United States General Accounting Office

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Report to Congressional Requesters

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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-234478

April 14, 1989

The Honorable Donald W. Riegle, Jr., Chairman
The Honorable Jake Garn, Ranking Republican Member
Committee on Banking, Housing and
Urban Affairs
United States Senate

This report responds to your request that we identify regulatory issues for coordination among international securities markets and that we assess the extent of international coordination efforts. This report discusses ongoing coordination endeavors in such areas as capital adequacy, accounting and auditing practices, listing and disclosure rules, and clearing and settlement systems.

Our review indicates that capital adequacy regulation will be among the most important issues that regulators from different nations must address as internationalization proceeds. In addition, international clearance and settlements practices will become an increasingly important but complex issue, meriting continued attention. Finally, U.S. regulators must ensure that they are coordinating among themselves in approaching international securities coordination.

As agreed with your office, we plan no further distribution of this report until 30 days after its issuance date unless you release its contents earlier. At that time, we will provide copies to executive agencies, congressional committees and other interested parties.

Frank C Conahan

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

The Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the Ranking Minority Member, and the Chairman of the Subcommittee on Securities requested GAO to (1) identify what issues the United States should be considering to better coordinate international regulation of the securities markets and (2) assess the extent of international coordination.

GAO reviewed the coordination efforts among regulators and market participants in several key market regulation areas including capital adequacy, listing and disclosure rules, accounting and auditing practices, and clearance and settlement systems. GAO focused its efforts on identifying

- ongoing coordination endeavors and prospects for the future
- major impediments to coordination, and
- any consensus on issues needing immediate attention.

Background

As securities markets become increasingly international markets, offering investors and securities issuers many advantages, they also pose increased risks. Disturbances in one market may affect other markets. Thus, regulators must be concerned with the rules and functioning of international as well as national markets, raising the question of whether international securities markets require internationally coordinated regulation.

Results in Brief

The internationalization of securities markets is inevitable and will necessitate some changes in current national regulatory policies. GAO concluded that capital adequacy regulation will be among the most important issues that regulators from different nations must address as internationalization proceeds. Such regulation is central to the ability of securities firms to withstand losses in the normal course of trading and thus is a major contributor to investor confidence in the integrity of the system as a whole. As the ultimate providers of liquidity to financial markets, central banks should participate in setting regulatory standards.

GAO also concluded that international clearing and settlements practices will become an increasingly important but complex issue, thus meriting continued attention. By reducing risks associated with transactions, progress in developing an efficient and timely clearance and settlement system can lessen the level of securities firm capital needed to ensure their financial integrity. Finally, U.S. regulators must ensure that they coordinate their own approaches to international security regulation.

GAO Analysis

Capital Adequacy Standards

Coordination of capital adequacy standards has not been an urgent issue. As cross-border transactions increase, however, it will become more difficult for a firm to know all the parties with whom it trades, increasing the risk of a transaction not being completed. The customer's principal basis for protection against this risk is the firm's capital, creating the need to ensure that all firms that trade on international markets meet at least some minimum level of capital. Minimum capital requirements reduce the potential that the default of one firm would lead to defaults of other firms, even if those firms were better capitalized. While most regulators and market participants told GAO that this was an important issue, little progress has been made to coordinate capital adequacy standards internationally.

The role of central banks in formulating coordinated capital requirements for securities firms also will deserve greater attention as securities markets become increasingly international. In nations where universal banking powers exist, the central banks are already involved. In other nations, including the United States, central banks are not involved. Central banks, however, have been forced by circumstance to serve as sources of liquidity to securities markets in past emergencies, particularly the October 1987 crash. Their past role, and the potential that some future emergency might require similar actions, suggest that central banks should be involved in efforts to coordinate the capital adequacy standards of securities firms. Furthermore, it is also important that central banks reach agreements on international responsibilities in the event of a crisis.

Clearance and Settlement Systems

International clearance and settlement systems will become an increasingly important issue as well. Such systems are currently being considered, but few actions have been taken to date because the level of cross-border transactions is not high enough to justify profitable investment. As the desirability of cross-border transactions increases, an international system may be developed as a mechanism to reduce the risks and transactions costs inherent in such trading. Conversely, lack of such a system, may actually hinder an expansion of cross-border trading. Thus, in the clearance and settlement area, there is a question about whether the need to trade internationally will stimulate development of international systems or whether the development of systems must precede the further growth in international transactions.

Information Exchange

U.S. securities regulators have entered into a number of agreements with their foreign counterparts to coordinate some aspects of securities regulation. Many of these agreements deal with facilitating enforcement investigations or sharing financial information. Some foreign officials expressed concern that the U.S. Freedom of Information Act would permit release of information shared with U.S. regulators, even if foreign law would prohibit release of such information. The SEC has requested legislative changes to ensure adequate confidentiality of shared information.

Interagency Coordination

Finally, as internationalization proceeds, it will become more important to ensure that U.S. agencies themselves coordinate their approaches to international securities issues. With the increased involvement of U.S. securities firms and exchanges in international markets, such coordination becomes more crucial to enable the United States to effectively participate in worldwide coordination efforts. However, there is no formal process today to assure that a unified domestic approach to international coordination occurs.

Recommendations

The purpose of GAO's report is to provide an overview of coordination efforts among regulators and market participants in several key market regulation areas and identify ongoing efforts, future prospects and major impediments to such coordination. Therefore, GAO is making no recommendations.

Agency Comments

As requested by the Chairman's office, GAO did not obtain agency comments on its report, although it did discuss the report informally with agency officials and incorporated their suggestions as appropriate.

Contents

Abbreviations

CFTC	Commodity Futures Trading Commission
EC	European Community
FIBV	Federation Internationale des Bourse de Valeurs
GAAP	Generally Accepted Accounting Principles
IOSCO	International Organization of Securities Commissions
ISE	London International Stock Exchange
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automatic Quotation System
OECD	Organization for Economic Cooperation and Development
SEC	Securities and Exchange Commission
SIB	Securities and Investment Board
SRO	Self-regulatory Organization
U.K.	United Kingdom

Globalization of the Securities Markets and Need for Coordination

The internationalization of the securities markets is changing the makeup of world finance and the nature of its regulation. Securities firms are purchasing foreign investment houses and locating branches in foreign markets. Investors are increasingly conducting cross-border transactions, both in the secondary markets and for new issues. Doing so provides both investors and issuers access to larger capital markets than their domestic markets. As internationalization of securities markets continues, occurrences in one market can potentially affect other markets and, in the extreme, the worldwide financial system. Thus, regulators must be concerned with the rules and functioning of both their own and other major markets, raising the question of whether international securities markets require internationally coordinated regulation. Coordination of international securities regulation is not as advanced as it is for international banking regulation. Coordination can involve many different activities, ranging from standardization, where one set of international rules is adhered to by all markets, to harmonization, where individual markets maintain different regulations which satisfy an international standard.

Regulators, experts, and market participants generally agree that although there is no present crisis demanding immediate action, coordination of securities regulation can help achieve regulatory goals in an international environment. These goals are to maintain the safety and soundness of the financial system, protect investors, protect market integrity, and maintain viable markets. Regulation, either by governments or the markets themselves, seeks to meet these goals and to gain the confidence of investors which will allow for an orderly investment environment.

The case for coordination, according to some observers, was reinforced by the market crash of October 19, 1987, when the U.S. financial markets experienced a severe shock which was quickly transmitted around the world. Although the unprecedented stock and futures price declines began in the U.S. markets, foreign markets also experienced dramatic price declines and increased trading activity during that same period. During the crisis, no agency or group of agencies was responsible for intermarket decisionmaking or for coordinating international decisions and no set of contingency plans were ready and waiting to be implemented.

Internationalization of Securities Markets

Many factors have contributed to the globalization of the different securities markets including (1) technological innovations, (2) an increased desire on the part of investors to acquire foreign securities to diversify their risks and earn higher returns, (3) removal of foreign exchange and capital controls in many countries, (4) the development of the Euro-markets[1], (5) reduction in regulatory restrictions, and (6) improvements in access to financial information. These trends affect all securities markets, including bond, stock and financial futures markets. The advance of technology has meant attaining instantaneous information about trading conditions, including prices and volume through computer screens, and the ability to buy and sell stocks without the necessity of a physical trading location such as the floor of a stock exchange. The removal of foreign exchange controls has freed investors to trade in foreign markets. Strong competition from the Euro-markets has encouraged innovations in domestic financial markets to take efforts to attract foreign capital and retain domestic business. And, deregulation of markets overseas has enabled firms to extend their distribution networks beyond their borders. Tables 1.1 and 1.2 illustrate the growth of internationalization through increased (1) foreign purchases and sales of U.S. stocks and (2) U.S. purchases and sales of foreign stocks, by various countries and table 1.3 illustrates activity in international and foreign bond offerings.

