TRADING FOREIGN SHARES

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Thank you. At the outset, let me remind you that the views I express are my own and not necessarily the views of the Commission, the individual Commissioners, or my colleagues on the Commission staff.[1]

Today, I will address the increasing pace of cross-border securities transactions. More companies are raising capital beyond their geographic boundaries.[2] U.S. investors are allocating their capital in foreign securities markets at a higher rate, and our securities markets have attracted an increasing share of foreign investments. It is important that our regulatory system not only continue to keep pace, but also facilitate the benefits of a global market place. So, I will share with you some of my views on the issue. I will propose a solution to remove from our securities markets possible frictions that do not serve to protect investors or facilitate capital formation and that may be unnecessary to maintain fair, orderly, and efficient markets.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the author's colleagues on the staff of the Commission.

[2] Christopher Cox, Chairman, SEC, Re-thinking Regulation in the Era of Global Securities Markets (Jan. 24, 2007), http://www.sec.gov/news/speech/2007/spch012407cc.htm ("Ever more public companies are raising capital beyond their geographic boundaries, and investors large and small are increasingly allocating their capital — and their business assets — outside their home countries.").

The SEC may use its exemptive authority, provided that it can make the requisite findings, to eliminate frictions that do not further our goals. At the same time, however, the SEC cannot abdicate its obligation to protect investors and further market integrity.

I. INTRODUCTION: THE ISSUE

The financial services industry is a large segment of our economy. It contributed $957.7 billion to U.S. Gross Domestic Product in 2005, or about 7.7 percent of total GDP.[3] The securities industry employs nearly 800,000 people.[4] That is over 200,000 people more than the total population of Boston or Washington, DC.[5] Indeed, it is a key component of the U.S. economy.

There has been a great deal of growth in the demand to trade securities. According to a joint report by the Investment Company Institute and the Securities Industry and Financial Markets Association, the number of households owning equities has increased more than three-fold since the early 1980s.[6] Half of U.S. households, nearly 57 million, own stocks directly or through mutual funds.[7] By comparison, approximately 40 million households viewed last week's Academy Awards.[8] Two-thirds of all equity investors in 2005 were in their peak earning and investing years – ages of 35 and 64.[9]

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[3] U.S. Bureau of Economic Analysis, *Gross-Domestic-Product-By-Industry Accounts, 1947-2006*, http://www.bea.gov/bea/industry/gpotables/gpo_list.cfm?anon=138&registered=0 (reporting that the financial services industry contributed $957.7 billion or 7.7% to U.S. Gross Domestic Product in 2005).

[4] U.S. Bureau of Labor Statistics, *National Industry-Specific Occupational Employment and Wage Estimates*, May 2006, http://www.bls.gov/oes/current/naics3_523000.htm (reporting that the securities industry employs 806,690 people).

[5] U.S. Census, http://www.census.gov/popest/cities/tables/SUB-EST2005-01.xls (noting population estimate of 559,034 for Boston and 550,521 for Washington, D.C. as of July 2005).

[6] Investment Company Institute and the Securities Industry and Financial Markets Association, *Equity Ownership In America, 2005*, http://www.sia.com/research/pdf/EquityOwnership05.pdf.

[7] *See id.*

[8] Nielsen Media Research, *Nielsen Television Index Ranking Report* (Feb. 19, 2007), *available at* www.nielsenmedia.com.

[9] Investment Company Institute and the Securities Industry and Financial Markets Association, *supra* note 5.

U.S. investors have an equity culture, as evidenced by their willingness to invest in mutual funds, equities, and exchange traded funds. This makes them attractive customers, both for U.S. and for foreign financial service providers.

The daily volume at the New York Stock Exchange has grown exponentially, from approximately 40 million shares in the 1980s to over 3 billion shares in recent times.[10] The NASDAQ has also seen its daily trading volume soar past the 3 billion shares mark.[11]

Demand has risen across the board (institutional and retail) as transactions costs have fallen. Institutional trading costs appear to have declined by about 23 basis points (roughly 5 cents per share) after the securities markets shifted in 2000 from trading in fractions, to trading in pennies – an average monthly savings of about $133 million in institutional trading costs.[12] The switch to decimals reduced the minimum "spread" or gap between buy and sell prices from 1/16 - the equivalent of 6.25 cents - to a penny.[13]

The SEC has had a fundamental role in the growth of the financial services markets – while working to maintain the integrity and vitality of the markets and protecting the interests of investors. Examples of regulatory changes that have facilitated innovation in the financial services markets include: the order handling rules, which cleared the way for electronic markets, best execution obligations, pennies in equities, penny pilot in options, Regulation NMS, and TRACE.

> Order Handling Rules. In 1996, the SEC adopted a rule requiring the display of customer limit orders and amended

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[10] *Breaking 3 Billion Shares, Again*, (New York Stock Exchange, New York, N.Y.), Oct. 2005, http://www.nyse.com/about/publication/1131450075438.html.

[11] Bill Barnhart, *NYSE, NASDAQ Ready to Reopen; Smooth Trading is Primary Goal*, CHICAGO TRIBUNE, September 16, 2001, at C5.

[12] Sugato Chakravarty, Venkatesh Panchapagesan, and Robert A. Wood, *Has Decimalization Hurt Institutional Investors? An Investigation into Trading Costs and Order Routing Practices of Buy-side Institutions* (2003), http://news-info.wustl.edu/pdf/venkatesh_may28_final.pdf.

[13] Aaron Elstein, *Brother Can You Spare A Decimal Point; Wall Street Trying to Set Prices For Trades*, INVESTMENT NEWS, May 26, 2003, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20030526/SUB/305260711/-1/INIssueAlert04 .

the rule governing publication of quotations to enhance the quality of published quotations for securities and to enhance competition and pricing efficiency in the markets.[14] The Limit Order Display Rule requires that limit orders be displayed when they are priced better than, or add to the size associated with, quotes posted by the specialist or market makers.[15] The rule allows the general public to compete directly with professional market participants in the quote-setting process. The Quote Rule requires a market maker to publicly display their most competitive quotes.[16] This rule gives the public access to quotes posted by market makers in Electronic Communication Networks (ECN).[17] For example, if a dealer places a limit order into an ECN, the price and quantity are incorporated in the ECN quote displayed on NASDAQ if it represents the best bid or offer in ECN.[18]

The display and quote rules fueled the rise of the ECNs. At the same time, the order handling rules benefit investors by increasing transparency in those markets and improving opportunities for the best execution of customer orders.

