony membership or association with a member or to place conditions upon membership or association; and

(2) authorize the Commission to accept reimbursement for expenses incurred in providing assistance to a foreign securities authority.

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE U.S. SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING S. 646, THE INTERNATIONAL SECURITIES
ENFORCEMENT COOPERATION ACT OF 1989

June 15, 1989

Chairman Dodd and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission (the "Commission") in support of S. 646, the proposed International Securities Enforcement Cooperation Act of 1989, introduced by Chairman Dodd and Senator Heinz on March 17, 1989. As this Subcommittee knows, the internationalization of the securities markets is one of the most significant recent developments in finance. Although this development has many beneficial effects, it has made the enforcement of the U.S. securities laws more difficult and more costly.

In its last session, Congress passed an important piece of legislation intended to aid in international cooperation to assist and enhance the enforcement of securities laws. Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988 1/ amended Section 21(a) of the Securities Exchange Act of 1934 to permit the Commission to provide investigative assistance to foreign securities authorities. That provision had been introduced as part of the proposed "International Securities

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1/ Pub. L. No. 100-704, 102 Stat. 4677.

Enforcement Cooperation Act of 1988," submitted to Congress by the Commission on June 3, 1988. On June 29 and August 3, 1988, I testified on behalf of the Commission before this Subcommittee and the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, respectively, in hearings concerning the June 1988 proposal. The testimony on those two occasions described Commission initiatives to obtain cooperation from other countries in the pursuit of evidence needed to investigate potential violations of our securities laws, and our work with international organizations to promote international cooperation in the securities enforcement field. 2/

Although Congress enacted the portion of the June 1988 proposal authorizing investigative assistance, three other proposed provisions were not enacted. The Commission continues to support strongly these three remaining provisions of the Commission's June 1988 proposal which are included in the current legislation. They are as follows:

(1) a provision exempting confidential documents received from foreign authorities from disclosure requirements under the Freedom of Information Act or other laws;

(2) a provision making explicit the Commission's rulemaking authority to provide nonpublic documents and other information to domestic and foreign authorities;

2/ See Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs on S. 2544, 100th Cong., 2d Sess., at 28-45 (1988)[hereinafter cited as "Senate Testimony"]; Statement of Chairman Ruder, Securities and Exchange Commission, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning the International Securities Enforcement Cooperation Act of 1988, at 9-24 (August 3, 1988).

(3) a provision granting the Commission explicit authority to censure, revoke the registration of, or impose employment restrictions upon securities professionals based upon the findings of a foreign court or foreign securities authority.

In addition, the Commission is seeking the enactment of two provisions that were not included in the June 1988 proposal. The first would authorize the Commission and self-regulatory organizations to prohibit any person who has been convicted of a felony from becoming a member or becoming associated with a member or to place conditions upon such membership or association. The second would provide authority for the Commission to accept payment or reimbursement for expenses incurred in providing assistance to a foreign securities authority.

I. INTRODUCTION AND SUMMARY

As explained in our testimony last year, the Commission has made significant strides in recent years in addressing enforcement problems raised by the internationalized marketplace. 3/ The Commission has successfully pursued several major fraud cases in which the U.S. securities laws were violated by persons operating from abroad or using foreign bank accounts, including, for example, SEC v. Dennis Levine 4/ and SEC v. Stephen Wang and Fred Lee 5/.

3/ See Senate Testimony, at 30-36. That testimony also describes the Commission's usual means of obtaining evidence and other assistance from foreign authorities when no MOU or informal arrangement exists.

4/ 86 Civ. 3276 (S.D.N.Y.)(RO).

5/ 88 Civ. 4461 (S.D.N.Y.)(RO).

A. Confidentiality of Foreign Documents

Much of the progress in international enforcement cooperation has been made through negotiation of memoranda of understanding, or "MOUs," with foreign securities authorities. Among other things, these bilateral agreements provide for mutual investigative assistance. The Commission has entered into MOUs with securities authorities in Switzerland, the United Kingdom, Japan, three Canadian provinces, and Brazil. 6/ These MOUs are important tools in international enforcement, and the Commission anticipates that it will be enter into additional MOUs with other countries.

In certain cases, however, the Commission has been unable to reach agreement on MOUs with foreign authorities because of conflicts between the confidentiality requirements of foreign nondisclosure laws and the Freedom of Information Act ("FOIA"). Some foreign laws require that documents provided to the Commission must, under certain circumstances, be kept confidential unless disclosure is necessary or required in the course of a Commission investigation or enforcement action. The Commission, of course, must comply with the FOIA and other laws which, in many cases, preclude withholding documents provided by foreign authorities from the public.

6/ The Commission also can obtain some investigative assistance from certain countries through mutual legal assistance treaties, the Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, opened for signature March 18, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444, and by informal agreements. See Senate Testimony, at 31, n.1 and accompanying text.

Section 2 of the proposed legislation would eliminate this potential conflict by amending Section 24 of the Exchange Act to enable the Commission to maintain the confidentiality of certain evidence received from foreign securities authorities. This provision is crucial to the Commission's ability to negotiate additional MOUs. In order to facilitate the cooperation of foreign authorities in providing the Commission with investigative assistance, the Commission urges Congress to exempt documents furnished to the Commission from disclosure if the foreign authority represents in good faith that the disclosure of the documents would violate the confidentiality requirements of its country's laws.

B. Providing Information to Foreign Authorities

Section 2(b) of the legislation also would make explicit the Commission's rulemaking authority to provide documents and other information to foreign authorities as well as to domestic authorities. The Commission currently grants access to its investigative files to certain securities enforcement entities, including domestic and foreign securities authorities and self-regulatory organizations. However, certain provisions of the federal securities laws arguably limit the disclosure of certain nonpublic documents. In view of the significance of this issue to the Commission's efforts to cooperate with both foreign and domestic securities officials, the Commission believes that it would be appropriate to make the Commission's authority explicit.

c. Sanctions on Securities Professionals

Sections 3 through 6 of the bill would amend the Exchange Act, the Advisers Act, and the Investment Company Act to permit the Commission, after an opportunity for a hearing, to exercise discretionary authority to utilize the findings of a foreign court or foreign securities authority in order to censure, revoke the registration of, or impose employment restrictions upon securities professionals registered to do business in the United States. The Commission already has such authority as to illegal or improper activity in the United States under these acts. Certain provisions of the federal securities laws also have been used to support the imposition of limitations on activities of securities professionals based upon the findings of a foreign court as to illegal activity abroad. In view of the rapid internationalization of the markets and the Commission's new authority to investigate on behalf of foreign securities authorities under Section 21(a)(2) of the Exchange Act, it would be appropriate to make explicit and to add to the Commission's existing authority the discretionary ability to utilize the findings of a foreign court or securities authority to sanction securities professionals in the United States.

The Commission believes that it should have this discretionary authority, exercisable after a hearing, to suspend, bar, or place appropriate restrictions upon securities professionals who have made false filings with foreign authorities; who have been convicted of certain crimes by foreign

courts; who have been enjoined by a foreign court from committing securities law violations; who have violated foreign securities laws; or who have aided and abetted such violations. Such authority would be a necessary and appropriate supplement to the Commission's authority to place limitations on securities professionals based on violations of U.S. laws. The Commission expects that, at least in part as a result of the enforcement assistance that the Commission will provide to foreign authorities pursuant to newly enacted Section 21(a)(2) of the Exchange Act, securities professionals will be subject to more aggressive enforcement efforts by such foreign authorities. It would be ironic and inconsistent with the Commission's mandate to protect investors if the Commission were to provide assistance leading to a finding that a securities professional had violated foreign securities laws substantially similar to U.S. laws, but could not prevent that securities professional from conducting business in the U.S. securities markets. The provisions of Sections 3 through 6 would protect against such a result.

Section 3(b) of the legislation would expand the class of persons subject to "statutory disqualification" pursuant to Section 3(a)(39) of the Exchange Act. It would expand the grounds on which the Commission or a self-regulatory organization ("SRO") could deny a person membership in, participation in, or association with a member of, the SRO in two ways. First, it would include certain foreign disciplinary actions within the definition. Second, it would amend subparagraph (F) of that

section, which by cross reference to Section 15(b)(4) of the Exchange Act makes persons convicted of specified felonies and misdemeanors subject to a statutory disqualification. The amendment would add "any other felony" to the list of crimes that subject a person to the statutory review process. This provision would permit the Commission and the SROs to review the proposed association of persons who have been convicted of crimes that are not currently specified, such as taking of property, assault, murder, and drug trafficking. This amendment would not automatically exclude every person convicted of a felony from the securities business. Rather, it would permit the Commission and SROs to consider the facts and circumstances surrounding a particular felony conviction and to impose appropriate safeguards to protect the U.S. markets and investors from unreasonable risks.

D. Reimbursement

Finally, in certain cases, foreign securities authorities have expressed a willingness to reimburse the Commission for travel, subsistence, and other necessary expenses incurred by the Commission and its employees in carrying out investigations for the foreign authority pursuant to Section 21(a)(2) of the Exchange Act or in providing other assistance. The Commission has been unable to accept such payments, however, because federal appropriations law prohibits federal agencies from accepting funds from outside sources absent specific statutory authority.

The proposed legislation would amend Section 4(c) of the Exchange Act to permit the Commission to accept reimbursement.

The Commission believes that it has made great progress in developing mechanisms and approaches for policing the internationalized U.S. markets. The International Securities Enforcement Cooperation Act of 1989 provides authority necessary to build on this progress. Enactment of the legislation would provide a critical vehicle for enhancing our efforts to maintain the integrity of the U.S. securities markets.

II. THE PROPOSED LEGISLATION

A. Legislation authorizing the Commission to assure confidential treatment of documents furnished to the Commission by foreign securities officials

The legislation would amend the securities laws to permit the Commission to assure confidential treatment for records provided to the Commission by foreign securities authorities. The Commission currently cannot provide such assurances of confidentiality because of its disclosure obligations under the FOIA and civil discovery rules. The legislation would permit the Commission to withhold from disclosure documents furnished to the Commission which might otherwise be required to be disclosed by the FOIA or under a third-party subpoena, if the foreign authority represents in good faith that the disclosure of such documents would be contrary to its country's laws. The Commission would, however, still be obligated to disclose such documents to Congress. The documents would also be subject to discovery requests in any enforcement action brought by the

United States or the Commission, absent a separate basis upon which to withhold them.

