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Cover Page Footnote

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THE ROLE OF THE SECURITIES AND EXCHANGE COMMISSION IN AN INTERNATIONALIZED MARKETPLACE

*JAMES R. DOTY**

Mr. Doty, General Counsel of the United States Securities and Exchange Commission ("SEC"), explores the complexities of an internationalized securities market and the appropriate role of the SEC in such a marketplace. Mr. Doty examines the cooperation of securities authorities from around the globe, including the SEC, to address problems of fraudulent conduct, capital adequacy, and standards of disclosure. Mr. Doty concludes that the SEC has been, and should continue to be, a "standard-setter" in the globalization process.

". . . to produce nothing wholly new and retain nothing wholly obsolete."
- A.M. Bickel, The Morality of Consent 26 (1975)
(paraphrasing Edmund Burke).

INTRODUCTION

CONSIDERING the role of the Securities and Exchange Commission ("SEC" or "Commission") over a nearly sixty-year history,[1] one is struck by the extent to which the very business of the Commission consists of the explanation of the standards imposed by its statutes, the justification of its actions by reference to those statutory standards, and the refinement of its means of seeking to advance those standards. The briefs filed, the opinions issued, the releases proposing and adopting rulemaking—all have as their purpose the articulation of standards of

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The author gratefully acknowledges the assistance of Susan Nash, Senior Counsel, Office of the General Counsel of the Commission, in researching and writing this article.

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This article is based on an address delivered by Mr. Doty on February 6, 1992, as part of the Fordham University School of Law Graduate Colloquium 1991-1992, Financial Institutions and Regulation, Transnational Financial Services in the 1990s.

1. The Commission was established pursuant to Section 4 of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78d (1988). The Commission is responsible not only for administering the Exchange Act, 15 U.S.C. §§ 78a to 78ll (1988), but also the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. §§ 77a to 77aa (1988); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1988); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbbb (1988); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1988); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1988); and the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa to 78lll (1988). For a general discussion of the statutes administered by the Commission, see 1 L. Loss & J. Seligman, Securities Regulation 226-77 (3d ed. 1989).

commercial conduct and the study of the appropriate regulatory means to achieve those standards. The focus on standards and means appears particularly relevant as the Commission faces the complexities of an internationalized securities marketplace.

It has not escaped the notice of the Commission's staff that today's markets are vastly different from the markets regulated by the first Commission in the 1930s.[2] Markets in the United States no longer exist separate and apart from markets throughout the world. Instead, our markets are closely linked to markets in other nations. Events in our markets affect, and are affected by, events in other nations' markets.

This internationalization of the securities markets has been occurring for some time, but its pace in the last several years has been especially dramatic. The trend toward internationalization is now evident in the news that greets us daily—the peoples of Central and Eastern Europe have expressed their preference for free markets over controlled economies; BCCI has demonstrated how a financial scandal can assume global dimensions. As the United States is engaged in trade negotiations over financial services with Canada and Mexico, the European Community is moving toward a unified market and the Uruguay Round of talks under the General Agreement on Tariffs and Trade enters a possibly critical phase. In each case, these negotiations will significantly affect the future of our domestic financial services industry.

Notwithstanding the pace and magnitude of these events, it is apparent that some of the basic assumptions of the United States system of securities regulation have stood the test of time. Commentators in other nations are expressing the view that the Commission is a structural model for combining enforcement effectiveness with capacity for change.[3] As is often the case when institutions are being reshaped to deal with the forces of economic change, it is essential to ask again the question: "What should be retained?"

The Commission was created by Congress to help ensure that United States markets are fair and efficient and that United States investors are treated fairly. That original Congressional mandate remains in place. Fraud and manipulation, described by Professor Louis Loss as

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2. *See generally* Staff of the U.S. Securities and Exchange Commission, Report to the Senate Comm. on Banking, Housing and Urban Affairs and the House Comm. on Energy and Commerce Concerning Internationalization of the Securities Markets (1987).

3. The editors of the *Economist* have been especially forthright about the appeal of the U.S. model:

> Britain has married legal complexity to conflict of interest. It is time to seek virtue elsewhere—in statutory rule by a single, independent body. Britain needs the equivalent of America's Securities and Exchange Commission (SEC).
>
> . . . .
>
> . . . When necessary, the SEC can operate informally in the old London style; few would ignore a call from the SEC's head of enforcement, audibly waggling his eyebrows. Yet the commission's rules are clear, and vigorously applied.

An SEC for London, Economist, Mar. 7, 1992, at 20.

