

Regulatory Schizophrenia

By Stephen J Nelson of The Nelson Law Firm

Originally Published in *Traders Magazine* on March 6, 2008

<http://www.tradersmagazine.com/news/100310-1.html>

As discussed in prior columns, the SEC determined over forty years ago that foreign issuers of securities traded over-the-counter (OTC) would not be required to provide the disclosures required by U.S. issuers, so long as they filed the disclosures made in their home country markets with the SEC. This exemption from the registration requirements of the Securities Exchange Act of 1934 is sometimes called the “information-supplying exemption.”

The information supplying exemption was based on the premise that foreign issuer disclosure had improved to the point where it would be sufficient to protect U.S. investors. However true that was forty years ago, it is certainly true that issuer disclosure generally has improved considerably over time in every market.

But, does the SEC really believe their public statements that foreign issuer disclosure is sufficient to protect U.S. investors?

The question recently bubbled to the surface at a meeting of OTC traders in Jersey City. A representative of FINRA, speaking on behalf of the Bulletin Board, was asked when FINRA intended to disseminate real-time trade reports for foreign securities.

A bit of background may be useful here.

In 1992, FINRA required market makers to report their trades in OTC Equity Securities within 90 seconds, completing a regulatory initiative that started about five years earlier. Regulators, of course, can use this data to monitor the quality of trade executions. In addition, however, these trade reports to FINRA are sold as market data to Reuters, Bloomberg and other market data vendors. This means that brokerage firm clients that subscribe to market data services can instantly determine whether they have received a good execution. In short, trade reporting is a very effective way of making sure that market makers are providing best execution. Customers who believe they are not being well-served take their business elsewhere, a much more effective way of achieving compliance than an entire arsenal of regulatory fines and sanctions.

Initially, the move to real-time trade reporting was resisted by industry old-timers, who argued that other firms would use this information to determine their trading strategies. However dubious at the time, this argument seems rather quaint nowadays. Younger traders instantly realized that what goes around, comes around. The trade tape, which is how the public sees trade reports, is an effective

way of pointing out to customers how much you love them, as compared to how your competitors treat them. Moreover, customers are more willing to trade, if they believe the game is fair. The trade tape does a lot to convince customers that they are getting treated fairly, and this is good for business.

For technical reasons, real-time trade reporting was not required in 1992 for foreign securities, including American Depositary Receipts (ADRs). These securities presented some unusual systems issues, and FINRA requested more time from the SEC to do the necessary programming.

For many years, the SEC pressed FINRA to require real-time trade reporting for foreign securities, which was accomplished a few years ago. But, these reports were not disseminated to market data vendors. FINRA receives these reports, but customers do not have access to them. Instead, customers, and other traders, get market summaries at the end of the day. This behavior seemed odd because FINRA makes money from disseminating data, so it is in their interests to produce more of it.

The question presented at the Jersey City traders' meeting was really questioning FINRA's odd behavior. The response of FINRA's representative was shocking. He reported that FINRA was ready to go on this. But, the SEC was holding them up because of their concern that real-time trade reports would encourage more trading in unregistered foreign securities.

Say it ain't so. Lawyers immediately called the SEC, expecting a prompt denial of this outrageous claim. But, it was so.

It turns out that the pressure on FINRA to disseminate real-time trade reports to the market came from the SEC's Division of Trading and Markets. As the name suggests, this is the Division of the SEC responsible for market regulation and broker-dealer supervision. The direction to hold things up came from the SEC's Division of Corporation Finance, or "Corp Fin," as it is affectionately known by the securities bar. This is the Division that regulates issuer disclosure. It is also the largest of the SEC's Divisions, the recipient of most of the SEC's revenues, and far and away its most powerful group.

What this means is that Corp Fin is willing to risk harm to investors at the hands of their brokers to discourage them from trading unregistered securities. This also means that Corp Fin doesn't really believe that foreign disclosure has improved to the point where it provides adequate protection for investors, thereby eliminating the need for registration. And Corp Fin apparently has the power to overrule Trading and Markets on an issue that has to do with markets, not issuer disclosure.

This is regulatory schizophrenia, a form of insanity for which there is no obvious cure.

The ugly truth is that Corp Fin is not comfortable with foreign disclosure. It simply lacks the ability to make foreign issuers comply with U.S. disclosure standards. Corp Fin also can't convince U.S. investors not to trade the stuff. So, it attempts to discourage trading by limiting market disclosure.

It is probably true that people will avoid playing a game they believe is rigged. Real-time trade reports are good for business because they help convince investors the game is fair.

That said, it is strange regulatory policy that protects investors by intentionally exposing them to harm.

It is said that the best is enemy of the good. We might not be able to make foreign issuers live up to our disclosure standards. But, we do have the power to regulate U.S. markets and therefore make sure that trading in foreign securities in our OTC markets is efficient and that investors are treated fairly. It is folly to sacrifice this great virtue in a vain pursuit of an unattainable ideal.

* * * * *