U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Address to the
First General Plenary Session of

The U.S./Japan Bilateral Session:
A New Era in Legal and Economic Relations

(edited from the original text)

Tokyo, Japan
August 29, 1988

# GLOBALIZATION OF THE SECURITIES MARKETS

Edward H. Fleischman
Commissioner
Securities and Exchange Commission
Washington, D.C. 20549

---

Commissioner Fleischman also participated in a Committee Session of the U.S./Japan Bilateral Session, that took place on August 30, 1988 on the subject of Regulatory Change in Financial Markets. Commissioner Fleischman, former General Counsel to the Commission Edward Greene, and three members of the Japanese banking and legal communities presented prepared remarks and engaged in a panel discussion moderated by former General Counsel to the Commission Ralph Ferrara and by Kyoto University Professor Misao Tatsuta. An English language recording or transcript of that Committee Session is expected to become publicly available.

Mr. Moderator, Mr. Minister, Ladies and Gentlemen:

A subject of continuing reference during this Conference is likely to be the extraterritorial effect of national law. While my remarks this morning will focus on matters affecting financial markets more than on law as such, may I first demonstrate the extraterritorial reach of American legal requirements by complying, even here in Tokyo, with an SEC regulation which obliges me to advise you that the opinions I express here are my own opinions only, and are not the opinions of the U.S. Securities and Exchange Commission, of my fellow Commissioners, or of the SEC staff.

* * * * *

My subject today is globalization of securities markets.

The decade of the '80s has witnessed extraordinary growth in "internationalization" of -- i.e., in trans-national participation in -- major securities markets worldwide. The term "globalization" of securities markets may have been considered an exaggeration before October of last year, but the rolling, and interactive, impact of the market break during the six trading days Wednesday to Wednesday, October 14 to 21, certainly brought the effects of "globalization" into sharp focus.

To give some idea of the extent of trans-national participation in securities markets, an SEC Staff report published in July 1987 showed:

1. Nearly U.S. $250 billion in international securities offerings in 1986 -- three times the amount offered only three years earlier; and

2. Approximately U.S. $3,000 billion (three trillion dollars) in aggregate purchases and sales of foreign securities by Americans and of American securities by non-U.S. persons in 1986 (omitting all trans-national purchases and sales that involve neither a U.S. issuer nor a U.S. investor) -- more than five times the amount purchased and sold only three years earlier.

One result has been an increasing awareness, at every industrial, financial, and governmental level, of the potential to attract and divert funds used for investment and trading. When, for example, last October, the U.S. Treasury Bond contract went "limit up" on Monday night, October 19, in Chicago, nearly 40,000 Treasury Bond contracts moved to the London International Financial Futures Exchange on Tuesday morning.

The competitive position of companies is affected by disclosure requirements and by accounting standards imposed by different national regulatory authorities. The competitive position of markets is affected by listing requirements and by exclusions applicable to foreign companies.

The markets demonstrate their interconnected character by linkages such as those that exist between the American Stock Exchange and Amsterdam, the Chicago Mercantile Exchange and Singapore, the Chicago Board of Trade and the Tokyo Stock Exchange, the NASD and the International Stock Exchange in London as well as Singapore. Those linkages provide methods to exchange transaction information, arrange mutual clearing, and even in some cases to offset positions taken in one market with contrapositions taken in the linked market.

Investment bankers today can spreadsheet not only alternative costs and benefits of debt or equity or hybrids in the issuer's home country but also alternative costs and spreads available in Japan, in the United Kingdom, in continental Europe, and in the U.S. as well. Bids for well-known issuers' business can come equally from Nomura or Merrill Lynch, from National Westminster Bank or Deutsche Bank, from Credit Suisse or Goldman Sachs.

Extra-national participation in securities markets is not novel -- J.P. Morgan blazed no new trail in floating the bonds of the victorious Entente powers in World War I, although he underwrote foreign loans on a greater scale than ever before. But what, in this decade, has provided the catalyst for internationalization on the current scale? Among the factors to be considered in response to that question must be included:

A. <u>First, the impact of technology and telecommunications development</u>, which seems to have accumulated gradually below the surface and then to have made a sudden appearance with substantial effect upon the markets. Participants in the marketplace today have the near-instantaneous capability of receiving and transmitting new information, absorbing the information so received into the totality of the prior information that they had possessed, analyzing the revised complex of data, and reaching new or reaffirmed conclusions as to the course of market action to be followed.

