

# Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences

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Not long ago, Americans traded in New York, British traded in London, and Japanese traded in Tokyo. It was a simple world in which the flow of securities transactions respected political geography.

The essentially domestic character of securities markets made regulation a rather straightforward task. There was little concern that traders would move their business offshore if they disliked restrictions imposed by domestic authorities. There was also little concern that international transactions would be used as means to violate domestic securities regulations. Each market was an island—or so it seemed to regulators who had effective monopoly power and little reason to look beyond their own shores.

That world is dead and gone. The demise of domestic securities markets began during the 1960s and 1970s, and the notion of predominantly domestic markets clearly passed from the scene in the 1980s. Indeed, today's markets are international with a vengeance. Japanese investors trade in New York and London as easily as they trade in Tokyo or Osaka. London plays host to brokerage houses and investment banks from the world over. The internationalization of the U.S. markets is so well established that domestic exchanges actively market instruments tailored to meet the demands of domestic investors who seek to calibrate their exposure to foreign securities market risk.

Indeed, in 1988 alone, "a staggering \$10 trillion of securitized funds moved across national frontiers" (Heimann, 1989, p. 76).<sup>1</sup> Moreover, "global financial transactions currently account for an historically high multiple of the volume of world trade" (Heimann, 1989). These data strongly suggest that the movement of capital for investment-related purposes, and not simply for the financing of trade, "is driving the economic and financial world" (Heimann, 1989).

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No doubt, substantial barriers remain to complete internationalization of the world's securities markets, and there is reason to believe that markets will retain a comparative advantage in trading local securities. In particular, local markets have a comparative advantage in generating and interpreting information about local firms. Accounting standards, reporting requirements, and informal information-sharing mechanisms also differ dramatically across markets, and these institutional factors create further biases toward local trading. In addition, local investors may want to maintain disproportionately large portfolios of domestic securities because those instruments can provide a better match for the investor's liabilities or intended consumption stream. It is, therefore, unlikely that markets will ever reach a state of perfect internationalization, in which investors are totally indifferent among the geographic markets in which investments are traded. Nonetheless, the evidence shows that international investment activity has grown tremendously over the past decade, and there is reason to believe that international trading will continue to expand vigorously in the future.

As one example of the inroads made by internationalization, consider the fact that today, even the smallest U.S. investor can ride the internationalization wave. Several mutual funds now market foreign securities portfolios, often on a country-specific basis and in extremely small denominations. Aunt Minnie in Omaha can thus buy shares in the Japan, Germany, France, Italy, and Thailand funds, with an investment as small as \$1,000 in each (Kahn, 1990, p.1).<sup>2</sup> The profound implications of this simple form of internationalization are often overlooked—particularly from a regulatory perspective. When Aunt Minnie buys \$1,000 of the Japan Fund, she effectively decides to leave the United States' market, where her investments are fully governed by provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934.<sup>3</sup> Instead, through the Fund, her purchases and sales take place in Japan's markets where Japanese issuers are not required to make disclosures with the detail prescribed by U.S. securities laws. Secondary market transactions in Japan are also not subject to the vast panoply of legal restrictions found in United States' markets.<sup>4</sup> Accordingly, in today's internationalized securities markets, even the smallest investor can treat national regulatory regimes as partially discretionary constraints on investment activity.

Sophisticated investors have even greater latitude to structure their transactions to take advantage of international differences in regulatory regimes. Thus, U.S. traders who anticipate a change in stock prices might engage in an "exchange for physicals" transaction in the London market that could not be executed in the United States. They might also enter the Eurobond market or purchase other securities not offered for sale in the United States.<sup>5</sup>

As we head into the next decade, internationalization will increase investors' freedom to arrange their business affairs in order to select the regulatory environment most suitable for their financial goals. This freedom to choose among competing regulatory structures presents regulators with a series of challenges that were not contemplated at the time domestic regulatory regimes were initially crafted. In particular, most regulatory regimes are based on an implicitly autarkic model of the world's capital markets in which competition among regulators can safely be ignored. That assumption was quite reasonable during the 1930s, the time at which the U.S. regulatory structure was put in place. The world was then in the throes of a depression, and the notion of massive international capital flows was inconceivable.

But the autarky assumption no longer holds, even as a rough first approximation. Today's borders are sieves through which financial transactions flow like water through cheesecloth. As the pace of internationalization increases, so will the challenge to the basic foundation upon which current domestic regulatory regimes are constructed. This article focuses on those challenges, and on potential regulatory responses.

Part 1 of this article begins with an analysis of the extent and composition of internationalization in the world's equity securities markets during the decade of the eighties, viewed primarily from the United States' perspective. A major conclusion of this analysis is that much of the data commonly relied upon for the measurement of international capital market flows is highly deficient. Thus, despite clear evidence that internationalization is rapidly increasing, it is dangerous to put too much faith in the accuracy or relevance of many officially reported statistics.

Part 2 of this article explores the underlying economic, technological, and political forces that gave rise to internationalization. Part 3 suggests that the fundamental forces giving rise to internationalization are likely to grow in strength during the coming decade. Thus, whatever the current magnitude of internationalization, international trading is likely to become an even more significant factor in the world's securities markets.

Part 4 provides an overview of the challenges that internationalization poses for the world's securities regulators. It categorizes those challenges into three distinct forms: enforcement difficulties caused by internationalization of the world's markets; opportunities for efficiency-enhancing coordination that reduces the costs of international investing (as opposed to inefficient forms of standardization that, by reducing potentially beneficial variance in regulatory regimes, could actually increase the cost of capital); and opportunities for quality competition among regulators who legitimately set different regulatory standards for different markets. Part 5 explores the enforcement difficulties generated by internationalization and argues that investigatory cooperation is a legitimate response to a difficult externality problem. Part 6 considers the incentives for coordination of certain regulatory requirements. Part 7 analyzes the prospect for beneficial quality competition between markets with differing regulatory standards. Part 8 concludes the analysis with a brief summary of problems posed and likely solutions.

The bottom-line conclusion of the regulatory analysis is that great care must be exercised when evaluating arguments for greater standardization of world securities market regulation. From an economic perspective, the ultimate rationale for capital market regulation is the existence of a market failure that can be cured by regulation. The simple observation that different jurisdictions have different regulatory regimes does not in and of itself identify a market failure. Indeed, because a diversity of regulatory regimes can promote valuable experimentation and innovation, as well as act as a safety-valve against excessive regulation in specific markets, "too much" international standardization can actually harm the world's capital markets. Thus, while it is possible to support international enforcement cooperation designed to protect the domestic integrity of each sovereign's legal regime, and it is possible to support measures that coordinate regulatory requirements so as to minimize duplicative informational and filing burdens, measures that pursue more aggressive standardization must be viewed more cautiously and often deserve more immediate analysis than immediate support.

## 1. Internationalization: the facts

It is easier to describe internationalization of the world's securities markets in aggregate, qualitative terms than it is to detail internationalization in a careful quantitative manner. Quantitative measurement and international comparison raise interesting problems of price change and exchange rate adjustment. In addition, many key government statistics are maintained on the basis of historic book values that make it difficult to compare stocks and flows over time. Reliance on book values also makes it difficult to relate reported statistics to observed market values. Furthermore, funds often flow through several different markets as they travel from their initial source to their final investment destination. Middle Eastern deposits in European institutions that are invested in the United States might, for example, be measured as European, not Middle Eastern, investments. The circuitous flow of investment funds also creates an opportunity for double counting investment dollars as they flow through several markets. Moreover, an accurate quantitative portrayal of the state of securities market internationalization would require the use of data series prepared by several different governments: these data are not prepared in a manner designed to promote consistent comparability across time or over time.

Accordingly, there is good reason simply to observe that internationalization is "big" and to leave matters at that. Despite the wisdom inherent in that concise observation, this section attempts to quantify the growth of internationalization measured in terms of foreign investors transacting in U.S. equity securities markets, as well as U.S. investors transacting in foreign equity securities markets. The analysis is restricted to the period spanning 1980 through 1989, the most recent years for which full data are available. Moreover, as explained below, these calculations are subject to significant caveats.

### 1.1. Foreign transactions in U.S. equity securities markets

As an initial matter, it is important to recognize that purchases of U.S. equity securities by foreigners can be reported either as securities transactions or as direct foreign investments. When foreigners acquire less than 10 percent of a firm's equity, the acquisition is reported as a securities transaction. When a foreigner crosses the 10 percent threshold, the transaction is measured as direct foreign investment. A coherent assessment of foreign investment activity in U.S. equity securities markets thus requires simultaneous consideration of both forms of transactions.<sup>6</sup>

**1.1.1. Equity securities transactions.** As illustrated in table 1 and figure 1, aggregate foreign purchases and sales in U.S. equity securities markets, a measure of the volume of trading activity in U.S. markets rather than of net inflows or outflows from U.S. markets, stood at \$75.1 billion at the beginning of the decade. By 1989, the volume of those transactions had more than quintupled to \$416 billion. The peak 1987 volume of \$482 billion in foreign transactions represents a sixfold increase in foreign trading activity. Measured over the ten-year span, foreign transactions in U.S. equity securities markets grew at compound annual growth rate of 21.0 percent.

