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PRINCIPLES FOR FASHIONING INTER-AGENCY POLICY
IN THE
TRANSNATIONAL FINANCIAL MARKETS

Edward H. Fleischman
Commissioner
Securities and Exchange Commission
Washington, D.C. 20549

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

Whenever an SEC Commissioner rises to speak to market professionals outside his own country, the spectre of extraterritorial jurisdiction is visible, standing as if it were the Commissioner's shadow, reflected in the eyes of the audience. To exacerbate your fears on that score, may I first demonstrate the extraterritorial reach of American legal requirements by complying, even here in London, with an SEC regulation that obliges me to advise you that the opinions I express here are my own opinions only, and are not the opinions of the Commission, of my fellow Commissioners or of the SEC staff.

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Our host, John Damgard, in extending to me the invitation to speak at this conference, requested that I do a bit of crystal-ball-gazing, looking into the future, particularly with respect to inter-agency regulatory policies both on our side of the ocean and (with a weather eye out toward 1992) as they may span the sea.

I'll not pretend to be able to predict the future, but I shall this noontime describe one SEC Commissioner's views of the direction in which regulatory agency and inter-agency policy ought to develop, with reference to current examples of failures as well as successes along that route. And I'll do so, if you'll allow me, by postulating from the start that the financial markets, whatever their histories, however they may be organized, by whomever they are regulated, and in whichever time zone they may be situated, (1) extend to their participants the ability to substitute instruments to achieve like economic results, and (2) recognize no inhibition on that ability so artificial as a line arbitrarily drawn on a jurisdictional or geographic map.

I need not tell you that markets are transnational; that's why you are attending this conference. I need not draw to your attention the synthetic products functioning as equivalents or offsets to instruments as diverse as government bond futures and corporate common stock; that's the meat-and-potatoes of your daily business life. I need not remind you that when the U.S. Treasury bond contract went "limit up" in Chicago on Monday night, October 19, 1987, nearly 40,000 contracts moved to LIFFE on Tuesday morning; you knew the likelihood was there all along.

But perhaps I would do wisely to take a few moments to delineate some of the basic elements underlying those transnational markets. The elements themselves are so often taken for granted that their very mention seems in the nature of a primary-school lesson, but their implications lead toward such crystal-ball-gazing as I feel competent to do.

First, technology and telecommunications development.

Participants in the marketplace today have the near-instantaneous capability of receiving and transmitting new

information, absorbing the information so received into the totality of the prior information that they had possessed, analyzing the revised complex of data, and reaching new or reaffirmed conclusions as to the course of market action to be followed. The result is a world-wide, virtually-simultaneous knowledge of transactions and trends in the markets, which has yielded an extraordinary capability to react to events in any market, whether debt or equity, government or corporate, long-term or short-term, currency or futures.

There is a pronounced trend by professional market participants toward "passing the book": around-the-clock, twenty-four-hour risk monitoring, as market responsibility passes from London to New York to Tokyo and back to London again. Correlatively, there is an increasing ability to detect and to act on interrelationships between diverse markets, and of course there is increasing institutional pressure to do exactly that -- to act on relationships between markets in different instruments and in different countries in order to diversify and to hedge institutional portfolio investment.

Second, institutionalization.

Regardless of how "institution" is defined, institutions more and more dominate trading in markets world-wide, from trading in overnight bank reserves down to and including trading in corporate equities. 1/

A significant aspect of institutionalization is the aggregation of wealth under management, not in the sense of concentration in the hands of one or two decisionmakers but rather in the sense of concentration resulting from a constant net inflow of money to the pension funds, the insurers and the collective investment vehicles. It is still possible, at micro portfolio management levels, to invest as a classic venture capitalist, or a mezzanine financier, or a block purchaser in the public market -- choosing this industry over that, this geographic area rather than that, this company as a better all-around choice than that -- but, to an increasing extent, institutional portfolio holdings in sovereign debt, private debt and equities have become so large that institutional portfolio managers either have to follow an "issuer-blind" strategy by investing in equities just to match an appropriate index or else have to add and remove interest-rate risk and equity risk as overall components without regard to the component securities held in the portfolio. For purposes of those strategies, the

1/ An article in The Wall Street Journal, subsequent to this presentation, focused on the increasing role of institutional investors in the U.S. over-the-counter market. Steptoe, OTC Stocks Attract Institutional Investors, Become More Volatile, Wall St. J., July 26, 1989 at 1, col. 6.

institutions have turned to new financial instruments and techniques designed to address volatility and to hedge risk.

