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THE REGULATOR AS CATALYST TO CAPITAL FORMATION AND HEALTHY SECURITIES MARKETS

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I am pleased to have the opportunity to address this international group of securities experts from both the public and private sectors. Today, those who are responsible for regulating the securities markets, in the United States and in other countries, are faced with many challenges.

One special challenge has been persistent inflation, a problem throughout the free world since World War II. It has placed great pressures on investors to seek higher investment returns to keep pace with the declining purchasing power of their currency.

These pressures have sharpened the competition among investment alternatives and led to the creation of many new investment products, such as money market funds, financial futures and options, as well as novel forms of currency hedging, arbitrage and speculation. For investors battered by the effects of embedded inflation, the words of Paul Valery, French poet and critic, have a ring of truth: "The trouble with our times is that the <u>future</u> is not what it used to be."

The pressures of inflation have also been felt by both governmental and private issuers of securities. Inflation breeds deficits, which must be funded through capital raising. As governments enlarge their capital needs, they compete for scarce funds with private companies seeking to raise capital in the same markets. These and other factors have naturally led investment markets in different countries to compete more vigorously for foreign investment funds while seeking ways to retain domestic investment funds at home.

Mexico -- like the United States and other industrialized nations -- seeks to expand its domestic securities markets to supply needed capital for local businesses. Unlike some other countries, Mexico already has the benefit of a system of securities regulation ably administered under the leadership of Chairman Gustavo Petricioli, and existing securities markets. Unfortunately, the promising growth of activity on the Mexican Stock Exchange during the last half of the 1970's could not endure the twin pressures of inflation and high interest rates. As a result, in the past two years, the Exchange Index has suffered a major reversal, accompanied by speculation and widespread loss to public investors.

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

I can sympathize with these problems. Many equity investors in the U.S. markets have suffered during the same period, although the recovery in my country has been more rapid.

As a result of these recent events, the Exchange and the Mexican financial authorities are now faced with the difficult task of devising a strategy both to reawaken the interest of Mexican investors in their own Exchange and to attract foreign capital to Mexico. Actually, despite the ravages of inflation and high rates of interest, Mexico's first major effort to attract foreign equity capital from public investors was successfully completed just one year ago, when The Mexico Fund, an investment company registered under our laws, raised 120,000,000 dollars through a public offering, for reinvestment through Fondo Mexico in securities listed on the Mexican Stock Exchange. Unfortunately, this fund has not escaped the downturn in Mexico's capital markets. Its shares, which were orginally offered at $12 per share, now trade on the New York Stock Exchange at about $3.

I believe we all benefit from aggressive efforts to provide lively competition for the world's investment dollars, both within and across national boundries. Experience has taught us that free competition produces efficient, deep and liquid markets with the strength to weather economic adversity.

I look forward to further international efforts like Fondo Mexico, as soon as present economic uncertainties are removed, as well as the emergence in Mexico of an international securities market vigorously competing with the other great capital markets of the world.

In considering the challenges now faced in Mexico, I thought it might be helpful to discuss the importance of effective regulation to the creation <u>and</u> preservation of healthy securities markets, which we <u>all</u> recognize to be essential to the process of capital formation.

The foundation of strong capital markets is public confidence. With so many alternative investment products and markets to choose from, the investor seeking a fair return has no incentive to participate in markets which have not earned his confidence. It is the responsibility of securities regulators to create and maintain fairness in the marketplace sufficient to gain this confidence. With almost half a century of experience under its belt, the U.S. Securities and Exchange Commission has demonstrated that strong yet sensible regulation, applied in an evenhanded manner, will build an environment in which public confidence may flower.

The SEC was created five years after the great stock market crash of 1929. When Congress enacted the U.S. securities laws that gave birth to the SEC, its principal concern was to restore public confidence in the securities markets -- confidence which had so recently been shattered by revelations of wide-spread fraud and unfair practices. The SEC was faced from the start with an investment community that had just learned, through very painful experience, that its investments were at the mercy of a handful of professionals who controlled the securities markets for their own profit. And, when the speculative excesses of those professionals toppled the market, the losses were sustained in large part by the small investors.

The SEC's response was to fashion a system of regulation designed to eliminate unfair and fraudulent practices, and to encourage honest investment, competition and innovation in the securities markets. Although many important legal principles are set forth in the securities laws, in most areas Congress gave the SEC broad rulemaking powers to promulgate regulations for the protection of investors and otherwise in the public interest. Two areas which have been regulated by the SEC almost exclusively under its rulemaking powers are

-- Insider trading; and
-- Trading in options.