Table 1. Aggregate foreign purchases and sales of securities in U.S. markets, by geographic origin, 1980-1989 (\$ billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1980-1989 CAGR <sup>1</sup>	1989 Mkt shr
Canada	11.8	11.5	10.0	16.4	16.9	22.1	34.6	49.9	33.9	45.4	16.1%	10.9%
Total Europe	46.0	42.8	46.7	80.5	69.1	82.5	141.8	232.5	154.3	203.8	18.0%	48.9%
United Kingdom	12.4	13.4	18.8	29.2	28.3	37.6	64.6	103.9	73.4	97.2	25.7%	23.4%
Switzerland	17.9	14.9	14.2	26.2	20.3	21.6	37.0	59.5	34.9	42.6	10.1%	10.2%
Other Europe	15.7	14.6	13.8	25.1	20.5	23.3	40.2	69.0	46.0	64.0	16.9%	15.4%
Total Asia	9.8	12.9	14.9	21.3	18.7	25.1	55.3	142.4	129.7	98.0	29.1%	23.5%
Japan	1.9	1.4	2.0	3.3	2.7	7.8	26.9	102.6	104.6	60.8	47.0%	14.6%
Other Asia	7.9	11.5	12.9	18.1	15.9	17.3	28.4	39.8	25.1	37.2	18.7%	8.9%
Latin America	7.1	7.7	7.6	14.3	17.3	25.8	39.2	46.9	38.3	61.3	27.2%	14.7%
All other	0.4	0.5	0.7	1.6	2.4	3.5	6.6	10.3	7.8	7.8	39.3%	1.9%
Total	75.1	75.4	79.9	134.1	124.3	159.0	277.5	482.0	364.1	416.3	21.0%	100.0%

Source: Office of the Secretary, U.S. Department of Treasury, *Treasury Bulletin*, table CM-V-5, Spring issues.

<sup>1</sup>CAGR is the cumulative annual growth rate.

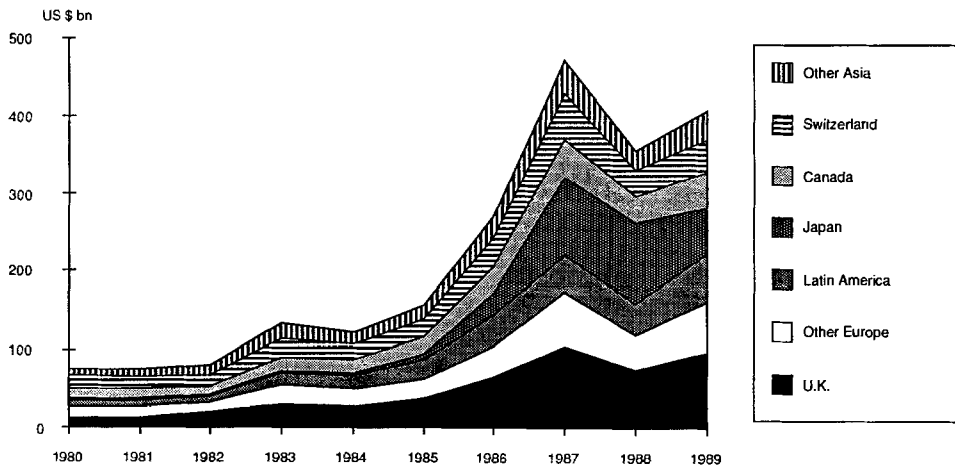


Figure 1. Aggregate foreign transactions in U.S. equities markets, by geographic origin, 1980-1989

Note: "Aggregate Foreign Transactions" is the sum of purchases and sales.

Source: U.S. Treasury Bulletin, various issues.

Though figure 1 hints that Japanese investment played a major role in the growth of foreign investment in the U.S. market, figure 2 illustrates this point more graphically. The horizontal axis of figure 2 measures the share of a particular nation's 1989 trading activity as a percentage of all foreign trading activity in that year. The vertical axis measures the compound annual growth rate between 1980 and 1989 for each nation's trading activity in U.S. equity securities markets. The areas of the circles, and the figures entered in the centers of those circles, describe the difference between purchases and sales aggregated over the nine-year period. Shaded areas indicate an excess of sales over purchases.<sup>7</sup>

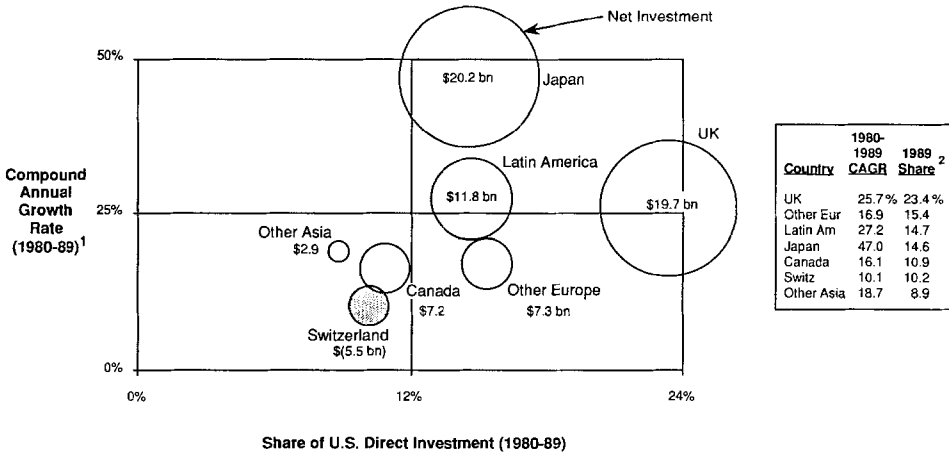


Figure 2. Growth rates, market shares, and net investment of foreigners in U.S. equities markets, by geographic origin, 1980–1989

<sup>1</sup>Based on 1980 and 1989 cumulative investment position.

<sup>2</sup>Does not add to 100 due to the omission of selected countries.

Note: Circle size represents net cumulative investment, 1980–1989.

Source: *Survey of Current Business*, various issues.

Figure 2 suggests quite clearly that Japan was a dominant force in the internationalization of the United States’ equity securities markets. The compound annual growth rate of Japan’s trading in U.S. markets, 47.0 percent, was substantially greater than Britain’s 25.7 percent rate. Indeed, that remarkable growth rate rocketed Japanese transactions from a mere \$1.9 billion in 1980 to \$104.6 billion in 1988, though volume declined to \$60.8 billion in 1989. Measured in terms of cross-sectional share, Japan’s 1989 trading constitutes 14.6 percent of all foreign trading in U.S. equity securities markets—a figure that trails Britain’s 23.4 percent share. These annual market share data can, however, be quite volatile; in 1988, Japan’s share of foreign trading was 28.7 percent, well ahead of Britain’s 23.4 percent. Japan’s net balance of \$20.2 billion in purchases over sales over the course of the decade was the largest flow measured into the market, though here the lead was slim over Britain’s \$19.7 billion net inflow.

Although the growth of foreign trading in the United States has been impressive, the data must be interpreted with a grain of salt because the total volume of all trading on U.S. securities exchanges also increased dramatically in the 1980s. Using the New York Stock Exchange as an index, the dollar value of transactions volume grew by 307 percent from \$382 billion in 1980 to \$1,556 billion in 1989 (*New York Stock Exchange Fact Book: 1990*, p. 80). Comparing this growth in total trading volume with the 454 percent growth in foreign activity over the same period suggests that foreign activity in the United States’ equity markets has, over the span of the decade, grown at a pace roughly 48 percent faster than that of the U.S. market as a whole.

Table 2. Foreign direct investment in the United States, by geographic origin, 1980-1989 (\$ billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1980-1989 CAGR <sup>1</sup>	1989 Share	Net Growth <sup>2</sup>
Canada	9.8	9.9	9.8	11.4	15.3	17.1	20.3	21.7	27.4	31.5	13.9%	7.9%	21.7
Total Europe	43.5	60.5	68.5	92.9	108.2	121.4	144.2	178.0	216.4	262.0	22.1%	65.4%	218.5
United Kingdom	11.3	15.6	23.3	32.2	38.4	43.6	55.9	74.9	101.9	119.1	29.9%	29.7%	107.8
Netherlands	16.2	23.1	21.5	29.2	33.7	37.1	40.7	47.0	49.0	60.5	15.8%	15.1%	44.3
Germany	5.3	7.2	8.2	10.8	12.3	14.8	17.3	19.6	23.8	28.2	20.4%	7.0%	22.9
Other Europe	10.7	14.6	15.5	20.7	23.8	25.9	30.3	36.5	41.7	54.2	19.7%	13.5%	43.5
Japan	4.2	7.0	8.7	11.3	16.0	19.3	26.8	33.4	53.4	69.7	36.6%	17.4%	65.5
Latin America	6.7	8.5	9.2	15.0	16.2	16.8	16.8	15.3	17.0	20.3	13.1%	5.1%	13.6
Middle East	0.7	3.6	4.5	4.4	5.3	5.0	4.9	5.1	5.8	6.4	27.1%	1.6%	5.7
Other	0.6	0.9	1.1	2.1	3.6	5.0	7.4	8.4	8.9	10.9	39.0%	2.7%	10.3
Total	65.5	90.4	101.8	137.1	164.6	184.6	220.4	261.9	328.9	400.8	22.3%	100.0%	335.3

Source: Bureau of Economic Analysis, Department of Commerce, *Survey of Current Business*, June issues.

<sup>1</sup>CAGR is the cumulative annual growth rate.

<sup>2</sup>Net growth is the absolute difference between foreign direct investment in 1980 and 1989.

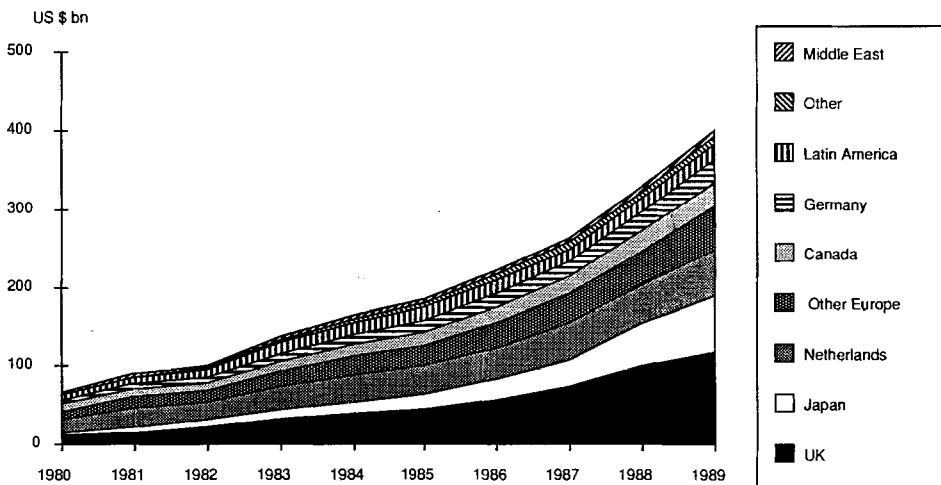


Figure 3. Foreign direct investment in the United States, by geographic origin, 1980-1989

Source: *Survey of Current Business*, June issues.