Third, volatility.

Volatility in currency exchange rates is only a phenomenon (during the post-war era) of the last decade-and-a-half. With the dismantling of capital controls in the late '70s and '80s came increasing cross-border flow of funds, increasing awareness of investment and trading opportunities in other national markets, and increasing necessity to take into account exchange rate fluctuations and their effect on operating and investment results. Concomitantly, the last decade-and-a-half has witnessed unprecedented volatility in interest rates, while rates themselves have reached unprecedented levels in several major countries including the U.S.

Further, inter-day and intra-day volatility in equities, while explainable in gross in relation to historic levels of trading volume, has since October 1987 caused the mass of individual investors to share what previously were concerns almost exclusive to the institutions. After all, the institutions do provide the markets with liquidity when any fraction of them is buying or selling, but they drain the markets of liquidity (October 19 and 20 are good examples) when too large a proportion of them decides to sell or to buy; they provide stability in the market so long as there is a normal distribution of variant opinion among them, but they magnify volatility when too many of them line up on either side of the market at the same time.

Fourth, innovation.

Innovation in financial instruments and techniques has borne a great portion of the burden of reacting to the stress of institutionalization and of greater volatility.

Perhaps foremost in their consequences for internationalization of markets have been currency-rate and interest-rate swaps, by which major institutions (primarily world-class banks whose acceptability as contra-parties to any swap is unquestioned) have linked together all the major capital markets. In addition to swaps, however, nearly every traditional instrument, from long bonds to puts and calls, has been revisited and adapted -- and introduced into national marketplaces where a need has been perceived. And, I hasten to point out, that process of adaptation and introduction was carried out by non-governmental entities, on the basis of non-governmental insight into the economic potential for these new instruments and techniques, sometimes despite the inertia or outright opposition of the relevant governmental regulatory authority. Standardized secondary options didn't even exist two decades ago; today they are commonplace, as is their derivative, the equity index options.

But what comes most prominently to mind are the interest-rate futures and ultimately the equity index futures -- because in the early '80s those screaming crowds (I'm avoiding the evil word "speculators", as if there could be markets without speculation) in the pits in Chicago divined how to adapt their wild and woolly markets, and their incomprehensible contract instruments, to do for securities (first for U.S. Government bonds, then for Treasury bills, then for corporate equity indexes) what those markets and instruments had traditionally done, and are doing in the summer of 1989, for farmers and food processors, for miners and metal processors, i.e., to discover forward prices and to assume or to transfer risk. In doing so, they provided the financial institutions with the ability to "lay off" the risk inherent in all or part of the debt and equity portions of the institutions' portfolios, not security-by-security but rather dollar-by-dollar and pound-by-pound.

The fact of the matter is that, if financial futures didn't exist, at this point we would undoubtedly have to invent them, and in the process we would have to remove any governmental restrictions tending to inhibit their viability.

Last, although possibly most important, governmental deregulation -- in the sense of sovereign policies recognizing that regulatory constraints on market forces, particularly constraints on economic competition between investments or between investment instruments or between the markets where analogous investment instruments are traded, do tend to inhibit rather than to encourage the interaction between purveyors and users of capital by which buyers and sellers, longs and shorts, primarily through the intermediation of professional traders, meet and agree on the terms of deployment of capital most advantageous to both sides.

