TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES & EXCHANGE COMMISSION

CONCERNING RECENT MARKET DEVELOPMENTS IN JAPAN

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

APRIL 17, 1992

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Riegle and Members of the Committee:

Thank you for the opportunity to address the recent developments in the Japanese securities market and the implications of international market developments for U.S. markets. In particular, I would like to review briefly the importance of strong clearance and settlement systems to the securities markets of both the U.S. and Japan.

I. Review of Recent Developments

A. Background: Characteristics of the U.S. and Japanese Securities Markets

Since 1948, when Japan enacted a new Securities and Exchange Law ("SEL") patterned after the U.S. securities laws, and 1949 when the new Tokyo Stock Exchange ("TSE") started operation, certain points of similarity between the U.S. and Japanese securities markets have been readily observable. The total equity market capitalization of U.S. markets as of April 15, 1992, was approximately $4.2 trillion, while the total capitalization for the securities traded on the TSE for April 16, 1992, was $2.3 trillion (in U.S. dollars). 1/ There is significant retail investor participation in both markets, and major

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1/ The market capitalization of the London market was about $1 trillion in 1991 (in U.S. dollars).

broker-dealers and institutional investors from the U.S. and Japan participate actively in both markets.

While the U.S. and Japanese securities markets share certain similarities, there also are differences that may affect the way the two markets operate, both in isolation and in relation to one another. For example, the structure of share ownership in Japan is such that Japanese corporations hold approximately 70% of all outstanding stock. This corporate "cross-shareholding" has shaped much of Japan's business life. As a result, the public "float" of the stock of most Japanese corporations is drastically smaller than that of major U.S. corporations.

The U.S. securities market is characterized by multiple exchanges and an active over-the-counter ("OTC") market. While the Japanese securities market has multiple exchanges, its OTC market is, relative to the U.S., inactive. More importantly, the number of the securities in the two markets differs. At the end of 1991, over 2,000 companies were listed in Japan, of which approximately 1,640 were quoted on the TSE. In addition, the securities of fewer than 300 companies were traded on the OTC market. By contrast, the U.S. securities market is more diverse in terms of the number and variety of issues traded. About 8,000 different securities are listed on securities exchanges or quoted in NASDAQ in the U.S. Another 8,000 securities are traded in the portion of the OTC market known as the "pink sheets," now served by the National Association of Securities Dealers' Inc. ("NASD") "bulletin board."

Likewise, the number of professional intermediaries in the Japanese securities market is smaller than in the U.S. For instance, in 1991, only 272 securities companies were licensed in Japan; 125 of those were members of the TSE. By contrast, in 1991,

approximately 8,800 registered broker-dealers operated in the U.S., and approximately 500 of these were members of the New York Stock Exchange ("NYSE").

Not only are the investors and the markets different: our approaches to the regulation of the markets also have differences, even though much of the Japanese statutory framework was patterned after U.S. laws. Disclosure systems, accounting principles, licensing and regulation of intermediaries, market access and many other areas involve significant differences between the U.S. system and that of Japan, despite the surface similarities of our systems. Among other differences, Japan still maintains fixed commissions for brokerage transactions, though the U.S. and virtually every other market has long since abandoned these price controls.

Like the market itself, the regulatory system in Japan differs significantly from that of the U.S. despite certain structural similarities. For example, Japan's stock exchanges act as self-regulatory organizations, just as in the U.S. exchanges act as self-regulatory organizations ("SROs"). There also is an umbrella SRO -- the Japan Securities Dealers Association -- like the U.S.'s NASD. Nonetheless, commentators have often noted that the operation of the overall regulatory structure is unique to Japan. The U.S. approach to regulation and oversight is characterized by the transparency of our regulatory regime -- all proposed rules and comments regarding the markets are discussed in a public forum and published for all to see. The Ministry of Finance's traditional system of administrative guidance, or gyoseishido (informal recommendations on courses of action related to the securities market), does not provide the same level of transparency of regulation. In addition, our counterpart agency within the Ministry of Finance does not have any authority to take civil enforcement actions comparable to that of the Commission.

B. Japan's Participation in the U.S. Securities Markets

Japanese investors play an important role in both the U.S. equity and debt markets. Japanese investors remain the largest foreign participants in the U.S. bond market, but their percentage share of participation has declined. In 1989, Japanese purchases and sales totaled $1.95 trillion, but that number had fallen to $1.3 trillion by 1991. As of year-end 1991, Japanese investors actually held only approximately $78 billion, or less than 2%, of total U.S. government and government-related debt. Japanese holdings of corporate debt were approximately $18 billion, or 1.1% of over $1.6 trillion in outstanding corporate bonds.

In the U.S. corporate equities market, Japanese investors are the second largest group of foreign investors. Japanese purchases and sales of U.S. equity securities totaled over $104.6 billion in 1988. However, the total value of Japanese trading in U.S. equities has fallen sharply in subsequent years. In 1991, the total dollar value of Japanese trading in U.S. equities was only $47.4 billion. At year-end 1991, Japanese investors actually held approximately $20 billion worth of U.S. equities, representing about 0.5% of U.S. market capitalization.

C. U. S. Participation in Japanese Securities Markets

In 1991, U.S. investors purchased and sold a record $939 billion of foreign securities ($274 billion in equity and $665 billion in debt). In terms of gross purchases and sales, Japanese securities were the second most actively traded foreign securities by Americans. In 1991, Japanese stocks comprised 20% of Americans' foreign equity transactions, and Japanese bonds accounted for 13% of U.S. trading in foreign debt securities.

D. Chronology of the Recent Market Decline in Tokyo

From its historic high of 38,915 set on December 29, 1989, the most widely followed stock index on the TSE, the Nikkei 225 stock index, declined 57% to its low of 16,598 on April 9, 1992. Since then it has rebounded slightly to 17,948 on April 15, 1992. 2/ During the same time, the Dow Jones Industrial Average ("DJIA") increased 22% (from 2,753 on December 29, 1989 to 3,353 on April 15, 1992). 3/

As of April 15, 1992, the Nikkei has declined 21.91% this year. The broader composite index of all common stocks on the TSE First Section, the TOPIX, also has declined by 22.90% during this period. 4/ In contrast, the most-widely followed stock index in U.S. markets, the DJIA has experienced a year-to-date gain of 5.84% in 1992.

Thus, in evaluating market developments in Japan, it is important to recognize that a major price correction has been underway for over two years. Importantly, this decline has been prolonged and gradual rather than short and precipitous. This has allowed market participants the greatest ability to adjust to the elimination of the speculative "bubble" that clearly had been created in Japanese stocks in the 1980s.

2/ See **Figure 1.**

3/ **Figure 2** provides a comparison of weekly closing values in both the Nikkei and DJIA from the December 29, 1989 high in the Nikkei to April 15, 1992. **Figure 3** indicates the relative changes in the two indexes using December 29, 1989, as a common starting point.

4/ This general market decline masks some large relative price changes in Japanese stocks. Bank and other financial services are down even more dramatically than the index, while some industrial issues are only down modestly.

The decline in all Japanese market indexes is somewhat larger when measured in dollars, due to a strengthening of the dollar against the yen. For an overview of the relationship between the U.S. Dollar and Japanese Yen since December 1, 1989, see **Figure 4.**

Despite the gradual manner in which this bubble has been deflated, there have been significant declines during the past few weeks. From March 2 to April 15, 1992, the Nikkei has declined 16.47% and the TOPIX has declined 15.32%. 5/ During this period, the Nikkei experienced six daily declines of over 3%, the greatest being the 3.95% decline on April 1, 1992. 6/ In contrast to the declines in the Nikkei exceeding 3%, the largest daily percentage decline in the DJIA during this period was the 1.89% decline on April 7, 1992. 7/

The recent declines on the TSE have occurred at the same time that trading volume has been sharply lower. Average daily trading volumes on the TSE have fallen from an annual high of 1.035 **billion** shares 8/ in 1988 to an average daily trading volume in 1992 of 243 **million** shares, a decline of 76.52%. 9/ This decline in trading volume will undoubtedly sharply reduce the income of Japanese broker-dealers, who depend on

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5/ **Figure 5** provides a comparison of daily closing values in both the Nikkei and DJIA from the March 2, 1992 to April 15, 1992. **Figure 6** indicates the relative changes in the two indexes using March 2, 1992 as a common starting point.

6/ None of the daily declines of less than 4% would be included in the top ten percentage declines in the Nikkei. On the other hand, the 7.55% gain in the Nikkei on April 10, 1992, was the fourth largest one-day percentage gain in the Nikkei. See **Figure 7**.

7/ See id. It may be worth noting that the 16.47% decline of the Nikkei during recent weeks represents only slightly more than one-half the decline the U.S. market experienced in 1987, when from Wednesday, October 14, 1987, through Monday, October 19, 1987, the DJIA declined 769.75 points, or 30.69%.