Decimalization. In June 2000, the SEC issued an order directing NASD and the national securities exchanges to act jointly in developing a plan to convert their quotations in equity securities and options from fractions to decimals (decimalization).[19] The markets chose to trade equities in pennies.[20] Many proponents of decimalization anticipated that penny prices would reduce trading costs for investors by, among other things, permitting quotation spreads (the difference between the highest bid quotation and the lowest

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[14] 17 C.F.R. 242.604 (2007); Richard C. Strasser, *How Much Information Is Enough: Securities Market Information and the Quest For a More Efficient Market*, 5 TENN. J. L. & BUS. 5, 19-21 (2003).
[15] *Id.*
[16] 17 C.F.R. 242.602 (2007).
[17] *Id.*
[18] Arthur Levitt, Chairman, SEC, Speech by SEC Chairman: Dynamic Markets, Timeless Principles (Sept. 23, 1999), http://www.sec.gov/news/speech/speecharchive/1999/spch295.htm.
[19] *With New Deadlines in Place, Industry Readies for* Decimals, SECURITIES WEEK, June 26, 2000, at 1.
[20] *NYSE Picks Stocks for Decimal Pilot; May be Fully converted by Year's End*, SECURITIES WEEK, July 10, 2000, at 1.

offer quotation) to narrow from the 1/16th minimum increment that was standard in the fractional environment.[21] Early studies by the SEC's Office of Economic Analysis (OEA) and NASDAQ indicated that there was significant narrowing of quotation spreads.[22] OEA estimated, for example, that from December 2000 to March 2001, quotation spreads in securities listed on the New York Stock Exchange narrowed an average of 37%, and effective spreads narrowed 15%.[23] The same studies observed even greater impact on NASDAQ securities, with spreads narrowing an average of 50% following decimalization, and effective spreads narrowing almost as much.[24]

Penny Pilot in Options. The SEC also has encouraged a pilot for exchanges to quote certain series of option classes in penny increments.[25] As of February 9th, options in 12 classes that are priced below $3 are quoted in pennies; options in those 12 classes priced $3 and above are quoted in nickels.[26] And all series of the QQQQ are quoted in pennies.[27] The exchanges and the SEC plan to closely examine the impact of these smaller increments on market quality and options system capacity. Preliminary indications are that spreads have narrowed, but the SEC staff has not yet analyzed whether there are differences in the benefits depending on the price and trading volume of the option.

Also worth noting is that all of the options exchanges have reduced or eliminated the fees they collected from market makers for use in paying for order flow for the 13 options

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[21] *What a Difference a Dot Makes*, L.A. Times, Aug. 30, 2000, at B8.
[22] Laura S. Unger, Acting Chair, U.S. Securities & Exchange Commission, Testimony Concerning the Effects of Decimalization on the Securities Market (May 24, 2001), http://www.sec.gov/news/testimony/052401tslu.htm.
[23] *Id.*
[24] *Id.*
[25] NYSE Arca, Inc., Notice of Filing of Proposed Rule Change to Create a Penny Pilot Program for Options Trading, SEC Release No. 34-54590 (Oct. 12, 2006), http://sec.gov/rules/sro/nysearca/2006/34-54590.pdf.
[26] *See* Press Release, U.S. Securities & Exchange Commission, Option Exchanges Begin Penny Pilot Quoting; Similar Move for Stocks Has Meant Better Prices for Investors (Jan. 26. 2007), http://www.sec.gov/news/press/2007/2007-10.htm.
[27] *Id*.

classes in the penny pilot.[28] This response is consistent with what we saw when stocks started trading in pennies.

Regulation NMS. In 2005, the SEC adopted Regulation NMS, for National Market System.[29] It is intended to modernize and strengthen the markets for equity securities by requiring markets to protect best quotes of automated markets.[30] This has prompted tremendous innovation in our markets. Shortly after the adoption of Regulation NMS, traditional markets intensified their strategic process of modernization. The New York Stock Exchange merged with the fully automated Arca Exchange, and initiated a move to a hybrid electronic-floor based trading system.[31] Similarly, NASDAQ has merged with Inet, registered as an exchange, and adopted the Inet trading technology as its trading platform.[32] The Amex is transforming its traditional floor-based market to a hybrid market that offers fully automated trading.

TRACE. In 1998, then SEC Chairman Levitt called for, and in 2001 the SEC approved, the first major transparency initiative in the corporate bond markets, in which the NASD mandated that all dealers and inter-dealers report the prices of corporate bond trades to its Trade Reporting and Compliance Engine (TRACE).[33] Some of the expected benefits from the increased transparency include: increased market efficiency; better risk and portfolio management; sophisticated trading strategies; better valuation models; new market participants; deterrent to improper trade practices;

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[28] Self-Regulatory Organizations; NYSE Arca Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 2Thereto Relating to Exchange Fees and Charges, Release No. 34-55223, 72 Fed. Reg. 27, 6306-8 (Feb. 9, 2007).

[29] *See* Press Release, U.S. Securities & Exchange Commission, SEC Adopts Regulation NMS and Provisions Regarding Investment Advisers Act of 1940 (Apr. 7, 2005), http://www.sec.gov/news/press/2005-48.htm.

[30] *Id.*

[31] Holman W. Jenkins Jr., *Antique for Sale*, WALL ST. J., June 27, 2005, at A15.

[32] Gaston F. Ceron, *Megamergers Roil Stock-Trading Scene*, WALL ST. J., June 1, 2005, at A6.

[33] Harrell Smith, *Fixed Income Trading 2005: Electronic Credit Markets & TRACE Take Center Stage*, 6 BUILDING AN EDGE 6 (Nov. 2006).

> and enhanced technology.[34] The MSRB committed to implementing trade reporting requirements in 1994, a process that culminated in January 2005 with "real-time" trade reporting for municipal securities.[35]

The changes in rules have unleashed the winds of change in the markets, driven by the revolution in technology and falling prices of communication technology, has affected the markets in profound ways. At the same time, there has been a lot of activity in the exchange space.

