REMARKS OF

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THE NEW CAPITAL ORDER: AMERICAN COMPETITIVENESS AND GLOBAL CAPITAL FLOWS

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The world is a very different place that it was five years ago. Communist regimes all over Eastern Europe have fallen and those countries are moving toward capitalism. The European Community is inching closer to becoming a reality. Emerging markets from Mexico to India are transforming their regulatory structures from central control to structures that now rely more heavily on natural market discipline. And values in Japan's stock and real estate market have finally retreated from previous historic highs.

Some of these changes have been wrenching for those who lived through them. But they also present enormous opportunities for those who are positioned to take advantage of them. The question is -- are U.S. investors positioned to take advantage of them?

That is a question that we at the SEC grapple with constantly. And with good cause. At one time, these events would have had little impact beyond national borders. But, today's markets are inextricably linked. Technology now permits capital to move with the speed of light in and out of new opportunities.

Capital, like a nature, abhors a vacuum. When not inhibited by artificial barriers or protectionism, it naturally flows to where it is scarce and to where returns are higher.

As businesses diversify internationally, they seek to raise capital in their new markets. Many syndicate managers have a new reference book on their desks -- an atlas. It's becoming standard fare for deals to have tranches in several countries.

Additionally, governments increasingly look to foreign investors to help fund their operations. The most vivid example of the degree to which governments rely on foreign investment is the massive privatizations in countries from Latin America to Eastern Europe.

And the other side of the equation is, of course, that investors naturally seek to gain exposure to other markets with faster growth rates and greater opportunities. U.S. financial firms have recognized the trends and have become global players to serve their customers' needs.

The evidence of these trends is irrefutable. Foreign companies from all over the world have raised more than $66 billion in capital in U.S. public and private markets in 1992, compared with $48 billion in 1991 and $34 billion in 1990. To date, 529 foreign companies have taken the plunge into the U.S. capital markets and become reporting companies. So far in 1993, seventeen issuers have entered the U.S. capital markets for the first time.

Those statistics show that American investors' interest in foreign stocks is on the rise. Last year, U.S. investors purchased and sold a record high of $270.9 billion of foreign equities in markets around the world. Investors now trade $1.1 trillion in foreign equity markets. That's 11% of all equity trading worldwide.

A substantial amount of their purchases are effected in U.S. markets. Treasury Department figures show that in 1982, investors purchased less than $10 billion in foreign stocks in U.S. markets. By the end of 1991, that figure had shot up to over $150 billion. We do not have final 1992 figures yet, but early estimates indicate that they will be up substantially.

Add to all that, the activity in the burgeoning international OTC derivatives markets and, as a famous Washington politician once said, "A billion here, a billion there, and pretty soon you're talking about real money.

At the same time that U.S. investors are exporting capital, they are also exporting some American notions on corporate-shareholder relations. American institutional investors are applying not so subtle pressure on foreign companies to be more responsive to shareholder interests. This wave of shareholder activism began here in the United States several years ago, crested last year when the SEC adopted sweeping changes to our proxy rules, and is now washing ashore in Europe and elsewhere. As investors have had success advancing their agendas with U.S. corporations, they have been emboldened to try to make inroads in foreign markets.

It's ironic, but the proliferation of indexing and other passive investing strategies has given rise to some very active shareholders. All indications are that they are ready to flex their muscles in the same aggressive manner that they have been in the United States in the last few years.

From France to Germany, institutions have begun challenging issuer restricted voting rights schemes. To enthusiastic applause from fellow shareholders, CalPERS and other institutional shareholders have rocked annual meetings by challenging the voting rights structures of such corporate giants as BSN in France and Siemens and RWE in Germany. They haven't prevailed yet, but the movement is gaining steam. It's not clear, however, whether Boone Pickings is ready yet to take another trip to Japan.

As U.S. investors are increasing their exposure in foreign markets, the SEC is working to make access to our capital markets appealing to foreign issuers. I would like to spend the rest of my time on some recent developments in the United States and give you an advance preview of some of likely future actions by the SEC. After all, it's clear that with or without us, U.S. investors are going to invest in foreign companies. It makes perfect sense that they be given the opportunity to do so in their home market, where they can trade under the investor protection scheme that they are used to.

