

# Cornell International Law Journal

---

Volume 28  
Issue 2 *Spring 1995*

Article 5

---

## Current Trends in International Securities Regulation

Simon M. Lorne

Follow this and additional works at: <http://scholarship.law.cornell.edu/cilj>

 Part of the [Law Commons](#)

---

### Recommended Citation

Lorne, Simon M. (1995) "Current Trends in International Securities Regulation," *Cornell International Law Journal*: Vol. 28: Iss. 2, Article 5.

Available at: <http://scholarship.law.cornell.edu/cilj/vol28/iss2/5>

This Article is brought to you for free and open access by Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell International Law Journal by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact [jmp8@cornell.edu](mailto:jmp8@cornell.edu).

# ADDRESS

*Simon M. Lorne* \*

---

## Current Trends in International Securities Regulation

Ideally, I would like to discuss the international aspects of securities regulation as Americans think of securities regulation and to tie everything together neatly. However, if there is a way to do that, I haven't discovered it.

In fact, American securities regulation has evolved over a period of some sixty years since the adoption of the Securities Act of 1933 and the Securities Exchange Act of 1934, and that evolution has taken place almost entirely in a domestic economy. For many years, America had the luxury of viewing itself as a large island with big oceans between it and the nearest country because, for the most part, Canada and Mexico were not really thought of in this context as foreign countries. As a result, our pattern of securities regulation developed virtually without regard to the international market.

Today, when we talk about the relationship between U.S. securities regulation and international securities markets, I think the only realistic way to do so is to look at the different ways in which American securities regulation operates and to see how each of those is affected by the international environment. It is perfectly clear today that we can no longer view ourselves as a self-sufficient island that doesn't need to pay attention to the rest of the world the way we could—or at least did—twenty, thirty, or fifty years ago.

For example, we have heard much about abuses involving derivative financial products and what happens when people and companies engage

---

\* General Counsel, Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, the Chairman, any Commissioner or any other member of the staff of the Commission. 17 C.F.R. § 200.735-4(e)(2)(ii) (1995). Additionally, certain matters discussed in this outline may be issues in litigation in which the Commission appears as a party or otherwise, and no statement made in this outline should be considered indicative of the views or positions that might be taken by the Commission in any such litigation. This address was delivered at Cornell Law School on May 1, 1995.

in transactions in such derivatives without paying sufficient attention to what they are doing. We have observed the consequences of carelessness in a number of areas. One of the most significant recent instances of loss from derivatives transactions occurred about one and one-half years ago with Metallgesellschaft, a German operation that had a very significant effect on a number of American companies.

Not too long ago, I was awakened fairly early in the morning with the news that a candidate for the office of President of Mexico had been assassinated. We, at the SEC, were in the office that morning monitoring international markets, and considering a request to halt the trading of Mexican securities in the United States. Ultimately, the markets agreed to a brief halt to allow that news to settle in so that investors could make informed decisions.

Most recently, there was the Barings PLC fiasco, which turned out not to have the enormous consequences that many of us first feared, but clearly illustrated the growing importance of globalization of the securities markets.

Every one of the major securities firms today has offices around the world and trades securities twenty-four hours a day. The flow of capital doesn't really have much respect for different regulatory regimes. It goes where the capital can most effectively be employed. Quite often, the impact of a regulatory regime is to artificially affect the economic decisions that would otherwise be made. I will talk more about that later, but it is perfectly clear that globalization of the securities markets is upon us.

At a different level, as I speak, we at the SEC are conducting a seminar for international securities regulators. It is the fifth annual seminar and in it we bring a number of securities regulators from emerging markets to the SEC headquarters in Washington, D.C. Our staff members talk to them for two weeks, eight hours a day, about how we regulate securities activities in the United States, so that we can help them think about their own securities regulation regimes.

In an interesting way, the experience with these foreign regulators poses what I view as the flip side of a question I was asked recently—whether Barings PLC would have been possible if American securities regulation circled the globe. There is a question that I like to ask when I talk with regulators from emerging markets (and we think primarily, though far from exclusively, about Eastern Europe in that regard): if we took 1995 American securities regulation and imposed it on the American securities markets of 1900, would those markets have been able to develop the way they did? I believe that people who study American securities regulation would benefit from pondering this question. It is useful for us to force ourselves away from the chauvinistic mindset that says “what works for America today is what ought to be everywhere today.” That isn't to say that foreign jurisdictions can't learn from our experience. One hopes that we can all learn from each other's experience. However, we should exercise some caution in exporting a fully developed regulatory system to a marketplace that is less than fully developed.