We have had new market centers: International Stock Exchange, Boston Options Exchange, and now BATS, which began trading in January 2006.[36] The NYSE plans to introduce a new corporate bond trading platform – NYSE | Bonds, using the technology of the NYSE Arca all-electronic trading platform, which aims to provide a more efficient and transparent way to trade corporate bonds.[37] The Chicago Board Options Exchange, the largest U.S. options exchange, recently launched its own stock exchange.[38]

Exchanges have demutualized and become for-profit. In 2005, approximately 213 years after its founding, the NYSE went public.[39] The Chicago Board of Trade went public in October 2005, 157 years after it opened its doors for business.[40] The century old Chicago Mercantile Exchange took the same step in 2002.[41] NASDAQ also went public in 2002, 31 years after its founding.[42]

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[34] *Id*. at 10.
[35] Aaron Lucchetti & Randall Smith, *Regulators Scrutinize Odd Muni-Bond Trading Patterns*, WALL ST. J., Jan. 27, 2004, at C1.
[36] Press Release, BATS, BATS Trading, Inc. is formed, (June 17, 2005) http://www.batstrading.com/press-release/20050617.php
[37] Cynthia Koons, *NYSE Is Cleared to Expand System for Bond Trading*, WALL ST. J., Nov. 18, 2006, at B5.
[38] John Authers, Norma Cohen & Anuj Gangahar, *Clearing the Floor: How a Regulatory Overhaul is Helping Rivals to Close in on the Big Board*, FIN. TIMES (London), Sept. 14, 2006, at 15.
[39] Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2558 (2006).
[40] Jesse Thomas, *CBOT Aims to Expand Asian Presence*, WALL ST. J., July 19, 2006.
[41] Peter A. McKay, *Taking Stock of Futures Exchanges*, WALL ST. J., Feb. 6, 2006, at C3.
[42] Aaron Lucchetti, *As Exchanges Become Profit-Seekers, Concerns Rise Over Risk to Investors*, WALL ST. J., Nov. 8, 2005, at C1.

Like all growing business areas, U.S. financial service providers are looking for alliances, both domestically and abroad. Exchanges have been joining forces through alliances and mergers.

- NASDAQ bought a 15 percent stake in the London Stock Exchange, and subsequently raised its stake to just below 30 percent in a failed takeover bid.

- The NYSE reached agreement to merge with pan-European stock and derivatives exchange Euronext in a deal that will create the first trans-Atlantic equities market.[43]

- The Chicago Mercantile Exchange reached agreement to buy cross-town rival CBOT to create the world's largest publicly traded futures exchange by market cap.[44]

- The NYSE formed a strategic alliance with the Tokyo Stock Exchange to develop and study opportunities in trading systems and technology, investment products and governance. Less than a month later, the Tokyo Stock Exchange and the London Stock Exchange announced that they would work together to share technology information and possibly develop new products.[45]

- The NYSE agreed to buy a 5-percent interest in the National Stock Exchange of India Ltd. in Mumbai for $115 million in cash.[46]

Technology has changed the global playing field for broker-dealers as well, as it has reduced the communication barriers that once separated markets.[47] As U.S. institutions' appetite for foreign securities has grown, so has the global reach of securities firms.[48]

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[43] Aaron Lucchetti, *NYSE Heads to Paris to Oversee Euronext Integration*, WALL ST. J., Mar. 29, 2007, at C2.
[44] Roger Cheng, *CBOT Calls Soar on New Bid*, WALL ST. J., Mar. 16, 2007, at C5.
[45] *London, Tokyo Exchanges Team Up*, WALL ST. J., Feb. 24, 2007, at B2.
[46] Gaston F. Ceron, *Earnings Digest -- Financial Services: NYSE Group Turns a Profit*, WALL ST. J., Feb. 3, 2007, at B14.
[47] *See* John Wagley, *Cross-Border Trading Gets Real*, SECURITIES INDUS. NEWS, Nov. 21, 2006.
[48] *See Id*.

U.S. "bulge bracket" firms have developed a multinational footprint, with operations that span the globe. There has been cross-border consolidation among broker-dealers as well.

- Credit Suisse Group, a financial services company headquartered in Zürich, Switzerland, purchased First Boston in 1988.[49] The firm later merged with Donaldson, Lufkin, & Jenrette.[50]

- Deutsche Bank AG with headquarters located in Frankfurt, Germany, acquired Bankers Trust in 1998, thereby acquiring the 200 year-old U.S. investment bank Alex. Brown & Sons.[51]

- In 2000, another Swiss financial services company, UBS AG, a financial services company, headquartered in Basel and Zürich, Switzerland, purchased U.S. brokerage firm PaineWebber Inc.[52]

In addition, foreign financial services companies have been increasingly reaching out to U.S. institutions pursuant to conditional exemptions from broker-dealer registration. But as the ease at dealing from overseas with U.S. persons has grown, and regulatory oversight in foreign jurisdictions has evolved, foreign securities firms and markets have inquired about access to U.S. markets without U.S. regulation, based on the nature and quality of their supervision. I believe the time has come to reconsider our approach and to allow access under conditions that protect U.S. investors and maintain the integrity of U.S. markets.

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[49] James Sterngold, *Swiss Gain Big Stake on Wall St. In Deal That Could Offer a Model*, N.Y. TIMES, Oct. 10, 1988, at A1.
[50] Gregory Zuckerman, *A Buyout Duo Reads Potential In Newspaper --- Avista Likes Quality Of Star Tribune Brand; Thoughts of Rebound*, WALL ST. J., Jan 6., 2007, at B1.
[51] Paul Beckett & Charles Gasparino,*Bankers Trust Question: Will Its Employees Show Loyalty After the Deutsche Bank Deal?*, WALL ST. J., May 14, 1999, at C2.
[52] Geraldo Samor & Edward Taylor, *UBS's Deal for Brazilian Bank Whets Its Acquisitive Appetite May Be Start of a Buying Spree*, WALL ST. J., May 10, 2006, at C4.

In this talk I will flesh this out for you, first detailing where we stand today in terms of allowing foreign exchanges and foreign broker-dealers to operate in the U.S.

II. BACKGROUND: HOW OUR MARKETS ARE REGULATED TODAY

There is not time here for a course on securities regulation, but the basic frame work for securities law is pretty straightforward. For our purposes, it is enough to think of the three actors who are involved in this space: corporate issuers, securities exchanges, and broker-dealers.

The federal securities laws are concerned with both the initial distribution of securities, and their subsequent trading. The securities laws afford investors broad protection through disclosure and anti-fraud provisions. In particular, the securities laws and SEC rules prohibit fraudulent activities by any person that defraud investors in the U.S., regardless of how novel or complex the scheme, or country of origin. Provisions in the securities laws prohibit certain types of trading activity outright, such as insider trading and market manipulation.