Table 1.1: Foreign Gross Purchases and Sales of U.S. Stocks by Country of Origin

Dollars in billions

Country	1982	1983	1984	1985	1986	1987	1988
Japan	$2.0	$3.3	$2.7	$7 8	$26.9	$102.6	$120.6
United Kingdom	18 7	29.2	27.5	37.6	64 6	103.9	75.6
Canada	10.0	16.4	16.8	22.1	34.6	50.0	32.7
France	5.0	8 0	5.7	6 0	9.6	20.1	12.5
Germany	3.4	7.5	6.2	6.1	10.0	16.2	11.3
All Other	40.8	69.7	63.8	79.4	131.8	189.2	131.7
Total	**$79.9**	**$134.1**	**$122.7**	**$159.0**	**$277.5**	**$482.0**	**$384.4**

[1]Markets that conduct business in a particular currency outside of the financial markets of the nation that issued the currency. For example, a Eurodollar market exists in London conducting business in U.S. dollar denominated financial instruments. The term "Euro", used instead of "external", reflects the geography of its origins rather than the scope of its functions.

Table 1.2: U.S. Gross Purchases and Sales of Foreign Stocks by Country

Dollars in billions

Country	1982	1983	1984	1985	1986	1987	1988[a]
Japan	$4.3	$8.0	$9.0	$11.6	$25.6	$47.7	$47.0
United Kingdom	3.6	6.5	7.8	13.3	32.6	67.8	46.7
Canada	2.9	5.0	4.4	6.8	9.8	18.8	11.8
France	0.8	1.3	1.0	1.2	4.2	6.1	3.5
Germany	0.5	1.2	0.9	1.9	6.1	8.6	4.8
All Other	3.6	8.3	7.6	10.9	21.9	40.4	27.9
Total	**$15.7**	**$30.3**	**$30.7**	**$45.7**	**$100.2**	**$189.4**	**$141.7**

[a]Preliminary 6-months data at annual rates, not seasonally adjusted
Source: U.S. Treasury Bulletin (various issues).

Table 1.3: International and Foreign Bond Offerings

Dollars in billions

Offerings	1985	1986	1987	1988[a]
All Issues				
International issues	$136.6	$187.7	$140.5	$135.7
Foreign issues	31.2	39.4	40.3	36.2
Special placements	1.3	1.0	•	2.5
Total	**$169.1**	**$228.1**	**$180.8**	**$174.4**
International Issues by Currency				
US Dollar	$96.8	$118.1	$58.1	$59.1
Yen	6.6	18.5	22.6	12.2
Deutschemark	9.6	17.1	15.0	17.5
Sterling	6.1	10.6	15.0	18.4
Australian dollar	3.1	3.4	8.8	5.8
ECU	6.9	7.1	7.4	7.1
Canadian dollar	2.9	5.1	6.0	9.8
French franc	1.1	3.5	1.8	2.1
Total	**$133.1**	**$183.4**	**$134.7**	**$132.0**
Foreign Issues by Market				
Switzerland	$14.9	$23.2	$24.3	$21.6
United States	4.9	6.8	7.4	6.8
Japan	6.3	5.2	4.1	4.4
Total	**$26.1**	**$35.2**	**$35.8**	**$32.8**

[a]January through September.
Source: Financial Market Trends, OECD, November 1988.

International Coordination of Securities Regulation

The need to consider coordination goes beyond dealing with a major financial upheaval such as the October 19th crash, but arises when regulators consider how to achieve their goals as markets become international. Governmental and market regulators are striving to ensure adequate investor protection and market integrity, but without imposing such onerous regulation that one market would have an inordinate competitive advantage over another. They are in the process of attempting to strike a balance between creating a regulatory environment with the flexibility to draw international investors and the safeguards to maintain a viable market. For example, one generally proposed scenario is that of "competition by laxity," whereby markets liberalize their regulations mostly to attract each others' business, but at the expense of maintaining a stable financial system. Many market participants, regulators and analysts believe that in reality a "flight to quality" is more often the case as investors generally seem to be willing to accept more stringent regulation to trade in a perceived safe and stable environment, such as the United States or the United Kingdom, over less regulated markets. In the end, investors are seeking to balance risk and return when deciding in which markets to allocate their resources. One example is the Hong Kong market, which had to close on October 19, 1987, and now must establish credibility.

International coordination of securities regulation is difficult. The varied regulatory structures among countries and the diverse rules and approaches to regulation create formidable obstacles to consensus. Furthermore, coordination is made more difficult when regulatory goals differ, such as when a primary goal of regulation in one market is investor protection while in another market the goal is development of that market. Coordination is further complicated by the multiple securities regulators within each market striving to coordinate their own regulations.

The differing regulatory structures of three major markets, the United States, the United Kingdom (U.K.), and Japan, affect their ability to coordinate regulation. First, the Glass Steagall Act in the United States and its equivalent, Article 65, in Japan separate the securities and banking industries and thus result in different regulatory structures than in the United Kingdom, where banks are allowed to engage in securities transactions. Second, major markets differ in their reliance on non-governmental self-regulatory organizations (SRO). The U.S. Securities and Exchange Commission (SEC) in its policy statement, "Regulation of International Securities Markets" of November 1988, stated that "in seeking solutions to common problems, securities regulators should be sensitive to cultural differences and national sovereignty concerns. Regulators should also be mindful and respectful of existing national regulatory frameworks."

The SEC suggested that an effective regulatory structure for an international securities market system would include the following features.

1. Efficient structures for quotation, price and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards.

2. Sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards that provide investor protection yet balance costs and benefits for market participants.

3. Fair and honest markets, achieved through regulation of abusive sales practices, prohibitions against fraudulent conduct, and high levels of enforcement cooperation.

Despite the obstacles, coordination efforts are proceeding in many areas and are accelerating within the European Community (EC) with the planned 1992 harmonization. EC efforts may give further impetus to coordination among the major markets which, in some cases, see the EC harmonization as a serious challenge.

The agencies that exercise regulatory responsibilities in the three major financial markets are described briefly in the following sections.

The United States

The U.S. securities and futures industries are governed by numerous SROs which are overseen at the federal level by the SEC and the Commodity Futures Trading Commission (CFTC). In addition, both the SEC and the CFTC are overseen by congressional committees.

The SEC is an independent, bipartisan, quasi-judicial regulatory agency, created by the Securities Exchange Act of 1934, to administer Federal laws which protect the public and investors against malpractice in the securities and financial markets. The financial instruments under SEC jurisdiction include stocks, corporate and treasury bonds, mutual funds, and securities options.

The CFTC is an independent, bipartisan, quasi-judicial regulatory agency created in 1974 to administer the Commodity Exchange Act and oversee the futures and commodity options industry to protect the public from fraud and manipulation in the marketplace. With certain minor exceptions, the CFTC has exclusive jurisdiction over the regulation of commodity futures and commodity option contracts in the United States.

SROs include numerous organized securities and futures exchanges, the Securities Clearing Corporation, and the National Association of Securities Dealers (NASD) which regulates the over-the-counter securities market. Other SROs are the National Futures Association which, pursuant to authority delegated by CFTC and subject to CFTC oversight, registers and oversees most futures market firms and professionals and the Municipal Securities Rulemaking Board which adopts rules regarding municipal securities transactions. The Securities Investor Protection Corporation is a private nonprofit membership corporation which protects customers against losses of failed securities firms.

The various states also have regulations governing the securities industry. In addition, the Federal Reserve Board has the authority to set margins, or borrowing requirements, for stocks (the SROs set minimum margin requirements for futures contracts).

The United Kingdom

The Financial Services Act of 1986 changed the structure of securities regulation in the United Kingdom by liberalizing the rules for investing in the stock market, with the overall purpose of improving the domestic and international competitiveness of the British securities markets. London is now the only one of the three major financial centers where foreign firms can carry out a full range of market activities. (The United States and Japan prohibit banks from dealing in securities domestically.)