I will now discuss the different threads of American securities regulation and explore how they work in the international environment. The first is the Enforcement Division of the Securities and Exchange Commission, which has been mildly engaged in international activities for a longer period than any other division of the agency. Its continued international involvement is due to the existence of questions about the extra-territorial enforcement of the securities laws. Those questions tend to resemble at their base the questions that arise when the local police force here in Ithaca chases somebody across state lines. A variety of jurisdictional questions arise, to which the answers are sometimes unclear. They are what I term relatively low intensity questions. We have negotiated with many other countries, particularly Switzerland, memoranda of understanding that help the enforcement of one country's laws and procedures in another, including discovery and information sharing. These memoranda constitute a relatively low, although quite important, level of international activity.

Our Investment Management Division is involved in a higher level of international activity. This division regulates mutual funds and investment advisors. There is currently a great deal of interest in both American investment abroad and foreign investment in the American markets. There are no questions posed if foreigners invest in American markets through American mutual funds or if foreign mutual funds invest in American securities. If foreign funds raise capital in the United States, questions do arise, but they are the same questions that are posed by any foreign issuer selling shares in our markets and are only slightly different, for reasons I will address shortly, from the issues facing domestic issuers. Finally, some questions arise when Americans invest in foreign countries, through mutual funds that we regulate, simply because the host countries of the investments may not have the same standards that we have here. In this regard, one thinks primarily about the clearance and settlement of securities transactions.

Our regulation of investment companies is fairly intrusive. We regulate them closely because our goal is to ensure that the operations of the company are handled in a manner that treats investors fairly. Thus, we need to be involved, and are involved, in the process of how that company invests, how it holds its securities, and what safeguards it has for its shareholders. This participation requires, for example, consideration of how an American fund with investments in Russia will hold those Russian investments. We are examining that kind of area and are working with our overseas counterparts to obtain a reasonable accommodation of interests.

Corporation Finance is the division within the SEC that deals with disclosure obligations, which many people traditionally think of as the primary focus of the SEC. Its involvement with foreign nationals comes on two fronts. One is the extent to which the overseas offerings must comply with domestic U.S. disclosure obligations as well as when and to what extent they are exempt from those requirements. Recently, there has

been a very interesting development in this area, and it illustrates how the focus on international activities has become domestically valuable for us.

In order to accommodate the desire of issuers for a greater degree of certainty with regard to overseas issuances, a few years ago we adopted Regulation S, which identifies circumstances under which offerings in foreign countries will not be deemed subject to American securities regulation. Regulation S includes limitations on when securities can be brought back into the United States. Those limitations are designed in large part to satisfy us, as regulators, that the offering really is a "foreign offering." What has now developed, however, is a practice of first issuing securities overseas, principally in Europe, at a significant discount from American market prices in order to avoid the U.S. registration process, and then bringing those securities back over here as soon as possible.

The initial response to that sort of activity was that it was an abuse of Regulation S. Some observers, however, notably including Commissioner Wallman, perceived a larger question: if it is economically worthwhile for an American corporation to issue its securities in Europe, even at a significant discount, in order to avoid the registration process, doesn't that tell us there is something wrong with the registration process itself? Shouldn't we reexamine the registration process and determine why people are behaving in this manner and what implications their behavior has for the process? As we pay more attention to what we are doing internationally, we find ourselves more compelled to think about what we are doing domestically and whether our actions are appropriate.

When a country moves a regulatory system into a new environment, it is forced to go back to basics and think about why the regulatory processes exist and whether they are performing an important function. This thought process is a valuable exercise for any agency. At present, the new Republican majority in Congress seems determined that we undertake that exercise to a greater degree than some of us might have preferred, but I would argue that this approach will be beneficial in the long run. In any event, partially in response to the concerns that Commissioner Wallman voiced with regard to the Regulation S activities, Chairman Levitt has now started an advisory committee, chaired by Commissioner Wallman, addressing the corporation disclosure and capital formation process. The committee is studying ways to make our processes in this area more efficient and more responsive.