Under the Securities Act, securities that are offered to the public must be registered with the SEC by the issuer, or be exempt from registration.[53] Securities offered privately to sophisticated investors need not be registered.[54] Also, securities offered offshore need not be registered.[55] In addition, the Exchange Act addresses the post-distribution period, that is, subsequent trading. Generally speaking, an issuer must register securities under the Exchange Act the first time that it has 500 shareholders of record in a class of equity securities and ten million dollars in total assets.[56] An issue must also be registered if listed on an exchange operating in the U.S.[57] Foreign issuers with requisite U.S. shareholders need not register if they are not traded on an exchange or an automated interdealer quotation system in the U.S.[58] Thus, issuers become

[53] 15 U.S.C. §§ 77(c), (e) (2007).
[54] *Id.* § 77(d).
[55] 17 CFR §§ 230.901-905.
[56] 15 U.S.C. § 78(l).
[57] *Id.*
[58] *Id.* § 78(l)(g)(3).

reporting companies as a result of either of the following: (1) registration of an offering of securities pursuant to the Securities Act, or (2) registration of a class of securities under the Exchange Act. The principal reports required to be filed with the SEC by reporting companies include the annual report on Form 10-K; the quarterly report on Form 10-Q; and current report on Form 8-K.[59] These forms require, among other things, that financial information comply with GAAP rules, or for foreign issuers, reconciliation to U.S. GAAP. The Securities Act and the Exchange Act subject the issuer, its officers and directors, as well as its underwriters to civil and criminal liability.[60]

The Securities Act, at times referred as the "truth in securities" law, has two basic objectives:

> (1) require that investors receive financial and other significant information concerning securities being offered for public sale; and
>
> (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities.[61]

A primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities.[62] This information enables investors to make informed judgments about whether to purchase a company's securities.[63] For this reason, a U.S. securities exchange cannot trade the shares of a foreign corporation unless those shares are registered in the U.S. and comparable periodic disclosure is filed.

Some foreign issuers have registered their shares with the SEC. But other major global firms have not.

The second group of players is the exchanges. The first thing to realize is that with the exception of a few exchanges, most trading done outside of the U.S. is electronic, and access to those exchanges is via a trading screen. Hence, the physical location of an

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[59] *Id.* U.S.C. § 78(o)(e).
[60] *See e.g. Id.* §§ 78(r), (ff).
[61] Registration Under the Securities Act of 1933, http://www.sec.gov/answers/regis33.htm (last visited Nov. 2, 2007) (numbering added).
[62] *Id.*
[63] *Id.*

exchange becomes an elusive concept, and what counts is the domicile of the exchange for regulatory and business purposes.
The statutory definition of "exchange" includes a "market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."[64] Rule 3b-16 under the Exchange Act interprets what is meant by this phrase. That is, one maintains a market place or facility, or otherwise performs functions commonly performed by a stock exchange if one: (1) brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.[65]

Every market that meets the definition of "exchange" under the Exchange Act must either register as a national securities exchange or be exempted from registration on the basis of limited transaction volume or as an alternative trading system. To be exempt as an alternative trading system, the system must not act as a self-regulatory organization or call itself an exchange.[66] Congress gave the exchanges the obligation to enforce their members' compliance with the federal securities laws and, in 1983, required every broker-dealer to become a member of an exchange or a securities association.[67] Direct access to exchanges is limited to registered broker-dealers.[68] Every registered exchange is required to assist the SEC in assuring fair and orderly markets, to have effective mechanisms for enforcing the securities laws and regulation, and to submit their rules to the SEC for review.[69]

The SEC is charged with helping to promote investor protection, to ensure fair and orderly markets, to prevent fraud and manipulation, and to promote market coordination and competition for the benefit of all investors. Congress decided that these goals should be achieved primarily through the regulation of exchanges and through authority it granted to the SEC in the 1975

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[64] 15 U.S.C. § 78(c)(a)(1).
[65] *See Id.*
[66] *See* 17 C.F.R. 242.300.
[67] 15 U.S.C. § 78(o)(a)(1).
[68] *Id.*
[69] *See e.g.* 15 U.S.C. § 78(f).

Amendments, to adopt rules that promote (1) economically efficient execution of securities transactions, (2) fair competition, (3) transparency, (4) investor access to the best markets, and (5) the opportunity for investors' orders to be executed without the participation of a dealer.[70]

Our national market system for U.S. registered stocks, as it has evolved since 1975, has sought the benefits both of market centralization, which enhances depth and liquidity in the markets, and competition. The SEC has sought to maintain this balance through a market system marked by balanced regulation, with individual markets that are linked together to make their best prices publicly known and accessible.

The Exchange Act requires registered exchanges and securities associations to consider the public interest in administering their markets, to allocate reasonable fees equitably, and to establish rules designed to admit members fairly.[71] The Exchange Act also requires registered exchanges and securities associations to establish rules that assure fair representation of members and investors in selecting directors and administering their organizations.[72]

> Self-Regulation. Exchanges and securities associations such as the NASD act as SROs and, as such, are required not only to comply with the Exchange Act, but also to carry out the purposes of the Exchange Act.[73] They do this principally by enforcing member compliance with the provisions of the Exchange Act and the rules promulgated thereunder, as well as with the rules of the exchanges or the associations.[74] This system requires exchanges and securities associations to establish rules and procedures to prevent fraud and manipulation and promote just and equitable principles of trade, typically by establishing audit trails, surveillance, and disciplinary programs.[75]

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[70] Pub. L. No. 29, 89 Stat. 97 (1975).
[71] *See generally,* 15 U.S.C. § 78(f).
[72] *Id.*
[73] *Id.* at § (b)(1).
[74] *Id.*
[75] *Id* at § (h)(J).