"problems [that] are as old as the cupidity of sellers and the gullibility of buyers,"[4] transcend national borders. Nations, however, have not always agreed on what should be done about fraud and manipulation. United States investors have found that United States standards of commercial conduct do not always apply in other markets.

The issues confronted by the Commission in an era of internationalization exhibit a complexity that they did not have when our markets were more insular. In order to regulate domestic markets and protect United States investors, today's Commission must be concerned with, among other things, (i) the effects on domestic markets and United States investors of actions taken abroad by private parties and foreign regulators; (ii) the international ramifications of the Commission's actions; and (iii) how those international ramifications, in turn, will feed back into or otherwise affect domestic markets and United States investors.

The standards of conduct applied by the Commission have become matters of significant international, as well as domestic, policy. Not surprisingly, they can become matters of controversy.

This Article addresses three international areas in which the sharp focus on standards is of particular, current importance for the Commission and for the future of our securities markets. Part I of the Article addresses the matter of the transparency—or opacity—of the market, and the related matter of the willingness—or reluctance—of law enforcement officials to cooperate to foster transparency and to address fraudulent or manipulative conduct. Part II discusses the fact that the stability of our linked markets may well depend on the capital adequacy of market participants, and upon some consensus among regulators with respect to capital standards. Part III discusses the standard of disclosure to the marketplace required of issuers seeking to raise capital in our markets—a standard that continues to be of major concern. Finally, the Article concludes that the Commission's standards have contributed to the strength of the United States markets and that the Commission's role in the globalization process has been that of a "standard-setter."

I. TRANSPARENCY AND ENFORCEMENT COOPERATION

A. *Transparency versus Secrecy*

"Transparency," in its most technical sense, is the degree to which real-time trade and quotation information are available to market participants. Transparency is important to fair and efficient markets for a variety of reasons. By providing market participants with current market data, transparency helps participants assess the value of securities in or-

4. 1 L. Loss & J. Seligman, *supra* note 1, at 3. *See generally* S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) (outlining abuses that led to enactment of Exchange Act); 1 L. Loss & J. Seligman, *supra* note 1, at 3-28 (discussion of abuses leading to enactment of federal securities laws); J. Seligman, The Transformation of Wall Street 1-100 (1982) (description of events leading to creation of Commission).

der to make informed investment decisions. Transparency eliminates a situation where "insiders" enter into transactions on the basis of current market data, leaving the public to invest on the basis of stale information. As a generally prevailing principle, therefore, transparency enhances market integrity and investor confidence. Transparency enables investors to determine whether they are charged fair prices by their brokers, or whether they are charged excessive markups or markdowns. The availability of quotation and transaction information also enables market participants to assist regulators in detecting insider trading and manipulation. Transparency also promotes competition among markets and market makers, contributing to more efficient pricing.[5]

The Commission supports transparency of securities markets,[6] but this stance is not universally shared around the globe. One of the major debates regarding world markets today is over the appropriate level of transparency.[7] Indeed, transparency has evidently been one of the stumbling blocks to agreement by the European Community on an Investment Services Directive, with members of the "Club Med Alliance" (France, Italy, and Spain) advocating complete transparency and members of the "Liberal Alliance" (United Kingdom, Germany, and the Netherlands) supporting next-day reporting for many trades.[8]

Transparency has recently raised broader issues for the Commission, involving both domestic and international concerns. At the same time that debates continue over transparency in other countries' markets, progress remains to be made with respect to transparency in the United States. Information released in the summer of 1991 by Salomon Brothers concerning its bidding in the market for United States government secur-

5. *See* Richard C. Breeden, Testimony on Behalf of the Commission Concerning The Government Securities Market, Before the Subcomm. on Telecommunications and Finance, Comm. on Energy and Commerce, U.S. House of Representatives 102d Cong., 1st Sess. 9-11 (Oct. 25, 1991); Department of the Treasury, Securities and Exchange Commission, & Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market B-87 (1992); The Division of Market Regulation of the U.S. Securities and Exchange Commission, *Automated Securities Trading: A Discussion of Selected Critical Issues*, at 10-12 (1991)(prepared for the IOSCO 1991 Annual Meeting Panel on Automated Trading, Washington, D.C.).

6. *See, e.g.*, Richard C. Breeden, Testimony on Behalf of the Commission Concerning The Commission's Authorization Request for Fiscal Years 1992-1994, Before the Subcomm. on Telecommunications and Finance, Comm. on Energy and Commerce, U.S. House of Representatives 102d Cong., 1st Sess. 6 (May 2, 1991).