By describing the SEC's efforts in these two areas I will try to illuminate the ways in which regulation can foster public confidence among investors. I will then consider more broadly how the effective regulator can serve as a catalyst to capital formation.

The Regulation of Insider Trading

Under U.S. law, the term "insider trading" refers to the purchase or sale of securities by an "insider" while in possession of "material" information not generally available to the public. The two most important terms in this definition are "material" and "insider." Neither was defined -- or, for that matter, even included -- in the securities laws from which the SEC asserted its authority to prohibit insider trading. Both have been the subject of important court cases.

"Material" information has been defined by the U.S. Supreme Court as information which the reasonable investor might consider important in deciding to buy, sell, hold or vote a security.

An "insider" is one who, by reason of his special relationship to an issuer, is in a position to learn of corporate developments before the public does and for whom it would be unfair to take advantage of that information for his personal benefit. Examples of "insiders" include officers, directors and employees of an issuer, as well as the lawyers, accountants and investment bankers who serve the issuer. Restrictions applicable to "insiders" apply as well to the tippees of insiders.

Since the early 1940's, the SEC has worked hard to control insider trading. Starting at a time when the practice was commonly accepted -- and even endorsed as a good investment strategy -- the SEC has succeeded in bringing the business community to the view that insider trading is both legally and ethically wrong. This accomplishment -- which I believe is one of the SEC's most notable success stories -- started with the promulgation, in 1942, of the SEC's now-famous Rule 10b-5. Rule 10b-5 made it unlawful, in connection with the purchase or sale of any security:

> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person . . . .

Over the years, the SEC has vigorously enforced Rule 10b-5 against insider trading, both in the courts and in its own administrative proceedings. The SEC has also made numerous public statements of policy strongly urging corporations, institutional investors, broker-dealers, law firms and accounting firms to adopt policies and guidelines designed to deter insider trading. Absent clear policies reasonably enforced, the SEC pointed out, a firm might be held responsible for the insider trading of its employees, on the theory of aiding and abetting or the traditional common law notion that a principal (the firm) is liable for the acts of its agent (the employee).

While it is impossible to know what might have happened if the SEC had remained silent, my strong sense, after 20 years in a private securities law practice, is that the SEC's campaign has had a profound effect. Today, insider trading is almost universally recognized as illegal and unethical. Numerous courts -- including our Supreme Court -- have verified this view of the law. And the policies and guidelines urged by the SEC have become commonplace within the securities industry. Of course, insider trading is not a thing of the past -- it still occurs with a frequency that is hard to reckon. But at least we can say that public attitudes toward the practice have changed dramatically since 1942.

But why prohibit insider trading in the first place? Numerous countries -- including Mexico -- have not yet chosen to follow the U. S. example in this area. Other countries -- France is one example -- rely mainly on public disclosure of insider trading as a policing mechanism. Still others -- like Japan -- have simply not enforced laws against insider trading that are already on the books.

In the United States, we believe that the health of our securities markets depends importantly on the prohibition against insider trading and the energetic enforcement of that prohibition. We have three reasons for this belief.

First, prohibiting insider trading encourages other investors to participate in the securities markets with the assurance that the system is not rigged against them. To the maximum extent feasible, market regulation should assure that all investors have equal access to material information. Investors should be able to assume that their skills of analysis, applied to the information available, will have a fair chance of resulting in profits. Investors ought not fear that insiders will take advantage of what they alone know to drain off profits otherwise available to all investors. If you were a public investor, why would you place your money in an investment where insiders had first call on the profits?

Second, issuers are helped by eliminating insider trading. Investor confidence in the fairness of the market facilitates capital formation by encouraging widespread participation in new securities issues as well as in the secondary markets. Moreover, if insiders are free to appropriate the value of secret information to themselves, issuers may be forced to provide a higher rate of return on their securities to compensate other investors for the profits siphoned off by the insiders.

The third reason is the simplest -- insider trading is wrong. There has grown up a general consensus in the business community that insider trading is unfair and unethical. While this idea is, in part, the product of the SEC's efforts, it is not limited to the United States. In virtually every free world country that has formally addressed the issue, the conclusion has been that insider trading is wrong. Judgments as to what to do about it may vary, but in no case has the view been that insider trading is an acceptable practice.

I should note at this point that there is a small group -- consisting mainly of certain economists -- who actually favor insider trading, or at least oppose efforts to fight it. They make the following arguments:

- Insider trading attracts more investors to the markets, thereby increasing depth and liquidity.
- Insider trading hurts no one, since the people with whom the insider deals were willing to trade anyway, even without knowledge of the secret information.
- Insider trading is an effective way of rewarding the entrepreneur whose special talents are critically important to the success of modern business corporations.
- Even if insider trading is wrong, there is no way to control it without using methods so drastic and expensive that their costs would greatly exceed the benefits obtained.