The U.S. capital markets are the largest, most efficient, and fairest markets in the world. That didn't happen by accident. In addition to good old-fashioned American know how, the emphasis that we place on adequate disclosure and tough enforcement of our anti-manipulation rules and other anti-fraud provisions has been the secret to our success.

The cost any issuer, whether U.S. or foreign, pays for access to the vast retail shareholder base in the United States is to provide full, complete disclosure of its financial condition. Viewed from that perspective, you can understand why the agreement the SEC recently reached with Daimler Benz was so long in coming. Both sides had legitimate arguments. German issuers argued that it would be too costly for them to comply with U.S. GAAP and that the kind of disclosure we require is not what German investors require.

On the other hand, there was concern in the United States that U.S. investors would not have important issuer information they now have when they make investment decisions. Of course, there was also concern about establishing a double standard and disadvantaging U.S. issuers as a result. In fact, we did hear from certain companies in Detroit that they had strong reservations about being disadvantaged compared with their foreign competitors.

The compromise we reached with Daimler Benz addressed these concerns. The SEC agreed that Daimler could provide basic German financial statements, together with financial information prepared in accordance with U.S. GAAP. In addition, we gave the company some leeway on some of its historical numbers, which would have been very costly to develop.

The agreement we reached with Daimler is a step in the right direction. Both Daimler and U.S. investors should benefit. Daimler will now be able to follow through on its desire to list its securities on the NYSE and to offer its securities directly to U.S. investors. U.S. investors will have the opportunity to invest at lower cost in a major German corporation, armed with disclosure in a form, and with the content, they are used to. The result should be an expansion of the company's capital base and enhanced shareholder value.

I am very hopeful that the leadership that Daimler showed will encourage other foreign companies that have been contemplating accessing the U.S. equity markets to do so. The press has speculated that Deutsche Bank and Nestle are in fact heading in that direction. I strongly encourage foreign issuers to approach the SEC on this issue. What once seemed to be an intractable issue, no longer is.

For those foreign issuers who are not yet prepared to follow in Daimler's footsteps, Rule 144A still remains a useful tool to raise capital in the United States. Rule 144A was intended to provide an attractive way for foreign issuers to access the private placement market in the United States. The adoption of the rule was enthusiastically received by the markets and the response has been gratifying. So far, 138 foreign companies have raised $10 billion in capital and 106 U.S. issuers have raised nearly $23 billion in the so-called "Rule 144A market."

Several years ago, Hollywood released a movie called "Field of Dreams." One of the classic lines from that movie was "if you build it, they will come." Well, we did, and they are.

Although Rule 144A has proven to be a success, we adopted the rule in its current form as a first step. We've had three years experience with it now and I think the time may be right to look at where we go next. There are three aspects of the current rule that I think merit re-examination:

-- whether we should open the market to greater institutional participation;

-- whether foreign private issuers should be required to supply certain information required by the rule; and

-- whether certain SEC anti-manipulation rules, in particular Rule 10b-6, have unnecessarily discouraged foreign issuers from entering the market.

Several months ago, the SEC expanded the categories of qualified institutional buyers, which is our term for institutions eligible to participate in the market, to include certain collective and master trust funds and insurance company separate accounts. At the time, I expressed the sentiment that we needed to consider going further.

Many of the comments we received on the proposal to expand the definition of QIB questioned why institutions such as mutual funds that had QIBs as advisers are not permitted to participate in the 144A market. Many commenters recommended that the SEC allow <u>any</u> institution whose investment adviser is a QIB to qualify under the rule. That would mean that retail investors in mutual funds would have indirect access to a market to which the SEC limited their direct access.

Of course, the fundamental difference between a retail investor acting alone and one that invests in a mutual fund is the professional investment adviser, who has greater research capability for ongoing due diligence. Where retail investors have the benefit of a registered investment adviser that is a QIB, the investor relies on the adviser -- and in fact has given authority to the adviser -- to make investment decisions. The investor is not involved in making any decisions on the desirability of a particular investment.

It may be that the SEC should allow institutions advised by a QIB to participate in this market. I believe that it certainly merits some thought, now that we have had three years of experience with the Rule. To the extent that this market has been hampered by illiquidity, allowing these institutions to participate in the market would go a long way toward alleviating liquidity problems.