The major innovations of the new system included replacing fixed brokerage commissions with negotiated commissions, eliminating single capacity trading, allowing foreigners to own up to 100 percent of a stock exchange member firm (the original ceiling was 29.9 percent), and implementing the stock exchange's automated price dissemination system. These innovations resulted in significant change; for example, single capacity trading had consisted of compulsory separation of stockbrokers (agents) and jobbers (dealers trading as principals from their own accounts), but the new system allows brokers and jobbers to buy and sell stocks both as principals and agents, thus increasing the number of market participants.

Notwithstanding the liberalization discussed above, the Financial Services Act also established a comprehensive scheme of regulation for the financial services industry. The new U.K. regulatory structure combines autonomous self-regulation and centralized control. The entire financial system is overseen by the Treasury and the Department of Trade and Industry, the former essentially over banking and the latter over securities and commodities. Both agencies are headed by members of Parliament, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry. The Department of Trade and Industry was responsible for writing the Financial Services Act and is the official government body which forms agreements with foreign government agencies on securities regulation.

The next level of regulation is the Securities and Investment Board (SIB) created by the Financial Services Act, to which the Department of Trade and Industry has transferred some of its authority. SIB is a private organization whose members are appointed jointly by the Secretary of State for Trade and the Governor of the Bank of England. While the SIB is financed by those it regulates, its rules are statutorily based and carry the force of law.

Each market and/or activity is also supervised either by an SRO or by a Recognized Investment Exchange, which are all overseen by the SIB. A Recognized Investment Exchange is a commercial entity which must meet certain minimum criteria, such as showing adequate financial resources and rules to ensure orderly conduct of business. It does not have regulatory functions like an SRO, but provides an organized market framework within which transactions can take place. The Recognized Investment Exchange cannot confer authorization as an investment business, as this can only be carried out by an SRO or the SIB. The SRO authorizes and regulates an investment business' relationship with the investing public. For example, the futures market is overseen by a Recognized Investment Exchange called London International Financial Futures Exchange Limited.

Japan

Japan has the most centralized regulatory structure of the three markets. The Securities and Exchange Law of 1947, patterned after the U.S. Securities Exchange Act of 1934, was enacted to provide regulation to ensure the proper operation of the economy and protect investors. The

Securities Bureau within the Ministry of Finance (MOF) was established in 1964 to administer regulation of the securities industry. The Bureau supervises and guides securities companies, stock exchanges, securities finance companies, foreign securities firms and banking institutions engaged in securities business. The Securities Exchange Council is an advisory body of the MOF whose purpose is to investigate issuance, trading and other securities matters. The Tokyo Stock Exchange and the Japanese Securities Dealers Association have some self-regulatory functions. In addition, futures are regulated by several Bureaus within the MOF, as well as by the Ministry of International Trade and Industry and the Ministry of Agriculture, Forestry and Fisheries.

Objectives, Scope, and Methodology

The Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the Ranking Minority Member, and the Chairman of the Subcommittee on Securities, asked us to identify what issues the United States should be considering to better coordinate international regulation of the securities markets and to determine the extent of coordination occurring internationally. We limited our analysis to bond, stock, and financial futures markets and did not examine the commodity futures industry.

We reviewed the coordination efforts among regulators and market participants in several key areas including capital adequacy, listing and disclosure rules, accounting and auditing practices, and clearance and settlement systems. Our focus was to identify ongoing endeavors, prospects for the future and major impediments to coordination. We tried to identify whether there was any consensus about which issues needed immediate attention, which issues were important but not urgent, and which issues presented only minor problems. The principal criteria we used to determine the issues were whether (1) international agreement on an issue is a key component for coordination on other issues to take place and (2) failure to coordinate international regulation would leave the U.S. markets vulnerable to disruption or seriously hinder federal efforts to achieve stated goals.

Our purpose was to assess the status of coordination efforts and to identify prospective issues rather than evaluate past agency actions in these areas.

We interviewed government regulators, stock exchange officials, and market participants in the United States, the United Kingdom and

Japan. In selecting market participants to interview, we did not randomly sample participants with a goal of being able to make statistically valid generalizations about all market participants. We did select market participants so that a broad spectrum of viewpoints could be included, particularly from the large U.S. firms heavily involved in international securities trading. Our characterization of market participant views, thus, relates to these selected interviewees, not necessarily to all participants in securities markets. We also interviewed academics and officials of international organizations representing regulators and market participants to obtain their views on the necessity for international securities coordination. We reviewed written agreements among regulators and materials provided by the various agencies and attended the annual conference of the International Organization of Securities Commissions in November 1988.

Our work was conducted between September and December 1988 in accordance with generally accepted government auditing standards.

Existing Vehicles for Coordination

Various international organizations provide forums for discussion and analysis of international securities regulation issues. Coordination is also taking place as a result of bilateral arrangements between individual country regulators and market participants.

The international organizations represent a wide variety of groups, from country regulators and government officials to private industry members and stock exchanges. This variety reflects the complex nature of securities regulation, which includes many types of players and provides evidence of general interest in coordination. Although such organizations have fostered international discussion and consensus on coordinating securities regulation, each has its own unique make-up and membership and has taken different approaches to coordination. No one organization has taken the lead.

Countries have taken advantage of international forums and have also coordinated securities regulation and enforcement activities directly with each other through formal and informal agreements among regulators and SROs and through computer linkages among stock exchanges and over-the-counter markets.

International Organizations

The major international organizations addressing securities regulation include, (1) the International Organization of Securities Commissions (IOSCO), (2) the Organization for Economic Cooperation and Development (OECD), (3) the Federation Internationale des Bourses de Valeurs (FIBV) (International Federation of Stock Exchanges), (4) the Consultative Group on Economic and Monetary Affairs (Group of Thirty), and (5) the Wilton Park Group.

While they do not act in isolation from each other, each organization addresses issues within the realm of its membership's concerns. IOSCO members are securities administrators; OECD member countries are represented by appointed ambassadors, and, once a year, by ministers of finance, foreign affairs, trade and other governmental regulators; FIBV consists of stock exchanges; the Group of Thirty consists of 30 individual international bankers, businessmen, academics, and former officials; and the Wilton Park Group is an informal group of securities and commodities regulators.

International Organization of Securities Commissions

The International Organization of Securities Commissions (IOSCO) is made up of securities regulators from more than 40 countries. In addition, associate members (such as the CFTC) and non-members (such as exchanges and securities houses) participate as interested observers.

IOSCO has evolved from a predominantly educational organization to one which facilitates international securities coordination efforts. Coordination is one of the primary purposes of IOSCO along with exchanging information, establishing standards and effective surveillance, and providing mutual assistance to ensure the integrity of the markets.

IOSCO established a technical committee to identify priority areas of concern and set up a working group for each area. The priority areas it identified were (1) equity offerings of securities on a multinational basis, (2) international accounting and auditing standards, (3) capital requirements for multinational securities firms and exchange of financial data, (4) constraints on the exchange of enforcement information and/or evidence between securities regulators, (5) off-market trading, (6) international clearance and settlement problems, and (7) futures markets.

As the principal representative of the United States, the SEC is a member of the working groups on enforcement, multinational offerings, accounting and auditing standards, capital requirements, and futures markets. CFTC is also a member of the enforcement and capital requirements groups and chairs the futures markets working group.

Organization for Economic Cooperation and Development

The OECD is made up of 24 developed country members. Its goals are to achieve high economic growth, contribute to sound economic expansion, and contribute to the expansion of world trade. OECD's macro-economic focus looks at securities coordination in terms of the international flow of capital, rather than harmonization of regulations.

Member countries are represented at the OECD by ambassadors and at periodic high-level meetings at the ministerial level by ministers of finance and other cabinet level officials from each country. The OECD also has a permanent research staff. Its ministerial level consists of cabinet level officials with authority over securities, banking, and other relevant areas and central banks are represented. These officials have the ability to enter into and enforce agreements at their respective national levels. The OECD is taking a more active role in addressing coordinated securities regulation and provides research to securities regulators.

