INTERNATIONAL AUTOMATED SECURITIES TRADING SYSTEMS - REGULATORY PROBLEMS

by

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INTRODUCTION

Increasingly, investors in securities markets view their activities in an international context. One of the by-products of the technological revolution and the rapid development of communications media has been that, more and more, investors are readily able to move their capital, not only from company to company, but from country to country. International securities markets and, in particular, electronic markets spanning jurisdictional boundaries, continue to grow in importance.

From an investor's point of view, the added freedom of being able to invest through one international system in different parts of the world is potentially an enormous advantage. But with that added freedom comes, of course, some additional risks. Investors must increasingly inform themselves of events and circumstances in different parts of the world before they can be in a position accurately to assess the implications of their investments. More importantly, in the present context, investors need to consider the extent to which the protection available for transactions executed on a conventional stock exchange will be available for transactions executed on international securities exchange systems.

The regulatory issues associated with international securities trading are vitally important to investors who utilise these systems. It must be said, however, that the principles underlying the international regulation of these matters are far from clear. Indeed, it is my view that international regulatory systems are presently insufficiently developed to permit international securities trading on a legally secure basis. Attention needs to be addressed, therefore, to the structures which might be put in place to overcome the inadequacies.

This paper attempts to identify some fundamental legal problems underlying international securities trading and to make a tentative first step towards identifying the means for solving those problems.

THE REGULATION AND ROLE OF CONVENTIONAL STOCK EXCHANGES

In those jurisdictions in which there is an established securities market there is also considerable legal regulation of trading in those securities. Part and parcel of the regulatory framework is the approach taken to stock exchanges. In most jurisdictions, securities markets are conducted by stock exchanges which, on the one hand, are subject to controls as to their methods of operation and which, on the other, are granted special status and given a significant role in the regulation and surveillance of the market.

In this way, the rules of stock exchanges may have a *quasi* statutory status, having received the imprimatur of statutory or regulatory approval. Those rules generally impose requirements on broker-dealers, whose continued right to participate in the market depends on their compliance with the rules. In a general sense, exchanges and their broker-dealer members provide a network of support for each trade, while their clients are anonymous at the time of trading as far as the market is concerned. The integrity of the system is necessary for the proper operation of the market and the protection of investors' interests.

Additionally, conventional stock exchanges are often given an important role in the surveillance of the market. Exchanges generally are given some of the responsibility for detecting improper activities, including insider trading and market manipulation. They are often responsible for the initial investigations and for supplying information regarding improper market activities to the appropriate regulatory authority, to enable that authority to pursue prosecutions. Access to information obtained by stock exchanges is in many cases critical to the success of regulators' efforts to detect and prosecute breaches of the law associated with securities trading.

Traditionally, then, stock exchanges generally occupy an important role in securing the efficient and fair operation of the stock markets which they operate. That role arises out of regulatory structures which set strict requirements for operating a stock market and create obligations on the part of stock exchanges designed to protect the interests of the investing public.

INTERNATIONAL SECURITIES TRADING - SOME IMPLICATIONS

At the outset, several different types of electronic systems should be distinguished.

In the first (and most established) category are the electronic information systems, often supplying 'real-time' information regarding trading activities on established stock exchanges. They are sometimes called 'electronic bulletin boards'. Early examples were the NASDAQ system in the United States and the SEAQ system in the United Kingdom. As originally conceived, these systems were 'passive', in the sense that they did not themselves provide for securities trading, although they certainly facilitated trading by telephone or other means. If they do not develop further into systems falling within one of the other categories, such systems bring considerable advantages, both to established stock exchanges and to investors. This is so because they allow the immediate dissemination of market information to participants and permit them to make better informed investment decisions.

