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# REGULATORY ASPECTS OF SECURITIES TRADING

## CAN REGULATORS OF INTERNATIONAL CAPITAL MARKETS STRIKE A BALANCE BETWEEN COMPETING INTERESTS?

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International securities markets have grown to be as large and vibrant as they are in part because the participants in those markets are not interested in regulation. Indeed, I have often thought that the ideal jurisdiction for most of these participants would be a kind of floating tropical island which has no taxing authority, no securities and exchange commission, no government prosecutors of any kind, and no self-regulatory organizations such as stock exchanges. But when these participants find havens from regulation, the greed that tends to propel the capital markets usually leads to abuses. The markets then are rocked by scandal, and there is a search for some sort of regulation to give investors the confidence that they generally seek in order to put their money into capital markets. Here I suppose my biases as a former SEC Commissioner and a present New York Stock Exchange Director are going to come out. It is my view that some amount of effective regulation is necessary to inspire the investor confidence necessary for the kinds of markets that both traders and investors—whether institutional investors or individual investors—need and want.

As a former SEC Commissioner, I had the privilege of going to Paris and London to discuss SEC regulation with various participants in those European markets. This was at a time when the Foreign Corrupt Practices Act had just been passed and there was great controversy, not only about that statute and all the SEC investigations that had preceded it, but also about some extremely controversial proposals for foreign issuer disclosure. I was subject to a barrage of criticism concerning the SEC and particularly its enforcement division. Nevertheless, at one dinner, after which I silently listened to all this adverse comment, one of the Swiss bankers who had been most vocal in his criticism said, "Of course, the thing about the United States markets that we envy so much is that you have the only marketplace in the world where the players have their cards above the table; that's what makes it such a good market." The international markets today are sufficiently mature so that there is a need for this kind of openness, or as the English call it, this kind of "transparency" in securities trading. To express this needed quality in terms of the American regulatory concepts, sufficient laws and regulations are necessary to insure fair and equitable trading markets.

There are, however, numerous difficulties in establishing any sort of regulatory system for the international securities markets. I will now briefly touch upon a few of the most important problems. Probably the most important barriers to any system of international regulation of the securities markets are the lack of any worldwide regulatory authority either to promulgate or to enforce a system of regulation, and the lack of any force to compel the different authorities that do exist in different countries to play by the same rules. There are international associations of stock exchanges. There also is an international association of securities commissions and similar regulators. These organizations, however, exist primarily for the purpose of mutual education and assistance. They have not developed to the point where they can propose or enforce regulations for the conduct of international securities trading. This would involve delicate problems of sovereignty, and it would also require some harmonization of very different regulatory systems among countries which have major capital markets. Moreover, even if those countries could agree as to how the primary or main capital markets should be regulated, there would then need to be some agreement on the part of countries with developing economies to accept and abide by the regulations that might be developed by the countries with major financial or capital centers.

Even within the United States we have had enormous difficulty establishing a national market system pursuant to the 1975 directive of Congress which amended the Securities Exchange Act of 1934 and ordered the SEC and the self-regulatory organizations to develop such a marketplace. In part, this has been because of problems in harmonizing exchange and over-the-counter trading systems. In part, it is because of the political problems in harmonizing the interests of various groups participating in the trading markets. Just as no one voluntarily gives up sovereignty or jurisdiction, no one willingly gives up market share. Harmonization efforts require political and economic compromise. Accordingly, there needs to be some perceived self-interest and long-term gain in order for participants to negotiate effective regulatory arrangements.

There are also specific differences in trading and legal systems that pose barriers to the international regulation of capital markets. First, there are very different trading systems both extant in the United States itself, and between other countries and the United States. The United States has two models. One model, which prevails on the New York Stock Exchange, the American Stock Exchange, and some other exchanges, features the unitary exchange specialist. In this kind of system the specialist, as an agent, executes orders left with him by other members of an exchange and, in addition, may execute orders as a principal to maintain a fair and orderly market. The second model is the over-the-counter dealer market, in which competing traders and dealers, acting as principals, negotiate securities prices. Most debt securities in the United States and in the Euromarket are traded in such an over-the-counter market.

In Japan there is a rather different system altogether that prevails on the floor of the Tokyo Stock Exchange. There, a system exists in which agency orders are transmitted to Satori members and matched for execution. Satori members may not receive orders from public customers nor trade for their own accounts. There is neither an auction nor a dealer system, although most orders are executed according to certain auction principles such as time and price priority.

The United Kingdom, until the present time, has had a single capacity system on the London Stock Exchange. Securities have been traded according to a system of brokers and jobbers, which has meant that agency and principal functions have been required to be conducted by separate firms. Although the unfixing of commission rates in London does not by law compel the English to go to a dual capacity system, they are going to do so because there is a feeling that the single capacity system cannot withstand the unfixing of commission rates. Now in a dual capacity system there is no separation of agency and principal trading. The London Stock Exchange has recognized that this creates new conflict of interest problems, and that there is a need now for order exposure and United States sale information. Otherwise there may not be adequate transparency or publicly available information on trades for investors to determine whether or not they have received fair executions.

