[Michigan Journal of International Law](https://repository.law.umich.edu/mjil)

Volume 9 | Issue 1

1988

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In the early 1960s, the Securities and Exchange Commission ("SEC") conducted a special study of the United States ("U.S.") securities markets whose significance was widely recognized.[1] In some respects, this study was born of a crisis[2] which itself was rooted in changes that had occurred since the early 1930s when the federal securities laws were adopted and the SEC was established.[3] The study resulted in several regulatory initiatives by the U.S. Congress and the SEC which both reflected and instigated changes in the structure of the U.S. securities

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The views expressed herein are those of the authors and do not necessarily represent those of the Commission, other Commissioners, or the staff of the Commission.

1. *See* U.S. SEC. AND EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION TO THE HOUSE COMMERCE COMMITTEE, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963)[hereinafter SPECIAL STUDY]. The SPECIAL STUDY has been characterized as "undoubtedly the single most influential document published in the history of the SEC." J. SELIGMAN, THE TRANSFORMATION OF WALL STREET 299 (1982).

2. *See* J. SELIGMAN, *supra* note 1, at 277-89, 296. Events that bear mentioning include a spate of fraudulent new stock offerings, a breakdown in American Stock Exchange regulatory oversight and delays in processing securities trades. *Id.* What was referred to as the May 1962 market "break" provided additional impetus. *See* SPECIAL STUDY, *supra* note 1, at 7. As applied to the stock market, the term "Market Break" refers to a period of unusually active trading in which price movements are both erratic and dramatic, and in which the avalanche of orders subjects market mechanisms to extraordinary strain.

3. *See* H.R. REP. NO. 882, 87th Cong., 1st Sess., 2–4, *reprinted in* 1961 U.S. CODE CONG. & AD. NEWS 2557–2562. For a history of the SEC and the evolution of the federal securities laws, see generally J. SELIGMAN, *supra* note 1.

markets.[4] Twenty-five years have passed. The securities markets have come through another crisis, the Market Break of October 1987 ("October Market Break").[5] Naturally, the October Market Break has spawned its own generation of studies.[6]

There is no doubt that the U.S. securities markets of today are as radically different from those of the 1960s, as those of the 1960s were from those of the 1930s. The many differences reflect fundamental changes in the structure of the securities markets and the securities industry, and have far-reaching implications for international securities regulation.[7]

The most significant of these structural changes is that the U.S. securities markets and their counterparts around the world have become unequivocally international. Internationalization is the product of and the moving force behind a wide range of structural changes occurring in the capital markets and the securities industry, but it is only one of the forces bringing about structural change. Two other contributing forces are the integration of the financial services industry and the institutionalization of the markets. Perhaps the most significant outgrowth of the confluence of these forces is the marked interdependence of world markets. This interdependence was graphically demonstrated by the global proportions of the October Market Break, which lent new significance to the adage—"When New York sneezes, Tokyo catches cold." The lesson learned in October 1987 was that, in a very real sense, world markets have become linked.

This article addresses the impact internationalization has had on the world's

4. The SPECIAL STUDY "provided a foundation for most of the reforms that occurred in the securities industry during the ensuing fifteen years." J. SELIGMAN, *supra* note 1, at 299. Legislative action included the Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964); regulatory reforms included the unfixing of stock exchange commission rates, *see infra* note 118 and accompanying text, and the development of over-the-counter automated quotation systems, *see* Simon & Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 26–44 (1986).

5. *See infra* notes 92–123 and accompanying text.

6. The first round of studies has been completed. They include: PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988); DIVISION OF MARKET REGULATION OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, THE OCTOBER 1987 MARKET BREAK REPORT (1988) [hereinafter MARKET BREAK REPORT]; DIVISIONS OF ECONOMIC ANALYSIS AND TRADING AND MARKETS OF THE U.S. COMMODITIES FUTURES TRADING COMMISSION, INTERIM REPORT TO THE COMMODITY FUTURES TRADING COMMISSION ON STOCK INDEX FUTURES AND CASH MARKET ACTIVITY DURING OCTOBER 1987 (1987) and FOLLOW-UP REPORT ON FINANCIAL OVERSIGHT OF STOCK INDEX FUTURES MARKETS DURING OCTOBER 1987 (1988); M. MILLER, J. HAWKES, B. MALKIEL & M. SCHOLES, PRELIMINARY REPORT OF THE COMMITTEE OF INQUIRY APPOINTED BY THE CHICAGO MERCANTILE EXCHANGE TO EXAMINE THE EVENTS SURROUNDING OCTOBER 19, 1987 (1987); N. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES (1987).

7. Between the 1930s and the 1960s, there were tremendous increases in the sizes of the securities industry, public investor participation, and the securities markets, particularly the OTC market. *See* 1 SPECIAL STUDY, *supra* note 1, at III, XV. That growth continued over the next 25 years, and the securities markets also became institutional and international, and linked to the recently developed stock index future markets. *See infra* notes 8–59, 92–123 and accompanying text.

securities markets with a particular focus on its role in forcing change in the structure of those markets. Part I describes the forces involved in the internationalization process, and analyzes capital movement and other phenomena that demonstrate the extent of internationalization. Next, it reviews the structural changes that securities markets and the securities industry have made in response to the internationalization process. Part II analyzes the measures regulators have taken to address the implications of those developments. Part III discusses the October Market Break and how it illustrates the interdependence and institutionalization of international securities markets. Part IV suggests that the events of last October have or should have changed our perception of the world and discusses the issues regulators will have to address in order to deal with interdependence, volatility and other characteristics of internationalized capital markets. Part V recommends that regulators respond to these issues by adopting a multilateral approach to certain international securities regulation issues.

I. The Nature and Scope of Globalization and Structural Change

A. Factors Contributing to the Internationalization Process

The long-term causes and effects of the globalization process are difficult to isolate and define. Nevertheless, it is pertinent and helpful to point out certain developments that clearly contributed to, if not initiated, the internationalization process.

Approximately twenty years ago, for economic reasons, issuers, investors and market professionals started to look beyond their borders for business and investment opportunities. Issuers, including those from the U.S., were engaged in the perpetual quest for cheap capital. The corollary to that phenomenon was investors' search for diversity in and a greater return on their investment portfolios. These desires resulted in occasional international securities transactions. All that was needed to internationalize the markets further was a cost-effective way for market professionals—brokers, dealers, investment bankers, and investment advisors—to bring together issuers and investors from around the world.

The continuing advance of telecommunications and data processing technology provided accessible and relatively inexpensive links between geographically separated issuers and investors. The speed, efficiency and accuracy with which market information may be transmitted and investment decisions may be implemented with the assistance of modern technology has opened up new worlds of opportunity and made it easier for issuers and investors to exploit those international opportunities.

Finally, the globalization process was fueled in part by government privatization programs. Significantly, offerings of securities in public entities tend to be larger than local markets can absorb; consequently, international interest often is necessary for success.[8] Many of the most notable privatizations have involved large public stock offerings conducted on a multinational basis or with significant foreign investor participation. The United Kingdom ("U.K.") has been the leader in this area, and can count among its privatization efforts four of the largest public stock offerings in history.[9] The privatization trend has swept over to France, where shares have been publicly offered in several national banks and companies.[10] Privatizations in Singapore, Malaysia, Japan, and even the U.S. demonstrate this is a global phenomenon.[11]

B. Perspectives on the Extent of Internationalization

Capital markets throughout the world became international quite rapidly, almost in tandem with the growth of the bull markets of the five years from 1982 to 1987.[12] Today, there are established international markets for the issuance and trading of numerous types of securities, including sovereign and corporate debt, convertible bonds and warrants, equities, and even derivative products such as options and futures on sovereign debt, foreign currencies, and stock indexes.

Privatizations are only one example of the fact that issuers and investors are no longer restricted to their local markets. Available statistics support the proposition that increasing amounts of capital are flowing across national borders. For example, foreign transactions in U.S. stocks and bonds totaled $295 billion in 1982. In 1987, the total was $3.3 trillion, up 1100%.[13] United States transactions in foreign securities during 1982 totaled $76.6 billion. In 1987, the figure was $591 billion, an increase of 770%.[14] These figures, however, are merely the readily identifiable manifestations of more significant changes in investment and capital raising strategies.

For example, other statistics indicate that internationalization has changed the

8. Lord Rockley, *Sale of Shares in State Enterprises*, Discussion Paper Presented to the 11th Ann. Conf. of the Int'l. Assoc. of Sec. Comm'ns., Paris, France, July 16–18, 1986, at 11.

9. These were the $12 billion British Petroleum, the $8 billion British Gas, the $5 billion British Telecom, and the $2.3 billion Rolls Royce multinational common stock offerings. *See* Forman, *British Petroleum Trading in London is Subdued as Buy Back Plan Cuts Fears*, Wall St. J., Nov. 2, 1987, at 6; Sacher, *Going Private*, Fin. World, Jan. 20, 1987, at 112–116; Feder, *Rolls Jet Engine Maker Soars in Initial Trading*, N.Y. Times, May 21, 1987 at D1.

10. *See France Offers Bank Stock*, N.Y. Times, May 8, 1987, at D15, col. 4; Revzin, *France Urges Citizenry to Break With Habit, Become Stockholders*, Wall St. J., Nov. 5, 1986, at 1, col. 4.

11. *See International Corporate Report*, Wall St. J., Aug. 23, 1985, at 19, col. 6 (Singapore Airlines Ltd.); *Bourse Report*, Wall St. J., Oct. 9, 1985, at 24 (Malaysian Airlines System); *International Corporate Report*, Wall St. J., Feb. 10, 1987, at 42, col. 3 (Nippon Telegraph & Telephone Corp.); Selby, *Inside the Conrail Deal*, INSTITUTIONAL INVESTOR (Int'l. Ed.), Apr. 1987, at 217.

12. For a discussion of the five year global bull markets, see *infra* notes 105–109 and accompanying text.

13. *See* U.S. DEPARTMENT OF THE TREASURY, TREASURY BULLETIN, Table CM-V-1 (Mar. 1983); U.S. DEPARTMENT OF THE TREASURY, TREASURY BULLETIN, Table CM-V-1 (Mar. 1988).

14. *See id.* Table CM-V-2 (Mar. 1983 & 1988).

way in which investors structure their portfolios. Private sector pension funds from industrialized nations are diversifying into foreign stocks and bonds, with the percentage of total assets invested in this manner doubling in the last six years. U.K. funds are the most diversified with 20% invested in foreign securities, while U.S. funds are among the least with 4% so invested.[15] The tenfold increase in foreign securities transactions between 1982 and 1987 also reflects this diversification.[16]

Figures relating to international bond and equity offerings are similarly instructive and demonstrate that internationalization has changed the way in which issuers raise capital. Companies from all over the globe are locating and using markets in which the least expensive financing is available without regard to geographical proximity to their base of operations. The highly developed international bond markets include Eurobonds, which are issued multinationally, and foreign bonds, which are issued in a single overseas market. In 1987, issuers tapped these markets for $177 billion, 22% less than the record amount raised in 1986 but more than double the 1982 total.[17] For the first time last year, Japanese issuers surpassed those from the U. S. as the largest users of international bond markets, accounting for 17% of new issue volume. U. S. issuers were a mere .5% behind, followed by issuers from the U. K. and France.[18]

Companies also have taken advantage of new opportunities to offer stock in overseas markets. The international equity market affords a corporation the opportunity to issue securities in several markets outside its home market. International equities, which generally are referred to as Euroequities, include stocks offered both simultaneously in multiple markets and in a single foreign equity market. Unlike the international bond markets, no sharp distinction is made between Euromarket and foreign issues. Notwithstanding tremendous recent growth, the Euroequity market is small compared to the Eurobond market.[19] New issues in the fledgling Euroequity market totaled a record $18 billion last year, over five times the 1985 total and nearly ten times that in 1984.[20] German, Italian,

15. REPORT OF THE STAFF OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMMITTEE ON ENERGY AND COMMERCE, INTERNATIONALIZATION OF THE SECURITIES MARKETS, at II-77 (July 27, 1987) (hereinafter cited as INTERNATIONALIZATION STUDY).

