Disclosure and Trading in an International Securities Market

The term "international securities market" has appeared for many years in the newspapers and scholarly journals. There has not, however, been any uniformly accepted explanation of exactly what this term means, or how such a market would come about in practice.

In my view, internationalization of the securities market may take one of two main forms. First, a corporation may sell its securities in countries other than the one which is its principal place of business. This involves an internationalization of the primary market for securities. Second, the same class of securities of a corporation may be listed on exchanges in more than one country. This involves an internationalization of the secondary trading market for securities.

The Securities and Exchange Commission (SEC) has over the past two years issued regulations that could serve as fruitful starting points for evolving an international trading market for securities. The SEC has issued new Form 20-F which applies to registration and periodic reporting under the Securities Exchange Act of 1934 by securities issuers from outside the United States.[1] The disclosure requirements in Form 20-F, as I will explain in more detail, represent a serious attempt to harmonize traditional American concepts of disclosure with the disclosure standards of other countries and international organizations. At the same time, the SEC has formulated the basic components for a national market system, including the concept of an issuer "qualified" to trade in this system. This qualified issuer concept, as I will elaborate, provides a potential vehicle for expanding the trading of foreign issues to all major American markets, and perhaps ultimately to all markets in major financial centers. Finally, I would like to discuss briefly steps already taken in the United States to broaden foreign membership on United States stock exchanges. In the past few years restrictions on foreign ownership of corporate exchange members have been removed to allow broker-dealers from other countries greater access to the United States securities markets.

I. Disclosure by Foreign Issuers

In 1977, the SEC proposed Form 20-F for use by foreign companies that either has registered or wished to register their securities under the Securities Exchange Act of 1934 or secondary market trading in the United States.[2] In

[1]Securities Exchange Act of 1934, Release No. 14,128 (Nov. 2, 1977), [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,361.

[2]*Id.* The SEC maintains a Public Rule-Making File.

general, the disclosure requirements proposed at that time followed closely the requirements then in effect for domestic issuers. As a result, the majority of commentators criticized the proposed rules for not being sufficiently sensitive to the unique problems faced by foreign issuers.

By contrast, in the final rules adopted in 1979, the SEC tried to accommodate the special needs of foreign issuers within the context of the American disclosure system.[3] In order to arrive at such an accommodation, the SEC examined the disclosure rules and guidelines utilized by various international organizations. These included the *Guidelines for Multinational Enterprises* and *Minimum Disclosure Rules Applicable to All Publicly Offered Securities* of the Organisation for Economic Co-operation and Development,[4] the Report of the Group of Experts on International Standards of Accounting and Reporting to the United Nations,[5] and perhaps most significantly the recently adopted Sixth Directive of the European Economic Community (EEC).[6]

Let me illustrate the SEC's efforts to harmonize American disclosure rules with foreign rules by reference to five controversial areas. First is the item on the description of business. The proposed rules would have required disclosure of corporate revenues and profits by industry and geographical segments, including a specific disclosure on environmental compliance along the lines of the reporting requirements for American issuers. In recognition of the fact that these requirements are not typically imposed by foreign jurisdictions, the rules as adopted deleted the specific disclosure on environmental compliance and substantially reduced the amount of segment reporting. Specifically, foreign issuers will only have to report revenues by segment, although a narrative discussion will be required if revenue and profit contributions of the respective segments differ significantly.

Second is the item on description of property. Again, the proposed rules would have required disclosure of corporate properties on a segment basis, along the same lines as the requirements for American companies. But the rules as adopted do not require a breakdown on a segment basis. The remaining area of controversy relates to oil and gas, an evolving area even for American companies. Here the Commission limited disclosure to reserve and production information during the last two fiscal years, and did not refer to reserve recognition accounting.

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[3]Securities Exchange Act Release No. 16,371 (Nov. 29, 1979), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,363.

[4]*Guidelines for Multinational Enterprises; Minimum Disclosure Rules Applicable to All Publicly Offered Securities,* COMM. ON FINANCIAL MARKETS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (1976).

[5]Report of the Group of Experts on International Standards of Accounting and Reporting, U.N. Doc. E-C # 10-33 (1977). This Report was not accepted by the United Nations Commission on Transnational Corporations.

[6]Council Directive of March 17, 1980, 23 O.J. EUR. COMM. (No. L 100) 1 (1980) [hereinafter cited as Sixth Directive].

