January 1988

Remarks on The Internationalization of the Securities Markets

Cynthia C. Lichtenstein
Boston College Law School, cynthia.lichtenstein@bc.edu

Recommended Citation
Cynthia C. Lichtenstein. "Remarks on The Internationalization of the Securities Markets." *American Society of International Law 82nd Annual Meeting* (1988).

tently or casually acquires inside information without realizing that it is inside information.

As is true for any directive, the EEC itself will not prohibit insiders or tippees from trading on the basis of inside information, but instead mandates the member states to pass new (or harmonize existing) legislation to this end. The nature of the penalties is to be left to the member states, but presumably they should impose both fines and jail sentences as appropriate penalties. There is no reference to private civil actions for damages, which would leave this as strictly optional, within the discretion of the member states.

The draft directive on insider trading is quite interesting, as it marks a new stage in the evolution of EEC securities law harmonization. It is currently in the process of review by the European Parliament. The prognosis for ultimate passage of a modified draft is quite favorable, although this will undoubtedly take another year or two.

That concludes my review of EEC securities law harmonization. It is clear that the EEC has achieved an extraordinary level of harmonization within the last decade. Further substantial attainments can be expected by 1992.

REMARKS BY CYNTHIA C. LICHTENSTEIN*

Linda Quinn and Roger Goebel spoke about harmonization in the field of securities law, harmonization of rules for the listing of securities and for trading, essentially at the point of issuance and in the primary markets. I'm going to address something quite different, the next step in ensuring the stability of the global financial system: convergence of capital adequacy requirements for multinational securities intermediaries.

This topic concerns the issue of convergence in "safety and soundness" requirements imposed on the actors in the internationalized securities markets by various countries. That may seem to you a very strange concept since the conventional wisdom is that, while consumer protection requirements can be harmonized, prudential regulation cannot be. Conventions recently have been proved wrong. We have heard a great deal in the last few years about international economic coordination—it is sometimes called the convergence of national economic policy. The reasons for that kind of convergence have to do with the basic requirements for underpinning the stability of the international monetary system and do not implicate regulation of private actors in the system. But many of you also may know about a rather momentous event that took place in December 1987. The central banks of the 12 major industrialized nations—the Group of Ten plus Switzerland and Luxembourg—announced agreement upon a framework of capital adequacy requirements for multinational banks, the Basle Agreement.[1] The idea that it is necessary for the industrialized nations to create a common minimum standard of capital adequacy for banking organizations is starting not to sound so strange anymore.

We all are aware that the safety and soundness of banks is very important to the stability of the international financial system. However, in the case of the Basle Agreement, no one really expected that that agreement would be achieved. In 1982, there was a panel at the ASIL Annual Meeting on the topic of "Cooperative Efforts in International Banking Regulation," and one of the panelists, Paul L. Lee, who had been Superintendent of Banks in New York, described efforts at international coordi-

*Professor of Law, Boston College Law School.

[1] 27 ILM 524 (1988).

nation of prudential requirements as being rudimentary.[2] Yet now, only six years later, there is an agreement that will be enacted by the national regulators, since it is their own proposal, and that will force multinational banks to increase their capital substantially. These harmonized requirements are also "risk-based", which is to say, capital will be measured not only against loans or banking assets, but also against exchange rate swaps, interest rate swaps, transactions called NIFs and RUFs,[3] and other new kinds of transactions with which multinational banks deal in the international capital markets. Generally all off-balance-sheet transactions will be covered and capital required to be held against them. Most remarkable, however, is that 12 different central banks, with 12 different ways of regulating the condition of the respective banking institutions, have agreed upon a common framework of requirements with national discretion only in the most minor details.

What, however, does all this have to do with securities firms? To us in the United States, because of the separation of commercial banking and investment banking still maintained in the Glass-Steagall Act, securities firms and banks are thought of separately, and there is very little public recognition of the need for regulation of safety and soundness for securities firms. We don't think that way. The public, particularly after October 19, 1987, is peripherally aware that there are risks, and that the SEC has net capital requirements for broker-dealers. But such requirements tend to be thought of as a matter of investor protection. The rationale for the net capital rules seems to be the hope that if a major securities firm were to fail, there would be sufficient liquidity so as to ensure that the customers could get back their securities. The result of this attitude is that the net capital rules do not seem to have been taken very seriously. For example, in a recent SEC stock "parking" charge, the legal defense raised (among others) was, in effect: "SEC, you really haven't enforced this before. Why are you suddenly coming down on us now?"

The reason is, of course, October 19, 1987. With October 19, 1987 came the recognition that the stability of the global financial system is threatened by the possibility of major securities firms failing. In the week of October 19th there were a number of events in the markets that bear closer examination. The central banks in all the markets that were collapsing on October 19 and 20 were required to provide massive amounts of liquidity to the securities firms to prevent systematic failures. In New York City, the 10 largest banks' access to the Federal Reserve Bank's discount window almost doubled their advances to broker-dealers that week. The Bank of England, the British central bank, provided market support for a British Petroleum privatization offering, claiming the markets and putting a floor on underwriting losses. In Hong Kong, a credit package for the Market Guaranty Corporation included participation by the two major entities that in effect perform the lender-of-last-resort function in that financial center.