The very articulation of these several elements suggests certain hypotheses concerning the direction of future regulatory policy affecting operation of transnational markets:

(1) The capability to analyze data from worldwide sources, and to monitor risk exposure and inter-market arbitrage opportunity, suggests more than the mere mathematical processing of information. To me at least, such capability suggests that economic function is the buried well toward which the dowser of data analysis is pointed. The definitional talismans that legislators and regulators use for regulatory purposes evidence frequently-encountered constellations of functional economic characteristics; the talismans can (and, I suppose, must) stretch somewhat to include additional economic facets as those develop, but the talismans are not infinitely elastic, and the fact that they no longer fit the gradually-evolving constellation of economic characteristics eventually becomes clear to the regulators as well as the data analyzers. In the securities field in the United States, perhaps "stock" and "investment contract" are the best examples. Together, they cover my

ownership interest in a private enterprise or a publicly-held business, whether or not ownership is divorced from management, but they do not encompass my ownership of something that calls itself shares in the cooperative apartment corporation in which my wife and I live in Washington -- the Supreme Court has recognized that that serves a quite distinct economic function.

Currently the battle is being fought over the definition of the phrase "contract for future delivery". 2/ I don't believe it will, or could, be decided on the basis of an exegesis of the words in § 2(a) of the Commodity Exchange Act alone. The words of a market-oriented statute must take their substance from the fundamental market realities to which they relate; when the legal superstructure diverges too far from those realities, the data analyzers' ability to disaggregate economic functions and to devise acceptable synthetics provides a discipline that, if forgotten, is most likely to leave the victorious regulators masters of an abandoned field.

(2) The aggregation of wealth under management and the need for new tools and techniques with which to manage that wealth suggests more than the mere acceptance of appropriate new instruments and markets. To me at least, they suggest that user initiative toward the solution of perceived market deficiencies, and toward forestalling the development of emerging market problems, is a vital force. Regulators, even more than legislators, tend to think of themselves as the sole source of constructive ideas for the protection of markets as well as of investors. I find that just isn't so. To the contrary, market professionals' understanding of market functions reflects immediate participation in the performance of those functions, with a feel for the proper operation of the market that only a rare regulator will ever possess; and the influence of

2/ This issue has arisen in the context of the efforts by the various securities exchanges to develop so-called market basket securities. In particular, the SEC issued an order approving proposals by several securities exchanges relating to the documentation for, and designation for exchange trading of, index participations. SRO; OCC; Order Approving Proposed Index Participations Disclosure Document and Designating Index Participations as Other OCC-Issued Securities, 54 F.R. 15280 (1989) (Release No. 34-26752, April 21, 1989). This order was appealed successfully by the Chicago Mercantile Exchange and the Chicago Board of Trade before the Court of Appeals for the 7th Circuit. Board of Trade of the City of Chicago and Chicago Mercantile Exchange v. SEC et al., ___ F.2d ___ (7th Cir. 1989), Fed. Sec. L. Rpt (CCH) [Current] ¶ 94559. In his opinion, Judge Easterbrook concluded that, because index participations have elements of futurity expected of a future, regulation of these instruments properly lies with the CFTC, not the SEC. The SEC subsequently petitioned for a rehearing.

institutions, as the dominant user group in most financial markets, has enormous capacity to be exercised continually to add to the safety, honesty and efficiency of those markets.

Recently, the Group of Thirty -- a private sector group of international businessmen, bankers and others concerned with the international financial system -- published the report of its steering committee (composed of individuals from eight different countries) 3/ on clearance and settlement. The set of nine recommendations, relating to such matters as securities depositories, trade comparisons, trade netting, same-day funds and rolling settlement, has already evoked the formation of a private-sector U.S. committee to review the recommendations and to propose implementary steps where appropriate, for submission to the SEC and to the Board of Governors of the Federal Reserve System by year-end. 4/ Similarly, I see from the issue of Futures and Options World included in our conference packets that the Association of Futures Brokers and Dealers is continuing its negotiation with both the CFTC and the Securities Investment Board for further compromise on the issue of segregation of U.S. customers' funds, while the Joint Exchanges Committee has gone on from working with the AFBD on that issue to address current DTI and SIB proposals for rulebook changes. 5/

(3) The increase in volatility suggests more than hiding in short-term investment in government or government-guaranteed paper on the excuse that "confidence in the market has been lost". To me at least, the transparent public financial markets are precisely where volatility is to be expected and, like the seashore, precisely where the waves have least effect on the long-distance swimmer.