16. *See* U.S. DEPARTMENT OF THE TREASURY, TREASURY BULLETIN, Table CM-V-1, CM-V-2 (Mar. 1983); U.S. DEPARTMENT OF THE TREASURY, TREASURY BULLETIN, Table CM-V-1, CM-V-2 (Mar. 1988). *See also supra* text accompanying notes 13 and 14.

17. *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FIN. STATISTICS MONTHLY (PT. 1), Table S.1 (Jan. 1984); ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FIN. STATISTICS MONTHLY (PT. 1), Table S.1 (Mar. 1988). *See also* INTERNATIONALIZATION STUDY, *supra* note 15, at G-3 to G-5.

18. *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FIN. STATISTICS MONTHLY (PT. 1), Table S.2 (Jan. 1988).

19. *See* INTERNATIONALIZATION STUDY, *supra* note 15, at II-52 to II-55.

20. *See Annual Financing Report*, EUROMONEY (SPECIAL SUPP.), Mar. 1988, at 32; INTERNATIONALIZATION STUDY, *supra* note 15, at 53.

and British issuers have been the major players in this market, although U.S. companies gradually are becoming more active.[21]

Securities offerings by foreign issuers in the United States ("Yankee Offerings") are significant for what they portend for the future when multinational and overseas offerings may be commonplace. Although still only a small fraction of overall international financing, the growth of Yankee offerings over the last five years illustrates this market's potential. Foreign corporations and governments raised $2.5 billion in the U.S. in 1982. The total in 1987 was $8 billion, over 300% higher.[22]

C. Response of Securities Markets To Internationalization

The impact of globalization on the various marketplaces in countries around the world and on the trading in those markets has been varied but nevertheless significant. As technology made offshore markets increasingly more accessible to investors, markets were forced to become more competitive in order to maintain and increase their market share of trading volume and listings. The changes have been dramatic and have included structural changes, such as international and domestic electronic market linkages, as well as internal market reforms.

International electronic trading and quotation linkages have proliferated during the past several years.[23] Trading linkages currently exist between three U.S. exchanges and two Canadian exchanges.[24] There also are quotation linkages between the National Association of Securities Dealers ("NASD") and the International Stock Exchange ("ISE") in London and the Stock Exchange of Singapore.[25] In addition, there is an arrangement between the American Stock Exchange ("Amex") and the European Options Exchange in Amsterdam for trading fungible stock index options.[26] The Montreal Exchange and the Vancouver Stock Exchange are linked to both Amsterdam and Sydney for options

21. *See* INTERNATIONALIZATION STUDY, *supra* note 15, at II-55 to II-57.

22. *See* SEC OFFICE OF ECONOMIC ANALYSIS, SEC MONTHLY STATISTICAL REVIEW, Tables M-350, M-370 (Mar. 1983); SEC OFFICE OF ECONOMIC ANALYSIS, SEC MONTHLY STATISTICAL REVIEW, Tables M-350, M-370 (Mar. 1988).

23. For a discussion of the economics of international market linkages, see Cox & Michael, *The Market for Markets — Development of International Securities and Commodities Trading*, 36 CATH. U.L. REV. 833 (1987).

24. *See* Sec. Exch. Act Rel. No. 23,075, 51 Fed. Reg. 11,854 (Mar. 28, 1986)(Midwest-Toronto); Sec. Exch. Act. Rel. No. 22,442, 50 Fed. Reg. 39,201 (Sept. 20, 1985)(American-Toronto); Sec. Exch. Act Rel. No. 21,925, 50 Fed. Reg. 14,480 (Apr. 8, 1985)(Boston-Montreal). *See also* INTERNATIONALIZATION STUDY, *supra* note 15, at V-49 to V-57.

25. *See* Sec. Exch. Act Rel. No. 23,158, 51 Fed. Reg. 15,989 (Apr. 21, 1986)(ISE); Sec. Exch. Act Rel. No. 25,457, 52 Fed. Reg. 9156 (Mar. 14, 1988)(Singapore).

26. *See* Sec. Exch. Act Rel. No. 24,831, 52 Fed. Reg. 32,368 (Apr. 14, 1987); Sec. Exch. Act. Rel. No. 24,832, 52 Fed. Reg. 32,377 (April 14, 1987).

trading.[27] Furthermore, the European Community ("EC") expects to link the stock markets of twelve member states into a continuous trading network in the fall of 1988.[28] Moreover, discussions are pending that could result in additional linkages between U.S. and foreign markets.[29]

Another approach taken by stock exchanges to enhance their competitiveness in this era of global markets has been to combine with other domestic markets. The U.S. securities exchanges have been electronically linked since the late 1970s.[30] Following the U.S. pattern, exchange markets in several countries are joining forces with their domestic counterparts in varying ways. For example, in 1987 the four Hong Kong exchanges merged into a unified exchange with one trading floor,[31] and the six Australian and eight German stock exchanges recently became electronically linked and centrally governed integrated markets.[32] U.S. markets now are exploring a second generation of alliances. For example, the Chicago Board Options Exchange has merged with the Cincinnati Stock Exchange,[33] and has a joint venture with the Chicago Board of Trade for dual trading of futures and options.[34]

Securities markets' efforts to increase their competitiveness have included significant internal structural reforms. Some of these reforms were brought about, at least in part, by the realization that domestic markets were becoming, or were likely to be, non-competitive in the global context. The most dramatic reformation to date was the U.K.'s Big Bang in October 1986. Prodded by the

27. *See* U.S. DEPARTMENT OF THE TREASURY, NATIONAL TREATMENT STUDY: REPORT TO CONGRESS ON FOREIGN GOVERNMENT TREATMENT OF U.S. COMMERCIAL BANKING AND SECURITIES ORGANIZATIONS(1986 UPDATE) 58 (Dec. 18, 1986).

28. *See* Quinn, *Europeans Tie the Knot*, INSTITUTIONAL INVESTOR, Dec. 1987, at 185. The exchanges of Amsterdam, Athens, Brussels, Copenhagen, Dublin, Frankfurt, Lisbon, London, Luxembourg, Madrid, Milan, and Paris will be participating in the Interbourse Data Information System. *Id.*

29. The New York and Midwest Stock Exchanges are considering linkages with the ISE, and the New York and Amsterdam Stock Exchanges also are considering one. *See* McMurray & Anders, *Big Board, London Exchange Discuss Trading, Data Reporting Joint Ventures*, Wall St. J., Jan. 7, 1985, at 3, col. 2; Grant, *Midwest Discussing Trading Link With London*, INVESTMENT DEALERS' DIG., Feb. 9, 1987, at 8; Dutt, *Big Board Explores Amsterdam Link*, INVESTMENT DEALERS' DIG., Apr. 21, 1986, at 6.

30. The American, Boston, Midwest, New York, Pacific, and Philadelphia Stock Exchanges were linked for real-time consolidated transaction and composite quotation reporting in 1974 and 1978 respectively, and for trading in 1978 by the Intermarket Trading System. *See* Simon & Colby, *supra* note 4, at 50; Cox & Michael, *supra* note 23, at 846–850.

31. *See Hong Kong Trading Comes of Age*, N.Y. Times, Oct. 5, 1987, at D16; *Hong Kong Stock Exchanges: Four Into One Won't Go Easily*, ECONOMIST, Feb. 1, 1986, at 77.

32. *See Birth of the Australian Stock Exchange*, EUROMONEY (SPONSORED SUPP.) Feb. 1986, at 115–117; *Eight Exchanges, One Voice*, EUROMONEY, Feb. 1986, at 159.

33. *See* Sec. Exch. Act Rel. No. 24,090, 52 Fed. Reg. 5225 (Feb. 19, 1987).

34. *See Markets Form Joint Venture*, N.Y. Times, Feb. 15, 1988, at D4; McMurray, *CBOT Forms Joint Venture With CBOE*, Wall St. J., June 26, 1987, at 2, col. 6. Regulatory approvals will be necessary before dual trading commences.

British government, the ISE unfixed commission rates, abolished the single capacity system prohibiting member firms from acting as both brokers and dealers and removed restrictions on foreign ownership of member firms.[35] In addition, the exchange merged with the association for the Euromarket houses, thereby creating a unified market for British and international equities.[36]

To facilitate the growth of its marketplace, the ISE implemented an entirely new trading system that allows members to execute trades on the exchange floor and upstairs through a computerized trading system. It also provided for real-time quotations and, for the more actively traded securities, real-time transaction reporting. Within months of implementation of the new trading system the bulk of the trading took place upstairs. Consequently, the exchange decided to close its trading floor because of lack of use.[37]

Other countries are following Britain's example with their own versions of "Big Bang." Canada and France are implementing structural reforms whose hallmarks will be the opening, over time, of the Toronto Stock Exchange and Paris Bourse to foreign investment firms and domestic and foreign banks.[38] The Paris Bourse also is extending its traditional two-hour trading day and exploring continuous trading.[39] In addition, Spain is planning sweeping structural reforms which should include opening the stock market to banks and foreign brokers and a shift to continuous computerized trading.[40]

Of course, U.S. markets are not immune to the pressure of competition from abroad, nor are they oblivious to the fact of internationalization. Therefore, they also are adapting themselves to the new competitive environment. In the process, the markets are changing their basic structure. For example, to increase the capital available for marketmaking, the New York Stock Exchange ("NYSE"), with SEC approval, recently began permitting retail member firms to acquire specialist units, a relationship that had been previously prohibited. The stated purpose of this change is to give the specialist, who is responsible for making fair and orderly auction markets on the exchange floor, access to the substantial capital needed to compete in today's global markets.[41]

A further response to international competition both in the U.S. and abroad has been to modify exchange listing standards to accommodate foreign issuers.

35. *See, e.g., Flinging Open the Doors of Change*, EUROMONEY (BIG BANG SUPP.), Aug. 1986, at 2.

36. *See Way Cleared for Merger of London Exchange, IRSO*, Wall St. J., Nov. 13, 1986, at 64.

37. *See* Almond, *Computers Kill London Tradition*, Wash. Times, Mar. 4, 1987, at 12C.

38. *See* Jordan, *Canadian Financial Services — The New Broom*, 3 FIN. SERV. REG. (S&P) 177 (1987); Lewis, *Foreigners Will Be Able to Own French Brokers*, N.Y. Times, Mar. 11, 1987, at D1.

39. *See* Roth, *Battling for Survival*, Wall St. J., Sept. 29, 1986, at 32D.

40. *See* Bray, *Spain Aims to Computerize Trading, Break Brokers' Monopoly Over Exchange*, Wall St. J., Feb. 8, 1988, at 32D.

