# CHAPTER I

## INTRODUCTION */

Internationalization of the securities markets is not a new phenomenon. Throughout much of history investors have assumed the risks attendant to investing in a foreign economy. The degree to which the world's securities markets have become internationalized, however, is unprecedented. These developments are a result both of technological advances and of the removal of restrictions on foreign participation by many of the world's securities markets.

For example, the increase in the number of bonds issued internationally has grown dramatically in the last six years. In 1980, the total amount of bonds issued internationally was approximately $38 billion. Last year, that figure was $254 billion. Of that amount almost $44 billion was raised by U.S. issuers. Last year, U.S. investors' transactions in foreign equity securities reached a record $102 billion, while foreign investors purchased and sold approximately $277 billion in U.S. equity securities.

---

*/ This report was prepared by the staff of the Securities and Exchange Commission. The report has not been reviewed by the Commission and does not represent the Commission's views. The staff report is the first of a two-part effort. The staff anticipates that the Commission will utilize the staff report in formulating its views on policy and legislative initiatives in the internationalization area.

With these new opportunities come new challenges. The laws governing the securities markets of various countries are diverse. Indeed, there are significant differences among the regulations in different nations, in terms of nature, purpose, and degree of protection. Issuers seeking to raise capital in more than one country may face significant problems in complying with requirements in different markets. Investors may be confused by the lack of comparability in disclosure standards and unaware of the risks of investing outside of their domestic securities markets. In addition, the ability to move capital quickly across national boundaries and to engage in securities transactions through off-shore entities provides new mechanisms for the unscrupulous to engage in securities fraud, and presents new obstacles for law enforcement agencies.

The House Committee on Energy and Commerce and the Senate Committee on Banking, Housing and Urban Affairs directed the Securities and Exchange Commission to conduct a study of the issues raised by the accelerating internationalization of the securities markets. This report by the Commission's staff concludes the first part of that study.

The Commission's Directorate of Economic and Policy Analysis ("DEPA") has conducted an extensive study of the movement of capital in the last decade. Chapter II of the report discusses the results of that study, which focuses on the economic, institutional and regulatory forces shaping the process of internationalization.

The U.S. securities markets have influenced the trend toward internationalization. This influence has resulted from the relatively large size of the U.S. economy and from the ability of U.S. markets to adapt to changing circumstances. At the end of last year, the market capitalization of U.S. equity securities totalled approximately $2.6 trillion or about 43% of the world's total stock market capitalization.

Internationalization also has been marked by increasing competition among the world's securities markets, as the staff study reports. For example, measured in U.S. dollars Japan's markets grew at an annual rate of 23% from 1978 to 1986, Italy's grew 39%, and the United Kingdom's markets grew at an annual rate of 18%. By comparison, the U.S. equity market grew 14% annually during this period. Moreover, in the last two years, the Japanese markets grew at an annual rate of 68% as compared with 22% for U.S. markets. Even when the decline in the value of the U.S. dollar is taken into account, the Japanese equity market grew by 34% between 1984 and 1986.

The U.S. markets have served as a model for foreign markets by developing new products and by promoting competition among market professionals. Chapter II discusses recent developments in a number of other countries that emulate the American markets. For example, in the United Kingdom brokerage commissions have been deregulated only within the last year; the United States deregulated them in 1975. In addition, financial products such as standardized options, securitized asset pools and financial futures, all of which are well-established in the United States, are just being introduced around the world.

This chapter concludes with an analysis of the impact that internationalization has had on the U.S. markets. In 1980, U.S. corporations raised about 12% of their public debt financing abroad. By 1986, 22% of U.S. corporate bond financings were being conducted abroad. Last year, as noted, U.S. investors purchased and sold over $100 billion in foreign stocks and foreign investors traded a record $277 billion in U.S. domestic equity securities. Foreign investment by U.S. private sector pension funds has also increased dramatically from an estimated $3.3 billion in 1980 to approximately $45 billion in 1986. At the same time, however, the number of foreign equities traded on U.S. exchanges has remained relatively static, as has the amount of foreign issues of stocks and bonds registered with the Commission for sale in the United States. While foreign debt and equity issues offered in the United States have increased significantly in absolute terms from approximately $4.4 billion in 1981 to $6.4 billion in 1986, they have remained relatively stable as a percentage of the total debt and equity issued in the United States due to the tremendous growth in those issues over the last five years.