There is thus now, since October 19th, more general recognition of both the interconnectedness of the capital markets and of the necessity for concern with the sound-

[2][1982] PROC. AM. SOC. INT'L L. 353.

[3]NIFs and RUFs are transactions in which a bank that is acting as a sales agent for a corporate issuer's notes (NIF = Note Issuance Facility; RU = Revolving Underwriting Facility) promises the issuer that if the notes do not sell as anticipated, the bank will make a loan to the issuer in the amount of the unplaced notes. The financial statements of the bank do not reflect this promise, since it is a contingent one, but the bank is incurring a risk that it will be making a loan to a corporation at the very moment that the market has decided it does not wish to hold the corporation's obligations. Hence a system of capital adequacy requirements that takes risk into account will require capital to be held against the bank's contingent obligation under the Note Issuance Facility.

ness of the major actors in those markets, the major international securities firms. Similarly, there is now much more general recognition that the international trading in securities denominated in dollars is paid for through the Clearing House International Payments System (CHIPS) and that the multinational banks that participate in that system are themselves or their affiliates are the major securities houses in countries other than the United States and Japan. It was the connection between the failure of Bank Herstat in 1974 and the CHIPS system that originally triggered the formation of the Basle Supervisors' Committee by the central banks meeting at the Bank for International Settlements in Basle. It now may be the recognition, in the wake of October 1987, of the interconnectedness of the actors in the capital markets and the international financial system that has triggered concern with the capital adequacy of the major securities firms. The process of coordination by banking authorities and securities administrators of capital adequacy requirements for multinational securities firms will not be easy, but I will venture to predict that in the next four to six years we shall see international agreement on capital adequacy requirements for securities firms in the international capital markets.

Four years ago, people would not have agreed with that prediction, but four years ago no one would have believed that the Basle Agreement for capital standards for multinational banks could be achieved. This is not to minimize the difficulties of harmonization in this field. The Basle central bankers at least had a common culture of supervision and control over their respective banking systems. The degree of market regulation exercised by the SEC is probably unique among securities regulators, even as the United Kingdom just now is thrashing out its new forms of supervision under the Financial Services Act of 1986.

An agreement by the supervisory authorities concerned with international securities firms will be even more complex than the working out by the banking supervisory authorities of the Basle framework for capital adequacy. An official of the Bank of England, Rodney Gilpin, gave a talk at an International Law Association Seminar on the Internationalization of the Capital Markets held shortly after October 19th. Mr. Gilpin described the difficulties in working out the concept of "lead regulator" in the United Kingdom where many of the participants in the markets are both clearing banks and major securities organizations.

The United Kingdom, unlike the United States and Japan, permits its major clearing banks with access to the international payments system also to conduct, in the same entity, or in affiliates of the bank, full-scale securities operations. Mr. Gilpin pointed out the difficulties this makes for the supervisor concerned with soundness. He noted that the Basle group has worked out capital adequacy requirements for banks on the basis of credit risk. When we think conceptually, said Mr. Gilpin, about what is necessary for capital adequacy for securities firms, then the concern is with something called position risk. In short, the banking supervisors focus on credit risk; the securities regulators, to the extent they do consider capital adequacy for securities trading firms, focus on position risk. Thus, in the new world of concern with the soundness of integrated financial entities doing both a banking and a securities business, the regulators will have to learn how to work together. Moreover, the regulators will have to think about what is position risk in markets that are behaving, as they have since October, with extraordinary volatility. What level of capital is needed to support an underwriter's or trader's business when suddenly the portfolio has fallen 500 points? It's unprecedented. So, at least in the United States and the United Kingdom, the supervisors are only beginning to think about it. Mr. Gilpin's talk then went on to describe the U.K. efforts to work out which supervisor would be the lead regulator for firms that are simultaneously in the international banking markets and the international securities markets.

At the time Mr. Gilpin spoke, it had been agreed that the Bank of England would be the lead regulator for organizations that combine in one corporate entity both the banking business and the securities business, and to the extent that the banking business exceeds the quantum of the securities business, the Bank of England will be the supervisor both of its own capital adequacy requirements and also of the Security and Investment Board's capital adequacy requirements. To the extent that there are organizations with separate affiliates doing separate businesses, then the proposal is to have a committee of the supervisors meet to administer the separate capital adequacy requirements. What has not been worked out fully is the capital adequacy requirements that will be imposed by the Securities and Investment Board. As of this writing, those requirements were much less clear than the capital adequacy requirements being imposed by the Bank of England, which will follow the rules of the Basle Agreement.