8/ While average daily share volumes on the TSE of over a billion shares may appear to dwarf daily volume figures for the NYSE, it is important to realize that the low average share price on the TSE and currency-conversion factors serve somewhat to inflate the TSE share volume figures. For example, the TSE 1991 Fact Book indicates average daily volume (for domestic stocks) in 1990 of 500 million shares, with a value of 758.8 billion yen. Using an average spot value for the yen in 1990 of 145 yen to the U.S. Dollar (figure from Bloomberg Financial Markets), this TSE average daily volume has a value of approximately $5.2 billion. The NYSE indicates that, for 1990, its average daily volume for domestic stocks was virtually the same, at $5.7 billion.

9/ See **Figure 8**.

commission income to a greater extent than their U.S. counterparts. This reduced trading volume may reflect many factors, one of which is public outrage over the massive scandals involving customer favoritism in the "loss reimbursement" practices of Japanese firms.

The price declines on the TSE since 1989 have brought the historically high price/earnings ("P/E") ratios on the TSE down to levels that are more common on other international markets. During the 1980s, the Japanese market enjoyed explosive growth in P/E ratios. Japanese stock prices averaged a P/E ratio of only about 20 in 1980, but rose to a multiple of over 70 times earnings by 1989. This nearly four-fold growth in price as a multiple of earnings exceeded the growth in any other major market by an order of magnitude. According to the TSE, the P/E ratios for stocks in the First Section have declined from a year-end high of 70.6 in 1989 to 37.8 in 1991. 10/ As of April 10, 1992, the P/E ratio for TOPIX had declined further to 30.6, compared to 27.1 for the NYSE composite index and 25.3 for the Standard & Poor's 500 stock index. 11/

E. Correlation of Price Changes between U.S. and Japanese Markets

Figure 11 provides a side-by-side comparison of daily percentage changes in the Nikkei and DJIA for the recent market declines from March 2 to April 10, 1992. The data to date provides little evidence that daily changes in the Nikkei have influenced prices in the DJIA later on the same trade dates to any appreciable degree on average.

10/ See **Figure 9.**

11/ See **Figure 10.** Of course "P/E" ratios cannot be compared directly due to very significant differences in the measurement and reporting of earnings in the two countries.

Several of the sharp daily price swings in the Nikkei in March and April have been followed by similar, but more moderate, price swings in the DJIA on the same trade dates. For example, some follow-through may have been evident on the following dates:

- The 3.50% decline in the Nikkei on April 7 was followed by a 1.89% decline in the DJIA.

- The 3.46% decline in the Nikkei on April 8 was followed by a 1.00% decline in the DJIA.

- Similarly, the 2.13% rise in the Nikkei on March 19 was followed by a 0.22% rise in the DJIA.

On the other hand, several other sharp declines in the Nikkei were followed by moderate rises in the DJIA later the same trade date.

- The 2.03% decline in the Nikkei on March 3 was followed by a 0.46% rise in the DJIA.

- The 3.03% decline in the Nikkei on March 16 was followed by a 0.01% rise in the DJIA.

- The 3.95% decline in the Nikkei on April 1 (the sharpest percentage decline in the review period) was followed by a 0.43% rise in the DJIA.

- In fact, the largest percentage rise in the DJIA during this period, the 1.37% rise on April 9 (following the easing in the Federal Funds Rate), occurred on the same trade date that the Nikkei experienced a 3.36% decline.

There also is little evidence in the data for March and April 1992 to support the inverse proposition, i.e., that daily price swings in the DJIA consistently have had a follow-through effect on the Nikkei on the next trading session. **Figure 12** provides a side-by-side comparison of daily percentage changes in the DJIA with the next trade date's percentage changes in the Nikkei from March 2 to April 9, 1992. 12/

- This graph does show that the largest percentage gains in the DJIA (1.37%) and the Nikkei (7.55%) did take place back-to-back on April 9 and 10, respectively.

- Similarly, the price declines of 1.89% and 1.00% in the DJIA on April 7 and 8, respectively, were followed on the next trading sessions by declines in the Nikkei 3.46% and 3.36%, respectively.

- On the other hand, the Nikkei's declines of 2.03%, 3.03%, 3.95%, and 3.50% on March 3 and 16 and April 1 and 7, respectively, were not preceded by previous day declines in the DJIA. 13/

12/ For example, in **Figure 12**, the 1.37% rise in the DJIA on April 9 appears side-by-side with the 7.55% rise in the Nikkei on April 10.

13/ On March 31, the DJIA rose 0.01% prior to the April 1 decline in the Nikkei of 3.95%. Due to the scale of **Figure 12** the 0.01% rise in the DJIA on March 31 is barely visible.

In addition, the Commission staff also has attempted to discern the relationship between stock price movements in the U.S. and Japan by "regressing" percentage changes in the DJIA on those of the Nikkei. For the period January, 1986 to April, 1992, the estimated relation between the indexes was 0.14, which means that, if the Nikkei declines 10%, the expected associated movement in the DJIA would be a decline of 1.4%. The Commission staff found, however, that the variation around this "expected" associated movement is very large, because, on average, movements in the DJIA and Nikkei explain only about 2% of the variation in the other index. 14/ In other words, while these types of analyses should not justify complacency, the staff's regression analyses would appear to be consistent with the view that past percentage changes in one market's index have been, statistically speaking, poor indicators of actual changes in the other market's index. 15/

A review of all the foregoing information makes it difficult to discern any significant direct correlation in price levels between the two markets. Indeed, events in Japan seem to represent the removal of a "bubble" caused by excess speculation, asset-inflation or other causes that were unique to Japan, and not replicated in the U.S., London, or other major world markets. As stock prices in Japan compared to underlying corporate earnings move closer to value levels in other major world markets, there is no basis for assuming that values in Japan would begin to show a decline below comparable world valuation levels. Given that the earning power of major Japanese publicly-held companies has proven strong

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14/ The Commission staff also performed the same regressions year by year. The amount of variation in one index that is related to variation in the other index was low for all years, on average close to the 2% obtained for the six year period. In one of the six years, 1989, the DJIA and Nikkei were, on average, negatively related.

15/ See, e.g., Eun & Shim, International Transmission of Stock Market Movements, 24 J. Fin. & Quan. Analysis 241 (1989); Hamao, Masalis & Ng, Correlations in Price Changes and Volatility Across International Stock Markets, 3 Rev. Fin. Stud. 281 (1990); and Becker, Finnerty & Gupta, The Intertemporal Relation Between the U.S. and Japanese Stock Markets, 45 J. Fin. 1297 (1990).

over a long period, it is more likely that both domestic and international investors would capitalize the value of those corporate earnings streams in a manner not less favorable than for the earnings of non-Japanese companies.

II. The Importance of Broker-Dealer Capital Standards

While there may not be any basis for assuming that the market in Japan represents a generalized threat to the U.S. market, from a prudential perspective the SEC constantly tries to assess the stability of the U.S. system in light of potential shocks emanating from outside the U.S. due to any of a variety of contingencies. Both the SEC's capital rules for broker-dealers and the U.S. clearance and settlement system are very important factors in seeking to provide the maximum resilience of the U.S. system.

A. Subsidiaries and Affiliates of Japanese Firms Doing Business in the United States

Approximately 30 registered broker-dealers doing business in the United States are subsidiaries or affiliates of Japanese companies. Though the Japanese companies are among the largest in the world, these U.S. affiliates are not as large as the very largest U.S. based broker-dealers. At December 31, 1991, the U.S. broker-dealer affiliates of the four largest Japanese securities firms had total capital of about $1.5 billion, or approximately 2.7% of all capital of all broker-dealers in the U.S.

B. United States Broker-Dealers Doing Business in Japan Either Directly or Through Affiliates or Subsidiaries

There are approximately 20 U.S. broker-dealers headquartered in the U.S. doing business in Japan either directly or through affiliates or subsidiaries. Although these entities have some exposure to the Japanese securities markets through proprietary positions in

Japanese securities, the exposure appears to be hedged and does not seem material in light of their global capital reserves.

C. Capital Standards in the United States

The Commission's net capital requirement mandates that each broker-dealer must maintain liquidity in excess of liabilities in order to cover potential market and credit risk associated with the broker-dealer's assets. 16/ The primary emphasis is on providing sufficient liquid assets to meet liabilities including customer and counterparty liabilities, and thus to prevent a failure of a firm from resulting in loss to customers or counterparties. By requiring broker-dealers to maintain liquid assets sufficient to satisfy their obligations, the net capital requirement provides a protective cushion without drying up the liquidity necessary to ensure the orderly operation of the securities market.

In addition to the basic net capital requirement, the net capital rule ensures the continued liquidity of broker-dealers by requiring them to mark their securities positions to market value every day. Even after securities positions are marked to reflect market value, the net capital requirement affords further protection by providing that a broker-dealer must deduct a certain percentage of the market value of all proprietary securities positions from its net worth. 17/ These percentage deductions, known as "haircuts," are intended to reflect the actual liquidity of the broker-dealer's proprietary positions by providing a cushion for

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16/ The Commission's rule provides two alternative methods for computing compliance with the net capital requirement. Under the basic method, a broker-dealer must have net capital equal to at least 6.67% of aggregate indebtedness (defined to exclude liabilities that are adequately collateralized by an asset). Under the alternative method of computing net capital, a broker-dealer must maintain net capital equal to at least 2% of its customer-related receivables.