The result is a worldwide simultaneous knowledge of transactions and trends in the markets. This has yielded an extraordinary capability to react to events in any market, whether debt or equity, government or corporate, long-term or short-term, currency or futures. There is a pronounced trend by professional market participants toward what is called "passing the book": around-the-clock, twenty-four-hour risk monitoring, as market responsibility passes from Tokyo to London to New York and back to Tokyo again. Correlatively, there is an increasing ability to detect and to act on interrelationships between diverse markets, and of course there is increasing institutional pressure to do exactly that -- to act on relationships between markets in different countries in order to diversify and to hedge institutional portfolio investment.

B. <u>A second factor is institutionalization</u>. Regardless of how "institution" is defined, institutions more and more dominate trading in markets worldwide, down to and including corporate equities.

A significant aspect of institutionalization is the aggregation of wealth under management, not in the sense of concentration in the hands of one or two decision makers but rather in the sense of concentration resulting from a constant net inflow of money to the pension funds, the insurers, and the mutual funds. It is still possible, at micro portfolio management levels, to invest as a classic venture capitalist, or a mezzanine financier, or a block purchaser in the public market -- choosing this industry over that, this geographic area rather than that, this company as a better all-around choice than that -- but, to an increasing extent, institutional portfolio holdings in sovereign debt, corporate debt, and equities have become so large that institutional portfolio managers either have to follow an "issuer-blind" strategy (i.e., invest in equities just to match an appropriate index), or else management has to add and remove interest-rate risk and equity risk as overall components without regard to the individual issues held in the portfolio. And for that purpose the institutions have turned to new financial instruments and techniques designed to address volatility and to hedge risk.

C. For volatility is itself a causative factor. Volatility in currency exchange rates is only a phenomenon (during the post-war era) of the last decade-and-a-half. With the dismantling of capital controls in the late '70s and '80s came increasing cross-border flow of funds, increasing awareness of investing and trading opportunities in other national markets, and increasing necessity to take into account exchange rate fluctuations and their effect on investment results. Concomitantly, the last decade-and-a-half has witnessed unprecedented volatility in interest rates, while rates themselves reached unprecedented levels in several major countries including the U.S.

Finally, inter-day and intra-day volatility in equities, while perhaps explainable in gross in relation to historic levels of trading volume, has since October 1987 caused the mass of average investors to share what previously were concerns almost exclusive to the institutions. After all, the institutions do provide the markets with liquidity when any fraction of them is buying, but they deprive the markets of liquidity (October 19 and 20, 1987, are good examples) when too large a fraction of them decides to sell. They provide stability in the market so long as there is a normal distribution of variant opinion among them, but they magnify volatility when too many of them line up on either side of the market at the same time.

D. It is a fourth factor, innovation in financial instruments and techniques, that has borne a great portion of the burden of responding to institutionalization and to greater volatility. Perhaps foremost in their consequences for internationalization of markets have been currency-rate and interest-rate swaps, by which major market participants (primarily world-class banks whose acceptability as contraparties to any swap is unquestioned) have linked together all the major capital markets. In addition to swaps, however, nearly every traditional instrument, from long bonds to puts and calls, has been revisited and adapted -- and introduced into national marketplaces where a need was perceived. Standardized secondary options didn't even exist two decades ago; today they are commonplace, and we also have their derivative, the equity index options.

But what comes most prominently to mind are the interest-rate futures, and ultimately the equity index futures, because in the early '80s those screaming crowds -- I'm avoiding the evil word "speculators", as if there could be markets without speculation -- in the pits in Chicago divined how to adapt their wild and woolly markets, and their incomprehensible contract instruments, to do for securities (first for U.S. Government bonds, then for Treasury bills, then for corporate equity indexes) what those markets and instruments had traditionally done, and are doing in the summer of 1988, for farmers and food processors, for miners and metal processors; i.e., to discover forward prices and to assume or to transfer risk. In doing so, they provided the financial institutions with the ability to "lay off" the risk inherent in all or part of the debt and equity portions of the institutions' portfolios, not security-by-security but rather dollar-by-dollar.

The fact of the matter is, however, that, if financial futures didn't exist, at this point we would undoubtedly have to invent them, and in the process we would have to remove any governmental restrictions tending to inhibit their viability.

E. <u>Which brings me to the last, and probably most important, of these factors: governmental deregulation</u> -- which is to say, sovereign policies recognizing that regulatory constraints on market forces, particularly constraints on economic competition between investments or between investment instruments or between the markets where analogous investment instruments are traded, do tend to inhibit rather than to encourage the interaction between purveyors and users of capital by which buyers and sellers, longs and shorts, primarily through the intermediation of professional traders, meet and agree on the terms of deployment of capital most advantageous to both sides.

