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A Regulatory Dilemma: Electronic Access to Foreign Markets

by Brandon Becker, Soo J. Yim, and Alexander K.A. Greenawalt *

It is by now a well-known fact that the explosive growth of computer and information technology is having a transformative effect on the nature of securities trading, with sophisticated online systems providing both a supplement and an alternative to the physical space of the traditional exchange floor. While these developments portend great possibilities for increased efficiency and flexibility in securities trading, they also pose novel issues for regulators, who are grappling with a situation that defies conventional regulatory categories. Special complexities arise in the area of cross-border trading, where computer terminals physically located in one jurisdiction can provide access to markets operating in another jurisdiction, eroding the functional distinctions

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between trading on U.S. and foreign markets. With foreign markets and securities subject to regulatory regimes that may differ substantially from their U.S. counterparts, questions arise as to how U.S. agencies can both facilitate the development of more efficient markets and protect investors from fraud and uninformed decision-making.

Thus far, neither the Securities and Exchange Commission ("SEC") nor the Commodity Futures Trading Commission ("CFTC") has implemented a comprehensive framework for regulating online cross-border trading, but both agencies have taken preliminary steps. In 1997 and 1998 respectively, the SEC and CFTC each published a "Concept Release" broaching the subject of how best to adapt to the technology-driven changes affecting their respective fields of regulation.[1] Both releases contemplate an overhaul of the current regulatory framework for cross-border trading.

[T]he SEC and the CFTC are under increasing pressure to address the ramifications of the explosive growth in online trading systems both within and outside the United States.

The SEC has not taken any further initiative toward comprehensive rulemaking since publishing its 1997 release. Instead, it has chosen to face the issues raised by cross-border trading on a case-by-case basis, most recently exempting the London-based Tradepoint Stock Exchange from registration as a national securities exchange.[2] The CFTC, on other hand, proposed in March of this year a set of comprehensive rules concerning order routing and electronic access to foreign futures markets.[3] Since the recent resignation of former Chairperson Brooksley Born, however, the proposed rules have been withdrawn, and it is unlikely that the CFTC will resume any such comprehensive rulemaking effort in the near future.[4] Thus both the SEC and CFTC have proposed, and then stepped back from, comprehensive regulation.

This article reviews the current developments relating to cross-border trading in light of the regulators' abortive attempts to adopt a new comprehensive framework. While the future of cross-border trading remains open-ended for now, it is clear that both the SEC and the CFTC are under increasing pressure to address the ramifications of the explosive growth in online trading systems both within and outside the United States. With increasing amounts of investment capital being placed globally, the need to conduct cross-border transactions in an efficient manner is growing. U.S. investors will benefit significantly from clear guidelines delineating how new technology may be used to enter and execute orders on foreign markets.

SEC Approaches

Traditionally, the SEC has regulated U.S. investors' access to foreign markets through an extension of its regulatory framework for "foreign broker-dealers" under the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, Rule 15a-6 under the Exchange Act sets forth guidelines detailing how foreign broker-dealers can conduct certain securities business with U.S. investors without triggering the U.S. broker-dealer registration requirement.[5] The prohibition against general solicitation activities by foreign broker-dealers under that rule has had the practical effect of restricting U.S. investors' direct access to foreign markets. To execute cross-border transactions involving foreign securities, U.S. investors typically have been forced to pass through several steps of broker-dealer intermediation. For example, an investor would first contact a U.S. broker-dealer for current market information concerning a foreign security, and then perhaps place an order to purchase or sell the security with that broker-dealer. This order, in turn, would be forwarded to a foreign broker-dealer who was a member of the appropriate foreign market for execution.

In the context of traditional trading methods, the SEC's primary regulatory concern has been to protect U.S. investors from any improper contacts with foreign markets and foreign investment professionals, whose activities might be subject to less stringent regulation than those prevailing in the United States. The growth of online trading, however, challenges the continued relevance of such protections, as more and more investors seek immediate access to market information and direct control over the trading process. Today, the proliferation of automated

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links between investors and broker-dealers and, in turn, between broker-dealers and foreign markets can effectively provide investors with a direct connection to foreign markets.[6] For example, a U.S. broker-dealer may provide an automated interface between a U.S. customer and a foreign market by connecting the customer's computer system to its own, which, in turn, is connected to the foreign market's trading facility. The U.S. broker-dealer's link to the foreign market may be arranged either directly in its capacity as an electronic member, or indirectly through agreement or affiliation with a local member of the foreign market. The result, from the investor's perspective, is that "trading on a foreign market through an access provider is often indistinguishable from trading on a domestic market."[7]

Today, the proliferation of automated links between investors and broker-dealers and, in turn, between broker-dealers and foreign markets can effectively provide investors with a direct connection to foreign markets.