17/ A broker-dealer computes its net worth in accordance with generally accepted accounting principles and then adds to that amount subordinated liabilities containing certain characteristics. Such subordinated liabilities are treated as akin to net worth in the capital computation.

possible future market losses in liquidating the positions. Finally, a broker-dealer may not include in its net worth calculation certain assets not readily convertible into cash.

If a broker-dealer fails to meet its minimum net capital requirement, it immediately must cease to conduct a securities business. In addition, the net capital rule contains early warning provisions specifying levels below which a firm's net capital should not fall. 18/ When a broker-dealer's net capital drops below the early warning levels, a broker-dealer must notify the Commission and must refrain from paying dividends or withdrawing equity capital in any form to pay shareholders or partners. The rules of some SROs also contain provisions restricting a broker-dealer's securities business when its net capital reaches early warning levels. These Commission and SRO restrictions are designed to prevent a broker-dealer from depleting its capital to the point that it cannot satisfy its minimum net capital requirement.

The rule also requires broker-dealers to notify the SEC and the appropriate SRO of large capital withdrawals made to benefit affiliates, subsidiaries and other persons related to the broker-dealer. The rule provides the SEC the authority to block certain withdrawals of capital that would expose the broker-dealer to an unacceptable level of financial risk. Finally, the rule also prohibits withdrawals of equity capital if the withdrawals would cause the broker-dealer's net capital to be less than 25% of the haircuts required by the net capital rule as to the broker-dealer's readily marketable securities.

The SEC's net capital rules are the highest in the world. These rules have enabled even the largest firms such as Drexel Burnham to be closed without any loss to customers or

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18/ The early warning level is 10% of aggregate indebtedness for firms electing the basic method, and 5% of aggregate debit items for firms using the alternative method.

any federal expenditures. Similarly, the capital requirements for Japanese broker-dealers are also very strong in global terms. These high capital requirements and the rigors of daily marking to market in the U.S. help prevent even the sharpest market price changes -- such as those experienced in October 1987 -- from leading to failures of major broker-dealer firms.

III. The Importance of Clearance and Settlement to the Securities Markets in the U.S. and Japan

As important as adequate capital is to a sound securities market, speedy and efficient clearance and settlement is perhaps the most important means of reducing systemic risk in securities markets. Indeed, if every securities trade could be simultaneously cleared and settled with same-day funds, a vast portion of credit risk would be eliminated from the world's securities markets.

A. Clearance and Settlement in the U.S. and Japan

Common to all clearance and settlement systems for securities transactions are a few basic processing steps. Generally, trades are reported by the marketplace to a comparison facility. Comparison is the process of ensuring that both sides to a trade agree to the essential terms of the trade, e.g., price, number of shares, and the identity of the other party to the transaction. Comparison can take place at a clearing corporation, such as National Securities Clearing Corporation ("NSCC"), or at a marketplace such as the NYSE or Philadelphia Stock Exchange. Comparison can also take place at the time of execution if trades are executed through an automated system on a "locked-in" basis. If the terms of a trade compare, processing continues. In the U.S. and Japan, comparison is completed by the morning of the day after the trade, referred to as "T+1."

The next processing step is "clearing," or accounting for settlement. Here systems differ widely among the world's clearing systems. In the U.S., most equity transactions among broker-dealers are cleared through continuous-net-settlement ("CNS") accounting systems operated by clearing corporations that are registered as clearing agencies with the Commission, e.g., NSCC. In CNS systems, the clearing corporation nets each broker-dealer's settling purchases and sales in each security to arrive at a daily net deliver or receive obligation in each security and a single net payment obligation for each broker. Broker-dealers then settle those net obligations with the clearing corporation. The clearing corporation guarantees the settlement obligations of each broker-dealer's contra trading party from the time they are reported as compared until settlement. Under the U.S. system, brokers can either deliver securities on the settlement date or they can carry open delivery commitments forward to net against the next day's settlement. In 1991, NSCC processed an average daily volume of approximately 517,000 transactions. The average daily volume of funds and securities settled through NSCC exceeded $36 billion in 1991.

In Japan, trades among broker-dealers on the TSE are cleared by the Japan Securities Clearing Corporation ("JSCC"), a wholly-owned subsidiary of the TSE. JSCC uses a netting system based on the number of shares traded and the payment due to or from each member broker. JSCC does not, however, net one day's obligations with the next day's obligations, so a failed trade drops from the system and must be reinstated between the parties at some later date.

The final processing step, settlement, involves the payment of money and delivery of securities. In the U.S., settlement takes place on the fifth business day after trade date, or T+5. Securities deliveries between the clearing corporation and its participants generally are made through automated bookkeeping entries to their accounts at a depository, such as

the epository Trust Company ("DTC"), which is also a clearing agency registered with the Commission. Securities depositories "immobilize" securities certificates, permitting electronic book-entry transfer of securities to settle securities transactions. In 1991, DTC, the largest U.S. depository, held on deposit corporate equity and debt securities, municipal securities and commercial paper valued at $5.5 trillion. In 1991, DTC processed 79 million book-entry transfers valued at $13.9 trillion. The average cost of clearing a trade through the U.S. system is far less than in most clearance systems in use around the world today.

Money settlement among broker-dealers for most trades in corporate securities in the U.S. is effected by means of certified checks passing between the clearing corporation and its members. Thus, settlement occurs in "next-day" rather than "same-day" funds. Most trades are processed through clearing corporations, with the clearing corporation being substituted as the contra party on the day after trade date. Nevertheless, a particular trade will not settle with certainty until six days after trade date. Though credit risk is "assumed" by NSCC on T+1, the bulk of its reserves are generated by a pool of funds from its members. Any sizable loss incurred by NSCC due to the failure of a party to a trade would, in essence, have to be absorbed by all member firms, creating the risk of a ripple effect. Thus, the slower the clearance process, the greater the risk that is created for the overall system.

In Japan, the standard settlement period is three business days after trade date, or T+3. A new centralized securities depository recently has begun operations, seeking to replace the physical transfer of paper certificates with U.S.-style book entry procedures. The Japan Securities Depository Center ("JASDEC") now settles by book-entry the majority

of broker-to-broker ("street-side") TSE transactions. JASDEC has approximately 5 billion shares on deposit with a U.S. dollar value of roughly $30-35 billion. 19/

Although TSE members are required, wherever practicable, to settle their securities delivery obligations on street-side transactions through JASDEC, money settlement takes place outside JASDEC, generally through settling banks often chosen by the TSE. Trading parties submit a check to TSE for the net amount owed to TSE for trades that have cleared, and subsequently TSE issues a check for the amount payable into the bank account of each net receiving member. 20/ Thus, trades in Japan are settled more quickly than currently occurs in the U.S., but payment is also made in funds that are not immediately available.

Settlement between broker-dealers and individual investors typically involves delivery of securities and payment of funds directly between the parties. Because the typical institutional investor engages a financial institution to hold its funds and securities portfolios as a custodian, the process is more complex and includes instructing the financial institution to release funds or securities against delivery or payment by the broker-dealer. In the U.S., securities depositories facilitate the comparison of trades between brokers and indirect market participants through Institutional Delivery ("ID") systems, which provide for automated confirmation and affirmation of trades by institutions, broker-dealers and

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19/ JSCC and International Securities Clearing Corporation ("ISCC"), a clearing agency subsidiary of NSCC registered under 17A of the Securities Exchange Act of 1934, operate a limited custody link through which ISCC sponsors an account for JSCC at DTC. Recent statistics for the ISCC/JSCC link indicate that the JSCC account generates approximately 2,500 book-entry transfers in a calendar quarter. The link facilitates efficient clearance and settlement of TSE member trades in Japan of U.S. securities; no such link exists that supports the trading of Japanese securities in the U.S.

20/ U.S. investors trading in Japanese stocks in Japan must do so through financial intermediaries who participate in the Japanese market. These investors, like their Japanese counterparts investing in the U.S., must have Japanese funds or securities available in Japan to meet their payment and delivery obligations just like any other Japanese investor.

custodian banks. In 1991, 94% of institutional trades in corporate equity securities and 77% of institutional trades in municipal securities were confirmed and affirmed through these automated facilities.

A small scale affirmation system, called Funds Information Relay System ("FIRST") has been implemented in Japan, permitting participating securities houses to access a communications network to report the results of the executed trade to participating trust banks by the evening of trade date or morning of the day after trade date.

