Statistics evidence the increasing internationalization of the capital markets. By every measure, one sees the ascendency of a global view of capital markets and their use in capital formation. This view is shared by both the suppliers and users of capital and the financial intermediaries who serve them. One important implication of the global view is a growing substitutability among the world’s major securities markets, leading to increased competition among regulators of those markets to hold and increase the securities business transacted within their jurisdictions.

United States equity markets are losing ground to foreign ones as deregulation outside the United States proceeds apace. The Securities Industry Association reports that, during the past twelve years, the United States has seen its share of the world equity markets shrink from over sixty-one percent to just over thirty percent. The Securities and Exchange Commission (SEC) reports that, as a percentage of total registrations in the United States, foreign issues have decreased from thirteen percent in 1977 to three percent in 1986. Recently, at least fourteen companies in the United States have chosen the London market to float their initial public offerings, subsequently registering their issues on the London Stock Exchange’s unlisted securities market. The reason assigned for choosing this surprising venue for capital raising was lower costs. At the end of 1986, only fifty-nine foreign companies were listed on the New York Stock Exchange (of which one-third were Canadian), compared to 512 foreign listings on the London Stock Exchange.

These statistics bespeak a problem for the SEC. For fifty years, this agency has been relatively free of competition from other market-

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places and regulators. For the future, the SEC can expect these pressures to increase dramatically. The root causes are (i) the demand of U.S. investors for securities of foreign issuers, (ii) the demand of foreign issuers for cheap capital, (iii) the relatively high cost of raising capital in the United States, and (iv) the growing ease with which investors and issuers can find one another outside the United States.

The important question, then, is whether, to what extent, and in what ways the SEC will deregulate in response to competitive pressures exerted by the globalization of capital markets and our country’s stake in preserving its dominant, or at least major, role in those markets. Will a “competition among regulators” encourage the SEC to pare away unnecessary rules by applying a more vigorous cost-benefit analysis — one in which investor protection will be only one of several factors to be weighed? An affirmative answer is found in a number of recent SEC actions, suggestive of broad policy direction as well as specific future steps.

Among these “straws in the wind” is Rule 3a12-8,1 permitting futures trading in the United States on unregistered foreign sovereign debt. Although foreign sovereign debt itself must be registered to be sold in the United States, futures now can be traded without registration of the underlying securities. Another “straw” is the SEC staff no-action position permitting London Stock Exchange market-makers to place their quotes on NASDAQ (and accept resulting orders in London) without registering as broker-dealers in the United States.2 Others include the SEC staff consideration being given to a “free trading zone” in the United States for institutional trading in unregistered securities, the two no-action letters granted last year to College Retirement Equities Fund,3 confirming the staff’s willingness to recognize the legitimate (and growing) interests of U.S. institutional investors not to be so “protected” by U.S. laws that they are disadvantaged as global investors, and the Vickers da Costa no-action letter,4 permitting this foreign broker-dealer and its foreign affiliates, without registering as U.S. broker-dealers, to cover the U.S. Vickers subsidiary in its NASDAQ market-making functions so as to assure that the U.S. subsidiary

functions solely as riskless principal.

I see these actions as examples of a new balancing test that responds to the competitiveness of the worldwide marketplace and the need for the SEC to accommodate its rules in the interest of keeping U.S. investors on shore. For the SEC, the quandary has been whether to protect U.S. investors somewhat by lessening the traditional rules, or by sticking to those rules, to protect not at all, as U.S. investors go offshore and U.S. markets erode against all foreign competition. These "straws in the wind" signal — perhaps — a willingness by the SEC to bend in pragmatic ways.

The U.S. federal securities laws started out as, and in the main have continued to be, a conservative regulatory approach to investor protection, based on full disclosure. This approach stands in sharp contrast with the "merit" approach adopted by many of our states in their blue sky laws but rejected by Congress in 1933 and 1934 when our basic securities laws were written. Yet in a sense, the rigorous application of the U.S. federal securities laws to foreign issuers whose securities trade or are offered in the United States has the effect of imposing a U.S.-devised regulatory "merit" system on foreign issuers. (To cite but one example, only the U.S. concept of "generally accepted auditing standards" will suffice for offerings made here.) Advances in communications technology are rapidly making it as easy for investors and issuers (both domestic and foreign) to avoid this U.S. merit system as it has been for domestic investors and issuers to avoid state merit systems in the past. (One startling statistic: since 1964 the real cost of recording, transmitting and processing information has fallen by more than ninety-five percent.)

I want to dwell for a moment on the obstacles our securities laws present to foreign issuers seeking to tap U.S. sources of capital, and one route around this obstacle. The statistics noted earlier confirm what securities laws practitioners already knew. Our rigid and detailed rules regarding disclosure, accounting principles and auditing standards, together with the statutory framework for assessing damages against officers and directors who are negligent, discourage foreign firms from raising capital here.