41. *See* Sec. Exch. Act Rel. No. 23,768, 51 Fed. Reg. 41,183 (Nov. 13, 1986).

The NYSE and the Amex proposed, and the SEC approved,[42] rule changes to allow them to waive listing standards with which foreign firms cannot comply because of legal or practical impediments. The waivers apply to certain corporate governance and disclosure requirements.[43] Similarly, the Tokyo Stock Exchange has streamlined the disclosure requirements that foreign issuers must satisfy in order to list.[44] In addition, the EC has issued directives establishing minimum listing standards, disclosure standards for companies that are to be listed and periodic reporting requirements for listed companies, thus making it possible to use a single text to list simultaneously in member states' markets.[45]

D. Effects of Internationalization on the Structure of the Financial Services Industry

Internationalization has had as significant an impact on the financial services industry as it has had on the markets. One such effect is the erosion of sectorial barriers in the financial services industry. In the U.S., Japan and Canada, the different sectors of the financial services industry (banking, securities and insurance) have been separated by statute. During the past two decades, these statutory barriers have been eroded by competitive market forces.[46] Globalization has accelerated this erosion and changed the structure of U.S. banking. As a result, U.S. banking is adapting to the structure prevalent in most countries, where banks engage in all facets of commercial and investment banking.

Major U.S. banks are deriving increasing portions of their domestic revenues from activities that skirt the edges of the Glass Steagall Act[47] such as mergers and acquisitions, private placements and loan sales.[48] Furthermore, notwithstanding Glass Steagall, the bank regulators have recently authorized U.S. banks to en-

42. *See infra* notes 74–79 and accompanying text.

43. *See* Sec. Exch. Act Rel. No. 24,634, 52 Fed. Reg. 24,230 (June 29, 1987). The Commission also approved the NASD's new OTC transaction reporting plan which provides foreign issuers with similar waivers of the plan's periodic reporting and corporate governance requirements. *See id.* at 24,231 n. 9; Sec. Exch. Act Rel. No. 24,663, 52 Fed. Reg. 24,234 (June 23, 1987).

44. *See The Nikko Perspective in International Equities*, EUROMONEY INT'L EQUITIES SPECIAL SURVEY (SPONSORED SUPP.), Nov. 1986, at 3.

45. Address by Geoffrey Fitchew, Director General for Financial Institutions and Company Law, Commission of the European Communities, European Stock/OTC Markets Conference (New York, Oct 1. 1987)(discussing the European Community's legislation on securities markets)[hereinafter *Fitchew Address*]. *See also* 22 O.J. EUR. COMM. (No. L 66) 21 (1979); 23 O.J. EUR. COMM. (No. L 100) 1 (1980). All but two member states have conformed their laws to the terms of these directives. *See* INTERNATIONALIZATION STUDY, *supra* note 15, at III-77.

46. Of course, during the past seven years, U.S. bank regulators have assisted and encouraged this erosion. *See infra* note 49 and accompanying text.

47. Banking Act of 1933, Ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.) [hereinafter Glass-Steagall Act].

48. *See, e.g.*, Weberman, *First Join 'Em, Then Beat 'Em*, FORBES, Feb. 23, 1987, at 152.

gage in an array of securities activities domestically that they previously had been able to do only overseas.[49]

Globalization has increased the pace of the involvement of U.S. and Japanese banks in the securities aspects of the financial services industry. This has been possible because neither Glass Steagall nor its Japanese counterpart apply extraterritorially. In many instances, American and Japanese banks are learning the securities business through their participation in the internationalization process. Large U.S. and Japanese banks are becoming major players in foreign securities markets by acquiring local securities firms or developing securities expertise in their worldwide branch networks. By following either or a combination of these strategies, the Citicorps and the Industrial Bank of Japans of the world are becoming leading securities underwriters and traders.[50]

The British, Canadian and French "Big Bangs" mean that their securities markets will be open to U.S. banks.[51] Recently, the Japanese Ministry of Finance authorized certain U.S. and British banks to operate securities subsidiaries in Japan.[52] The interesting, albeit anomalous result is that a bank, technically precluded from engaging in a full range of securities business in the U.S., may or may soon do so in Britain, Canada, France and Japan.

Globalization also has had a significant effect on securities industry structure. Securities firms are modifying their structure as they position themselves to meet the challenges posed by internationalization. The first step in this process has been the acquisition of additional capital or at least gaining access to it. In this regard, many major U.S. securities firms have merged into much larger American companies engaged in such disparate businesses as insurance, retailing and manufacturing.[53] Other U.S. securities firms have increased their capital by forming joint ventures with or selling significant minority interests to non-U.S. enterprises.[54]

49. *See Fed Approves Underwriting Applications of J.P. Morgan, Citicorp, Bankers Trust*, 19 Fed. Sec. L. Rep. (BNA) 628 (1987); *Fed's Section 20 Decision Stayed; More BHCs Win Underwriting Approval*, 19 Fed. Sec. L. Rep. (BNA) 739 (1987); *Fed's Section 20 Orders Upheld, But Market Share Test Reversed*, 20 Fed. Sec. L. Rep. (BNA) 225 (1988).

50. *See* Berg, *Citicorp Buys Australian Brokerage*, N.Y. Times, May 6, 1987, at D4, col. 1; Sesit & Herman, *Aubrey G. Lanston & Co. Will be Sold to a Unit of Industrial Bank of Japan*, Wall St. J., Oct. 30, 1986, at 3, col. 1; Sesit, *Industrial Bank of Japan Expands Role to Win Slice of World's Investment Banking Business*, Wall St. J., July 16, 1985, at 36, col. 3.

51. *See supra* notes 35–38 and accompanying text.

52. *See* Sesit, *Japan to Allow Securities Units for U.S. Banks*, Wall St. J., Mar. 19, 1987, at 2, col. 5; *Midland Bank Unit Wins Securities License in Japan*, Wall St. J., Dec. 22, 1986, at 23, col. 3.

53. *See* Rozen, *Bearing Gifts: Wall Street's Best, and Worst, Corporate Parents*, INVESTMENT DEALERS' DIG., Apr. 20, 1987, at 18.

54. The leading joint venture is between the First Boston Corp. and Credit Suisse. *See* Winkler, *First Boston Venture With Swiss Thrives*, Wall St. J., Apr. 29, 1987, at 24, col. 1. Three major firms recently sold interests to Japanese enterprises. *See* Nash, *Goldman's Japan Tie Cleared*, N.Y. Times, Nov. 20, 1986, at D1, col. 1. (12.5% nonvoting limited partnership interest sold to Sumitomo Bank Ltd.); Cowan, *Japanese Partner for Shearson*, N.Y. Times, Mar. 20, 1987, at D1, col. 5 (13% interest

Another notable feature of the internationalization of the securities markets has been the dramatic overseas expansion of major securities firms. During the bull market of 1982–1987, U.S. firms established new or significantly enlarged existing branches or affiliates in Europe and Japan.[55] In turn, Japanese and European firms have established footholds in North America.[56] With far flung networks of offices linked by sophisticated telecommunications technology, securities firms have given meaning to the concept of global markets in which firms underwrite and trade securities around the world and around the clock.[57]

In the wake of their global expansion, U.S. securities firms seem to be reevaluating the benefits of integration and being able to offer clients a full range of financial products and services. As a result, some firms are reducing the services and products offered to their clients.[58] Whether this development reflects a long term trend to focus resources on higher margin activities or rather is simply the natural outgrowth of unfettered competition is difficult to determine. The current retrenchment is probably a result of both and does not in any way reflect a step backwards in the globalization process.[59]

II. Regulatory Responses to Changes in the Securities Markets Wrought By Globalization

Regulators of the international securities markets are intensely aware of the pressures forcing change in their respective markets, and are aware that significant developments abroad may and generally do have profound effects on their domestic markets. They also have recognized that these conditions make some degree of international regulatory cooperation necessary. Nevertheless, regulators generally have not developed comprehensive standards for regulation of the international securities markets. Rather than formulating broad cooperative measures that anticipate potential problems, regulators have devised narrow and often unilateral responses to specific market regulation issues as they arise. The

sold to Nippon Life Insurance Co.); Gilpin, *Japanese Buy Stake in Paine Webber*, N.Y. Times, Dec. 1, 1987, at D1, col. 1 (25% equity stake sold to Yasuda Mutual Life Insurance Co.).

55. *See* Schmerken, *Waving the Flag Abroad*, Wall St. Computer Rev., Oct. 1987, at 17.

56. *See Japan on Wall Street*, Bus. Wk., Sept. 7, 1987, at 82; Laursen, *Can British Banks Survive in the USA?*, Investment Dealers' Dig., June 22, 1987, at 22. That expansion continues unabated. *See* Sesit, *Foreign Firms Are Eager to Capture Bigger Chunck of U.S. Equity Market*, Wall St. J., Feb. 16, 1988, at 51, col. 2.

57. *See How Merrill Lynch Moves Its Stock Deals All Around the World*, Wall St. J., Nov. 1, 1987, at 1; Marion, *Creating A Global Book*, Institutional Investor, Mar. 1987, at 265.

58. *See* Picker, *Ebb Tide on Wall Street*, Institutional Investor, Dec. 1987 at 64; Forman, *Britain's Deregulation Leaves a Casualty Trail in the Securities Industry*, Wall St. J. Oct. 14, 1987, at 1.

59. While cutting back selectively in the U.K., *see supra* note 58, U.S. firms are expanding significantly in Japan. *See* Sulkin, *U.S. Finance Firms in Japan Expect to Expand Staff*, Wall St. J., Jan. 28, 1988, at 11.

exception to the general rule has been international surveillance and information sharing, where the emphasis is on cooperative efforts to enforce existing laws, not the adoption of new substantive rules.

A. U.S. Regulatory Response

The responses of U.S. regulators to international developments have for the most part been focused on fostering competition and preventing business from flowing off-shore while assuring that investor protection standards are maintained. As disccussed below, U.S. regulators have exhibited the appropriate flexibility in their approaches to bank securities activities, trading practices during securities distributions and foreign broker-dealer registration, but more flexibility than necessary as far as the NYSE and Amex foreign listing rules are concerned.

1. Bank Securities Activities

The gradual breaching of the Glass Steagall Act's separation between commercial and investment banking[60] has raised important market integrity and investor protection concerns. As an initial response, the SEC adopted Rule 3b-9 under the 1934 Act requiring banks engaged in certain securities activities to register as broker-dealers.[61] The courts overturned Rule 3b-9,[62] but not until after most banks registered their securities affiliates. The SEC then proposed legislation essentially implementing Rule 3b-9 through statutory amendment.[63]

Congress is considering legislation that would repeal the Glass Steagall Act in its entirety.[64] The SEC's position on this issue is that banks can be as active as they care to be in the securities industry as long as those activities are conducted through affiliates registered with the SEC, and there are adequate safeguards against conflicts of interest and related investor protection concerns. The SEC, therefore, has made its support for the repeal of Glass Steagall contingent upon a requirement similar to Rule 3b-9.[65]

60. *See supra* notes 47–49.

61. *See* Sec. Exch. Act Rel. No. 22,205, 50 Fed. Reg. 28,385 (July 1, 1985).

62. *See* Am. Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986).