B. Efforts to Strengthen Clearance and Settlement Systems

In the U.S. clearance and settlement system, clearing corporations, such as NSCC and the Options Clearing Corporation, attempt to contain the risk to the overall trading system from the failure of a market participant of significant size by maintaining strict financial and operational standards, sophisticated risk-monitoring systems, and clearing funds designed to mutualize the risk of a participant default. The U.S. system has proven capable of handling high volumes of trading and high levels of volatility. Past experience, however, has demonstrated areas where the system could be improved. In particular, the U.S. system should, in my view, be designed to clear trades faster, and to provide payment in immediately available funds.

A variety of groups have been working to strengthen clearance and settlement systems worldwide. These include the International Organization of Securities Commissions, and a private sector group called the "Group of Thirty." The Group of Thirty has proposed

nine standards for clearance systems worldwide, seven of which already were met by the U.S. system. 21/

The two recommendations not already met by the U.S. are settlement not later than T+3 and use of same day funds to settle securities transactions. A high-level Steering Committee composed of both broker-dealers and banks did extensive work analyzing the problems of converting to faster, T+3 settlement using immediately available funds. The study led the Committees to recommend four changes in the U.S. securities markets: depository-eligibility for all new issues; book-entry settlement for trades involving institutional customers; a T+3 settlement cycle; and use of same day funds to settle securities transactions.

The Commission hosted a Roundtable discussion in November 1990 and aired these and other issues with representatives of the securities and banking industries. Following this Roundtable, I asked John Bachmann, Managing Principal of Edward D. Jones & Co. of St. Louis, Missouri to lead an industry Task Force to identify more completely the specific changes that need to be made and the sequence of specific steps that should be taken to achieve the target goals. The Task Force Report will be issued shortly, and I believe it forms the basis for prompt action to begin implementing specific enhancements to the U.S. clearance and settlement system.

Of course there are costs to enhancing the clearance and settlement system to make it operate with greater speed and certainty. However, in any clearance system, time inevitably

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21/ The seven recommendations addressed the following matters: a central depository system, a two-sided comparison system for institutional trades, delivery versus payment, stock lending, study of the need for netting arrangements, T+1 comparison, and International Standards Organization protocols for securities codes and messages.

translates into risk, and today our risks are measured in trillions of dollars and the effect on tens of millions of investors in the U.S. alone. While there are many market risks that cannot be eliminated by laws or regulations, we can reduce significantly overall risk in the trading markets by strengthening the clearance and settlement system.

After nearly three years of detailed analysis in both the SEC and the private sector, it is now my firm belief that the time for implementation of these clearance and settlement reforms has arrived. Though our current system is very good, making it even more resilient is perhaps the single best way to protect the integrity of the U.S. trading market from any sudden shock resulting from either domestic or international events.

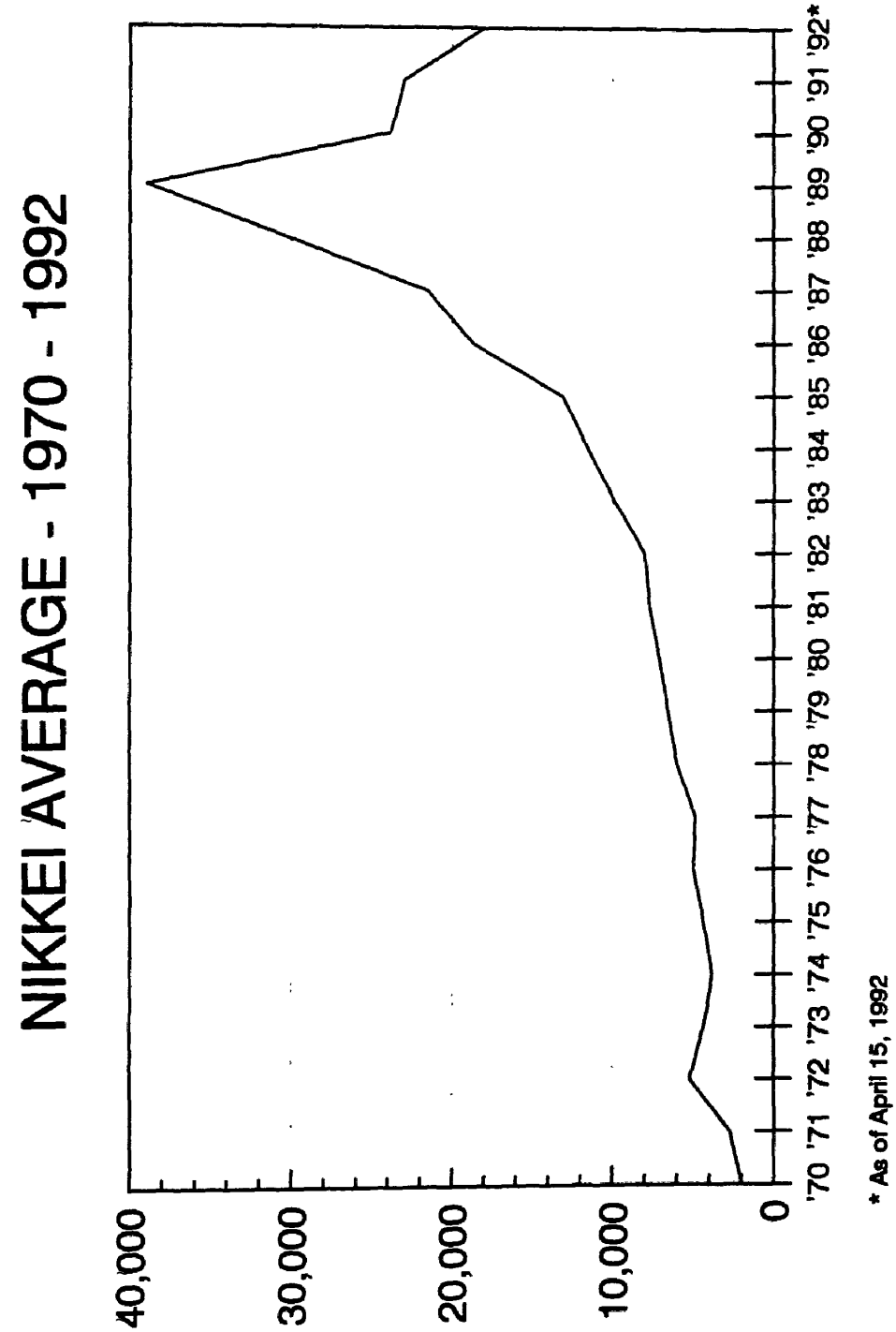
IV. Conclusion

There are many possible explanations for the recent market trends in Japan, ranging from macroeconomic developments to technical factors. There is no discernible basis for assuming that Japan's dramatically higher market valuations in the past decade, compared with other world markets, will be replaced by dramatically lower valuations than world markets in the next decade. If the Japanese market correction that has taken place to date stabilizes at current levels, the overall world market will not be exposed to the significant economic risk that the speculative bubble in Japanese stocks formerly represented. The SEC has a long and extensive history of close cooperation with the Japanese Ministry of Finance. We strongly value that relationship and plan to continue active consultations in the future on a wide range of supervisory issues designed to enhance the stability of both of these important markets.

Ultimately, free markets move both up and down. Any system that sought to prevent market forces from determining valuations ultimately would not succeed, and considerable

dislocation could result. Open, transparent and competitive markets coupled with sensible supervisory standards for markets and their participants can help ensure overall market stability and integrity. For the future, U.S. authorities can best foster a safe and stable marketplace through strong capital requirements based on the most recent market valuations, and a faster clearance and settlement system here at home, while seeking to promote healthy markets abroad through close consultation with our foreign supervisory colleagues. While the direct risk of developments in Japan to U.S. markets appears to be minimal, the reality of international markets means that the U.S. system needs to be designed to withstand economic shocks emanating from both domestic and foreign sources.