In entering into MOUs with the Commission, authorities in foreign countries have committed themselves to obtaining and providing the Commission with documents, some of which otherwise would be kept confidential. These authorities are willing to permit public use of these documents for the purpose of investigating and prosecuting securities law violators. However, they have expressed concern about the disclosure of such documents when the Commission decides not to prosecute a particular matter.

The Commission's disclosure obligations under the FOIA are the same for records obtained from foreign securities authorities as they are for records obtained from other sources. Accordingly, the documents must be disclosed under the FOIA unless they fall within a specified FOIA exemption. Likewise, such documents generally must be disclosed pursuant to a third-party subpoena served on the Commission unless a legal privilege or other defense is available. Because of these disclosure obligations, foreign securities authorities have expressed concerns about providing the Commission with information relevant to ongoing investigations. They also have stated that their own domestic laws preclude them from entering into agreements with the Commission unless the Commission is able to fulfill the confidentiality requirements of the foreign country's laws. In some cases, MOU negotiations have been frustrated by the

Commission's inability to provide assurances that documents and testimony transmitted to the Commission by foreign authorities will be kept confidential.

Section 2 of the Commission's legislative proposal would establish an exemption from disclosure under the FOIA or other applicable law. Adoption of this provision will enhance the Commission's ability to obtain otherwise unobtainable confidential documents from foreign countries for law enforcement purposes. Unless an appropriate FOIA exemption is created, many foreign securities authorities may be unwilling or unable to enter into MOUs with the Commission. More generally, the Commission believes that principles of comity make it appropriate to exempt from disclosure confidential documents obtained from a foreign government if those documents could not be disclosed under the laws of that foreign government.

The exemption is not unlimited. The proposed Section 24(d) would supersede the FOIA 7/ by authorizing the Commission to withhold from disclosure documents obtained from a foreign securities authority only if the foreign authority has in "good faith" represented to the Commission that public disclosure of such records would be contrary to the laws of the foreign

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7/ Certain statutes have been found to preempt or supersede the FOIA. See, e.g., Ricchio v. Kline, 773 F.2d 1389, 1392 (D.C. Cir. 1985)(holding that the FOIA was preempted by the Presidential Recordings and Materials Preservation Act, the sole purpose of which is "to preserve" and "to provide access to" a certain specific body of records). By superseding the FOIA, the statute would avoid the need by the Commission to rely on a FOIA exemption in order to withhold confidential information from disclosure.

country. 8/ The term "foreign securities authority," as defined in Section 3(a)(50) of the Exchange Act, which was enacted as part of the Insider Trading and Securities Fraud Enforcement Act passed last year, includes government agencies and self-regulatory organizations which "administer" or "enforce" the securities laws.

B. Legislation granting the Commission rulemaking authority to permit access to its files by persons, both domestic and foreign, engaged in securities law enforcement and oversight

The Commission's Rules of Practice authorize the Director of the Division of Enforcement to provide access to non-public materials in the Commission's investigative files to domestic and foreign governmental authorities, self-regulatory organizations, and other specified persons. 9/ In addition, Rule 2 of the Commission's Rules Relating to Investigations authorizes designated members of the Commission staff to "engage in discussions" concerning the nonpublic materials with the persons specified in Rule 30-4(a)(7). 10/ These access rules have

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8/ Absent a "good faith" standard, the statute might bind the Commission to follow the dictates of a foreign government. The "good faith" requirement would permit the Commission to inquire into the legitimacy of the foreign government's non-disclosure request.

9/ Rule 30-4(a)(7), 17 C.F.R. 200.30-4(a)(7).

10/ 17 C.F.R. 203.2. Other relevant rules include: Rule 2.5(b) of the Commission's Rules On Informal and Other Procedures, 17 C.F.R. 202.5(b), which states that the Commission may "grant requests for access to its files made by domestic and foreign governmental authorities, self-regulatory organizations such as stock exchanges or the [NASD], and other persons or entities"; Administrative Regulation 19-1(1)(b), (continued...)

frequently provided the basis for making nonpublic materials available to other enforcement agencies and to SROs engaged in prosecuting securities law violations.

The Commission's access rules are longstanding. However, Section 24(b) of the Exchange Act, 15 U.S.C. 78x(b), enacted in 1975, makes it unlawful "for any member, officer, or employee of the Commission to disclose to any person other than a member, officer or employee of the Commission, or to use for personal benefit, any information contained in any application, statement, report, contract, correspondence, notice or other document filed with or otherwise obtained by the Commission (1) in contravention of the rules and regulations of the Commission under [the FOIA], or (2) in circumstances where the Commission has determined pursuant to such rules to accord confidential treatment of information." Section 24(b) was intended to make all requests for confidential treatment of information subject to the FOIA

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persons or entities"; Administrative Regulation 19-1(1)(b), SECR 19-1(1)(b), which provides that "the prohibition[s] against the use of non-public information or documents" imposed by various Commission rules do "not apply to the use of such materials as necessary or appropriate by members of the staff in pursuing Commission investigations, examinations or in the discharge of other official responsibilities"; Administrative Regulation 19-1(1)(c), SECR 19-1(1)(c), which sets forth a policy approving the use of non-public materials and the furnishing of "such assistance as may be required for the effective presentation or prosecution of a case" in circumstances where the Commission refers matters to the Justice Department or grants access to its files to any federal, state or foreign government authority; and the Commission's policies and procedures concerning the "routine uses" of systems of records in the Commission's possession that are covered by the Privacy Act. See, e.g., 41 Fed. Reg. 41550 (September 22, 1976) and 54 Fed. Reg. 24454 (June 7, 1989).

rules. 11/ There is nothing in the legislative history of Section 24(b) suggesting that Congress intended to undermine the Commission's access program. Nevertheless, it could be argued that the language of Section 24(b) precludes disclosure of documents that are determined under the FOIA to be confidential.

In most situations, the Commission receives an access request before the staff makes a confidential treatment determination, and Section 24(b) is not, therefore, at issue. On occasion, however, Section 24(b) can pose an obstacle to compliance with an access request.

Additional problems with the Commission's access program may arise from other statutory provisions. Section 210(b) of the Advisers Act bars the staff from making information relating to a Commission investigation public if the information was obtained pursuant to that Act, unless the Commission expressly authorizes such disclosure (with exceptions for public hearings and disclosure to Congress). Section 45(a) of the Investment Company Act restricts disclosure of certain non-public documents received by the Commission pursuant to that Act, except insofar as disclosure is made to federal or state government officials.

To make clear the Commission's authority to grant access to its files to domestic and foreign authorities, the Exchange Act

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11/ Prior to the 1975 Amendment, the Commission provided confidential treatment under both the FOIA rules and under Section 24(a), which at that time prescribed standards for granting confidential treatment to information filed with the Commission. The Amendments were intended to end the latter procedure. See S. Rep. No. 94-75, 94th Cong., 1st Sess. 137, reprinted in 1974 U.S. Cong. & Admin. News 179, 314.

should be amended to provide the Commission with explicit authority in this area.

The proposed amendment would add new subsection (c) to Section 24 of the Exchange Act to grant the Commission rulemaking authority to define categories of persons to whom access may be given. As a result, the Commission will have flexibility in adjusting its access rules in the future. In addition, by specifying that the Commission may provide access to foreign persons, the Commission's authority as to this matter will be made explicit. 12/ The provision as to confidentiality of records would strengthen the Commission's ability to refuse to provide records to persons who will make the records public for purposes other than those stated in an access request. 13/

The proposed legislation provides that it would not alter the Commission's responsibilities under the Right to Financial Privacy Act. 14/

12/ By including the phrase "notwithstanding any other provision of law," the amendment will supersede Section 45(a) of the Investment Company Act and Section 210(b) of the Investment Advisers Act.

13/ Commission policy now requires that the person making the access request state the purposes for which the requested information will be used and certify that no public use will be made of the information except for the purposes specified. These or similar procedures would continue to be used after the legislation is enacted. In the international context, where the Commission has entered into MOUs, such MOUs delineate the public uses that can be made of information which the Commission provides pursuant to the access program.

14/ 12 U.S.C. 3401 et seq. See Section 2(b) of the proposed legislation, which would add new Section 24(e) to the (continued...)

C. Legislation authorizing the Commission to impose sanctions on securities professionals for violations of foreign laws or for committing felonies

1. Overview

One likely result of efforts by foreign securities authorities to strengthen their securities law enforcement will be an increase in the number of enforcement or disciplinary proceedings brought against securities professionals, such as brokers, dealers, and investment advisers, who operate in the United States as well as abroad. Indeed, such actions may result at least in part from the assistance provided to foreign authorities by the Commission pursuant to newly enacted Section 21(a)(2) of the Exchange Act. The Commission, however, currently does not have explicit authority to impose administrative sanctions against securities professionals based upon foreign findings of illegal or improper activities overseas (although, as discussed below, the Commission has some authority in this area). The proposed legislation would provide that the Commission could, in its discretion, after an opportunity for a hearing, impose sanctions on a securities professional who has been found to have engaged in misconduct abroad when, had the order or finding of violation been made in a U.S. proceeding, the professional would have been subject to a Commission disciplinary proceeding. This amendment would give the Commission discretion to bring an administrative proceeding based on foreign misconduct, just as it

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14/(...continued)
Exchange Act. See also H.R. Rep. No. 95-1383, 95th Cong., 2d. Sess. 247 (1978).

has discretion to bring such actions based on domestic misconduct. Sections 3 through 6 of the bill would amend Sections 15(b)(4) and 3(a)(39) of the Exchange Act; Section 9(b) of the Investment Company Act; and Section 203(e) of the Advisers Act to provide the Commission with this express authority.

2. Specific concerns

a. Sanctions based upon foreign convictions

U.S. broker-dealers, investment advisers, and investment companies have increased significantly their activities in foreign markets. 15/ The activities of foreign professionals in the U.S. markets also are likely to increase. 16/ As a result,

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15/ See Internationalization of the Securities Markets, Report of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, dated July 27, 1987, at Chapter VII. With regard to investment companies, the report states that there has been a dramatic increase in the number of U.S. investment companies that emphasize foreign securities in their portfolios and that it has become more common for investment companies registered in the U.S. to issue their securities in foreign markets. As of January 1988, there were 154 registered investment companies of all types that concentrate their portfolio securities in foreign securities. These funds, which are widely held by U.S. investors, use foreign broker-dealers to execute portfolio transactions, foreign custodians to hold portfolio securities and foreign advisers to help manage their portfolios. With regard to broker-dealers, major foreign markets usually facilitate entry by granting national treatment to U.S. securities firms. France has substantially increased access to its markets by foreign firms, id. at V-3, and the Tokyo Stock Exchange recently increased the number of seats allocated to foreign firms. In addition, affiliates of U.S. broker-dealers now engage in significant market-making activities in London. Id. at V-21.