The third chapter of the report, prepared by the Division of Corporation Finance, examines disclosure and distribution issues relating to international offerings of securities. The international capital markets provide mechanisms by which individuals and institutions are able to participate in highly diversified financial investment vehicles. Corporation Finance's chapter details the procedural aspects of bringing a Eurobond issue to market, including marketing considerations, organization and timing, and the nature of disclosure and investor protection available in that market.

With respect to international issues of equity securities, the report notes that the mechanisms that have for many years been utilized in offering debt instruments internationally are now being mobilized for the purpose of placing shares of major corporations through an international network, sometimes called the Euroequity market. This growing market reflects the desire of large corporations to issue their equities internationally in order to obtain a broad shareholder base and to realize a price that is more representative of international market demand for the corporation's shares. The chapter examines a number of open issues in the Euroequity market including the nature of investors in that market and the development of a secondary market for equity securities apart from the home market. The study notes that when the home market is the only viable secondary market for a large multinational issue, securities may flow back to that home market soon after they are issued, depressing the share price.

The chapter summarizes the U.S. distribution and disclosure requirements and their application to international issues of securities. The chapter also provides a comparative picture of the securities regulations of the European Economic Community and eight countries with substantial securities markets: the United Kingdom, Japan, Canada, the Federal Republic of Germany, France, Australia, Switzerland, and the Netherlands. A detailed description is provided of the statutory scheme and regulatory authority in each nation; also discussed are the nature of the securities markets and the issuers, the types of securities traded, the nature of both the primary and the secondary market, liability provisions, and other regulatory requirements.

A similar comparative discussion is provided for tender offer regulation in the U.S. and the eight countries mentioned above. The section also discusses certain disclosure and other compliance issues encountered by foreign bidders in complying with U.S. tender offer regulation. The study notes that U.S. law may apply not only to a foreign bidder making an offer for an American corporation, but also to an offer for a foreign corporation's securities if the securities are held in the United States. In order to avoid application of U.S. law, foreign bidders on occasion have taken precautions to prevent the extention of the tender offer to U.S. citizens or residents. In some cases, this has deprived those U.S. investors of an opportunity to participate in the premium offered in the tender offer. Foreign bidder objections to making offers in the U.S. appear to center on the financial disclosure requirements and the Securities Act registration requirements where securities are offered in exchange for the target's shares. Conflicts also may arise where foreign law forbids the disclosure of certain information required to be disclosed pursuant to U.S. law.

The chapter concludes with an examination of two important current issues, the jurisdictional reach of the registration provisions of the Securities Act and direct access to U.S. capital markets by foreign issuers. The study notes that the extraterritorial application of the registration provisions has resulted in the use of complex and costly offering procedures to avoid such provisions, resulting in exclusion of U.S. persons from investment opportunities. The study discusses a possible alternative approach based on the territorial application of the registration provisions. With respect to access to U.S. markets by foreign issuers, the chapter notes the reluctance of some foreign issuers to participate in the U.S. capital markets and that this reluctance may force U.S. investors who want to trade foreign securities to do so off shore. This could adversely affect the ability of U.S. markets to compete with foreign markets as well as result in additional costs to U.S. investors.

In examining issues relating to internationalization, the Commission issued a concept release seeking comments on several approaches for the registration of specified foreign securities. One approach would allow use of the offering document required in an issuer's home country as the prospectus for offerings in the United States. If such a reciprocal approach were to be used, key questions to be addressed would include the countries that should be included, the classes of issuers that may participate, and the types of securities that may be issued. The comparability of accounting and auditing standards will be an important consideration in determining the jurisdictions to be included. In its release, the Commission proposed to proceed initially with the United Kingdom and Canada because the disclosure and accounting practices of those countries are most similar to those of the United States, and because U.S. investors are relatively familiar with those countries' standards. Alternatively, the release proposed a common prospectus approach. This approach would entail an agreement that an offering document meeting certain disclosure standards could be used in two or more of the three countries.

A majority of commentators endorsed the Commission's initiative. Although many believed the common prospectus approach to be the ideal, a majority favored some type of reciprocal approach as the one most easily implemented.