**1.1.2. Direct investment.** Table 2 and figure 3 describe the increase in foreign direct investment in the United States. From a total of \$65.5 billion in 1980, foreign direct investment grew at a compound annual rate of 22.3 percent to \$400.8 billion in 1989. This growth rate is roughly comparable to that observed in the securities transactions data.

Disaggregation of the data by country of origin, as displayed in figure 4, reveals that Britain and Japan were once again the international market's prime movers. Britain is the

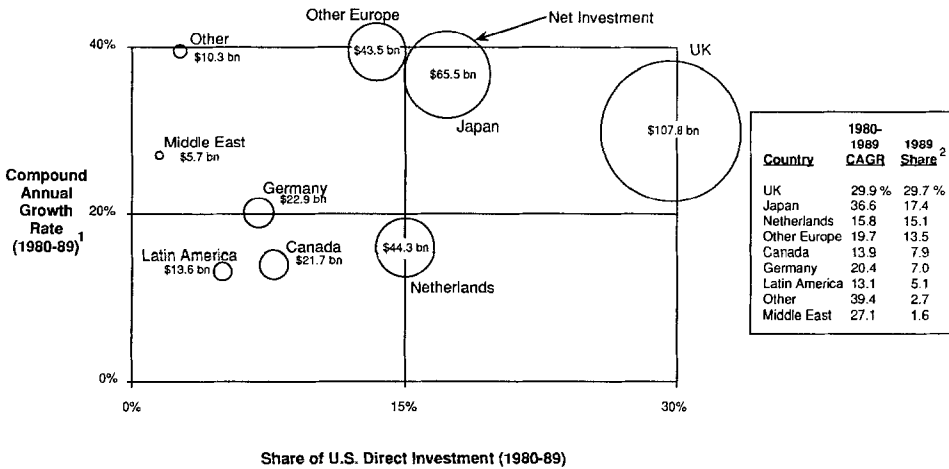


Figure 4. Growth rates, market shares, and net foreign direct investment, by geographic origin, 1980-1989

<sup>1</sup>Based on 1980 and 1989 cumulative investment position.

<sup>2</sup>Does not add to 100 due to the omission of selected countries.

Note: Circle size represents net cumulative investment, 1980-1989.

Source: *Survey of Current Business*, various issues.

largest foreign direct investor in the United States, and during the 1980s increased its direct investment by \$107.8 billion to a total of \$119.1 billion. Japan began the decade with a smaller direct investment base of only \$4.2 billion in the United States, but by 1988 became the second largest foreign direct investor by committing \$65.5 billion in new investments for a total direct investment position of \$69.7 billion.

Interpreting these data, however, requires an added degree of caution. Although a firm might nominally be considered a U.S. firm, its assets and revenues may in fact be largely foreign. Similarly, many foreign firms have large percentages of their assets and revenues outside their "home" jurisdictions. For example, Nestle, a Swiss firm, has 98 percent of its sales and 95 percent of its assets outside of Switzerland; ICI, the British chemical concern, has 78 percent of its sales and 50 percent of its assets outside Britain; Gillette, a U.S. firm, has 65 percent of its sales and 63 percent of its assets outside the United States; and Cannon, a Japanese firm, has 69 percent of its sales and 32 percent of its assets outside Japan.<sup>8</sup> Thus, the purchase or sale of a U.S., Swiss, British, or other firm does not necessarily mean the purchase or sale of a predominantly U.S., Swiss, British, or other business. In addition, as previously mentioned, because the data measure investments in terms of book value, not market value, they are not directly comparable over time. Thus, British and Dutch investment positions acquired over a relatively long period, at book prices that are low in comparison to their current market values, could well have a market value far in excess of Japanese holdings which have been acquired more recently at book prices that more closely approximate their market values.

Moreover, despite the growth in foreign direct investment in the United States, U.S. investors continue to control a larger portion of the U.S. economy than is the case abroad.



Foreign owned capital averages over 10 percent of gross national product (GNP) in most industrial countries, but in the United States, "it probably still stands below 7% of GNP" (Morgan Guaranty Trust Co., 1989, p. 3). Thus, a major bank observes that "U.S. investments abroad are far more prominent in foreign economies than are foreign investments in the United States. For example, U.S. investments in the United Kingdom are four times greater as a proportion of U.K. GNP than are U.K. investments in the United States relative to U.S. GNP" (Morgan Guaranty Trust Co., 1989, p. 3).

## 1.2. U.S. transactions in foreign equity securities markets

**1.2.1. Equity securities transactions.** The growth in foreign transactions in U.S. equity markets is mirrored by the growth of U.S. transactions in foreign markets. As illustrated in table 3 and figure 5, U.S. trading in foreign equity securities markets expanded at a cumulative annual growth rate of 32.8 percent, a rate higher than foreign activity growth rates in the United States. Thus, during the years spanning 1980 to 1989, total U.S. purchases and sales of securities abroad grew from \$17.9 billion to \$230.3 billion.

The international composition of these transactions is more complex, as displayed in figure 6. Again, it is clear that the Japanese and British markets were the dominant sources of growth. Britain attracted 34.8 percent of U.S. trading activity abroad in 1989, while Japan attracted 28.6 percent. Again, these market share data are highly volatile on an annual basis: in 1988, Japan and Britain both attracted roughly a third of U.S. aggregate U.S. transactions abroad. A sharp increase during 1988 in equity sales by U.S. investors in Japan, however, suggests that U.S. investors have been disinvesting in Tokyo securities during the 1980s. That statistic must, however, be interpreted with caution because of the substantial increase in Tokyo share prices. Many of the sales occurring

Table 3. Aggregate U.S. purchases and sales of foreign securities, by geographic region, 1980-1989 (\$ billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1980-1989 CAGR <sup>1</sup>	1989 Mkt shr
Canada	6.7	4.9	2.9	5.0	4.4	6.8	9.8	18.9	9.7	10.9	5.5%	4.7%
Total Europe	6.9	5.7	6.5	13.6	13.3	21.5	55.3	101.4	75.6	128.9	38.5%	56.0%
United Kingdom	2.8	2.9	3.6	6.5	7.8	13.3	32.6	67.9	51.2	80.1	45.3%	34.8%
Switzerland	1.6	0.9	0.7	1.8	1.3	1.6	3.2	6.3	5.3	8.5	20.8%	3.7%
Other Europe	2.5	1.9	2.2	5.4	4.2	6.6	19.5	27.2	19.1	40.3	36.0%	17.5%
Total Asia	3.3	6.5	5.1	9.4	10.7	14.0	30.1	56.7	56.2	75.8	41.8%	32.9%
Japan	2.7	5.4	4.3	8.0	9.0	11.6	25.6	47.8	50.4	65.8	42.4%	28.6%
Other Asia	0.6	1.1	0.8	1.4	1.6	2.5	4.5	8.9	5.8	10.1	38.0%	4.3%
Latin America	0.7	1.1	0.8	1.6	0.9	1.2	3.6	7.1	5.3	9.3	33.3%	4.0%
All other	0.3	0.4	0.3	0.8	1.1	2.0	2.7	5.8	4.8	5.4	36.4%	2.3%
Total	17.9	18.6	15.7	30.3	30.4	45.6	101.5	189.8	151.4	230.3	32.8%	100.0%

Source: Office of the Secretary, U.S. Department of Treasury, *Treasury Bulletin*, table CM-V-5, Spring issues.

<sup>1</sup>CARG is the cumulative annual growth rate.

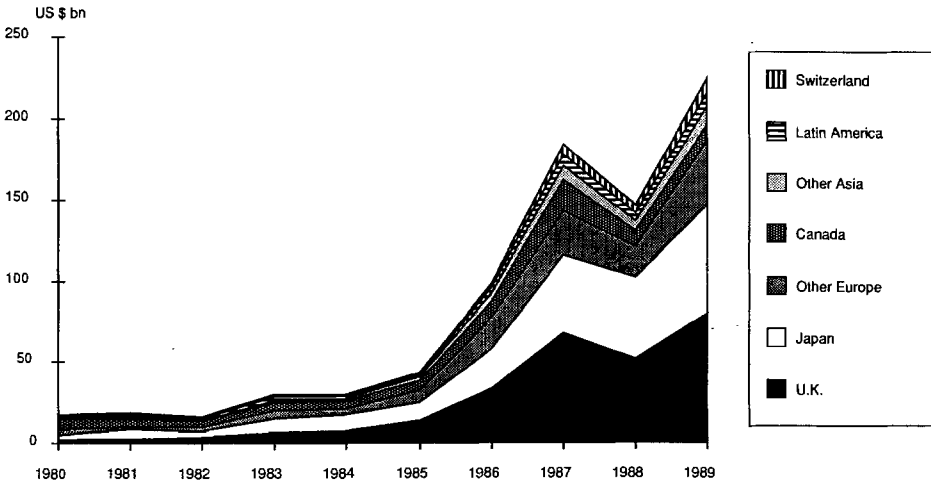


Figure 5. Aggregate U.S. transactions in foreign equity markets, by geographic region, 1980-1989  
 Note: "Aggregate U.S. Transactions" is the sum of purchases and sales.  
 Source: U.S. Treasury Bulletin, various issues.