16/ See id. at I-14-16; II-78-90. The report indicates that over 120 investment advisers from 20 countries have

(continued...)

the Commission is likely to confront a growing number of securities professionals who have been disciplined abroad for illegal or improper activities working or seeking to work in this country.

The Commission currently has substantial authority to curtail the securities activities of certain convicted criminals and other wrongdoers for illegal or improper conduct in this country. Under Sections 15(b)(4) and (b)(6) of the Exchange Act, the Commission may censure, limit the activities, functions, or operations of, suspend for up to twelve months, or revoke the registration of any broker or dealer, or bar from association with any broker or dealer, any person: who is found to have violated the federal securities laws, rules, or regulations thereunder; who is convicted of a "felony or misdemeanor" within

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16/(...continued)
registered with the Commission. With regard to investment companies, in 1984, the Commission transmitted a legislative proposal to Congress that would amend Section 7(d) of the Investment Company Act to give the Commission greater flexibility in permitting foreign investment companies access to the U.S. securities markets. Although this proposal never was introduced in either House of Congress, the Commission anticipates renewed interest in a legislative proposal to amend Section 7(d). In addition, the Commission is considering the possibility of reciprocal arrangements between the United States and foreign nations with respect to multinational offerings of mutual fund securities. Finally, recently-adopted Rule 6c-9 will facilitate the offering of foreign bank securities in the U.S. Investment Company Act Rel. No. 16093 (Oct. 29, 1987).

With regard to broker-dealers, about 150 foreign firms had established branches in the United States as of 1987; for their part, U.S. firms had over 250 branches in foreign countries, excluding Canada and Mexico. Id. at Chapter V, Appendix B-66 (remarks of James M. Davin, Vice-Chairman, NASD).

the preceding ten years involving specified crimes; who willfully has filed a false or misleading statement in any registration statement or report filed with the Commission; or who has willfully aided and abetted a violation of any portion of the federal securities or commodities laws. Such a person also is subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. 17/ Sections 203(e) and (f) of the Advisers Act provide the Commission with disciplinary authority as to investment advisers and persons associated with registered investment advisers, similar to that in Sections 15(b)(4) and (6) of the Exchange Act. 18/

In addition, Section 9(a) of the Investment Company Act generally prohibits a person convicted of a securities-related crime or subject to a securities-related injunction from serving as an employee, officer, director, member of an advisory board,

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17/ As a result, when such a person seeks to become associated with a member of an SRO, that SRO and the Commission have the opportunity to give special review to the person's employment application or to restrict or prevent reentry into the business where appropriate for the protection of investors. See Section 15A(g)(2) of the Exchange Act and Rule 19h-1 thereunder.

18/ Section 15(b)(6) of the Exchange Act and Section 203(f) of the Investment Advisers Act authorize the Commission to limit the activities of a person associated or seeking to become associated with a broker-dealer or investment adviser if the Commission finds that the person has committed any of the acts or has been convicted or enjoined as designated in Section 15(b)(4) or Section 203(e). As a result, any addition to the Commission's authority under Section 15(b)(4) and Section 203(e) will, by implication, expand the Commission's authority under Section 15(b)(6) and Section 203(f).

investment adviser, or depositor of a registered investment company, or principal underwriter for any registered open-end company, unit investment trust, or face-amount certificate company. The automatic statutory disqualification in Section 9(a) is supplemented by the Commission's authority under Section 9(b). Under Section 9(b), the Commission may prohibit a person from serving in any of the capacities cited in Section 9(a) or as an affiliated person of a registered investment company's investment adviser, depositor, or principal underwriter if the person willfully has caused a false or misleading statement to be made in any registration statement or report filed with the Commission or if the person has willfully violated or aided and abetted a violation of any provision of the federal securities or commodities laws.

Although the provisions discussed above do not mention the Commission's authority to impose sanctions based on foreign misconduct, certain of the provisions can be so applied. In particular, Sections 15(b)(4)(B) of the Exchange Act, 203(e)(2) of the Advisers Act, and 9(a)(1) of the Investment Company Act refer to a "felony or misdemeanor" conviction for specified crimes. Neither the statutes nor their legislative histories specify that the crime or conviction must take place in the United States. 19/ On at least one occasion, the Commission has

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19/ Investment Trusts and Investment Companies: Hearings Before a Subcommittee on the Senate Committee on Banking and Currency, 76th Cong. 3d Sess. 7, 31, 559 (statement of Honorable Charles F. Adams) (1940); Investment Trusts and (continued...)

used its authority under Section 15(b)(4)(B), to revoke the U.S. registration of a Canadian broker-dealer who was convicted of crimes in Canada involving the purchase or sale of securities. 20/ Likewise, under Sections 15(b)(4)(C) of the Exchange Act and 203(e)(3) of the Advisers Act, the Commission may impose sanctions based upon a securities-related injunction entered by a "court of competent jurisdiction," and, under Section 9(a)(2) of the Investment Company Act, such an enjoined person's association with a registered investment company is limited. These statutes are not explicitly limited to injunctions entered by U.S. courts. 21/

As to other provisions, however, this authority needs to be clarified and, in some cases, expanded. First, the Commission's authority to impose sanctions on a professional 22/ and to restrict association with a registered investment company 23/

19/(...continued)
Investment Companies: Hearings Before a Subcommittee on the House of Representatives Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 13, 46, 97 (1940). As to Section 15(b)(4)(B) of the Exchange Act (originally Section 15(b)(5)(B)), see H. Rep. No. 1418, 88th Cong., 2d Sess. 21 (1964).

20/ In the Matter of R.P. Clarke & Co., 10 S.E.C. 1072 (1942). See also L. Loss, Securities Regulation 1303, n. 51 (2d ed. 1961) (citing R.P. Clarke decision and stating that the Commission may impose sanctions under Section 15(b)(4)(B) based upon a conviction in a foreign court).

21/ See L. Loss, Securities Regulation at 1305 (2d ed. 1961) (stating that a "court of competent jurisdiction" as set forth in Section 15(b)(4)(C), may include a foreign court).

22/ Section 15(b)(4)(A) of the Exchange Act and Section 203(e)(1) of the Investment Advisers Act.

23/ Section 9(b)(1) of the Investment Company Act.

for a misstatement in an application for registration or report filed with the Commission does not extend to misstatements made to foreign regulatory authorities. Second, the Commission's authority to impose sanctions on the professional 24/ or to restrict association with a registered investment company 25/ for willful violation of the U.S. securities and commodities laws does not extend to violations of foreign securities laws. Finally, the Commission's authority to impose sanctions on professionals for aiding and abetting a violation or failing reasonably to supervise a person subject to the professional's control in violation of the U.S. securities laws 26/ and to restrict association with a registered investment company of personnel who are found to have aided and abetted these violations 27/ does not extend to activities that violate foreign securities and commodities laws. The legislation would provide the Commission with authority to act in each of these circumstances.

In addition, as to the provisions under which the Commission does have authority to impose sanctions, the legislation would make such authority explicit and would preclude certain challenges which might be possible under the existing

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24/ Section 15(b)(4)(D) of the Exchange Act and Section 203(e)(4) of the Investment Advisers Act.

25/ Section 9(b)(2) of the Investment Company Act.

26/ Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(5) of the Investment Advisers Act.

27/ Section 9(b)(3) of the Investment Company Act.

statutes. In particular, Section 15(b)(4)(B) of the Exchange Act, Section 203(e)(2) of the Advisers Act, and Section 9(a)(1) of the Investment Company Act refer to convictions for a "felony or misdemeanor" as the basis for a Commission sanction. A securities professional who was convicted in a country that does not define crimes as "felonies" or "misdemeanors" might challenge the Commission's authority under these sections. A Commission administrative sanction also might be challenged when the foreign offense for which the securities professional was convicted is not one of the exact offenses specifically covered by the statutory provisions. As discussed below, the proposed legislation would undercut such defenses by providing for Commission sanctions based upon foreign convictions for crimes "substantially equivalent" to those listed in the statute. The legislation also would foreclose the potential argument that the statutory provisions that allow the Commission to impose sanctions on professionals who have been enjoined from acting in specific capacities, such as underwriters or investment advisers, 28/ do not apply to persons whose profession is not so defined in a foreign country. The proposed amendments would resolve the potential difficulties posed by differences in employment terms by permitting sanctions based upon an injunction entered against a professional who performs a "substantially equivalent" function to the activities currently listed in the statute.

28/ Section 15(b)(4)(C) of the Exchange Act; Section 203(e)(3) of the Investment Advisers Act; and Section 9(a)(2) of the Investment Company Act.

The proposed legislation would also create a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act, when a foreign securities authority or foreign court makes findings of illegal or improper conduct.

The Commission's action against a securities professional would not be automatic. The statutory procedure for imposing sanctions for foreign misconduct would be the same as that currently in place for imposing sanctions for domestic misconduct. The Commission would provide the securities professional with notice and an opportunity for a hearing before imposing a sanction. The securities professional would thus have an opportunity to present evidence on his or her own behalf, in order to demonstrate that the imposition of sanctions would not be in the public interest. In addition, if the professional makes a persuasive due process or jurisdictional attack on the foreign adjudicative proceedings, the Commission may be required to permit relitigation of the underlying offense. 29/

b. Felonies as bases for statutory disqualification

In addition, the legislation would amend newly redesignated subparagraph (F) of Section 3(a)(39) of the Exchange Act, which by cross reference to Section 15(b)(4) of that Act makes persons convicted of specified felonies and misdemeanors subject to

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29/ Similarly, in a Commission review, pursuant to 15 U.S.C. 19(d)-(f), of an SRO disciplinary or membership proceeding against a person subject to a statutory disqualification, the Commission might find it necessary to remand the proceeding to the SRO for relitigation of the underlying offense in cases where persuasive due process or jurisdictional challenges to the foreign proceeding are made.

statutory disqualification, by adding "any other felony" to the crimes listed as possible bases for denial of SRO membership or participation or association with an SRO member. This provision would permit the Commission and the SROs to scrutinize persons who have been convicted of crimes that are not currently specified, such as taking of property, assault, murder, and drug trafficking. The proposed amendment responds to concerns brought to the Commission's attention by the National Association of Securities Dealers. The National Business Conduct Committee of the NASD, which is responsible for all NASD disciplinary actions, has endorsed this provision of the proposed legislation as a desirable means of improving ethics in the securities industry. Of particular concern to the NASD was the recent association of a convicted drug dealer with an NASD member firm in a principal capacity. The Commission expects that the national securities exchanges also will find it appropriate to review the qualifications of persons seeking membership or association who have been convicted of felonies.