The second category is made up of 'free-standing' electronic securities trading systems. These systems independently list securities and create their own markets in them. The electronic trading systems being developed by some of the established stock exchanges (for example, the SEATS system of the Australian Stock Exchange) will ultimately fall into this category if the trading floors of those exchanges are phased out. NASD's recently developed Portal trading system for securities privately placed under the new Rule 144A also falls into this category, as do many

of the computerised trading systems being developed by or in conjunction with futures exchanges.

Between these two categories are two others. In the third category are the electronic market access systems. These allow for automated trading of securities quoted on an established exchange, but the pricing processes are integrated with the central price-fixing mechanism in a manner which avoids market fragmentation. Typically these systems are designed to conform to the market displacement and off-board trading rules of the exchange, and are accessed through broker-dealer members of the exchange.

The fourth category comprises electronic trading systems which list securities already quoted on established stock exchanges, relying 'parasitically' on information derived from trading on the markets of the established exchanges but providing a separate, electronic market for the securities which they list. Typically they provide direct access to trading for certain investors (for example, institutions) without broker intermediation.

The present discussion is directed towards the third and fourth categories. Systems in both these categories permit automated trading in securities without the need for participants to enter the conventional markets of the established stock exchanges, although the rules of those exchanges may apply to transactions entered into on systems within the third category because of the way in which those systems effectively 'attach' themselves to established exchanges' markets. Apart from questions relating to the application of the rules of various established stock exchanges to trades on those systems, however, similar regulatory issues arise in relation to each category.

Recent controversy about the Reuters system, Instinet, relates to whether the system should develop as a third or fourth category system. The Instinet system 'attaches' itself to established exchanges' markets. It is a proprietary system, in the sense that it is owned and operated by Reuters or its subsidiaries and

is conducted for profit. Instinet performs many of the market functions of a conventional stock exchange, permitting the matching of offers and bids and the allocation of trades accordingly, but it lists securities which are already quoted on established stock exchanges, 'borrows' the central market's pricing information, and provides an alternative trading medium for those securities. It also performs electronically some of the functions of a conventional broker-dealer, in the sense that it electronically seeks out the best execution for subscribers' trades, much as a broker-dealer does in a conventional stock market.

Unless the system evolves into an electronic market access system, serious problems will arise out of its operation alongside existing stock markets, not least of which is the impact on the liquidity of established stock markets. A recent decision of the Ontario Securities Commission relating to a proposal to expand the use of the Instinet trading system in that Province contains a persuasive argument for approaching these systems with some trepidation (*In re the Securities Act, R.S.O. 1980, Chapter 466* (1990) 13 OSCB 1705). The Commission apparently accepted the expert evidence put before it that -

> *the Instinet system would divert order flow away from the [Toronto Stock] Exchange and consequently reduce the liquidity of the Exchange's central auction market*

and that -

> *the market fragmentation aggravated by that diversion of order flow would adversely affect the cost of capital of Exchange-listed issuers and so hurt capital formation in Canada.*

The Commission accordingly declined to give its 'non-disapproval' to a proposal which would have permitted the Instinet trading system to operate in Ontario through computer terminals installed in brokers' offices.

In addition to the problems associated with fragmentation of markets and the resulting effect on liquidity and the costs of capital formation brought about by the introduction of these systems, substantial problems arise with regard to the surveillance of the markets created by the systems, the financial status and responsibility of their users, the capacity of the systems to deal with unusual volumes, and whether the operational parameters built into the systems will ensure the maintenance of fair and orderly markets and a minimum level of protection for investors. The introduction of international securities trading systems, therefore, raises some fundamental regulatory issues.

Regulation of the Systems

There is presently no international law dealing specifically with international securities markets. The US Securities and Exchange Commission has endeavoured to fill this vacuum by developing increasingly sophisticated policies with respect to the extra-territorial reach of its own laws and its treatment of foreign participants in its markets. The SEC regards itself as having responsibility to provide regulatory leadership, though in its Policy Statement of November 1988 it acknowledges the need to be sensitive to the national priorities of regulators in other countries.