FIGURE 1


NIKKEI AVERAGE - 1970 - 1992
40,000
30,000
20,000
10,000
0
'70 '71 '72 '73 '74 '75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92*
* As of April 15, 1992

DJIA - NIKKEI CLOSING VALUES
DECEMBER 89 - APRIL 1992

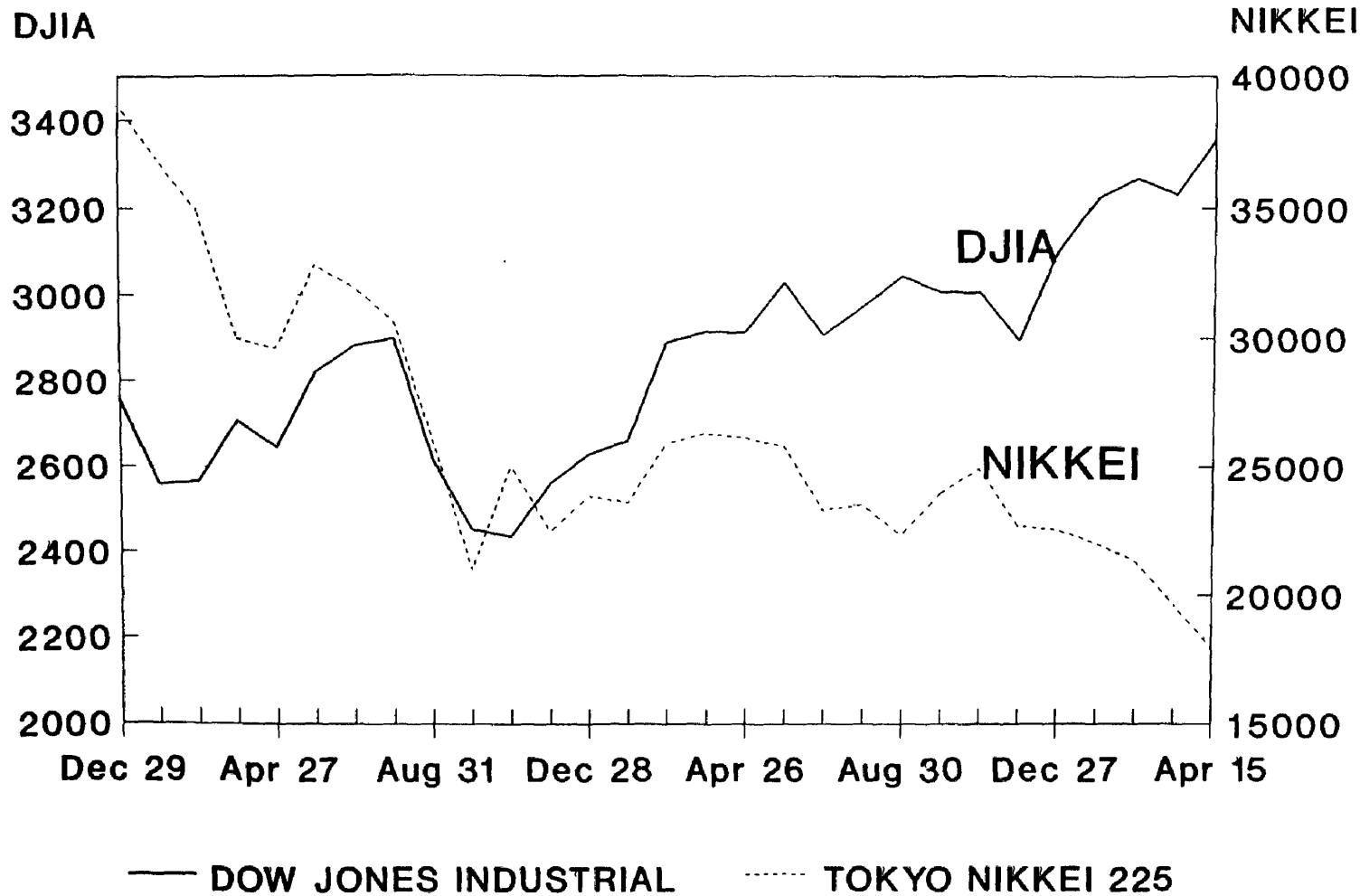


FIGURE 2

Monthly Data **April 92 - As of 4/15/92**

DJIA - NIKKEI COMPARATIVE CHANGES
DECEMBER 89 - APRIL 15, 1992

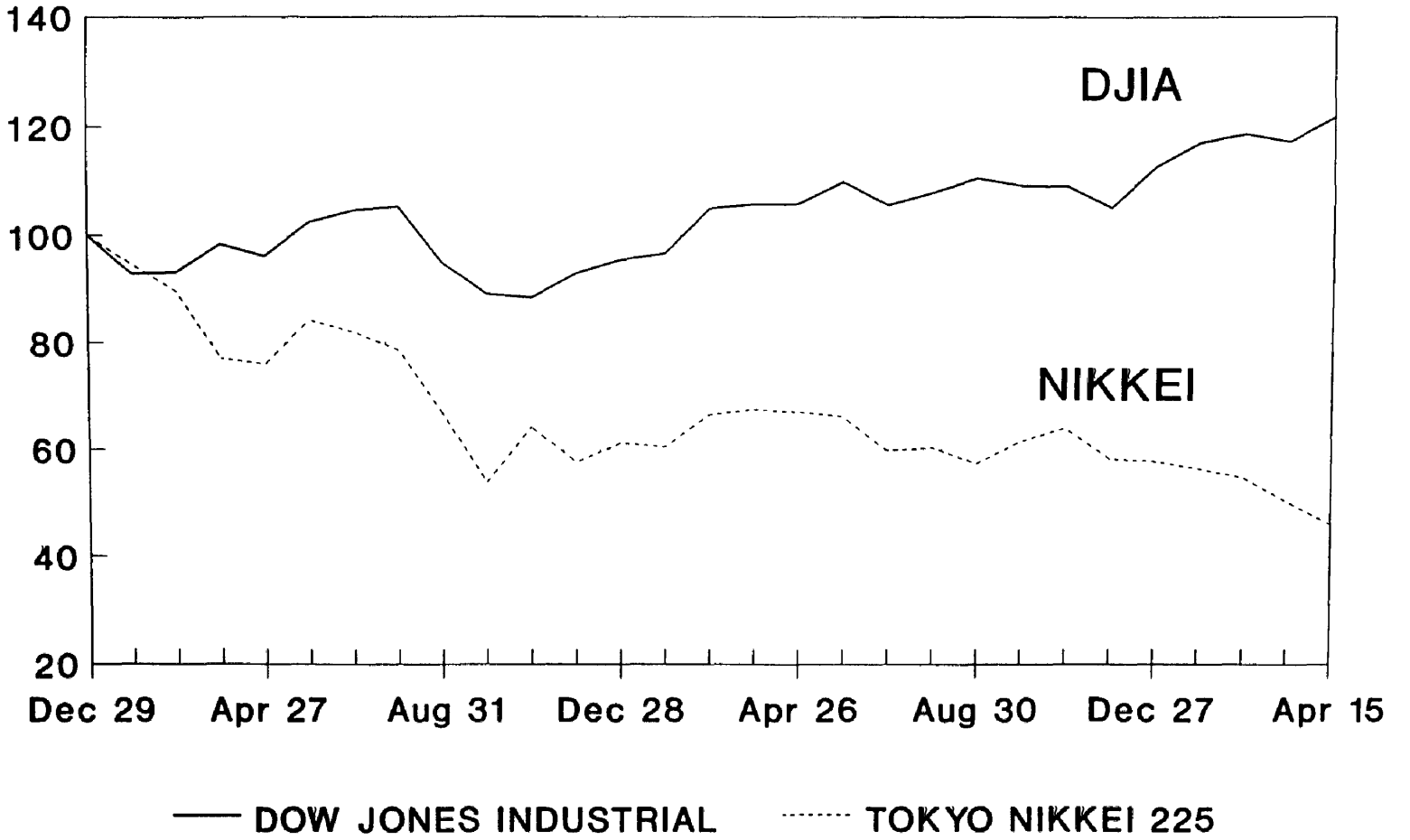
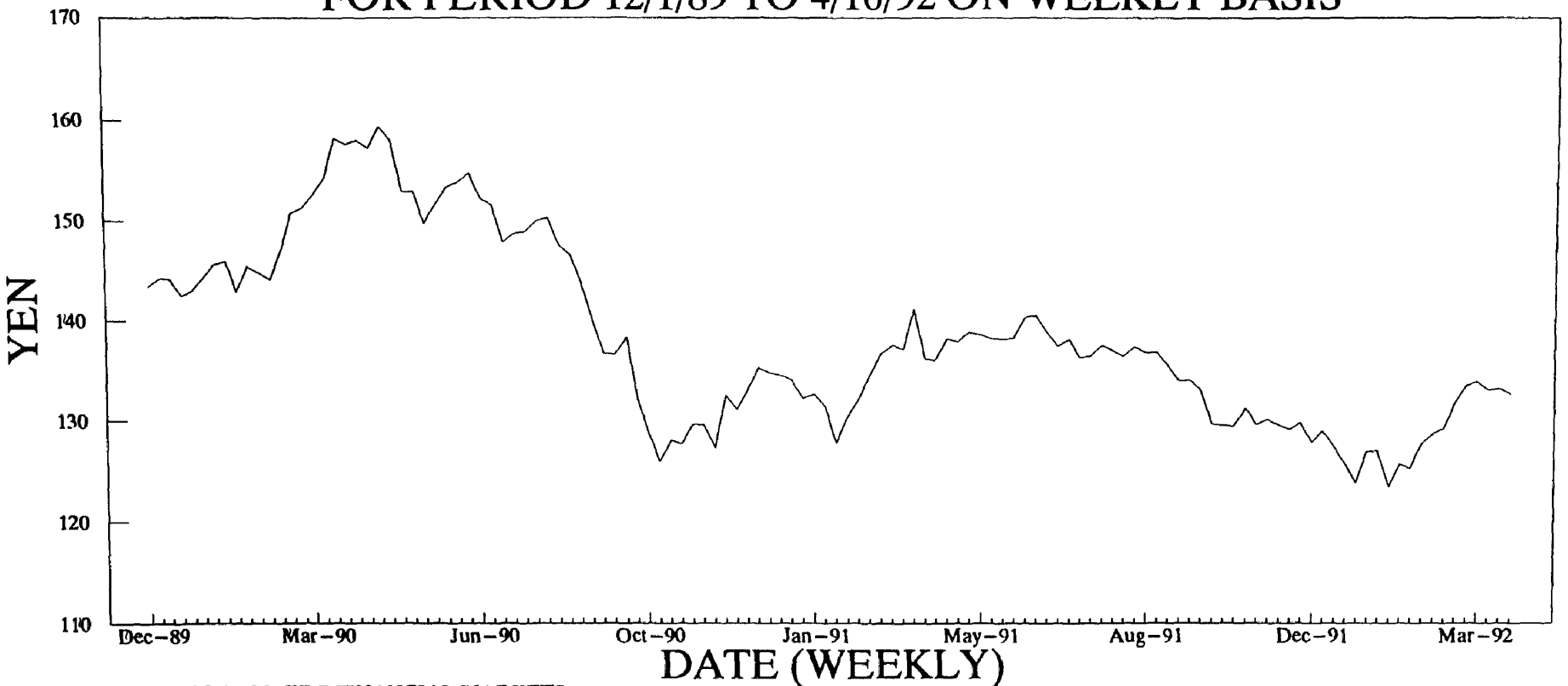