3. The proposed legislation

Sections 3 through 6 of the proposed legislation would add new Sections 15(b)(4)(G) to the Exchange Act, 203(e)(7) to the Advisers Act, and 9(b)(4) to the Investment Company Act. These provisions would apply the proscriptions of Sections 15(b)(4)(A), (D), and (E) of the Exchange Act, Sections 203(e)(1), (4), and (5) of the Advisers Act, and Sections 9(b)(1), (2) and (3) of the Investment Company Act to an international context. Thus, the

Commission would be able to impose sanctions on the professional if the professional has been found by a "foreign financial regulatory authority" -- a defined term in the Acts -- to have made false or misleading statements in registration statements or reports filed with the authority; violated foreign statutory or regulatory provisions regarding securities or commodities transactions; or aided, abetted, or otherwise caused another person's violation of such foreign securities or commodities provisions or failed to supervise a person who has committed a violation of such provisions. The term "foreign financial regulatory authority" would be defined in new Sections 3(a)(51) of the Exchange Act, 202(a)(24) of the Advisers Act, and 2(a)(50) of the Investment Company Act. It would include a "foreign securities authority," which is defined in Section 3(a)(50) of the Exchange Act, or an organization that is essentially equivalent to a self-regulatory organization. The term "foreign securities authority" would also be defined under this legislation in Section 202(a)(23) of the Advisers Act and Section 2(a)(49) of the Investment Company Act as it is defined under Section 2(a)(50) of the Exchange Act, i.e., "any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws relating to securities." 30/

30/ As noted above (supra n. 18), Section 15(b)(6) of the Exchange Act and Section 203(f) of the Investment Advisers Act authorize the Commission to limit activities of a person associated or seeking to become associated with a broker-
(continued...)

Sections 15(b)(4)(G), 203(e)(7), and 9(b)(4) are substantially similar to the subsections of 15(b)(4), 203(e), and 9(b) discussed above. The most significant difference between the existing and the new provisions is that the legislation would not require that the foreign authorities find "willful" misconduct, i.e., a "willful" false filing, a "willful" statutory violation, or "willful" secondary liability. The Commission recommends this approach because of a potential disparity in standards of willfulness in different countries and because some countries may not require a "willful" violation. The proposed language would provide the Commission with flexibility in deciding whether the facts of a particular case indicate a state of mind comparable to willfulness so as to warrant imposition of sanctions.

In addition, Section 15(b)(4)(B) of the Exchange Act and Section 203(e)(2) of the Advisers Act would be amended to grant the Commission explicit authority to consider convictions by a foreign court of competent jurisdiction of any crime enumerated in current Section 15(b)(4)(B) and Section 203(e)(2) or a "substantially equivalent" foreign crime; Section 15(b)(4)(C) of

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30/(...continued)
dealer or investment adviser if the Commission finds that the person has committed any of the acts or has been convicted or enjoined as designated in Section 15(b)(4) or Section 203(e). Because this legislation requires the addition of new paragraphs in Section 15(b)(4) and Section 203(e), it provides for conforming amendments to Section 15(b)(6) and Section 203(f). Section 3 of the legislation would also make conforming amendments to Sections 15B(c), 15C(c), 15C(f), and 17A(c) of the Exchange Act.

the Exchange Act and Section 203(e)(3) of the Advisers Act would be amended to state explicitly that the Commission may consider injunctions imposed by a foreign court of competent jurisdiction in connection with any of the activities designated in the statute, or a "substantially equivalent" foreign activity. The Commission would have authority to restrict association with a registered investment company based on the same factors in new Sections 9(b)(5) and (6).

It should be noted that the Commission does not recommend an amendment to Section 9(a) of the Investment Company Act, which prohibits association in certain capacities with a registered investment company by persons who have been convicted of certain offenses or who have been subject to specified injunctions. Section 9(a) is a self-policing mechanism, the purpose of which "is to prevent persons with unsavory records from occupying these positions where they have so much power and where faithfulness to the fiduciary obligations is so important." 31/ The automatic disqualification provisions of Section 9(a), coupled with the Commission's exemptive authority under Section 9(c) to avoid any inequitable results, are indispensable means of safeguarding the integrity of registered investment companies. However, due process concerns may be presented by legislation that would automatically bar a person solely on the basis of a foreign finding of a violation of foreign law, without any prior notice

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31/ Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 46 (1940).

or opportunity for hearing by a U.S. court or administrative agency. These concerns are avoided if the Commission determines, on a case-by-case basis, whether the foreign finding justifies a bar, rather than relying exclusively on a foreign finding of a violation of foreign law. The amendment would not create any competitive disparities because, just as Section 9(a) applies equally to U.S. and foreign persons that have been convicted or enjoined in a manner specified in the statute, amended Section 9(b) would grant the Commission authority to institute an administrative proceeding against either a U.S. or foreign person that has committed an equivalent foreign violation and has been sanctioned by a foreign authority.

D. Reimbursement of expenses incurred by the Commission in assisting foreign securities authorities

Federal appropriations law prohibits federal agencies from accepting funds from outside sources absent specific statutory authority. Accordingly, Section 7 of the bill would amend Section 4(c) of the Exchange Act to permit the Commission to accept reimbursement from a foreign securities authority or on behalf of such authority, for travel, court reporters, subsistence, and other expenses incurred by the Commission, its members, and employees in carrying out investigations for the foreign authority pursuant to Section 21(a)(2) of the Exchange Act or in providing other assistance. Foreign authorities have, in certain cases, agreed to reimburse the Commission for such expenses. Indeed, the Commission has already incurred significant travel expenses in providing assistance to foreign

securities authorities. In recommending this amendment, the Commission expects to seek reimbursement only for its out-of-pocket expenses incurred in providing assistance to foreign securities authorities.

III. CONCLUSION

Internationalization of the U.S. securities markets presents some of the greatest challenges to the Commission's efforts to protect the U.S. markets from fraud. The Commission believes that it has made great strides in developing mechanisms and approaches for policing the internationalized U.S. markets. The International Securities Enforcement Cooperation Act of 1989 would provide the authority necessary to build on this momentum.

Senator DODD. Let me if I can begin by asking sort of a broad question and get your response to it. I'd like to get your assessment of what you see as the greatest risk, if you will, confronting the U.S. securities markets and the capital formation process in the next decade. What are those risks and what steps, in your view, should be taken now by both the private sector and by government—what steps can we be taking and what steps can the private sector take to minimize those risks as you see them?

Mr. RUDER. I would answer that question in two ways.

The first has to do with the safety and soundness of our own system in the United States with some corollary attention to matters abroad. The second, addresses the question of possible loss of the importance of the U.S. position in the world's capital markets.

With regard to the first, as you may know, the Commission has cooperated with the self-regulatory organizations, with the Federal Reserve Board, with the CFTC and Treasury to develop systems to improve our markets here. We have made great progress, I think, in improving the order routing and execution system, the automation of securities transactions. We have improved broker communications with customers. We are working very hard to improve the clearance and settlement system, which has been subject to a worldwide initiative proposed recently by the Group of Thirty. We have worked on information exchange between exchanges and within markets, and we have devoted some time to putting circuit breakers in place so that we can have a pause in our markets should they have problems.

There is an area that I believe needs further attention. It's a very difficult area. That is the question of how to make more capital available in times of market stress. I have urged caution by institutional investors in their investment strategies so that they do not lead us by some herd instinct into a dramatic market decline. I have also urged the institutional investors and the corporations of America to consider that they may have some responsibilities to step forward in a market crisis to provide the necessary liquidity.

In the other area, the area of protection, if you will, or motivation of our own financial services industry, I think that there is a great deal to be done in terms of providing a meaningful competitive position for us.

With regard to regulation, I think it's fair to say that the automation of our securities markets is the driving force, both nationally and internationally, and that we will see over the next years this automation producing regulatory problems for us. We are hesitant at the Commission, however, to try to introduce regulatory measures before these systems become operational because we do not want to interfere with innovative product design and systems. We are monitoring and watching carefully.

Senator DODD. What sort of things do you see as being difficult? I mean, I appreciate your not wanting to step in and try to regulate automation that hasn't occurred yet, but be a little bit more specific, if you can, about that.

Mr. RUDER. What will happen, in my opinion, is that we will begin to have what's called screen-based trading of world class debt and equity issues, at the corporate level at least, throughout the world and that we will begin to see after-hours trading in stocks

and bonds. This screen-based trading, if it is on a 24-hour basis and is systematic throughout the world, is going to present regulatory problems because the question will be who is going to regulate those markets. We are looking at that problem. We must look, as well, at the rise of what might be called proprietary trading systems. That is, systems which do not have an exchange membership as their base, and the question of how those proprietary systems should be regulated is one that is of great interest.

In the clearing and settlement area, we have urged internationally, and are cooperating in the development of, clearing and settlement systems in which each country has an automated net settlement immobilized security clearing and settlement process. We have also urged intermarket links between the clearing agencies in countries, so that we can achieve the kind of stability in the clearance, settlement and payment system which will be very important as our markets develop.

These matters are very technical and very important. It is also, I think, important to look at our disclosure system. We have the most rigorous disclosure system in the world, and one of the problems that we face is how to accommodate the interests of foreign issuers coming to our markets in the face of our more rigorous disclosure system. We need to look at the question of whether and how we should relax our disclosure system at all in order to accommodate this. In that area, we are proceeding with multilateral discussions about relaxation of disclosure, and we are also looking at accounting systems which are the very hardest area. Our Chief Accountant is participating in the IASC, the International Accounting Standards Committee, to see whether there can be some harmonization of international accounting standards.

The issues are enormously complex. Rather than looking at them all at the same time, we think that we can parcel the issues out. As I think my opening statement setting forth the different areas indicates, we can look at them in individual areas and try to attack each problem individually and eventually look towards a very well-coordinated global system.

Senator DODD. Let me jump in other area quickly. I see the yellow light, but with just the two of us here, we can probably dispense with that clock there. [Laughter.]

Yesterday, in chatting with Chairman Greenspan, one of the statements that he made, that again I think was generally supported by all of our witnesses, was the notion that certainly one of the things that became quite clear after the October 1987 break, as we now euphemistically call it, was that our securities options and futures markets were really one market. What I want is you to comment on that conclusion that others have reached to see if you agree with that. We also have seen the difficulty of getting the different regulators of those markets and the participants of those markets to agree on a given set of practices. Now clearly some very constructive steps have been taken since October, 1987. But we know that we still have some significant disagreement in a number of areas. The margin area is one, which, as I mentioned yesterday, I spent Monday in Chicago, and the Chicago Board of Options Exchange really spent a whole lunch on that one issue, which won't come as a great surprise to you.