The SEC has developed or is developing policies with respect to such matters as -

(a) simultaneous multi-national issue of securities;

(b) the extra-territorial scope of U.S. prospectus law (Regulation S);

(c) the treatment of foreign issuers entering U.S. markets, through the disclosure requirements of Form 20F and Forms 1, 2 and 3, and the 'information supplying' exemption from registration under the 1934 Act (Rule 12g3 - 2(b));

(d) private placements by foreign issuers in U.S. markets (Rule 144A);

(e) registration of foreign broker-dealers (Rule 15a-6); and

(f) proprietary trading systems (Release 26708).

In addition, the SEC has negotiated memoranda of understanding with securities regulators in other countries (to date, Switzerland, the United Kingdom, Japan, several Canadian Provinces, Brazil, the Netherlands and France) dealing with issues of investigation and enforcement of national securities laws and has secured Congressional support for these arrangements in the Insider Trading and Securities Fraud Enforcement Act of 1988. United States courts have applied the 'conduct' and 'effects' tests and the Second Restatement on Foreign Relations Law to determine the extra-territorial scope of U.S. securities laws, demonstrating that U.S. courts are prepared to apply those laws extensively to circumstances having off-shore elements.

Of these developments, SEC Release 26708, which deals with proprietary trading systems, is of most immediate interest in the present context. Under the proposal contained in the Release, proprietary systems would be permitted to operate only after approval is given by the SEC. Approval would only be given after the submission of a 'business plan' covering the proposed operation of the system, submitted by a sponsor which would ultimately take responsibility for compliance with the terms of the plan and U.S. Federal law relating to securities trading.

Release 26708 contemplates business plans for proprietary systems dealing with the following matters:

(a) surveillance of the market, including details of staffing, systems and procedures to be employed to this end, the maintenance of trading and financial records, and agreement by the sponsor to report suspected violations of securities law to the SEC;

(b) the financial status and responsibility of users (especially foreign users), including a detailed description of the system's requirements with regard to the financial soundness and integrity of participants and subscribers and details of staffing, systems and procedures employed to ensure that these requirements are met;

(c) the system's capacity to deal with unusual volumes and the consequences of overloading of the system;

(d) details of the operational rules governing the operation of the system, so as to ensure a minimum level of investor protection, the maintenance of fair and orderly markets, and so as to remove impediments to a national market system and a national system for clearance and settlement of trades;

(e) details of the rules governing access to the system and a description of how those rules are to be applied by the system to ensure fair and non-discriminatory access; and

(f) a description of how the system will operate to enhance fair competition, based on the principle that equal regulatory burdens should apply to established stock exchanges and proposed proprietary systems.

Many of the international securities trading systems will be proprietary trading systems to which Release 26708 will apply. The SEC may endeavour to regulate those systems which operate in the United States and their operation, to the extent that the 'conduct' and 'effects' tests will permit the application of U.S. regulations to particular trades made within the systems. However, the question remains as to the effect of other regulatory structures on international securities trading systems. To what extent, for example, will Japanese, United Kingdom, Canadian or Australian laws apply to those systems? What is the effect of inconsistency between those laws?

Consider the following hypothetical situation. An Australian company based in Sydney develops 'Autotrade', a computer system that displays comprehensive real-time trading, bid and offer information for all markets on which the top 300 international equity securities are traded. The issuers of these securities are companies with major international operations whose securities are quoted on the New York and/or London Stock Exchanges, and sometimes on other stock exchanges. The system automatically matches and executes corresponding bids and offers, and permits a subscriber to accept a bid or offer by entering a 'trade' instruction. It derives the real-time information from stock exchanges, but is not otherwise linked to any exchange, and its trades are not reconciled to the reporting, displacement and off-board trading rules of any exchange. All trades are settled through Autotrade's settlement agents, who use Euromarket settlement facilities, which are physically located in Luxembourg. The subscribers are only institutional investors, and broker-dealers are prohibited from subscribing. There are now 2,000 subscribers accessing the system through terminals located in 12 countries. 800 subscribers are US institutions. Subscriber agreements are expressed to be governed by the law of England. On average, 4% of the total daily turnover of the top 300 international equity securities is traded through Autotrade.