FIGURE 3

Note: 100 = 12/31/89 Monthly Data

JAPANESE YEN SPOT RATE

FOR PERIOD 12/1/89 TO 4/10/92 ON WEEKLY BASIS



DATASOURCE: BLOOMBERG FINANCIAL MARKETS

FIGURE 4

DJIA - NIKKEI CLOSING VALUES
MARCH 2 - APRIL 15, 1992

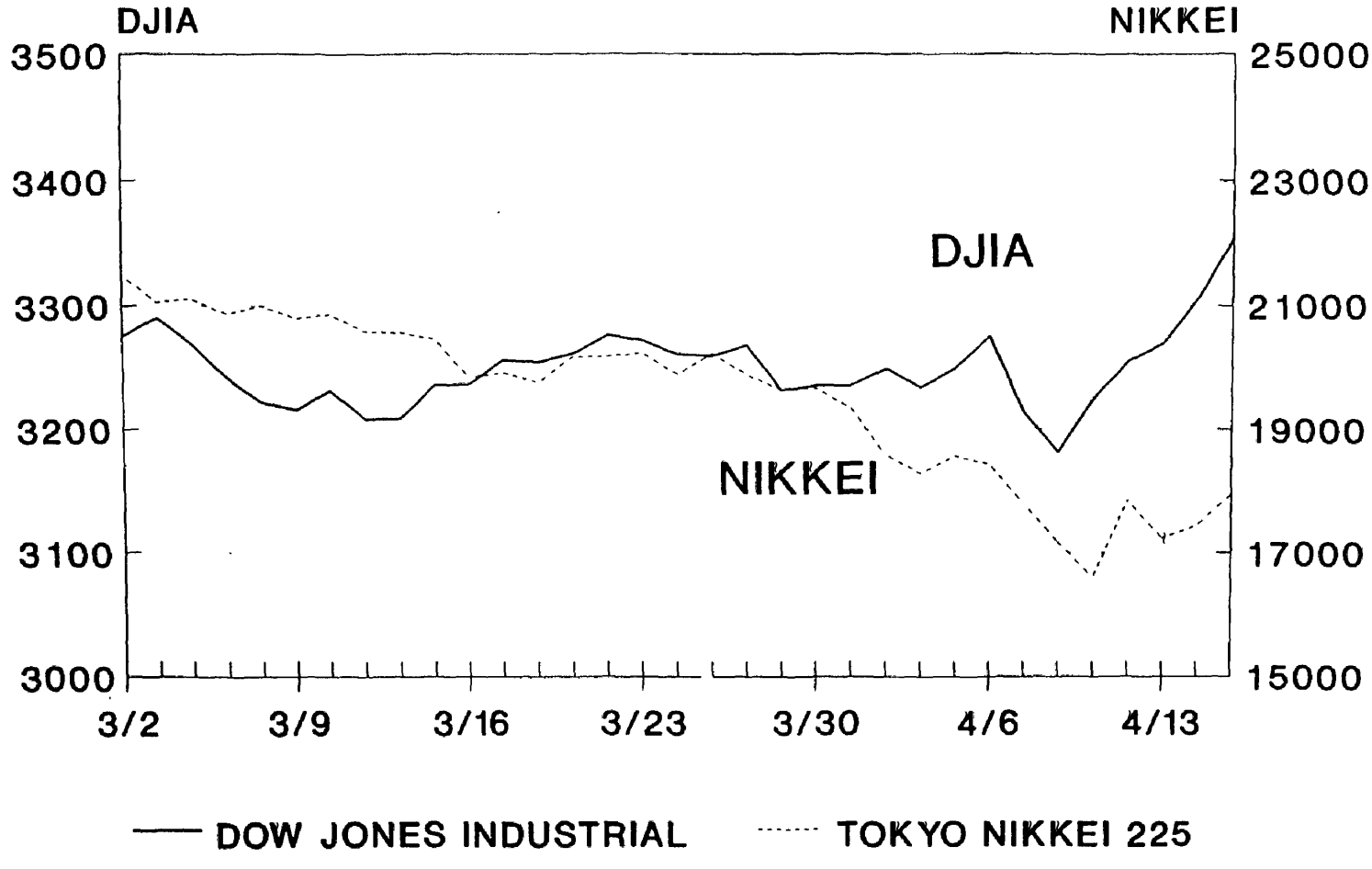
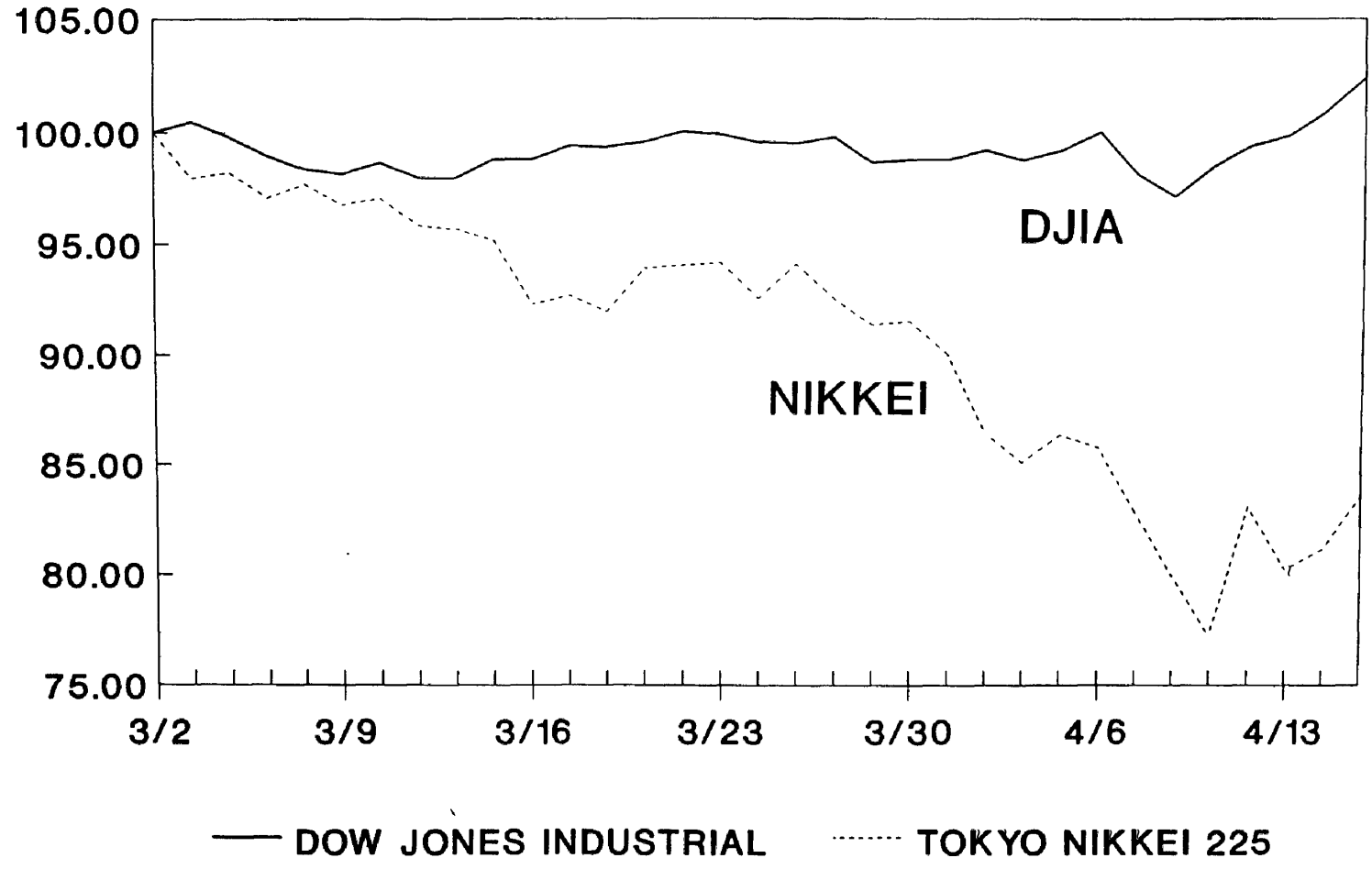