In the mid to late 1970s, when the U.S. felt the shock of oil-price inflation magnified throughout the economy, a veteran Kuhn Loeb & Co. banker suggested that I read an article about Germany in 1922-23 (my prior knowledge had come only from academic history courses and postage stamps overprinted with zeros). 6/ The article pointed out that, after hyperinflation, those who had owned (and not sold) their stock in industrial

3/ Clearance and Settlement Systems in the World's Securities Markets, Group of Thirty, New York and London (March, 1989).

4/ Group of Thirty Recommendations Prompt U.S. to Form Response Committee, Wall Street Letter 4 (May 29, 1989).

5/ Segregation Talks Continue, Futures and Options World 13 (June 1989). SIB Gains CFTC Exemption but UK Concessions Necessary, Id., at 21. JEC: A Voice for London, Id., at 37.

6/ The Nightmare German Inflation, Scientific Market Analysis, Princeton, N.J. (March 1970).

enterprises still owned the same proportion of the productive capability in the German economy; they had let the wave wash over them and hadn't been washed away. For those who must sell under the impact of the wave, of course, that is no answer. The answer on our side of the ocean, to date, has been a schedule of trade-halts intended to afford the opportunity for communicating imbalance information with a view to attracting the contra-side once that information has been distributed. I note, again, that the initiative for that schedule came from the major affected marketplaces, the CME and the NYSE, themselves.

(4) Innovation in financial instruments is, with rare exceptions, a product of marketplace or, occasionally, financial-purveyor initiative, but innovation suggests more (and less) than the Los Alamos-type explosion of financial futures in Chicago. To me at least, the insight into default rates and the adaptation of unsecured debt instruments that enabled a variety of commercial and industrial firms to utilize unrated long-term debt in financing, both for corporate development and for takeover purposes, is equally important. And what is constantly to be remembered is that any new financial instrument requires some unknowable combination of need, support, timing, credibility and Lord-knows-what-else to avoid failure. I would myself gladly have contributed to the purchase of an entrance badge to the trading pit for the corporate bond contract (where is it now?) or of a Phlx or AmEx seat with rights to trade IPs (setting aside jurisdictional battles, those participations hardly have a guarantee of success). Ten years ago, Silicon Valley desperately needed a D-RAM contract; why didn't I realize it then, and will the Pacific Stock Exchange be too late now?

(5) Deregulation suggests more -- much more -- than cost/benefit analysis, paperwork reduction and the generalized encouragement of competition to get the regulators' job done by Adam Smith's unseen hand. To me at least, all that I've been exploring today reaches finally toward a notion of performance of the regulators' role in a quite different manner from heretofore.

Let me illustrate by examples.

We in the States -- "we" meaning the SEC and the CFTC -- are being drawn into coordinated policymaking, together with the FRB and the Treasury Department, via the President's Working Group, initiated in the last Administration by Under Secretary Gould and presently being carried forward by Under Secretary Glauber (former executive director of the Brady Commission). ^{7/} Like

^{7/} See, e.g., Interim Report of the Working Group on Financial Markets, Submitted to the President of the United States (May 1988), in which the Department of the Treasury, the CFTC, the SEC, and the Board of Governors of the Federal Reserve System and their respective staffs cooperated in developing preliminary observations about the steps

horses first being broken to yoke and bridle, we are bucking at the loss of our vaunted independence. But what an opportunity affords itself!! Each Agency has acknowledged expertise in complementary and overlapping aspects of the financial markets. All four Agencies have come to the realization that common problems -- clearing and settlement, for example -- present the most serious challenges to continued development of the markets nationally and worldwide. Despite the inside-the-Washington-Beltway traditions of jealous exclusivity and turf defense, these end-of-century challenges demand inter-agency communication, inter-agency cooperation, and inter-agency coordination. The fact that leadership comes from the Executive Branch is not surprising; the danger that some see in leadership from that source is of far less concern than is the alternative of market obsolescence and irrelevance for lack of common policy.