7. *See* The Division of Market Regulation, *supra* note 5, at 10-17; J.R. Hardiman, *Automation and Electronic Trading: Key Issues for Regulating in a New Era*, at 4-5 (Sept. 26, 1991)(presented at the IOSCO 1991 Annual Conference, Washington, D.C.); Franks & Schaefer, *Equity Market Transparency*, Stock Exchange Q., Apr.-June 1991, at 7; Trade Publication and Price Transparency on the International Stock Exchange, A Report by the Director General of Fair Trading to the Secretary of State for Trade and Industry (Apr. 1990).

8. *See* Heyman, *Regulation of International Securities Markets: The Perspective of the Division of Market Regulation, U.S. Securities and Exchange Commission*, ALI-ABA Course of Study, Internationalization of the Securities Markets: Business Experience and Regulatory Policy 86-87 (Sept. 23, 1991).

ities has focused public attention on disclosure and trading practices in that market.[9]

In the dialogue over transparency, it will be suggested that users' appetite for transparency is insatiable and that it is impossible to know when the desirable degree of transparency has been achieved. Although transparency may in fact be a matter of degree, it cannot be seriously argued that the optimal degree has been achieved. This is an area where the United States leads by example; and its investors, who increasingly launch into new and distant markets, have a real interest in our continuing to press for higher standards.

B. *Insider Trading and Enforcement Cooperation*

Just as transparency depends on the timely delivery of information to the market, the fairness and integrity of the market also require an enforcement response when individuals attempt to take advantage of opacity or engage in other fraudulent practices. Just as there are differences of international opinion about transparency, there are also divergent views among nations about enforcement response.

The internationalized marketplace has created new opportunities for fraud to cross national boundaries, limited only by the creativity of its perpetrators. Fraud can be perpetrated from within one country upon investors in another country.[10] Readers of James B. Stewart's *Den of Thieves*[11] will appreciate that fraud can be perpetrated from within one country upon investors of that country, using bank accounts or corporate entities in a second country to evade detection.[12] Or the perpetrators of fraud in one country can transfer their assets to another jurisdiction, thereby rendering a judgment difficult to enforce.[13] Despite these difficulties posed by globalization of the marketplace, the Commission is committed to protecting United States investors and safeguarding the integrity of United States markets. For this purpose, the Commission employs means of law enforcement that are available both domestically and through international cooperation.[14]

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9. *See* Dept. of the Treasury, Securities and Exchange Commission, & Board of Governors of the Federal Reserve System, *supra* note 5, at C-1 to C-7 (description of events involving Salomon Brothers). Although the U.S. equity markets overall have achieved a high degree of transparency, improvements in the transparency of the government securities markets have become a matter of Congressional interest.

10. *See, e.g.*, SEC v. International Swiss Inv. Corp., Litigation Release No. 11704 (Apr. 15, 1988), 40 SEC Docket 1286 (boiler room operated in Latin American countries to sell securities to U.S. investors).

11. J.B. Stewart, *Den of Thieves* (1991).

12. *See, e.g.*, SEC v. Levine, Litigation Release No. 11095 (May 12, 1986), 35 SEC Docket 1212 (May 12, 1986) (insider trading by investment banker in New York City conducted through accounts in the names of Panamanian corporations located at the Bahamian branch of a foreign financial institution).

13. *See id.*

14. For a discussion of international enforcement issues, see Mann & Lustgarten, *Internationalization of Insider Trading Enforcement—A Guide to Regulation and Coopera-*

Judicial decisions in the United States have established that the Commission may bring enforcement actions with respect to transactions that have extraterritorial aspects, provided that either an "effects" test or a "conduct" test is satisfied.[15] These tests together provide a view of jurisdiction under the federal securities laws that is crucial to the Commission's ability to bring enforcement actions to protect United States markets and United States investors.

The Commission's enforcement program can be effective only if the actions it brings result in enforceable judgments. One mechanism that the Commission employs in order to obtain enforceable judgments is the asset freeze.[16] Deterrence of fraudulent activities by the Commission depends, in significant part, on the ability to render those activities unprofitable. The federal securities laws and the courts provide the Commission with various remedies that can render fraudulent activity unprofitable, including disgorgement[17] and civil penalties.[18] The asset freeze, in turn, makes it possible for the Commission to collect monetary judgments, by assuring that the frozen funds will not be removed from the jurisdiction of the United States courts.