The Federation Internationale Des Bourses De Valeurs

FIBV (International Federation of Stock Exchanges) has a membership of 33 stock exchanges. Its primary function is to facilitate the exchange of information among stock exchanges. Unlike other international groups such as IOSCO and OECD, the FIBV does not coordinate international securities regulation, but rather provides pertinent information, such as each country's securities rules and regulations, for stock exchanges to use in their own regulatory efforts. Member exchanges decide what issues to address and recent studies have focused on clearance and settlement and listing and disclosure.

Group of Thirty

The Consultative Group on Economic and Monetary Affairs or The Group of Thirty is an ad hoc group which studies broad financial issues, such as balance of payments, third world debt, and global securities markets. It consists of 30 individuals from four different groups: international bankers, international businessmen (non-bankers), academics, and past and present officials.

Wilton Park Group

This informal group of securities regulators was set up within the last four years, promoted by the Department of Trade and Industry in the United Kingdom. Its primary focus is to develop a means for supervisory agencies to share information that is needed for enforcement purposes. It does not generally address the broader regulatory issues arising from the internationalization of markets.

Regulators and Industry Perceptions of IOSCO and OECD

Regulators and market participants told us that international coordinating organizations like IOSCO and OECD allow regulators to discuss securities concerns and to focus on pertinent problems that require regulatory action. Such forums facilitate the exchange of information face-to-face and encourage coordination efforts.

U.S. and foreign regulators and market representatives generally have a positive view of IOSCO's coordination efforts. Most regulators and market representatives cited IOSCO's changing role from educator to coordinator. Historically, IOSCO was primarily an educational organization to benefit its original South American members. However, IOSCO has been changing and the newly formed technical committee and its various working groups are shifting the focus of the organization more toward international coordination of securities regulation.

Opinions differed, however, on IOSCO's ability to achieve securities regulation coordination and its potential role as "spokesman" for international securities regulators. IOSCO has several limitations. It does not have the advantage of a permanent full-time research staff on which it can draw for support. Furthermore, as a private group, IOSCO's initiatives may not be adopted as readily as those of a multilateral organization. IOSCO's membership was viewed as both a strength and a weakness. While many people we talked with agreed that regulators are, and should be, major players in any attempt toward international coordination of regulation, they also agreed, in general, that market participants need to be involved in discussions concerning the development of international regulatory standards. Furthermore, other than as observers, central banks are not represented at IOSCO, even though securities and banking activities are not separated in most countries and banks play a role in ensuring the liquidity of financial markets.

While it is seeking an active role in addressing coordination of securities markets, OECD was not viewed by either regulators or market participants as a major player. This was because OECD is an informational group rather than a standard setting body like IOSCO. One U.S. official pointed out that while the OECD was not a regulatory body, it has a policy coordination role to play. OECD staff felt that the ministerial level of membership and its large permanent staff provide a relevant forum for regulators to discuss coordination problems and devise pertinent solutions toward harmonization.

Status of Regulatory Agreements and Market Linkages

In addition to the multinational forums for coordination, other coordination mechanisms exist in the form of government to government regulatory agreements and direct linkages between markets. The purpose of linkages can vary, including allowing markets to share information, track the activities of traders, and monitor against stock manipulation or to expand the investment opportunities of exchange members.

Regulatory Agreements

Regulatory agreements include Memoranda of Understanding (MOU), information sharing agreements, treaties, and agreements on regulatory jurisdiction and reciprocal regulation. MOUs are non-binding statements of the intent of parties, while treaties obligate signatories.

Most U.S. MOUs are between the SEC or CFTC and their foreign regulatory counterparts and deal with facilitating enforcement investigations or sharing financial information. They originated with the SEC's efforts to enforce U.S. securities laws in an international environment and difficulty in obtaining information located outside U.S. borders, and thus beyond SEC jurisdiction. To address these problems, formal bilateral understandings were reached which provide for the sharing of information.

Examples of MOUs to share information for enforcement purposes include those between the SEC and the (1) Brazil Comissao de Valores Mobiliarios for mutual cooperation in administering and enforcing U.S. and Brazilian securities laws, (2) Securities Bureau of the Japanese Ministry of Finance to share investigative and surveillance information as each government enforces its securities laws, (3) Canadian Securities Commissions of Quebec, Ontario, and British Columbia to cooperate in enforcing and administering Canadian and U.S. securities laws, (4) U.K. Department of Trade and Industry in matters related to securities, and between the CFTC and the U.K. Department of Trade and Industry in matters related to futures to exchange information to facilitate the performance of their respective functions.

More recently, MOUs have gone beyond enforcement to cover financial information. For example, the CFTC and the U.K. SIB and U.S. and U.K. futures SROs have entered into a MOU under which both countries will share information regarding the financial condition of U.S. futures commission merchants and their U.K. branch offices. Based on the shared information, the relevant U.K. regulator will waive its financial requirements in favor of the United States enforcing its own capital requirements on the branches. This allows the U.S. branches to operate in the U.K. without being subject to duplicative financial requirements. (The SEC views this as a useful model to share information on affiliates.) A similar MOU has been signed by the SEC, the SIB, U.S. and U.K. SROs, and the Bank of England, stating that based on financial information shared between the two markets, U.K. capital adequacy rules for some U.S. broker-dealers located in the U.K. will be waived.

The United States has signed treaties for mutual assistance in criminal matters with Switzerland, the Kingdom of the Netherlands, the Republic of Turkey and the Italian Republic.

Agreements on reciprocal regulation are being considered by the SEC. For example, Canada and the United States have been working on an agreement that would allow so called world class issuers to enter each of the other countries' capital markets without filing two different sets of documents to register securities. The United States would honor Canada's requirements and Canada would honor those of the United States, so the SEC would accept a Canadian prospectus without further review. In addition, the CFTC has issued "comparability" orders which permit firms in certain foreign jurisdictions to offer and sell foreign futures and option products to investors in the United States. Under these orders, the CFTC will accept substantial compliance by these firms with certain foreign requirements that are deemed to be comparable to the U.S. requirements.

Trading Linkages

Trading linkages between markets facilitate international trades by allowing traders on the floor of one exchange to compare prices and make trades on another exchange of which the trader is not a member. They also allow traders to trade around the clock by taking advantage of trading linkages with other time zones. Trading linkages between stock exchanges and between futures exchanges allow buy and sell orders to be sent directly from the floor of one exchange to the floor of another. The markets involved commit themselves to honoring the quotes at the time the order is transmitted. The number of linkages, however, has grown faster than the increase of business channelled through them and have not been terribly successful from a business standpoint.

Examples of trading linkages are the Boston Stock Exchange/ Montreal Stock Exchange, in which U.S. stocks listed on both exchanges can be traded on either exchange to obtain the best price for the stock, and the London International Stock Exchange (ISE)/NASD, in which the ISE and NASD operate a quotation exchange arrangement. ISE shows quotations for about 300 securities on NASD's NASDAQ system and NASD quotes about 300 securities on ISE's quotation dissemination system.

Consensus of Views

A common theme among the officials we interviewed was that regulatory coordination is an evolutionary process. They said MOUs formalize communication between parties that is already occurring and bilateral agreements can encourage multilateral agreements.

A U.S. official maintained that, unlike more formalized treaties, MOUs provided the flexibility to permit regulators and officials on each side to adjust to changes in market practices and procedures; for example, the SEC is using MOUs to establish a "track record" and win the trust of foreign regulators in obtaining enforcement information. Foreign officials' concern about the release of information under the U.S. Freedom of

Information Act has been an impediment to U.S. negotiation of such agreements, although the SEC has requested that legislation be changed to guarantee absolute confidentiality. Another U.S. official believed information sharing agreements made access to foreign markets easier and considered them a first step to international coordination.

Officials told us that the U.S. decentralized regulatory structure has made it more difficult to establish MOUs and information sharing agreements. U.S. securities regulation is shared among the SEC, CFTC and the Federal Reserve, while many countries have one governmental securities regulator. In some cases, multiple agreements must be made because more than one U.S. agency is involved. The United Kingdom, with a similar regulatory structure, has a similar problem. Some officials and market participants told us that U.S. efforts could be improved if U.S. regulators ensured common agreements prior to international negotiations. For example, one foreign regulator described difficulties in negotiating agreements with U.S. regulators that provide consistent rules for sharing information. A major reason, he told us, was that the U.S. regulators took different views of their consumer protection mandates. Similarly, we were told that negotiations by securities regulators in another nation were complicated by inadequate sharing of information within the U.S. government.