It is widely recognized that differences in accounting and auditing standards present significant problems for the development of international markets. These differences present road blocks to issuers seeking to raise capital outside their home market. They also create difficulties for investors attempting to evaluate the economic merits of investments in the securities of corporations whose financial statements have been prepared and audited according to different standards. Chapter IV of the report, which was prepared by the Office of the Chief Accountant, discusses the differences in accounting principles and auditing standards in a number of countries, concentrating on differences caused by the method by which such standards are promulgated. In general, the staff study indicates that where there is a wide dispersal of corporate ownership, accounting principles tend to be established by the accounting profession and reflect the financial status of the entity for which the financial statements were prepared. By comparison, where ownership is concentrated, accounting principles are more likely to be set by governmental agencies, in which case countervailing policies (for example, the need to collect tax revenues) may affect the depiction of financial status. The chapter also describes the various efforts under way by international accounting associations to harmonize auditing and accounting standards.

Commission rules permit a foreign issuer, with certain exceptions, to prepare its financial statements according to accounting principles that are generally accepted in the issuer's home country. If there are material differences between such principles and generally accepted accounting principles in the United States, the financial statements must include a reconciliation of these differences. With respect to auditing standards, however, the Commission's staff seeks assurance that the examinations of financial statements by foreign auditors are as extensive and complete as those conducted by U.S. auditors. In this regard, the staff requires foreign auditors to demonstrate that the accounting firm is professionally qualified and in good standing in the jurisdiction where its offices are located, that its professional staff is knowledgeable about U.S. accounting and auditing standards as well as Commission rules and other pronouncements, and that U.S. auditing standards and the Commission's rules have been followed in connection with the particular audit. Generally, this is demonstrated by the foreign issuer's employment of an accounting firm currently practicing before the Commission as a consultant or co-auditor.

Included in the chapter is a comparative study of accountant liability provisions in four countries: Canada, the United Kingdom, Australia and Japan. The study indicates that, for the most part, laws relating to accountant liability in these countries are similar and that generally some type of due diligence defense is available to accountants.

The Division of Market Regulation has prepared a comprehensive report on the international secondary markets, set forth in Chapter V. The report describes the secondary trading market in Eurobonds as a model of a major, integrated multinational securities market. Trading in this $3.5 trillion market is centered in London. Trades are executed over the counter by telephone among a network of members of the Association of International Bond Dealers ("AIBD"), a voluntary self-regulatory organization. In 1986, the Council of AIBD Reporting Dealers was formed to establish trading and reporting obligations for AIBD dealers.

With respect to international equity markets, the Division notes that, while there are now more than 500 companies whose shares are listed and traded outside their home countries, trading is limited, particularly with respect to U.S. securities. Very little foreign trading in U.S. securities occurs during U.S. trading hours, and broker-dealer firms indicate that the trading in U.S. securities overseas occurs almost entirely among foreign investors and sophisticated U.S. institutional investors. Recent developments, however, particularly the deregulation of markets in the United Kingdom, suggest that the degree of worldwide competition in equity securities may increase in the future.

The chapter describes the operations of multinational securities firms and the methods by which such firms conduct trading in the markets of several nations. This section of the chapter focuses on regulatory concerns in overseeing large multinational firms actively conducting a securities business in many different countries, particularly the difficulties in ensuring the financial integrity of these firms. Although the staff is not presently aware of specific problems, the increased internationalization of securities markets has raised concerns about the ability of the Commission and the U.S. self-regulatory organizations ("SROs") to ensure the financial integrity and responsibility of U.S. registered broker-dealers. These concerns arise, in part, because the Commission and the SROs lack authority to examine and regulate the activities of unregistered overseas affiliates.

With respect to foreign broker-dealers transacting business in the U.S., the Commission's staff has not required broker-dealer registration in all instances within the jurisdictional reach of the Securities Exchange Act. Where exceptions have been made to accommodate international trading, however, the necessary predicate has been adequate protection for investors and the integrity of the U.S. markets. For example, on April 21, 1986, the Commission approved a pilot program jointly undertaken by the National Association of Securities Dealers ("NASD") and the International Stock Exchange ("ISE") that makes certain market information, including securities quotations by market makers, available in both the United Kingdom and the U.S. Shortly thereafter, the Division of Market Regulation took a temporary no-action position to allow quotes of foreign market makers entered into the ISE's automated quotation system to be disseminated in the U.S. through the NASD system, and trades resulting from those quotes to be executed without either the foreign market maker or the International Stock Exchange registering as a broker-dealer.

