Remarks Of

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Reexamining Our Debt Markets and Proprietary Trading Systems

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

With the introduction of new financing techniques, our debt markets have become increasingly important. Notwithstanding their growing importance in this country, they have taken a back seat to our nation's equity markets. I would like to spend a few minutes discussing the need for the Commission to focus more attention on strengthening the integrity of our nation's debt markets.

Another area that undoubtedly should receive increased attention at the Commission is the regulation of new trading systems. These automated trading systems, referred to as "proprietary trading systems," have increased substantially in number recently, although the dollar volume of trading in these systems is still not that large. Such systems are now available for trading equity, debt and even derivative products and offer a variety of trading alternatives to traditional exchange markets. The increasing institutional interest in such systems is bringing the regulatory apparatus developed over the past 10 years for these systems under close scrutiny. And justifiably so. Thus, I also wish to spend a few minutes discussing the need for the Commission to reexamine the current regulatory structure, or lack thereof, of proprietary trading systems.

II. Debt Markets

A. Growth

Over the past thirty years, the attitude of American corporations on the use of leverage has changed significantly. The average debt to total long-term financing ratio of all non-financial corporations has increased steadily, rising from 15% to almost 40%. Ignoring the large private placement market, rated, publicly issued, long-term corporate debt outstanding now totals nearly $800 billion. By far, the fastest growing segment of this market in the 1980s was non-investment grade debt, which now accounts for over $200 billion.

While the corporate debt markets have been growing in importance, the character of our world securities markets has been changing as well. In addition to a panoply of new products and markets, retail participation in the markets has shifted significantly to surrogates. The line between debt and equity products also has become blurred with the creation of products like REMICs and money market preferred stock - and with attempts by some major issuers to diminish the investor franchise that has long characterized equity participation in a corporation. In fact, although most of our notions of corporate control under the federal securities laws are keyed to equity holders, the so-called "vulture capitalists" have demonstrated that the destiny of many corporations can be more easily controlled by acquiring their debt. In light of these changes, I do believe that it is time for the Commission to undertake an assessment of the protections afforded debt investors.

B. Need For Protections

As you are aware, bondholders are viewed under state corporate law as contract claimants to whom no fiduciary duty is owed by a corporation's directors. In theory, debt investors may negotiate the terms of the indenture and preserve their rights by requiring protective covenants in the bond contract. Thus, the responsibilities of directors to bondholders are defined precisely by the terms of the contract and not by the general notions of fiduciary duty or fairness that govern the relationship between shareholders and directors.[1]

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1 It has been suggested that the distinction between duties owed to shareholders and bondholders can be justified by their different economic interests. Decisions affecting a corporation are likely to have the most significant effect on those on the bottom end of the pecking order - the shareholders. To illustrate this contrast in perspective, (continued...)

If the sole recourse of bondholders under state corporate law is to enforce contractual rights under the bond contract, then investors need the protections of adequate disclosure and of a market that can transmit accurate, current price information, so that the value of the bond contract can be reflected in the price of the security.

C. The Federal Securities Laws

Beyond the fundamental distinctions that exist between bondholders and equity holders under state corporate law, there also is a distinction that is evident in our federal securities laws. Many of the inherent safeguards, and many of the structural market protections, that are present in the equity markets do not exist for debt holders under our federal securities laws. And, until recently, the Commission's focus, in terms of

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[1](...continued)

economists note that once an issuer has precisely enough revenues to repay the bondholders, the bondholders have no incentive to encourage the corporation to engage in additional activities that are likely to involve risks, because the bondholders will not share in the rewards. See Lehn & Poulson, The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts, 15 J. of Corp. Law, 199, 205, n.49 (1990), citing, T. Copeland & J. Weston, Financial Theory and Corporate Policy, 509 (3rd ed. 1988).

investor protection, has largely been on the most visible segment of the securities markets - the equities market.

In 1975, for example, Congress added Section 11A to the Exchange Act and required the Commission to establish a National Market System for securities. As a result of this Congressional mandate, the Commission and industry jointly have worked on the development of an efficient National Market System for equity securities. We now have an intermarket trading system and real time quote and trade reports that allow investors the chance to identify and access the most competitive markets for a particular security.

The debt markets, however, have largely been an "after-thought" in our regulatory scheme. The 1975 legislation that required the Commission to take a hard look at the way equity securities were traded barely mentioned the market for over-the-counter and exchange listed corporate debt. While the Commission has discussed for over twenty years the prospect of improving transparency in the debt markets, the high yield corporate debt market currently still lacks the disclosure and price discovery mechanisms that characterize modern efficient markets.