U.K. officials noted that forming international agreements is sometimes made difficult when the regulatory standards of foreign exchanges are lower than those of the U.K. They commented that coordination of securities and futures regulation is at a less advanced stage than coordination for banking regulation. Another regulator noted that coordination of banking regulation was achieved because there was a convergence of interest among regulators and bankers. This may be less the case for securities, however, which is thought to be less mature than banking.

Japanese regulators preferred bilateral agreements over multilateral treaties for information exchange because they believed that bilateral agreements better met the specific needs of each party while multilateral agreements inherently involve greater compromise among parties with different needs and goals.

Conclusions

Regulatory coordination is occurring through various types of agreements, both formal and informal, bilateral and multilateral and through a variety of international forums. No one international organization has taken the lead in coordinating securities regulation, partly because of the range of players involved and partly because such coordination is in a formative stage.

As internationalization proceeds, it will become more important to ensure that U.S. agencies themselves coordinate their approaches to international securities issues. With the increased involvement of U.S. securities firms and exchanges in international markets, such coordination becomes more crucial to enable the United States to effectively participate in worldwide coordination efforts. However, there is no formal process today to guarantee that a unified domestic approach to international coordination occurs.

Of the two international organizations, IOSCO and OECD, each has advantages as a vehicle for international securities coordination. While IOSCO has no full time permanent staff to facilitate its coordination efforts, its committees and working groups are focusing on the pertinent regulatory issues and its membership is familiar with the obstacles to be overcome. However, because IOSCO consists of only securities commissioners, it lacks other major players, such as central banks. It is also a private group whose suggestions may be less likely to be adopted by governments than the proposals made by ministerial level representatives like those in the OECD.

OECD has a wide array of representatives at the ministerial level in foreign affairs, finance, trade, and other areas, whose government positions at home may give them some influence in implementing OECD initiatives. It is also the organization in which both governmental agencies and central banks are represented. The OECD staff provides a research base that could play an important role in coordinating activities.

Outside of the efforts of international organizations, individual countries have initiated their own forms of coordination, including MOUs, information sharing agreements, trading linkages, and treaties. Such coordination began in the enforcement area and is now moving into the area of financial information sharing. To date, most coordination has been bilateral in nature, which allows the agreements to be specific.

Capital Adequacy

Capital adequacy requirements and their enforcement are designed to ensure that securities firms are able to withstand normal business losses attributable to taking risks in securities trading, and thus ensure that the market offers adequate protection against other-than-market losses to the firm's customers. Adequate capitalization ensures smooth operation in normal times and provides a basis to minimize disruption to the system and avoid a cascade of defaults should a firm be unable to honor its trading commitments.

International trading of securities has greatly increased the extent to which firms in various countries deal with one another and decreased the extent to which firms will necessarily know all the other parties involved in the transactions, i.e., the counterparties, thus increasing counterparty risk.[1] To the extent that trades can clear and be settled rapidly, the counterparty risk is minimized, reducing the capital that is required to ensure smooth operation. International clearance and settlement systems (discussed in the next chapter) vary considerably in the time it takes to complete a transaction. Thus, it is necessary to evaluate counterparty risk and assess the reliability of a trading partner, and capital adequacy is an important component in making this judgement. The comparative stringency of capital adequacy requirements and their coordination internationally thus are central issues in the development of international financial markets because (1) they foster the expansion of international trading relationships by ensuring that all traders meet at least a minimum standard and (2) less stringent capital requirements in a given trading center could lead to a rippling of defaults if firms are not able to meet their obligations.

Coordinating capital adequacy is important for three general reasons. First, capital adequacy of firms is an important measure of financial integrity. The risk of trading securities in a given market is directly dependent on the financial strength of firms participating in that market. In general, if less stringent or less well enforced capital adequacy standards exist, the greater the potential for defaults and breakdowns in trading which damage the integrity of the entire market.

Second, maintenance of capital to absorb losses, even normal losses, is costly. Therefore, firms with less stringent or poorly enforced capital requirements and their respective markets may have a competitive

[1]The party who bears the risk depends on the type of transaction. For example, with futures contracts, the clearinghouses guarantee the trades by becoming the buyer to all sell contracts and vice-versa.

advantage over other more stringently regulated firms or markets, since their cost of doing business may be lower.

Third, adequate capital is the primary protection against heightened potential for systemic problems, i.e., the possibility that failure of a firm will spill over national boundaries, causing firms in other countries to fail. The risk of systemic problems raises the potential that a "safety net," possibly including central bank intervention, would be needed during financial crises to supplement private capital and liquidity and ensure the integrity of the system. Such central bank intervention occurred in several nations during the October 1987 crash. Firms of all qualities might be expected to compete in markets with low standards while only firms of high quality compete in markets with high capital adequacy standards. This could result in high quality firms dealing directly with low quality firms in less stringently regulated markets, thus exposing the high quality firms, the markets in which they operate, and the international financial system to a greater level of risk.

A threat to the integrity of financial markets ultimately involves central banks. However, the role of central banks is not clear since, for the most part, they do not formally acknowledge a lender-of-last-resort function for securities firms and markets. Nevertheless, they have exercised this function on a case by case basis. International coordination in the event of a crisis is further complicated since it is not clear whether central banks would accept responsibility for their home country firms' problems in host country markets or whether they would deal with problems only as they arose in their home country markets.

Consensus of Views

The participants we interviewed felt, in virtually every case, that capital adequacy was an important matter to consider. Although none felt that current differences create significant operating problems or pose a significant hazard, they did rank it among the highest of those regulatory issues needing coordination internationally.

At the current time, most of the participants felt there was not a need for uniformity in international standards. Participant opinions varied considerably, ranging from standardization of rules to standardization of definitions (even if the requirements are different) to harmonization of goals (even if the rules are different).

Financial Integrity of the Firm

While there is general agreement on the importance and goals of capital adequacy regulation, the capital adequacy rules, definitions, and implementation differ considerably among the three major markets of New York, London, and Tokyo. (See app. I for discussion of differences.) The consensus of views was that this was primarily or entirely an operational issue within these markets and that as long as there was consistency of goals, the financial soundness of firms would not be affected.

However, some market participants were concerned that in coordinating capital adequacy standards, universal banks and securities firms need to be treated on a comparable basis. The Glass-Steagall Act in the United States and Article 65 in Japan prohibit banks from dealing in securities domestically. Such restrictions do not exist in other major financial centers, such as the United Kingdom and West Germany, which permit universal banking.

The U.K. participants we talked with were especially concerned with such consistency as the problem already exists in their market. The central bank, securities regulators and SROs are currently discussing how best to handle the situation. Capital adequacy rules are set by the Bank of England for banks engaging in securities activities and different capital adequacy rules are set by the Securities Association for securities houses. Most participants believed that the Bank of England rules are more strict than those set by The Securities Association (a securities SRO), except in the area of underwriting, where banks doing securities work are perceived to have an advantage. But the fact that capital adequacy requirements are calculated differently for firms doing the same business could put one at a competitive advantage over another. Another concern is that capital adequacy rules for banks may not be appropriate for the securities business and therefore may not provide an adequate cushion to absorb losses as intended.

Systemic Risk and the Role of Central Banks

Some market participants were concerned that uneven capital requirements, if regulation in some markets are inadequate, could result in a widespread rippling of defaults that could create an international financial crisis, potentially requiring central bank intervention. Regardless of the regulatory philosophy behind the establishment of the level of capital requirements, there is widespread agreement that a firm's capital represents the first line of defense in preserving financial integrity. In most cases, a firm's default on its obligations and consequent insolvency is of concern only to its creditors and to the regulatory authorities responsible for dealing with the losses. In other cases, however, a firm's default could have such adverse effects on its creditors or a firm's multiple defaults during a difficult period could be so widespread that the financial system is jeopardized. As the internationalization of trading grows, uneven capital requirements mean that some markets or the firms principally or entirely based in those markets would be less able to withstand a crisis than others.

Some of those we spoke with expressed serious concern over the issue of systemic risk, particularly in the aftermath of the October 1987 stock market crash. One participant, who was especially concerned with this issue, told us that it does not have to be a major player to "tumble" the system and create systemic imbalances.