Principles of private international law are available to assist us in determining the national law which will govern the formation and performance of subscriber agreements, the formation and performance of trading contracts, settlement and transfer of title to securities, and the extent to which national regulatory laws apply to the system and its operator. The trouble is that the application of these principles will be complex and uncertain, and the result may in the end be unsatisfying. It is tempting to say that all aspects of Autotrade should be regulated by a single lead regulator. In the absence of an international securities regulator, the securities regulator of one particular country will need to be selected. The country selected should be the one with which the system is most closely connected. But which country is that? Australia, because the system was developed and happens to be operated from that country? If that

is correct, would the analysis be altered if we discovered that the computer mainframe had been placed in the Cook Islands? In any case, will the United States Securities and Exchange Commission be content to leave regulation of such a major system, impacting substantially on US securities markets, to the regulator of a smaller country (or, indeed, to any other regulator without SEC involvement)? Should it ever be determinative to take into account the place at which a bid or offer is entered into the computer system, the place at which the 'trade' button is pushed, the place of the stock exchange on which the subject securities are quoted, or the place of settlement? To the extent that the system operates in a truly international fashion, trading in truly international securities, it is arguable that none of these national connections should have any governing significance.

Regulation of Market Participants

The problem of identifying which regulatory structure or structures applies or apply to trading on international securities trading systems raises a number of further questions. Quite apart from issues relating to the operation of the systems themselves, questions arise as to how inconsistencies in various laws relating to matters such as takeovers, substantial shareholder limitations, insider trading and market manipulation will be resolved. Laws such as these often proscribe certain conduct which would have an adverse effect on the market, investors in it, or the public interest more generally. Particularly insofar as it is conduct (rather than its result) which is prohibited, doubts may arise as to the extent of the extra-territorial operation of these laws. Moreover, considerable differences exist between jurisdictions as to the range of acceptable and unacceptable conduct by participants in securities markets, and differences may also exist as to the extent of the application of those laws. Inconsistent legal requirements may therefore apply, or participants in international markets may be subject to a range of requirements (depending on the individual securities being dealt with) with

which they may be unfamiliar. These problems must substantially increase the complexity of investors' decisions when those decisions are made in an international context.

Regulation of Systems Users

The regulation of users of or subscribers to international securities trading systems gives rise to further problems.

The first question relates to the application of foreign registration requirements to broker-dealers who use those systems. Non-U.S. brokers who subscribe to a system operating in the United States and enter orders through it would appear to be required to obtain registration as broker-dealers in the United States, and perhaps in other jurisdictions in which those systems operate. The SEC's new Rule 15a-6 appears to produce this result, and none of the safe harbours from the registration requirement would seem to apply. The SEC staff have 'given assurances that enforcement action would not be recommended for lack of broker-dealer registration with respect to the collective distribution by organised foreign exchanges of foreign market makers' quotes, in the absence of other inducements to trade', but these assurances appear to 'apply only to third-party systems that do not allow securities transactions to be executed between the foreign broker-dealer and persons in the United States through the System' (SEC Release No. 27017 of 11 July 1989 - CCH Fed. Sec. L. Rep. ¶84,428).

There may be a question as to whether trades are conducted through the international securities exchange system acting as a broker, in which case a non-U.S. dealer might be exempt from the registration requirements under Rule 15a-6(a)(3)(i). It is questionable whether the operators of such a system would wish its subscribers to utilise this exemption, however, because a broker-dealer who engages in activities on behalf of foreign brokers under Rule 15a-6 is required to perform some surveillance and other forms of enforcement activity, all of which those operators may well wish to avoid.