Another aspect of the Division of Corporation Finance's involvement in international activities has to do with listings of foreign companies' securities on U.S. stock exchanges. As the world becomes smaller and smaller, more and more foreign entities want to tap the American capital markets. Similarly, many American investors want the opportunity to invest in foreign companies. The principal question in this context is: to what extent should American accounting policies apply to foreign corporations that historically have not had to adopt U.S. Generally Accepted Accounting Principles? Our initial reaction was that if we apply accounting principles to American companies because we think they are impor-

tant to American investors, then those same principles, or substantially identical principles, ought to be applied to a foreign company that wants to raise money from American investors. We shouldn't simply be waiving application of the normal accounting principles because, for example, a German company isn't used to complying with them. Most of us still retain this view—what I believe to be the correct view of life. If a German company, Daimler-Benz for example, wants to list its securities as it did some two years ago on the New York Stock Exchange, then it needs to comply substantially with the Generally Accepted Accounting Principles in effect in the United States. If it is not willing to do so, then it will not be allowed to have its securities listed. Although some American money may get into that company, we will not invite that result.

There is one area in which that view has somewhat changed. Some of our corporate disclosure requirements embedded in accounting principles may exist not merely to protect investors but also to affect corporate behavior. A good example is the U.S. requirement in proxy solicitations that management create a compensation committee which gives a report about compensation practices. While that proxy statement requirement was adopted in order to provide shareholders with important disclosures, it was also adopted to affect the way in which corporate compensation committees think about executive compensation. The goal was to focus the committee members' attention and say to them: "You are going to have to talk to shareholders about this so you ought to treat it carefully." To some degree, this kind of thinking has always played a role in the application of our disclosure processes.

To the extent that our disclosure obligations are established in order to permit the advancement of these corporate governance concerns rather than to provide disclosure to American investors, one can argue rationally that those standards should apply to American companies but not necessarily to foreign companies. One could suggest that we have a far stronger interest in affecting the management behavior of companies subject to American jurisdiction than we do in trying to affect the behavior of companies outside of our borders.

This point leads me to the most difficult area of all—one which raises the Barings PLC issue. I refer to the activities of our Division of Market Regulation. The Division of Corporation Finance is designed to require disclosure, i.e., to allow companies to do whatever they want, but generally to require that there be disclosure so that investors may make an informed decision. The Division of Market Regulation, by contrast, is designed to regulate directly the securities industry, including both the self-regulatory organizations, which in this country operate the securities markets, and participants in securities marketing activities—brokers and dealers in securities. I want to focus on the regulation of market participants for the moment because that is the principal area overseen by the Division of Market Regulation that has significant international implications.

We regulate market participants in two principal ways. The first is in their dealings with customers: Are they following appropriate sales prac-

tices? Are they making sensible recommendations to customers? Are they improperly taking advantage of customers? Those issues are not terribly affected by international considerations. The other area is regulation of the firm's net capital and financial stability, i.e., regulating how much capital the firm has in place in order to do business and establishing requirements for the measurement of its capital. For example, if a securities firm owns 100,000 shares of General Motors Common Stock, how does one value those shares? Is it simply the market price, or is it the market price less a discount in order to reflect some risk of possible market declines? In a fairly detailed set of regulations, the SEC establishes how to measure different holdings and how the relationship of assets and liabilities is to be measured and maintained by a firm engaged in the securities business.

We have established these requirements in the first instance so that customers will have the security of knowing they are dealing with a firm that has real substance. There is, of course, the Securities Investor Protection Corporation (SIPC), which has insurance programs that are in some respects comparable to the more familiar banking insurance programs, although far from identical. SIPC provides some elements of safety, but we have always primarily relied on our capital regulation requirements.

Initially, capital requirements were probably established primarily for the protection of customers, including counterparties with whom firms trade. If we are regulating and need to maintain fairness in the markets, we must make sure that professional market participants can deal with and rely upon each other. Our capital regulation provides the basis for that mutual reliance. More and more frequently, however, as some of the securities firms have become very large, we are confronted with an additional concern that is being addressed by net capital rules. This concern involves "systemic risk." By that term, we refer to the risk that the failure of a very large firm might affect other firms, creating a potential domino effect. Especially during the last few years, with very large securities firms, we have sensed a need to address that kind of regulatory function—i.e., a regulatory function that is much more like the traditional regulation exercised by the banking regulators. In addressing this topic, I should first emphasize that every responsible group that has examined the topic of systemic risk has concluded that the risk is extremely slight. Nonetheless, its existence cannot be ignored.

Such an undertaking is extraordinarily difficult for regulators in the current environment. We regulate domestic securities firms. Those firms compete domestically in a large number of areas, with banks, with insurance companies, and with hedge funds—partnership pools of money that are put together for investment purposes in an unregulated environment. All of those entities, and others, compete among themselves but also with their foreign counterparts. Each entity has a different regulatory framework. Some have suggested that a degree of regulatory competition is sometimes desirable, in that it keeps us all honest. It avoids the possibility that anybody will overregulate. However, I am concerned that such com-

petition will lead to operating inefficiencies, regulatory inefficiencies, and a lack of any regulatory control.

