Chapter 4

America% Competitors in Global Securities Trading

In the competition for leadership in global securities trading, America's chief competitors at present are Japan and the United Kingdom.[1] The European Community is making a strong effort to integrate and strengthen the securities markets of its member nations (which include the United Kingdom) into a trading arena that can compete on equal terms with the United States and Japan. There is much skepticism, even among proponents, that this can be achieved in the near future, but the EC countries, as well as other nations such as Canada, Australia, Singapore, and Hong Kong are, or could become, niche competitors.

Institutional investors have the incentive, the information access, and the technological infrastructure to trade across national boundaries. In making the decision to do so, they balance several factors: price, liquidity, cost (including regulatory costs), and safety (i.e., transparency and fairness). Some markets with high investment returns are limited or risky.

The conventional wisdom about market liquidity has been that the trading for a specific security will always concentrate in one marketplace. With technology making possible nearly instantaneous comparison and arbitrage of prices (eventually on a 24-hour basis), that rule may not forever hold true. There could be more than one liquid market, or the active market for a stock may migrate from one country to another or from one time zone to another.

The serious constraints on international trading at present are the lack of essential protective regulations or enforcement in some countries (see chs. 3 and 6), and clearing and settlement risks (see ch. 5). As these barriers are reduced, competition to serve international investors will increase. In this competitive arena, the United States' position may depend ultimately on the advantages it can get from information technology and from prudential regulation that assures transparency and fairness.

JAPAN

The Tokyo Stock Exchange (TSE) was the world's largest market in value of investments from 1987 to early 1990. It had been a bull market for 7 years, growing from $370 billion in 1980 to $2,803 billion in 1987, interrupted only briefly by the October 1987 crash. In February 1990, its prices began a steep, spasmodic decline. This had little immediate effect on other major markets, but some experts worry that if the Japanese market should really crash, its investors might be forced to pull their money out of other markets to cover the losses, causing the crash to spread around the world.

The TSE traces its institutional history back to 1878, but it was organized in its present form during the United States occupation of Japan, and stock trading began in April 1949. There are several exchanges in Japan, but the TSE handles about 86 percent of transactions by volume and by value. The Osaka Exchange accounts for roughly 10 percent, the Nagoya for about 4 percent, and others less than 1 percent together.[2] The TSE is described in its own literature as a quasi-government organization, and "a place for domestic and foreign investors to invest their assets . . . [and] by making it easy for enterprises or the nation to raise capital, it also makes an important contribution to economic development. "

Traditionally Japanese corporations depended heavily on debt financing (typically less than 20 percent of corporate capital has been equity); and most of that came from banks rather than from securities markets.[3] But large Japanese firms now raise over 60 percent of their funds in the capital market.[4]

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[1] This chapter draws on several OTA contractor reports, including: Eric K. Clemons, Principal Investigator, with Stephen P. Broad, Ravi Venkateswaran, and Bruce W. Weber, "Globalization of Securities Markets" (Philadelphia, PA: Wharton School, University of Pennsylvania, July 1989); Peter Schwartz, "Scenarios for Regulation of International Securities Trading" (San Francisco, CA: Global Business Network, Nov. 3, 1990); Manning Gilbert Warren III, "Securities Regulation in the European Communities" (Tuscaloosa, AL: University of Alabama Law School, August 1989).

[2] Tokyo Stock Exchange, 1989 *Fact Book*, p. 17.

[3] *The* GT *Guide to World Equity Markets 1988* (London: Euromony Publications, 1988).

[4] Statement by Masahiko Kadotani, of the Ministry of Finance, at the 14th Annual Conference of IOSCO, in Venice, Sept. 18-21, 1989.

Recent Trends

TSE began trading foreign stocks in December 1973, with six listed foreign stocks.[5] In 1985 the number began to rise dramatically, and reached 120 by early 1990.[6] The average daily turnover of foreign stocks is about 790,000 shares compared to over 1 billion total daily volume.[7]

Japan's primary market for government bonds was virtually closed to foreigners until 1986. When there was a new government bond issue, Japanese banks, securities firms, and life insurance companies would form an underwriting syndicate and divide up the issue among themselves for distribution.[8] Foreign banks and securities firms were not members of the syndicate but were occasionally allotted a small part of the issue. In 1989, Japan moved to a partial auction system for selling 10-year bonds.

The number of foreign member-firms on the TSE has increased slowly, to 22 in 1989. After the stock market crash in 1987, the 45 foreign securities firms in Tokyo began to reduce their staffs. In the year ending September, 1988, 39 of the 45 foreign firms in Tokyo had net losses, but during the next year, they were by most accounts doing well.[9] They account for only about 5 to 7 percent of trading volume, possibly because they lack good retail channels (the active sector of the market is trading by individual investors).

The TSE still has fixed commissions (except for large trades, for which commissions have recently been unregulated). Traders try to turn over as many shares as possible, as often as possible, to capture gains, because the ratio of dividends to prices is very low.[10] Both domestic and foreign traders concentrate on the relatively few Japanese institutional investors seeking short-term profits. This usually means buying and selling Japanese securities, because information about them is most quickly available. Foreign investors for the last 5 years have been net sellers, and their share of trading has fallen from 10 to 2 percent.

How the Market Works

Trading at the TSE takes place as a continuous order-driven market, where buy and sell orders interact directly. There are no official market-makers, no specialists, and no affirmative obligation to make markets. All securities must be traded through an authorized securities dealer. The Big Four securities houses: Nomura, Daiwa, Nikko, and Yamaichi, together account for about 40 percent of the trading, for their own accounts and for customers (in 1960, the same four firms accounted for 70 Percent) .11

In Japan, institutions and corporations hold the majority of stocks, but tend not to trade them. Individuals do most of the trading. Ownership of shares of companies listed on the eight exchanges in Japan in 1988 was as follows:[12]

	Percent
Banks and other financial institutions	44.6
Business corporations	24.9
Individuals	23.6
Foreigners	3.6
Securities firms	2.5
Investment trusts	2.4
Government/local government	0.8

There are two kinds of exchange members-regular and Saitori. Regular securities company

[5] Tokyo Stock Exchange, *1989 Fact Book*, p. 19.

[6] Data supplied by Mr. Yuji Shibuya of the Nomura Research Institute, Tokyo, Fax 81-2-277-8498, Nov. 15, 1989, updated courtesy Of the International Securities Clearing Corp., May 1990.

[7] Tokyo Stock Exchange, 1989 *Fact Book.*

[8] Ko Sakai, "GovernmentBondM arket: More Liberalization Measures Urged To Raise Foreign Share," *The Japan Economic Journal*, Summer 1988, p. 28.

[9] *The Wall Street Journal, reported* on Aug. 16, 1989, that Salomon Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley Japan Ltd. are doing well in Japan, but "on the whole, foreign losers vastly outnumber the winners. (Marcus W. Brauchli, "U.S. Brokerage Firms Operating in Japan Have Mixed Results," p. 1. See also "Gaijin, Gaijin, Gone," *The Economist,* Jan. 14,1989, p. 69. In 1990, most new reports say that American securities firms in Tokyo are making money. (*Financial Times* Special Section on Japanese Markets, III-ix, Mar. 15, 1990.)

[10] Shuzo Nakeshiima, "The Outline of the Current Situation and the Problems of Investor Protection in Japan," presented at the NASAA Conference in Washington, DC, Apr. 26, 1990.

[11] Rex Brown, "Medium-Sized Firms Prosper Through Their Banking Links," *Financial Times*, Special Section on Japanese Markets, Mar. 15,1990, HI-vi.

[12] These figures are from the TSE *Fact* Book *1989*, p. 92, which does not explain why they add to 102.4 percent. It is likely that "investment trusts, 2.4 percent" overlaps with the figures for banks and other financial institutions, Foreign ownership peaked in 1984, at 6.3 percent.

members, like broker/dealers in the United States, receive orders from customers or trade for their own account. They execute trades through four Saitori members, who match buyers and sellers. Saitori members are not analogous to U.S. market-makers since they can neither trade for their own account nor accept orders from public investors. They record a match of buy and sell orders but do not become a counterpart to a trade.