Some of those we spoke with cautioned that there are no guarantees that the central banks would step in during any future emergency, but most market participants assumed that the central banks would ultimately provide adequate liquidity and thus ensure the integrity of the system if private capital were inadequate. In fact, some central banks, including the Federal Reserve and the Bank of England did act in that capacity during the October 1987 crash. The Federal Reserve provided liquidity to the banking system through expansionary open market operations and suspended rules governing the lending of securities. U.K. regulators told us that the Bank of England also intervened, and directed banks to keep the credit windows open. Some question whether the central banks should formally become either the lender-of-last-resort or a guarantor of liquidity to the system, arguing that it could create a "moral hazard" for the system, increasing the incentive to take excessive risks in the belief that losses will be covered by central banks. However, because central banks historically have been sources of liquidity in times of crisis, some of those we spoke with believe that central banks should be involved with securities and other regulators in establishing and coordinating capital adequacy regulation and standards for securities firms.

Coordination Efforts

Despite the fact that most of those we spoke with felt that capital adequacy was among the most important coordination challenges, little progress has been made in this area. One of the most important efforts concerning international coordination of capital requirements involves work toward reconciling differences in European country requirements with the 1992 European Community directives on harmonized capital rules. In addition, several of those we spoke with felt that IOSCO was attempting to better coordinate capital adequacy regulation.

Conclusions

Because of the concern about systemic risks, we believe that coordinating capital adequacy is one of the most important issues of internationalization. While none of those we interviewed believed that capital adequacy regulation posed an urgent problem, it was widely believed to be among the most important areas requiring coordination. Concern was based on the need to better assure the financial integrity of international transactions and on the potential consequence of inadequate regulation, particularly a heightened potential of systemic financial problems and central bank intervention. Despite the importance of this issue, little progress has been made to better coordinate capital adequacy regulation internationally.

The limited progress is probably attributable to (1) the fact that no crisis has been seen in the current system, (2) capital adequacy regulation is highly complex, and (3) different countries' approaches to capital adequacy regulation evolve from differing philosophies. For example, Japan relies on high levels of capital and less direct regulation while the United States and United Kingdom rely on more direct regulation to offset some of the dangers of a lower level of required capital.

Capital adequacy of securities firms is the first line of defense in the event of a financial crisis; past crises, however, have required a safety net, including central bank intervention, to supplement financial capital. Because of this, we believe that central banks should play a role in coordinating capital adequacy requirements. They have served as guarantors of liquidity in past crises, particularly in October 1987, and cannot be sure they will not be called upon to do so again. It is particularly important, in our view, that central banks attempt to reach agreements on international responsibilities in the event of a crisis.

Clearance and Settlement

Clearance and settlement is a collection of activities undertaken by exchanges, clearinghouses, and depositories after a securities transaction has been made. These activities can be classified as trade processing, risk management, and settlement. In trade processing, trades received from the buy and sell sides are matched or compared. In risk management, protective measures such as margin requirements, guarantee funds, default procedures, monitoring programs, and information sharing systems have been implemented to ensure that clearing members do not endanger the financial integrity of the clearinghouse. Settlement occurs when the clearinghouse and depository pass securities to the buyer either physically or through a book entry system (i.e., ownership is transferred without the security instrument physically changing hands) and pay the seller. In the case of futures and options, instruments are paperless, so the transaction is completed when money is exchanged.

To the extent that securities are traded internationally, the lack of international clearance and settlement links to facilitate cross-border settlements, coupled with the existence of widely varying clearance and settlement systems among the world's capital markets, increases investor risk and costs.[1] However, this is not a major issue as long as the vast majority of transactions occur within domestic markets, as is the case today because foreign participants are obliged to follow the same rules as domestic participants. If cross-border transactions become more common, however, harmonization of international clearance and settlement systems will become more important; an international clearance and settlement system, furthermore, may facilitate cross-border transactions. Additionally, by reducing the counterparty risk in transactions, progress toward a more timely and efficient clearance and settlement system can lessen the level of securities firm capital that is needed to ensure financial integrity.

Settlement time frames and settlement procedures for financial instruments vary widely among international markets—from 3 days in Tokyo and 5 in New York for corporate equities to one month in France—with physical clearance and settlement the rule in some markets, such as Japan and Italy, and book entry or even "dematerialized"[2] securities in

[1] The risks to individual market participants include counterparty risk, error risk, and market risk. Increased costs include unnecessary interest expense incurred because securities cannot be delivered and payment received efficiently and, in the worst case, the resources required to fund net receivables from failed security transactions could impair an institution's financial viability.

[2] Elimination of stock certificates.

other markets such as France. Trades cleared and settled through U.S. facilities are processed in a continuous net settlement system,[3] while many other systems are delivery versus payment systems[4] or require members to settle trades on a trade-for-trade basis.[5] The lack of standardization in settlement practices, particularly differing financial responsibilities of clearinghouses, increases the risk and likelihood of errors which ultimately affect the cost of doing business. Additionally, longer settlement periods result in greater potential settlement exposure.

Consensus of Views

Most regulators and SROs agreed that clearance and settlement is an important issue, yet standardization will be difficult to achieve since clearance and settlement is basically a domestic procedure with transactions occurring within domestic markets. Some regulators have encouraged clearance and settlement linkages,[6] but few exist due to low profitability.

The time to clear and settle is an important attribute of market competitiveness, and most participants viewed a short settlement time, e.g., three to five days, as the goal for an international standard. Some Japanese participants think a consistent set of international securities trading symbols and transactions codes would facilitate the international clearance and settlement process, and believe a rolling settlement system[7] for each country is a prerequisite for harmonization.

Coordination Efforts

Multinational organizations such as IOSCO, FIBV, and the Group of Thirty, are currently discussing uniform or, alternatively, compatible standards and procedures for clearance and settlement systems. For example,

[3]An accounting system that settles daily transactions between brokers in which the net increase or decrease in accounts is recorded and carried forward to the next day.

[4]Instructions or terms of a security transaction, indicating that settlement is to be made upon delivery of those securities. Delivery versus payment systems do not provide a net settlement system for participants.

[5]Trade-for-trade settlement systems generally do not provide participants with guarantees of their securities trades. Participants may use the clearing system for comparison of their trades and delivery, but the clearing system's role remains that of an agent to the parties.

[6]Linkages provide access to U.S. clearing agency services by non-U.S. clearing systems on behalf of their members and U.S. clearing agencies access on behalf of their members to non-U.S. clearing systems to alleviate problems.

[7]A rolling settlement system involves daily settlement as in the continuous net settlement system in the United States. All futures trading is settled in one day and marked to the market each day.

IOSCO's clearance and settlement working group presented a simplified model for assessing risk associated with clearance and settlement at its recent annual conference. FIBV sponsored a seminar in April 1987 which focused on problems in cross-border settlement and resulted in the approval of seven resolutions which provided at least a uniform focus on the problem. The Group of Thirty sponsored a symposium in March 1988 on clearance and settlement issues in global securities markets. The Group of Thirty is proposing a more uniform system for global securities clearance and settlement including immobilized securities[8] with receipt and delivery done by book entry, central clearing as in the Eurobond markets, uniform settlement periods, consistent trade guarantees, and increased automation.

Since 1980, several U.S. registered clearing agencies have pursued clearance and settlement linkages with their foreign counterparts. These linkages provide non-U.S. broker/dealers and institutional customers with indirect access to U.S. clearing agencies through their domestic clearing entity. In 1985, the International Securities Clearing Corporation was created to facilitate clearance and settlement of U.S. firms' global trading. Its strategy is to link clearing and depository organizations in other countries to provide locally accessible clearance and settlement capabilities for U.S. firms dealing in foreign securities and for foreign firms dealing in U.S. securities.

Conclusions

Coordination of clearance and settlement systems is not an urgent need, since it remains primarily a domestic function today. However, if cross-border transactions become more common, investor risks and costs could increase. An efficient clearance and settlement process in global capital markets could reduce these costs and risks. This possibility, coupled with the complexity of devising a coordinated system, suggests that this is an area that merits careful study and consideration as international trading increases.

Clearance and settlement linkages provide improved mechanisms for facilitating international trades. But different settlement cycles, systems capabilities, or financial responsibility and operational standards still exist. Clearance and settlement linkages are a step forward, but the lack of uniform standards will still have to be addressed if cross-border

[8]Stock certificates which are maintained in a central location without physical delivery.

transactions become more important. Indeed, lack of progress in harmonizing clearance and settlement systems could impede the growth of such transactions.