63. *See* U.S. SEC. AND EXCH. COMM'N, STATEMENT IN SUPPORT OF PROPOSED AMENDMENTS TO MODIFY THE DEFINITIONS OF BROKER AND DEALER IN THE SECURITIES EXCHANGE ACT OF 1934 (May 4, 1987). Draft bills implementing the proposed amendments have been introduced in the Senate and House. *See* S. 1175, 100th Cong., 1st Sess., 133 CONG. REC. S.6224 (May 8, 1987); H.R. 2557, 100th Cong., 1st Sess., 133 CONG. REC. H. 4056 (May 28, 1987).

64. The Senate passed such a bill on Mar. 30, 1988, and transmitted it to the House of Representatives for its consideration. *See* S. 1886, 100th Cong., 2d Sess. 134 CONG. REC. S. 3520 (Mar. 31, 1988).

65. *See* MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE CONCERNING FINANCIAL SERVICES DEREGULATION AND REPEAL OF THE GLASS STEAGALL ACT (Apr. 11, 1988).

2. Trading Practices During International Securities Distributions

The proliferation of multinational stock offerings in the Euroequity market[66] has raised a growing number of questions about the extraterritorial applicability of Rules 10b-6 and 10b-7 under the 1934 Act. Rule 10b-6 is an antimanipulative rule generally prohibiting persons engaged in a securities distribution from artificially conditioning the market to facilitate the distribution. Rule 10b-7 provides a safe harbor from this prohibition for transactions that stabilize the market.[67] The SEC's position has been that these rules apply extraterritorially to overseas distribution participants who are affiliated with U.S. distribution participants or when the distribution in which they are participating occurs partially in the U.S. The rationale is that activities of these overseas distribution participants could adversely affect the U.S. market for the security being offered.[68]

On eight occasions in 1987, the SEC was faced with requests from non-U.S. distribution participants for exemptions from Rules 10b-6 and 10b-7 so that they could continue certain customary activities in foreign jurisdictions that would violate the rules. The SEC granted the requests, but only after imposing conditions to assure that these overseas activities would not result in a manipulation of the U.S. markets. In this way, the SEC accommodated Rules 10b-6 and 10b-7 to the realities of international securities offerings while taking into account the protections that the federal securities law provide U.S. investors.[69]

3. Foreign Broker-Dealer Activities

The development of international linkages and the concomitant increased international dissemination of market information[70] has brought foreign broker-dealers within the 1934 Act's broker-dealer registration requirements which, like Rules 10b-6 and 10b-7,[71] have extraterritorial application. These requirements apply extraterritorially when a foreign broker-dealer employs U.S. jurisdictional

66. *See supra* notes 9 and 19–21 and accompanying text.

67. *See* 17 C.F.R. § 240.10b-6, 10b-7 (1987). Rule 10b-6 achieves its objective by generally prohibiting distribution participants from bidding or purchasing or inducing purchases of the security subject to the distribution either just before or during the distribution. *Id.* The rules apply to distribution participants' affiliates. *Id.* § 240.10b-6(c)(6).

68. *See* INTERNATIONALIZATION STUDY, *supra* note 15, at V-77 to V-85. *See also infra* note 69 and accompanying text.

69. *See* letters regarding The British Petroleum Co., p.l.c. (Available Oct. 14 & Nov. 6, 1987); The International Stock Exchange of the United Kingdom and the Republic of Ireland (Available Oct. 5, 1987); Banco de Santander, S.A. (Available July 29 & Oct. 26, 1987); Banco Central, S.A. (Available July 1, 1987); Companion Telefonica Nacional de Espana, S.T. (Available June 12, 1987); C.H. Beazer (Holdings) PLC (Available May 28, 1987); Rhone Poulenc, S.A. (Available Mar. 17, 1987). The SEC also granted three other requests for relief. *See* letters regarding Tokio Marine Fire Insurance Co. (Available Oct. 1, 1987); Barclays PLC, Sec. Exch. Act Rel. No. 24,487, 38 S.E.C. DOCKET 461 (May 19, 1987); Phillips, N.V., Sec. Exch. Act Rel. No. 24,486, 38 S.E.C. DOCKET 457 (May 12, 1986).

70. *See supra* notes 24–29 and accompanying text.

71. *See supra* notes 67–70 and accompanying text.

means to offer or sell securities in the U.S. The jurisdictional means requirement is readily satisfied. It encompasses use of U.S. mails or any means or instrumentality of interstate commerce.[72]

The SEC has reconciled its broker-dealer registration requirements to the practical needs of internationalization by not requiring registration every time foreign broker-dealers have used U.S. jurisdictional means. In determining whether registration is necessary, the SEC has analyzed how widespread a foreign broker-dealer's solicitations to U.S. investors and trading in the U.S. have been. For example, the SEC has issued no-action letters permitting U.K. market makers, without registering as broker-dealers in the U.S., to enter quotations into the ISE's automated quotation system that would be disseminated in the U.S. through the NASD-ISE quotation linkage or the ISE's TOPIC services.[73]

4. NYSE and Amex Foreign Listing Standards

The NYSE's and Amex's desire to obtain more foreign listings led the two markets to propose rule amendments that would permit the waiver of certain listing standards for foreign issuers. Among other things, the rule amendments allowed the waiver of U.S. voting rights requirements which conflicted with common practices in the issuers' home countries.[74] These proposals raised very difficult questions about the extent to which accommodations should be made to U.S. regulations to facilitate internationalization. Unlike the Rules 10b-6 and 10b-7 and foreign broker-dealer matters,[75] they involved the domestic rather than the extraterritorial application of U.S. securities regulation. Moreover, they were in direct conflict with the purposes of the SEC's almost simultaneously proposed Rule 19c-4 under the 1934 Act.[76]

Proposed Rule 19c-4 reflected a fundamental policy determination that it was necessary for the protection of investors to prohibit publicly-held, listed companies from disenfranchising their shareholders. The proposed rule would accomplish this objective by generally prohibiting any U.S. market from listing or continuing to list the equity securities of any issuer that takes any action that nullifies, restricts, or disparately reduces shareholder voting rights. However, the rule as proposed includes an exemption for foreign issuers,[77] the appropriateness of which is questionable. If Rule 19c-4 were adopted without such an exemption, a foreign issuer with a "one share/one vote" or a dual capital structure could initially offer securities to U.S. investors and list on a U.S. market. Once listed, however, a foreign issuer generally could not alter the proportionate voting rights

72. *See* INTERNATIONALIZATION STUDY, *supra* note 15, at V-41 to V-42.
73. *See id.* at V-42 to V-47.
74. *See supra* note 43 and accompanying text.
75. *See supra* notes 67–73 and accompanying text.
76. *See* Sec. Exch. Act Rel. No. 24,623, 52 Fed. Reg. 23,665 (June 22, 1987).
77. *See id.* at 23,671–74.

of its securities in a way that disenfranchised its existing shareholders without running afoul of Rule 19c-4's proscription.[78]

Despite the broad shareholder suffrage concerns underlying Rule 19c-4, a majority of the SEC voted to approve the NYSE and Amex foreign listing standards as proposed.[79] The majority apparently believed that these rules, with the voting rights waiver included, were needed to facilitate foreign listings in the U.S. markets. The majority also felt that U.S. investors would be better protected if they could purchase those foreign securities in the U.S. While the latter point may be true, it was not necessary to waive Rule 19c-4's disenfranchisement protection to encourage foreign companies to list in the first place. Foreign companies with dual class capitalization still would be able to list; only those companies that already were listed would be prohibited from disenfranchising their U.S. shareholders. The majority, therefore, inappropriately discounted the importance of providing investors in foreign securities that are publicly-traded in U.S. markets with the protections of Rule 19c-4, and thereby inappropriately and unnecessarily established a double standard for U.S. and foreign issuers.

B. International Regulatory Responses

The regulatory responses of markets abroad to globalization have, on occasion, been coordinated with and, in some respects, have been similar to U.S. regulation. For example, this trend is apparent in the measures that foreign markets are taking to provide for insider trading prohibitions and formal self-regulatory structures.

Insider trading once was proscribed only in the U.S.,[80] but a number of countries recently have adopted such laws. France and the United Kingdom enacted insider trading prohibitions in 1970 and 1980 respectively, and strength-

78. The proposed rule would prohibit recapitalizations that, among other things, eliminate the voting control of public shareholders, offer lower voting stock with higher dividends in return for stock with higher voting rights and condition voting rights of shares on the length of time the shares have been held or the amount of shares owned. *See id.* at 23,673.

79. *See* Sec. Exch. Act Rel. No. 24,634, 52 Fed. Reg. 24,230 (June 23, 1987). Four Commissioners voted for approval; Commissioner Peters abstained because she disagreed with the voting rights waiver for the reasons discussed above, but otherwise strongly supported the thrust of the amendments. The Commission also voted to exclude foreign equity securities from proposed Rule 19c-4. *See* Sec. Exch. Act Rel. No. 24,623, 52 Fed. Reg. 23,665 (June 22, 1987).

80. Insider trading is prohibited in the United States by Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1987). In addition, Section 14(e) of the 1934 Act, 15 U.S.C. § 78n(e) (1982), and Rule 14e-3 thereunder, 17 C.F.R. § 240.14e-3 (1987), proscribe such conduct in the context of a tender offer. Rule 10b-5 was adopted in 1942, *see* Sec. Exch. Act Rel. No. 3230, 13 Fed. Reg. 8177 (May 21, 1942), and was supplemented in 1980 by Rule 14e-3, *see* Sec. Act Rel. No. 6239, 45 Fed. Reg. 60418 (Sept. 4, 1980).

ened those prohibitions in 1983 and 1985 respectively.[81] Sweden made insider trading illegal in 1985. Amsterdam Stock Exchange rules essentially accomplished the same objective in the Netherlands in 1986,[82] and the Swiss Parliament gave final approval to a statutory prohibition against insider trading in December 1987.[83] Additional laws can be expected. Japan plans tougher insider trading prohibitions.[84] Italy, Belgium, Denmark, Ireland, and New Zealand are considering new restraints,[85] and the EC has proposed a directive prohibiting insider trading.[86]

The U.K.'s post-Big Bang regulatory framework exemplifies the trend towards more structured oversight of securities markets with a view towards investor protection. The new Financial Services Act 1986 imposes a statutory scheme of self-regulation in the U.K. which is similar to the U.S. system in the sense that regulatory responsibility is shared by the markets and government. Under the Act, the U.K. government delegated many of its powers to the Securities and Investments Board ("SIB"), a body funded and staffed by the industry. The SIB, in turn, has delegated supervisory control of different sectors of the industry to self-regulatory organizations ("SROs"). The ISE is the principal such SRO.[87]

C. *Surveillance Information Sharing Exceptions*

A significant exception to the general rule that international securities regulation has been unilateral rather than cooperative is the negotiation of bilateral memoranda of understanding ("MOU") and surveillance agreements designed to facilitate enforcement of the local securities laws in global markets. The SEC has entered into bilateral information sharing agreements with authorities in the United Kingdom, Japan, Switzerland and, on January 7, 1988, Canada.[88]

81. *See* Lightburn, *Insider Trading in France*, INT'L. FIN. L. REV., Jan. 1988, at 23, 23–24; Grass, *Insider Trading in the U.K.*, SEC. TRADERS' MONTHLY, Jan. 1987, at 14. France is considering another strengthening of its insider trading laws, *see Insider Trading in France, supra, at 26-27*, and the U.K. intends to make insider trading an extraditable offense, *see Insider Curb in British Bill*, N.Y. Times, Feb. 13, 1988, at 48.