In executing large block orders (300,000 shares or more), a regular member can act as both seller and buyer. However, in active stocks the proportion of block trades was only 6.5 percent in 1988,[13] because institutions tend not to trade as much as individuals.

TSE trades only listed securities, and a decision by the Exchange to list a security must be approved by the Minister of Finance. Listed foreign stocks and bonds may be denominated in either yen or foreign currency but exchange settlement is chiefly denominated in yen. Japanese stocks often trade at much higher price-earnings ratios than American stocks, averaging 65: 1 as compared to 12: 1 at the New York Stock Exchange (NYSE), in part because earnings are not consolidated due to corporate cross-listing and in part because of differences in accounting practices.

Most of the stocks are traded only on the Computer-Assisted Order Routing and Execution System (CORES). Exchange member companies have on-line terminals in their main offices to send in orders and receive verification. In the TSE Computer-Assisted Trading Room Saitori clerks monitor the computers, which automatically match orders on their "Book Display Device" or display screens. When a transaction is completed, the notice is sent to a Trade Report Output Device in the office of the firm that placed the orders, and recorded on the Saitori members' Trade Report Printers.

There are three kinds of stocks:

- First Section issues, the most actively traded stocks (1,169 in 1989), of which only the 150 most "blue-chip' trade on the stock exchange floor, while the rest trade on CORES;

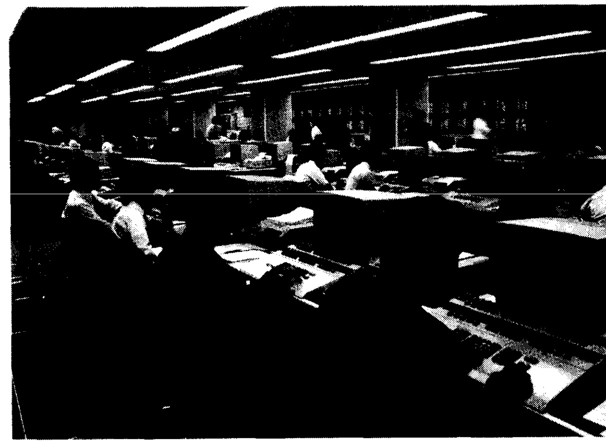

Photo credit: Courtesy of Tokyo Stock Exchanges

Tokyo Stock Exchange computer-assisted trading room

- Second Section stocks (434 listed), all trade on CORES; and
- Foreign Division listings (120),also trade on CORES.

Of the 1,723 listed issues in 1989,1,573 are traded only electronically. However the other 150 issues, which trade on the floor, represent about 78 percent of all trading volume by shares.[14] Stock Price display boards immediately display the price information. The layout of the Exchange floor is much like that of the NYSE, but the hand signals used by the traders are more like those used at the Chicago futures exchange.

Only First Section stocks can be traded on margin. The customer deposits guarantee money at a prescribed rate with the securities company, and can also use securities as collateral (they are given a special "loan value"). The customer pays interest until he returns the money borrowed from the securities company. For individual investors, about 39 percent of transactions were margined in 1988, an 8 percent increase in that year. The use of margins had been declining since 1982, although the value of margined transactions had continued to rise (as much as 39 percent in 1988).[15]

A market information system conveys quote and price information to the offices of the securities

[13] Tokyo Stock Exchange, *Fact Book 1989,* p. 16.

[14] These figures were supplied by Nomura Research Institute, New York, NY, January 1990. The TSE *Fact Book 1989* lists comparable figures fOr 1988: of 1,802 listed stock (1,690 domestic, 112 foreign), 1,652 are traded on CORES and 150 on the floor.

[15] Tokyo Stock Exchange, *Fact Book 1989,* p. 24.

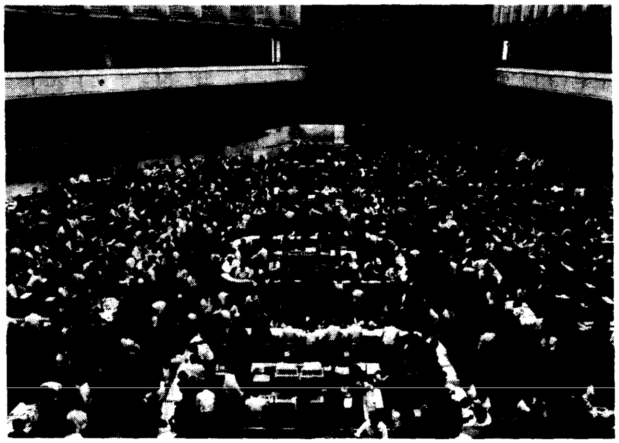

Photo *credit: Courtesy of Tokyo Stock Exchanges*

Tokyo Stock Exchange stock trading floor

Photo credit: Courtesy of Tokyo Stock Exchanges

Government Bond Block Trading Room

companies, the media, and information vendors as well as to the stock price display boards on the trading floor. However, no vendor is permitted to provide real-time digital price or quote streams to investors away from the floor.

The bond trading floor is much like the stock trading floor. Member companies place orders by telephone directly to Saitori members in a special government bond block trading room. However, most bond trading is over the counter, including large block trading in government bonds and yen-denominated foreign bonds.

Since there are no market-makers or specialists in the TSE, the function of keeping an orderly market is handled in other ways.[16] When there is a major order imbalance in a listed stock, the Exchange posts a "special bid quote" or a "special asked quote" that is better than the last sale price. This can be renewed or modified every 5 minutes until it elicits enough orders to reestablish some equilibrium. Another way of controlling ups and downs is the daily price limit (which is imposed on the basis not of a percentage change in price but an absolute yen limit). Listed stocks cannot be traded at a price that exceeds the limit of price fluctuation from the closing price of the previous day (the permitted fluctuation is proportional to the price level, i.e., a high-priced stock can fluctuate more than one selling at a much lower price.) Finally, there are temporary trading halts when the market becomes too volatile.

Derivative Products Markets

In 1985 the Tokyo Exchange started anew market for long-term Japanese government bond futures. Trading is conducted largely by computer. In *3 years, this* has become one of the major financial futures markets of the world. Access to futures trading is open not only to regular member firms, but also to non-member securities companies and banks.

In June 1987, the Osaka Securities Exchange began trading on stock average futures, using a bundle of 50 blue-chip stocks traded in Osaka. Trading in cash-settled TOPIX futures at the Tokyo Exchange and the Nikkei 225 futures at the Osaka both began on September 3, 1988.[17] This was described as an opportunity "to offset general market risk, gain financial protection, maintain profitability, invest in the market as a whole, and arbitrage between futures and cash markets. ' A representative of the Ministry of Finance, Sadaaki Hirasawa, said that government policy would encourage the development of futures markets with "high priority for protecting the position of investors and other market participants."[18]

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16 Ibid., p. 12.

17 The Nikkei Average Share Price Index is similar to the Dow Jones, and is built on the prices of *225* First Section stocks. The principal difficulty with this index is that it is not weighted and the Tokyo stock price index (TOPIX) was developed in 1969 to remedy this-it is the weighted average of all First Section stocks.

18 Sadaaki Hirasawa, "Catching Up-Fast," *Look Japan,* July 1988, p. 10.

But on December 8,1988, the Nikkei 225 first fell nearly 200 points in the first 15 minutes of TSE trading and then jumped 300 points in the final 30 minutes. Program trading led by U.S. firms was blamed. On the day before, there was an unprecedented volume of trading in stocks, as traders took advantage of price differences between stocks and stock-index futures on the first contract expiration date for contracts.

A month later (Jan. 13, 1989) the president of the exchange said publicly that the exchange might move to restrict arbitrage trading between stocks and stock-index futures because arbitrage by foreigners might induce "excessive volatility and confusion.' '[19] Before Japan's second witching hour, March 7, 1989, there was worry that a sell-off could drop the Nikkei by as many as 1,000 points. Accordingly, the exchange followed the example of the Chicago Mercantile Exchange and changed the rules so that the settlement price for TOPIX futures is based on the opening stock prices the day after expiration. The Exchange also changed stock margins from 30 to 40 percent.[20] In December 1989, two New York firms—Salomon Brothers and Morgan Stanley-who had publicly announced that they would cease program trading in the United States, were reported to be actively program trading in Tokyo, arbitraging between the two stock indexes, the Nikkei and TOPIX.[21] The vice-chairman of Salomon Brothers, Stanley Shopkorn, was quoted[22] as saying,

> The Japanese have an ability to monitor and make sure the market works in a more orderly fashion. They don't have the fears that U.S. investors have regarding index arbitrage.