Notwithstanding the extraterritorial application of the federal securities laws by United States courts and the availability of enforcement tools

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tion, ALI-ABA Course of Study, Internationalization of the Securities Markets: Business Experience and Regulatory Policy 73 (1991); McLucas, DeTore, & Fountain, *Protecting Investors from International Fraud—Legal and Enforcement Developments* (presented at the IOSCO 1991 Annual Conference, Washington, D.C.); Doty, *Developments in International Securities Law Litigation and Technical Assistance to Emerging Securities Markets*, ALI-ABA Course of Study, Internationalization of the Securities Markets: Business Experience and Regulatory Policy 125 (1991).

15. *See* Doty, *supra* note 14, at 130-39.

For cases construing the "effects" test, see Consolidated Gold Fields PLC v. Minorco, 871 F.2d 252 (2d Cir.), *as modified*, 890 F.2d 569 (2d Cir.), *cert. dismissed*, 492 U.S. 939 (1989); Des Brisay v. Goldfield Corp., 549 F.2d 133 (9th Cir. 1977); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 906 (1969).

For cases construing the "conduct" test, see IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); IIT v. Vencap, Ltd., 519 F.2d 1001 (2d Cir. 1975); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972).

16. *See, e.g.*, SEC v. Certain Purchasers of Common Stock and Call Option Contracts for the Common Stock of Contel Corp., Litigation Release No. 12542 (July 13, 1990), 46 SEC Docket 1395; SEC v. Fondation Hai, Litigation Release No. 12353 (Jan. 18, 1990), 45 SEC Docket 714; SEC v. Finacor Anstalt, Litigation Release No. 12296 (Nov. 20, 1989), 44 SEC Docket 2231; SEC v. Certain Unknown Purchasers in the Common Stock of, and Call Options for the Common Stock of, Santa Fe Int'l, Litigation Release No. 9484 (Oct. 26, 1981), 23 SEC Docket 1378; SEC v. Banca Della Svizzera Italiana, Litigation Release No. 9334 (Apr. 3, 1981), 22 SEC Docket 749. *See generally* McLucas, DeTore & Fountain, *supra* note 14, at 22-25.

17. *See, e.g.*, SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985); SEC v. Commonwealth Chem. Secs., Inc., 574 F.2d 90 (2d Cir. 1978); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

18. *See, e.g.*, Exchange Act, §§ 21(d)(3), 21A; 15 U.S.C.A. §§ 78u(d)(3), 78u-1 (West Supp. 1991).

such as the asset freeze, the Commission has placed increasing emphasis on international cooperation. Because fraud has become a global problem, global solutions are required.

International cooperation in securities law enforcement becomes possible when countries share common concepts about the nature of activities that are fraudulent and that therefore should be prohibited. Absent agreement on wrongful conduct, countries have often been reluctant to cooperate on enforcement matters.

It can be a difficult matter for countries to agree on even the most fundamental principles of securities law regulation, but, as the example of insider trading demonstrates, agreement is possible. The United States and the Commission have been world leaders in outlawing and prosecuting insider trading. In recent years, and in significant part due to the example set by the United States and the Commission, a number of other nations have enacted insider trading prohibitions or have strengthened those already in place. These nations include Switzerland, the United Kingdom, Japan, France, and The Netherlands.[19] In addition, all of the European Community members are committed to prohibiting insider trading by June 1, 1992.[20] The extent to which United States standards of conduct for corporate insiders have influenced other cultures was vividly illustrated recently when a major German bank terminated an employee following allegations of insider trading.[21] For a nation that in the past has not prohibited insider trading by law,[22] this event reveals an extraordinary cultural change in process. While insider trading laws vary from country to country, it is significant that some form of prohibition on insider trading is becoming widely accepted.

One of the greatest difficulties of investigating illegal cross-border conduct is gathering evidence. Accordingly, international cooperation in enforcement investigations is crucial to successful prosecution of such fraudulent activities. Commission efforts to obtain evidence from abroad can involve the expenditure of substantial time and resources, and, particularly where blocking or secrecy laws are involved, may be unwelcome by governmental authorities in other countries. For these reasons, the Commission has embarked on a highly successful program of negotiating bilateral memoranda of understanding ("MOUs") that facilitate the exchange of information.[23] The Commission has entered into more than ten MOUs and other enforcement cooperation understandings,[24] and is

19. *See generally* Mann & Lustgarten, *supra* note 14, at 107-22.

20. *See* Directive No. 89/592, Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30, *reprinted in* 1 Common Mkt. Rep. (CCH) ¶ 1761.

21. *See German Insider Trading; Behind the Times*, Economist, July 13, 1991, at 86.

22. *See Stock Trading Without Borders*, Fortune, Dec. 2, 1991, at 158 (German legislature considering law prohibiting insider trading).