Another imporant recent development has been the establishment of market linkages between U.S. and foreign stock exchanges. The Commission approved the first such trading link in 1984, between the Montreal Stock Exchange and Boston Stock Exchange. The first trading link between a primary U.S. market and a primary foreign market was approved in 1985, between the American Stock Exchange and the Toronto Stock Exchange. At this time, trading is limited to the 34 dually listed securities shared by the two exchanges and usage has been relatively low. In the future, the exchanges anticipate that they will seek Commission approval to expand the list of eligible securities to include those traded on either exchange. A linkage between the Midwest Stock Exchange and the Toronto Stock Exchange also has been approved. In reviewing these trading linkages, the Commission has required that adequate provision be made for the sharing of enforcement and surveillance information and that any exchange seeking to link with a U.S. exchange have the ability to discipline its members for violations of its rules governing trades made through the linkage.

The lack of international clearance and settlement links to facilitate cross border settlements, and the existence of widely varying clearance and settlement systems within national markets, are significant problems. The Division discusses the problems in international clearance and settlement and the linkages that have developed between national clearance and settlement systems.

This chapter concludes with an examination of some recent Commission initiatives. The Commission recently approved rule proposals submitted by the American and New York Stock Exchanges to enable the exchanges to waive or modify certain corporate goverance and financial disclosure listing standards for foreign companies. The rule changes permit the exchanges to consider a foreign company's compliance with the laws, customs, and practices of the country of its domicile, in determining whether the company has complied with otherwise applicable listing standards. A similar proposal by the NASD was approved at the same time. Further, at a public meeting on May 9, 1986, the Commission considered comments received in response to its earlier release on the internationalization of the trading markets. The Commission endorsed the view of commentators that it should proceed cautiously in responding to the growth of transnational trading. The Commission instructed the staff to facilitate the development of international linkages between securities markets and clearing agencies and to ensure that such linkages incorporate adequate market surveillance and information sharing arrangements.

The next chapter of the report, prepared by the Division of Investment Management, describes the effects of internationalization on investment companies and investment advisers. The Division reports that participation by U.S investment companies and advisers in foreign and international markets has increased significantly. The number of domestic open-end investment companies that emphasize foreign securities in their portfolios has nearly tripled since 1983 and the total assets of these firms have grown from $3.5 to over $15 billion in that time. Over 120 investment advisers from 20 countries have registered with the Commission. At the same time, it has become more common for investment companies registered in the U.S. to issue their securities in foreign markets. This is due in part to the relaxation by some countries of regulations designed to discourage foreign investment as well as to the increased popularity of collective investment vehicles with individual investors in foreign markets.

Participation by foreign investment companies in U.S. markets has been limited by Section 7(d) of the Investment Company Act. That Section prohibits an investment company that is not organized under the laws of the U.S. or a state of the U.S. from publicly offering its securities in this country unless it first obtains an order from the Commission. The Commission is authorized to issue an order permitting such sales only if it finds that (1) by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce effectively the provisions of the ICA against the foreign company, and (2) the issuance of an order is consistent with the public interest and the protection of investors. Commission rules require that, to obtain such an order, the fund's assets and records must be kept in the U.S., the fund's by-laws and charter must contain, in substance, certain provisions of the ICA and be enforceable in the U.S., and a majority of the fund's officers and directors must be U.S. citizens (with a majority of these citizens resident in the U.S.). At present, only five investment companies are operating in the U.S. pursuant to an order under Section 7(d). In 1984 the Commission recommended to Congress that it amend Section 7(d) to broaden the Commission's exemptive authority with respect to foreign investment companies. The staff has also been studying the possibility of recommending a reciprocal approach to investment company registration based on either a

Directive of the EEC relating to collective investments or the Standard Rules for the Operations of Institutions for Collective Investment in Securities promulgated by the Organization for Economic Cooperation and Development ("OECD").