Third is the item on management remuneration. The proposed rule would have required the identification of the three highest paid officers or directors, and disclosure of the aggregate remuneration and similar benefits paid to these three persons. In the adopted rules, however, the SEC recognized that such a disclosure would be inconsistent with concepts of privacy in certain foreign jurisdictions. As a result, the SEC required only that there by disclosure of aggregate remuneration and similar benefits paid to all directors and officers as a group.[7]

Fourth is the item on the interest of management in certain transactions. As proposed, this item would have required a description of all material transactions between the registrant and its management similar to those required of American issuers. In response to the commentators, however, the SEC in its final rules decided to condition the disclosure of information on interested transactions to that information being made public pursuant to foreign laws or regulations.

Fifth, and finally, the SEC continued to allow foreign issuers to file financial statements on the basis of the generally accepted accounting principles (GAAP) in the United States. Despite the efforts of the International Accounting Standards Committee, the SEC recognizes that there are significant differences among accounting principles in various countries. Therefore, the SEC will only require foreign issuers to discuss any significant differences between the principles used in their financial statements and GAAP in the United States.[8]

Thus, while hardly revolutionary, new Form 20-F does represent a good faith effort on the part of the SEC to be sensitive to the needs of foreign issuers. Further, the disclosure standards in Form 20-F are remarkably similar to the standards in the recently adopted Sixth Directive of the EEC.[9] This is not to say that Form 20-F constitutes the most appropriate disclosure standard for all countries; rather it is only to say that Form 20-F may be a useful point to begin talking about the harmonization of international disclosure standards.

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[7]The SEC also issued an interpretation, for registration statements filed under the Securities Act of 1933, that would allow disclosure of management remuneration and other benefits on an aggregate basis. *See* Securities Act of 1933 Release No. 6157 (Nov. 29, 1979), 1 FED. SEC. L. REP. (CCH) ¶ 3849.

[8]The SEC has not yet revised its disclosure requirements for registration of securities offerings under the Securities Act of 1933 to conform to the disclosure requirements in Form 20-F for registration and periodic reporting under the Securities Exchange Act of 1934. No registration form is particularly specified for use by foreign issuers but Form S-1 is generally used for this purpose. In practice, the SEC may not require a foreign issuer filing a registration statement under the Securities Act of 1933 to redo completely its financial statements; rather, the SEC may permit such a foreign issuer to describe *and quantify* any significant differences between its financial statements and what such statements would be under GAAP.

[9]*See* Sixth Directive, note 6 *supra*.

II. Qualified Securities

While I sincerely hope that international disclosure standards will evolve, I know realistically that this evolution is much more likely to occur if there is some concrete incentive to the relevant parties. Given the many barriers to formulating a consensus on international disclosure standards, there must be some material reward to overcome these barriers. This incentive might be provided if compliance with international disclosure standards, plus fulfillment of a few other relevant criteria, would qualify an issuer for trading in all the major stock exchanges in the world.

In the United States, the SEC is currently working on rules for qualified securities for the purposes of the national market system. This system will connect all major stock markets in the United States by means of a modern communications network. As I will elaborate, the rules for qualified securities could incorporate international disclosure standards so that foreign issues meeting these standards, and perhaps some additional criteria, could be traded in the national market system. This would provide a material incentive for issuers to follow international disclosure standards. Moreover, it might be possible to develop criteria for qualified securities for the purposes of an international market system and these criteria could incorporate an international set of disclosure standards. This would, of course, provide an even greater incentive to reach a consensus on such standards.

Let me pursue this line of inquiry by explaining a little more about the national market system and qualified securities. The national market system can be broken down into five functional components.[10] First is a composite quote reporter which displays the current bid and ask prices being offered by specialists and market makers in the relevant security. This quote reporter has been available to broker-dealers for nearly two years, though there are still some design changes to be made.

Second is an order routing system, by which broker-dealers can send orders quickly to the market that appears to offer the best quotations. Since 1978, an electronic communications system has been in operation which enables traders on the floors of four different exchanges to send orders to other exchanges.[11] Still to be developed, however, is a system which would enable brokers and dealers in their offices throughout the country automatically to route their orders to any market center. In this regard, there have been extensive discussions about expanding the use of a computerized message switch now used by broker-dealers in their offices to route orders to the New York and American Stock Exchanges.

Third is a mechanism for executing public "limit" orders (specifying a particular price for execution rather than the market price) that are sent to

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[10] *See* Securities Exchange Act Release No. 15,671 (March 22, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,016.