82. *See* Rundfelt, *Insider Trading Regulation in Europe*, 1 J. ACCT., AUDITING & FIN., Spring 1986, at 125; Fouquet, *Europe Studying Ways to Fight Insider Profiteering*, Wash. Post, Mar. 5, 1987, at E3.

83. *See Swiss Vote Insider Penalties*, N.Y. Times, Dec. 19, 1987, at 40. *See also* Haymann, *Swiss to Outlaw Insider Trading*, INT'L FIN. L. REV., Oct. 1987, at 30.

84. *See Japan Insider Curbs Asked*, N.Y. Times, Feb. 25, 1988, at D22; *Japan Finance Agency Studies Ways to Alter Insider Trading Term*, Wall St. J., Apr. 27, 1988, at 30.

85. *See Europe Studying Ways to Fight Insider Profiteering*, *supra* note 82; *New Zealand to Introduce Rules on Insider Trading*, N.Y. Times, Dec. 29, 1987, at 12.

86. *See Fitchew Address*, *supra* note 45, at 16.

87. *See generally* Abrams, *The U.K. Financial Services Act 1986*, 3 REV. FIN. SERV. REG. (S&P) 101 (1987); Brayne, *The U.K. Financial Services Act 1986*, 20 REV. SEC. & COMM. REG. (S&P) 51 (1987). The new regulatory framework took effect on April 29, 1988. *See* Cohn, *Tough Securities Laws For a Wary London*, N.Y. Times, Apr. 29, 1988, at D1.

88. *See* Memorandum of Understanding on Exchange of Information Between the United States

The U.S./Canada MOU is particularly significant because the scope of assistance to be provided thereunder is broader than in any prior MOU. The MOU provides that the parties will seek legislative authority to allow them to conduct investigations on the others' behalf.[89] Once fully implemented, the MOU would allow the SEC to obtain testimony and documents from persons residing in Canada through subpoenas issued by the Canadian regulators, and would authorize the SEC to provide similar assistance to Canadian regulators.[90] The MOUs that the U.S. has with Canada and the U.K. are supplemented by surveillance and information sharing clauses that the SEC has required to be part of linkage agreements between U.S. and foreign securities markets.[91]

III. THE OCTOBER 1987 MARKET BREAK

Clearly, the October Market Break was one of the most dramatic events in the history of the U.S. financial markets. The steep and abrupt decline in the markets was, to say the very least, startling. Although some found the precipitous adjustment in the market on October 19, 1987 "breathtakingly efficient," most found it a cause for alarm.

The SEC's Division of Market Regulation prepared a comprehensive study of the Market Break, which was released on February 2, 1988.[92] A full and detailed analysis of the SEC Staff Study on the Market Break and the SEC's findings is not within the scope of this article. However, a brief summary of those matters is necessary to lay a foundation for the conclusions which are influenced by perceptions and observations drawn from the Market Break.

The SEC Staff Study does not answer the question of why the market value of

Securities and Exchange Commission and the United Kingdom Department of Trade and Industry in Matters Relating to Securities and Between the United STates Commodity Futures Trading Commission and the United Kingdom Department of Trade and Industry in Matters Relating to Futures (Sept. 23, 1986), *reprinted in* 25 INT'L LEGAL MATERIALS 1431 (1986); Memorandum of the United States Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance on the Sharing of Information (May 23, 1986), *reprinted* in 25 INT'L LEGAL MATERIALS 1429 (1986); Memorandum of Understanding (Aug. 31, 1982), 22 INT'L LEGAL MATERIALS 1 (1983) (between the United States and the Swiss Confederation); Memorandum of Understanding between the United States Securities and Exchange Commission and the Ontario Securities Commission, the Commission des valeurs mobilieres du Quebec, and the British Columbia Securities Commission (Jan. 7, 1988), *reprinted in* —— INT'L LEGAL MATERIALS ——— (1988). *See also* INTERNATIONALIZATION STUDY, *supra* note 15, VII-60 to VII-68.

89. The SEC agreed to propose such legislation to Congress on May 5, 1988. *See SEC to Seek Authority to Conduct Probes at Request of Foreign Governments*, 20 Fed. Sec. L. Rep. (BNA) 676 (1988).

90. *See supra* note 88.

91. *See supra* notes 24–25 and accompanying text. *See also* INTERNATIONALIZATION STUDY, *supra* note 15, at V-57 to V-60.

92. *See* MARKET BREAK REPORT, *supra* note 6.

common stocks decreased by over 30% in October 1987.[93] Rather, it reconstructs and analyzes trading activity during the period from October 6 to October 21, with a view to determining what happened. The Staff concluded that the initial decline that immediately preceded the October 19 Market Break was triggered by changed investor perceptions regarding investment fundamentals and economic conditions.[94] This conclusion is certainly correct but does not expressly identify that which the evidence suggests was the principal trigger of the Market Break in the U.S., namely the announcement that the House Ways and Means Committee had agreed upon a proposed tax bill that would have disadvantaged takeovers and leveraged buy-outs.[95] Thus, the perception by institutional investors that the takeover premium component of their holdings was threatened triggered a massive sell-off notwithstanding the very uncertain future of the bill. Therefore, to the extent the proposed bill was a factor, the market's reaction was not a particularly rational response.

The SEC Staff Study found that rapid stock and futures sales by institutions were a significant factor in accelerating and exacerbating the declines experienced during the October Market Break.[96] During specific critical time periods on October 19, for example, index arbitrage, index substitution or portfolio insurance[97]—or all three—accounted for between 30% and 65% of total NYSE volume in the stocks comprising the S&P 500 index.[98] The trading that occurred between 1:00 and 2:00 p.m. that day is illustrative. The combination of selling from portfolio insurance and index arbitrage totalled more than 40% of volume in the S&P 500 stocks, and more than 60% in three different 10 minute intervals within that hour.[99]

Based on the analysis contained in the Staff Study of the Market Break, the

93. *See id.* at 2-1. This calculation is based on movements in the Dow Jones Industrial Average, the most widely followed U.S. stock market indicator. Using other measures, the declines still would have been greater than 20%. *See id.*

94. *See id.* at 3-9 to 3-11.

95. For one of the more thoughtful early analyses of the effects of the proposed takeover tax bill, see Yardeni, *That M&A Tax Scare Rattling the Markets*, Wall St. J., Oct. 28, 1987, at 26.

96. *See* MARKET BREAK REPORT, *supra* note 6, at 3-11.

97. Index arbitrage involves offsetting stock and stock index futures purchases and sales designed to profit from pricing discrepancies between the stocks comprising the index and the future. Index substitution is a form of index arbitrage employed by a fund that seeks to replicate the performance of a stock index by holding each of the component stocks in proportion to its weighting in the index. Portfolio insurance refers to dynamic hedging strategies designed to control market risks in diversified portfolios by buying and selling futures. For stock portfolios replicating an index, these strategies call for futures sales as stock values decline and futures purchases as stock values increase. *Id.* at 1-2 to 1-5.

98. *See id. at 3-12.*

99. *See id.* Concentrated institutional stock selling also was the largest single direct factor responsible for the NYSE's initial opening declines on October 19. Continued institutional selling, combined with panic selling in a broad range of stocks and an absence of buyers, contributed to the freefall decline in the final hour of trading that day. *Id.* at 2-19, 3-11.

SEC reached four broad conclusions as a result of which it made a number of specific recommendations to the U.S. Congress.[100] The first conclusion is that the markets for stock, stock index futures and stock index options form a single market.[101] The second conclusion is that new trading mechanisms, such as computer-assisted portfolio insurance and index arbitrage, cause extraordinary volume and volatility that can overwhelm the capacity of the markets. The volume and volatility is in part an outgrowth of the institutionalization of the market and institutions' use of these trading strategies.[102] The SEC's third conclusion is that there are weaknesses in areas such as specialist and market maker performance, capital adequacy and clearing and settlement that must be remedied.[103] Finally, the SEC concluded that the events of October 19 and 20, 1987 dramatically confirmed the globalization of the securities markets.[104]

A. *The Interdependence of the World's Securities Markets*

The most significant change in the world capital markets brought about, or at a minimum heightened, by globalization is their interdependence. Markets no longer can be viewed as standing separate and independent of one another. The very changes that have made markets more competitive and more accessible to issuers and investors wherever situated have also made the markets more susceptible to experiencing the after-shocks of problems elsewhere. As a result, global markets signify much more than the opportunity to raise capital 10,000 miles from one's base of operations or to trade securities around the world and around the clock. The degree of interdependence, even if only psychological, demonstrates a synergism that must be taken into account by the markets, the industry and the regulators.

Markets gradually became interdependent as they gradually became global. There were clear signs before October 1987 that activity in and the perceived integrity and fairness of one market could have significant consequences for another. The 1982-1987 bull market, which actually was a global phenomenon,[105]

100. For a discussion of some of these recommendations, see *infra* notes 135–137 and accompanying text.

101. *See* U.S. SEC. AND EXCH. COMM'N, RECOMMENDATIONS REGARDING THE OCTOBER 1987 MARKET BREAK 5 (Feb. 3, 1988) [hereinafter SEC RECOMMENDATIONS]. The SEC stated that the boundaries between these three physically distinct marketplaces "are crossed to such an extent and with such frequency that these markets are unified," and that "[s]tock index futures and stock index options are used as economic substitutes for NYSE stocks." *Id.*

102. *See id.* at 5-7. The SEC recognized that "[o]n October 19 and 20 the amount for portfolio selling was so large . . . that market mechanisms adequate for the vast majority of trading situations failed on a massive scale." *Id.* at 6.

103. *See id.* at 8, 10-12.

104. *See id.* at 8. The SEC found that, "[i]n a sense, the market for United States equities can be viewed as including not only the domestic futures, options, and stock markets, but the major foreign markets as well." *Id.*

105. *See, e.g., The Roaring Eighties*, ECONOMIST, Oct. 24, 1987, at 84.

can be seen as a prime example of this interdependence. In the U.S. the Dow Jones Industrial Average ("DJIA") reached 2,746 on August 25, 1987, its highest level in history. This was over three times its level in August 1982 just five years previous.[106] Markets in other countries experienced similar unprecedented rises. For example, in 1987 Japan's Nikkei Dow Jones Industrial Index ("Nikkei 225") and the U.K.'s Financial Times-Stock Exchange 100 Index ("FT-SE 100") also approached three times their August 1982 levels.[107] Yet, in several of those markets, particularly the U.S. and Japan, unprecedented growth was not obviously related to changes in fundamental economic factors.[108] While other developments such as increased takeover activity in the U.S. and lack of alternative investments to stocks in Japan could explain the 1982–1987 bull market in those countries,[109] the global bull market can be explained, at least in part, by psychology. In other words, the growth in one market spurred increases in other markets, or more precisely investors' perceptions of the significance of growth in foreign markets stimulated growth in their own markets.

The global Market Break of October 1987 underscored the extent to which all markets have become interdependent. It was expected that the ability of investors to move capital from one market to another easily and rapidly might have "dramatic" consequences.[110] However, it is apparent that less concern has been given to the psychological links between the markets. An examination of intra-day price movements in several international markets before, during and after the October Market Break demonstrates there are strong ties between the world's equity markets.