But on February 26, 1990, after the Tokyo market dropped by 11.5 percent in a week, program trading was again blamed for the break. The Tokyo Stock Exchange imposed restrictions on computerized program trading between the futures and cash markets, and the Ministry of Finance was reported to have called in large institutional investors and leading brokers to discuss the market situation.[23] After further declines in the market, U.S. firms were asked in early March to restrict their program trading.[24]

It is thought that program trading in Japan is mostly done by U.S. fins. To do program trading, brokers need to sell huge blocks of stocks, which may depress the prices of those stocks. In Japan, companies may identify which broker was selling the stock and punish them by withholding underwriting or other business from that company. The U.S. firms say, however, that much of their program trading is on behalf of large Japanese insurance companies and trust banks.[25] In the midst of the renewed controversy about program trading, in March 1990, Nomura Securities Co. (the largest securities firm in the world) announced that it would begin program trading, and had hired an experienced American securities expert to oversee their new activity .26

Futures and options trading, nevertheless, is growing rapidly.27 Three index options contracts began trading in mid-1989. The volume of trading in the most popular of these, the option on the Nikkei-225, has grown to about 65,000 contracts per day.

Over-the-Counter Market

About 250 companies are listed on Japan's over-the-counter market; to be listed requires that an average 2,000 shares are sold per month.[28] This

19Quoted in "Tokyo Exchange May Act To Curb Arbitrage Trades,' *Wall Street Journal,* Jan. 13, 1989p. C 14,

20"By Bell, Book, and Candle," *The Economist, Mar. 4,* 1989.

21"U.S. Firms Using Program Trading Make Tokyo Stock Market Jump," *Wall Street Journal,* Dec. 9, 1989, p. C 1.

22Sarah Bartlett, "~@ Arbitrage for U.S. Finns, " New *York Times,* Dec. 19, 1989, p. D 5.

23Michiyo Nakamota and Stefan Wagstyl, "Tokyo Curbs Arbitrage Trading," *Financial Times,* Feb. 27, 1990, p. 1.

24Marcus Brauchli and Masayoshi Kanabayashi, "U.S. Brokers Asked in Japan To Curb Program Trading, *Wall Street Journal, Mar. 9, 1990.*

25Ibid.

26Michael R. Sesit and Craig Torres, "Nomura To Plunge Into Program Trading on Global Scale, Challenging U.S. Lead," *The Asian Wall Street Journal Weekly, Mar.* 19, 1990, p. 27.

27Trading in the N&k&225 and TOPIX futures contracts, added together, is now higher than trading in the U.S. Standard & poor 500 index futures (according to Andrew Freeman, "Japanese Contracts Could Overtake U.S. Equivalents, " in the special section of Japanese markets, *Financial Times, Mar. 9,* 1990) but such comparison can be misleading. Because of differences in U.S. and Japanese margining systems, it is customary to sell and repurchase more frequently, to capture profits.

28*Asset International,* Nov. 20, 1989, p. 9.

market grew at a rate much slower than expected until mid-1989, but thereafter became more active. The Japan Securities Dealers Association has developed anew electronic quotations system modeled on the NASDAQ (National Associates of Securities Dealers Automated Quotation) system in the United States; it will be called JASDAQ.

The over-the-counter market was the locus of the "Recruit-Cosmos" influence-peddling scandal, in which senior government officials, including the finance minister, made large profits by buying a company's stock just before, and selling it just after, it was approved for over-the-counter sale. The Japan Securities Dealers Association, which is the self-regulatory organization for the over-the-counter market, has now proposed new, tighter, regulation to prevent this kind of insider trading.

Clearing and Settlement

All clearing and settlement for stocks is handled by the Japan Securities Clearing Corp. (JSCC), a subsidiary of the TSE, and is usually done on the third business day after the trade. The failed-trade rate is less than 1 percent. Recently, high volumes of trading are pushing this system to its limits, and a "back office" (after-the-trade paperwork) crisis is threatened. (See ***Appendix A: Clearing and Settlement,*** for a detailed description.)

There is a book-entry clearing system; however, JSCC is technically required to return the deposited share certificates to the owners once a year and whenever a shareholder requests it. This is a major burden on the institutions and the market. Discussions on how to improve the system have gone on for many years. A Central Depository and Clearing of Securities Law was enacted in 1984, but the new Depository Center that it sought to create is not yet operating; it may begin in late 1991. Settlement costs in Japan are very high compared to other markets.

For foreign stocks, clearing and settlement is through full book-entry transfer at the JSCC, which has cooperative agreements with overseas public clearing organizations, securities depositories, and commercial banks that keep the underlying foreign shares in the home country.

Market Regulation[29]

The TSE is a non-profit corporation, self-regulating but under the close supervision of the Ministry of Finance. Many changes have been made in the regulatory and tax structure since 1987. Exchange members themselves proposed new rules to curb stock manipulation, to make initial public offerings more competitive, and to dismantle procedures that allow stock to be transferred to selected people at advantageous prices (as in the recent Recruit-Cosmos scandal).

TSE publications prominently emphasize a determination to guarantee the public interest and protect investors, and they tie this to "the principle of auction,' which is defined as time and price *priority.*[30] *Rules* say **that** financial statements and any other company news that may influence the prices of securities must be "disclosed accurately, promptly, and impartially, at the appropriate moment without delay. " Nevertheless the Japanese markets are far from transparent. The Ministry of Finance announced in January 1989 that it would tighten stock-ownership disclosure rules, making them similar to U.S. and British regulations.[31]

Although insider trading has always been against the rules, neither violations nor reprimands were made public, and most market participants reportedly did not consider them a serious violation of either law or ethics. In early 1989 Japan for the first time provided criminal penalties for insider trading. Japan's Securities Exchange Act of 1948 has many investor protection clauses patterned after those in U.S. laws, but according to a leading Japanese critic of the markets, the laws ''have not been satisfactorily enforced."[32] Shuzo Nakashima, of the Hijiribashi Law Firm, identifies two reasons for this: 1) because of cross-holding of shares among corporations, the interests of other shareholders can be "ignored and neglected most of the time' and 2)

[29]**Sources:** "Regulations of the **Tokyo** Stock Exchange," 1986; "Constitution of the **Tokyo** Stock Exchange," 1986; "Listing Regulations of the **Tokyo Stock Exchange," 1984**; "A Listing Guide for Foreign Companies," no date; **all** supplied by the **Tokyo** Stock Exchange.

[30]**That** is, the lowest-priced offer and the highest-priced bid has **first** priority, and if two are placed at the same price, priority is given to that received first.

[31]**Marcus** W. **Brauchli, ''Japanese** Regulators Seeking **To** Tighten Rules **on Stock-Ownership** Disclosure, "Asian *Wall StreetJournal,* Jan. ***23,1989, p. 18,***

[32]**Nakashima,** *op. cit.,* footnote **10.**

enforcement is neglected because the regulating authority (the Securities Bureau of the Ministry of Finance) is chiefly concerned with the growth of the Japan securities industry and its brokerage firms. Mr. Nakashima lists as major problems insider trading, price manipulations, churning, and fraud by securities advisers.

Japan, like the United States, legally separates banking from securities markets, the Glass-Steagall Act having been the model for Japan's Article 65, adopted during the American Occupation. As in the United States, this separation has been made less effective by a combination of deregulation and technology. The largest banks are demanding universal banking (i.e., permission for banks to engage in all kinds of financial activity, including securities trading) while the securities firms want to preserve the separation. The Ministry of Finance is reported to be considering a compromise in which banks could set up brokerage subsidiaries and securities firms could open bank subsidiaries.[33]

This issue has been complicated by the impending introduction of GLOBEX (discussed in ch. 2), the electronic trading system being introduced by the Chicago Mercantile Exchange and Reuters. Japanese banks began planning to put GLOBEX terminals in their offices for trading interest rates and currency futures, and later stock index futures and options. But the banks were for a time discouraged by the Ministry of Finance; but on May 21,1990, the Ministry of Finance approved the use of GLOBEX terminals.