That remains an area of disagreement. Differences between the SEC and the CFTC with respect to coordinated clearance in the domestic markets is another area where agreement has been slow.

It gets to this particular point. One, do you believe that the one market theory applies to global markets? Are our domestic and foreign financial and securities market so interdependent that from a regulatory standpoint we must look at them as one, in your view?

Secondly, if we have difficulties in forging compromise and agreement among regulators of our domestic markets, what do you see as the outlook of greater cooperation and coordination on global markets on the international front? Can you identify, as well, the significant areas where you believe that international coordination is likely and where it is less likely.

Lastly, again we discussed this with Chairman Greenspan yesterday, comment on whether or not in your view there is enough effort being made. The Group of 30 is pursuing the clearance and settlement issue. There is a lot of discussion going on among regulators. I know you have talked to your counterparts, but is there enough of a coordinated effort going on, in your view, to really minimize the kinds of problems we have seen or to maximize the greater coordination that I think we all recognize must exist within the next decade if these markets are to be successful?

That is a lot of "one" question, but . . .

Mr. RUDER. I will try to respond as briefly as I can. Nationally, I believe that there is a single market involving stocks, options on stocks, and the futures products on stock indices. The question of how that should be regulated is one that has been the subject of debate and is not one which is being pursued actively by me or the Commission, in terms of legislative change. I believe, however, that it is possible for good cooperation to exist between the regulatory authorities, and I can report to you that the degree of cooperation between the Commission and the CFTC in this area is quite good. We are regularly in contact with the CFTC, and I believe that we can act cooperatively.

With regard to the margin area, I have some personal disagreements, as you know, with the way in which the margin system works. Again, we haven't pursued this on a Commission basis very vigorously. My own view still remains that we ought to have coordinated margin regulations in accordance with a somewhat more rationalized system than we now have. I think the important thing, however, internationally, is to recognize that the United States and Japan are the only nations in which the regulation of the various financial markets is split the way it is in the United States. We have three regulators, essentially. We have more than one banking regulator, and we also have separate banking, securities and futures regulators.

Worldwide, it is the banking regulators that regulate all of these areas, so that the idea of uncoordinated regulation is not likely to be one which exists in other countries, since there will be a single banking regulator which can make ultimate decisions regarding this regulation.

We must face internationally the problem of dealing with regulatory bodies which may be somewhat different from ours. For instance, when I found myself in what we call our quadrilateral talks

with the Fed, the Bank of England and SIB over in Great Britain, we were dealing with what is a recognized difference in regulation, that there is a different manner of regulation overseas.

Nevertheless, I can report to you that, in the securities area, more countries are beginning to recognize the necessity of having a separate securities regulatory commission. Such a commission, as you know, now exists in Great Britain where previously in did not. Japan has had one for a long time, but more recently, we have seen legislation and the growth of organizations like the SEC in the Netherlands, in Spain, and I understand, in Finland, there is legislation that is going this way. I think there is a growing understanding that there are differences between the regulatory needs in the securities business and those in the banking business. Here I think it is important to recognize that we are dealing in the securities business with high risk activities, short-term risk activities, which require a different kind of regulation, I think, than the banking system really has.

The existence of the International Organization of Securities Commissions is a very important step forward. That organization until three years ago was more or less just an annual meeting organization, but three years ago in Paris, Chairman Shad made a speech in which he urged the organization of working groups, and since that time we have had active working groups dealing with specific subject matters—capital adequacy, disclosure, enforcement and accounting matters. These groups are working actively and involved in face-to-face discussions, so that we are moving towards, I think, international understanding of where we should be going.

I am pleased to say that there is a dramatic increase in cooperative attitudes between securities regulators worldwide. I cannot tell you that all the problems are being solved, but we are certainly giant steps forward from where we were three years ago, and I suspect that the increase in cooperation will be geometric, as we move into the future.

Senator DODD. That is encouraging. A good part of yesterday's debate focused—from the private sector, particularly—on Glass-Steagall. Not surprisingly, those who came from the commercial banking sector advocated very strongly for, if not the repeal of Glass-Steagall, as close to repeal as you could possible get. Others, from the securities industry, indicated that they didn't think that that was really the problem, that regulatory reform was really not so much the problem as was our lack of savings in the U.S., which I have already indicated. Several witnesses said that if they had to identify any one thing, that would be the one area in which they would encourage the government to move aggressively.

I wonder if you might just comment quickly, if you could, on Glass-Steagall, on the issue of savings, and which of these issues really has a profound effect on the loss of the competitiveness of our capitol markets.

Mr. RUDER. Well, as you know, the Commission position is that we support reform or repeal of Glass-Steagall as long as there is provision made for the Commission to regulate the securities activities of banks. I think that repeal or reform is essential for us to consolidate our competitive position internationally. We are under some severe constraints because our banks and securities people

can't do the same things abroad that others can. I think those restraints need to be removed, and I do think that the capital strength of the resulting institutions will be better. I am not an economist and can't really discuss adequately the savings question. I do understand that the economists generally are in agreement that we should increase the savings rate in the United States as a means of financing our deficit and as a means of bringing our economy to better order. But I can only say that that is a third party statement as far as I am concerned.

Senator DODD. I appreciate that. I have taken far too much time. Senator Heinz.

Senator HEINZ. Chairman Ruder, I think you properly identified the two greatest problems or risks to the system when you talk about making sure that our markets are both stable and liquid in the face of stress and, secondly, that we maintain the competitiveness of U.S. financial markets.

As you know better than anybody else, the main thrust of the 1933 and 1934 Securities Acts were, above all, investor protection, and that is what our registration provisions are about. That is what the creation of the self-regulatory organizations in the 1934 Act are all about; the exchange standards and so forth. As a result of that, U.S. equity markets are, as a general matter, much more stringently regulated than are other major equity markets abroad. The obvious question arises as to how that globalization process that was discussed yesterday, is going to affect the future framework of stock market regulation in the U.S., and to what extent, in order to meet the competition from foreign markets, will we have to liberalize or modify our standards.

You have mentioned some initiatives that the SEC is undertaking that I would generally characterize as liberalism. But my question to you is, what does this really portend for shareholder protection? Are we necessarily on a slippery slope away from the basic underpinnings of the 1933 and 1934 Acts, away from the high standard of investor protection that we have traditionally observed?

Mr. RUDER. No, I do not believe we are. The adjustments in our disclosure mechanisms, I think, will always be made with an eye to making sure that there is adequate disclosure of information to the markets. We are fiddling with the system and not trying to trash it.

I think the other part of it, which I did not emphasize in my response to Senator Dodd, is that we will continue a vigorous enforcement system for shareholder protection, and our antifraud regulation will continue to be as strong and even stronger than it has been in the past. There has been a great deal of debate about whether a strict enforcement system is going to enhance a securities market, and it is at least my opinion that capital will flow to the market which is recognized as a market with a high degree of integrity. For that reason, I think that the enforcement efforts are consistent with the maintenance of a strong capital market here.

Senator HEINZ. You mentioned your more recent rulemaking initiatives, Rule 144, Regulation S, and reciprocal prospectuses. I am inclined to agree with the general intent of those proposals, which is to innovate in the face of change. If you don't innovate in the face of change, you will be left high and dry and gasping on the

beach. But some would suggest that you are going too far in trying to accommodate foreign issuers. In particular, they would argue that Rule 144 is a large step backward from the disclosure orientation of the 1933 and 1934 Acts.

Is the process really necessary to maintain competitive markets? Where do you draw the line on the appropriate level of disclosure?

Mr. RUDER. We are going to repropose Rule 144(A) in response to a number of comments that have been received, or at least I understand the staff's recommendation to us will be to repropose it. There has been substantial concern that Rule 144(A) went too far in terms of creating a private market for securities. There is a suggestion that we should draw back to having 144(A) merely recognize the institutional private market which exists, and to try to structure around that market. I can't predict either what the staff will say or what our Commissioners will do.

Senator HEINZ. Let me ask you a personal, but not necessarily philosophical, question, which is: in general, do you think we should revise the 1933 and 1934 Acts to allow institutional investors, who are supposedly sophisticated, knowledgeable, expert and all the other qualities that they claim, to fend for themselves?

Mr. RUDER. I don't believe we need to revise the Act in order to accomplish that goal.

Senator HEINZ. Let me rephrase my question. As a general matter, whether or not we revise the Acts per se, philosophically, is it your view that institutional investors who are all those things I said, or they at least say, should be allowed to fend for themselves? They don't need your help?

Mr. RUDER. Yes. I agree with that.

Senator HEINZ. But for the institutional investor, it is caveat emptor.

Mr. RUDER. The idea is that they are smart enough to know what to ask, and they have sufficient financial power to force the answers to those questions. Of course, they would still be protected by other provisions of the federal securities laws, such as the antifraud provisions, regardless of whether or not the transaction was exempt from the Securities Act registration requirements under Rule 144(A).

Senator HEINZ. I would love to know who the institution was that advised Time shareholders that the Warner deal was a good deal.

Mr. RUDER. I don't know the answer to that question, and I doubt my enforcement staff would let me comment on that.

Senator HEINZ. That was a gratuitous comment, and so it should probably be stricken from the record. But presumably, somebody hired a very sophisticated investment banking firm that according to the market only got it wrong by $60 or so a share. Such is life, I guess.

Senator DODD. They were doing it the old way.

Senator HEINZ. Yes. Yes. You will listen to some other things I shouldn't say too. [Laughter.]

Thank you, Mr. Chairman.

Let me get at this issue which is a significant issue, I think, in another way too, because virtually every witness who has come before this committee, and I don't mean just yesterday, but on lots

of other occasions, has identified institutionalization as one of the principal contributing factors to the globalization process. Given that, and given the advances in telecommunications, screen based trading, 24-hour trading, more products, different products, different trading strategies, what does the future hold for the individual investor that we all say we want to protect? Is he or she going to be there, or are they so out of it with all these new products, instruments, and technologies, that they are relegated to using professional investment managers through mutual funds or otherwise? If that is true, what does that mean for us?

Mr. RUDER. I will give a "the glass is half full or half empty" answer. Forty-five percent of the equities in this country are owned by institutional investors. Fifty-five percent are owned by individuals.

Senator HEINZ. That's overall.