23. *See generally* Mann & Lustgarten, *supra* note 14, at 99-106; McLucas, DeTore, & Fountain, *supra* note 14, at 27-30.

24. *See* International Series Release No. 2 (Aug. 31, 1982), 43 SEC Docket 141 (Switzerland); International Series Release No. 5 (May 23, 1986), 43 SEC Docket 184 (Japan);

engaged in negotiating additional enforcement understandings.

The implementation of international information-sharing agreements can raise difficult issues, such as the authority of one country's regulators to provide assistance and the degree of confidentiality that can be granted by the recipient country to information received. The Commission, however, has worked to resolve those problems when they arise—for example, by seeking the enactment of legislation expressly authorizing the Commission to conduct investigations of violations of foreign law,[25] exempting from the Freedom of Information Act certain records obtained by the Commission from foreign regulators,[26] and granting the Commission rulemaking authority to provide information to foreign authorities upon receipt of appropriate assurances of confidentiality.[27] The recent successes of the Commission in furthering international information-sharing give every reason to believe that such activities will increase in the future and prove ever more effective in combatting international fraud.

II. CAPITAL ADEQUACY

Each day securities markets involve a multitude of transactions by a variety of parties. Many of these transactions are interdependent, in the sense that failure by one party to settle a transaction could undermine a counterparty's ability to settle a second transaction, and so on, causing a chain reaction of failures to settle. For this reason, it is crucial to the effective functioning of a securities market that the participants have confidence in one another's ability to settle transactions. Capital adequacy standards have as their goal encouraging such confidence and helping to ensure that a securities firm could wind down its business in an orderly fashion without causing loss to its customers or to other participants in the securities markets and without causing chaos or loss of confidence in

International Series Release No. 6 (Jan. 7, 1988), 43 SEC Docket 186 (Ontario; Quebec; British Columbia); International Series Release No. 7 (July 1, 1988), 43 SEC Docket 206 (Brazil); International Series Release No. 112 (Sept. 26, 1989), 44 SEC Docket 1319 (Italy); International Series Release No. 115 (Jan 12, 1990), 45 SEC Docket 715 (Netherlands); International Series Release No. 117 (Jan. 12, 1990), 45 SEC Docket 726 (France); International Series Release No. 137 (Aug. 8, 1990), 46 SEC Docket 1715 (Luxembourg); International Series Release No. 181 (Oct. 22, 1990), 47 SEC Docket 1128 (Mexico); International Series Release No. 227 (Feb. 4, 1991), 48 SEC Docket 229 (France); International Series Release No. 321 (Sept. 30, 1991), 49 SEC Docket 1747 (Norway); International Series Release No. 322 (Sept. 30, 1991), 49 SEC Docket 1764 (Sweden); International Series Release No. 323 (Sept. 30, 1991), 49 SEC Docket 1767 (United Kingdom); International Series Release No. 354 (Dec. 18, 1991), 50 SEC Docket 878 (Argentina); *see also* International Series Release No. 320 (Sept. 30, 1991), 49 SEC Docket 1746 (declaring intention of SEC and Commission of the European Communities to facilitate enforcement cooperation between the SEC and the national authorities of the European community).

25. *See* Exchange Act, § 21(a)(2), 15 U.S.C. § 78u(a)(2) (1988).

26. *See* Exchange Act, § 24(d), 15 U.S.C.A. § 78x(d) (West Supp. 1991).

27. *See* Exchange Act, § 24(c), 15 U.S.C.A. § 78x(c) (West Supp. 1991).

the securities markets.[28]

The United States has long had capital adequacy rules for securities firms.[29] In a world of globalized markets, however, the failure of a major securities firm, whether in the United States, Great Britain, Japan, or another nation with an internationally active securities exchange, could have deleterious effects on markets throughout the world, causing losses to investors around the world and impairing confidence in all of the world's markets. For this reason, regulators around the world can no longer afford to establish and maintain capital rules for their own countries without regard to the worldwide consequences of their actions. The problem of capital standards in a world of globalized markets is further complicated by the fact that internationally active banks, as well as securities firms, are engaged in securities activities, although these banks may be subject to an entirely different regulatory scheme from securities firms.

The Commission, through the International Organization of Securities Commissions ("IOSCO"), is engaged in efforts to coordinate with banking regulators to address capital issues.[30] In January 1992, the Technical Committee of IOSCO, chaired by Chairman Breeden of the SEC, and the Basle Committee on Banking Supervision, chaired by President Corrigan of the Federal Reserve Bank of New York, met in Geneva. The joint session, a subject of some public attention, considered the capital requirements needed to cover market risks for traded debt and equity positions entered into by commercial banks and securities firms in major industrialized countries.