FIGURE 5

Daily Close

DJIA - NIKKEI COMPARATIVE CHANGES
MARCH 2 - APRIL 15, 1992



Note: 100 = MARCH 2, 1992 CLOSE

FIGURE 6

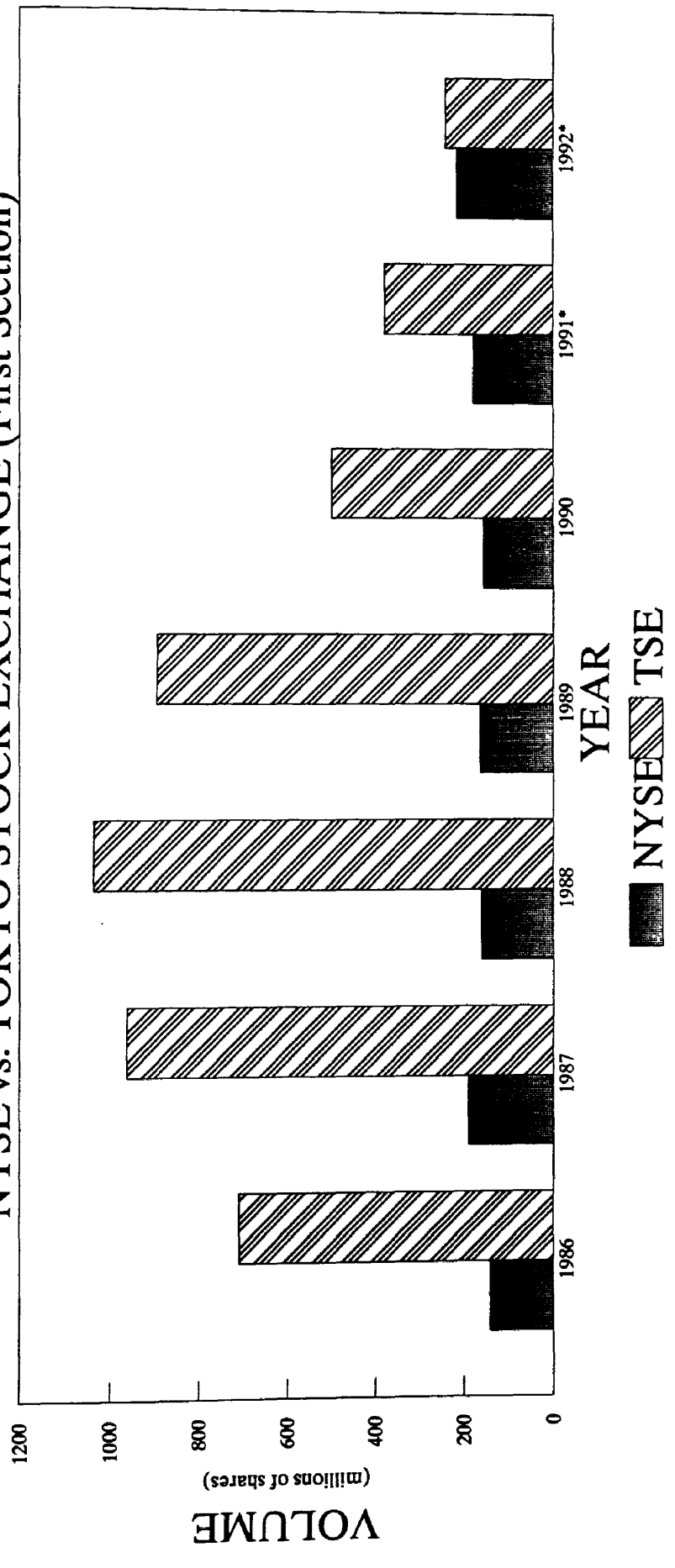
FIGURE 7

LARGEST % DECLINES IN NIKKEI		
DATE	% CHANGE	CLOSE
20-Oct-87	14.90%	21,910.08
05-Mar-53	10.00%	340.41
30-Apr-70	8.69%	2,114.32
16-Aug-71	7.68%	2,530.48
14-Dec-49	6.97%	98.50
30-Mar-53	6.73%	318.96
24-Jun-72	6.61%	3,421.02
02-Apr-90	6.60%	28,002.07
19-Aug-91	5.95%	21,456.76
19-Aug-71	5.93%	2,190.16

LARGEST % ADVANCES IN NIKKEI		
DATE	% CHANGE	CLOSE
02-Oct-90	13.24%	22,898.41
15-Dec-49	11.29%	109.62
21-Oct-87	9.30%	23,947.40
10-Apr-92	7.55%	17,850.66
16-Apr-53	6.41%	355.03
06-Mar-53	6.31%	361.88
06-Jan-88	5.63%	22,790.50
15-Jul-50	5.51%	103.82
15-Aug-90	5.40%	28,112.12
13-Feb-50	5.39%	112.94

DATA SOURCE: Quick America Corporation

FIGURE 8



DATASOURCE: NYSE data from NYSE
* TSE data from TSE 1991 Fact Book except 1991 and 1992 from NYSE

1992 data is for First Quarter

1972 – 1992 YEAR–END PRICE/EARNINGS RATIOS

NYSE COMPOSITE INDEX vs. TOPIX COMPOSITE INDEX

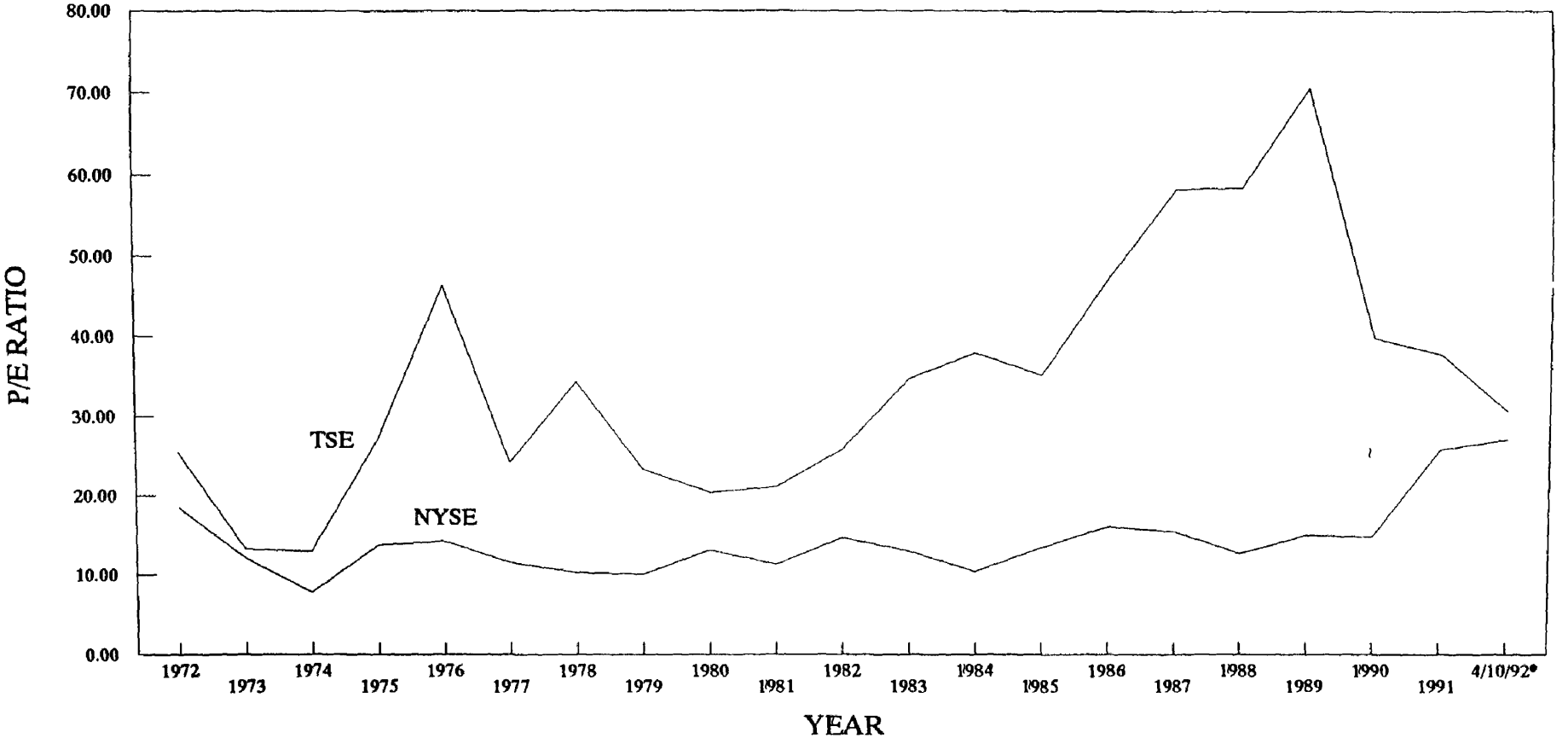


FIGURE 9

—— NYSE COMPOSITE INDEX P/E ("NYSE")