The downward price movements during the two-week period beginning October 14, 1987 were striking in the suddenness with which they occurred and in the fact that they occurred in all major markets. This is particularly significant because the stock market declines occurred in countries such as Japan and Germany which did not have the economic problems (to wit, declining currency values, trade deficit and budget deficit) identified by some as the causes of the U.S. market decline.[111]

106. *See id.*; MARKET BREAK REPORT, *supra* note 6, at 2-1. The DJIA is a broad-based index consisting of the 30 most actively traded, highly capitalized NYSE-listed companies.

107. *See The Roaring Eighties*, *supra* note 105. The Nikkei 225 and the FT-SE 100 also are broad-based indexes. The former consists of the 225 most highly capitalized Tokyo Stock Exchange listings and the latter of the 100 most actively traded ISE stocks.

108. *See, e.g., That M&A Tax Scare Rattling the Markets*, *supra* note 95; *The 'Crash of '88' Scenario*, NEWSWEEK, Nov. 23, 1987, at 49.

109. *See id.*

110. However, the evidence gathered by the SEC Staff suggests that international equity trading (whether it was sales by foreign investors trading in U.S. markets or sales of U.S. securities in foreign markets) did not have a disproportionate effect on the decline of U.S. markets in October 1987. *See* MARKET BREAK REPORT, *supra* note 6, at II-2 to II-3. *But see Ricks, Task Force's Brady Says Japanese Sales of U.S. Bonds Touched Off Oct. 19 Crash*, Wall St. J., Apr. 22, 1988, at 18.

111. *See, e.g.,Extraordinary Butchery*, ECONOMIST, Oct. 24, 1987, at 75, 76 (currency volume);

During the week of October 12th, the DJIA declined by a total of 9.6%. Tokyo reacted quickly on Monday, October 19. Heavy selling pressure forced the Tokyo market down steadily throughout the day to close down 2.3%. Trading opened in London later that day, already down 7.8% from the previous week. The London market steadily declined throughout early trading, and closed down 12.6% for the day. The U.S. market followed, opening down 10.9% from Friday's close. At the time, the London market was down approximately 13% from the previous week's close and 6% from its October 19 opening. The DJIA closed down a record 22.6% for the day.[112]

Tuesday, October 20th brought no respite. The Nikkei 225 fell 7.5% during the morning session and dropped further during the afternoon session, for a record one-day decline of 14.7%. When trading began in London later on October 20, the market immediately dropped 19.3% from its previous close. In afternoon trading, London staged a rally; the market closed down 12.2% for the day. New York opened with the DJIA up 211 points. Although the DJIA gained 5.9% for the day, the rally was not broad-based.[113]

To measure the degree to which U.S. markets led or followed other markets, the SEC Staff examined the correlation of movements in several international stock indexes.[114] The data reviewed indicated that the U.S. markets did influence price movements in other markets. The Staff found that during the weeks of October 12 and October 19 the percentage change in the S&P 500 index had a significant effect on the next day's values of both the Tokyo Stock Exchange's TKE Composite and the ISE's FT-SE 100.[115] The Staff also found that, during the weeks of October 12 and October 19, movements in the TKE Composite and the FT-SE 100 had significantly less effect on the values of the S&P 500 index.[116] Naturally, caution should be used in drawing conclusions from this correlation data. Nevertheless, it does appear that a market event such as that which occurred in October 1987 can be expected to cause significant reaction and change in other markets even though the triggering event has no clearly identifiable connection with those markets.

In Our Hands, Wall St. J., Oct. 20, 1987, at 38 (trade deficit); *Fire Alarm on Wall Street*, N.Y. Times, Oct. 20, 1987, at A34 (budget deficit).

112. MARKET BREAK REPORT, *supra* note 6, at 11-5 to 11-6.

113. *Id.* at 11-6.

114. *See id.* at II-6 to II-7, II-24 to II-25. The Staff calculated partial correlation coefficients between intra-day percentage changes in the S&P 500 and subsequent opening values, early trading values, closing values, and close-to-close movements of the Tokyo Stock Exchange's TKE Composite and the ISE's FT-SE 100 during the period from October 12 through October 23, 1987. The staff also examined the correlation coefficients assuming the foreign market led the U.S. market. Partial correlation coefficients measure the degree to which two variables (for example, two stock indexes) move together. *Id.* at II-6.

115. *See id.* at II-6 to II-7.

116. *See id.* at II-7. The staff found that TKE Composite movements had relatively small effects on the S&P 500, and that the FT-SE 100 had effects that were greater, but much smaller than those the S&P 500 had on the FT-SE 100. *Id.*

B. The Institutionalization of the Securities Markets

As indicated, the SEC concluded that trading by institutions contributed significantly to the U.S. market decline in October 1987. In fact, the breadth and size of the market break reflects the degree to which the investor community has gradually become institutionalized and the impact this phenomena has had on the markets. The influence of institutions on the market was felt long before October 1987. For example, institutions' increasing investment in stocks traded in the over-the-counter ("OTC") market served to make the NASD's multiple market maker system a formidable competitor to the venerated specialist/auction market of the NYSE.[117] Moreover, institutions spearheaded the drive to unfix brokerage commissions[118] and their investment strategies and goals spurred the development of block trading[119] and computer-assisted trading [120], all of which have had a profound effect on the structure, liquidity and efficiency of the market.

The Market Break of October 1987 was a rude reminder of significance of institutional trading both with respect to the strategies used and the size of transactions executed. Institutions were the predominant source of selling pressure during the week of October 19, 1987 and their concentrated activity during critical periods accelerated and exacerbated the decline.[121] Noting that certain trading strategies by institutions contributed significantly to the Market Break, however, is not to say that these strategies or those that use them are villains. As former SEC commissioner Bevis Longstreth stated, "[T]he market was a victim of its own successes."[122] Mr. Longstreth properly points out that although new

117. The OTC market encompasses all securities trading that takes place off the floor of a stock exchange. The NASD is the SRO responsible for OTC market oversight, and operates the NASDAQ system, which provides a medium by which broker-dealers making markets in OTC stocks disseminate quotations and enter trade reports. *See generally* NASD, THE NASDAQ HANDBOOK (1987). From 1980 to 1986, NASDAQ grew more rapidly than the NYSE and the Amex, and now ranks third in the world behind only the New York and Tokyo Stock Exchanges in terms of equity trading dollar volume. *Id.* at 14. During roughly the same period, institutional holdings of NASDAQ stocks grew nearly 3.5 times from $20 billion to $68.6 billion. *Id.* at 196.

118. *See* J. SELIGMAN, *supra* note 1, at 473–86.

119. *See* 8 INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 64, 92d Cong., 1st Sess. 87–95 (1971). A block generally consists of 10,000 or more shares and, because of its size, "cannot be executed in the exchange auction market in the normal course." *Id.* at 87. A broker-dealer acting as a block positioner ordinarily assumes responsibility for executing the block in a fair and orderly manner, and does so through one or a combination of the following strategies. The first is to work the block in smaller pieces through the specialist on the exchange floor. The second is to arrange contra side interest upstairs and bring the trade to the floor for the specialist to cross. The third is to take all or some of the block into inventory. *Id.* at 87-90.

120. *See* MARKET BREAK REPORT, *supra* note 6, at 3-2 to 3-5.

121. *See* MARKET BREAK REPORT, *supra* note 6, at 2-8, 2-19 to 2-20. *See supra* notes 96–99 and accompanying text.

122. Longstreth, *Villains, Victims and Volatility After Black Monday*, Chi. Tribune, Apr. 5, 1988, at 15.

products (*e.g.*, futures and options) and advances in technology have vastly improved today's markets, they also have had undesirable side effects, including the potential for increased volatility.[123]

IV. The Post-October Market Break Regulatory Issues

The purpose of the foregoing discussion was to demonstrate that internationalization and related forces have had a dramatic impact on market structure worldwide. The process has also played a significant role in shaping the investment strategies and objectives of market participants. Notwithstanding the fact that major market centers have made determined efforts to retain their respective unique characteristics, they have been forced by international competition to assume some of the trappings of competing markets.

In many respects, the interdependence of individual capital markets is highlighted by characteristics they share. One such characteristic is their vulnerability to trading dominated by institutional investors whose concentrated market power can drive prices down as rapidly as it can drive prices up.[124] A second is that both the banking and securities industries increasingly are competing to provide the same services to investors and issuers.[125] A third is that international securities markets themselves are changing their structure to accommodate foreign customs, practices and laws in order to attract and retain listings and order flow, and thus may be harmonizing themselves into homogeneity.[126]

The emergence of a new global environment in which there are interdependent markets with common characteristics requires regulators to reexamine their approach to international securities regulation. In the past, some regulators have followed a laissez-faire approach, relying on the notion that the markets are efficient and will develop in the optimal manner if left to their own devices. Others, cautious about relinquishing any sovereignty, have resisted the concept of formulating international initiatives imposing substantive regulation on their markets. The narrow scope of the initiatives regulators have undertaken thus far reflects these attitudes.[127]

The October 1987 Market Break demonstrates that regulators worldwide should consider a different and potentially radical approach to regulating the international securities markets. Regulators wedded to the efficient market hypothesis[128] need to forego blind reliance on the theory as a justification for a

123. *Id.*

124. *See supra* notes 96–99, and accompanying text.

125. *See supra* notes 47–52 and accompanying text.

126. *See supra* notes 24–45 and accompanying text.

127. *See supra* notes 60–87 and accompanying text. Surveillance and information sharing, where the greatest strides have been made, involves enforcing existing laws, not imposing of new rules on the market. *See supra* notes 88–91 and accompanying text.

128. The efficient market hypothesis generally provides that the stock market responds rationally to

merely reactive regulatory posture. That theory provided a dubious basis for a rigid laissez-faire approach before October 1987, and an untenable one after October 1987.[129] While the unprecedented volatility of today's securities markets may reflect breathtaking efficiency, it also reflects an irrationality that should be cause for concern, if not action.

Notwithstanding lingering doubt in some quarters, there has been significant movement in the area of international cooperative regulation. Initiatives that regulators have pursued thus far have laid the groundwork for more comprehensive global regulatory action. These efforts demonstrate a cooperative spirit and a nascent awareness of market interdependence. The bilateral information sharing and surveillance agreements entered into by the U.S. and a number of other countries[130] evince the parties' recognition of the dual needs to obtain overseas cooperation in order to provide effective oversight of one's own markets and to assist others in overseeing their own markets. The spread of insider trading laws[131] demonstrates an understanding not only that certain regulations enhance the perception of a marketplace's integrity and fairness, but also that a single market will more easily integrate itself into an efficiently functioning global marketplace the less disparate is its regulatory system. The Rule 10b-6 and 10b-7 requests for relief[132] reflect the applicants' tacit acceptance of the SEC's position that these rules have extraterritorial effect, and the SEC's granting of relief reflects a willingness to accommodate these rules to the realities of globalization.

But for the October 1987 Market Break, regulatory initiatives in the international securities market probably could have continued to evolve slowly. However, the Market Break rather emphatically underscored the problems and weaknesses in our markets. In seeking solutions for these matters, regulators must adopt a balanced approach between doing something and doing nothing in order to avoid paralysis.

The task facing regulators in this regard is a weighty one, since the many reports on the Market Break,[133] and those yet to come, offer no definitive answer as to why U.S. markets declined so sharply in October 1987 and why the rest of the world followed. One explanation is that investor psychology and behavior changed such that investors became more dynamic; they changed their holdings

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available information and stock prices consequently reflect all such information. For the classic discussion of the hypothesis, see Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

129. *See Galbraith on Market's "Pixiation"*, Wall St. J., Mar. 11, 1988, at 39, col. 1; *"Efficient Market" Was a Good Idea — And Then Came the Crash*, BUS. WEEK, Feb. 22, 1988, at 140; Donnell, *Efficient-Market Theorists are Puzzled by Gyrations in Stock Market*, Wall St. J., Oct. 23, 1987, at 7.