Difficult questions also arise with respect to the prescription of capital adequacy requirements for systems users. It is arguable that international computerised trading systems do not of themselves deal with the exchange of title to securities for money, because matters of settlement are handled through settlement agents using orthodox procedures, and therefore the use of the system does not involve financial exposure. To a degree, the validity of this argument depends upon the system design. If the system is structured so that the operating company stands contractually between the selling and buying subscribers, failure of either subscriber to perform a contract would appear to affect the financial integrity of the system, and therefore the financial position of subscribers is highly relevant.

Regulation of Transactions

More generally, questions will arise as to which national law applies to regulate trading on international securities systems.

For example, where the order of an Australian investor is electronically matched with the order of a U.S. investor in respect of a U.K. security, which law governs the transaction? It would be curious if the answer to this question depended upon the location of the computer which causes the matching to occur, and equally curious if it depended on the location of the terminal used to enter the second (or for that matter the first) bid or offer.

It might follow from such reasoning that investors could choose the level of regulation for the transaction by locating computer terminals in relatively unregulated countries and affecting trades through those terminals - a clearly unacceptable result. If the transaction in question were held to be governed by both U.S. and Australian law, for example, on the ground that there is a sufficient level of connection with both jurisdictions, direct conflicts of legal requirements could arise. For example, Australian and American laws with respect to short selling and market stabilisation are markedly different. The subscriber

agreement under which the international trading system is used may well stipulate the law which is to govern that agreement. While this choice of law clause is effective as regards the law of contract, it probably would not operate to exclude the application of statutory securities laws if they are otherwise applicable.

These questions of applicable law are of fundamental importance to effective regulation. The principles of private international law may cause us to focus attention on technical questions leading to 'wrong' regulatory results, especially if the applicable legal system does not have a developed system of securities regulation at all.

Regulation of Settlement of Trades

Other difficult questions arise with respect to the national laws applying to the settlement of trades. It may be that the applicable law would be determined by the place of operation of the international securities trading system or, perhaps, the domicile of the parties to the trade. Similar concerns arise insofar as the parties are thereby in a position to choose the law applying to the transaction, independently of any regulatory consideration or, perhaps, even contrary to regulatory interests.

Enforcement of Contracts

A further implication of the choice of law possibilities is that subscribers to the agreement may be forced to seek enforcement in other jurisdictions. In this way, some subscribers may be subject to a litigation burden not borne by others. This may distort the operation of the market. In addition, it may be necessary for subscribers to become familiar with the range of rules applying in several foreign stock exchanges if the rules of those exchanges are to apply to the international trading systems. For example, if a transaction were executed in the United States in respect of a security quoted on a U.S. stock exchange, it may be subject to some of the rules of that exchange. It is conceivable that it would be necessary,

therefore, for investors in other parts of the world to become familiar with the rules of various U.S. exchanges so that they may designate the exchange whose rules are most advantageous to them. This result would not be in the interests of those investors or, if it were, it would be to the detriment of regulatory objectives and would add a level of regulatory complexity to investment decision making which is undesirable.

Regulation of Issuers

Problems also arise with respect to disclosure requirements. Issuers of securities in one country may well be required to register as issuers in another country, by virtue of electronic trading sufficiently connected with the latter country. On the other hand, in some countries the use of international securities trading systems may permit the introduction of various securities into a jurisdiction without a disclosure base being available for investors. The differences which exist between prospectus requirements in the various jurisdictions, therefore, may have a direct impact on issuers of securities listed on international electronic securities trading systems.

A full analysis of the definitions of 'directed selling efforts in the United States' and 'offshore transaction' and the concept of offers and sales being 'within the United States', would reveal that the new Regulation S adopted by the Securities and Exchange Commission of the United States does not adequately address these questions.

Overall Market Regulation

Perhaps most importantly of all, in view of recent experience with the volatility of securities markets, questions arise relating to authority of national regulators to intervene in trading on an international system to protect investors against market collapse. The size of market fluctuations may be extremely large in comparison with the size of individual stock markets. The advent of modern communications means that market shocks are transmitted very rapidly around the world. The

international regulatory machinery to provide minimum protection for investors in respect of market volatility is not yet in place.