In theory, at least, this network of rules has been found necessary to protect U.S. investors. This public goal provides the statutory underpinning to the rules. It is doubtful, however, that a solid empirical case in support of this proposition could be made. Nor does the SEC consistently impose those rules on public distributions. Consider, for example, the rules governing the public offering of investment company shares, particularly those proposing to invest in the securities of foreign...
The U.S. investment company increasingly is being used as a vehicle for U.S. investors to acquire the securities of foreign issuers unwilling to incur the burdens of registration here. Today there are more than eighty U.S. investment companies specializing in foreign securities, with assets of more than $24 billion. The dichotomy between the extensive information required of a foreign issuer seeking to access U.S. investors directly by registering under the Securities Act, and the skimpy data routinely permitted by the SEC for investment companies seeking to assemble a pool of capital for investment in foreign issuers outside the United States, is nothing less than breathtaking. The Templeton Global Income Fund, a closed-end fund underwritten by Merrill Lynch, raised $1.1 billion on a prospectus that revealed nothing about the Templeton record of performance in managing money (which is very good, I am told) and was so all-encompassing in its description of the types of securities to be purchased (for example, among corporates', they could be domestic or foreign, rated from AAA to CC or unrated if of "comparable quality") as to be essentially a "blind pool."5

Of course, once the investment company is funded, it can invest in foreign issuers outside our shores, thus enabling those issuers to access U.S. capital without conforming to our rules. One can reasonably question the logic and coherence of our securities laws when such drastically different rules apply to these two routes by which foreign issuers can reach U.S. investors. I would not try to defend what strikes me, in important respects, as inadequate disclosure requirements for the new global form of blind pool, of which the Templeton Fund is but one among many examples. But I do believe our rules impose unnecessary burdens on foreign issuers that cannot reasonably be justified as necessary to investor protection.

The ease with which not only capital, but business and labor too, can move across borders was noted last fall in regard to taxation by the economist Herbert Stein in an op-ed piece for The Wall Street Journal.6 Mr. Stein suggests that resource mobility will foster international tax competition, tending to limit the tax rates that nations can impose, with corresponding constraints on expenditures. Since, in the case of

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5 At the height of the South Sea Bubble, in the early eighteenth century, public funds were raised by a company whose purpose, as described in its "prospectus," was "for carrying on an undertaking of great importance, but nobody to know what it is." L. Loss, Fundamentals of Securities Regulation 2 (2d ed. 1988). By describing Templeton's fund as a blind pool, I do not mean to suggest it reaches the towering level of obscurity achieved by this eighteenth century English company, but it could well trace its ancestry to this source.

capital markets as in taxation, the challenge is to lower the governmental cost of transacting business consistent with the public interest, Mr. Stein's point serves as a useful analog, helpful in appreciating some of the implications of the vastly more competitive environment in which our capital markets will operate in the future.

The pressures to lower transaction costs by moving transactions offshore are increasing. Glass-Steagall7 prohibitions against bank underwriting and dealing in corporate securities in the United States have significant anti-competitive effects, increasing the cost of capital raised in the United States compared to the Euromarkets. This is true because securitization has become the most cost-effective method of financing for most U.S. corporations, but domestic banks cannot compete with investment banks in the United States because the distribution of securities is involved. Banks, however, can compete abroad. Glass-Steagall, therefore, will increasingly be a force tending to erode United States dominance in capital markets.

In international markets, securitized lending accounted for more than eighty percent of the gross new credit arranged in 1986 compared with about fifty percent in the mid-1970s. Increasingly, banks are taking their corporate clients offshore where they can compete through underwriting and dealing, as well as traditional bank lending, beyond the reach of Glass-Steagall. Deregulatory efforts by foreign jurisdictions will aid and abet these challenges to United States dominance.

Removing the growing burden of Glass-Steagall is not within the SEC's charter. But many other costly aspects of our capital markets lie squarely within that agency's responsibility. To respond effectively to the international competition, the SEC must be willing to disenthrall itself from past successes. It will have to challenge the continuing utility of the various securities laws in their present forms. It may have to abandon certain types of regulation previously viewed as essential. For example, in areas dominated by professionals on all sides of a transaction, the antifraud rules, backed up by law enforcement, should suffice. These professionalized areas are large, having grown exponentially since the 1930s, when there were few pension funds or mutual funds. Today the top 300 institutional money managers handle about $2 trillion in pooled investment funds — a sum equal to about three-quarters of the total assets of our 14,000 commercial banks. Competitive pressures from non-U.S. capital markets are likely to hasten the day when this sort of approach becomes a reality, initially for foreign issuers, but ultimately for domestic issuers as well.