In 1994, there were unsuccessful domestic efforts to consolidate banking regulation. There is a very real likelihood that the Glass-Steagall Act will be substantially reformed by the current Congress, and it may well permit banks to engage more fully in investment banking activities and vice versa. We may well receive some greater degree of functional regulation as a part of that reform for which the SEC has been arguing over the past several years, so that we can regulate securities activities regardless of who conducts them, and ensure a level playing field that protects customers. We will see how that development unfolds, but the fact remains at present that the firms whose capital we regulate and find it important to regulate can very easily move capital out of the regulated entity—out of the brokerage firm—into an unregulated affiliate and engage in very substantial trading activities, or they can move substantial parts of their operations overseas. London is one possibility as the next home, but it could be Tokyo, Hong Kong, or anywhere else in the world.

Capital is very mobile in this respect. Thus, when the SEC tries to regulate the capital position of an American securities firm, the firm considers whether those regulations are interfering with its operations to such a degree that it should consider moving the regulated operations out of the entity or out of the jurisdiction entirely. As a result, our options in the current environment are somewhat limited. However, there is also pressure to design the regulatory processes rationally in order to avoid unnecessary movement of capital. For the most part, we are talking about firms that accept the notion of regulation because they realize some real benefits from a pattern of regulation that helps to ensure safer markets for all.

We are currently doing two things to address those problems. First, Chairman Levitt some months ago asked a group of the biggest firms to assemble the so-called Derivatives Policy Group in order to compile an analysis of risk management systems that would help us monitor how each firm is operating outside of our direct regulation. He asked these firms to act on a voluntary basis. They accepted the invitation and provided the SEC with their report in April 1995. Pursuant to that report, they are now commencing the process of sending information to us regarding firm-wide activities which take place outside the regulated entity over which we have clear jurisdiction.

I happened to have a conversation with a Managing Director of one of those firms. He was an active part of the group that put together the report. When I spoke with him, his firm was in the process of generating the first actual report to the SEC and he said: "You know, we hadn't really thought about it when we were designing the report, but now that we are rolling up our sleeves and providing the information, that is an extraordinarily useful management tool for us." He found that the firm is better able to manage its risk exposure and better able to understand areas in which it is exposed because of the information it is providing to the SEC. This activity has been fruitful and will likely expand. There is always an



element of concern when one is dealing with voluntary compliance, but we should now be better able to track the world-wide activities of the firms.

Second, we are continuing to discuss regulatory matters with our foreign counterparts on a regular basis. I was asked earlier whether the Barings experience could have been avoided with greater international cooperation. I think if Barings had been following the procedures outlined by the Derivatives Policy Group and paying attention to them, the debacle probably could and should have been avoided. I can't tell you that with certainty because it appears that information was available within Barings that should have indicated the presence of these risks. Would more information have caused somebody to lift up a hand and say: "Wait a minute, do we know what is going on over there in Singapore?" I don't know. Do I think it likely that we will adopt on an international basis mandatory standards that would require people to avoid that kind of problem? I don't think so. After all, in the United States it wasn't so long ago that Drexel Burnham Lambert, a very substantial firm, got itself into an unacceptable liquidity position and failed. It is fairly clear to me that the Commission paid close attention to that situation but ultimately concluded that the proper answer was to allow the firm to fail. The Commission will allow that to happen if doing so does not unduly jeopardize other market participants. It will allow the market to operate in a natural manner. One thinks about intervention when one has concerns about broader systemic risk. We are engaged in activities to try to avoid those risks, and we will pay attention to them. My best guess is that the information in Barings would have been more clear if everybody had followed the procedures of the Derivatives Policy Group. However, some cases like Barings may happen anyway, and quite possibly they should.

When I began this talk, I said I didn't see any clear way to weave the threads of the international activities of the SEC into a single, coherent fabric. Each of our major divisions—the Divisions of Enforcement, Investment Management, Corporation Finance, and Market Regulation, as well as the Office of General Counsel—is involved in international concerns to one degree or another. In the global financial world of 1995, we cannot responsibly avoid a heavy dose of international concern. Each division addresses different international concerns in its own way. Perhaps that is not surprising, but it is rather symbolic of the way American enterprises have entered the international environment over recent decades. Each enterprise has entered that environment individually, for its own reasons, to satisfy its own needs. But when viewed in the aggregate, they have created a fully American sector in the international marketplace.