130. *See supra* notes 88–91 and accompanying text.

131. *See supra* notes 80–86 and accompanying text.

132. *See supra* notes 67–69 and accompanying text.

133. *See supra* note 6.

in reaction to and in the direction of the market.[134] In addition, because institutions are the dominant investors whose investment strategies seem to reflect common tastes and beliefs, the situation inevitably led to a break in the assumed equilibrium of the so-called efficient market.

Regulators cannot prescribe investors' tastes or beliefs, nor proscribe a change in investor psychology. They can, nonetheless, influence these intangibles by focusing on initiatives that have a bearing on restoring investor confidence, an unobservable, unmeasurable but vitally important element to the stability of our securities markets. If incorrect beliefs can cause a break in the equilibrium of the market, regulators are correct to focus on investor confidence, particularly since it seems that the market increasingly reacts more to perceptions about what is happening in the market rather than to information on traditional investment fundamentals and economic conditions.

Based on the conclusions it drew from the Market Break, the SEC made a number of recommendations to Congress. Many of these recommendations are very specific and are directly tied to the structure and operation of the U.S. market. However, several of the recommendations are more universal in nature and thus very relevant to international markets. The SEC believes that the primary response to the Market Break should be to expand the capacity of the markets through operational reforms and coordination measures.[135] Thus, it specifically recommended, among other things, that the NYSE require increased specialist capital and that self-clearing specialists be required either to establish committed lines of credit or otherwise satisfy higher capital requirements.[136]

The SEC also suggested changes in the stock index futures markets to improve liquidity and alleviate the transmission of massive selling pressure and price instability to the stock markets. Thus, the SEC recommended, among other things, coordinated openings and closings with futures markets to follow the stock market. It also recommended harmonization of margin requirements and implementation of a coordinated credit, clearing and settlement system to decrease uncertainty about total risk exposures of market participants and enhance the flow of credit between markets.[137]

Certain of these recommendations may be implemented in the U.S. markets. Because of the global nature of the crises and market interdependence, it is reasonable to conclude that any U.S. regulatory initiative growing out of the October Market Break in the U.S. would be most effective if adopted internationally. International markets would benefit significantly if uniform or at least harmonious regulations were adopted in the areas of capital adequacy, margin

134. *See* BLACK, AN EQUILIBRIUM MODEL OF THE CRASH (1988) (unpublished paper on file with Michigan Journal of International Law).

135. *See* SEC RECOMMENDATIONS, *supra* note 101.

136. *See id* at 10. Self-clearing specialists process, compare, settle and finance their own securities transactions.

137. *See id.* at 18–19, 14–15, and 23–24.

requirements, position limits and coordinated credit, clearing and settlement systems.

The extent to which broker-dealers are engaged in international activities may have a significant impact on their ability to meet their obligations in any one situs. Thus, capital adequacy rules relating to both market risk and credit risk ought to be international in scope.[138] Moreover, they should take into account off-balance sheet financing,[139] the need to harmonize pertinent accounting principles[140] and the new multilateral bank standards.[141]

Although the SEC recommended increasing margins in the futures markets to a level consistent to stock margins, it is not at all clear this suggestion will be acted upon. However, if it is, margin requirements should be harmonized internationally. Experience during the Market Break demonstrated that traders unable to effect futures transactions in the U.S. did so in London.[142] To the extent that regulators determine margin requirements are necessary to dampen speculation and provide order in the futures and equity markets, these initiatives will be most effective if they are applicable in all major markets to which an investor has access.

The rationale for increasing stock index futures margins is to reduce the high degree of leverage that futures traders possess in relation to the stock market.[143] That rationale applies to the international markets as well. It is clear that lower margins in the futures markets encouraged institutions to increase their holdings by buying futures as a substitute for stock or as a hedge for long stock positions.[144] If institutions transfer this trading offshore, the long-term result will simply be creation of the same selling pressure in overseas markets that the U.S.

138. The SEC's net capital rule, 17 C.F.R. § 240.15c3-1 (1987), establishes requirements for U.S. registered broker-dealers that generally are based on the market risk of inventory positions, but does not apply to affiliates that are not registered in the U.S. or are located overseas.

139. In the U.S., the Financial Accounting Standards Board ("FASB"), which establishes U.S. Generally Accepted Accounting Principles, is developing broad standards for accounting for new financial instruments and transactions that currently are not fully reflected in corporate financial statements. *See FASB Moves to Improve Financial Instruments Disclosure*, FIN. EXECUTIVE, Mar.–Apr. 1988, at 18. The transactions under review include activities such as interest rate swaps that broker-dealers generally conduct through unregistered affiliates.

140. Work is underway in this area under the auspices of the International Federation of Accountants. *See* Jayson, *IFAC's Traveling Salesman*, MGMT. ACCT'G, Oct., 1986, at 22. To date, more progress has been made with auditing standards than with accounting standards. *See Acceptable Global GAAP Still Far Off, Audit Rules Moving Already, Sampson Says*, 19 Sec. Reg. L. Rep. (BNA) 529.

141. *See* Friesen, *Comparative Bank Capital Guidelines*, 3 FED. REV. FIN. SERV. REG. S&P 113 (1987); *Global Capital Adequacy Test Mulled for Broker Units*, INVEST. DEALER'S DIG., Mar. 7, 1988, at 6.

142. *See* MARKET BREAK REPORT, *supra* note 6, at 2-10 to 2-11, 2-17 n.59, and 11-4.

143. *See* SEC RECOMMENDATIONS, *supra* note 101, at 14.

144. *See* MARKET BREAK REPORT, *supra* note 6, at 3-20.

markets experienced on October 19, 1987, with the potential of triggering another global crisis.

Position limits also act as a dampener on the trading markets. To the extent they exist, they are generally designed to control price volatility by controlling the amount of a product that can be purchased and thus sold by a single investor.[145] Standards and rules with respect to position limits should certainly be coordinated among markets both domestic and international. The position limits need not be identical in every market place but they should be required to be aggregated so that they serve their purpose as a dampener on volatility in times of crisis.

One of the most important areas to be addressed in the aftermath of the October Market Break is the U.S. clearance and settlement systems. Effective clearance and settlement systems are the backbone of an efficiently run market. Although U.S systems performed reasonably well during the October Market Break, based on SEC findings, steps will undoubtedly be taken to coordinate and harmonize clearance and settlement across U.S. stock, options and futures markets in order to reduce the costs and risks of operational and financial failure in periods of volatility. Parallel, coordinated international initiatives should be undertaken to facilitate cross-border settlements. For example, initiatives to increase automation; develop compatible systems, and standardize or harmonize settlement cycles, delivery requirements and standards relating to financial responsibility and operations would be very beneficial.

V. The Need for a New Approach to International Securities Cooperation

The October Market Break demonstrated that financial markets, although separate and distinct, are interdependent and thus function with a ripple effect. Therefore, unlike manufacturing industries or other service industries, financial markets cannot seek disparate solutions to common problems without risking calamitious results. Consequently, a new approach to international securities cooperation is needed in order to address effectively the regulatory issues discussed above. Comparable rules for the major markets worldwide should be devised in certain specific areas, and multilateral negotiations may be the most efficient means to achieve this objective.

Thus far, bilateral negotiations have been the principal means by which international regulatory cooperation has been achieved. Indeed, such negotiations have provided a very effective and efficient vehicle for developing arrangements

145. *See* SEC Recommendations, *supra* note 101, at 32. The SEC, however, concluded that it would not be necessary to decrease or aggregate position limits if other recommended measures were implemented.

for sharing information, obtaining assistance in enforcement investigations and promoting worldwide market surveillance.[146]

The appeal of bilateral agreements is that they may be formulated and implemented as rapidly as the parties desire. More importantly, they may be tailored to the specific goals of the parties. Thus, in the experience of the SEC, the informal bilateral agreement has proven a very useful tool in obtaining assistance from abroad in enforcement matters. Its usefulness is due in no small measure to the fact that the bilateral agreement has permitted regulators to develop the concept and scope of international cooperation in the securities area over a period of time. This evolutionary approach permitted the fact of cooperation to proceed while the concept was refined in accordance with experience. Given their success, regulators should continue to pursue bilateral agreements.

However, informal bilateral agreements may be, in the words of the noted economist Henry Kaufman, ". . . inadequate to deal with the vicissitudes in the international financial area."[147] Mr. Kaufman suggests creating an international institution with the authority to set uniform trading, accounting, capital and disclosure standards for the international markets and the professionals that operate in them.[148] Mr. Kaufman is on the right track in his views about the problem to be solved; however, an international institution may not be the best way to achieve those objectives. One major obstacle would be finding a way to clothe an independent institution with the authority to dictate standards to governmental agencies. It may be just as quick and efficient to negotiate multilateral agreements as to obtain membership approval of the dictates of an international institution.

To date, cooperative regulatory efforts in the international securities markets have not generated multilateral agreements, in part because of concerns about sovereign independence and the impracticality of obtaining agreement among several parties. Nevertheless, lessons learned about the interdependence of the international securities markets as a result of the October Market Break suggest that multilateral negotiations are an approach that should be explored in formulating a response to the global market break.[149] For example, the problems identified in Part IV as being potential subjects for new international regulatory initiatives are common to most of the major markets, in that they either are related directly to operations of international securities firms or they reflect universal vulnerability in the various markets. Addressing such problems on anything less than a multilateral basis would ignore the fact of interdependence and could

146. *See supra* notes 88–91 and accompanying text.

147. Kaufman, *The Dangerous Volatility in the Financial Markets Isn't Going Away*, Wash. Post, Feb. 4, 1988, at A23, col. 3.

148. *Id.*

149. *See Global Bank Rules to Limit Securities Risks are Urged*, Wall St. J., Feb. 2, 1988, at 45, col. 3.

result in disparate standards that might ultimately trigger or aggravate another market disruption.

Furthermore, failing to deal with these regulatory issues on a multilateral basis could result in rules and regulations becoming pawns in the intermarket competition for listings and order flow with potentially deleterious effects. It would be most unfortunate if the quest for integrity, fairness and liquidity in our international markets were undermined by an individual market's desire to attract business at the expense of these goals.[150] An institutional investor engaged in program trading can wreak as much havoc in London or Hong Kong as in New York. Of course, any move to multilateral agreements must not ignore the premise that markets are distinct and have their own unique character which should be preserved. Nevertheless, there are certain specific areas in which significant benefits are to be derived by having the objective of national independence give way to the imperative of global interdependence.

Under certain circumstances, multilateral negotiations may not only be sound policy but also may be practicable. International regulators have been discussing general policy questions for some time at meetings of groups such as the International Organization of Securities Commissions and the International Federation of Stock Exchanges. The regular meetings of these and other groups have fostered a sufficient spirit of cooperation among regulators that it may be feasible to move beyond general discussions to concrete multilateral negotiations. The key to success will be to ensure that any proposed initiatives are narrowly focused responses to clearly identified problems.