Tokyo as a World Center for Securities Trading

Japan is often mentioned as America's top competitor in securities trading, primarily because the Tokyo Stock Exchange rivals the NYSE as the world's largest market. It is not, however, as intimationalized as London, nor as accessible to foreign traders or investors as either New York or London. Language, culture, and high startup costs are all significant barriers.

Most of Tokyo's trading is concentrated in a few major issues; the 30 most active stocks account for about 46 percent of volume by transactions and 39 percent by value. No one is allowed to deliver real-time digital price data by electronic systems to investors. Frequent trading halts may alarm some foreign investors who are not accustomed to circuit-breakers. There is a trading tax in Japan, of 0.30 percent of the value of the transaction. Commissions, particularly for retail customers, are high compared to other markets, and the paper-based settlement system, which does not centralize settlement between brokers and custodians, is expensive for institutional traders. Investor protection is weak. So long as Japan's economy is strong, however, its securities markets will continue to be strong competition for those in the United States.

THE UNITED KINGDOM

London is the other major competitor to New York stock markets and Chicago futures markets in world trading. The International Stock Exchange of the United Kingdom and the Republic of Ireland (ISE, or informally, the London Stock Exchange)[34] is the most "internationalized' of the major markets, with 1,987 domestic and 707 foreign listings (23 percent). It trades listed bonds and equities, unlisted securities, and options.[35] The ISE is now struggling to adjust to changes brought about by deregulation, automation, and the crash of 1987, but it has many advantages as a center for global trading. Foreign shares account for about a quarter of all transactions at the ISE.

The ISE is among the world's largest stock markets by capitalization, but usually ranks after Tokyo, New York, NASDAQ, and Osaka. The average number of ''bargains' (trades) per day increased by 42 percent from 1983 to 1988, but the average number of shares traded increased by 192 percent (to 408.5 million), reflecting an increase in the number of large blocks.

London is also the home of the 7-year-old London International Financial Futures Exchange (LIFFE)

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[33] "Japanese Financial Deregulation: Into the Doldrums," *The Economist*, May 20, 1989, p. 87.

[34] Separate exchanges in eight cities—London, Belfast, Birmingham, Bristol, Dublin, Glascow, Liverpool, and Manchester-were merged in 1973. The London Stock Exchange was renamed the International Stock Exchange in 1986. Spicer & Oppenheimer, *Stock Markets Around the World* (New York, NY: John Wiley& Sons, 1988); pp. 207 ff.

[35] The Unlisted Securities Market handles issues of companies that are not listed because they wish to raise smaller sums of money than listing requires, wish to release a smaller percentage of total equities, or have too short a trading record. There is an over-the-counter market for equity and corporate bonds.

and the center of the Eurobond market, although neither is part of the ISE.[36] The Eurobond market is an over-the-counter market operated by banks and stockbrokers. Its investors are principally institutions, and Japanese firms have come to dominate Eurobond underwriting.

Most major American and Japanese securities firms are members of the ISE, but none has succeeded in capturing a significant market share in U.K. securities. American firms have done well in marketing advisory services, banking services, and in mergers and acquisitions.

In October 1986, the British Government deregulated the securities market, an event known as "Big Bang." Fixed minimum commission rates were abolished. Mandated separation of brokering and dealing functions ("single capacity") was also abolished; firms could now operate as both brokers and dealers, trading for customers and for themselves. Big Bang opened up the markets. British banks were allowed for the first time to become full-service financial institutions; they can underwrite securities and can own brokerage houses. Restrictions on foreign membership ended. Foreign banks can now own up to 100 percent of British brokerage fins. Most of the leading firms in the ISE are now corporations, many owned by international banks and finance houses. Before deregulation, they were all partnerships and the London Stock Exchange was much like a gentlemen's club.

The change in market structure was profound; the Council of the International Stock Exchange says:

> Indeed it was thought that these changes in working practice were so great that it would not be possible to implement them in a staged manner but they would all have to be implemented in a "big bang."[37]

The ISE Planning Committee "had been worried that insufficient market-making capacity would come forward,' but instead 'the degree of oversubscription was awesome."[38] The rigorous competition among them contributed to serious adjustment problems. Nevertheless, business volumes increased significantly after Big Bang, by some 85 percent for customer business and an equal proportion through ''inter-market-maker dealings.

How the Market Works

ISE modeled its new electronic trading support system-Stock Exchange Automated Quotations (SEAQ)--after the National Association of Securities Dealers Automated Quotations system (NASDAQ) in the United States, deliberately rejecting the specialist system in favor of competing market-makers. Quotations are displayed on the computer network, and transactions can take place either by telephone or on the floor. In fact, the floor was quickly abandoned,[39] and all trading takes place by telephone. The distinction between exchange and over-the-counter trading effectively disappeared. The ISE's competing market-makers are required to try to make continuous markets in the stocks in which they deal from 9 a.m. to 5 p.m., but they do not have the affirmative obligation to trade their inventory that NYSE specialists have.

After deregulation, commissions paid by institutional investors dropped to about 0.2 percent of transaction value, or moved to a "net price, free of commission" basis.[40] In spite of the halving of commissions, ***The Financial Times*** reported in October 1987 that London stock exchange firms had earned much higher income over the year ''as a result of the upsurge in turnover during the past year, particularly from small investors."[41]

Immediately after Big Bang, market-maker firms spent millions on computer systems. Big Bang led to rapid expansion (the number of market-makers on ISE grew from 5 to 31). Competition was intense. After the 1987 crash, the drop in trading volume put

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[36] Settlement and custody for Eurobonds are directed by the Association of International Bond Dealers (AIBD) and processed either by Euroclear, in Brussels, or Cedel in Luxembourg.

[37] ''Review of the Central Market in U.K. Equities,' A Consultative Document from the Council of the International Stock Exchange [hereafter cited as "Council of the ISE"], May 1989.

[38] Ibid., p. 6.

[39] It is empty most of the time. Observers report that on Oct. 19.20,1987, when the New York exchange floor and Chicago pits were bedlam, the London floor was eerily empty. All action was "upstairs" in the members' offices and trading rooms.

[40] There is a value-added tax of 15 percent on commissions, a transfer stamp of 0.5 percent on purchases, and a levy of £0.80 on trades of over £1000 to finance the regulatory framework. It was announced in March 1990, that the transfer stamp duty will be eliminated when a new computerized registration system, described later in this chapter, is completed.

[41] Clive Wolman, ''SE Firms Stock Up on Earnings," *Financial Times*, Oct. 27, 1988, p. 14.

the London securities industry into a period of severe cost-cutting and budget-tightening. By March 1989, it was reported that British brokerage houses had lost $2 billion since Big Bang, and had eliminated thousands of jobs.[42]

There have been continuing problems for ISE. A year after the crash, there was evidence that an increasing amount of business **was** being done off-exchange using market prices available on SEAQ. The Council of the ISE concluded that 'the threat of fragmentation was very real."[43] SEAQ required traders to post on its computer display their bids and offers and the quantity of shares for which they are prepared to deal at that price. For this "transparency" big market-makers paid a price. Smaller, competing market-makers could "dump" stocks on them or raid their inventories, thus conveniently closing out their own positions at the end of each trading day.[44] When two large market-maker firms announced that they were reducing the size of deals that they would guarantee to transact at their SEAQ-quoted prices, the ISE dropped its "inter-market-maker obligation," the requirement that market-making firms deal with one another at the quoted prices.[45] A second change in the roles allowed reporting of large trades to be delayed until the following day, so that traders can buy and sell large blocks of securities without immediately moving the market price.