Although there are obvious differences between the equity markets and the debt markets, and efforts are underway to make improvements, with the technology and resources we now have available, additional attention should be devoted to improving our debt markets. To illustrate one of the problems that currently exists, The Wall Street Journal reported last March that a retail customer was quoted bids of $22 and $34 for a company's bonds by different market makers on the same day.[2] Current trade price reporting would reduce price disparities by enhancing competition among dealers in debt securities and by allowing customers to make more informed investment decisions.

This different level of regulatory protection afforded debt and equity investors is not only evident in our market structure. It also exists under the Commission's periodic reporting and tender offer regulatory scheme. In fact, in the high yield corporate debt markets, the absence of secondary market information may be the greatest impediment to increased efficiency. For corporate issuers, for example, secondary market information is

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2 Laurie Cohen, "Let the Small Investor Beware of Those Junk Bond Prices," Wall Street Journal, p.C1 (March 18, 1991).

required only if there are 300 or more equity investors, regardless of the number of debt holders the corporation may have.

Debt tender offers also are not subject to many of the significant regulatory protections that accompany offers for equity securities. For example, the Commission's rules do not impose any filing or disclosure requirements for cash deals. Proration, withdrawal, all-holders, and best price protections do not exist. The only requirements are that the issuer comply with general antifraud measures and observe minimum offering periods.

These disparities in our regulation are all too apparent to investors. There have been debt tenders by public companies recently where issuers and affiliated parties have repurchased large amounts of their non-investment grade debt, as part of restructurings, without offering their debt holders the same basic disclosure protections received by equity investors. In addition, public companies recently have gone private and repurchased their debt at severe discounts when the absence of periodic reports greatly reduced liquidity in the secondary market. Finally, there are reports in the press that insider trading is rampant in the debt markets. I am aware of reports that active trading in certain junk bonds has occurred prior to the announcement of material events.[3] While we are confronted with some different legal issues when pursuing insider trading in the debt markets, among the legion of enforcement actions taken by the Commission, I cannot cite a single completed case involving insider trading in debt securities. Indeed, I also find surprising the notion reflected in some of our antifraud rules that bond prices solely are based upon changes in interest rates and therefore cannot be manipulated.

D. The Future

Although the solution to some of the problems in the debt markets may need to come from federal and state legislators, it appears that progress already is underway in the industry and at the Commission. There already has been movement at the NYSE and the NASD to increase the price transparency in the non-investment grade corporate debt market. In the 1990s, I also increasingly sense an awareness at the

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[3] George Anders, "Is Insider Trading Widespread in Junk Market?," Wall Street Journal, p.C1, (January 31, 1991); Matthew Schifrin, "Sellers Beware," Forbes, p.36 (January 21, 1991).

Commission of the need to focus more attention on improving our debt markets.

Last fall, the Commission received a rulemaking petition from Fidelity Management requesting that the Commission address the recent practice of coupling tender offers for debt securities with consent solicitations that seek to strip the bonds held by non-tendering investors of their protective covenants. The Fidelity proposal would make some of the same disclosure safeguards currently available to equity investors, also available to bondholders. Debt holders would be required to receive notice of the results of the solicitation, and thus information regarding the exact terms of the security they are being asked to surrender, before having to decide whether to tender into the offer. The Commission will, in the near future, take a serious look at that petition, as well as the general area of debt buybacks, to see if additional regulatory measures are appropriate.

III. New Trading Systems

Another area that also deserves increased attention by the Commission is the regulation of new trading systems, also known as proprietary trading systems. As is often the case with a new area of regulation, the regulatory structure for these systems evolved in part as a series of case-by-case responses to particular proposals. Moreover, the approach to the regulation of these systems was developed in a very different market context than is present today. Ten years ago, and even as recently as two years ago, proprietary trading systems were developed primarily to service specialized, and generally rather limited, institutional trading needs. The Commission's regulatory approach was a function of this environment; it properly reflected the experimental nature of new systems and was designed to foster innovation. As these systems have matured, however, the Commission must address the need for the regulation of these systems to mature. Issues such as market fragmentation, equal regulation with markets operated by self-regulatory systems, and market transparency begin to take on a very different aspect than when these systems were more purely experimental.

While these changing circumstances suggest that a reexamination of our regulatory approach to these systems is in order, let me emphasize that the goal of this reexamination should not be, and cannot be under the pro-competitive statutes that we administer, the protection of the market shares of the exchanges or the NASD. Indeed, it is clear that the primary factor motivating institutional interest in alternative trading systems is a genuine desire to reduce some of the costs of transacting on traditional markets. Thus, to be balanced, the Commission must include within the scope of any reexamination consideration of any regulatory anachronisms or lingering inefficiencies in our existing market structures and trading mechanisms.