Deregulation here in Japan bears a significant relationship to the emergence of Tokyo as a co-equal among the principal capital markets of the world. During the past few years, examples include:

1. Rescission of restrictions previously limiting Japanese banks in payment of interest on large deposits, in dealing in Japanese government bonds, in issuance of large-size long-term CDs, and in issuance of convertible bonds;

2. De-control of many restrictions on Euroyen and swap contracts;

3. Permission for inauguration of commercial paper markets with participation by non-Japanese dealers and non-Japanese issuers; and

4. The recent announcement of permission for the creation of futures markets in Japan.

One commentator wrote that the primary factor in last year's acceptance of sixteen non-Japanese members by the Tokyo Stock Exchange was "the recognition, on the part of the Ministry of Finance, the Exchange and the Japanese securities industry, of the . . . benefits of . . . internationalization to Japanese markets and institutions."

The factors that have accelerated internationalization of securities markets to date will inevitably continue to exert similar pressure for the foreseeable future. What is not inevitable -- what is in fact within our control -- is the response to that pressure on the part of each of us, as individuals, as legal professionals, and as contributors to governmental policy.

As a matter of regulatory attitude, the U.S. Securities and Exchange Commission has throughout this decade sought to respond to internationalization with encouragement, with concern not to react in a manner that would dam or artificially channel market development by application of regulatory policies that were devised for the different problems of a bygone day.

The Chairman of the SEC, in an address to Keidanren here in Tokyo in February, articulated a group of principles for consideration by market participants and market policymakers throughout the world as they seek to adapt to internationalization:

1. Sound standards for disclosure, including mutually agreeable auditing and accounting standards.

2. Promotion of market fairness, including prohibitions against market manipulation, against misrepresentations to the marketplace, and against insider trading.

3. Widespread availability of quotation and price information.

4. Efficient and compatible clearance and settlement systems.

5. Registration qualifications and conduct requirements for market professionals designed to promote integrity and honesty in the profession.

6. Improvement of capital adequacy standards for market participants in order to provide greater stability and liquidity for all markets.

7. Establishment of the tools for international surveillance and law enforcement.

What I find implicit in that group of principles is a willingness to learn both from the markets as they develop and from other systems of market regulation as they mature -- and I find that very encouraging.

Each country must, of course, enforce its own law in its own territory, and may be expected to reach out to censure improper activities engaged in outside its borders that have a substantial effect on its own securities markets or on the securities owned by its nationals or residents -- but always subject to the bounds of comity (*i.e.*, the willingness of other states to respect the exercise of jurisdiction in the particular circumstances). The premise is that few countries would allow themselves to become havens for perpetrators of securities fraud simply because the victims are residents or nationals elsewhere. In bilateral contracts that have ripened into memoranda of understanding with Japan, Switzerland, Great Britain, three Canadian provinces, and Brazil, the SEC has found that premise to be true. Pursuant to the latest of those memoranda, we have requested (and the U.S. Congress is currently considering) authority to assist other countries' enforcement of their own securities laws when suspected violators or other persons with relevant information are found in the U.S.

We are also pursuing approaches based on reciprocity in public offerings of certain securities by so-called "world class" issuers, in exchange offers, and in tender offers where a material but far-from-dominant portion of the target company's stock is held on the other side of a national boundary. We have signaled the desirability of applying reciprocal principles to some broker-dealer oversight matters as well.

And we are drawing back to approaches based on territoriality in certain trans-national securities offerings, where "territoriality" carries the notion of protection solely by the laws of the jurisdiction governing the marketplace -- <u>and</u> where there is reason to believe that investors expect no other protection.

I find these avenues of approach foresightful and encouraging.

For a government regulatory agency -- and an aggressive one, at that -- to be willing to draw back from asserting outreach jurisdiction, to recognize that there are others elsewhere --

here at the Securities Bureau of the Ministry of Finance, or at the recently established Securities Investment Board in London, or at the only-newly-authorized Dutch commission, or even at that other U.S. commission in Washington which regulates the virtually foreign futures contract markets -- who have approaches to the same problems that differ from ours but who may be just as insightful, just as well adapted to the turn-of-the-millennium world of interacting international markets as are we, is truly remarkable. It deserves encouragement.

And, I suggest, it is precisely the willingness to proceed on the basis of comity, reciprocity, and territoriality that affords the greatest likelihood of effectuating the core elements of the principles put forward by the SEC's Chairman, and that therefore affords the most promise of reaping for issuers and investors, worldwide, the true benefits of globalization of markets.