As a result of the Geneva meetings, IOSCO and the Basle Committee issued a joint statement containing preliminary understandings on minimum capital standards.[31] These standards would apply to all of the securities positions of securities firms, but only to the trading books of banks. One issue at the Geneva meetings was the fact that United States securities firms maintain capital cushions under the Commission's "comprehensive" standard—the so-called "15% haircut" rule for equity positions. A number of other countries favored the "building block" approach. This approach would permit lower capital cushions for long equity positions offset by unrelated short equity positions. The Geneva understandings recognize that regulators such as the Commission may

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28. For a discussion of the need for capital adequacy standards, see The Technical Committee of IOSCO, Report Concerning Capital Adequacy Standards for Securities Firms 6-7 (1989).

29. *See* 17 C.F.R. § 240.15c3-1 (1991) (net capital requirements for brokers and dealers).

30. *See* Memorandum From IOSCO's Technical Committee to the Basle Committee on Banking Supervision, Appendix A to the Final Communique of the XVI Conference of IOSCO (1991).

31. *See* Joint Statement of Richard C. Breeden, Chairman, Technical Committee, IOSCO, and E. Gerald Corrigan, Chairman, Basle Committee on Banking Supervision (Jan. 29, 1992)(on file at SEC library).

continue to apply a "comprehensive" standard when that results in capital requirements at least as high as or higher than the building block approach.

Another issue faced by the regulators in Geneva concerned the definition of capital, which for securities firms generally includes a significant component of short-term subordinated debt[32]—a concept that has not generally found favor with bank supervisors. The Geneva understandings recognize a generous limit on the use of short-term subordinated debt with a "lock-in" clause[33] to meet securities firms' capital requirements.

In each case, the Geneva understandings leave the United States and other members free to set high, but workable, standards of capital maintenance for securities firms. The challenge for the future will be to avoid employing lower capital standards as a magnet to attract securities firms to a "gamblers' market" as nations seek to maintain or enhance their exchange volume. On the other extreme, higher capital standards may be employed as a trade barrier to entry. The linked securities markets of the world thus have an enormous stake in the maintenance of appropriate standards of capital adequacy.

III. Disclosure

Disclosure has always been at the heart of our system of federal securities regulation.[34] The Commission has expended considerable effort to

32. *See* 17 C.F.R. §§ 240.15c3-1, 240.15c3-1d (1991).

33. A "lock-in" clause provides that a loan "cannot be repaid (even at maturity) if [repayment] would bring the firm's capital below the required minimum or, in some cases, below a threshold set at a level above the minimum." Memorandum From IOSCO's Technical Committee to the Basle Committee on Banking Supervision, *supra* note 30, at 4.

34. The federal securities laws have eschewed a system of "merit" regulation, where a regulatory body would be charged with determining whether a securities offering could proceed based on the application of substantive standards, such as fairness to investors. A number of state securities laws have adopted a "merit" regulation approach. *See* 1 L. Loss & J. Seligman, *supra* note 1, at 107-22. The dual federal-state regulatory system in the United States itself raises significant issues in a world of internationalized markets. Chairman Breeden addressed the implications of this dual system for persons considering whether to use U.S. capital markets.

> Our dual federal-state regulatory system also impedes efficient capital raising. In stark contrast to the unified market that is likely to emerge from EC 92, the states are erecting, rather than tearing down, roadblocks to capital raising. . . . Of equal concern are the 50 different sets of blue sky laws, and 50 different corporate governance and professional licensing schemes. Practically speaking, this means that each of the 50 states can set different standards for the sale of securities within its borders. Unless this situation is reversed, in two years time, it may be easier to complete a distribution of stock by an Italian company from Portugal to Greece than for Morgan Stanley to do a comparable offering throughout the U.S.

Richard C. Breeden, Colloquy on Globalization of Securities and Financial Market Regulation in the 1990s, Remarks Before the Administrative Conference of the United States, Washington, D.C. 11-12 (June 14, 1990) (transcript available in SEC library).

minimize the burdens imposed on transnational securities offerings by differing disclosure systems.[35] Recently, however, the Commission's disclosure standards have come under criticism from United States exchange officials seeking to list the securities of certain foreign issuers on their exchanges.