Empirical data drawn from the international bond markets illustrate the growing challenge of foreign markets to United States dominance in capital formation. Until the U.S. experiment with interest equalization in 1964, the principal market for foreign bonds was the United States. The exchange controls and capital market restrictions imposed by European and Japanese capital markets made them much less accessible to foreign issuers. Triggered by the IET, the Eurobond market began to grow in the mid-1960s and, aided by significant regulatory legislation around the globe, is now the dominant marketplace for corporate debt, whether denominated in dollars, yen, deutsche marks, or sterling.

The United States has been the world leader in favoring competition over capital market controls, and this has proved a major factor in making our markets attractive to foreigners. However, the United States has also been the world leader in fashioning elaborate and, for the issuer, burdensome rules for the protection of investors; these rules have deterred foreign issuers from coming to our shores, a reality that becomes increasingly important as other countries follow our lead by dropping capital market controls in favor of competition. The SEC's detailed rules regarding disclosure, accounting principles and auditing standards, when combined with our general litigious environment and the specific threat of statutory liability for officers and directors if mistakes are made, add up to a large dose of deterrence.

Recent statistics support these conclusions. Between 1981 and 1986, the Eurobond market grew from $31.3 billion to $187.7 billion, or 600%, and the dollar denominated portion of that market grew from $25.8 billion to $118.1 billion, or 457%. Over the same period, the public market for foreign bonds in the United States was essentially flat at $6.9 billion in 1981 and $6.8 billion in 1986. These numbers suggest an aversion to the U.S. marketplace in comparison to the much less regulated Eurobond market. That the tough regulations affecting publicly offered and traded bonds in the United States are a significant factor in this matter is suggested by another statistic. Over this same period, 1981 to 1986, foreign bonds sold in the United States by private placement increased from $2.0 billion to $10.9 billion, or 545%.

Although a privately placed security enjoys less liquidity than one publicly sold through a registered offering, it avoids the considerable burdens of registration. It seems reasonable to assume that this factor

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* I am indebted to Terry Chuppe, Associate Director, Hugh R. Haworth, Chief of Disclosure Policy Analysis, and Marvin G. Watkins, Financial Economist, Office of Economic Analysis, Securities and Exchange Commission, for sharing with me the statistical material used in this part of the paper.
largely accounts for the stunning growth in the private market for foreign bonds over a period (1981-86) when the public market for foreign bonds was flat.

In urging an evaluation of this data with regard to the need for further deregulation of our capital markets, I do not devalue the importance of our rules in protecting investors and in fostering a sense of confidence among investors that they are being protected — i.e., that the game is fair. But the numbers suggest that investors themselves, most of whom in these markets are highly sophisticated, are increasingly willing to meet issuers in regulatory surroundings less protective of their interests, and accordingly less burdensome and threatening to the issuers, than our own public markets.

There is a domestic analog to the growing competitive pressures from foreign market centers, useful in the way it reveals how accommodating the SEC can be. Congressional support for small business grew throughout the decade of the seventies, exerting pressure on the SEC to tilt toward the interest of capital formation by small business by reducing the cost of raising capital, even if the result was a diminution in investor protection. Congress, in effect, invited the SEC to use a balancing test in regulating to serve both of these competing national goals.\textsuperscript{9} Form S-18\textsuperscript{10} (adopted in 1979) and Regulation D\textsuperscript{11} (adopted in 1982) were the principal results. Among other things, Regulation D permits issuers to offer publicly up to $500,000 worth of securities to anyone without being required to furnish specific information (although the antifraud rules remain applicable).\textsuperscript{12} In addition, offerings of up to $5


\textsuperscript{12} 17 C.F.R. §230.504 (1987).
million can be made to any number of "accredited investors" without furnishing specific information. The definition of "accredited investor" includes individuals with substantial income or substantial net worth, even though they lack sufficient knowledge and experience in financial and business matters to be capable of evaluating the prospective investment. In 1986, some $60 billion of securities were issued under Regulation D.

Whatever the merits of the deregulatory effort evidenced by Form S-18 and Regulation D (a question that should certainly be taken up with the empirical evidence of a long bull market and sudden crash behind us), this experience illustrates a willingness on the part of the SEC, when pushed, to accommodate its rules to a broader set of interests than it previously had been willing to recognize. As such it, too, offers a promising "straw in the wind."