Similarly, we in the States are battling over the IPs contracts, representing our respective constituencies and defending our respective jurisdictions in the traditional way. 8/ But I do believe that what counts more than where these contracts are traded and by whom their trading is regulated is whether they trade at all. That's not to ask whether as a product they'll succeed; success will have to be earned in the marketplace. It is to ask whether, under any suggested alternative or compromise to the April SEC Order, IPs stand a practical chance of being put up on a board to succeed or to fail on their market merits. I think not -- and that, above all else, justifies my vote "yea" this past spring. 9/

As a final stateside example within my own ken, last June, in preparation for a public meeting of the SEC to consider proposals aimed at international activities of securities professionals directed from abroad at potential customers within the United States, I made a phone call to a very knowledgeable British solicitor in the New York office of a London firm, to ask what his "wish list" on that general subject would be. In unlawyerlike fashion, he hurdled all the irksome but small-bore issues and went well beyond anything then being placed before the Commission for consideration: ultimately, said he, you've got to work toward some kind of mutual recognition of registered professionals. Well, everyone knows that -- but it's for another decade (which soon now means another century). Nevertheless I introduced the thought at the public meeting; it had never previously had a formal airing. The implications were such that there was fear of commitment, but ultimately some aspirational

necessary for more effective coordination of the various sectors of the financial marketplace.

8/ See n. 2 supra.

9/ Open Meeting of the Securities and Exchange Commission (March 14, 1989).

language was found acceptable for exposure well toward the end of the SEC Release. 10/ What happened next is amazing: the seed took root; it germinated within the staff of our own Division of Market Regulation; the leaves and buds have appeared within the past several weeks when, at a conference like this one, a staff official said casually that some form of mutual recognition of broker-dealer registration would be recommended to the Commission this summer; and the flowers will open in the form of what is referred to as a Concept Release before the French Republic reaches its 200th birthday. 11/ All because we were benefitted by the spur of an outsider's good idea. All regulators need the spur of outsiders' good ideas.

Examples abound as well in the international arena.

For twenty-five years the SEC has been insistent that it alone could protect Americans, wherever in the world they are, from non-disclosure and fraud in securities transactions. 12/ In the summer of 1989 we are finally about to acknowledge, with Regulation S 13/ (on public offerings abroad) and Rule 15a-6 14/ (on international broker-dealer activities) that the securities markets here in London, and in Paris, Zurich, Stockholm and Amsterdam, are themselves conducted under rules designed to assure marketplace integrity and investor protection -- that we can restrict our job to the oversight of our own domestic markets and can rely on the rules of the local securities road to afford equal protection to Americans deliberately travelling abroad for investment transactions. We are, in other words, beginning to accept the congeries of concepts embodied in the idea of "national treatment" in the financial sphere.

10/ Registration Requirements for Foreign Broker-Dealers, 53 F.R. 23645, 23652 (1988), Securities Exchange Act Release No. 25801, 41 SEC Docket (CCH) 164, 179-180 (1988).

11/ Recognition of Foreign Broker-Dealer Regulation, 54 F.R. 30087 (1989), Securities Exchange Act Release No. 27018, 43 SEC Docket (CCH) 2110 (1989), published subsequent to this presentation.

12/ Registration of Foreign Offerings By Domestic Issuers; Registration of Underwriters of Foreign Offerings As Broker-Dealers, 29 F.R. 9828 (1964) [codified at 12 CFR 231], (Securities Act Release No. 4708, July 9, 1964).

13/ Offshore Offers and Sales, 54 F.R. 30063 (1989), Securities Act Release No. 6838, 43 SEC Docket (CCH) 2008 (1989), published subsequent to this presentation.

14/ Registration Requirements for Foreign Broker-Dealers, 54 F.R. 30013 (1989), Securities Exchange Act Release No. 27017, 43 SEC Docket (CCH) 2079 (1989), published subsequent to this presentation.