Having concluded that multilateral agreements imposing international rules or procedures are likely to be beneficial in resolving the problems identified in Part IV above, the threshold question persists, namely what the optimal vehicle for attaining this goal is. The possible alternatives are multilateral negotiations among: (1) sovereign governments, resulting in treaties binding upon all signatories after ratification; (2) regulatory agencies and their counterparts, resulting in agreements to propose administrative rules for adoption in their respective countries; and (3) the SROs, resulting in similar agreements. Each of these alternatives has its advantages and disadvantages as is more fully discussed below. However, considering the costs and benefits associated with each approach, multilateral negotiations between SROs presently appear to be the best approach.

A. *Treaties*

Sovereign governments interested in effecting international accords generally do so by negotiating treaties. The decision to bind a nation to a treaty implicates serious matters of national policy; in part due to this factor, the processes by which treaties are negotiated, executed and ratified are very time consuming and

150. *See A Post-Mortem on the Market Crash,* Fin. Times, Feb. 11, 1988, at 12, col. 1.

cumbersome. Unfortunately, the complexity of the process may be directly proportionate to the number of persons involved rather than the nature or scope of the subject. For example, negotiation of a treaty on securities regulation by the U.S., no matter how specific and narrowly focused, would probably involve the Departments of State, Justice, and the Treasury in addition to any number of other agencies, including state regulators, having an interest in the regulation of the financial services industry and therefore, by extension, our capital markets. Each department and agency may be expected to bring its own special interests and expertise to bear on the problem at hand.

Of course, the SEC already consults with various agencies with respect to the formulation of bilateral agreements such as those negotiated by the SEC during the past four years. However, in the context of treaty negotiations, as opposed to a negotiation of informal memoranda of understanding, the process is far more intricate and therefore more cumbersome. Departments and agencies other than the SEC would expect and indeed undoubtedly demand to act and be regarded as principal participants, rather than mere consultants, in the negotiation process.

Finally, treaties must be submitted to Congress for ratification. It is doubtful that a narrowly-drawn treaty dealing with international regulation of the securities markets would provoke the controversy or hostility encountered by other political issues such as the trade negotiations with Canada or the disarmament negotiations with the Soviet Union. Nevertheless, whether Congress would act promptly to ratify any such treaty, or would ratify it at all, is open to question.

There are several reasons to view congressional ratification as a serious potential pitfall. One is that there is no certainty that Congress will act, even if a proposed treaty is non-controversial. Frequently, Congress does not take legislative action where there is no political capital to be gained by or from doing so. A second is that Congress has demonstrated over the past decade or so that it lacks the will or the capacity to act decisively on financial issues except perhaps in crises situations. For example, non-action on numerous legislative proposals dealing with important issues to the financial markets such as tender offers and the repeal of Glass Steagall have demonstrated that, at times, Congress is not effective in striking the compromises necessary to reconcile competing interests that are a natural occurrence in a pluralistic society. In fact, there is currently considerable speculation that Congress will elect to do nothing in the face of the October Market Break, not even the limited and yet logical response of merging the regulatory oversight over securities and futures on stock indexes into a single regulatory agency, namely the SEC.

The process and procedures applicable to the negotiation and ratification of an international treaty are quite similar in other nations. Therefore, one would expect to encounter similar problems. An example of the amount of time that is or can be consumed in negotiating treaties can be found in the experience of the EC and its efforts adopt uniform rules concerning the sale of collective investment vehicles within the common market. The EC has, as part of its charter, a commitment by each and everyone of its members to further their common interests to the extent possible through eliminating barriers to international commerce and achieving uniformity of laws. Notwithstanding this commitment, it required ten years for the EC to negotiate the substance of the directive relating to the cross-border marketing of collective investment vehicles. Moreover, although this directive was adopted by the EC in 1986, member states have until October 1989 to complete the unification process.[151]

B. Administrative Rules

Another approach to multilateral agreements on securities regulation would be for agencies such as the SEC and its counterparts in other countries to negotiate standards for international securities transactions and market participants. The agencies would then adopt the standards as rules in their respective countries. Placing the negotiation of international multilateral accords within the administrative process has great potential. It avoids the complications of having to defer to other governmental agencies,[152] and also avoids the political quicksand of trying to sell a proposal to legislatures. It may also be presumed that a rulemaking initiative will probably require substantially less time than adoption of a treaty because an agency such as the SEC has control over its own processes. Thus, one can conclude that the administrative approach would be considerably less time consuming and burdensome than proceeding by way of national treaty because third parties would be eliminated from the negotiation and adoption stages.

Although it would avoid many of the pitfalls involved in the negotiation and ratification of a treaty, the administrative approach has its own problems. The SEC is subject to the Administrative Procedure Act ("APA")[153] and generally may not, therefore, adopt rules unless it provides notice and an opportunity to comment to persons affected by the proposed rule.[154] This procedure can require as little time as sixty days and as much as six to twelve months depending on whether the rule is complex or controversial.

One significant drawback to the administrative process as currently practiced under the APA is that, based on precedent and tradition, an invitation to comment presupposes that the SEC will react to comments made. This complicates matters when the proposal being commented upon is one whose terms have already been negotiated with the expectation that they would not be changed substantially. If

151. *See* 28 O.J. EUR. COMM. (NO. L 375) 3 (1985); *SEE ALSO* INTERNATIONALIZATION STUDY, *supra* note 15, at IV-18 to VI-21.

152. Of course, any negotiations between an independent agency such as the SEC and its foreign counterparts would be undertaken in consultation with other U.S. agencies so that their views could be taken into account.

153. 5 U.S.C. § 551–59 (1982).

154. *Id.* § 553(b)(c).

this expectation is to be honored, it could be argued that the opportunity to comment on any proposed international regulatory scheme is essentially meaningless and therefore in violation of the APA. This problem could be avoided to some extent by conducting parallel negotiations with representatives of the securities industry while the multilateral accord was being negotiated with other regulators; but this would presumably lengthen the negotiations. Another alternative already in use at the SEC is to seek comment on the *concept* of a rulemaking initiative and then take the comments into account when negotiating the rule.[155]

A second significant drawback to the administrative approach is that not all of the major markets have independent governmental agencies such as the SEC with jurisdiction over the securities markets and authority to adopt rules affecting those markets and market participants. For example, in Canada, France, Australia and Hong Kong, there are governmental agencies with jurisdiction over the securities markets. The Canadian agencies[156] have powers that generally parallel those of the SEC. However, the French agency[157] does not have the authority to adopt rules without parliamentary approval. The Australian and Hong Kong agencies' respective jurisdictions[158] are sufficiently different that it would be difficult to work out a uniform procedural approach to a common problem.

There are no independent governmental agencies with powers approaching that of the SEC in countries such as U.K., The Netherlands, the Federal Republic of Germany, or Japan, where the primary regulators are the stock exchanges or other SROs operating under the oversight of the finance ministries (or, in the case of U.K., the Department of Trade and Industry).

C. *Self-Regulatory Organizations*

The final alternative is to take the first step toward negotiating multilateral agreements through SROs such as the NASD and the various exchanges. The SROs in major markets, regardless of the differences in the scope and nature of their authority, have jurisdiction over most market participants through a registration process and the power to adopt rules and regulations establishing the conditions upon which membership in the SRO may be acquired and maintained.

155. For example, the SEC has solicited comment on alternative conceptual approaches for facilitating multinational offerings. *See* Sec. Act. Rel. No. 6568, 50 Fed. Reg. 9,281 (Feb. 28, 1985). The SEC is still considering how best to move from the concept stage to the rule proposal stage.

156. Securities regulation in Canada is the responsibility of the individual provinces. The regulators of the Canadian provinces in which much of that country's securities business takes place are the Ontario and British Columbia Securities Commissions and the Commission des valeurs mobilieres du Quebec.

157. The Commission des Operations de Bourse is the French securities regulator.

158. The National Companies and Securities Commission regulates the Australian securities markets, and the Office of the Commissioner for Securities and Commodities has that authority in Hong Kong.

There are many advantages to having multilateral international regulatory initiatives conducted through SROs. First, most exchanges are as informed and knowledgeable as governmental agencies about the prevailing problems of the international securities markets, including those manifested during the recent October Market Break. Moreover, since the exchanges are the markets, they may be more sensitive and knowledgeable about the nuances and intricacies of market operations and thus may be in a position to develop tailor-made solutions to perceived problems. Experience teaches us that business people, if properly motivated, can and do move expeditiously on a project. Negotiating multilateral accords should be no different. The exchanges can readily and easily communicate the nature and scope of any proposed regulatory initiative to their members in a less formalistic and presumably less time consuming manner than governmental agencies. Informal consultations with governmental oversight agencies should also speed up the approval process to the extent that there are systems like that existing in the U.S., which require any rule adopted by an SRO to be approved by the governmental agency having oversight responsibility.[159]

It seems that negotiations between SROs would be the best way to achieve multilateral agreements regulating the securities markets. One of the advantages is that the process could be undertaken with the encouragement and under the oversight of government regulators but nevertheless independent of them. In light of the fact that the areas most in need of multilateral action are generally within the jurisdiction of the SRO's (i.e., capital requirements, trading restrictions and clearance and settlement systems), the SROs are likely to be willing to pursue multilateral agreements simply as matters of good business and competitive advantage if they are persuaded that such initiatives will enhance the integrity and fairness of the marketplace and consequently boost investor confidence in those markets. Recent experience with U.S. SROs' reactions to problems which surfaced in their markets during the October 1987 Market Break is instructive and, to a certain extent, comforting in that regard.[160] To the extent that SROs are recalcitrant about pursuing needed accords, their government overseers have the ability to encourage them to action.[161]

159. In the U.S., however, this process is complicated by the fact that SRO rule proposals are subject to notice and comment procedures similar to those imposed by the APA upon the SEC. Those procedures are mandated by § 19(b) of the 1934 Act, 15 U.S.C. § 78s(b)(1982), and Rule 19b-4 thereunder, 17 C.F.R. § 240.19b-4 (1987) SRO rule changes generally are approved with little or no modification following the notice and comment period. That should certainly be the case for those that result from multilateral negotiations about which the SEC was consulted.

160. The exchanges and the NASD did not hesitate to take immediate and vigorous regulatory steps to resolve these problems. *See The October Market Break: Hearings before the Senate Committee on Agriculture, Nutrition and Forestry,* 100th Cong., 2d Sess. (Mar. 17, 1988)(testimony of David S. Ruder, Chairman, U.S. Securities and Exchange Commission), at 8–21; *Id.* at Appendix A.

161. The U.S. stock exchanges' development of the Intermarket Trading System, *see supra* note 30, provides one such illustration. The exchanges developed this system so that the SEC would not

VI. Conclusion

Internationalization has had a profound and far-reaching impact on the world's securities markets. The changes brought about by the internationalization process will not disappear even though the way they are manifested will vary depending on the ebb and flow of the economic currents in the markets. Since global securities markets have become a permanent, albeit ever-changing, part of the regulatory landscape, regulators must be prepared to deal with the interdependence, volatility and other factors affecting those markets. This article suggests a benefical approach to regulatory action. Whatever regulatory initiatives are pursued, they should take into account that the market is not one-dimensional. It is efficient at times and inefficient at others. It can be rational and emotional, act on knowledge or react in ignorance and uncertainty. All of these attributes must be kept in mind in formulating any regulatory response to the current market problems.

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force upon them a form of linkage that they deemed a threat to the continued viability of their trading. *See* J. Seligman, *supra* note 1, at 523–33.