When I prepared these remarks for testimony before the House of Representatives Subcommittee on Telecommunications and Finance last summer, the SEC had not transmitted its financial guarantee study to Congress. That study, undertaken at the direction of Congress to examine the use of the Section 3(a)(2) exemption from registration under the Securities Act for securities guaranteed by banks and the lack of parallel exemption for securities similarly guaranteed by insurance policies, was delivered to Congress on August 31, 1987. Its reasoning and recommendations could make one fearful that what seemed to be important "straws in the wind" pointing toward a more pragmatic regulatory approach may, in fact, be just random events. To explain what I mean, a little background is necessary. Section 3(a)(2) exempts from registration not only securities issued by a bank, as in a case of a letter of credit (LC), which increasingly has been used by corporate borrowers to lower their cost of money. Both the LC and the underlying security it enhances are subject to the antifraud provisions of both the Securities Act (Section 17) and the Securities Exchange Act (Rule 10b-5).

Although Section 3(a)(8) of the Securities Act exempts insurance

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policies from registration, there is no exemption for the securities guaranteed by those policies. This difference, the SEC found, creates “an apparent competitive advantage for banks” over insurance companies, since a bank LC and an insurance policy are alternative forms of financial guarantee that compete wherever such credit enhancements are needed. Insurance policies enjoy one possibly significant advantage over bank LCs under both securities laws: they are not considered to be “securities” at all, and thus are not subject to the antifraud rules. But no finding of possible competitive advantage for insurance companies is made on this account. The SEC’s recommendation to Congress, based on its finding of “apparent competitive advantages for banks in providing financial guarantees,” is to amend Section 3(a)(2) to remove the exemption for securities guaranteed by a bank, as in the bank LC. What is puzzling about this recommendation is:

(1) the lack of any significant finding in the study supporting the need for registration of the guaranteed security to protect investors or otherwise serve the public interest;

(2) the rejection, as not determinative, of evidence adduced by commentators that investors have never suffered a loss on bank guaranteed securities distributed to the public;

(3) the SEC’s recommendation that registration of the issuer’s securities — a costly and, to the marketplace, unnecessary step — be required, despite the study’s findings that the rating agencies (a) play the key role in the marketing of guaranteed securities, (b) have been “quite reliable” in assigning the highest rating category, and (c) base their ratings on the credit strength of the supporting institution (whether bank or insurance company), without examining the creditworthiness of the issuer at all. (The SEC would preserve the exemption from registration for the supporting institution’s instrument (whether LC or insurance policy), concerning which the marketplace attaches the highest importance);

(4) the failure to examine the Congressional purposes behind the Section 3(a)(2) exemption (except cursorily in a footnote) or the long operational experience with the exemption since 1933 in terms of costs and benefits to the investing public and issuers; and

(5) overall, the implicit assumption of the study that the burden of proof in deciding how to address an apparent competitive inequality derived from unequal regulation rests with those who would achieve equality by removing regulation from the more burdened rather than with those who would add regulation to the less burdened.

Congress should look carefully at this matter before following the SEC’s advice. Despite the study’s abundance of valuable data, it does
not answer the specific questions the SEC was directed to analyze in Section 10520 of the Government Securities Act of 1986; instead, the study appears to assume that registration under the Securities Act is always a net benefit for investors.

This study and its conclusions were not affected by the competitive pressures of internationalization or any special interest of Congress. Indeed, this point may explain why, despite the discouraging message of the SEC's financial guarantee study, those "straws in the wind" earlier mentioned are, in fact, real signals of future directions wherever competitive pressures from non-U.S. markets are felt.

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This paper was written before the mid-October 1987 crash. Despite the push for new forms of regulation that are emerging out of the various studies of the crash, the thesis of this paper need not be altered. Indeed, the points need to be pressed even more forcefully, lest they get lost in a wave of regulatory fervor, seeking to punish or remove the villains responsible for the market's sudden descent.

No villain caused Black Monday. The marketplace was a victim of its own successes. Advances in order execution, communication, product and service development and computer capacity and speed have all contributed to make today's marketplace vastly better for investors. Improvements include, in particular, (a) the near-instant delivery to substantially all investors of substantially all information material to investment choice and (b) the opportunity for investors to act upon that information almost instantaneously. Futures and options on securities indices are two examples of new products that facilitate the rapid execution of investment decisions at low cost. Families of mutual funds that permit swift transfers from equity to debt or debt to equity are another example.

These important benefits to investors necessarily have adverse side effects, including, most importantly, the potential for greater market volatility, as the events surrounding Black Monday illustrate. The broad conceptual question that needs to be addressed — with deliberative care — is whether, to what extent and in what particular ways, if any, the adverse side effects of these changes are sufficiently deleterious to warrant governmental intervention, taking into account the costs that such intervention will impose. This agenda, whatever the outcome, ought not to impede the kind of study argued for here: a careful review

of the SEC's role in a global, competitive and multimarket setting, looking to balance investor protection interests with the national goal of maintaining our nation's preeminence as a capital market center.