> With respect to market operations, a registered exchange adopts rules governing all aspects of trading on its market, including the manner in which trading interest is displayed and orders interact. These rules must treat all market participants – particularly public customers – fairly and equitably, and refrain from imposing any unnecessary or inappropriate burdens on competition.[76]
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> In addition, a registered exchange must adopt appropriate listing standards for its listed companies, and have rules assuring that transactions on the exchange participate efficiently and effectively in the clearance and settlement process.[77] With respect to member regulation, a registered exchange must have a wide range of rules that assure appropriate member conduct, sales practices (including rules that require members to obtain best execution of customer orders and the suitability of recommended transactions), financial responsibility, supervision, disciplinary proceedings, education and training.[78] Registered exchanges are required to surveil vigorously their markets for inappropriate conduct, and their members for violations of their rules and the federal securities laws and rules, and to take appropriate disciplinary action.[79] In this regard, exchanges provide the first line of defense in the enforcement of the U.S. regime of securities regulation. Without the benefit of self-regulation by the exchanges, the SEC's oversight of the U.S. markets would be reduced.
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> Continuity of Market Operations. U.S. exchanges are required to maintain sufficient systems capacity to handle foreseeable trading volume.[80] In addition, exchanges must maintain appropriate computer system integrity and security to operate a market. To this end, exchanges must submit systems changes that are rules of the exchange to the SEC for review. The failure of a market to maintain systems in

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[76] *Id.* at § (b)(8).
[77] *Id.*
[78] *Id* at § (b)(7).
[79] *Id*.
[80] Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70,844, 70,846-47 (Dec. 22, 1998) (to be codified at 17 C.F.R. pt. 202, 240, 242 and 249).

compliance with SEC standards would jeopardize its ability to remain operational during periods of market stress.

Price Transparency. Registered exchanges are required to disseminate real-time trade and quotation information to the public through joint participation in market-wide quotation and transaction reporting plans.[81] This consolidation of market information is a critical component of the U.S. national market system, as the resulting price transparency promotes efficient price discovery and helps assure best execution of customer orders. The exclusion of a market from the consolidated data stream would impair transparency and price discovery for U.S. investors.

Fair Access and Fair Competition. All registered exchanges must accept all qualified US broker-dealers as members, have fair membership standards, not unfairly deny persons access to their trading or other facilities, and equitably allocate reasonable fees and other charges among their members.[82] These safeguards help assure that competition among US markets and market participants will be vigorous but fair. If a market was not subject to these requirements, it could unfairly discriminate or deny access to a U.S. broker-dealer and compete unfairly with U.S. exchanges.

Rule Filing Process. Registered exchanges are required to file rule changes with the SEC that encompass all material aspects of trading on their markets and regulation of their members.[83] The notice, public comment, and SEC review process that is associated with this rule filing requirement is the primary means through which the SEC determines whether exchanges are designed to fulfill their critical self-regulatory functions discussed above. Markets operated in the U.S. without being subject to this requirement would deprive U.S. investors the benefit of SEC oversight and public comment in this process.

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[81] *See generally* 15 U.S.C. § 78(m).
[82] *See generally* 15 U.S.C. § 78(f).
[83] 17 CFR 240.19b-4 (2007).

Exchanges not registered in the United States may not be required provide many of these protections, especially provisions that seek to prevent fraud or manipulation. So U.S. investors might not be protected from insider trading, front running, trading ahead, etc. Briefly, today no foreign exchange can put one of their trading screens in the U.S. unless it registers under Section 6 of the Exchange Act. Of course, the market information from foreign exchanges is widely available in the U.S. Thus, the restrictions on foreign screens essentially limit foreign exchanges from admitting U.S. persons as members. The only exception to this rule was a small volume exception granted in 1999 for Tradepoint Financial Networks plc, which operates as a securities exchange from facilities in London as the Tradepoint Stock Exchange.[84] The SEC made the exemption effective with certain conditions:

- The average daily dollar value of trades (measured on a quarterly basis) involving a U.S. member may not exceed $40 million; and its worldwide average daily volume (measured on a quarterly basis) does not exceed ten percent of the average daily volume of the LSE.[85]

- In addition, the screens displaying quotations in securities not registered under the Exchange Act may be accessible only to qualified institutional buyers or QIBs (generally defined in Rule 144A as an entity that owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers), non-U.S. persons, and international agencies.[86] The unregistered securities may be resold only through the Tradepoint QIB Market or otherwise outside the U.S.[87]

The last group of players is the brokers. Again, a broker-dealer generally cannot do business with U.S. investors unless it registers as a broker-dealer under section 15 of the Exchange Act.

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[84] U.S. SECURITIES & EXCHANGE COMMISSION, COMMISSION INFORMATION: TRADEPOINT FINANCIAL NETWORKS PLC; ORDER GRANTING LIMITED VOLUME EXEMPTION FROM REGISTRATION AS AN EXCHANGE UNDER SECTION 5 OF THE SECURITIES EXCHANGE ACT**,** *available at* http://www.sec.gov/rules/other/34-41199.htm.
[85] *Id.*
[86] *Id.*
[87] *Id.*

Section 3(a)(4) of the Exchange Act defines a broker generally as any person engaged in the business of effecting transactions in securities for the account of others.[88] Section 3(a)(5) of the Exchange Act defines a "dealer" generally as a person that is "engaged in the business of buying and selling securities" for its own account through a broker or otherwise, and excepts persons who do not buy or sell securities "as part of a regular business."[89]

Registered broker-dealers are subject to U.S. laws, regulations and supervisory structures intended to protect investors and the securities markets. Before it begins doing business, a broker-dealer must become a member of an SRO.[90]

This registration allows the SEC and SROs, for example, to review qualifications of a broker-dealer or to properly examine a broker-dealer. It also is designed to assure that broker-dealers maintain adequate competency levels, by satisfying SRO qualification requirements. The registration and other SEC and SRO requirements allow investors to learn about the professional background, registration/license statuses and conduct of registered broker-dealers.

In addition, every registered broker-dealer must be a member of the Securities Investor Protection Corporation, or SIPC, which was created by Congress to provide a mechanism to assist customers of a registered broker-dealer in receiving their cash and securities up to specified limits in the event of liquidation by the broker-dealer.[91] Broker-dealers are subject to statutory disqualification standards and the SEC's and SRO's disciplinary authority, which are designed to prevent persons with an adverse disciplinary history from becoming, or becoming associated with, registered broker-dealers.[92] Broker-dealers also are subject to financial responsibility requirements that are designed to safeguard customer assets.

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[88] *See generally* 15 U.S.C. § 78(c)(a)(4).
[89] *See generally* 15 U.S.C. § 78(c)(a)(5).
[90] U.S. SECURITIES & EXCHANGE COMMISSION, GUIDE TO BROKER-DEALER REGULATION (Dec. 2005), http://www.sec.gov/divisions/marketreg/bdguide.htm.
[91] 15 U.S.C. § 78(ccc)(a)(2).
[92] U.S. SECURITIES & EXCHANGE COMMISSION, REPORT ON REFUNDS, SALES PRACTICES, AND REVENUES FROM PERIODIC PAYMENT PLANS 21 (Mar. 2007), http://www.sec.gov/news/studies/2007/secpppreport0307.pdf.