I have discussed the U.K. work on who will be the lead regulator because if one is trying to work out a convergence of capital adequacy requirements for organizations in the international capital markets, it will be necessary to take into account the need for agreement between the banking supervisors and the securities regulators. Who is going to do the job of setting the ultimate standard for capital adequacy as between the securities regulators and the banking regulators? We will, of course, face here in United States exactly the same problem because Glass-Steagall's "wall of separation" between banking and the securities business in the United States will not remain. The Senate passed, on March 30, 1988, the Proxmire bill which largely will dismantle Glass-Steagall[4] if the House agrees to a similar bill. We do not know as of this writing if the House will enact the Proxmire bill or similar legislation this session, but I believe that sooner or later a restructuring of our financial markets regulation will occur and probably will resemble the Proxmire bill.

When this big event does occur, it will be necessary for the banking regulators and the securities regulators to start talking together about capital adequacy requirements for the new combined organizations. The Proxmire bill recognizes this and provides for it. The Proxmire bill contains a most interesting provision and is the reason why I think we ultimately shall have international convergence of capital adequacy requirements for securities activities. Sec. 111 of the Proxmire bill, entitled "Study on Harmonizing the Regulation of Banking and Securities Organizations", requires the SEC, the Commodity Futures Trading Commission (CFTC) and the banking regulators to come together on harmonization of domestic requirements, working out who will be the lead regulator and how capital adequacy and reporting requirements will be done when the securities activities and the banking activities are combined, but the regulators also are directed to include in the study what is being done in terms of efforts to achieve international harmony and convergence of capital adequacy and financial condition reporting standards for banks, securities firms and companies controlling banks and securities firms. The study is also to comment on

> the advisability of establishing a permanent international framework for developing and implementing global policies to better harmonize financial market regulation, including capital adequacy standards; registration and reporting standards for banks and securities firms (including associated activities in futures markets), and companies controlling banks and securities firms; direct trading, clearing, and funds transfer mechanisms; routine exchange of information to facilitate in-

[4] S. 1986, 100th Cong., 2d Sess. (1987), 134 Cong. Rec. S3437 (March 30, 1988).

> ternational market surveillance of capital positions, trading activity, intercompany transfers, and potential abusive practices; exchange of information to facilitate the investigation of individual enforcement cases; dealing with international market emergencies; and approval of new products and services; . . .

Section 111(c) of the Proxmire bill specifically requires consultation of all the regulatory agencies, that is, the U.S. agencies with their international counterparts. The Senate Report on the Proxmire bill states that the purpose of consultation is to have the agencies "develop proposed revisions to harmonize the capital adequacy of banking and securities organizations using the recent international agreement among bank regulators as a model.[5]

These provisions in the Proxmire bill are, I think, a clear indication of the seriousness with which the regulatory harmonization process for this area is regarded. There are other indications also. Very recently the securities regulators of the industrialized nations have organized themselves into the International Organization of Securities Commissions (IOSCO) modeled consciously along the lines of the Basle group of banking supervisors. IOSCO's Technical Committee was set up in May 1987 and meeting in July, created five separate working groups, one of which was to discuss definitional and capital adequacy maintenance for multinational securities intermediaries, as well as exchange of financial data.[6] This group was scheduled to meet in February 1988 in Paris. I have been unable to find any public report of that meeting, but my guess would be that the group is concerned with the problems of working out a common scheme. I think we will see in a few years an international agreement on the amount of capital securities firms must have to support their dealing and underwriting activities in these international markets.

Comments by Gerhard Wegen*

It's hard to comment upon what has been said previously by the eminent members of this panel. Yet I do want to venture some comments. First of all, I have been in this country for three or four days meeting a couple of securities lawyers, and they all said, "Oh, what a topic, Internationalization of Securities Markets." It is difficult to pin down what the meaning of the term is. I just venture to say that, if we look at the internationalization, we first should look at the national systems that underlie these international markets. We have seen here today an outline of the EEC position, which is very interesting because it is a highly regulated jurisdiction, and we have seen what the EEC is proposing to do. It is a somewhat regulatory approach. And we have heard the capital adequacy comments, and they are also very interesting.

I want you to understand what is perhaps a continental approach to the internationalization of securities markets, and I want to highlight some of the structural idiosyncrasies of Germany as an example of a continental jurisdiction that is totally different from securities regulations in the United States. The way in which we discuss internationalization is very different. I think it is essential for practitioners to understand first of all at least what the requirements are in another jurisdiction when they enter into it, because they will have to cope with the domestic regulations. We have to cope with the EEC rules, and I guess foreigners have to cope with what is present in Germany.

[5]S Rep. 305, 100th Cong., 2nd Sess. (1987), to accompany S. 1886, at p. 73.

[6]19 SEC. REG. & L. REP. 1303 (8/21/87).

*Of the Bar of Stuttgart, Federal Republic of Germany; of the New York Bar; licensed foreign attorney, Brussels, Belgium.