The rationale for these "temporary" changes was that they would lead to market-makers displaying more realistic sizes on SEAQ. While there might be an immediate reduction in inter-market-maker business and large block trades, it was hoped that some firms would provide more competitive prices in large trades in the knowledge that they could sell off large blocks through retail outlets and their positions would not be jeopardized by having to deal with their competitors at these favorable prices.

Subsequent analysis of response to the changes indicates that there has been an increase in the proportion of deals done "at the touch" (i.e., at the best bid/offer on SEAQ) and no significant decline in intra-market liquidity, but also no immediate increase in large trades on the exchange--the trend to off-market trading had not reversed.

The rule changes made the market less "transparent,' and decreased the flow of information. Last-trade prices for large blocks are not at once available. This made it difficult to provide efficient indexes for purposes of pricing derivative products.[46] It tended to create a ''two-tier' market by encouraging market-makers to reserve their best prices for large clients, buying or selling large size blocks at negotiated prices. SEAQ was therefore less reliable at reflecting true market prices. In fact, however institutions often continued to deal among themselves and stay away from the exchange altogether.

Although some critics blame the "automation" of the market (meaning the demise of its trading floor activity) for its problems, others appear to fault the exchange for poorly conceived, poorly planned, and poorly integrated systems. For example, a recent editorial in *The Economist* said,

> Punished by the inertia brought on by internal dissent, the exchange has never truly found its place in the decartelized world that followed the City of London's Big Bang in October 1986. . . . Member firms have lost hundreds of millions of pounds in the fierce competition to trade British equities. The efficiency of this screen-driven money-loser has highlighted, in turn, the awful inefficiency of London's paper-pushing settlement system-as well as the mish-mash of technical systems that makeup the market's creaky infrastructure.[47]

The editorial identified two problems with the ISE related to technology: a) the difficulty of using the same system to serve both small private clients and large institutional investors, and b) the separation of domestic and international markets with separate rules and trading systems.

42**Most American Banks had bought British firms lost money, Chase Manhattan bank ended its equity operation in London** in January 1989 with a $40 million loss. Security Pacific Corp. and Citicorp also lost money.

43Council of ISE, op. cit., footnote 38, p. 7.

44In the United States, NASD found it desirableble to prohibit the use of NASDAQ' small-order execution system by professional traders, who would "pick off' market-makers' displayed quotes before the market-makers could react to news or rumors affecting the value of stock.

45Under the older market-makers had to trade with clients, agency brokers, and others market-makers at the **price they had listed** on SEAQ. Under the new rule market-makers must trade at that price with clients and agency brokers, but not with other market-makers.

46The index usually used to indicate the performance of the ISE, is the Financial Times/Stock Exchange 100 Share Index, or FTSE.

47"Tower or Indecision," The ***Economist,*** Feb. 24, 1990.

An editorial in the ***Financial Times,*** on the other hand, suggested that the exchange's central divisions and services should be "unbundled' and broken apart, made to "stand on their own feet."[48] The editorial said,

> Nor, given the exchange's current maze of electronic services, many of them in urgent need of overhaul, is it clear why member firms should **want to** be tied to the exchange by the sort of electronic umbilical cord envisaged by the Elwes group [an ISE policy committee that is described below].

In other words, there appears to be a general disquiet and dissatisfaction with the ISE, but little consensus on the nature, the causes, or the treatment of the problem. There is a continuing debate about the structure of the exchange. Some members advise better integration of ISE's domestic and international trading (now handled by separate divisions at the exchange). Others take an opposite approach, arguing that there should be different procedures, different technology, and different rules for professional/international trades and for retail/domestic trades, possibly even a return to the trading floor for the latter—an institutionalized two-tier market. A third school believes that ISE's major problem is simpler—cut-throat competition among its now 25 market-makers-and can be solved only when some of them are shaken out.

By early 1990, the exchange was considering reverting to its old rules, restoring the obligations of market-makers for firm bids and offers, dealing with all customers at displayed quotes, and reporting large trades' prices immediately. These changes were recommended by an internal policy subcommittee called the Elwes group. The Elwes Report asserted its conclusion that:

> . . .within the developing European and International environment, whilst *SEAQ* and the Competing Market Maker System, with telephone negotiation, will remain pre-eminent **as a** means of transacting large securities business, there will be a growing acceptance of automatic execution systems for small business as well as greater demand for efficient limit minding and execution facilities especially for the less liquid securities.[49]

The report said the role of the exchange was shrinking, as trading migrated away from the exchange to off-board trading, creating the danger of fragmentation of the central market. The committee emphasized the importance of encouraging retail clients, and its continued belief that a quote-driven system, rather than an order-driven system[50] "should be the mechanism for trading EK equities.' There were four primary recommendations:

- the introduction of a central limit order facility;
- mandatory preferencing of orders, requiring brokers to direct their orders over telephone or proprietary dealing systems to market-makers displaying the best price (rather than one not displaying the best price, but willing to trade at the best price);
- an "order exposure" rule for agency crosses and matching principals, requiring their orders to be exposed to a market-maker and take account of existing limit orders,
- requiring market-makers to meet a minimum quote size, with larger trades published as to size immediately and as to price 90 minutes later.

The preferencing recommendation was aimed **at the** problem that unless a market-maker is assured of a reward (increased order flow) for making the best bid/offer, there is no incentive to make competitive prices and narrow the price spread, especially if by so doing he allows his competitors to "hit" him at that price. The price-discovery function of the market is threatened, and the central market may become irrelevant. The report recommended that the old rules obligating market-makers to make firm prices in size for brokers dealing as principals be reinstated. The committee also called for efforts to improve cost-effectiveness (especially improvement of the settlement system).

Following the release of the Elwes Report, the ISE began restructuring, by eliminating 80 percent of its committees and eliminating 350 jobs, with further

[48] *"Future of the Stock Market" [Lead editiorial], London's Financial* Times, Mar. 2, 1990,p. 18.

[49] Its chairman was Nigel Elwes of Warburg Securities. The Report of the Special Committee on Market Development "Review of the Central Market in UK Equities," March **1990.**

50 In the United States, the National Association of Securities Dealers' Automated Quotation system (NASDAQ), used by over-the-counter dealers, is a quote-driven system. The New York Stock Exchange uses "order-driven" systems, meaning that the customer bids and offers, rather than dealers' quotes, are the basis of matching buyers and sellers to determine a going price.

reductions expected. The exchange was to be reorganized into three divisions, each of which will have its own managing director, management board, and responsibility for its own computer systems and rule-making. The three divisions will be: 1) a primary markets division to carry out regulatory responsibilities and provide services for corporate issuers, 2) a trading markets division to manage secondary trading, and 3) a settlements division. The exchange said that the restructuring was to ''bring focus to its disparate operations and introduce a more commercial environment for its managers.''[51] The chief executive of the exchange emphasized in interviews that an immediate task would be the "rationalizing" and "re-engineering" of the many large computer systems serving the various trading markets.

In spite of its problems, SEAQ was given credit for strong performance on October 16, 1989, when European markets fell sharply following the 7 percent drop in the U.S. stock market the previous Friday.[52] The ISE index value dropped 9 percent but regained most of that before the end of the day. SEAQ continued to quote real-time prices throughout the slide and thereby drew trades from the French bourse, which closed, and Frankfort, where the market fell 13 percent.

Clearing and Settlement

Equities and corporate bonds are traded in 2-week **"account periods."** All trades done in a given **account period are** scheduled for settlement on the sixth business day after the end of the account period. Thus settlement may be as late as 16 business days or 21 calendar days after the trade. Clearing and settlement costs are high. ***(See AppendixA: Clearing and Settlement,*** for **a** detailed description.)

Settlement between brokers and market-makers is through a central clearing service, TALISMAN, owned by the ISE and linked to company registrars. Individual investors, but not institutions, must settle with their broker whether or not the broker has satisfied his part of the settlement. For government securities, there is a computerized book-entry transfer system, operated by the Bank of England, and settlement is normally on the next business day.