Broker-dealers must meet certain financial responsibility requirements, including: maintaining minimum amounts of liquid assets, or net capital; safeguarding the customer funds and securities; and making and preserving accurate books and records.[93]

Broker-dealers are subject to extensive sales practice standards under federal laws and SRO rules. Antifraud provisions of the securities laws prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices.[94] Broker-dealers owe their customers a duty of fair dealing.[95] They must seek to obtain best execution, that is, the most favorable terms available under the circumstances, for their customer orders. They must only make suitable recommendations. They must disclose all known material facts to investors before effecting a trade.[96] A broker-dealer must provide its customers, at or before the completion of a transaction, with basic information about the trade.[97] To prevent insider trading, Section 15(f) of the Act specifically requires broker-dealers to have and enforce written policies and procedures reasonably designed to prevent their employees from misusing material non-public information.[98]

The reason for these essential provisions is investor protection and the financial soundness of the securities markets.

While, generally, foreign broker-dealers dealing with U.S. customers in the U.S. must register with the SEC, seventeen years ago, the SEC exempted foreign broker-dealers from registration in certain circumstances. The SEC said in Rule 15-a6 that a foreign broker can do business with U.S. investors and brokers without registration within certain conditions, including:

(1) execution of unsolicited securities transactions;

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[93] Per Jebson, *How To Fix Unpaid Arbitration Awards*, 26 PACE L. REV. 183, 218 (2005).
[94] 15 U.S.C. § 78(j).
[95] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 131 (1973).
[96] 15 U.S.C. § 78(j).
[97] Norman S. Poser, Liability *of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U.L. Rev. 1463 (2001).
[98] 15 U.S.C. § 78(o)(b)(4)(E); Alexander C. Dill, *Broker Deal Regulation Under the Securities and Exchange Act of 1934: The Case of Independent Contracting*, 1994 COLUM. BUS. L. REV. 189, n. 134 (1994).

(2) solicited contacts limited to:

(a) providing research reports to large institutional investors;

(b) effecting transactions for large institutional investors, if the trade is booked through a US-registered broker or dealer; or

(3) executing transactions directly with U.S. registered brokers or dealers.[99]

The most direct forms of contact under the rule are limited to "major U.S. institutional investors" which are functionally similar to QIBs.[100] The rationale for limiting these types of direct contracts to QIB-like-entities is based on the limited ability of smaller investors, especially individuals, to marshal the necessary resources or investment expertise to fully assess the risks of transacting with foreign broker-dealers without the intermediation of a U.S. broker-dealer. These investors may not recognize the implications of transacting directly with a foreign broker-dealer including difficulty in (i) determining their ability to obtain redress for botched transactions, (ii) understanding the screening process for agents of the foreign broker-dealer, and (iii) understanding the different conduct standards that apply to the foreign broker-dealer.

For example, to become licensed to sell securities, all persons associated with a U.S. broker-dealer are required to pass a qualifications test covering substantive aspects of the securities business.[101] SEC and SRO rules also are designed to assure that those persons associated with broker-dealers who have committed abuses that would make them subject to a statutory disqualification are prohibited from working in the securities industry or are subject to appropriate conditions such as enhanced supervision. The SROs also require that persons involved in the management of the broker-dealer pass additional examinations relating to supervisory procedures and requirements. These qualification requirements are supplemented by continuing education requirements, the broker-dealer's duty to supervise its employees to prevent violations of the federal securities laws, and the specific supervisory procedures imposed by the SROs. In addition, our rules and those of the SROs

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[99] 17 C.F.R. 240.15a-6.
[100] *Id.*
[101] 15 U.S.C. § 78(o)(b)(7)(B).

provide firms with targeted sales practice standards to address particular types of abuse. Furthermore, U.S. broker-dealers and their associated persons must comply with specific guidelines concerning the content and review of communications with the public, including advertisements. Smaller investors transacting more directly with foreign broker-dealers may lack the ability to effectively assess what, if any, similar protections are afforded under a different regulatory regime.

The requirement that foreign brokers be registered in order to directly contact US individuals and small institutions is wholly consistent with the registration requirements for US broker-dealers. US broker-dealers must be registered to deal with all investors, large and small, and the broker-dealer investor protection standards apply to their dealings with all investors, with a few exceptions for large institutions. In contrast, unregistered securities can be sold to individuals that are "accredited investors," and hedge funds can be sold to unlimited numbers of individuals that are "qualified purchasers." Why is that?

First, it must be recognized that broker-dealer regulation is a predicate for the unregistered security and hedge fund exceptions. In most cases, these products are sold by broker-dealers to investors, who are more dependent on the broker-dealer's advice, given the lack of standardized disclosures or investment restrictions for these products. It has long been acknowledged that most investors rely heavily on the advice of their advisors even when they have full disclosure documents. As the SEC's Special Study of Securities Markets said in 1963, "No amount of disclosure in a prospectus can be effective to protect investors unless the securities are sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells."[102] So in these cases, regulation of broker-dealers is especially important.

In addition, while wealth can enable individual investors to spread their risk through diversification, or allow them to sustain some losses without dramatic changes to their living standard, some may argue that it is not a reliable standard of sophistication for individuals dealing with a broker-dealer. The securities markets are

[102] SEC, Report of Special Study of Securities Markets, Pt. I, H.R. Doc. No. 94, 88th Cong., 1st Sess. 588 (1963).

replete with examples of wealthy investors being misled or defrauded by firms hawking securities. And securities firms that cater to affluent individuals readily admit that wealth is not always a reliable proxy for sophistication in dealing with financial advisors. Individual wealth can be attained in many ways, some of which develop sophistication in financial matters, but many of which don't. In contrast, large institutions have the structure and the resources to hire dedicated staff that can develop sophistication in financial matters. For these reason, the SEC has consistently required broker-dealer registration for all US brokers dealing with US investors, and has applied US customer protection standards to their dealings with all but the largest institutional investors, even when they were selling unregistered securities.

At the same time as it adopted Rule 15a-6, the SEC published a concept release on the concept of recognizing foreign country regulation of broker-dealers in place of U.S. registration.[103] The practical effect of current law is that foreign exchanges and foreign broker-dealers dealing directly with U.S. investors in the United States must either register or be exempt from registration.