The SEC Concept Release highlights the potential implications of these emerging cross-border trading applications. One concern is that the increasing interchangeability between domestic and foreign trading might "lead many investors to expect that such trading would be subject to the same protections provided by the U.S. securities laws."[8] Investors with such expectations could be adversely affected if a foreign market operates under relatively lax disclosure and anti-fraud regulations.

Seeking ways to protect investors without unnecessarily burdening an efficient, cost-effective means of investing in foreign securities, the SEC has posed three possible regulatory alternatives:

1. Relying solely on a market's home country regulator after the SEC determines which markets are subject to regulation "comparable" to that of the United States;
2. Requiring all foreign markets to register with the SEC as national securities exchanges or apply for an exemption from registration; and
3. Developing a tailored scheme to regulate any entity that provides U.S. investors with the ability to trade directly on foreign markets.[9]

The Concept Release does not appear to favor either of the first two approaches. A system of identifying comparable foreign regulation would provide regulatory certainty to foreign markets and minimize additional costs by showing reasonable deference to the home country's governance, but the SEC has identified significant drawbacks to this option. Most notably, since many foreign markets do not have the same disclosure and anti-fraud regulations as the United States, the SEC was concerned that the proposed system would do little to address the fundamental problem of U.S. investors unwittingly relying on less stringent regulatory regimes.

Of course, requiring foreign markets either to register as national securities exchanges or apply for exemptions would solve this problem by effectively subjecting those markets to U.S. regulations. As noted in the Concept Release, however, this option would lead quickly to the practical problem of how to apply the U.S. regulatory scheme, which is not designed for entities already regulated abroad, to markets with limited activities in the United States. The SEC also would be faced with the jurisdictional problems of imposing requirements on foreign markets offering "remote" access to U.S. investors.

Given its reservations regarding the first two options, the SEC focused greater attention on the third, more limited option—aiming at entities that provide direct access to foreign markets ("access providers"). Specifically, the SEC invited comment on an approach that would divide access providers into two distinct categories: (1) foreign markets and information vendors registered as securities information processors ("SIPs") under Section 11A of the Exchange Act, and (2) U.S. and foreign broker-dealers providing access to their customers in the United States.

The first category—consisting of SIPs—would cover access providers that enable U.S. members of foreign markets to trade directly on these markets from remote locations. As SIPs, access providers would be subject to certain recordkeeping, reporting, disclosure, and anti-fraud requirements. As for broker-dealer access providers, they would be subject to a separate

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regulatory regime—one sensitive to the new technology's potential to transform investors into the functional equivalent of local members of such foreign markets. As contemplated by the SEC, broker-dealer access provider regulation might resemble that of SIPs, but with additional requirements, such as mandatory disclosure to customers of the risks relating to trading on foreign markets.

In addition to identifying these two basic categories of access providers, the SEC also discussed possible conditions relating to the type of investors and securities involved in cross-border trading. For example, the Concept Release entertained the possibility of limiting access to certain sophisticated U.S. institutional investors; it also solicited views on whether the current practice of allowing both institutional and non-institutional investors to buy unregistered foreign securities made sense within the new context of real-time online cross-border trading.

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The Concept Release drew wide-ranging responses from both foreign and domestic markets. For example, the London Stock Exchange commented that in lieu of applying any specific category of U.S. registration requirements to foreign markets, the SEC should focus on the characteristics of each foreign market and compare such market's standards with those of a domestic market.[10] The New York Stock Exchange, on the other hand, commented that providing any additional regulatory relief to facilitate cross-border trading activities beyond what is currently permissible under Rule 15a-6 was not warranted and that "any foreign market that does business in the United States should be subject to regulation substantially similar to U.S. markets."[11]

As discussed above, the SEC has taken no further steps since the 1997 Concept Release to overhaul the regulation of cross-border trading. Therefore, it is still too early to predict how the issues raised in the Concept Release ultimately will be resolved. What is clear, however, is that the SEC cannot wait much longer.