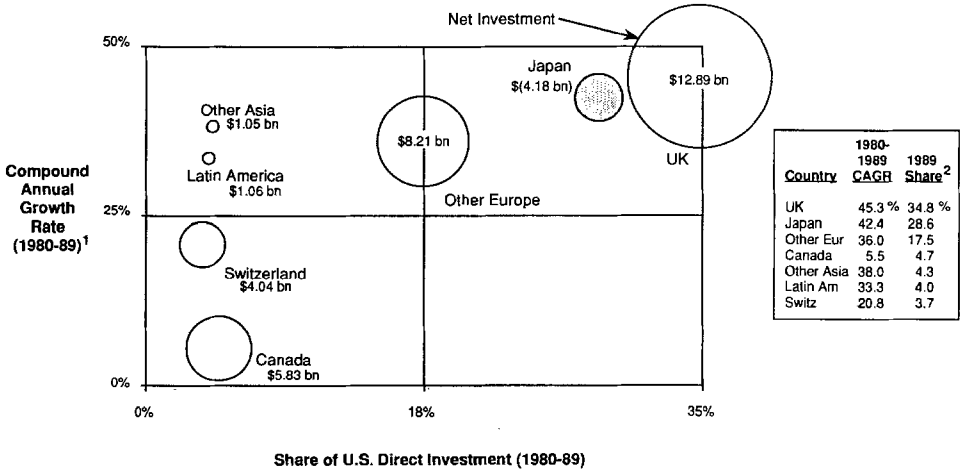


Figure 6. Growth rates, market shares, and net investment of U.S. investors in foreign equity markets, by geographic region, 1980-1989  
<sup>1</sup>Based on 1980 and 1989 cumulative investment position.  
<sup>2</sup>Does not add to 100 due to the omission of selected countries.  
 Note: Circle size represents net cumulative investment, 1980-1989.  
 Source: Survey of Current Business, various issues.

during 1988 may have been of securities acquired at substantially lower prices, and U.S. participants may still hold significant Japanese market positions despite 1988 sales.

**1.2.2. Direct investment.** Patterns in U.S. direct investment abroad are, however, quite different from those displayed by other forms of investment analyzed in this article. As suggested by table 4 and figure 7, U.S. direct investment abroad grew at a relatively slow compound annual growth rate of 5.2 percent, roughly a quarter of the growth rates displayed by other forms of securities market activity. Figure 8 indicates that the largest

Table 4. United States direct investment abroad, by geographic region, 1980–1989 (\$ billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1980–1989 CAGR <sup>1</sup>	1989 Share	Net Growth <sup>2</sup>
Canada	44.6	45.1	44.5	47.6	50.5	47.1	50.2	58.4	62.6	66.9	4.6%	17.9%	22.3
Total Europe	95.7	101.5	99.9	102.7	103.7	105.4	123.2	146.2	156.9	176.7	7.1%	47.3%	81.0
United Kingdom	28.1	30.3	30.8	30.8	32.1	32.8	35.0	42.0	49.3	60.8	9.0%	16.3%	32.7
Germany	15.4	15.8	15.9	16.0	15.2	16.7	20.3	24.8	21.7	23.1	4.6%	6.2%	7.7
Switzerland	11.3	12.5	13.3	15.0	16.0	15.8	17.5	19.5	18.4	20.0	6.5%	5.4%	8.7
Other Europe	40.9	42.9	39.9	40.9	40.4	40.1	50.4	59.9	67.5	72.8	6.6%	19.5%	31.9
Total Asia	14.7	17.9	19.2	21.5	24.6	24.8	27.3	31.4	36.4	40.3	11.9%	10.8%	25.6
Japan	6.3	6.8	6.9	8.0	8.4	9.2	11.3	14.7	17.9	19.3	13.2%	5.2%	13.0
Other Asia	8.4	11.1	12.3	13.5	16.2	15.6	16.0	16.7	18.5	21.0	10.7%	5.6%	12.6
Latin America	38.3	38.9	33.0	29.7	28.1	27.9	35.0	44.9	51.0	61.4	5.4%	16.4%	23.1
Other	22.1	23.0	24.7	25.5	26.5	24.8	24.3	27.1	26.6	28.1	2.7%	7.5%	6.0
Total	215.4	226.4	221.3	227.0	233.4	230.0	260.0	308.0	333.5	373.4	6.3%	100.0%	158.0

Source: Bureau of Economic Analysis, Department of Commerce, *Survey of Current Business*, June issues.

<sup>1</sup>CAGR is the cumulative annual growth rate.

<sup>2</sup>Net growth is the absolute difference between foreign direct investment in 1980 and 1989.

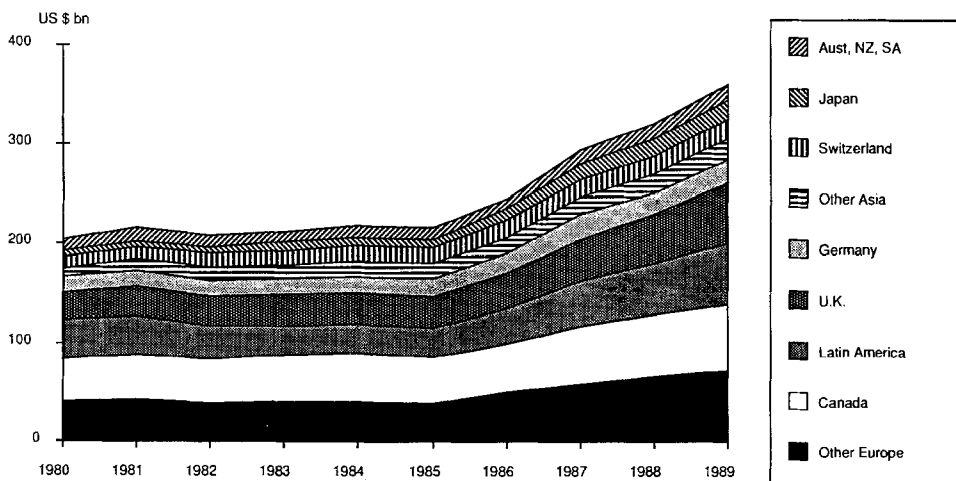


Figure 7. Aggregate U.S. direct investment abroad, by geographic region, 1980–1989

Source: *Survey of Current Business*, June issues.

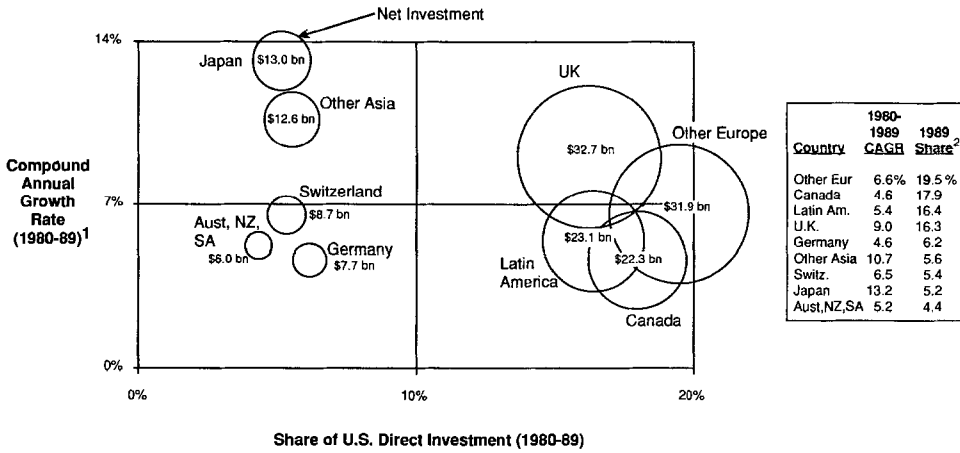


Figure 8. Growth rates, market shares, and net direct investment of U.S. investors abroad, by geographic region, 1980-1989

<sup>1</sup>Based on 1980 and 1989 cumulative investment position.

<sup>2</sup>Does not add to 100 due to the omission of selected countries.

Note: Circle size represents net cumulative investment, 1980-1989.

Source: *Survey of Current Business*, various issues.

U.S. investments were in Europe (outside of Britain), Britain, and Canada. Although direct investment in Japan displays the highest growth rate, it is measured from an extraordinarily small initial book value of \$6.3 billion. Thus, while the aggregate book value of U.S. investments in Japan roughly tripled during the decade, the 1988 book value of U.S. investment in Japan (\$19.3 billion) remains a relatively low number.

Again, however, statistics can be quite deceiving. United States' investors have, for decades, been actively acquiring positions abroad, and the market value of their positions far exceeds their stated book value. By one estimate, the market value of U.S. direct investment abroad is at least twice the book value stated in U.S. government statistics (Ulam and Dewald, 1989). A second source suggests that "the relatively older U.S. investments [abroad] have a market value more than three times their book value, while foreign holdings in the United States are worth almost twice their book value. On this basis, the excess of U.S. direct investment assets abroad over foreign assets in the United States probably exceeds \$100 billion" (Morgan Guaranty Trust Co., 1989, pp. 3-4).

**2. The forces causing internationalization**

Internationalization is not a random event. It is the rational consequence of a series of economic, technological, and political forces that grew in strength throughout the 1980s. Although it is possible to identify several distinct developments that are primarily responsible for the growth of internationalization, it is important to recognize that these forces are not wholly independent. Economics, technology, and politics shape each other and

interact, often in subtle but profound ways. However, when developments in economics, technology, and politics reinforce each other by moving in a common direction, the effect on the marketplace can be most striking.

That is precisely what happened in the decade of the eighties: the forces of economics, technology, and politics all moved toward internationalization of the world's capital markets. Capital market imbalances, advances in telecommunications and computational capabilities, advances in the technology of finance, the evolution of derivative product markets, and a worldwide move toward capital market deregulation occurred simultaneously. The confluence of these forces inalterably changed the shape of the world's securities markets.