Mr. RUDER. That's overall, yes. The 45 percent is a very significant figure, and 70 to 80 percent of the transactions on the organized exchanges is due to these institutions. I think, however, that the individual investor still has a very fine opportunity to buy stocks that have value and hold those stocks and get rich.

Senator HEINZ. And sell those that aren't going to have value.

Mr. RUDER. By and large you find people who suddenly wake up one morning and find the stocks that they have held for 30 years and haven't paid much attention to are now worth millions. That really, I think, indicates the kind of reward for patient investment that one ought to look for.

Senator HEINZ. It is also a prescription for continued vigilance and prudent regulation by the SEC, is it not?

Mr. RUDER. Yes, it is, but I have a personal view that many, many of our private investors are misguided in terms of what the stock market is all about. They think in terms of winners and losers and short-term profits and ability to make timing decisions. None of that is appropriate, in my view, for the small investor. When I think of small investor, I think of the patient, long-term investor as providing a real cornerstone for our economy.

Senator HEINZ. As opposed to arbitrage and all of the rest?

Mr. RUDER. All of the rest.

Senator HEINZ. An interesting regulatory dichotomy is, of course, that in the international securities markets, securities transactions are, to varying degrees, heavily regulated. It depends on what country you are talking about. Certainly, here it is true. Yet currency exchange and swap markets aren't. There don't seem to be any major problems, at least as yet, in the latter markets.

Does that mean we are overregulating the securities market?

Mr. RUDER. No, I don't think so. These currency and swap markets abroad and even in the United States, when we talk about our primary dealer market in Treasuries, are very, very liquid markets, and they have an enormous number of participants. There seems to be some self-regulation going on in terms of the participants being so sophisticated that they are able to trust each other, and they have transaction, payment and settlement systems which work.

In the securities markets, we don't have that phenomenon as much, and, as I look at it, we have far more products. We have in

the United States, I believe, 14,000 companies which are registered with us as public companies, and there are markets for the securities of all 14,000 of those companies. That involves a much different system than you could talk about if you are talking about a system with basically fungible financial products such as Treasury bills or Eurodollars or interest rate futures.

Senator HEINZ. Yesterday, I gather that there was a fair amount of discussion about international clearance and settlement. You touched upon that in your remarks, and in that connection, you indicated that the Commission plans to assist in efforts to evaluate and implement the Group of Thirty recommendations.

Mr. RUDER. That's right.

Senator HEINZ. Could you be a bit more explicit in identifying some of the specific steps you are taking in that regard, or planning to take, to improve clearance and settlement mechanisms and implement the relevant recommendations of the Group of Thirty?

Mr. RUDER. The Group of thirty report had some nine separate——

Senator DODD. Let me raise one question. Why is that important, the clearance and settlement question?

Mr. RUDER. It is probably the least well-known but most important facet of our securities markets. When I try to talk about this subject to lay groups, I say, you may not think clearance, settlement and payment systems are very important, but the real question for you, as an investor, is, will you get paid? When you start to put it into those terms, if you have a system in which the contraparties, parties on each side of the transaction, don't know whether they are going to get paid or not, you won't have an effective system.

Senator HEINZ. I think the chairman wants this on the record so everybody is clear on how critical this is. There are different settlement dates all around the world. In New York, it is five days. In Germany, it is three days

In Italy, I—it's manana, you know. There's no word that conveys the urgency of manana in Italy. [Laughter.]

Senator DODD. In Japan, it's yesterday. [Laughter.]

Senator HEINZ. And obviously, if we have a truly linked market, we could get to the point where we have one just truly linked group of exchanges, everybody with a computer terminal, trading on a screen, between, for example, Milan and New York and Tokyo, 24 hours a day—people never seeing their wives and children, and all the other terrible things that could happen. You've got the discontinuity of people not settling up in Milan until the next month. There are obviously serious problems that could develop.

Is that too apocryphal a view?

Mr. RUDER. No.

Senator DODD. And do you support my child-care bill, as a result, Senator Heinz is saying? [Laughter.]

Mr. RUDER. Your vision of a single global trading system all done on the same international exchange, no matter how defined, with a single international clearance and settlement system, is one which is, I think, many, many, many years away rather than a few years away.

Senator HEINZ. Apart from that, as they say?

Mr. RUDER. It is extremely important, if we are going to develop systems that we have the ability to have transactions take place between residents of different countries. The way the Group of Thirty report proceeds, is based, in part, upon a recommendation which the Commission made in the early stages of its report. Instead of trying to have a single global clearance and settlement system, we have separate clearance and settlement systems in each country. I may say, even in the United States, it is important that we have these systems. In the October 1987 market break, we had near breakdowns in some of our clearance settlement payment systems, breakdowns which would have been just as severe for the economy as the degree in drop in the market.

One of the reasons that the working group on securities markets has prospered has been its joint recognition of the clearance and settlement function. If you take the nine recommendations of the Group of Thrity, six of them are already fairly much in place in the United States, so that we are moving to questions of how and whether to implement three of them.

The first one is an increase in the trade comparison feature. We are working actively with the exchanges to move the day in which trades are compared in the stock markets to what is called T plus 1, the day after the transaction. Heretofore, that has been T plus 3, and we want to move it forward so that the parties within the market will know to whom they owe money. That T plus 1 comparison system is something which we are moving toward, and which we think is a feasible result.

The Group of Thirty then says that we ought to have settlement on T plus 3, three days after the trading date. Today in the United States, our settlement system in the stock market is T plus 5, and we are not yet moving rapidly towards T plus 3, and there are some objections to it, objections that need to be dealt with and dealt with carefully. The question for institutional and professional investors is not a difficult one because the institutional investors and the brokerage firms doing proprietary trading are participants in a certificate-less security system, and they can make settlements if they know who they owe within a three-day period.

The problem here is for the people who have certificates to find their certificates and send them to the broker and to have the broker be able to count on their doing so so that it can clear in three days. So the three-day settlement has some very great difficulties in it.

The third question of great importance is the transfer from so-called next day funds to same day funds, and the question there is, will we change from a system which we have in the United States that when you pay at the end of the day, you pay by check, which doesn't clear till the next morning, or do you pay in some way in funds which are available to the other side on the same day. That change, if it were to occur, would have very great impact on the way our systems operate, and we believe will require even greater attention.

Here I may say, speaking individually, that I think it is necessary that the United States not be the country that opposes what is clearly a rationally good system. We find ourselves now being on

the outside of a system in which, because of the Group of Thirty Report, Germany and Japan and England and all the other countries now have a system which works better than ours. I really believe that there is a lot of self-interest in making our own system the best that one could imagine.

Senator HEINZ. Chairman Ruder, that is a very good and comprehensive answer, and I thank you for it. I have one last question which came to mind when I was visiting the Tokyo Stock Exchange last April? There, of course, they do have a trading floor, but if you don't want to do business on the floor, you can move upstairs and do all your trading on a screen, and the floor is there, in a sense, just because they want to show you something. [Laughter.]

You ask them, why do you need that? And they say, well, we could do it all up on a screen, but we don't have the specialist system, we don't have somebody that is a market maker who provides liquidity. The question I asked myself was well, if the Tokyo Exchange does not need a specialist system, who does? I suspect it's us. Somewhere along the line we assume most of the risks for Japan.

The question I've got is, what is going to happen to the specialist and the system that we all think of when we think of the floor of the New York Stock Exchange and most of our other exchanges? What is going to happen as the markets become more interrelated and interdependent? Is what we see today in New York going to go the way of the dinosaur, or is it going to evolve and turn into some 5,000-pound gorilla?

Mr. RUDER. I really can't answer that question. We have two interactive places where securities are traded. One is in the pits and the futures exchanges and on the floors of our stock exchanges. It is possible to have screen-based trading, and, as you know, in Japan, they have two systems. In their second tier, they have a purely screen-based automated trading system, and they don't have anybody trading in the stock. In their most active stocks, they do have a floor, but some tell me that the floor isn't essential to their trading system. I don't know the answer to that, but one has to ask the question of how it is that human beings will desire to communicate, and I don't think that that answer is yet apparent.

If you have ever gone down to the floor of the stock exchange in busy times or into the commodities or option pits, you will see that the communication is really fast, and the question is whether or not people are going to be willing to step away from that. I guess if you asked me to make my long-term bet, I would say probably eventually, yes.

Senator HEINZ. If that is right, should we allow the process to develop slowly, in a sense be sure it goes very slowly, or should we take steps to facilitate the evolution in a more timely fashion?

Mr. RUDER. There is no doubt about the fact we should take steps to allow something to happen. We should not be in the way of it happening, but I think that if you have an economic system that is working as well as our country's does and a capital market that works as well as ours, you may want to hesitate before you step in and say we think you fellows ought to disband it and start another kind, because you may not end up with something that is as good

as you already have. I think natural market forces will result in change over time, and certainly, the regulatory system ought not to step in the way.

Senator HEINZ. One thing that, in a sense, troubles me about that scenario is that the market making and liquidity function that we tend to place a fairly significant value on will obviously disappear, and the question is, how significant is that?

Mr. RUDER. You know the leader in non-exchange market making, nonfloor market making is our very own National Association of Securities Dealers. It has been their automated system for trading using competing market makers, using a screen-based system which, indeed, has been a model for the International Stock Exchange. I think it has made it possible for the futures exchanges to imagine Globex and Aurora and their complicated systems.

Senator HEINZ. Mr. Chairman, I understand that. The question is——

Mr. RUDER. They do have good depth and liquidity in that NASDAQ system for the more high volume stocks, so one can't predict whether or not, if you moved away from the floor, whether you would have sound market-making liquidity. I happen to think, yes, if there is a natural market reason for people to want to trade stocks, if you don't have a floor, they are going to do it off the floor and do it in an automated way.

The question is whether or not there is a great deal to be gained by having those people talk to each other every day and have a feel for what is going on. I guess we are all human, and I somehow get a little frightened if I think everybody is going to be able to do everything in their own house and never have to get outside to buy stocks and groceries.

Senator HEINZ. It makes that 24-hour-a-day a lot easier.

Mr. RUDER. Yes. There is an opinion that says that, in the securities area, 24-hour trading will always be dominated by the local marketplace. That is, the market for American stocks will be dominated by the American trading and for Japanese stocks, by the Japanese, and for European stocks, by the Europeans, and that the other trading will be peripheral to those main markets.

Senator HEINZ. Mr. Chairman, thank you.