Accounting and Auditing Standards

Accounting principles and auditing standards are key factors in achieving mutually acceptable disclosure of financial data for firms whose stock is traded on exchanges or who issue debt instruments.

National differences in accounting standards and disclosure requirements have a potential to hamper international capital raising efforts because (1) of the costs in time and money to consolidate divergent financial information when national laws or practices differ or (2) companies are reluctant to disclose information which is not required by their (home) country's disclosure requirements. For example, financial reporting for segments, (i.e., segmentation of financial information of a business by industry and/or geographic area in which the business operates), of an enterprise is a requirement of U.S. generally accepted accounting principles (GAAP) but not of Japanese accounting principles. Japanese issuers are reluctant to provide segment information; this appears to be one reason that some have avoided U.S. markets when selling new equity securities. However, such disclosure requirements, by ensuring that investors have better information about the financial condition of businesses that issue equity and debt securities, provide a safer market, which attracts both investors and issuers.

The accounting principles of industrialized countries have certain basic concepts in common, including accrual accounting and adherence to the theories of consistency, conservatism, and the going concern concept.[1] Although implementation of these broad practices may be different from country to country, these similarities provide the SEC with a basis to accept financial statements presented in accordance with accounting principles that are generally accepted in the issuer's home country if accompanied by a reconciliation to U.S. GAAP. Such similarities also provide the basis for coordination and harmonization of accounting standards over time to narrow the differences.

Auditing standards among nations are more divergent, however. In some foreign countries, statutory audits attest to the conformity of the company's accounts with the law, not necessarily with a true and fair view of the company's financial position and results of operations as do audits in the United States. For example, confirmation of accounts receivable and observation of inventory often are not performed in statutory audits. In practice, however, most multinational corporations have

[1]Consistency means that the same accounting principles are used from year to year; conservatism means that profits are not anticipated but losses are provided for; and the going concern concept uses historical costs to provide the basis for financial statements, since it is assumed that assets will continue to be used in the business.

audits conducted that do present a true and fair view of the company's position. They will do so to reflect the multinational scope of their operations and finances. Furthermore, most of these multinational corporations are audited by large international accounting firms, who perform full audits which attest to more than conformity with statutory requirements.

The SEC has taken the position that, while divergent accounting principles can be reconciled in public reporting, audits must conform to U.S. standards. Issuers that have had only statutory audits or do not otherwise conform to U.S. standards are not permitted to raise capital or register for trading in the United States until the financial statements for the latest 3 years have been audited on a basis equivalent to U.S. generally accepted auditing standards. International coordination of auditing standards may be a more difficult objective than coordination of accounting standards, at least from a U.S. regulatory perspective, but efforts are underway by some groups to achieve more conformity.

Consensus of Views

Foreign regulators, SROs, and market participants believe that generally accepted principles are needed, but standards should not be as strict as those in the United States. They stated that it is unrealistic to expect the rest of the world to follow U.S. standards. U.S. SROs, like many foreign participants, think the United States should assess each country's standards and consider accepting reciprocity. U.S. regulators, on the other hand, are pursuing the goal of convergence of accounting and auditing standards, using the U.S. standards as the model.

There was some disagreement concerning the impact of U.S. accounting and auditing standards on the level of foreign securities issued in the United States. U.S. market participants believe that the strictness of U.S. rules and the SEC's unwillingness to accept other markets' auditing standards has kept some foreign companies from listing on U.S. exchanges. SEC staff, however, told us that they were aware of only three large international issuers that have been denied access to U.S. markets within the past 2 years because their audits were not in compliance with U.S. auditing standards.

Coordination Efforts

Organizations, such as the International Accounting Standards Committee, the International Federation of Accountants, IOSCO, and OECD, have been involved in several projects to encourage voluntary harmonization of accounting principles, with the active involvement of regulators, accounting bodies, and market participants. The International Accounting Standards Committee proposed to amend its existing measurement and reporting standards alternatives to establish one set of international standards.[2] The International Federation of Accountants issued guidelines on professional ethics, prequalification education and training, and auditing guidelines. IOSCO and OECD are both promoting international comparability of financial statements and harmonization of accounting and auditing standards.

Conclusions

We did not find evidence that different national accounting and auditing standards are a significant obstacle to multinational offerings of corporate securities. Coordination of accounting standards is fairly well advanced. Differences do exist on auditing standards, but the practical effect of these differences may not be significant. Many audits of multinational corporations are conducted by multinational accounting firms; in practice, their audits do test whether the corporation's accounts present a true and fair picture of the corporation's financial status.

[2]SEC accepts foreign issuers' statements that comply with these international standards or reconcile to U.S. GAAP.

Listing and Disclosure

Listing and disclosure regulations are designed to protect investors from fraud and to disclose pertinent financial information so investors can make informed investment decisions. The investing public needs the same type of basic information disclosed for an investment decision regardless of whether the issuer is foreign or domestic, and the interests of the public are served by the opportunity to invest in a variety of securities, including foreign securities. Foreign corporations base their decision whether or not to list on a national exchange not only on listing and disclosure requirements but also on the inherently related accounting and auditing standards of the nation.

Consensus of Views

Most regulators and exchange officials agreed that U.S. listing and disclosure standards are the most stringent of any market. Foreign participants told us that the strict U.S. requirements could be viewed as an "irritant" but were not a significant deterrent to listing on U.S. exchanges. U.S. exchange officials, regulators, and academic experts however, felt that the stringent requirements and the increased transaction costs of doing business in their market put U.S. exchanges at a competitive disadvantage. While U.S. exchange officials said they are not losing U.S. stock listings, they believe they are not getting many foreign listings. According to a New York Stock Exchange official, no Japanese firms have listed on U.S. exchanges since 1978.

Japanese market participants, on the other hand, said they see no need for coordination in this area, since the major Japanese companies had already listed in New York and London.

U.K. participants believe their rules are almost as stringent as the United States, and therefore listing and disclosure differences are not of great concern.

Coordination Efforts

The SEC is currently working on three major international initiatives. The first initiative is a proposed reciprocal disclosure system with the Ontario and Quebec exchanges. The aim of the program is to enable an issuer to prepare a disclosure document according to the requirements of its home jurisdiction and to use that document for securities offerings in the other participating jurisdictions.

Second, the SEC proposed Regulation S to define precisely when a transaction occurs offshore. It provides that any offer or sale that occurs within the United States is subject to U.S. registration requirements and that any sale that occurs outside the United States is not subject to U.S. registration requirements.

The third SEC initiative is proposed Rule 144A, which permits freer resales of privately placed, unregistered securities by institutional investors. Rule 144A will affect U.S. as well as offshore investors, who use the private placement market in the United States. It will make U.S. private placements more attractive to overseas investors and may directly facilitate foreign participation in the U.S. market.

CFTC issued new regulations in 1987 on the sale of foreign futures and options to U.S. investors. The regulations extend the regulatory requirements for purely domestic transactions to foreign transactions undertaken by U.S. residents. The regulations contain an exemptive procedure so that entities or individuals located outside the United States can be exempted from certain U.S. requirements. In particular, the CFTC would accept compliance with comparable foreign regulations in satisfaction of CFTC requirements provided appropriate information sharing arrangements existed with the applicable foreign regulatory bodies. Any person or entity so exempted must nonetheless comply with the CFTC's requirement for disclosing the special risks associated with non-U.S. transactions. Domestically, the CFTC is examining the feasibility of consolidating in one statement the disclosure currently required for domestic, foreign, and linked transactions.

Listing in Japan is based on home country rule and Japanese laws have been amended to relax disclosure procedures, allow the filing of different forms, and shorten the waiting period for foreign issuers.[1] In the United Kingdom, if a stock is listed on an accepted exchange, such as New York and Tokyo, it can be traded in London without being listed there.

Conclusions

Coordination of listing and disclosure requirements is not a priority item. Regulators and market participants agree that U.S. listing and disclosure requirements are the most stringent and some U.S. exchanges perceive they are at a competitive disadvantage through higher U.S. transaction costs and limited foreign listings. However, no statistical evidence to support this perception has been documented.

[1]The issue must be listed on an exchange in the home market, and thus NASD is excluded. The MOF is currently reviewing this restriction.