I have alluded to the problem of availability of information. In the United States, current quotation and last sale information is available on a real time basis. Also, there is disclosure by public companies of market sensitive corporate information. In order for the international markets to be linked, equivalent information and disclosure systems need to be developed in other countries. Yet, to date neither has there been the regulatory system to compel or even encourage that kind of disclosure, nor has the economic need been felt for participants to make this sort of disclosure voluntarily.

Another very important difference is the differing legal systems of countries that have major capital markets. For example, in the United States we have statutes that compel a separation of investment and commercial banking, whereas in Europe there is universal banking. In the United States we have a system of self-regulatory organization oversight of the stock exchanges and the securities industry. In the United Kingdom, the London Stock Exchange has regulated trading with no real government oversight. Now the United Kingdom is heading toward a system of self-regulation that probably will have some commonality with the American system, except that the United Kingdom is very resistant to having a government presence like the SEC to compel effective self-regulation. Because of the unique American system of regulation and oversight by the SEC and self-regulatory organizations, problems in the international governance of the trading markets are difficult to resolve now, and probably will continue to be difficult to resolve. In some countries, the primary regulator is the stock exchange, which is a private self-regulatory organization. In the United States the primary regulator is the SEC—an independent government agency which oversees the stock exchanges and the NASD. Generally, with regard to international cooperation and regulation, an entity which is a private self-regulatory organization, such as an exchange in a country other than the United States, does not really want to work in cooperation with a United States government agency because there is a fear of governmental interference and sovereignty issues. At the same time it is difficult to accomplish certain things on a government-to-government basis because of the need to include the United States self-regulatory organizations in any system of effective oversight. I do not believe the United States is going to succeed in persuading countries such as the United Kingdom or Japan, which are major players in the capital markets, to agree to a legal or regulatory system that is anywhere near as complex as the system that we have in the United States.

In this connection I should mention the fifty blue-sky securities commissions in the various states. In connection with a variety of proposals for international cooperation, such as the SEC concept release on simultaneous distribution of securities in different countries, even the SEC can become hamstrung in trying to harmonize its regulations with the regulations of other countries because of the problems of compliance with the blue-sky laws of the fifty states.

Another difference in the legal systems is the reliance on litigation to protect investors in the United States. In the United Kingdom the laws generally provide for criminal rather than civil enforcement and, therefore, prosecution is rare. In general, the Japanese simply do not favor litigation as a means to redress injuries.

In the United States we have developed the inter-market trading system ("ITS") in response to the congressional directive for a national market system. Whether this kind of a linkage of various domestic markets will provide a model for international linkages time will tell, but again I will note there are no super-regulatory agencies to compel the kind of cooperation that was necessary among various United States exchanges in order to develop the ITS. Another difference in legal standards is the barriers to access that exist in many foreign countries to the entry of United States financial institutions into the foreign markets. This has been particularly true in Japan where many American firms have been trying for years to join the Tokyo Stock Exchange.*

Recently the SEC came out with two different requests for comments concerning, on the one hand, the internationalization of the securities markets in relation to offerings, and on the other, the internationalization of the securities markets in relation to trading.

Obviously, there is a serious problem regarding international enforcement of any sort of anti-fraud provisions designed to ensure market integrity. There are few surveillance or enforcement mechanisms in place to safeguard the integrity of securities trading conducted simultaneously in multiple international markets. As the global market becomes more developed, fraud or manipulation in multiply-listed securities may adversely affect the market for those securities in a variety of different jurisdictions. In general, the SEC has taken the approach of trying to police the international markets by attempting to extend its jurisdiction, both with respect to its power to obtain information regarding certain foreign activities and with respect to enforcing American securities laws more or less on a worldwide basis.

One of the more controversial proposals that the SEC has come out with in recent years is the "waiver by conduct" concept. Under this proposal, a purchase or sale of securities from abroad in a United States market would constitute an implied consent to disclosure of information and evidence relevant to the transaction for purposes of any SEC enforcement action. The legal predicate for this theory is an extension of state long-arm statutes to the international arena. The proposal, however, has been severely criticized, both within the United States and abroad, so it is doubtful whether this particular proposal will become the law. At the same time, the problem of obtaining evidence in other countries is a very real one, not only for the SEC, but also for other agencies.

Information is a very real problem, and it is unclear whether it can be solved by treaty or through international negotiation. Sooner or later it may be possible that some heavy-handed approach, like waiver by conduct, will be adopted not only by United States regulators, but by the regulators in other mature capital markets who really do not want the markets in their countries to be manipulated by investors in situations where the regulators cannot obtain any information about who has been trading in what securities.

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* *Ed:* Several months after this conference, the Tokyo Stock Exchange awarded six exchange seats to foreign firms. Merrill Lynch Pierce Fenner and Smith, Goldman Sachs, and Morgan Stanley are the three American firms that have been awarded seats. Joining the three American firms will be Vickers da Costa, Ltd. (the London-based affiliate of Citicorp), S.G. Warburg & Co. of London, and Jardine Fleming (Securities) Ltd. of Hong Kong. Wall St. Journal, Jan. 31, 1986 at 24, col. 1.