We are of course still a bit uncertain on our path. I listened recently to a discussion concerning the efforts of the International Accounting Standards Committee to reach agreement on preferred standards in application of accounting principles, as a worldwide benchmark, and concerning the intended efforts of a variety of private professional groups, both in accounting and in law, to press the desirability of acceptance of those standards, once agreed on, by securities exchanges and authoritative governmental bureaus around the world. I was concerned to hear our Agency's view expressed as "support withheld till we see the final product", but I was dismayed to hear an expression of official Agency concern that private American groups might work at cross purposes to ours if we don't concur in that final product. A regulatory agency must respect the good faith of the professionals who practice before it!

In sum, at this time of increasingly urgent pressures on markets to provide capital funds, to support governments and trade, to hedge exposures and to shift risk, it is, as well, increasingly urgent that regulators realize both their own limitations and their own strengths.

No regulatory agency or group of regulators can restore the simpler markets of yesteryear. Financial instruments are not like genies to be forced back into bottles and corked for burial in some cave; rather, financial instruments that truly serve users' legitimate purposes will give rise to markets where those instruments can be traded, regardless of the anguish of legislators, regulators or competitors who choose to maintain position by denying that the new instruments exist.

No regulatory agency or group of regulators can duplicate the isolation of a by-gone day, when market users were a small coterie of professionals (a la the novelettes of de Maupassant) and the service catchment of each market stopped at river's edge, not to think of seashore or national boundary; rather, we are interdependent among markets, and the telecommunications devices have developed a thousand thousand fronds of intertwining market information without regard to borders and boundaries.

No regulatory agency or group of regulators can know the markets as well as the participants and governors of that market. The insightful understanding that regulators have far greater capacity to oversee an SRO governed by market participants than to undertake direct day-to-day market governance is an American contribution to international markets of which Americans may justly be proud.

No regulatory agency or group of regulators can afford to insulate itself from the constant strain of objections, criticisms and suggestions emanating from the regulated communities and from those engaged with them academically, legally, or co-professionally. Oftentimes, the answers to

vexing problems are more clearly seen from the regulated than from the regulating perspective.

Finally, each regulatory agency will more closely approach its own optimal performance, will better achieve its own goals, to the extent that it establishes a set of priorities designed to benefit the markets it regulates and the users of the instruments traded on those markets (issuers in the capital markets as well as traders, speculators in the zero-sum markets as well as hedgers) rather than to preserve itself and its functions. Creating and articulating those priorities for public discussion, demonstrating the tensions inherent in the balancing of interests in an international market arena, justifying the expenditure of public funds to keep the markets honest but explaining that confidence in fair and honest markets does not equate to confidence that every participant will make money in those markets -- those are among the functions that only regulators can perform. Adapting a passage from last year's OECD publication on Financial Market Trends, 15/ I sincerely believe that, while costly and unnecessary regulation may drive market operations to offshore centers, reasonable supervision creating deep and transparent markets that inspire investor confidence can actually strengthen markets and attract market participation.

Regulators, after all, are not seers with full knowledge of the future, nor are we omniscient as to the present. For all that, we have a responsibility that falls on none of you -- and we must do our best as best we see it. Press us to do so -- and impress us constantly with the mistakes you see us making. Assume our good faith; don't assume our good will. Challenge our self-importance, deflate our self-satisfaction, and prod -- always prod -- us to move further, to understand more, to adapt more effectively.

To put a respectful American's spin on all this: in mid-1986 I was here in London for a pre-Big-Bang, pre-effectiveness-of-the-Financial-Services-Act conference held at a conference center southwest of London. There, not far from Runnymede, looking at the assembled market barons, I muttered something about not relying too much on the king, i.e., on the new regulators. Today on the same theme I remind you, loudly, that 750 years of British history witness a process of authority flowing from Throne to Barons to Commons -- not flowing easily, but demanded, forced, taken. For the last 300 years it has been Sovereign-Lords-and-Commons linked in indissoluble relation.

So should it be in our sphere: authority will not rest in the regulators; it will -- and should -- be pried away toward market participants for the ultimate benefit of market users.

15/ Special Feature: Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries, Financial Market Trends 17 (1988).

Together, then, regulators, market professionals, and users -- together you and we -- will be able to bring about turn-of-the-millennium markets deeper, fairer, broader, more transparent (in part because they are more transnational), than the markets any of us, separately, would have anticipated even a scant few years ago.