When foreign issuers make public offerings of securities to United

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35. The means have included the recognition of home-country disclosure where systems can be reconciled. In 1991, the Commission adopted regulations implementing a multijurisdictional disclosure system to facilitate cross-border offerings of securities and continuous reporting by certain Canadian issuers. *See* 56 Fed. Reg. 30,036 (1991) (to be codified at 17 C.F.R. pts. 200, 201, 210, 229, 230, 239, 240, 249, 260, and 269). In order to remove unnecessary impediments to capital formation, the system permits eligible Canadian issuers to satisfy U.S. registration and reporting requirements by providing disclosure documents prepared in accordance with Canadian requirements. The multijurisdictional disclosure system also allows certain cash tender and exchange offers for securities of Canadian issuers to be conducted in accordance with Canadian requirements.

The Commission is presently working with other countries, with a view toward extending the multijurisdictional system in the future. The Commission has also proposed rules that would facilitate rights offers and exchange and tender offers with respect to foreign securities held in limited amounts in the United States on a basis similar to the multijurisdictional disclosure system with Canada. *See* 56 Fed. Reg. 27,564 (1991) (to be codified at 17 C.F.R. pts. 230, 239, and 240) (proposed June 4, 1991) (rights offers); 56 Fed. Reg. 27,582 (1991) (to be codified at 17 C.F.R. pts. 200, 230, 239, 240, and 260) (proposed June 5, 1991) (exchange and tender offers).

The Commission has taken other steps to minimize the burden on transnational securities offerings. In 1990, for example, the Commission adopted Rule 144A to provide a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain restricted securities to "qualified institutional buyers." 17 C.F.R § 230.144A (1991). Rule 144A gives formal acknowledgment to the institutional resale market for restricted securities, where the participants are professional institutional investors who are able to make investment decisions without the protections of Securities Act registration. *See* Resale of Restricted Securities, Securities Act Release No. 6806, 53 Fed. Reg. 44,016, 44,022 (Oct. 25, 1988). The Commission has also approved a rule change by the National Association of Securities Dealers ("NASD"), establishing the PORTAL system. PORTAL is a screen-based marketplace for secondary trading of unregistered securities that are exempt from Securities Act registration requirements pursuant to Rule 144A. *See* Operation of the PORTAL Market, Exchange Act Release No. 27956, 55 Fed. Reg. 18,781 (Apr. 27, 1990).

The Commission also adopted Regulation S in 1990, to clarify the extraterritorial application of the registration provisions of the Securities Act. *See* 17 C.F.R. §§ 230.901-904 (1991). Regulation S does not limit the applicability of the antifraud provisions of the federal securities laws to a transaction that, pursuant to Regulation S, is not required to be registered. *See* Offshore Offers and Sales, Securities Act Release No. 6863, 55 Fed. Reg. 18,306 (Apr. 24, 1990).

Rule 144A and Regulation S were adopted, in part, as an adaptation to the global securities markets.

> [Rule 144A] may have significant implications for offerings by foreign issuers. Foreign issuers who previously may have foregone raising capital in the United States due to the compliance costs and liability exposure associated with registered public offerings, and the costs of financing inherent in placing restricted securities, may find private placements in the United States a more viable capital-raising option as a result of the combined effect of proposed Rule 144A and proposed Regulation S.

Resale of Restricted Securities, *supra*, at 44,022.

States retail investors, the Commission requires that the issuers provide the same disclosures that are required of United States issuers. This includes reconciliation to United States generally accepted accounting principles ("GAAP") of the issuer's equity and net income as shown in its financial statements prepared using the issuer's home-country accounting principles. The Commission's insistence on comparable disclosures by foreign and domestic issuers selling in the public retail market reflects the conviction that such disclosure facilitates informed investment decisions. Unlike sophisticated institutional investors (covered by Rule 144A), retail investors are not presumed capable of fending for themselves in obtaining the information needed to make investment decisions.[36] The matter is complicated by the potential competitive risk posed to United States issuers seeking capital in our own markets if foreign issuers were allowed to list on our exchanges without complying with United States disclosure requirements.[37]

In recent years, there have been calls for a relaxation of United States disclosure standards, particularly the reconciliation of equity and net income to United States GAAP, in order to attract major European stocks to seek listing on United States exchanges.[38] Proponents of such relaxation argue that foreign issuers are deterred from United States listing by the associated high regulatory costs and by the requirement to reconcile their equity and net income to that which would be reported under United States GAAP. Reconciliation has been resisted, in particular, by German issuers. The Commission's adherence to its standards—its insistence on compliance with United States regulatory requirements—is alleged to drive trading in foreign securities offshore, making the United States markets less competitive. In reality, however, a large and growing universe of foreign issuers provide the required disclosure and list upon United States exchanges.