While registration is considered by critics as onerous, the exemption has also essentially required that firms that want to regularly provide services to U.S. customers establish a U.S. broker-dealer affiliate to interface with those customers. Some have criticized this regulation as economic protectionism designed to preserve the position of U.S. financial services provides and markets.

III. TODAY: THE PRESSURES

You may ask, how all of this working in practice? I would answer that while U.S. regulation is providing valuable protection to U.S. investors, this approach to registration of foreign markets and broker-dealers could benefit from consideration of developments in today's capital markets.

For example, can you, as an individual, own interest in an E.U. company, XYZ Company, today? The answer is yes, and it can

[103] Laura S. Unger, Remarks at Third National Securities Trading on the Internet Conference (Jan. 24, 2000), *available at* http://www.sec.gov/news/speech/spch344.htm.

be done many ways. You can buy a mutual fund or an ETF with a large stake in XYZ Co., obtaining the benefit of the expertise and acumen of the mutual fund adviser. You can buy XYZ Co. American Depository Receipts under certain ADR programs. You could buy XYZ Co. ordinary shares from your broker who may sell it out of inventory, or buy it from U.S. market makers in XYZ Co. Or, the U.S. broker may buy the shares on a foreign exchange though a foreign affiliate that is a member of that exchange or though a non-affiliate correspondent broker-dealer.

Thus, if the SEC's investor protection concern is about *retail* access to unregistered securities, it is already here. For instance, a major U.S. on-line broker-dealer recently announced its new global trading platform, which will allow individual-investor customers in the U.S. to buy and sell foreign securities in their local currency. The firm is starting with online trading for stocks in Canada, France, Germany, Hong Kong, Japan and the United Kingdom, but it also is offering broker-assisted trading in additional countries and hopes to eventually include as many as 42 international markets and related currencies in the online system. I suspect that other U.S. broker-dealers have or are developing similar foreign trading systems.
With regard to institutional investors generally, the largest ones maintain foreign trading desks in places like Tokyo, Hong Kong, London, and Paris. They access foreign exchanges though foreign broker-dealers without any involvement of U.S. broker-dealers. Other large institutions access foreign markets to buy foreign securities through a foreign broker operating under Rule 15a-6, with the trade being booked through a U.S. broker-dealer. Other institutions trade in foreign markets through U.S. brokers, who execute in foreign markets electronically through affiliates.

As retail ownership of securities has increased since the 1980s, so, too, has investment activity in foreign securities. U.S. gross transactions in foreign securities grew dramatically from $53 billion to almost $7.4 trillion since the 1980s. Nearly two-thirds of all equity investors in 2005 hold foreign equities through ownership of individual stock in foreign companies or ownership of international or global mutual funds, up from about half in 1999 and 2002.[104]

[104] Investment Company Institute and the Securities Industry and Financial Markets Association, *supra* note 6.

Many experts advise investors, for diversification reasons, to have international investments in their portfolios. This is true despite questions about investor protection and issue disclosure arrangements in some foreign markets. We recognize the broad economic benefits that can be gained for incorporating foreign securities into an individual's portfolio. However, an advisor generally serve as a gatekeeper and performs due diligence, when retail investors purchase foreign securities through directed brokerage plans or through mutual funds. As more sophisticated parties, advisors generally are in a better position to understand the differences between regulatory regimes and make appropriate decisions.

To reprise the current situation, US investors have a growing appetite for foreign securities, which they are obtaining in various ways. Individuals purchasing foreign securities are currently doing so through US brokers or investment advisers, and thus are protected by US regulation of the brokers' or advisers' conduct. US institutions may have greater contact with foreign brokers, but to the extent they are trading from within the US, the foreign broker's activities are still limited by the conditions of Rule 15a-6. US brokers access foreign exchanges through foreign brokers.

Over the years, a number of foreign markets and jurisdictions have questioned whether registration of foreign markets and brokers in the US is essential to investor protection if the foreign jurisdiction affords regulation comparable to that in the US. European Union countries in particular have been complaining that the U.S. "pro-investor protection" stand is protectionist of our domestic institutions and firms.

The SEC's response has generally been that our statutory mandate requires us to place investor protection first, and we currently provide better than national treatment to foreign entities, who are welcome to do business here if they register, or for brokers, if they comply with the significantly less demanding terms of Rule 15a-6. Frankly, I can't agree with suggestions that our prudential regulatory requirements are protectionist-motivated, or that investors are denied fundamental access to foreign securities or markets.

However, there may be more that we can do to reduce costs and frictions of obtaining foreign securities in the US, without jeopardizing investor protection for US investors. In fact, we may be able to work cooperatively with foreign regulators to raise standards for investors in all of our markets.

IV. A COOPERATIVE APPROACH

In thinking about a cooperative approach, it would not be my aim to forego all protections, enabling foreign exchanges and foreign broker-dealers to conduct business within U.S. borders without any conditions or regulation. This approach may be inconsistent with the SEC's legal obligations and would erode the investor protections that have contributed to the preeminence of the U.S. financial markets. In fact, the integrity of the U.S. system likely would be jeopardized: facing competition from lightly regulated foreign firms, U.S. financial services providers may choose to relocate overseas.

We need a different solution.

The SEC has broad general exemptive authority, provided it can make findings with regard to the public interest and the protection of investors. In 1996, Congress provided the SEC with flexibility to regulate the marketplace by giving the SEC broad authority to exempt any person from any of the provisions of the Exchange Act and impose appropriate conditions on their operation.[105] The Exchange Act was enacted at a time when it was recognized that a regulatory structure for securities exchanges would "be of little value tomorrow if it is not flexible enough to meet new conditions immediately as they arise and demand attention in the public interest."[106] As the Senate recognized in 1934, "exchanges cannot be regulated efficiently under a rigid statutory program….considerable latitude is allowed for the exercise of administrative discretion in the regulation of both exchanges and the over-the-counter market."[107] Those statements ring evermore true today. The SEC's exemptive authority, combined with the ability to

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[105] Exchange Act § 36, 15 U.S.C. 78mm, enacted as part of the National Securities Markets Improvement Act of 1996, Pub. L. 104-290 (Oct. 1996).
[106] SEC, *Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. Pt. 1 (1963), at 6.
[107] S. Rep. No. 792, 73rd Cong., 2d Sess. (1934) at 5.

facilitate a national market system, provides the SEC with the tools it needs to adopt a cooperative framework without compromising its mandate of investor protection.