I will not stop here to answer these arguments in detail. Suffice it to say, in rebuttal:

- Insider trading attracts precisely the wrong investors to the markets -- much in the way that shoplifting may fill the stores, but with the wrong kind of customers.
- It is no less wrong to deprive someone of profits fairly earned on his investment simply because these profits were not anticipated. Moreover, insider trading can bankrupt market professionals, such as specialists and market makers, who have a continuing obligation to trade with the public to promote stable prices.

- Corporate managers should be compensated openly -- from the corporate treasury -- not in the dark from the pockets of shareholders. In many cases, the people who are aware of inside information are not the ones who deserve such a reward. And, of course, the entrepreneurial reward theory makes no sense when the insider sells on bad news not yet made public.

- Insider trading can and must be controlled. The risk to the continued health of the U.S. securities markets of failing in this task is too serious to countenance. In short, the benefits of the effort do, indeed, outweigh the costs.

In the United States, the prohibition against insider trading is mainly derived from SEC regulation and court decisions. For this reason, many important questions are just now being considered by the courts, and we sometimes find it difficult to apply the old rules to novel situations.

Other countries, like Great Britain, have enacted specific and detailed legislation to fight insider trading. The clarity and precision of this approach has much to recommend it.

The English statute is not only more precise than the U.S.law, it is considerably more severe. Not only does the English law apply to situations not clearly covered by our law, but the English statute makes insider trading a crime, punishable by a fine and jail term. While U.S. law in theory permits criminal prosecution for insider trading, such cases are quite rare and very hard to prove. Typically, in the United States, violations of the insider trading rules will result in an injunction obtained by the SEC, plus exposure to private damage actions for lost profits by deceived investors. However, courts have been reluctant to hold an insider liable for an amount greater than his illegal profit.

This limitation on liability has served as a great disincentive for private parties to bring damage actions against inside traders. Since the public stock markets do not operate through face-to-face dealing, there can be thousands of investors harmed by one instance of insider trading. If the limited recovery is divided among them, there would simply be no incentive to sue. In this regard, it is also important to remember that, in the United States, the winning party in a private lawsuit still has to pay his own lawyer.

Recent cases of insider trading show that, through devices such as options trading, enormous profits can be made in a short time with relatively small investments. For example, in one case the SEC recently brought, the son of a company's director was alleged to have made a profit of over $400,000 in just two days with a $3,125 investment in call options based on inside information about a proposed merger. With profits like these available, it is difficult to deter this type of conduct when the worst we can do is to force the insider to surrender his illegal profits and accept an injunction not to violate the law again. He has nothing to lose!

It is for this reason that I have urged the SEC to recommend legislation to Congress which would subject one guilty of insider trading to liability equal to at least three times the illegal profit. This money would be available first, to investors who were harmed, second, to the company and, finally, if no one else claimed it, to the government, like any other fine. Moreover, any private party who succeeds in winning an insider trading case would be entitled to have his attorney's fees paid by the guilty insider. Such a law would fast become an important part of the SEC's fight against insider trading.

I have also suggested other, perhaps less drastic, changes to improve our chances in the fight against insider trading:

- Restrictions on trading in options by insiders - the English have done this since 1967!

- Expanded authority for the SEC directly to order a person to "cease and desist" from insider trading, with disobedience punishable by a court imposed fine.

- Special legislation which would make it easier for the SEC to prove a violation of Rule 10b-5 in insider trading cases where an injunction is sought.

The SEC is now considering each of these proposals and expects to submit proposed legislation to Congress in the near future. While it is difficult to predict Congress' reaction in the current climate of political uncertainty, I am optimistic that action in this area will come within the next few years.

In conclusion, I would repeat that the control of insider trading is critical to establishing public confidence in the securities markets. This is no less true in Mexico than it is in the United States. Moreover, the interdependence of the international trading centers makes the approach to insider trading in one center of growing importance to the successful implementation of approaches being pursued in other centers. For these reasons, I exhort the Mexican securities professionals and government officials to work together promptly to develop an effective program to outlaw insider trading.

Regulation of Option Transactions

I understand that, among the new financial products being considered by the Mexican Stock Exchange and the Mexican Securities Commission, are equity options and financial futures. Since the SEC does not regulate the futures markets, I will not discuss them directly. We do regulate the equity options markets, however, and because the instruments traded there may in some cases be viewed as the functional equivalents of certain futures, much of what I have to say about our experience with equity options will be useful in considering the development of financial futures as well.