[11] *See* Securities Exchange Act Release No. 14,661 (April 14, 1978).

either an exchange specialist or to a market maker. While trying to preserve the various already existing types of execution facilities, the SEC has proposed the concept of a national limit order file so that public "limit" orders throughout the national market system would be executed according to specified priorities.[12]

Fourth is the consolidated transaction reporting tape, which reports in consolidated form the last sale price for a security in all the markets in which that security is actively traded. This component of the national market system has been operational for several years.

Fifth is the national clearing system which, like the consolidated tape, comes into play after the execution of a securities trade. A merger of three of the major clearing corporations, together with the development of interfaces with other clearing entities, is gradually providing a mechanism by which payment can be effected for securities throughout the whole national market system.[13]

While these five functional components of a national market system are evolving, the SEC will also have to make some basic decisions about what securities will be qualified for trade in this system. At present, this system includes most of the securities listed on the New York and American Stock Exchanges and a limited number of securities listed on the so-called regional exchanges. However, the SEC has recently proposed a more expansive category for qualified securities.[14] That proposal sets forth quantitative criteria under which equity securities traded solely over-the-counter as well as exchange-listed equity securities would be included in the national market system. The proposed criteria require certain minimum assets, earnings, number of shareholders, number of shares outstanding and trading volume. The Commission's proposal actually establishes two different sets of standards. A security meeting the first, more stringent, set of standards automatically would be included in the national market system; a security which satisfies the second set of standards would be eligible for designation as a qualified security upon the request either of the issuer or of two markets on which the security is or will be traded.

The SEC has not yet focused on the question of whether foreign issues should be traded in the national market system and, if so, according to what criteria. In my view, one criterion would most likely be adequate disclosure to investors; and this criterion might be satisfied by compliance with international disclosure standards. In addition, there would probably have to be some other criteria in order for foreign issues to trade in the national market system, such as the assets of the issuer and the number of public shareholders. But if qualified securities for the purpose of the national market system were

[12] *See* Securities Exchange Act Release No. 13,163 (Jan. 13, 1977).
[13] *Id.*
[14] *See* Securities Act Release No. 6083 (June 21, 1979).

tied to a significant degree to international disclosure standards, this might provide a concrete incentive for compliance with such standards.

Moreover, it is conceivable that the SEC proposal on qualified securities could give rise to discussions about standards for qualified securities in an international securities market. Such standards could incorporate the international disclosure standards and other appropriate criteria such as financial assets and shareholder composition of the issuer. The evolution of such qualification standards would, of course, provide even greater incentives for compliance with international disclosure standards.

I recognize that the International Federation of Stock Exchanges has developed minimum listing standards, and I applaud the efforts of the federation. However, these minimum listing standards are only voluntary, and each country may set higher standards. More importantly, the minimum listing standards are so low that issuers meeting these standards would not necessarily be admitted to trading on many of the major stock exchanges in the world.

It is easy to understand why the adoption of high international minimum standards has been widely resisted. In many countries, the setting of high minimum standards for the purposes of an international agreement would effectively exclude a large number of issuers from the capital markets of that country. This is particularly a problem for small and moderate-sized issuers, whose securities are not likely to be traded in international capital markets.

Thus a better approach than relatively low international minimum standards may be to establish relatively high maximum international standards so that securities meeting these standards would always be admissible for trading by the major exchanges in all countries. Such maximum standards would be designed for use by the large multinationals which are likely to seek access to the capital markets of several countries. Of course, each country could allow securities to trade on domestic markets even if these securities did not meet the international maximum standards, so that these standards would not impose any hardship on domestic issuers.

One practical concern, however, is how high such standards should be set. Use of the relatively stringent New York Exchange standards as to assets, income, and share distribution might result in greater access by United States companies to foreign listing but not in any significant improvement in access to United States markets by foreign companies. United States companies are already much better represented on a number of major foreign exchanges than are foreign companies in the United States exchanges. Figures computed in 1977 indicate that some 181 United States stocks were listed on the Amsterdam Stock Exchange, eighty-seven on the London Stock Exchange and sixty-one on the Geneva Stock Exchange.[15] At that time only twenty-seven non-Canadian foreign stocks were listed on the New York and American Stock

[15] R. Stephens, *Reevaluation of Disclosure Requirements for Foreign Issuers*, 45 GEO. WASH. L. REV. 494 (1977).