Summary

In the absence of some satisfactory international agreement, there must be serious concern that international securities trading systems will prejudice the integrity of existing national securities regulation systems. Will the users of those systems effect transactions in circumstances which would not be permitted if the trading occurred in one or several countries? Will subscribers to the system be able to avoid national insider trading law by locating their terminals in a country which does not prohibit that activity?

SOME PROPOSALS

The problems which currently exist in relation to the regulation of international securities trading seem to me to fall into three broad categories. They are -

(a) first, problems which arise because of uncertainty as to which regulatory framework is to apply to a given transaction;

(b) secondly, problems which arise because of lack of an international structure of regulation in which obligations can be enforced notwithstanding jurisdictional boundaries; and

(c) thirdly, problems which already exist in conventional markets but which are exacerbated by international securities trading systems, particularly electronic systems.

Uncertainty as to Applicable Law

Present uncertainty as to the appropriate law to apply to a given transaction arises essentially out of the lack of 'tailor-made' principles of international law which would determine that issue. Those principles clearly need to be developed. There would appear to be two alternatives:

(a) to have one uniform law governing the transfer of securities - this is a solution which has the attraction of simplicity but which is, of course, impossible to achieve in practice; or

(b) to have a set of clear and appropriate criteria by which to decide which law is to apply - this is a solution also requiring international agreement, but probably agreement which is far more likely to be achievable.

Problems of Investigation and Enforcement

As suggested previously in this paper, while it might be that the regulatory regime of one country will apply to an international securities transfer, there is a separate question as to whether the regulator concerned will have the practical ability to detect breaches of those regulations and prosecute offenders.

This is, again, an area in which international co-operation will be necessary. The result of the co-operative process will need to be a system in which jurisdictional boundaries do not affect in a practical sense the enforceability of the appropriate regulatory system, whether that is achieved by giving the foreign regulator access to offenders in other jurisdictions or by creating parallel offences in each jurisdiction to enable prosecutions to be brought on behalf of a foreign regulator.

In the short term, the SEC's existing practice of negotiating memoranda of understanding might be more widely adopted and expanded. In the longer term, however, regulators in the various jurisdictions need to be given unrestricted access to

surveillance information obtained wherever transactions are conducted which may be subject to a prosecution by that regulator. In my submission, a tangled web of bilateral international memoranda of understanding cannot be relied upon to achieve this.

There are obviously enormous practical problems in putting in place an effective, multilateral international scheme. But, in my submission, unless that is done there is little prospect of achieving a coherent regulatory structure which might ensure the proper operation of international securities trading systems. Co-operation has been achieved in other spheres; the process needs to be adopted in the context of international securities trading as a matter of priority.

Exacerbated Problems

The present paper is probably not the appropriate place to be dealing with the broader issues associated with the inadequacy of existing regulatory structures generally. Suffice it to say that problems such as the need to improve the protection for investors from market shocks need to be addressed all the more urgently because of the on-going development of international securities trading systems which emphasise the effects of those problems. In other words, solutions will need to be found having regard to the international context.

CONCLUSIONS

The development of international securities trading systems not only opens up a range of new opportunities for investors. Those systems raise important regulatory issues which, to date, have not been resolved.

Systems for international securities trading raise regulatory issues at the level of the systems themselves, their users and operators, at a transactional level and at the level of investor participation in the market. As well, questions arise as to market surveillance and enforcement in ways which do not exist in the context of conventional stock exchanges and stock markets.

The solution to these problems lies only in increased international efforts to secure principles which will permit a clear determination of applicable law and appropriate regulatory authority. Uniform legal and administrative arrangements binding the regulators in each jurisdiction, addressing the issues outlined in this paper, are urgently needed to remove the uncertainties which presently exist as far as international securities trading is concerned.