Additional Issues Relevant to Regulatory Coordination

Two additional issues related to coordination of securities regulation emerged during our review: (1) the Economic Community's (EC) planned removal of all internal trade barriers in 1992 and (2) the U.S. temporary adoption of coordinated trading halts (circuit breakers) on the stock and futures exchanges.

The 1992 European Community Harmonization of Trade Rules

The European Community plans to unite Europe by the end of 1992, under one system of rules and regulations in all aspects of trade, including capital markets. This harmonization of capital market regulation in the 12 European Community countries is important because the one large market which should emerge will likely become a major player in the financial markets, exercising correspondingly greater influence than the EC currently has. However, the evolving nature of specific EC plans for 1992 have caused some uncertainty about how the harmonized market will affect markets and market participants outside the EC.

Many issues of interest to non-EC markets are emerging. Whether or not the new EC securities regulations are more or less stringent than those of other major markets will influence investors' decisions about entering, remaining in, or leaving markets. There are fears that as internal barriers are removed, the EC would limit access to its markets, thus having major ramifications on the worldwide financial system. This concern could be heightened by the fact that financial services and banking are not covered by the international trading rules of the General Agreement on Tariffs and Trade. The EC has considered enforcing reciprocity rules in 1992, meaning that non-EC countries must open their own markets to the EC in order to gain access to the EC markets, thus raising the question of whether non-EC countries would want to bend their rules to fit those of the EC.

EC plans for a harmonized financial market build on three principal components.

1. Freedom of capital movement among the EC member nations.

2. Freedom of services, meaning that firms in one member nation can offer services in other member nations.

3. Freedom of establishment, meaning that firms in one member nation may freely establish branches or otherwise establish their activities in other member nations.

To accomplish these goals, the EC's program calls for legislation, regulation, and directives that build on three major building blocks: (1) harmonization of standards at a basic minimum level, (2) mutual recognition, or agreement to recognize the adequacy of standards imposed by other member nations, and (3) home country control, or agreement that the responsibility for regulation and supervision remains with the home country regulator.

Consensus of Views

The participants we spoke with generally agreed that the 1992 harmonization deserved close consideration. Some U.S. market participants told us that although the U.K. market participants and regulators hope the EC will adopt regulations similar to its own, rules more likely will be a mix of U.K. rules and the less stringent rules of other EC markets. Some participants asserted that 1992 will induce more international coordination among regulators. One example cited was the capital adequacy directive now being drawn up by the European Commission, which could form a de facto international standard. Other U.S. participants were concerned that U.S. business could lose some market share to its EC competitors, since cross-border transactions may be somewhat easier among European countries. Finally, there was some concern that the United States needed better coordination among its domestic regulators in order to speak with one voice on 1992 issues.

Some U.K. market participants believed the EC standards would probably be somewhat lower than their own and expressed some concern that less reputable firms would be allowed to trade in the United Kingdom. Under the EC doctrine of "mutual recognition," the United Kingdom would not be able to impose rules on securities firms authorized or licensed to do business by other EC nations when these firms conduct business in London, although U.K. regulations may provide for higher requirements for U.K. firms (including foreign firms' subsidiaries that are organized in the United Kingdom). One participant also pointed out that increased cross-border investment transactions within Europe after 1992 will increase the commercial need for fast, efficient clearance and settlement systems. Although participants felt there was a possibility that the United Kingdom could lose securities-related trade should the united Europe have relatively more liberalized rules, most believed losses would be minimal due to the U.K.'s greater market experience and efficiency.

The Japanese market participants we spoke with expected that the reciprocity issue would present some problems in 1992, but some believed that the harmonization would force more coordination outside the EC. One market participant said that the EC harmonization may even serve as a model for coordination for the rest of the world.

Conclusions

International securities regulators are very interested in the 1992 harmonization. Although the EC actions are motivated by a desire for a common internal market, the harmonization effort will inevitably contribute to coordination of securities regulation worldwide.

Circuit Breakers

In the aftermath of the October 19, 1987, stock market crisis, regulators considered adopting coordinated trading halts, known as circuit breakers, among markets that are tied together to allow an orderly response to sudden, steep declines in stock and futures market prices. Circuit breakers are designed to stop trading for a specified period of time in order for firms to evaluate their own positions after a chaotic trading period, to clear up back office processing problems, and for markets to seek additional information on supply and demand conditions. The theory is that the markets, given time to assess additional information, will be able to resume trading in a more orderly manner.

On the eve of the first anniversary of the stock market crash, the SEC, CFTC, and NASD approved a one-year experimental program of trading halts proposed by the New York Stock Exchange and the Chicago Mercantile Exchange.[1] The program calls for a one-hour trading halt across markets when the Dow Jones average of 30 industrial stocks plunges by 250 points or more from the previous day's closing. If the Dow falls by 400 points, the trading halt would be 2 hours.

Consensus of Views

While U.S. regulators support circuit breakers, those we spoke to were not sanguine about the prospects of foreign market acceptance of the concept. One official believed that competitive market forces would prevent foreign exchanges from coordinating closing their markets in response to a trading halt in the United States.

The U.K. participants we spoke with generally did not support the notion of trading halts. Some of them believed that traders in New York and

[1]The NASD approved the program despite its opposition in principle to the concept of circuit breakers. NASD believed it would have faced unacceptable risks if it were to remain open during a crisis while all other markets closed.

Chicago would shift to London or Tokyo in response to a circuit breaker in New York. Some believed that London would have the operational capacity to handle the resulting increased volume, while others were more skeptical. One U.K. official also pointed out that the cash and derivative markets in London are not as interlocked or dependent upon each other as in the U.S. market. One official believed that circuit breakers were a simplistic response to a crisis situation and that, in fact, markets should be allowed to function during such periods rather than be subject to trading limits.

The Japanese market uses trading halts when very large disparities in the buy and sell orders develop for individual stock transactions. Halts can also occur when the saitori[2] become overloaded or when price limits are hit and no one wants to trade at the maximum or minimum limit. The officials we spoke with believed their price limit system worked well for Japan but were doubtful that it should be applied in the United States or elsewhere. However, contracts to trade TOPIX and Nikkei 225[3] on the Chicago Board of Trade and the Chicago Mercantile Exchange stipulate price limits. The officials maintained that circuit breakers should be applied on a country by country basis according to need and that a common international solution was not feasible.

Conclusions

The type of circuit breakers envisioned by the United States are not generally supported by other major markets and therefore would be difficult to coordinate worldwide. Market and national regulators generally wish to retain the flexibility to deal with a crisis situation in the manner they believe best fits their regulatory environment, and not all countries have linked their cash and futures markets to the same extent as the United States. Others maintain that circuit breakers do not work and that in fact limitations would be harmful during price declines. Coordination on this issue is unlikely in the near future.

[2]Saitori member clerks match the sell and buy orders according to the trading rules of the Exchange.

[3]TOPIX is a futures contract based on the Tokyo Stock Exchange's stock price index and traded on the Tokyo Stock Exchange. Nikkei 225 is a futures contract based on the Tokyo Stock Exchange's stock price average of 225 listed issues and traded on the Osaka Stock Exchange.

Comparison of Capital Requirements

In the United States, capital requirements for securities firms are relatively low with considerable regulatory oversight to preserve financial integrity. In the United Kingdom, the same general regulatory philosophy is followed, i.e., low capital requirements coupled with considerable oversight to maintain financial integrity. Firms in the Japanese market, on the other hand, are subject to high capital requirements and less direct regulatory oversight and supervision.

Even though the philosophy of the United States and the United Kingdom is the same, the manner in which regulatory capital is calculated is different. Both nations require securities firms to maintain at least a certain level of liquid capital to protect customers from losses in the event that firms go out of business. The activities of the firms are restricted by the level of liquid capital they maintain. How an asset is counted toward capital depends on its riskiness, and the two nations have different ways to make the calculation. The U.S. method starts with total capital and then three types of deductions are applied to derive the capital that will be counted as meeting regulatory requirements. The deductions address liquidity, credit risk and potential trading risk. The net capital which remains after all deductions then is compared with a minimum requirement for firm size. The United Kingdom now uses the reverse approach, in which liquid capital is calculated starting at a minimum base, given a firm's size, and the value of the firm's assets, given their riskiness, is added back in.

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