### *2.1. Capital market imbalances*

The first and perhaps most significant force giving rise to internationalization of the world's stock markets is purely economic. Because of international differences in savings rates and investment opportunities, as well as international trade imbalances, the decade of the eighties witnessed the evolution of distinct classes of capital importers and exporters (Morgan Guaranty Trust, 1989, pp. 3–4). On the capital export side of the ledger, OPEC nations were the dominant suppliers of excess capital toward the beginning of the decade. Towards the middle and end of the decade, Japan clearly assumed the role of the world's major capital supplier (Morgan Guaranty Trust, 1989, pp. 3–4).<sup>9</sup>

On the capital import side of the ledger, the emergence of the United States as a major capital importer was the decade's most significant development. Indeed, in the course of the decade, the United States moved from being the world's largest creditor to its largest debtor—a shift in position that could be accomplished only as a result of massive capital flows.<sup>10</sup> The equities traded on the world's securities markets are a particular form of capital. As market theorists have frequently explained, equities represent contingent claims on firm resources that remain after debtholders and other senior claimants are paid off.<sup>11</sup> Worldwide shifts in capital flows would, therefore, naturally be reflected in the world's securities markets.

Given this perspective on the fundamental economic forces underlying internationalization of the world's securities markets, it becomes relatively easy to predict that internationalization is not a passing phase. After all, as long as certain economies have distinct comparative advantages in acting as suppliers and consumers of investable capital, the incentive for cross-border security investment remains. Indeed, in light of the powerful economic and demographic forces suggesting that capital market imbalances are likely to persist, internationalization seems certain to be a permanent fixture of the world's securities markets.

### *2.2. Technology*

The effect of technology on internationalization of the world's securities markets is difficult to overstate. Advances in telecommunication and computation technology have

dramatically reduced the cost of trading in both domestic and international markets.<sup>12</sup> Without these technological advances, the cost of obtaining information about market conditions halfway around the world would create a significant barrier to international investment.

Indeed, the central role played by technology becomes obvious when one walks into any modern trading room. The “screen” is the trader’s most important tool. Because of the telecommunications links and computational ability behind the screen, traders located anywhere in the world can call up international news and current capital market prices for thousands of instruments traded on any of the world’s major markets. Moreover, by combining analytical functions with access to copious data streams, technology offers traders a tool that allows them quickly to solve complex valuation problems and identify potential trading opportunities. Without these tools, the international market would quickly degenerate into a Tower of Babel: a world in which traders in one market would be largely ignorant of developments in other markets and incapable of comprehending the significance of foreign developments for their own investment decisions.

Viewed from this perspective, the remarkable advance in technology between 1980 and 1990 is absolutely critical to the evolution of today’s internationalized securities market. It would literally be impossible to operate today’s global market with technology that was state of the art in 1980: transmission and computation rates would be too slow, telecommunications costs would be too expensive, and critical analytic tools would be unworkable because the available hardware would simply be unable to support the necessary software.

### 2.3. *Finance theory*

Modern finance theory provides powerful insights into the value of portfolio diversification. It also provides techniques for hedging and arbitraging among markets, as well as techniques for redefining and reallocating risk among purchasers and sellers of securities.<sup>13</sup> Each of these insights played a significant role in the evolution of the modern internationalized securities market, either by providing an incentive to engage in international transactions or by providing a tool that improved the pricing and efficiency of international markets.

Portfolio theory, for example, teaches the value of diversification. For many years, investors viewed diversification as an exercise to be conducted within a market or across various investment categories. Thus, investors would diversify by broadening the list of stocks in their portfolios, or balancing their equity investments with investments in bonds, real estate, or venture capital.<sup>14</sup> These investments would, however, take place primarily within domestic markets.

Recently, however, investors have begun considering the benefits of diversification across national markets. Thus, instead of merely diversifying within domestic borders, investors now seek to hedge against domestic market risk by purchasing foreign equities, bonds, real estate, and other assets. Indeed, they are also beginning to view the foreign

currency markets not only as a means through which to hedge currency risk but also as an independent investment opportunity.<sup>15</sup> The most obvious evidence of this development is, perhaps, the emergence of “global” mutual funds designed specifically to offer to investors a low-cost means of achieving global market diversification, even with a relatively small investment (see Heimann, 1989). The evolution of portfolio theory has thus provided investors with an incentive to look beyond their own shores and has thereby increased the demand for foreign securities trading.

The ability to arbitrage and hedge across markets is also central to the operation of an international securities marketplace. Investors typically seek assurances that the prices they face in any one market are reasonable in light of the prices available in other markets. Investors also often seek to tailor their risk exposure by buying or selling instruments that provide a useful hedge against undesired risk. Issuers have similar demands. They want assurances that they are not being underpaid for their securities and often want to issue securities with specific risk characteristics that are particularly suited to their financing needs. For example, the purchaser of a Japanese equity warrant would want assurances that the warrant is fairly priced. He might also want to hedge his position against exchange rate or interest rate risk. And, the issuer of those same warrants might want assurances that he can hedge his risk by engaging in a series of fairly priced futures market transactions that have the stability to net out foreign exchange fluctuations.

Providing such price integrity and hedging capability is no simple matter in a world of complex financial instruments denominated in a smorgasbord of currencies. Fortunately, the modern technology of finance provides a broad array of analytical tools that are readily adapted to the challenges posed by international securities markets. The technology of finance now allows traders to calculate complex equilibrium relationships between cash, options, and futures markets, thereby providing the basic tools necessary for traders to arbitrage away inefficient price differences. Similarly, the technology of finance allows investors to craft highly specialized instruments with characteristics that are carefully designed to match the interests of particular buyers and sellers.<sup>16</sup> Without this ability, international and domestic securities markets would be much more rudimentary trading institutions lacking in both liquidity and imagination.

With the current state of the art, the technology of finance is sufficiently evolved that it supports the creation of new trading instruments that are specifically designed to take advantage of opportunities created by the international nature of the market itself. For example, in early 1990 several investment banks designed Nikkei puts that allow retail investors to buy and sell the risk that the Japanese equity market will suffer a decline.<sup>17</sup> The issuers of these instruments often had no direct exposure to the Japanese equity markets. They were able to issue these instruments only because of the availability of futures and other markets that allow them to hedge against specific forms of equity and currency risk. The net result of the transaction was to create a new equity-like instrument that requires, as a condition of its existence, liquid international futures and options markets. Thus, international markets have reached a stage where they provide not only the environment in which trades take place but also the rationale for the creation of new instruments that would not exist but for the international nature of the market itself.

#### 2.4. *Derivative markets*

Closely related to the changes wrought by advances in finance theory are the benefits created by the evolution of an international network of derivative product markets. In 1980, securities markets were dominated by “plain vanilla” stock exchanges. Securities-related options and futures markets were rare, and their volumes were relatively small. Today, however, each of the world’s major trading markets has a troika of equities, options, and futures markets.<sup>18</sup>

The evolution of derivative product markets has particular significance for foreign traders. In many situations, foreign traders have hedging demands that differ significantly from those of domestic traders.<sup>19</sup> These demands can be quite difficult, if not impossible, to satisfy absent an active and liquid derivative products market. The emergence of these markets therefore provides a service that is of particular value to international investors and promotes the internationalization of the world’s securities markets.

In many instances, the world’s derivative product markets are keenly aware of the intense interest in international trading for hedging and other purposes. In response to this demand, many markets introduced international products specifically designed to allow domestic investors to trade foreign security-related risks. For example, in the United States, investors can trade futures on the Nikkei Stock Average through the Singapore International Monetary Exchange, futures on the Financial Times Stock Index (FT-SE) 100 through the London International Financial Futures Exchange, and futures on the Toronto Stock Exchange 300 through the Toronto Futures Exchange (see Rosenbaum, 1990, p. 50).

#### 2.5. *Deregulation*

Regulatory barriers have long been an impediment to securities trading on both a domestic and international level. Several countries have, however, recently lowered regulatory barriers that made trading unnecessarily expensive for all market participants. Most notably, in 1987 the London markets eliminated fixed commission rates as part of their “Big Bang.”<sup>20</sup> These domestic liberalizations benefit international traders as much as domestic ones and have helped reduce the cost of intermarket capital flows.

On the international trade front, Japanese markets have lowered many of the barriers that traditionally kept foreign firms out of the country (Viner, 1988; Tanji, 1987; Miller, 1990; “Openness, Not Retaliation . . .,” 1990, p. 5). Although these barriers are substantially reduced, and although international firms now have a more than token presence in Tokyo, significant barriers to foreign entry and participation remain. Further progress in opening Japan’s markets could thus facilitate even greater internationalization of the world’s securities markets.<sup>21</sup>

Most significant, perhaps, is the fact that some regulators have begun adjusting their domestic regulatory regimes in response to perceived competition from abroad. The recent decision by the United States Securities and Exchange Commission to adopt Rule 144A—a provision that will allow the free and liquid trading of privately placed foreign



instruments among large institutional investors in the United States—was motivated in part by the observation that the United States' financial services industry was being harmed by overly narrow interpretations of the registration requirements of the Securities Act (U.S. SEC, 1990). If Rule 144A operates as some of its proponents expect, capital costs for U.S. issuers should be reduced and many foreign firms should for the first time enter the U.S. market with special "144A placements" offered to institutional investors (Greene and Beller, 1990).

Similarly, the spectre of foreign competition can be used as a weapon in domestic regulatory debates. The Securities and Exchange Commission, for example, recently announced a sweeping review of current U.S. accounting standards to determine whether they are "affecting adversely the ability of U.S. companies to compete internationally with foreign companies whose home country's accounting rules may be less stringent than U.S. standards" ("SEC Launches Extensive Review . . .," 1990). If the review indicates that current accounting regulations impose costs that disadvantage U.S. firms in international competition, then the Commission may well initiate changes designed to make U.S. reporting requirements more "competitive" in the international marketplace ("SEC Launches Extensive Review . . .," 1990).

### 3. The future of internationalization

Given the fact that internationalization did not evolve by chance, it is equally unlikely that its future will be determined by random forces. Though economic prognostication is surely one of the more dangerous hobbies known to man, certain trends that are already well-established in the world's marketplace make it highly likely that tomorrow's securities markets will be even more globalized than today's.