Trading in equity options on U. S. securities exchanges began in 1973, and has rapidly increased in popularity since that time. Options contracts have standardized terms which permit them to be purchased and sold in the secondary markets. Standardized contracts also permit the recognition of profit and the limitation of losses through the purchase of an offsetting option contract, thus avoiding the necessity of exercising the option and selling the underlying stock.

Options are used mainly by two types of investors: "hedgers," who desire to minimize the risk to themselves of unfavorable short-term price movements in securities they own, and "speculators," who seek to profit directly from predicting those short-term price movements. I emphasize "short-term" because the present practice is to trade options with a maximum life of nine months. The participation of both hedgers <u>and</u> speculators is considered necessary for successful markets.

It is important to realize that options trading can be complex and very risky. It is appropriate only for certain investors. Much can be learned from some unfortunate experiences in the United States markets, where options have sometimes been sold to unsophisticated investors who did not fully understand the risks of such trading.

Trading in options is regulated by both the SEC and by the individual options exchanges. In addition to administering its own rules, the SEC has the responsibility of overseeing the operations of the options exchanges, approving their rules, and reviewing their disciplinary actions.

The explosive early growth of options trading from 1973 to 1977, together with increasing incidents of abuse, led the SEC to call for a moratorium on all options trading until an improved regulatory structure could be developed by the SEC, the exchanges and the member firms. The SEC also directed a detailed investigation of the public options markets. After more than a year of effort, the so-called "Options Study" was released by the SEC in 1979. It concluded that "options can provide useful alternative investment strategies to those who understand the complexities and risks of options trading." The report warned, however, that serious inadequacies existed in the then current structure of the options markets. These included:

- o inadequate surveillance of the markets by the exchanges, resulting in an inability to detect manipulation and other trading abuses;
- o sales practice abuses, including failure to disclose risks and the promotion of inappropriate or illogical option strategies;
- o inadequate supervision by the exchanges of their member firms' selling practices; and
- o inadequate sharing of surveillance information among exchanges.

The options moratorium lasted from July of 1977 until March of 1980. Since the resumption of options trading, problems have not entirely disappeared, but the SEC now believes it has the means, both directly and through the exchanges, to monitor and control the options markets effectively.

Under the current regulations governing options trading, stock options may be traded only on securities that meet certain standards designed to assure that the underlying security is widely held, actively traded, and issued by large, well-capitalized and stable companies. These listing standards offer some assurance that the options will not harm the market for the underlying stock, either by making that market more volatile or by facilitating manipulation.

Sales practices in the options markets are now more closely controlled, to protect investors. For example, customer accounts must be specifically approved for options trading by a supervisor of the broker-dealer firm. In addition, the customer must receive a copy of a detailed prospectus explaining the terms, risks, uses and mechanics of options before he trades. Broker-dealers are also required to develop written supervisory procedures with respect to options trading. And persons who sell or supervise the sale of options are required to pass special qualification examinations.

In recent years there has grown up a tremendous interest in the creation and trading of options and other derivative instruments -- principally futures -- on non-equity securities, including debt securities issued by the U.S. government and it agencies, corporate debt securities and such novel instruments as stock and commodity indices, foreign currency options and many more. We have even seen doubly derivative instruments proposed -- an option on a future on a security!

In many ways, non-equity options and futures present the same regulatory problems as equity options. But they also possess risk characteristics not shared by the equity derivatives. Indeed, in today's unusually volatile debt markets, these types of instruments can be considerably riskier than their equity counterparts.

Non-equity derivative instruments also present novel problems in the applicaton of existing legal principles. For example, advance knowledge of government debt policy decisions, money supply figures or tax policy could present a trader in interest rate sensitive securities with an unfair advantage over the rest of the market. But the application of our insider trading rules to this type of situation is uncertain. The English insider trading statute I mentioned earlier deals with this situation directly by placing special obligations on government employees. The SEC may have to consider a similar approach at some point if abuses develop.

One regulatory problem which is unique to this area is the division of jurisdiction over certain of these newer instruments between the SEC and its sister agency, the Commodities Futures Trading Commission (CFTC). Forty years after the SEC was born, Congress created the CFTC and gave it broad responsibility to regulate commodity "futures." Unfortunately, in doing so, Congress defined "commodity" so broadly that traditional "securities" could be covered. As novel financial products are created, a large gray area has emerged, in which the power of the two agencies overlaps.