—— TOPIX COMPOSITE INDEX P/E ("TSE")

ALL NYSE COMPOSITE INDEX FIGURES FROM NYSE
TOPIX YEAR–END FIGURES FROM TSE
* TOPIX FIGURE FOR 4/10/92 FROM BLOOMBERG FINANCIAL MARKETS

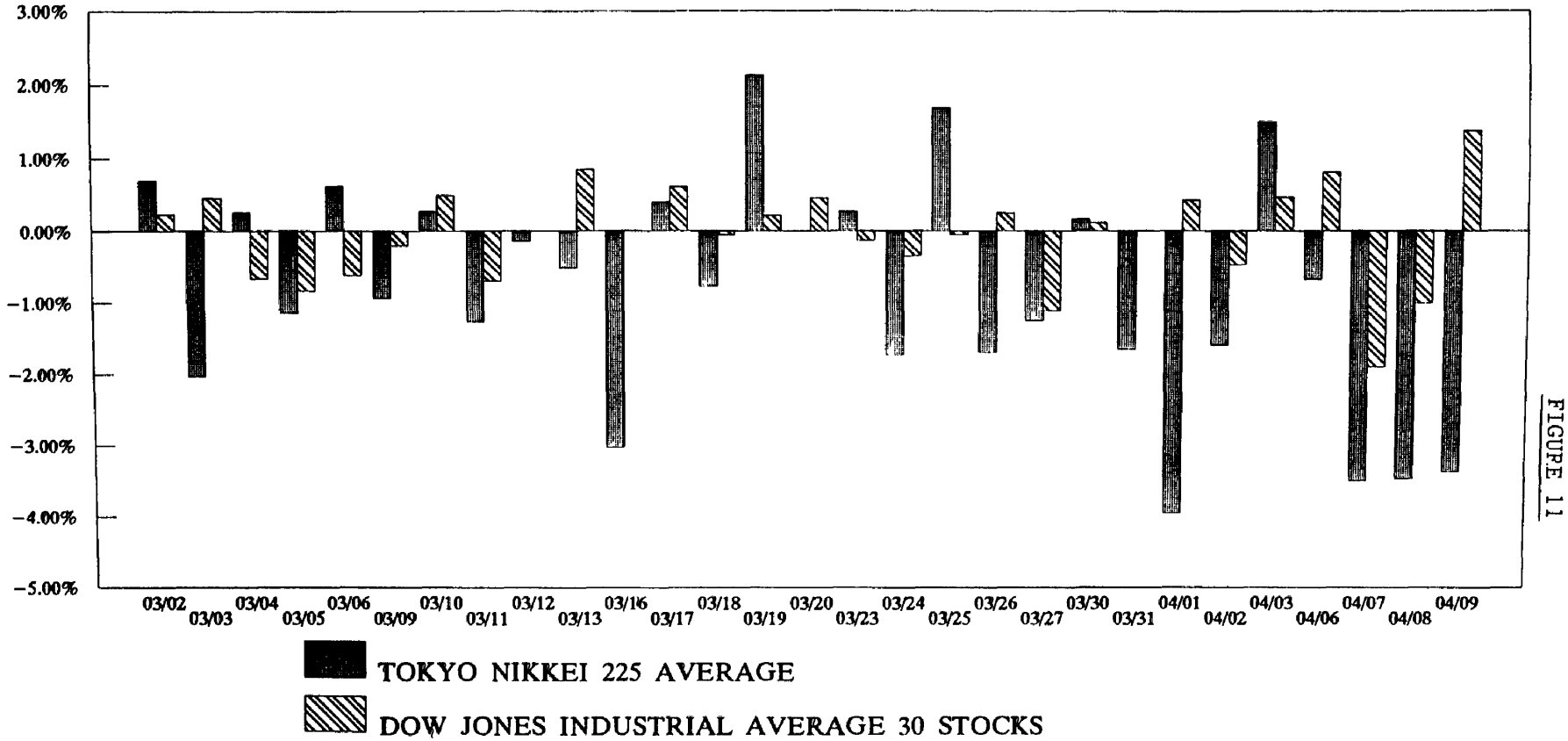
FIGURE 10

PRICE/EARNINGS RATIOS As of April 10, 1992	
TSE First Section	30.6
NYSE Composite Index	27.1*
S&P 500 Index	25.3
U.K Ordinary	19.1

* NYSE Composite Index from NYSE
Source: All other figures from Bloomberg Financial Markets

NIKKEI – DJIA DAILY PERCENT CHANGES

MARCH – APRIL 1992

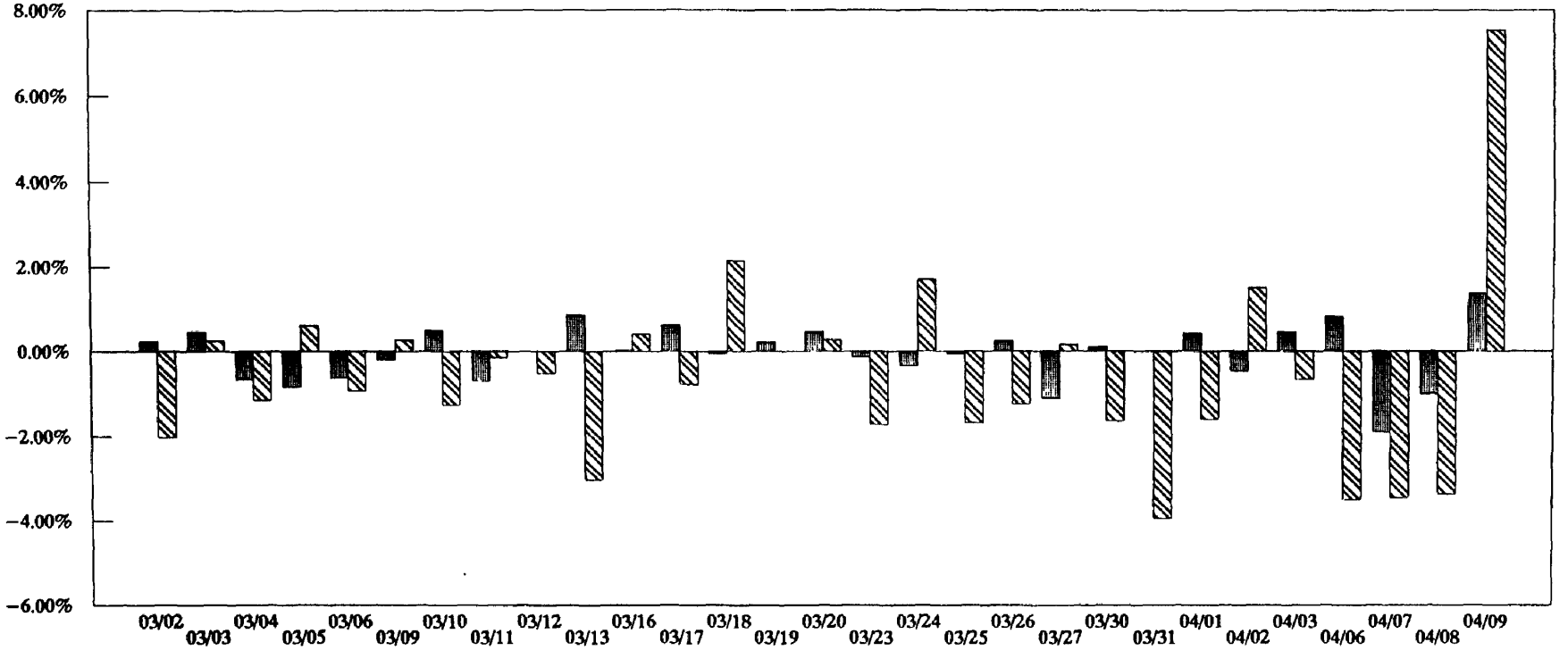


SOURCE: BLOOMBERG FINANCIAL MARKETS

FIGURE 11

DJIA – NIKKEI DAILY PERCENT CHANGES

MARCH – APRIL 1992



DOW JONES INDUSTRIAL AVERAGE 30 STOCKS – DAY CHANGE

TOKYO NIKKEI 225 AVERAGE – FOLLOWING DAY CHANGE

SOURCE: BLOOMBERG FINANCIAL MARKETS

FIGURE 12