In March of this year, the SEC granted an exemption from national securities exchange registration to the Tradepoint Stock Exchange, a for-profit screen-based electronic market that facilitates the trading of certain foreign securities listed on the London Stock Exchange.[12] The Commission based the exemption on the fact that Tradepoint will effect only a limited number of transactions. With Tradepoint reportedly handling 160 million shares a month (compared to the London Stock Exchange's 1.1 billion shares a day at the time the exemption was pending), that conclusion would appear justified.[13] In early May, however, a consortium of major firms led by Instinet Corporation, which includes Morgan Stanley Dean Witter & Co., J.P. Morgan & Co., and Archipelago L.L.C., announced plans to acquire a majority interest in Tradepoint's operator, Tradepoint Financial Networks PLC.[14] The investment promises to boost Tradepoint's profile and increase its trade volume.

CFTC Approaches

Like the SEC, the CFTC has been grappling with the novel issues raised by technological advances promising U.S. investors a seamless link to foreign markets. Historically, however, the two regulators have differed in their approach to regulating cross-border trading. The SEC focuses on foreign market intermediaries and their contacts with U.S. investors. In comparison, the CFTC has focused directly on the cross-border activities of foreign futures exchanges and considered their potential status as domestic "contract markets" under the Commodity Exchange Act ("CEA"). Under Section 4(a) of the CEA, unless specifically exempted, transactions in futures contracts in the United States must take place on, or subject to the rules of, a designated contract market and must be executed by or through a member of the contract market.

In 1996, the Deutsche Terminborse ("DTB"), which since has merged with another market to form Eurex, was the first foreign futures exchange to seek and receive a no-action letter from the CFTC staff.[15] The staff approved DTB's request to install its trading terminals in the U.S. offices of its member firms based on the following representations in the no-action request:

- The DTB members using the terminals to

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place orders on behalf of U.S. customers would be registered with the CFTC as futures commission merchants ("FCMs");

- The CFTC staff would have access to the members' relevant books and records; and
- DTB was a "bona fide" foreign futures exchange primarily engaged in business in Germany.

After issuing the DTB letter, however, the CFTC declined to process any further requests for no-action letters, deciding instead to develop a comprehensive framework for governing cross-border trading through determinate rules.

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In March of this year, following its 1998 Concept Release, the CFTC issued a proposal for regulating cross-border trading.[16] Under the contemplated framework, U.S. investors could use online trading systems to enter orders for futures contracts listed on automated foreign boards of trades, provided that the systems met certain minimum safety standards. The proposed rules distinguish between two different types of automated trading systems: direct execution system ("DES") and automated order routing system ("AORS"). The term "DES" encompasses any automated system that is not an AORS and that allows orders to be placed with a foreign board of trade where, "without substantial human intervention, trade matching takes place."[17] An AORS, on the other hand, is a system on which investors submit orders "through another party"—typically, an FCM—for transmission to an automated foreign board of trade for execution.[18] The primary distinction between DESs and AORSs is that an AORS is accessible to investors, while a DES is accessible only to the members of the sponsoring foreign board of trade. Investors can have indirect access to a DES by entering orders through an AORS to a member.

Under the CFTC's proposal, a foreign market would have been able to place DES terminals in the United States, provided that it petitioned the CFTC for exemption from designation as a contract market and met certain specified conditions, including those relating to its "home country" regulation:

- The home country must have an established regulatory scheme "generally comparable" to that of the United States;
- The system must be "approved by the petitioner's home country regulator following a review . . . that applied the standards set forth in the 1990 International Organization of Securities Commission's report on screen-based trading systems . . . or substantially similar standard"; and
- The petitioner must enter into satisfactory information sharing arrangements involving the CFTC and its home country regulator.[19]

AORSs were to be subject to similar conditions before U.S. investors could access the foreign market through such systems. In addition, an FCM (or firm exempted from FCM registration) operating a qualified AORS would have assumed certain recordkeeping and consumer-protection requirements.[20] Notably, the firm must have been able to block, "on a unilateral and immediate basis," any use of the AORS where necessary or appropriate for the protection of the firm and investors.[21]

The chief proponent of the proposed rules was the former CFTC Chairperson Brooksley Born, who recently left the agency in the midst of much controversy generated by the proposal.[22] The other three commissioners—Barbara Holum, David Spears and James Newsome—believed that the proposed requirements were overly complex and unduly burdensome, and they publicly opposed the proposed regulatory framework from the outset.[23] The public comments filed with the CFTC subsequent to the publication of the release made it clear that their concerns were echoed by many industry participants. In particular, the proposal was criticized for requiring foreign markets to seek a specific exemption from the contract market designation and then conditioning such exemption, in part, on the so-called "generally comparable" home-country regulation.[24] Neither requirement was imposed in the CFTC's no-action letter to DTB.