Market Regulation

The Financial Services Act of 1986 is now the basis of Britain's securities markets regulation. The ISE is a registered investment exchange, whose members must belong to a self-regulatory organization such as The Securities Association (TSA), which also oversees the Eurobond market and corporate finance activities. Both the ISE and TSA come under The Securities and Investment Board, which authorizes exchanges and self-regulatory organizations, and is itself overseen by the British Government Department of Trade and Industry. The ISE and TSA share responsibilities for investor protection.

Big Bang represented access deregulation, but not prudential deregulation. The United Kingdom has more investor protection and related regulation than other European countries.[53] Because of the European Community's 1992 Directives, aimed at harmonization of regulation, there may be pressure to relax these regulations. The British securities industry reportedly shares a consensus that the 1986 Financial Services Act and the resulting level of prudential regulation is too burdensome and could detract from London's competitiveness.[54]

The London International Financial Futures Exchange (LIFFE)

LIFFE is not part of the ISE,[55] but its presence adds strength to London's position in securities trading, as does the presence of the Eurobond Market. LIFFE was organized in 1982. It trades futures contracts on interest rates, currency rates,

51 As reported by Richard Waters, "London SE Sharke-up Cuts 350 Jobs, Most Committees," in the Financial Times, Mar. 22, p. 1.

52During and after the 1987 crash there were criticisms of ISE performance as there were of other national exchanges. The Exchange rejected proposals breakers be instituted. There were complaints that some market-makers did not answer their telephones to avoid having to deal; but later evaluation indicated that much of this could be blamed on lack of telephone line capacity. The Council of ISE reports that: "Institutions in general acknowledged they had been able to divest in some lines of stock with market makers whose motivation in entering into bargains could only have been loyalty to their customers and their duty under the rules of the exchange.. . [T]he market makers were net buyers of securities to the value of L.250 million . . ." Council of ISE, op. cit., footnote 38, p. 7.

53Sir David Scholey, "Deregulated Competition or Competitive Deregulation?" *Institutional Investor,* April 1989, PP. 12-13.

54Based on interviews conducted by E. Clemens and others for OTA, op. cit., footnote 1.

55On Apr. 4, 1990 there was an announcement in London that LIFFE and the London Traded Option Market which is part of ISE, would merge; the form of this merger is not yet clear.

and on the stock index. It also trades American-style options contracts.[56]

In its promotional literature, LIFFE stresses the advantages of its position between the Far East and North America, when ". . the gap between the end of trading in the Far East and the start of trading in Chicago can be as much as six hours."[57] LIFFE is developing an electronic trading system, Automated Pit Trading System or APT, that emulates open-outcry trading, and is similar to the AURORA system developed by the Chicago Board of Trade (see ch. 2). APT is intended to extend trading hours to cover the European trading day, but it will not be a 24-hour system and will not be available outside the United Kingdom (LIFFE says that the cost of high-speed communications links is prohibitively high).[58]

London as a World Center for Securities Trading

London has a long tradition as an international financial center, and is now the most internationalized of the major securities markets. The liquidity and depth on the ISE are generally good. Very large positions are routinely moved at the 'touch price," or the best buy or sell quote on SEAQ. Until rule changes in February 1989 (allowing traders to delay reporting deals over £ 100,000) transparency was considered to be excellent (market-makers had argued that there was too much transparency). It is now less transparent, but the 1989 rule changes may be reversed. Market surveillance is considered to be good.

Spreads and commissions have been driven down by competition and are now very low; however, settlement costs are disproportionately high. For 8 years there have been plans to end the use of share certificates by developing a computerized share register— ''Transfer and Automated Registration of Uncertified Stock,' or TAURUS. It was delayed by "Big Bang" and the post-1987 decline, and the ISE's efforts to complete the design have been criticized as too costly by registrars and banks (many of whom have vested interests in the paper-based system, since it provides them with fees).

Since the introduction of SEAQ International, as much as 25 percent of the total turnover in French and German stocks on a given day has involved at least one counterpart in London. After Sweden, in 1986, imposed a trading tax of 1 percent on both sides of a trade, trading volume in shares of 10 Swedish companies rose temporarily in London, to 5 times the volume on the Stockholm bourse.[59] Now 15 firms make market in the& Swedish shares on SEAQ International.

Nevertheless, the ISE has serious problems. The competition between London's markets and those on the continent is strong. How this competition will develop in the context of the European Community's 1992 initiative is uncertain.

THE EUROPEAN COMMUNITY MARKETS

Europe has 39 stock exchanges, as well as some uncentralized or over-the-counter markets and informal, off-exchange trading networks. European stock markets, apart from London's, are not now strong competitors to the major market countries. However, one of the major objectives of the Commission of the European Community (EC) is to create and strengthen a European securities trading arena. Significant progress has been made in harmonizing securities laws and regulations--i.e., making them similar and more compatible with the goal of achieving effective harmonization by 1992.

There are proposals to establish a European equities exchange network on which a "Single European List" of shares of 300 large European and foreign corporations would be traded, through an intermarket trading system, like the Intermarket Trading System (ITS) in the United States. On the other hand, Andrew Hugh Smith, chairman of the ISE, has proposed that SEAQ-International be the

56 There are two kinds of opions. Conventional or "traditional" options, sometimes called European-style options, can be written on any listed security, are for a period of 3 months, are traded over the counter, are not transferable, and must be exercised on a specific day. "Traded options" or American-style options are available on specific securities, for 3,6, and 9 months, and may be cashed by sale. Both kinds of options can be written in both the United States and Europe. LIFFE options are American-style options and include options on futures. See *LIFFE: An Introduction,* published by LIFFE.

57 Ibid.

58 "Europe Forges Ahead in the Technology Race," *Futures and Options, Special* Supplement to *Euromoney,* July 1, 1989, p. 24.

59 "Taking Stock Home," *The Economist, May 28,1988,* p. 102.

international marketplace, under a' 'joint initiative' of the ISE and the German Federation of Stock Exchanges, based in Frankfort. The Federation of European Community Stock Exchanges is planning "le PIPE," a network to distribute market data from and among 12 EC member countries. This could, in time, develop into a trading system.

The EC has a consumer potential that is 1.5 times that of the United States and 3 times that of Japan, but the EC countries do not have a strong tradition of individual investment in securities. Their exchanges are, however, already ''international. " A number of them have recently been deregulated to give broadened access to their markets, and some have begun ambitious programs of automation. The EC must therefore be considered a potential competitor in global securities trading.

Of the 12 EC countries, the United Kingdom, already discussed, has about 35 percent of total market capitalization, West Germany has about 13 percent, and France nearly 12 percent. West Germany began, in 1989, a screen-based system (IBIS) for displaying market data on major stocks at eight West German exchanges. The Paris bourse is making significant investments in technology in an effort to strengthen and expand its market share.[60] It has, in the past 6 years, created four new markets, for: 1) issues of small companies (the Second Marche), 2) futures contracts (MATIF), 3) options (MONEP), and 4) money market funds (Inter-SVT). France has also restructured the stock exchange for broader capitalization, re-privatized its government-controlled banking system, and lifted all foreign exchange controls.

Other European markets are also being strengthened and are undergoing technological and regulatory changes. Individual ownership of securities is not widespread in Europe.[61] Even in the United Kingdom, which has the most well-developed securities markets, less than 3 percent of households owned corporate shares in 1980 compared to about 19 percent the United States,[62] although this increased in the 1980s because of privatization of some British nationalized industries. Probably for this reason, there were no strong customer protection regulations in Europe; most European countries did not mandate full disclosure, prohibit insider trading, or have securities regulatory agencies. With the privatization of state-owned enterprises in several countries, bringing with it national policies for encouraging stock ownership, prudential securities regulation began to emerge. No comprehensive national securities laws were enacted until recently, under prodding by the Commission of the EC and following several widely reported stock market abuses.

The EC'S 1992 Initiative

The Commission of the EC recognized from its beginning in 1957 that there should be special benefits from the integration of financial services markets, due to the "unique pivotal role played by financial services in catalyzing the economy as a whole."[63] But there was little progress for nearly 30 years. In 1985 the Commission of the EC issued a White Paper, *"Completing the Internal Market,"*[64] *an* ambitious legislative proposal to achieve a single market by the end of 1992. The White Paper proposed 300 directives aimed at regulatory harmonization among the member states.[65] In 1986,279 White Paper proposals (and a Dec. 31, 1992, deadline for implementation) were incorporated in an Amendment to the Treaty of Rome, entitled the Single European Act. This strengthened the legal framework for development of a common market.