Senator DODD. Thank you. Let me just come into that last question that Senator Heinz has raised. It is a very important one. I again had a chance to see Globex, at least a model, in Chicago early this week. And the question that I raised with the people at the Board of Trade is exactly the question Senator Heinz has raised. Who makes the market? I mean, there are the locals, so to speak, in the pits today that make that market, and there is a great concern as to how world-wide trading is going to operate and work in the absence of that human element. With screen-based trading, you sort of take that element out, not to mention the liquidity issue.

Mr. RUDER. In the screen-based trading, company A says, we are a market maker in this area, and here is our quote. Someone else says, all right, we will hit your quote. The question then is, for how many shares or what quantity will this person be willing to make a firm market, and then you do get into some real questions about liquidity. As I understand the theory of Globex trading or NAS-

DAQ's recent announcement about some possibility of after-hours trading in its market, there will be market makers who will be willing to trade in size using a screen and the liquidity will be there.

Now I share your concern that it might not be. You certainly wouldn't want to say dismantle the floor and let's go to some other system. Again, however, I see no reason why it shouldn't be there, if one were to create a different market.

Senator DODD. What about the third element that Senator Heinz has raised and that is crime. I remember when I was in the House, when Mill Batten was chairman of the New York Stock Exchange, and I went to see him and asked him what his problems were. He said, well, one of the issues was this whole question of off-floor trading, and one of the great concerns then was that this would be more difficult for your enforcement officers to apprehend the fraudulent operators.

Mr. RUDER. I think today it is quite the opposite. Screen-based trading has the advantage of creating a trail. The computers don't forget to write it down, because it is part of the system. You can go back and create an audit trail. That is going on right now in the NASDAQ system where they are proposing to bring more of their penny stocks into the system and having a better audit trail for it.

I don't think that there is anything inherently bad about those systems in terms of enforcement. I would much prefer to see the early development of these 24-hour trading systems or screen trading systems to be done in a system where a single regulator had jurisdiction. That is, for instance, what is going on in the Globex. It will be the Chicago Mercantile Exchange product which is traded 24 hours, and anybody that desires to trade in that system is going to have to say I accept the regulation of the CFTC over that product and the Chicago Merc regulation, and the clearance and settlement will be done all in the United States. That same kind of a system would give a lot more regulatory certainty, if I could know that all of the after-hours trading in NASDAQ stocks would be in a NASDAQ that we would regulate, or in London stocks would be in a system regulated by the British. What would give rise to some regulatory concern would be if you tried to have a cooperative agreement in order to pass the regulation along with the book, if you will.

Senator DODD. I didn't mean to dwell on that.

Mr. RUDER. They are really hard questions which need a lot of analysis.

Senator DODD. Let me jump to one or two other points very quickly. We have kept you a long time as it is. Yesterday, Robert Hormats, in testifying before the committee, noted that the problem, and I quote him here, he says, "The SEC does not have regulatory authority over unregistered foreign subsidiaries of U.S. securities houses, and offshore activities of foreign subsidies of all countries are regulated only with difficulty."

I know this is an issue we have addressed in legislation that was the subject of a hearing last month, S. 648, in the provisions dealing with risk assessment for holding company systems. You were not at that hearing, and it would be helpful if you could give an example or two about why you need that authority, particularly in

the global market. You could follow that one up with the giving us your opinion on whether or not foreign securities regulators have similar authority, or if we adopt this provision, will we be placing on our firms a competitive disadvantage?

Mr. RUDER. I believe that the U.S. securities firms are the only competitors in the major securities markets in the world which are not subject to the kind of regulatory oversight that we seek in our risk assessment legislation. I think if our risk assessment legislation should be adopted, it would improve the competitive system for our markets. If there is a holding company which has a broker-dealer affiliate in it, a parent with a broker-dealer which is engaged in business, there will be sister affiliates which will be engaged in other kinds of activities, and these holding companies will take much of their really risk-based activities out of their broker-dealer system because of difficulties with our net capital requirements and regulatory matters, and they will engage in such things as bridge loan transactions in connection with takeovers, foreign currency transactions, and interest rate swap transactions, all kinds of transactions which have a great deal of risk in them. And yet, as the U.S. regulator of these broker-dealers, the Commission doesn't have access to the information regarding what their risk positions are.

And what difference does that make? In times of stress when there is a call to us to say we hear that such-and-such a company is in trouble, we don't know whether that company is in trouble or not. Because the problem may be not that the broker-dealer is in trouble but that some other element of the holding company system is in trouble. It is not only whether they actually are in trouble but also what the bankers call contagion. If unit A is doing fine, but unit B is reputed not to be doing well, then people may not want to deal with unit A, because it is part of the same system.

We would like to be in the position of knowing what their risks are, so that we could confer with other regulators such as the Federal Reserve Board or the CFTC to see whether there is something we should do. There was some comment about the possibility of the Fed having power to get this information. We do know that in some sense the Fed has more power to get information from our broker-dealers than we do, because many of those broker-dealers are primary dealers in the bond market which the Fed regulates.

But that is not a rational way for the system to work—for me to have to call up Jerry Corrigan and say, Hey, Jerry, do you have any information on Merrill Lynch? That is not just the way it should work. I ought to be able to call the head of Merrill Lynch and say, we are hearing some rumors, and we would like to know what the answers to those are, and not have them be able to say, well, we don't have to answer you.

I think they should be required to answer us.

Senator DODD. All right. I understand that side of the equation. The other side is, of course, the argument made that in these foreign markets that requirement is not present.

Mr. RUDER. It is, though. The British banking authorities are the ones that have really been pushing us. They say we don't know what to do. We are regulating a U.S. affiliate of an American holding company, and we don't have any way of knowing about the

strength of the holding company. We know that about any British participant in our markets, because we can get to them through the banking regulators. In Germany, the system is constructed so the banks have all the information, I think, and share it if they need to, and in Japan, the Ministry of Finance gets it through its very intimate relationship with the banks and the brokerages.

Senator DODD. So the argument that somehow this is only required among U.S. firms is totally without any merit.

Mr. RUDER. It is without merit. In fact, as I say, if we could have that kind of information, then we would be able to provide assurances informally that people aren't in trouble, and the rumors that so-and-so is in trouble could be dispelled.

Senator DODD. I think we have created a pretty good legislative history here for that approach.

Let me turn now to the Fortress Europe issue. We are going to hear from one of our colleagues from the other side of the Atlantic shortly, but I wanted to discuss this a little bit with you. There is concern that we will be faced with a closed market as a result of the Europe 1992 initiative.

I wonder if you might comment on that and whether or not you are currently in negotiations with the European Community, representatives of the European Community, to address those concerns.

Mr. RUDER. Well, as you know, there has been great concern by the administration that the European Community may insist upon what is called reciprocal treatment, which would mean that no entity could enter a market unless its country of domicile allows foreign entities to operate on equivalent terms. I believe the better regulatory system, as I understand it, and I would support it, is the home country system, whereby you would treat everybody within your home country equally and then anybody that could comply with the standards that any country had would be able to enter the system. I think that is much better for competition.

In the European Community, they have recently promulgated, I think it is called the Second Banking Directive, which has given us more hope for so-called "national" or "home country" treatment rather than strict reciprocity treatment. I think that, after a lot of discussion with the Europeans that the 1992 system will move towards that kind of regulatory approach, so that Fortress Europe won't keep our people out.

Another thing that is happening is that in order to guard against the possibility that they will say everybody that is in this system can stay in it but we will have no new entrants, a lot of our financial service people are going to Europe now and establishing operations in Europe so they will have a subsidiary or an affiliate there.

Senator DODD. I am very familiar with that.

Let me turn to another area. Senator Heinz raised the issue of a number of specific regulatory changes, 144(a) being the one that has generated a tremendous amount of interest. Clearly, the institutional investors have different needs and different responsibilities from individual investors. We watched the Japanese markets in the market break of 1987, and we didn't find a lot of the major institutional selling. There was some jawboning that went on there within the Ministry of Finance, we understand. Do you think this

is the better way to be going here, that when you are looking at those kinds of situations, a crisis environment, that jawboning can work, and that you don't need to necessarily have a tight regulatory scheme in place?

Mr. RUDER. In the 1933 Act environment—the disclosures accompanying sales of securities—we think that the institutions are able to take care of themselves. As long as the institutions buy and sell with each other, there is not much need to impose regulation. We would not let them sell to the public, and we would continue to impose that kind of regulation.

When we move over into the 1934 Act or market area, I think that a good combination of regulation, jawboning and self-interest is the way to go. We, for instance, are looking very carefully at the net capital standards for specialists and whether or not they should be improved. We have urged the New York Stock Exchange to file, and they just have filed with us, a proposal for market basket trading of portfolios of securities on their market as a means of increasing liquidity.

Ultimately, the source of liquidity in a volatile market has to be in the private sector, and there have to be a lot of individual decisions which create that liquidity. And I suppose ultimately, as banking regulators all over the world know, the central bank has to make some decision about whether to make liquid funds available for people who want to engage in those transactions.

Senator DODD. One last question from Senator Riegle I would raise with you that he asked me to raise.

It is not really an international sector area, but he would like to get your response to it, if you could.

Do you still support closing the 13(b) ten-day window period in the tender offer area? In the past, this has been a noncontroversial issue at the SEC, and Senator Riegle asked whether or not this is still the case.

Mr. RUDER. I asked Linda Quinn, our Director of the Division of Corporation Finance, whether our recommendation was still for five days and a standstill, and she said it is. That means our position is that we think that the filing period should be reduced to five days, but that there be a standstill imposed until there was disclosure of more than 5 percent.

Senator DODD. OK. If there is any further questions, Senator Riegle can go into that with you.

Senator HEINZ. Mr. Chairman, just on that point, if I might.

Senator DODD. Fine.

Senator HEINZ. Yesterday, the committee was advised that the EC is developing EC-wide securities regulations. Is the SEC well plugged into that?

Mr. RUDER. We are in active consultation with the people at the EC, and we have various people consulting. It is not quite as certain as you may have been advised, but when I talk about the Second Banking Directive, we are following and we have people who are in contact with the EC. We tend to deal in specifics. We tend to deal in the enforcement area, in the capital adequacy area, in the disclosure area, and we get bits and pieces of the larger picture. But the answer to your question is yes, we are.

Senator HEINZ. Are you saying that the master plan that the Commission is working with has not yet been revealed to you?

Mr. RUDER. The EC?

Senator HEINZ. Yes.

Mr. RUDER. Well, as it is revealed publicly, it is revealed.

Senator HEINZ. To what extent is that, from your point of view? To what extent do you have all the information you need?

Mr. RUDER. I will have to consult with my people, but I don't think that they have declared a master plan in securities regulation at this point.