Imbalances between the sources of investable capital and the locations offering the most profitable investment alternatives are likely to continue. Indeed, because of the opening of Eastern Europe, the reunification of Germany, Europe 1992, the aging of the Japanese population, and possible increases in the price of oil, to mention only a few relevant factors, there is a significant chance that the pattern of capital flows in the 1990s will differ materially from the patterns observed during the eighties.<sup>22</sup> These changed patterns do not foretell a decrease in internationalization; instead they suggest changes in capital flows and a new shape to internationalization.

The pace of technological change is also likely to quicken.<sup>23</sup> Advances in computer and telecommunication technology are likely to reduce the costs even further and make available services that are quantitatively and qualitatively quite superior to the level of services that are currently available. Particularly noteworthy is the possibility that electronic trading will mature and come into its own during the coming decade. The Chicago Mercantile Exchange and The Chicago Board of Trade have jointly agreed to develop an after-hours computerized trading system,<sup>24</sup> and the New York Stock Exchange has also announced plans to introduce automated after-hours securities trading.<sup>25</sup> It is a trivial

technological step from after-hours electronic trading to electronic trading at all times of the day.<sup>26</sup>

In addition, the introduction of computerized trading systems may bring more fundamental changes to the structure and operation of domestic equity marketplaces. Electronic crossing networks in which large institutional traders are able to transact a portion of their business have already captured a small but potentially significant piece of the market.<sup>27</sup> The possibility of discrete single price clearing auctions is also being actively explored.<sup>28</sup> If only a fraction of these changes come to pass in the nineties, the shape of domestic securities markets is sure to change and the pace of internationalization is certain to be enhanced.

Progress in our understanding of the technology of finance is somewhat more difficult to predict. However, no additional progress is necessary in order to sustain substantial additional internationalization of the world's capital markets. In particular, there is reason to believe that many investors are insufficiently diversified from an international perspective. Thus, even if the nineties bring no analytic breakthroughs leading to greater internationalization, a great deal of internationalization could take place simply as a result of investors' desire to implement lessons that have already been learned.

Additional growth and diversity in the derivative product markets also seems assured in the coming decade. As already mentioned, derivative product markets are actively moving toward electronic trading. Moreover, these marketplaces are introducing new products specifically designed to facilitate the internationalization of the world's capital markets. The net result of this activity is certain to be an increase in interest in international derivative product trading that will be correlated with an increase in international securities trading.

The final and clearly most difficult piece of the puzzle regarding the future of the internationalization concerns the fate of deregulation. If the world's markets are simply able to maintain the status quo, then the opportunity for enhanced internationalization will be preserved. Preservation of the status quo will not, however, generate many of the benefits surely to arise from further reductions of barriers to international capital flows, particularly those that continue to exist in Japan. But if the world's major markets retreat from many of the liberalizations of the past decade and begin penalizing foreign or domestic traders either by introducing new barriers to entry or by increasing transactions costs, then all bets are off.<sup>29</sup> Significant and imprudent steps toward reregulation are the one identifiable force on the horizon that could stall or even reverse the market's trend toward internationalization.

While it seems highly improbable that the world will experience massive reregulation that turns back the hands of time and returns the world's securities markets to a relatively autarkic state, it is worthwhile to remember that the reunification of Germany, which seemed inevitable as of mid-1990, seemed impossible at the beginning of 1989. Politicians are among the most unpredictable forces in nature and can cause a great deal to happen—good and bad—in a relatively short period of time. Ideally, political intervention will have a beneficial effect on the world's securities markets, but politics is one area where prediction is too dangerous even to be ventured.

#### **4. Consequences for regulators: three distinct challenges**

Although internationalization is sure to have significant consequences for investors, issuers, securities markets, and the financial services industry, few market participants will find their future as affected by internationalization as the world's securities regulators. During the 1980s, internationalization changed the art of securities trading. In the 1990s, internationalization will revolutionize the art of securities regulation.

This revolution in the art of regulation will occur in three distinct forms. First, there is a set of international cooperative measures that are necessary if domestic regulators are to be able to continue effectively to regulate their own domestic markets. Simply put, internationalization creates an opportunity for the evasion of legitimately adopted domestic regulatory requirements. This opportunity for evasion, which can be considered as a form of externality, can be addressed through cooperative international investigatory measures.

Second, the world's securities markets are beset by a maze of contradictory and incompatible regulatory requirements that often serve no real purpose. Many of these differences are simply the result of historical accident, and they often impose costs that outweigh any benefits. Coordination of these regulatory requirements so as to reduce the compliance burdens associated with international trading would benefit issuers and investors worldwide. For example, coordinated registration and accounting procedures could materially reduce the costs of raising capital in an international market. Coordination is, however, a double-edged sword because if the international marketplace coordinates at a quality level that is too low or too high, or if the imposition of international standards drives efficient diversity out of the market, then the cost of coordination can, in some cases, outweigh its benefits.

Third, there is a set of regulatory standards for which different nations may legitimately wish to adopt different approaches. Diversity in regulation is not necessarily harmful. Diversity can foster beneficial innovation and competition among regulators, and it need not lead to an inexorable race to the bottom. Nations that recognize this point may even wish to establish diverse regulatory regimes even within their own jurisdictions—a foresighted step that the United States recently extended within its own securities market.

The major challenge for regulators will, however, be to distinguish situations in which coordination is desirable from those in which diversity yields greater benefits. The remainder of this article addresses these three sets of regulatory challenges and the progress that has been made addressing each.

#### **5. International cooperation and domestic regulatory integrity**

Given the realities of an internationalized securities marketplace, no nation will be able to enforce even its most basic antifraud strictures without the cooperation of a substantial number of its trading partners. To illustrate this new reality, consider the following example. A British subject violates British law in the course of trading British securities

with other British subjects in British markets. The violative trades are, however, channeled through the United States, Japan, Switzerland, or other foreign jurisdictions. Under these circumstances, Britain will not be able to enforce its own rules against its own subjects trading its own securities in its own markets without the active cooperation of its international financial market trading partners.

This example is more than hypothetical. The recent revelation of the "Quinn scandals" in Europe suggests that tens of millions of dollars have been stolen from European investors as the result of a scheme based on transactions in United States securities markets (*SEC v. Arnold Kimmes et al.*, 1989). Without the active cooperation of United States law enforcement agencies, European authorities would be hard pressed to develop a case against a fraud that occurred in their own back yard.<sup>30</sup>

In a similar vein, a recent study by the General Accounting Office determined that trades originating abroad represented more than one-third of all cases of suspected insider trading referred to the United States Securities and Exchange Commission in 1987.<sup>31</sup> As several cases have demonstrated, such trading can be generated by U.S. nationals electing to trade from foreign locales for the express purpose of evading detection by United States authorities (Levine, 1990, p. 80).<sup>32</sup>

Significantly, no nation need impose its philosophy of market regulation on any of its trading partners in order successfully to address this level of fraud. Each nation can continue to define fraud as it likes; each can adopt its own approach to insider trading regulation; and each can set whatever penalties it deems appropriate under the circumstances. All that is needed is a common understanding that the purpose of internationalization is to facilitate legitimate trading. The purpose of internationalization in the world's securities market is not to provide a means of evading the domestic regulations of participating markets, nor is it an excuse for one nation unilaterally to impose its standards on trading that does not involve its own markets.

The problems posed by international fraud can be addressed by cooperation rooted in the simplest form of enlightened self-interest. Putting aside rogue jurisdictions that perceive little benefit from assuring that their market facilities are not used to shelter illegal offshore trading affairs of the world's securities markets, each jurisdiction has a legitimate interest in maintaining its ability to enforce its domestic regulations in its domestic markets. This enforcement capacity can be maintained only if cooperation is forthcoming from trading partners. But cooperation will be forthcoming only if the favor is returned.

This rather straightforward fact of modern commercial life explains a great deal of the success achieved by the Securities and Exchange Commission in negotiating its network of memoranda of understanding, treaties, communique, and accords. These bilateral understandings today exist between the United States and agencies of the United Kingdom, Japan, Switzerland, France, the Netherlands, Brazil, Ontario, Quebec, Canada, Italy, Turkey, the Cayman Islands, and the International Organization of Securities Commissions. Together they create an effective network through which foreign jurisdictions can obtain information from the United States about activities that might constitute violations abroad.<sup>33</sup> Similarly, they create an effective network whereby U.S. authorities can obtain information about violations in domestic U.S. markets resulting from foreign trades.<sup>34</sup>

In order further to enhance the ability of U.S. authorities to cooperate in investigations of foreign securities law violations, Congress adopted the Insider Trading and Securities Enforcement Act of 1988 (see House of Representatives 5133, 100th Congress, 2nd Session (1988), Section 6). That statute contains a provision empowering the Securities and Exchange Commission to conduct investigations on behalf of foreign securities authorities, even if there is no allegation that U.S. law has been violated. This provision was adopted both in order to assist investigations of foreign securities law violations and to provide an inducement for foreign trading partners to adopt reciprocal cooperative provisions.<sup>35</sup>

The value of a cooperative approach to international enforcement issues is particularly striking in light of the SEC's experience in the early part of the eighties. At that time, the Commission relied primarily on unilateral attempts to obtain foreign-based evidence. Those efforts were often fruitless. In addition, the efforts were "time consuming, expensive, and strained international relations" (Levine and Callcott, 1989, p. 3).<sup>36</sup> In contrast, having invested the effort of explaining to foreign jurisdictions the value of a bilateral understanding that allows each party to protect and promote the interests of the other, the Commission is now reaping the rewards of its more cooperative approach.