In these directives the EC did not seek to establish identical regulatory regimes, but instead prescribed basic essential principles with a requirement of

[60] Discussion with Paris bourse officials, Apr. 2, 1990.

[61] B. de Caires, *GT Guide* to *World Equity Markets 1988,* 101; *Euromoney Public,* 1988, p. 113.

[62] ''Into the Provinces," *The Economist, Nov. 12, 1988,* p. 131; also SEC, "Internationalization of Securities Markets," Staff Report to U.S. Senate Committee on Banking, Housing, and Urban Affairs and House of Representatives Committee on Energy and Commerce, 1987.

[63] Cecchini, *The European Challenge 1992: The Benefits of a Single Market,* 1988, p. *37.*

[64] *Completing the Internal Market*: white paper from the Commission to the European Council, COM (85) 310 final, June 14.1985.

[65] Under the Treaty of Rome, "directives" proposed by the 17-person Commission (2 representatives each from the 5 largest countries and 1 representative each from 7 smaller member states) and unanimously accepted by the EC Council of Members, must be implemented by national legislation within each member state within a prescribed period of time. The directives are binding in terms of result but national legislatures have some discretion as to ''choice of forma and methods.'' Thieffry, Van Doorn, and Lowe, "The Single European Market: A Practitioner's Guide to 1992," 12 *B.C. Int'l & Comp. L. Rev., 1989,* pp. 357, 360. The Single European Act of 1986 amended the Treaty to substitute "qualified majority" for the requirement of unanimity in approval of directives by the Council.

mutual recognition. This appears to have made acceptance of the proposed directives much easier. About half of the 279 directives issued have been approved by the EC Council of Ministers, meaning that they are now mandatory. Some of these directives directly create supranational securities law; others are company law directives that provide the foundation and complement the securities regulations. Directives adopted or proposed in the field of securities regulation include the Stock Exchange Directives enacted prior to the Single European Act of 1986, and more diverse proposals dealing with mutual funds, prospectuses, investment services, and insider trading (box 4-A.) The last three reflect a change in the EC's approach from seeking commonality to seeking reciprocity. All of these directives rest on the foundation of full disclosure and equivalent protection built by the company law directives.

EC's company law and securities law directives seek to create a global common market for securities trading by establishing regulatory harmony and a higher level of prudential regulation to make European exchanges more attractive to foreign and domestic investors. Regulatory harmony should provide European investors with greater opportunities for portfolio diversification. Increased prudential regulation-safeguards against investor abuse and more comprehensive disclosure obligations—should promote public confidence in both primary and secondary securities markets and should also result in development of a European database on publicly held corporations. This will facilitate wider knowledge of European companies among investors, analysts, and advisers around the world, and could result in stronger demand for EC company securities.[66] It is also hoped that greater liquidity in the securities markets will promote the use of securities to fired acquisitions of other businesses; and that this will result in economies of scale. Finally, increased prudential regulation should make it easier for EC corporate issues to satisfy the regulations of stricter national authorities (e.g., the United States) and thus expand the opportunities for EC companies to raise capital outside of Europe, reducing the cost of capital.

There may also be substantial benefits for non-EC fins, including those from the United States. They will be confronted with stronger competition from European firms expanding to pan-European operations, but the directives should also result in a more level playing field for U.S. firms, because the European companies will be subjected to more stringent prudential regulations (and thus some costs they have not incurred in the past). U.S. firms, having met more stringent U.S. regulations, will have no serious difficulties or additional costs in complying with EC requirements.

It appeared for a time that the benefits of the newly integrated single market would be denied to non-EC fins. Under Article 58 of the Treaty of Rome,[67] all firms organized within an EC state are considered "nationals" and accorded regulatory parity, presumably without regard to the origin of their capital. This would apply to EC-incorporated subsidiaries of U.S. firms (although not to branches of U.S. firms). However, the reciprocity and mutual recognition provisions of some of the EC securities law directives, especially the proposed Investment Services Directive (see box 4-A), seemed to contradict Article 50's ban on discrimination. The EC ''White Paper" also reflected a Commission policy that concessions should be extracted from non-member states in exchange for the benefits,[68] and this was reiterated in the Cecchini Report, which said:

> In return, EC governments will have the right to expect appropriate responses from the community's economic partners abroad, notably the U.S. and Japan. If the fruits of the European home market are to be shared internationally, there must also be a fair share-out of the burdens of global economic responsibility, with market opening measures extended internationally on a firm basis of reciprocity.[69]

This caused non-EC firms to fear that they would not have access to the "single market" and would be at a disadvantage relative to EC firms. The proposed Investment Services Directive, for example, could

[66] Cecchini, op. cit., footnote 64, p.%.

[67] '' Companies or firms formed in accordance with the law of a member state and having their registered office, central administration, or principle place of business within the Community shall.. . be treated in the same way as national persons who are nationals of member states."

[68] *Completing the Internal Market, White Paper from the Commission to the European Council*, COM (85) 310 final; pm. 19, the only reference to non-member states, says: "Moreover, the commercial identity of the community must be considered so that our trading partners will not be given the benefit of a wider market without themselves making similar concessions."

[69] Cecchini, op. cit., footnote 64, pp. XIX-XX.

Box 4-A—EC Securities Law Directives

The Admission Directive (No. 79/279), adopted in 1979, is intended to facilitate greater interpenetration of member states' securities markets, thereby contributing to establishment of a European Capital market. Together with two other directives1, it is intended "to establish. . . a coordinated information policy on securities." The directive assumes agreements with non-member states to recognize listing particulars, but the non-member states' laws must give equivalent protection to investors, and the non-member state must also provide reciprocity to the EC member-states. For the United States (and Canada) which have significantly more comprehensive disclosure requirements, it is unlikely that reciprocal accords can be negotiated in the foreseeable future.

The directive provides ***minimum*** requirements for listing, to construct a regulatory floor for equivalent protection for investors throughout Europe. It contemplates a "subsequent closer alignment of rules," which might be accomplished either by further directives strengthening the requirements, or by requiring mutual recognition which would effectively lower them (any exchange, as a political and economic matter, would be unable to impose stricter requirements on domestic firms than on firms from other member states).

The ***Listing Particulars Directive (No. 80/390),*** adopted in 1980 and sometimes called the Information Directive, requires extensive disclosure to the general public (some member states had required disclosure only to regulatory or self-regulatory bodies). It requires an information sheet with common disclosure standards and a prescribed format, so that for the first time investors and analysts can make comparisons easily on a multinational basis. This directive influenced the SEC in its development of U.S. disclosure forms for foreign issuers.[2]

In 1987, the EC Council of Ministers amended the Listing Particulars Directive to include a mutual recognition directive (once approved in a member state, listing particulars must be recognized by other member states, and no additional information may be required). This means that a state with more stringent disclosure requirements is in the position of imposing more disclosure and greater costs on its domestic issuers than foreign issuers must meet. Almost surely this will mean lowering disclosure requirements to the existing lowest common denominator.

The Interim Reports Directive (Mp... 82/121) adopted in 1982, requires issuers of equity securities listed on member-state exchanges to publish certain financial reports at six month intervals. It is intended for investor protection.

The Public Offer Prospectus Directive (No.89/298), adopted in 1989 after 10 years of controversy, protects investors by requiring risk-related information from corporations in the form of a prospectus. There are regimes for both listed and unlisted securities but because the directive was adopted after lengthy negotiations it is riddled with exemptions that reduce its scope: exemptions for private placements, certain *small offerings,* minimum purchase offerings, exchange offers, employee offerings, eurobonds, and euroequities. Eurosecurities were exempted because the industry repeatedly threatened to trade elsewhere. The disclosure requirements are not as strict as those in the United States. The directive does however embody the principle that investors throughout the EC should be protected, and should be provided equivalent protection.