Following closely on the heels of Born's June 1

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departure, the CFTC withdrew its proposal on June 2.[25] This development did not take the futures industry by surprise, as the three commissioners previously had written a letter to Born requesting her to withdraw the proposal in favor of more streamlined regulation.[26] Simultaneously, the CFTC lifted its moratorium on no-action letters to foreign markets and their online trading systems. Effective immediately, the CFTC staff may respond to no-action requests from foreign futures markets seeking to provide electronic access on a cross-border basis.

Indeed, on July 23, staff in the Division of Trading and Markets issued a no-action letter to the London International Financial Futures and Options Exchange ("LIFFE"), permitting that exchange to make its system available to its members and their customers in the United States without being designated as a contract market under Section 5 of the CEA.[27] The LIFFE letter is expected to address the concern that Eurex has enjoyed a competitive advantage for the past three years while U.S. investors' access to other foreign futures markets was impeded by the moratorium. The LIFFE letter shares many similarities with the DTB letter: Both are premised on the notion that the U.S. contract market designation may not be appropriate for "bona fide" foreign markets that are already subject to a credible regulatory regime abroad.

The staff's response to LIFFE, however, includes a few new requirements. For example, LIFFE members seeking to use the trading system in their U.S. offices must appoint a U.S. agent for service of process. More important, when an LIFFE member that is also registered as an FCM accepts an electronic order from a U.S. investor using an AORS, that order must be "intermediated" by the FCM, subject to existing regulatory requirements and any additional requirements that the CFTC may impose in the future. At present, it is not clear exactly what an FCM must do to satisfy this "intermediation" requirement. For instance, must the FCM be able to block any customer use of AORSs unilaterally, on a real-time basis, in a manner similar to that proposed by the CFTC in its March release?

Similarly, it remains to be seen how much further competition and market innovation will flow from the no-action letter process. When the CFTC lifted the moratorium, it deliberately declined to provide any specific guidelines, preferring instead to review each request for cross-border trading on a case-by-case basis. While the CFTC might argue that such discretion is necessary in order to respond to new market developments in a flexible manner, it is also true that opponents can use regulatory uncertainty to stall the introduction of new trading systems. For example, U.S. futures exchanges criticize the CFTC's decision to lift the moratorium as a regulatory accommodation that grants an unfair advantage to their foreign competition.[28] Sensitive to these concerns, CFTC staff may subject each new no-action request by a foreign market to intense review and scrutiny. Despite the DTB and LIFFE letters, the process might be more time-consuming than expected.

Conclusion

Recent developments at both the SEC and the CFTC indicate that regulators are still struggling with the ramifications of technology, as the familiar distinctions between domestic and foreign markets disappear. There is an increasing asymmetry between the emerging world of global electronic trading and the traditional notion of regulation based on geographic space.[29] While the SEC and the CFTC remain mired in the regulatory dilemmas posed by cross-border trading, the continuing globalization of investment opportunities leads more and more U.S. investors to seek access to foreign markets in one form or another (whether electronic or manual).

[R]egulators must continue public debate on how to define a set of comprehensive standards governing electronic access to foreign markets.

The demands of this rapidly evolving market threaten the long-term sustainability of a case-by-case approach to regulation. Indeed, regulators must continue public debate on how to define a set of comprehensive standards governing electronic access to foreign markets. With improved regulatory certainty, sponsors of online systems can offer the benefits of technological innovations

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to U.S. investors without incurring the undue costs and delays associated with an individualized approval process. This outcome will promote greater efficiency and competition in the global market for financial services.