Indeed, the value of international enforcement cooperation extends far beyond the operation of the world's securities markets. In late April of 1990 representatives of the Group of Seven (Britain, Canada, France, Italy, Japan, the United States, and West Germany) met with representatives of eight other nations, some of which are known for their bank secrecy laws (including Switzerland, Austria, and Luxembourg), to discuss problems raised by money laundering arising out of international narcotics traffic.<sup>37</sup> The meeting led to the proposal of a broad set of regulatory and banking reforms designed to pierce through the shield erected by bank secrecy laws (Labaton, 1990, p. c1). Evidently, the benefits of international enforcement cooperation are not limited to the world's securities markets, and progress in this direction can be expected along many different fronts.

No doubt, some market participants might object to even this level of enforcement cooperation on the ground that certain domestic regulations are inefficient. By prohibiting foreign trading in violation of these strictures, international enforcement cooperation could thus reduce market efficiency. The difficulty with this argument, however, is that it is essentially lawless. No legal regime can operate in an environment in which compliance is voluntary. Indeed, even when regulations properly address market externalities, some traders will perceive that their interests are adversely affected and will attempt to evade domestic regulations on the premise that those regulations are inefficient. If avoidance can be justified on this rationale, then compliance becomes discretionary, and domestic legal regimes lose their force.

Thus, unless one believes that regulation of capital market transactions is suspect in all circumstances, provisions to protect the enforcement integrity of the legal regime are, at some level, necessary. The socially accepted means of expressing objection to an inefficient regulation is to work within the system to change the regulation, and not to evade the regulation through illegal means. Furthermore, if a regulation is in fact inefficient, it creates opportunities for other markets to establish trading systems that do not suffer

from the same inefficiency and through which traders can legitimately interact. International competition thus acts as a potential safety-valve governing the extent to which local regulators can impose inefficient constraints without forcing transactions offshore.

## **6. International regulatory coordination: when is it efficient?**

Enforcement cooperation is not the only area in which regulators will be challenged by the international market. Issuers and investors alike often complain that multiple and inconsistent registration and accounting standards add to the costs of international investing. From this perspective, if regulators can successfully coordinate certain disclosure and accounting requirements, the cost of capital will be reduced and the efficiency of the markets will be enhanced.<sup>38</sup>

Even though it is unrealistic—and perhaps even undesirable—to think of a single registration statement that could be used by all issuers in all markets, there clearly are situations in which a dose of coordination can be accomplished at relatively low cost and with obvious benefit for all market participants. In particular, when the substance of the required disclosures are sufficiently similar, nothing is gained by requiring issuers to replicate those disclosures in separate registration statements. Under those circumstances, it makes sense for securities regulators to consider a single filing that would be acceptable for multiple jurisdictions.

The United States and Ontario have embarked on just such an experiment. In 1989 the Securities and Exchange Commission and the Ontario Securities Commission issued a notice of proposed rulemaking that described a procedure for filing a registration statement that would be jointly acceptable by both authorities.<sup>39</sup> No doubt, this effort was initially undertaken by the United States and a Canadian province because the similarities in their registration requirements made coordination a relatively easy task. However, as regulators learn that the compromises necessary for a meaningful degree of coordination do not require an abdication of basic regulatory principles, the opportunities for cooperation could increase dramatically. In this regard, it is important that regulators not be overly ambitious. Even if wide-scale coordination between two countries turns out to be infeasible, there may be portions of registration statements or other filings that can be standardized much to the market's advantage.

Coordination in the area of international accounting procedures provides special challenges and opportunities.<sup>40</sup> Investors considering a choice between different markets are often confronted with the need to compare financial results reported according to wildly different accounting conventions. In many situations, the first step in reaching an investment decision involves the difficult exercise of translating one set of financial results into another country's accounting convention.<sup>41</sup> To many international investors, there is no innate preference for one reporting system over another. Instead, there is a desire for ready comparability.

To satisfy this market demand, regulators might want to consider adopting domestic conventions specifically designed to facilitate international comparability of financial reports. In some situations these facilitation conventions might be easily implemented:

rules for consolidation of subsidiaries, depreciation, and tax accounting are all areas where comparability can be enhanced with little or no damage to domestic philosophies of accounting and disclosure.

In other situations, however, achieving comparability will be far more difficult. For example, certain European countries allow issuers to maintain hidden reserves that are used to smooth earnings over time.<sup>42</sup> Other nations, such as the United States, would find such accounting practices fundamentally inconsistent with their domestic market philosophies. Accordingly, they are unlikely to accept such reports within their jurisdictions, unless accompanied by "comparability" data that would effectively destroy the fundamental purpose of the hidden reserve account. Under these circumstances, it is probably asking too much to expect markets with such divergent philosophies of accounting easily to achieve some middle-ground accommodation. The existence of such differences does not, however, mean that substantial progress could not be made on several other fronts.

One other area of international coordination deserves special mention. Capital standards are often a point of serious contention because firms subject to more stringent requirements often argue that they are unfairly forced to compete with less credit-worthy institutions in a process that is potentially damaging for the stability of the world's financial markets. Such controversy preceded the adoption of the Basle international capital adequacy standards for the banking industry, and some observers have asked whether similar standardized capital requirements are appropriate in the securities industry.<sup>43</sup>

Needless to say, this is a contentious issue. Unlike the banking industry, which is perceived to have government backing on an international scale, the securities industry in the United States is not backed by government insurance, as evidenced by the government's decision to allow Drexel Burnham Lambert to fail (Hershey, 1990, p. 2). Accordingly, the argument for international minimum net capital standards would have to be quite different than the arguments frequently presented in the banking sector.

The process of setting international capital standards would also surely be bloody. Whatever the rule finally adopted, some securities firms would surely see themselves as disadvantaged and would lobby heavily against adoption of the proposed standards. Moreover, the debate would, to say the least, be highly complex and would raise questions involving the valuation of a large array of securities positions, the definition and treatment of hedged positions, and the measurement of risk related to intricate swap market and option positions.<sup>44</sup>

## **7. Quality competition: the danger of an über-regulator**

Having observed that there are several dimensions in which international cooperation and coordination are potentially desirable, it should be emphasized that complete standardization is not necessarily in the world economy's best interest. Put another way, it is doubtful that the world's securities markets would be improved if they were subject to the control of a single über-regulator enforcing a consistent, worldwide set of regulations.

There is value in diversity. Diversity promotes experimentation and innovation in regulation just as it does in product and service competition.<sup>45</sup> Diversity also allows securities market participants to select transaction quality levels that are most suitable given the parties' preferences and prevailing market conditions. Excessive standardization could stifle important forms of innovation and prohibit markets and firms from providing socially desirable quality levels that are inconsistent with worldwide standards.

Indeed, there is an important perspective from which diversity among regulatory regimes can add value to all the world's securities markets. Regulation can increase or decrease the quality of investments and transactions available in any one market. It can increase or decrease disclosure by issuers, speed or slow settlement, and forbid or permit many practices that have the effect of shifting various forms of risk among different classes of investors.

Quality, however, comes at a price. In many situations, investors are willing to pay an additional amount to support a regulatory regime that provides valuable quality safeguards. If, however, investors do not desire the quality level imposed by a particular regulatory regime, or if investors find that the price of the quality generated by regulation is too high relative to other alternatives available in the marketplace, then investors will search out markets that provide preferable price-quality combinations.

International quality competition among regulators thus provides a market mechanism that helps prevent regulators from adopting rules that impose costs in excess of their benefits. Without this disciplining effect of the market, investors would effectively have no recourse in addressing inefficient regulatory structures other than frontal assault on domestic regulations and regulators themselves. Moreover, and perhaps more importantly, domestic regulators can learn from their international peers. If a regulatory approach works well and at relatively low cost in a foreign jurisdiction, might it not also work well in the domestic jurisdiction markets? Excessive standardization would eliminate both of these beneficial mechanisms from the marketplace.

In a world of price-quality competition among securities regulators—a world that is already upon us—it is also valuable to observe that a single jurisdiction can have more than one price-quality combination in its own domestic market. A jurisdiction can achieve this result by having different rules for investors and transactions with different characteristics. In particular, it may be politically or economically reasonable for marketplaces to adopt levels of protection for smaller, less sophisticated investors that differ from the regulations that apply to transactions involving larger investors with greater sophistication.

Interestingly, both the United States and the United Kingdom have recently taken steps in this direction. In the United States, the recent adoption of Rule 144A creates a liquid market for the free secondary trading of privately placed securities among large institutional investors.<sup>46</sup> In Britain, the SIB decided to permit "business investors" to participate in various financial and commodity market transactions without being subject to stricter rules that apply to other, less sophisticated investors. These "business investors" are generally corporations with capital or net assets of at least 500,000 pounds, local governments, or other public bodies.<sup>47</sup>



Regulation, therefore, does not necessarily imply standardization, either on an international level or within a single jurisdiction. Regulations can be carefully tailored to address apparent externalities, and these externalities can vary across jurisdictions, across transactions, and over time. Strong proponents of international standardization across a broad range of market practices thus tend to overstate their case. Instead, the most prudent path for international securities market regulation may involve a balanced approach that relies on basic forms of enforcement cooperation and compliance coordination, rather than adherence to a single trans-national regulatory philosophy.

## 8. Conclusion

Internationalization of the world's securities markets is here to stay. Internationalization grew quickly during the 1980s because of the confluence of economic, technological, and political forces. The same forces are likely to gather strength during the coming decade. Indeed, if current trends continue, internationalization is certain to increase during the coming decade to levels well above those currently observed in the world's securities markets.

Internationalization will pose a particular challenge for securities regulators. Because of the ease with which international transactions can be used to evade domestic regulatory strictures, regulators have a common incentive to cooperate in international securities enforcement efforts. Significantly, this form of cooperation does not require international agreement as to the substance of any domestic regulatory regime. Each country can, for example, continue to define illegal insider trading in any way it sees fit, and yet cooperate in efforts to identify persons who use the mechanisms of the international marketplace to evade legitimately adopted domestic regulations.

Internationalization will also provide opportunities for efficient coordination of registration and accounting requirements. Such measures can improve information flows to the market, reduce capital formation costs, and enhance secondary market liquidity.