The directive does not require member states to give mutual recognition to issuers from non-member states even if they comply with its disclosure requirements. It authorizes negotiations based on reciprocity (mutual recognition and substantial equivalence of regulatory regimes). Since companies in the United States and Canada will have met higher domestic requirements, they would like to be allowed merely to file a notice of their home country prospectuses, but reciprocity for EC members with lower disclosure requirements will be a sticking point.

The Mutual Funds Directive (No. 85/611), adopted in 1985 but amended in 1988, is intended to establish equivalent protection for investors in collective investment funds throughout the EC and to promote the circulation of these securities throughout the Community on "a level playing field. " The provisions relate to authorization, supervision, structure, activities, and"disclosure obligations. Once a mutual fired is authorized by

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1 **Listing Particulars,** D&&e **No. 80/390,** and Interim *Reports,* **Directive No. 82/121.**

2 **SEC Release No. 34-1635 1 (Nov.** 29, **1979); R. Pierce, "The Regulation of the Issuanc** eand Trading of Securities **in the** United States **and the** European Economic Community: A **Comparison,"** 3 ***J. Comp. Corp. L. & Sec. Reg.*** 129, 132-22 (1981).

Continued on *next page*

Box 4-A—EC Securities Law Directives--Continued

one member state under these provisions it may be marketed in all other member states with the home state generally responsible for supervision and control.

The directive does not apply to the closed-end type funds. The fund must offer collective investment in transferable securities, of capital raised from the public, operating on the principle of risk spreading; and its units must be repurchased or redeemed at the holder's request out of the fund's assets, directly or indirectly. According to industry spokesmen in the United States, this directive could serve as the basis for international agreements beyond [EC] boundaries," facilitating the internationalization of mutual funds.[3]

The ***Proposed Investment Services Directive,*** newly proposed by the Commission in 1988, would establish mutual recognition of member states' authorization and supervision of investment firms. This would mean a single license for investment firms acting as brokerage agent, dealer, market-maker, portfolio managers, underwriter, or investment advisor anywhere in the EC. [Because banks and other credit institutions in the EC also provide investment services, a proposed Second Banking Directive contains similar provisions.] The home state must determine, before authorization, that the firm has sufficient financial resources to conduct the services that are to be provided; that the managers are of good reputation and experience; that the controlling shareholders of the firm are suitable; and that the firm submits a suitable business plan.

The directive requires member states each to promulgate prudential rules requiring investment firms to maintain sound administrative and accounting procedures and internal controls; to segregate investors' assets from the firm's own accounts; to participate in a general compensation fund to protect investors against the firm's default or bankruptcy; to provide regular information to the home state supervisory authority; to maintain adequate records; and to be organized in a way that minimizes conflicts of interest among the firm and its clients. Under the directive as it now stands, investment firms will continue to be regulated under the capital requirements and general business rules of the home member state, although EC directives in these two areas maybe developed later. A state's authority to regulate local activities of investment firms from other member states is largely removed by this directive,[4] but cooperation between home state and host state in preventing abusive practices is required by the directive.

Again, the most controversial aspect of this proposed directive is the issue of reciprocity. Investment firms (and their subsidiaries) from non-member states cannot enjoy the benefits of the directive's "single license" unless the fro's home state provides reciprocal treatment to all EC investment firms. However, there is a grandfather clause, and foreign firms may rush to incorporate as EC subsidiaries before the adoption and effective date of the directive. The related proposal for a Second Banking Directive modified the strict reciprocity requirement to require only "national treatment" (regulatory parity with domestic firms), and it is possible that this proposed Investment Services directive will also be so amended.

The ***Insider Trading Directive.*** First proposed in 1987, revised in 1988, and adopted by the Council of Ministers on June 19, 1989 (ratification not yet complete), this directive seeks to provide equivalent protection against insider trading for all EC investors. When it was first proposed in 1987 only three member states (Denmark, France, United Kingdom) had criminal penalties for insider trading. In the United States, securities regulators have not rigorously or officially defined insider information,[5] but this directive defines it as:

> . . . information which is unknown to the public of a specific nature and relating to one or more issuers of transferable securities, or to one or more transferable securities, which, if it were published, would be likely to have a material effect on the price of the transferable security or transferable securities in question,[6]

This directive is almost certain to be approved[7]; at present only Belgium, Ireland, Italy, and West Germany have yet to enact insider trading legislation. However, some observers fear that judges may still treat insider trading as "a gentlemanly misunderstanding rather than a crime."[8]

3"EC Directive on Mutual Funds May Serve as Basis for Global Agreement, ICI Says," *20* Sec. *Reg. &L. Rep.* (BNA) 1922 (Dec. 2, 1988).

4Each state retains limited power to restrict investment firms' conduct when necessary for "the public good," a concept based on Articles 36 and 56 of the Treaty of Rome.

5See *Symposium: Defining Insider Trading, 39 Ala. L. Rev. 337-558 (1988).*

6COM *(88) 549, O.J. Eur.Comm.* (No.C *277)* 13 (Oct.27, 1988).

7Nelson, "EC Members Near /@oral in United p@" *Wall St. Journal*, June 19, 1989, p. C 9.

8"Insider Trading in Europe: A Daft Draft," *The Economist*, May 20, 1989, p. 86.

deny a single EC license to EC-incorporated subsidiaries of U.S. fins; they would not be entitled to home-country control, i.e., authorization and supervision by the member-state in which they are incorporated unless equivalent treatment is granted by the United States. Because of differences in the scope and structure of the U.S. regulatory system, this equivalent recognition is politically unlikely. After strong protests, an amendment to the directive is being considered which would use the principle of national treatment rather than reciprocity.

It is less likely that the same change will be made in the reciprocity and mutual recognition provisions of other directives, including those dealing with Admission, Listing Particulars, and Public Offer Prospectuses (see box 4-A). The U.S. requirements regarding stock exchange listings and public offerings, administered by the SEC, are significantly stricter than EC requirements. They are not interchangeable with EC requirements and cannot be waived by the SEC to accommodate EC issuers, even though SEC has considerable regulatory flexibility, and has stated that it would favor recognition of the disclosure documents of foreign issuers if their home state provided reciprocal treatment and the disclosures were based on substantially equivalent standards.[70]

The basic problem is that the regulatory regime envisioned in EC securities laws directives, adopted and proposed, provides less protection for investors than is mandated in the United States. They include many exceptions and exclusions which greatly reduce the scope and effectiveness of the directives. For example, the Eurosecurities market-the largest European securities market-is exempted from the Public Offer Prospectus, although a number of problems have arisen with regard to interest and currency swaps, distribution methods, and disclosure.[71] In some areas there are as yet no EC directives. Among the number of regulatory areas not yet addressed are: rules of fair practice or essential standards to govern the conduct of EC investment firms; real-time publication of quotations, prices, and trading volume to assure market transparency. Participants in European securities markets will continue to be confronted by 12 sets of conflicting laws (or absence of law) dealing with essential areas of regulation in areas not covered by EC directives.

As yet, EC has no institutional mechanism for coordination and enforcement of the new regulatory system it is creating. Little has been done to harmonize enforcement. The directives provide for cooperation among authorities, but is likely that in some member states there is strong enforcement and in others, almost none.

There are two striking points to note about the EC 1992 initiatives in securities trading. First, EC has managed both to improve prudential regulation and to increase regulatory harmony-two goals that might have been assumed to be contradictory. Second, it may demonstrate that regulatory harmony can be achieved at least on a regional level. This suggests that harmony could also be achieved among the other OECD states, if the United States plays a strong role in promoting this goal.

70 "SEC Policy Statement on Regulation of International Securities Markets," SEC Rel. No. 33-6807, Nov. 14, 1988.

71 See P. Stonham, *Global Stock Market Reforms*, 1988, pp. 126-147. The rapid growth of swaps and options has led to less review of credit risk and failure to obtain collateral and a number of defaults have resulted. Prof. Manning Warren, III, op. cit., footnote 1, makes the point that despite assertions to the contrary the Eurosecurities market is to a large extent a retail market, and Euroequity offerings especially have large potential for abuse because of "gaping hopes in member state regulations,' unregulated sales pitches and timing pressures.