I am told that they have an investment directive. They are suggesting looking at mutual recognition of prospectuses. They are investigating in other areas, capital adequacy. There is no master plan being put forward by the EC at this point, and I think that may come, but I don't think it exists at this particular time.

Senator HEINZ. OK. Thank you. Thank you, Mr. Chairman.

Senator DODD. Well, Mr. Chairman, we thank you very much. We have kept you a little longer than I had planned to this morning, but we have covered a lot of ground.

There may be some additional questions by others. We have had busy schedules here for many members in the last two days. So there may be some written questions following up on this subject matter. But your comments are very, very helpful.

Once again, we wish you well. We hope to see you often here, as we said at the outset.

Mr. RUDER. I heard Senator Riegle's comment, and I believe it is very important that the Commission have strong leadership and make a good transition. So I am going to be quite careful with my own plans to see that I might accomplish that.

Senator DODD. I appreciate that. We all do as well.

So thank you very much for being with us.

Our second panel and they have been very patient—I hope it's been helpful for them to hear the Chairman of the Securities and Exchange Commission—Stephen Axilrod is the Vice Chairman of the Nikko Securities Company International, Incorporated, New York; The Right Honorable Lord Camoys is a colleague of ours, a member of the House of Lords, something that the Senate is referred to quite frequently by those who disagree with some of our actions from time to time. Lord Camoys, we are very pleased to have you with us. He is also Deputy Chairman of Barclays De Zoete Wedd Holdings Limited, Barclays Bank, London, England. John M. Hennessy is our third panelist, is the Vice Chairman and Chief Executive Officer-Designate of CS First Boston, Inc., in New York.

We want to thank all three of you for joining us here this morning and I apologize for going a little longer with the Chairman of the Securities and Exchange Commission, but we hope that may have been of some interest to all of you.

You're very gracious to be with us. Lord Camoys, we are particularly grateful to you for coming such a long distance to be with us here this morning and we recognize that you normally are sitting where we are, asking questions, rather than being on the other side of the table. We are doubly appreciative of your willingness to be a witness before this committee.

In fact, one idea that I haven't really even raised with my colleague but I'll do so here, I thought it might be interesting at some point for us to talk about some joint hearings between this subcommittee or committee and some of our counterpart committees in the European Community about some of these questions. It's something we might want to explore. I just raise it with you this morning. It occurred to me yesterday when I was anticipating your appearance here today. It might not be a bad idea for us to try to get together and listen to what some of the institutions in Europe are saying about Europe 1992 and their concerns about what we're apt to be doing over here might be helpful. So we thank you for being with us, as well as you, Mr. Hennessy and Mr. Axilrod.

We will begin in the order that I've introduced you. All of your statements will be included in the record as prepared and we would ask you to summarize if you could.

STATEMENT OF STEPHEN H. AXILROD, VICE CHAIRMAN, NIKKO SECURITIES COMPANY INTERNATIONAL, INC., NEW YORK, NY

Mr. AXILROD. Thank you very much, Mr. Chairman.

It's a pleasure to be here and I will try to summarize the statement I submitted and apologize in advance for some repetition of things you've undoubtedly already heard about.

In any event, my focus will be on certain issues raised by the ongoing globalization of securities markets, particularly as seen through the growing interconnection between the U.S. and Japanese markets. As you know, by and large, the issues involved are by no means unique to those markets and you've discussed very many of them today and yesterday. The meshing of national markets is a truly global phenomenon. As you have emphasized, it's based in a technical sense on the wonders of high technology and instant communication, but I believe it's based much more fundamentally on a growing realization that a more integrated economic world has a better chance of raising living standards for everyone. I think that's basically what's behind the European Community financial moves, for instance.

The U.S. and Japanese securities markets have become much more closely related in recent years as the forces pushing saving out of Japan has been balanced, or facilitated even, by forces in the U.S. that have pulled funds inward. At around the beginning of this decade, Japan implemented a policy to reduce its fiscal deficit, and with private saving high there, this led to a surplus of domestic saving. At about the same time in the U.S., we moved in the other direction. Our fiscal deficit was increased, while our private saving rate dropped sharply. We required funds to meet our domestic needs from Japan as well as certain other foreign countries who were positioned to supply them.

The large deficit in the U.S. international current account and surplus in the Japanese account measure these imbalances in domestic saving processes and serve as the conduits for the international transfer of funds. These imbalances are, in my view, unsustainable and they are in the process of correction as, among other things, budget deficits are reduced here and private saving I hope

is increased, while domestic spending rises in Japan. But the process is certainly not yet complete, far from it.

As this process continues, it draws U.S. and Japanese financial markets closer together through long-term capital outflows from Japan, which reached about $150 billion last year after being close to nothing at the beginning of the decade. The establishment of Japanese securities firms in the U.S. markets comes as they attempt to help manage those flows. What also follows is the necessary opening and diversification of the Japanese market to accommodate both their domestic needs and foreign investors and institutions as the yen is internationalized.

So as I see it, we are in a transitional stage during which Japan is establishing itself as a key player in international finance. Once existing savings imbalances are corrected, market relationships will take on a much more settled character with flows between the U.S. and Japan more two-way and with the Japanese market itself, as prevailing trends continue, even more adapted to the international market structure.

The securities industry in Japan has not been, nor has it had to be the main focus of domestic deregulation there. That's been reserved to the banking industry to date largely through the removal of interest rate ceilings. The securities industry has been more or less free to operate within the constraints of the Japanese version of Glass-Steagall and subject to the regulatory overview of the Ministry of Finance.

But globalization, associated international competitive forces, and the emergence of Japan as the leading net creditor nation have had a particular impact on the Japanese securities industry, bringing it much more prominently onto the world's stage than it had been.

Diversification and opening of the Japanese market have been matched by the diversification of securities companies into foreign markets and foreign activities.

To a considerable extent, now that Japanese industry and investors are moving abroad, securities firms have internationalized to maintain and indeed protect on a global basis customer relationships that had developed over the years in Japan. Similarly, U.S. and other foreign firms are moving into Japan because of the attraction of that market and its high capital values and high volume of business.

But doing business in foreign markets also inevitably entails development of a national customer base in those markets to some degree. That's necessary to acquire sufficient business acumen in the markets, to be established as a significant enough factor in the market to make services efficient and cost-effective, and more broadly to be able to take full advantage of the possibilities of globalization.

Now despite this domestic interpenetration of markets associated with the current phase of globalization, it seems to me that it is very unlikely that foreign security firms will become a dominant force in another country's domestic market. The strength of a foreign firm is its own domestic customer base and its expertise in its own market. Much of the business of foreign firms in another country's domestic market therefore is cross-border. For a Japanese se-

curities firm located in the U.S., this would include, for example, sales of Japanese equities to U.S. customers, sales of U.S. equities and bonds to Japanese clients, and underwriting of offerings by non-Japanese firms and Japanese firms in the Euromarkets and of course in the Japanese domestic markets.

But some of the business, as I mentioned, is purely domestic in the host market, involving transactions in this market confined to U.S. domestic customers, including subsidiaries of Japanese and other foreign firms. This would be the case for our firm, for example, in its primary dealer operation and also to a certain extent in equity and corporate finance activities.

Of course, today globalization has another aspect in addition to cross-border business and domestic interpenetration of markets. It also involves trading of one country's domestic instruments in another country's marketplace. We've had the Eurodollar market for a long time. The Euroyen market has developed in recent years. And in a sense, these are simply domestic markets displaced to foreign shores where there's more favorable regulatory and other types of treatment. U.S. Treasury securities are traded now, however, on a 24-hour basis around the world and the potential for development of cross-country products in futures markets is absolutely enormous.

The broad market policy issues raised by globalization trends revolve around the need for more international cooperation and monitoring to assure the stability, liquidity and safety of these integrated markets and also because of domestic interpenetration to see to the fair treatment of each country's market participants in foreign countries. Basically, though, I believe markets are working reasonably well. They need some but not substantial fixing from a global perspective. Equity markets have shown resilience after the crashes. Insider trading abuses are essentially a problem for domestic markets. They have not, as such, been a product of globalization.

Useful approaches to ensuring market safety and soundness in a global context would include a broad international agreement on capital standards for security firms (as we now have for banks). Japan is remodeling its capital requirements on an American/British model, and a basis may be developing for a broader international convergence. It would also be desirable for the various exchanges and self-regulatory bodies to cross-check prudential standards generally, given the internationalization of markets. The purpose, of course, is to avoid weak links around the world hospitable to unsound trading practices.

Because national interests are involved, a certain degree of intergovernmental oversight would certainly be desirable, though I believe that should be a gentle kind of oversight. Meanwhile, central banks around the world, because they are a source of unquestioned credit, have a key role to play in assuring the ultimate safety of the clearance and settlement mechanism as it has to cope with more internationalized markets.

With regard to questions about the fairness of treatment across national markets—and this has been a big question in U.S.-Japan security market relationships—these are best handled I believe through application of the principle of national treatment. This principle is embodied in U.S. law and practice toward banking and

securities markets. It is also the case in Japan. And I would hope it would be clearly adopted for the European Community, though there's clearly some fuzz around the edges there.

As compared with reciprocity as a principle, national treatment is much less ambiguous in practice and easy to administer. Foreign firms simply are treated no differently from domestic ones. Problems can arise if domestic market attitudes and business practices tend to handicap foreign firms more in one country than in another in efforts to compete with domestic firms. This may then require some reciprocal prodding in practice.

In any country, a foreign securities firm will find it difficult to penetrate domestic markets because it lacks a broad set of domestic contacts and affiliations through which business might be readily generated. But given that very practical and universal constraint, national treatment generally yields the fairest results for foreign firms when markets are more impersonal and within a country's institutional structure most competitive.

Now to summarize the summary, Mr. Chairman, globalization, as it clearly brings world security markets more closely together, will require more international cooperation and monitoring of market practices and standards by governmental and private bodies. In that sense, I would note that in the United States we may not have quite adjusted to the closer relationship of internal markets and that does complicate the international coordination process in some respects. As the stock market crash demonstrated, and as is also amply demonstrated by daily trading in equity and Treasury security markets here, the futures and cash markets are just simply one market. As they become even more involved internationally and with cross-border products, a more unified oversight domestically will help in coordinating global relationships more effectively.

I cannot avoid ending with the comment that orderly stable global markets basically depend on the major nations of the world pursuing sound, cooperative monetary and fiscal policies. Without that, no amount of high quality of regulatory oversight, prudential standards, or capital requirements will guarantee market stability.

Thank you.

[The complete prepared statement of Stephen H. Axilrod follows:]