The SEC would therefore need to make a determination that it is in the public interest, and consistent with the protection of investors, if foreign exchanges and broker-dealers are to be exempted from portions of the federal securities laws.

On what basis might we come to this conclusion?

First, foreign exchange screens in the United States –

As I discussed earlier, under the Exchange Act, exchanges can only admit brokers as members. Investors access exchanges through regulated brokers. Few, if any, foreign exchanges admit non-brokers as members, and I see little reason to change this fundamental approach.

As I also discussed earlier, information from foreign exchanges is widely available now. So the key issue is U.S. broker membership in U.S. foreign exchanges. Foreign exchanges can differ dramatically in their structure, acceptable trading practices, and oversight from U.S. markets.

So a new cooperative approach could offer the possibility of U.S. brokers joining foreign exchanges in jurisdictions with exchange regulation and oversight standards comparable to the U.S. where the jurisdiction cooperates with the SEC in assuring investor protection, as well as other statutory requirements.

Under this cooperation approach, the SEC could establish by rule conditions for exemption of exchange registration to foreign exchanges from jurisdictions that satisfy the conditions. Material breaches of any of the conditions would be grounds for the SEC to withdraw the exemption from a foreign exchange.
What conditions would be appropriate?

> Recognized Jurisdiction – The foreign exchange should be subject to regulatory oversight in its primary jurisdiction that protects investors and the integrity of the securities markets, including that which addresses: fair markets; fraud;

manipulation; insider trading; current trade reporting; net capital and financial responsibility of exchange members; and surveillance and enforcement. In addition, as a measure of comity, the foreign jurisdiction should provide regulatory relief to U.S. exchanges seeking to conduct business in that jurisdiction that is at least as extensive as that provided by the SEC.

Notice to Investors – Investors should have notice that their trading is being done in a foreign marketplace, which may not offer the same protections afforded to them in the United States. As discussed earlier, advancements in technology have made the physical location of an exchange an elusive concept. Given what is at stake, it is imperative that investors chose the foreign marketplace knowingly, and with full disclosure of the relevant differences.

Foreign Securities Only – In my view, the need for exemption is limited to access to foreign securities, rather than U.S.-registered issues. These are the securities sought overseas by U.S. investors. Moreover, the advantages this cooperative approach would give unregistered foreign exchanges over U.S. registered exchanges are hardest to justify with respect to U.S. securities. "Foreign securities" while hard to define, would look both at the nature of the issue and the U.S. share of trading volume.

U.S. Membership Limited to Broker-Dealers – As I mentioned, the foreign exchange should not provide direct access to U.S. persons other than registered U.S. broker-dealers.

Fair Access – And, it would not be appropriate for an exempt foreign exchange to unfairly discriminate among U.S. broker-dealers or U.S. and foreign broker-dealers in granting access to services. To allow foreign exchanges to discriminate unfairly would call into question the purpose of the exemption.

MOU – It would be important that the SEC and the non-US exchange's home regulator coordinate their oversight in a manner designed to assure effective regulation in both

jurisdictions. Among other things, the SEC and the foreign regulator should coordinate inspections, and regularly share information regarding the exchange. This goal may be accomplished through memoranda of understanding with the foreign regulator that address information sharing and other forms of regulatory cooperation.

Recordkeeping, Reporting and Disclosure – I would want for the SEC to be able to obtain access to separately identifiable audit trail of orders sent to, and executed on, the foreign exchange by U.S. members. The SEC should also have access to trading information involving U.S. investors. I would also want to ensure that any privacy laws in an exchange's home country would not impede its ability to provide the SEC with books and records relating to the U.S. activities of the foreign exchange.

Among other major consequences, this cooperative approach would avoid the foreign exchange from needing to file its changes in rules for approval by the SEC. U.S. exchanges still must do so. Clearly, this disparity would be noticed by U.S. exchanges. To relieve this competitive disadvantage, the SEC would need to consider speeding up the rule filing process for trading rules.

With regard to foreign broker-dealers, a similar cooperative approach could apply to foreign brokers dealing with large institutional investors. In effect, this would ease the requirements of Rule 15a-6 for foreign brokers subject to comparable regulation by their host jurisdiction, allowing them to deal directly U.S. QIBs in the U.S. I am mindful that if not carefully structured, this approach could raise investor protection concerns, as well as competitive concerns for U.S. brokers. With certain parameters, however, those concerns may be minimized.

In order to preserve investor protection and promote market competition, this cooperative approach for foreign brokers would depend on a determination that the home country regulatory regime for brokers dealing with overseas clients is comparable to the protections provided to US investors by US broker-dealer oversight. At least initially, I would envision it being limited to encompassing transactions in which a foreign broker-dealer deals with U.S. QIBs in the U.S. in foreign securities or U.S. government securities.

Limiting the transactions to foreign securities focuses the approach on where the need for direct access to foreign brokers is most compelling: access to foreign securities. U.S. investors are likely to have a greater expectation that transactions involving domestic securities (as opposed to foreign securities) will be subject to full SEC oversight. The limitation to QIBs, at least initially, helps ensure that the investors involved are familiar with foreign market practices, and have the resources to understand and bear the risks of dealing with an unregistered foreign broker-dealer. It also reflects the inherent imprecision in comparing U.S. and home country supervision of broker-dealers.

Finally, recognition of foreign broker-dealer registration and regulators as substantively equivalent to U.S. broker-dealer registration and regulators could be conditioned on further basic requirements:

> (A) the existence of a supervisory cooperation, investigative and financial memorandum of understanding between the SEC and the foreign regulatory authority;
> (B) compliance by foreign broker-dealers with specific U.S. regulatory requirements including notice and record access requirements; and
>
> (C) reciprocal treatment of U.S. broker-dealers by the home jurisdiction of the foreign broker-dealer.

V. CONCLUSION

While the SEC raised the concept of mutual recognition for brokers 17 years ago, it still is a novel approach for it. In thinking it through, the SEC needs to be deliberate, for much is at stake. The SEC also needs to think about how investors are informed about the destination of their orders given the many ways that an order for foreign securities can be executed as the world becomes more closely linked. But there is much to be gained from a cooperative approach. Through greater communication and cooperation between international regulators and comparison of regulatory regimes, a degree of harmonization may result that produces stronger protections for investors in many jurisdictions. At the same time, this approach offers the promise of reducing the costs of trading around the globe.