International standardization can, however, be carried too far. Not all transactions need conform to identical standards, and market participants can have perfectly legitimate reasons for desiring to conduct different aspects of their business under different regulatory regimes. Diversity among regulatory regimes can also foster beneficial innovation and experimentation. Most significantly, perhaps, it can provide a form of regulatory competition that prevents regulators from adopting rules that systematically impose costs in excess of their benefits.

Viewed from this perspective, the dominant challenge for the coming decade will be to identify areas in which international regulatory cooperation is beneficial, while avoiding areas in which diversity and competition among regulators is more desirable. No doubt the task will be challenging, and there will be much room for debate and error, but a great deal hinges on regulators getting this distinction just right.

## Notes

1. For an extensive analysis of the internationalization of the world's securities markets see U.S. Securities and Exchange Commission (1987). See also Chuppe, Haworth, and Watkins, 1989b; Chuppe, Haworth, and Watkins, 1989a; Winch, Knight, and Jickling, 1989; Allen, 1986.
2. In 1988 there were 121 mutual funds classified as international, global equity, or global bond funds, whereas in 1983 there were no such funds. (according to the Investment Company Institute's *Mutual Fund Fact Book* 20, 1989; see also Cooper (1990, p. 179) where she argues that there may now be a glut of country funds in the market.)
3. Technically, the investment is made in a United States fund that is subject to U.S. regulations at the fund level, but the fund's managers then invest the fund's assets in offshore markets that are not subject to U.S. regulation.
4. For a description of the differences between U.S. and Japanese approaches to insider trading regulation see Akashi (1989) who indicates a much weaker enforcement of insider trading rules in Japan than in the United States.
5. See, for example, *College Retirement Equities Fund*, U.S. Securities and Exchange Commission, No Action Letter (available February 18, 1987), which permits the College Retirement Equities Fund to participate in French privatization offerings on a private-placement basis. French authorities sought assurances that, by simply selling to U.S. institutional investors, they would not become subject to the registration provisions of U.S. securities laws. See also *Offshore Offers and Sales*, 17 CFR §230.901-04 (May 1990), Securities Act Release No. 6863 (April 24, 1990), 55 *Fed. Reg.* 18306 (May 2, 1990), for the adoption of Regulation S which accepts a territorial principle of jurisdiction regarding the application of U.S. registration requirements to international securities offerings.
6. Because most foreign direct investments in the United States represent blocks averaging 80.2 percent of the affiliate's equity, and because foreign investments tend to be either significantly greater or less than a 10 percent interest in a firm's equity, the data are relatively insensitive to the specific use of a 10 percent threshold to distinguish among these types of transactions (Graham and Krugman, 1989).
7. The figures describing aggregate differences between purchases and sales must be interpreted with particular caution because they are based on book values and fail to adjust for fluctuations in market values over time. Thus, even in situations where the data suggest net disinvestment, as in the case of Switzerland, the market value of securities held in the United States might well have increased because of a general rise in stock market values.
8. Statistics are from "The Stateless World of Manufacturing," *Business Week*, May 14, 1990, p. 103; see also Julius, 1990; and Makin, 1990, forthcoming.
9. Recent data suggest the re-emergence of OPEC as a source of equity market purchases. See Henriques (1990, p. 15).
10. See, for example, United States Congress, Joint Economic Committee, *U.S. Foreign Debt*, 100th Congress, 2nd Session (September 13, 1988).
11. See, for example, Mason and Merton (1985, pp. 7-54).
12. See, for example, Wriston (1988-1989, pp. 63-75), who argues that advances in information technology have fundamentally weakened all governments' ability to control economic policy. See also U.S. Congress, Office of Technology Assessment, 1990; and Ayling (1986) for the effect that technology has on securities markets.
13. See, generally, Copeland and Weston (1988).
14. For a brief discussion of the benefits of diversification viewed from an international perspective see, for example, Sharpe (1985, pp. 706-721). See also Lessaw (1976, p. 32) and Solnik (1977, p. 51), the latter of whom states that an internationally diversified portfolio is one-tenth as risky as a well-diversified portfolio of U.S. stocks.
15. See, for example, Lewis, 1990; Black, 1989.
16. The evolution of the swap market, which now totals more than \$1 trillion in notional value, is an excellent example of a market in which instruments are tailored to the highly individual demands of specific market participants. See, for example, Walmsley (1988, pp. 125-147).
17. See, for example, McCahey, 1990, p. c1; Calvey, 1990, p. 1; Hargreaves, 1990, p. 35.
18. See, for example, "Faith in the Future." *Corporate Finance* (July 1990), p. 17, which describes selected new and proposed futures and options contracts in the U.S., European, and Japanese markets.

19. See, generally, Black (1989). See also Rosenbaum (1990, p. 50).
20. See, for example, Poser (1988).
21. See, for example, Brauchli (1990, p. A18).
22. Early evidence of this pattern is already emerging. In the first quarter of 1990, "despite a stable dollar, foreign investors were net sellers of U.S. securities for the first time since the third quarter of 1983. . . . [T]his new development emphasizes that the U.S. can no longer count on an unending supply of foreign capital" (Securities Industry Association, 1990).
23. See, generally, Bollenbacher (1990, p. 22).
24. See, for example, Kollar, 1990, p. 7A; "CBT Throws in the Towel . . .," 1990, p. 6.
25. Norris (1990, p. c2) describes plans of American and Cincinnati stock exchanges and of the Chicago Board Options Exchange to compete with newly announced after-hours trading system developed by the New York Stock Exchange.
26. "Plans are now under way to set up fully computerized and automated financial exchanges in Japan in the near future" ("Exchange Sets Sights . . .," 1989).
27. In an electronic crossing network, institutional buyers and sellers meet each other directly on a computer screen without intermediation by specialists or market makers. See, for example, U.S. Securities and Exchange Commission (1989).
28. See, for example, Wunsch (1989).
29. See, for example, Grundfest, 1990.
30. See also Schultz (1990, p. c1) for a description of frauds in the United States involving the sale of foreign securities.
31. See the opening statements of Hon. Douglas Bernard, Jr., and Hon. Gary Montjoy in *Problems With the SEC's Enforcement of the Securities Laws as to Suspicious Foreign Originated Trades*: Hearings before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, 100th Congress, 2nd Session (1988). See also Torres and Salwen (1990, p. A3) who note a spate of insider trading inquiries in connection with foreign acquisitions of publicly traded U.S. firms.
32. To maintain secrecy, Levine explains that he opened a numbered Swiss bank account and "went to great lengths to avoid creating a paper trail for investigators to follow. . . . [The bank] sent me no bank statements. I called in my trades from public phones—collect."
33. For an excellent summary of the current state of SEC enforcement efforts on the international front, as well as a summary of international information sharing arrangements, see Mann and Mari (1990).
34. Of interest is the observation that this degree of cooperation is forthcoming even from countries that have a long history of bank secrecy. These jurisdictions often recognize that their secrecy statutes were adopted for reasons that have nothing to do with the facilitation of illegal commerce, whether in the form of securities transactions or the laundering of drug money. Thus, in circumstances where sufficient evidence can be presented that a secrecy jurisdiction is being used for purposes inconsistent with the host jurisdiction's purpose in protecting depositor confidentiality, the host can be persuaded to lift the veil of secrecy.
35. See generally, Levine and Caldicott (1989).
36. See also Rider (1990) for a review that is critical of U.S. attempts to extend the scope of its international securities jurisdiction, particularly as reflected in the SEC's "waiver-by-conduct" proposal (Exchange Act Release No. 21186, 1984). "When somewhat presumptuously questioned as to how far his writ ran, Henry II responded, as far as his arrows reached! Given the developments that have since taken place in ballistics, such an approach to jurisdiction might even accommodate the extraterritorial zeal of our North American cousins."
37. See generally, Walter (1990).
38. See, for example, Note, "Barriers to the International Flow of Capital . . .," 1987. Variations in regulatory regimes present the "greatest obstacle to internationalization of capital markets."
39. Securities Act Release No. 6, 841 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84, 432 (July 26, 1989). See also Karmel, 1990, pp. 3-18; Waitzer, 1989.
40. See, for example, Beresford, 1990, pp. 17-24; Choi and Levich, 1990, forthcoming. See also "SEC Launches Extensive Review . . ." 1990.
41. See, for example, French and Poterba (1990) who explain half the disparity between U.S. and Japan price/earnings ratios by differences in accounting practices regarding consolidation of earnings from subsidiaries and depreciation of fixed assets. See also Choi and Levich (1990, forthcoming).

42. See, for example, Sychrava (1990, p. 15) who states that Swiss accounting procedures "allow you to hide earnings until you want to reveal them."
43. For a different and provocative view on the reasons for the adoption of international bank capital adequacy standards, see Kane (1990) who describes the Basle accord as a cartel-like arrangement among the world's banking regulators.
44. As an example of the likely parameters of of the controversy, consider the debate accompanying release of Revision Four of the EEC's Draft Capital Adequacy Directive. See Joint Letter of Merrill Lynch International, Morgan Stanley International, Salomon Brothers International, and Shearson, Lehman, Hutton International to the Rt. Hon Sir Leon Brittan, Vice President of The European Commission, Feb. 22, 1990; EEC, Directorate-General, Financial Institutions and Company Law, Discussion Document, *Issues Arising in the Draft Proposal for a Council Directive on Capital Adequacy of Investment Firms Including Credit Institutions* (Revision 4, November 1989); see also "Japan: New Rules Will Tighten Capital Adequacy Requirements," 2 International Securities Regulation Report 1 (August 2, 1989).
45. See, for example, Fischel (1988).
46. See Brauchli (1990).
47. See, for example, *Changes Introduced By the Companies Act, 1989*, Financial Regulation Report (December 1989); *Possible Changes to the FSA and a New Approach by the SIB*, Financial Regulation Report (March 1989).

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