Exchanges combined.[16] Since 1977, both the New York and the American Stock Exchanges have recognized that foreign companies may not be able to meet their share distribution requirements with United States shareholders and have established alternative listing criteria for such cases which reference worldwide share distribution. Although viewed by these stock exchanges as a means of facilitating foreign access to listings, these alternative standards are in some respects higher than the standards for domestic issuers. In fact, the New York and American Stock Exchanges presently have listings for only seventeen foreign issuers each.[17]

The experience of the International Federation of Exchanges suggests that international standards for qualified securities are not easily achieved. In order to provide a substantial incentive, compliance with international disclosure standards would have to constitute fulfillment of a major part of the qualification standards for trading in most of the major stock exchanges in the world. At the same time, each country and each exchange should be able to set different standards to accommodate the needs of domestic issuers and the relevant subset of foreign issuers.

III. Access to Exchange Membership

Access to exchange membership in the United States was broadened after passage of the Securities Acts Amendments of 1975[18] to remove the absolute bar previously imposed by the New York and American Stock Exchanges to foreign ownership of corporate exchange members. In addition, foreign membership has long been permitted on the United States regional exchanges and foreign-owned entities may register as broker-dealers under the Securities Exchange Act of 1934 and become members of the National Association of Securities Dealers. At the beginning of 1977, the SEC estimated that some thirty-one registered brokerage firms with United States offices or stock exchange memberships were owned by foreign financial institutions.[19] Thus,

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[16] *Id.* at 524 n. 46.

[17] *Id.* Both numbers exclude Canadian issuers, which are not entitled to use Form 20-F to register their securities on a United States national exchange, but must use the Form 10 registration statement required of domestic companies.

Many foreign issuers, however, take advantage of the exemption from registration under Rule 12g-2 by providing the SEC, on a current basis, with certain information made public in their home countries, filed with and made public by a stock exchange, or distributed to its security holders. The most recently published list of these companies identified a total of 161 private foreign issuers, of which 75 were Canadian issuers and 86 were domiciled in other foreign countries. The list includes major foreign companies, such as Fiat S.P.A., Burmah Oil Co., Ltd., Fisons Ltd., and Rank Organization, Ltd., that could readily qualify for New York or American Stock Exchange. *See* Securities Act Release No. 16,212 (Sept. 21, 1979), 2 FED. SEC. L. REP. (CCH) ¶ 23,317.

[18] 15 U.S.C. § 78(c)(1975).

[19] SEC, Major Issues Conference, Agenda Topic 3, Jan. 13-15, 1977.

foreign broker-dealers appear to have considerable access to the United States securities markets.

The reverse, however, is not true for United States securities firms who have or who wish to establish offices in foreign countries. A number of countries (including some EEC countries) absolutely prohibit exchange memberships for non-national individuals or firms, including domestic companies owned or controlled by non-nationals. Japan, France, The Netherlands and Belgium appear to have absolute prohibitions against such memberships.[20] Other countries, such as the Federal Republic of Germany and Switzerland, theoretically permit non-nationals to become exchange members but have other requirements which act as a practical bar to membership by United States securities firms. For example, membership may be limited to those banks that can meet criteria as to assets located within the country.

Some countries also impose very substantial restrictions on the activities in which a non-national securities firm may engage even when not a member of the stock exchange. For example, Japan apparently grants "full licenses" to foreign securities firms that meet certain very stringent requirements, including the maintenance of a specified percentage of capital in Japan as an "indemnity deposit." Only firms with a "full license" may engage in securities transactions with the public and the most recent information available indicates that only two United States firms have obtained "full licenses" in Japan. As an alternative, foreign firms may establish a licensed representative office but that office may only disseminate information; it may not even forward unsolicited orders for execution on a United States exchange. In France, a foreign firm may act only as an intermediary in transmitting orders from abroad to French brokers and receiving unsolicited orders for transmittal abroad.

I recognize that this area poses special problems because of the differences between the brokerage business in the United States and in certain foreign countries where it is conducted entirely by banks. The application of the Glass-Steagall Act[21] to the foreign activities of United States banks and, as extended by the International Banking Act of 1978,[22] to certain activities of foreign banks in the United States needs examination. Given the variety of restrictions placed on the activities of non-national securities firms even within the EEC, this appears to be an area in which general agreement may be particularly difficult to reach. But, in my view, it would be worthwhile to pursue discussions to provide greater access to trading markets around the world.

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[20]Result of an informal SEC survey; for more information, contact the author.
[21]12 U.S.C. ch. 3 & 6 (1976).
[22]12 U.S.C. § 3101, *et seq.* (1978), 92 Stat. 607 (1978).