Before delving into some of the specific issues that I believe merit more careful examination, let me briefly discuss an issue that, in my judgment, the Commission has handled properly and that is the interpretation of the definition of the statutory term "exchange." The definition of the term "exchange" is the critical concept in this area since the classification of a system as an exchange dictates statutory requirements and limitations very different from those that apply to a system not classified as an exchange. As described in the Commission's <u>Delta Options</u> order, the term "exchange" encompasses: "trading markets that, like the exchange markets of the mid-1930's and of today, are designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations."[4]

As recently confirmed by the Seventh Circuit, this interpretation is faithful to both the spirit and the letter of the Exchange Act.[5] While one can always debate the application of this interpretation to particular facts -- and I expect such debates will increase as the distinctions among systems narrow and the lines being drawn in particular cases become increasingly fine -- I believe it is hard to quibble with the interpretation itself, either as a legal or as a policy matter. While a bright line test may avoid some of the debates over particular systems, it also would strip the Exchange Act of the vitality and flexibility that Congress was seeking.

In our democratic government, process is important. And the current process the Commission utilizes to make the determination that a

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4 Exchange Act Release No. 27611 (Jan. 12, 1990).

5 Board of Trade of the City of Chicago and Chicago Mercantile Exchange v. SEC, No. 90-1246, slip op (7th Cir. Feb.4, 1991).

system is or is not an exchange should be reexamined. In legal terms, the current process is called the "no-action" process; in layman's terms, the process is informal, non-mandatory, non-public, <u>and</u>, to a large degree, not subject to judicial review. It was in large part because of these process flaws that the Commission in 1989 proposed Exchange Act Rule 15c2-10. As proposed, this rule would, among other things, require the registration of proprietary trading systems, permit public comment upon a registration application or upon material changes to the system, and allow for more effective judicial review of individual decisions. Thus, for process reasons alone, proposed Rule 15c2-10 offers great advantages over our current approach and deserves serious consideration.

Further, proposed Rule 15c2-10 would increase the regulatory responsibilities of proprietary trading systems and, thus, would not only enhance the oversight of trading in these systems but also would narrow the gap between the regulatory burdens of registered exchanges and proprietary trading systems. While the proposed rule does at least begin to address level playing field concerns, competitive disparity issues remain. As proprietary trading systems increasingly compete with exchanges and

NASDAQ for order flow, the Commission may need to consider reducing even further than does proposed Rule 15c2-10 the regulatory gap between exchanges and proprietary trading systems.

There are other important issues that this rule proposal does not address. For example, as trading of listed securities in proprietary trading systems increases, the market for these securities becomes increasingly fragmented. As I have previously mentioned, in 1975, Congress added Section 11A to the Exchange Act mandating that the Commission "facilitate the establishment of a national market system." An important goal of Congress in enacting Section 11A was to provide the Commission the authority to combat the market fragmentation confronting the markets in the early 1970's.

At the same time, the elimination of market fragmentation was not the only goal of Congress in enacting Section 11A. Another equally important goal was to assure "fair competition among brokers and dealers, among exchange markets, and between exchange markets <u>and markets other than exchanges</u>" (emphasis added). These national market system goals are neither self-defining nor easily compatible with one another.

Nonetheless, the elimination of market fragmentation is clearly an important statutory and policy consideration. Thus, I believe that Congressman John Dingell, the Chairman of the House Energy and Commerce Committee, was correct in writing the Commission as he recently did to request that the Commission address market fragmentation concerns raised by proprietary trading systems, as well as by the newly exempted exchange, the Wunsch Auction System. Although the Wunsch system itself has thus far failed to attract any real volume, in today's environment, I do not believe that the Commission can fairly avoid a serious discussion of market fragmentation issues by relying upon speculative thoughts about "limited volume."

Yet another issue in this area not addressed by proposed Rule 15c2-10 is the effect on the transparency of our markets as use of proprietary trading systems increases. Transparency is the cornerstone of the fairness and efficiency of our equity markets and must be carefully preserved. Proprietary trading systems report trades executed during regular market hours on a real-time basis, unlike exchange and NASDAQ systems, however, these systems do not publicly report quotations or priced orders entered through those facilities. In addition, trading conducted on such systems after regular market hours is not publicly reported. As use of proprietary trading systems increases, the Commission must reexamine the trade and quotation reporting requirements for these systems.

These are not easy issues. Proprietary trading systems have been important sources of innovation and competition in our markets. Yet changing circumstances and considerations of fair process, fair competition, and fair pricing require a reexamination of our regulatory approach to these systems. I look forward to this Commission reexamination, confident that it will be a balanced one that takes into account all sides and results in a comprehensive, fully modern, regulatory regime.

IV. Conclusion

In conclusion, I have highlighted why, in my judgment, the Commission should, in the debt area, become more active in its enforcement efforts, pay more attention to the lack of transparency, and be quicker to address current market practice abuses. I have also attempted to delineate the need for the Commission to now move the horse in front of the cart and provide an appropriate regulatory framework for proprietary trading systems. It is my recommendation and my hope that the Commission address all of these areas in some form or fashion this year.