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36. Commission testimony has described the issue this way:

> Public offerings of securities by foreign companies to U.S. retail investors present different issues [than Rule 144A]. Here the Commission has required foreign issuers to provide the same basic disclosures made by U.S. issuers so that U.S. investors will be able to make informed investment decisions on the basis of comparable information. Without this protection, investors might select a foreign company's stock on the basis of higher earnings per share, for example, only to discover later that differences in accounting or auditing standards made the foreign stock *look* better than that of a company using U.S. disclosure rules.

Breeden, *supra* note 6, at 7.

37. *See id.*

38. *See* Power & Salwen, *Big Board's Donaldson Says SEC Rules Could Cost Exchange Its Global Standing*, Wall St. J., Dec. 12, 1991, at C1, col. 3; Walter & Saunders, *National and Global Competitiveness of New York City as a Financial Center*, at 55-56 (New York University Salomon Center Occasional Paper No. 11, 1991); McLaughlin, *Listing Foreign Stocks on U.S. Exchanges: Time to Confront Reconciliation?*, 24 Rev. Sec. & Commodities Reg. 91 (1991); Karmel & Head, Report and Recommendations to the New York Stock Exchange, Inc. on Barriers to Foreign Issuer Listings 93-94 (Feb. 15, 1991).

On closer examination, cracks appear in proponents' arguments for lower standards. What is presented as a global problem—the ostensible "walling off" of United States investors and markets from a universe of foreign stocks—appears in fact to be a problem peculiar to a clutch of issuers who do not want to disclose the portion of currently reported earnings attributable to the liquidation of hidden reserves, the extent to which current earnings have been reduced by additions to those reserves, or the extent to which equity and taxable income have been reduced through the use of those reserves.

In the case of foreign listings, the Commission is invited to change standards of accounting disclosure in a particularly troubling sense: if issuers can report as current earnings amounts that are either reduced or augmented by additions to or reductions in hidden reserves, the "managed" earnings may or may not reflect actual performance for the reporting period. Accordingly, the Commission's staff has insisted on disclosure to enable users of financial statements to understand the contribution of reserves to reported earnings. Without such disclosure, there would seem to be a lack of comparability, in a fundamental sense, between the financial reporting of issuers reporting under United States GAAP and the German issuers who report their earnings with undisclosed reserve adjustments. It will be protested that investors do, in fact, trade in securities on the basis of non-comparable financial information. Again, we reach the defining principle of a standard—the fact that "other people do it" simply will not suffice if you have a duty to enforce a standard. Here, the Commission has a very clear duty. The fact that some purchasers do, in fact, purchase these German stocks does not justify creating an exception to United States GAAP standards, solely to accomodate a practice that permits a "managed" earnings picture, within the domestic securities market.

This does not mean that efforts to reduce the regulatory burden associated with the imposition by each country of its own accounting standards are ill-conceived. Indeed, the contrary is the case. The Commission has a keen interest in maintaining the preeminence of United States capital markets. A strong, principled stand on the "hidden reserve" issue does not preclude the agency from working toward acceptable international standards. Rather, it is an appropriate basis on which to commence the dialogue that can lead to creative and constructive solutions. The Commission has been actively engaged in efforts to increase harmonization of world accounting standards and will continue these efforts.[39] By pro-

39. *See* Breeden, *supra* note 6, at 7-8. The Commission is working with various international bodies, including IOSCO, the International Accounting Standards Committee ("IASC"), and the International Federation of Accountants, to develop comprehensive accounting and auditing standards. *See* Office of the Chief Accountant, U.S. Securities and Exchange Commission, *Accounting and Auditing*, at 11-13 (1991) (prepared for International Institute for Securities Market Development, sponsored by SEC, Washington, D.C.) (on file at SEC library). For a discussion of the work of IASC, see Fleming, *The*

ceeding in this manner, the Commission can foster improved quality of accounting standards throughout the world and can lend its endorsement only to accounting standards of adequate quality and scope to facilitate informed investment decisions.

CONCLUSION

The role of the Commission in the globalization process has largely been that of a "standard-setter." The Commission establishes standards to protect United States markets and United States investors. Those standards also frequently function as standards of measurement for other markets, even where our standards have not yet prevailed (as in transparency), where others have "adjusted off" our standards (as in capital adequacy), or where others object to our standards (as in accounting disclosure). In no small part, the Commission's global role derives from the depth and breadth of our markets, which have been fostered by the Commission's standards. The strength of our markets, I believe, makes the case for retaining the standards that have contributed to that strength.

Growing Importance of International Accounting Standards, J. Acct., Sept. 1991, at 100; *IASC's Work Programme: 1992/93 Plans*, IASC Insight, Dec. 1991, at 6.