This chapter also describes recent steps taken by the Commission to facilitate the offering of foreign bank securities in the U.S. On September 10, 1986, the Commission proposed Rule 6c-9 which would permit a foreign bank or its finance subsidiary to offer or sell its debt securities or non-voting preferred stock in the U.S. without registering as an investment company if certain requirements are met. At present, a foreign bank seeking to sell its securities in this country must register as an investment company or obtain an exemptive order from the Commission.

The final chapter in the staff's report discusses issues concerning the enforcement of the U.S. securities laws in a global securities market. Chapter VII, written by the Division of Enforcement and the Office of the General Counsel, notes that the internationalization of the securities markets has provided expanded opportunities for fraud as well as for legitimate investment activities.

The chapter begins with a discussion of the jurisdictional reach of the U.S. securities laws. In general, the courts have held that U.S. law applies whenever conduct takes place in the U.S. or conduct occurring abroad has subtantial effects in this country. Although the American Law Institute's recently revised

Restatement of the Foreign Relations Law of the United States departed from these theories, the ALI made changes, after discussions with the Commission's Office of the General Counsel, to bring the Revised Restatement closer to the existing case law.

The remainder of the chapter is devoted to an examination of the problems in conducting an investigation of possible violations of the U.S. securities laws where evidence is located abroad; several recent insider trading cases are described to illustrate the problems. In particular, the staff has found that blocking statutes, by which foreign governments prohibit or control the distribution of information, and secrecy laws, which establish rights by which individuals may require others to keep secret specific information, may create obtacles to the Commission's efforts to obtain information. Swiss laws protecting the confidentiality of information furnished to banks by their customers have been particularly problematic in insider trading investigations.

To overcome these and other difficulties, the staff has relied on international agreements, including treaties and memoranda of understanding. The U.S. has four treaties providing for mutual assistance in criminal matters: The Treaty Between the U.S. and the Swiss Confederation on Mutual Assistance in Criminal Matters, the Treaty on Mutual Legal Assistance with the Kingdom of the Netherlands, the Treaty with the Republic of Turkey on Extradition and Mutual Assistance in Criminal Matters and the Treaty Between the Italian Republic and the United

States on Mutual Assistance in Criminal Matters. Several other treaties have been negotiated but are not yet in force. Although these treaties primarily apply to criminal matters, the Commission is able to utilize them in connection with its civil enforcement of the securities laws because willful violation of these laws is a criminal offense.

The U.S. has also entered into a Memorandum of Understanding with the Swiss government to provide assistance to the Commission to investigate insider trading violations. The memorandum was recently used for the first time in an insider trading case to obtain the identity of a customer of a Swiss bank who traded in advance of the merger between two U.S. companies. In addition, the Commission has entered into memoranda of understanding with the United Kingdom and Japan.

The Commission and its staff also participate in several international organizations concerned with the internationalization of the securities markets and attendant enforcement problems. For example, the Commission is a member of the International Organization of Securities Commissions and chairs its working group on the exchange of enforcement information. In addition, last fall the Commission proposed that a working group of the OECD conduct a survey of OECD member countries concerning mutual assistance and cooperation in securities enforcement matters. That survey is under way.

In studying the internationalization of the securities markets as directed by the Committees of Congress and in preparing this report, Commission staff conducted extensive research in the fields of law, economics and accountancy. In addition, the staff engaged in extensive original research, interviewing and consulting with individuals and entities that participate in the international securities markets or are otherwise knowledgeable in areas relating to internationalization. The staff consulted with securities professionals, academics, economists, accounting and law firms, government agencies, and private organizations. The staff also had the benefit of the responses made by commentators to three releases issued by the Commission on the subject of internationalization. Additionally, the Roundtable on Internationalization, held by the Commission on February 17, 1987, provided valuable information. Participants included experts on many different aspects of internationalization.

The staff's report should serve as a description of the rapid and multifaceted changes that are taking place in the world's securities markets. The report also identifies numerous issues raised by the unprecedented rate of internationalization and describes Commission initiatives over the past few years to respond to these issues. The staff anticipates that the report may be utilized by the Committees and by the Commission to examine possible legislative, rulemaking or policy initiatives to deal with internationalization.