The SEC has recently negotiated a practical division of authority with the CFTC, and we have asked Congress to ratify that action. If Congress does so, the technical problems will have been solved, but another difficulty will remain. In an area where technically different instruments are functional equivalents, it will be particularly important for the SEC and the CFTC to cooperate in their regulation and to avoid significantly different approaches to the same problems. If that occurs, weaker regulation is likely to drive out more vigorous regulation as competitors seek the easiest and least expensive system to comply with. This tendency may, in fact, raise the threat of a repetition of the abuses that led to the options moratorium, a result which could disrupt our financial markets greatly.

We are hopeful that a "competition in laxity" between the SEC and the CFTC will not emerge. But the lesson for others should be clear. Avoid dual agencies responsible for competing products. Place under one agency's charge the regulation of securities and all their derivatives. Fortunately, Mexico, with its single Securities Commission, does not have this problem -- yet. I urge you, however, not to divide responsibility for regulating competing securities instruments among separate agencies. It will complicate your regulatory problems and make the successful operation of your local securities markets all the more difficult and uncertain.

The U.S. options experience has been a complex one which has challenged our ability to control strong economic forces. I offer that experience for the value it may have to the financial community in Mexico. Like many others entering a new field, we have done some things right and others wrong. If you study our mistakes as well as our successes, it will make your task immeasurably easier.

I want to conclude this topic with one further warning. Equity options markets, even with protective regulations in place, may not necessarily enhance investor confidence in the underlying capital markets, particularly if those capital markets have not developed a solid momentum of their own. Options are a "negative sum game" for the players. Losses and gains cancel out before expenses. After expenses, which go to the options exchanges and the brokers, the net loss is substantial.

As critics of these derivative instruments have observed, this "negative sum" aspect stands in contrast to investment in equities, where over the years we have witnessed a "positive sum game." The growth of companies in the United States over the 50-year period from 1926 to 1976, for example, resulted in a real return for investors in common stock of 6.9% per annum.

If a fledgling options market results in significant losses for a high percentage of the players, there is likely to be an adverse rub-off on the underlying capital markets. Investors who get burned by options may refuse to play in the capital markets at all. This has certainly been the experience of previous surges in speculative activity. For these reasons, I would encourage the most careful consideration of the wisdom of initiating an options market, or for that matter a futures market, as a means of restoring investor confidence in the capital markets of Mexico.

The Regulator as Catalyst in Capital Formation

The SEC was created to protect investors and the public interest by promoting fair and efficient securities markets. The responsibility for promoting capital formation -- the process by which companies raise capital -- was not directly assigned to the SEC. Yet, capital formation is at the heart of what we do. Protection of investors and promotion of fair and efficent markets were recognized by Congress in 1934, and many times since then, as essential prerequisites to an effective process of capital formation.

To an important degree, then, the SEC promotes capital formation simply by doing a responsible job of enforcing the laws and administering its regulations. But it is important to recognize how little direct, positive action an agency like the SEC can take to promote capital formation. We do not set or approve interest rates, national economic, monetary or tax policy, or even approve the specific terms of publicly offered securities. We administer no government guarantee programs and give away no money. The role of the SEC in promoting capital formation remains the limited one of assuring fair and efficient markets, protecting investors and in these ways building the confidence of investors in the use of the securities markets as a place to entrust their life's savings.

While regulation to promote investor protection and sound markets can directly serve to promote capital formation as well, over-regulation or misguided regulation can do the opposite. All regulation carries a cost, to be borne by the issuers and investors. For the regulator, the trick is to figure out whether the benefits of a proposed rule will outweigh the costs. This decision is exceedingly difficult to make prospectively, and even with the benefits of hindsight, it is often hard to know whether a particular regulation has produced a net benefit to the marketplace.

I also recognize that our experience in the United States is not necessarily going to apply completely and without modification to the Mexican capital markets. The smaller size, relative youth and current problems of the Mexican securities markets may require a somewhat different approach. For example, I would expect that there would be close cooperation and coordination among <u>all</u> the financial and securities regulators in Mexico in formulating a useful policy on how to stimulate healthy capital formation. At the same time, however, I warn the securities regulators not to lose sight of their fundamental mission. If basic concerns such as the protection of investors and the promotion of fair and efficient markets are forgotten in the interests of a quick fix through more direct incentives to stimulate investor interest, you may find that success is short-lived and the more basic problems remain.

The SEC has had periods of more and periods of less regulation. We are now in something of a deregulatory phase. Of course, we and our predecessors have always been searching for the most effective regulation -- which is to say that which does the job at the least cost to those affected -- where some form of regulation has been found necessary in order to serve the goals of investor protection, fair and efficient markets and capital formation. And we have tried to learn from our mistakes.

I hope those of you who are facing these issues in Mexico will be able to build on the experiences we have had in the United States.