Looking to the future, however, it is still difficult to predict the next steps. Both the SEC and CFTC must resolve conflicting policy demands as well as complex jurisdictional considerations. Global harmonization of regulatory oversight is one approach, but not a pragmatic one. Or, more carefully stated, global harmonization usually occurs at the rhetorical level, rather than at the practical level. An alternative approach based on home country regulation and deference to foreign regulatory authorities, however, seems equally impracticable. Witness the recent financial scandals involving multinational institutions such as the Bank of Credit & Commerce International[30] and Barlow Clowes.[31] A new regulatory framework is likely to emerge only in an incremental manner, as regulators haltingly grope forward with some combination of informed investor consent (e.g., "fend for themselves"); jurisdictional accommodation (e.g., "consent to service"); and *de facto* minimum standards across the territorial boundaries.[32] In the short run, this means that regulatory transparency will remain an elusive goal from the standpoint of both global investors and providers of cross-border trading technology.

Footnotes

1. *See* SEC, Release No. 34-38672, 62 Fed. Reg. 30485 (June 4, 1997); CFTC, Concept Release on the Placement of a Foreign Board of Trade's Computer Terminals in the United States, 63 Fed. Reg. 39779 (July 24, 1998).
2. Release No. 34-4199 (March 22, 1999).
3. Access to Automated Boards of Trade, 64 Fed. Reg. 14159 (Proposed March 24, 1999) (to be codified at 17 C.F.R. pts. 1 & 30).
4. *See, e.g.*, Mark Hendrickson, *CFTC Drops Moratorium on Foreign Exchanges' E-Access,* Securities Industry News, June 7, 1999, at 7.
5. Rule 15a-6 defines foreign broker-dealers as those entities that are organized and operating outside the United States whose activities, if conducted in the United States, would fall within the definition of "broker" or "dealer."
6. 62 Fed. Reg. at 30521.
7. *Id.* at 30522.
8. *Id.*
9. *Id.*
10. *See* letter from Dan Sheridan, Head of Market Regulation, London Stock Exchange, to Richard Lindsey, Director, Division of Market Regulation, dated September 2, 1997.
11. *See* letter from Daniel Parker Odell, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated October 17, 1997.
12. Release No. 34-4199 (March 22, 1999).
13. *Id.* at 2.
14. "Consortium Acquiring Majority Stake in Tradepoint Announce New Member," Bloomberg News Service, May 12, 1999.
15. C.F.T.C., No-Action Request To Permit DTB Screen Trading in the United States, Comm. Fut. L. Rep. ¶ 26,669 (1996).
16. *Supra* note 3.
17. Proposed 17 C.F.R. § 30.11.
18. *Id.* at § 1.3(tt).
19. *Id.* at § 30.11(b)(1)(i)-(vi).
20. *Id.* at § 1.71(b)(3)-(8).
21. *Id.* at § 1.71(b)(6).
22. *See, e.g.*, Cheryl Strauss Einhorn, Born Legacy: Brooksley Leaves CFTC in Turmoil, Barron's, May 17, 1999; Katherine M. Reynolds, Most of CFTC Aims to Allow Computer Access to Foreign Futures, Bloomberg, May 12, 1999.
23. *See* 64 Fed. Reg. at 14178 (Barbara P. Holum, David D. Spears, and James E. Newsome, concurring).
24. *See* Phyllis Diamond, International Developments: Comparability, Competitive Concerns Frame Debate over Foreign Terminals in U.S., Securities Regulation & Law Report, April 23, 1999 <http://pubs.bna.com>.
25. CFTC, Order of the Commission, June 2, 1999 <http://www.cftc.gov/opa/press99/foreignterminal.pdf>.
26. *See* Einhorn *supra* note 22.
27. CFTC, No-Action Response, July 23, 1999 <http://www.cftc.gov/tm/letters/99letters/liffe%20no-action.htm>.
28. *See* Domestic Futures Exchanges Oppose CFTC Plan for Foreign Boards, Securities Law Daily, June 29, 1999.
29. *See* Becker & Westbrook, Confronting Asymmetry: Global Financial Markets and National Regulation, 1 Int'l Fin. 339 (1998).
30. John Kerry and Hank Brown, 102d Cong., 2d Sess., The BCCI Affair, A Report to the Committee on Foreign Relations, United States Senate (Sen. Print 102-140) (1992).
31. Lever, *Barlow First Is Closed in Gibraltar*, The Times (London), June 10, 1988, at 25.
32. *See* Charlies E. Lindblom, *The Science of "Muddling Through,"* in The Politics of the Federal Bureaucracy 130 (Alan A. Altschuler & Norman C. Thomas eds. 1977).

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