Any discussion of liquidity in the Rule 144A market eventually turns to the development of a secondary market trading system. To date, the National Association of Securities Dealers' PORTAL system is the only such system in operation. So far, however, it's had a less than illustrious history. There are a number of probable reasons for this.

First, the NASD designed PORTAL not only as a secondary trading system, but also as a communications system to facilitate distributions. Despite the intuitive appeal of an automated system for distributions, the market seems to prefer to do business the old fashioned way: by telephone.

Second, the NASD made a calculated decision to develop PORTAL while the SEC was finalizing Rule 144A, rather than wait to see what the final rule would look like. Right before adopting Rule 144A, the SEC simplified the rule significantly and, as a result, PORTAL ended up placing more restrictions on its users than Rule 144A required.

What's less clear is why we haven't yet been able to approve a modified system. Since the adoption of Rule 144A and PORTAL, the SEC and the NASD have had lengthy negotiations on what the final PORTAL system would look like. I am not happy that it's taken nearly three years to get there, but I <u>am</u> very happy that we're now close to approving substantial changes to PORTAL. Hopefully, within a month or two, PORTAL will have a new lease on life. The private placement market is no longer the buy-and-hold market it once was. Hopefully, PORTAL will now be a viable means for increasing secondary market liquidity in this market.

The underlying premise behind Rule 144A was that very large institutional investors were capable of protecting their own interests and did not need <u>all</u> the protections provided by the registration requirements in our securities laws. Nevertheless, the SEC wasn't willing to leave investors entirely to their own devices and it required certain foreign issuers to supply basic financial information to investors.

As basic as the information supplying requirement is, it may be discouraging foreign issuers from using Rule 144A. Apparently, some issuers are concerned about the heightened liability they face in the United States by providing this information. I'm a little puzzled by this, because it seems to me that the information the Rule requires is fairly basic. The SEC expected that issuers would be able to meet the requirement with information they have readily at hand. Nevertheless, if this requirement is in fact discouraging foreign issuers from accessing this market, it's time to look at it again.

So far, the SEC hasn't extended the "big players can take care of themselves" philosophy beyond loosening some disclosure requirements. But some of us at the SEC are concerned about the effects of at least one anti-manipulation rule on this market.

Back in the days when markets were more isolated from each other, the SEC adopted Rule 10b-6 to limit the ability of distribution participants to artificially prop up the market for a security. The key word is "distribution." Unfortunately, it isn't clear whether the rule applies to so-called "Rule 144A private placements." The uncertainty has caused issuers to seek interpretive relief from the SEC on a case-by-case basis, eliminating a lot of the benefits of the streamlined procedures Rule 144A was supposed to provide.

Right now, the SEC is in the midst of re-examining its anti-manipulation rules, including Rule 10b-6, from the ground up. Two weeks ago, the SEC adopted changes to Rule 10b-6 to address liquidity problems that surfaced for some Nasdaq stocks under the old rule. The amendments allow certain market makers to engage in passive market making during distributions. I expect that the SEC will look at whether some broad-based relief from Rule 10b-6 is appropriate in connection with Rule 144A deals in the future.

Just as the growing predominance of institutional investors was the one of the moving forces behind the internationalization of the markets, their predominance has also been the moving force behind the growth of the international OTC derivatives market. As their hedging needs became more complex, Wall Street's -- and the City's -- rocket scientists stepped in to fill the void with customized products to suit every need.

The growth of the market has been phenomenal. a recent report by the U.S. banking agencies noted that by year-end 1991, the notional value of outstanding OTC derivatives was approximately $4.4 trillion -- a 790% increase from year-end 1986. And the size of some preliminary numbers the SEC has recently collected through our new risk assessment program indicate that $4.4 trillion may actually understate the size of the market.

These products provide enormous advantages for their users. But no one has yet invented the perfect financial instrument and these products raise issues that we all have to recognize and address. First OTC derivatives are really the first long-term credit risk broker-dealers have <u>intentionally</u> assumed (there was, of course, that short-lived experiment with bridge loans). And they represent the first time broker-dealers have assumed long-term credit risk to a significant degree.

Second, because much of this activity is effected in unregulated affiliates of the broker-dealer, the real size of this market is not known. That lack of information could become a critical issue during a future market crisis. We don't really know what the market overhang effect might be if all those so-called "sympathetic" hedges were adjusted simultaneously, or if liquidity was not there when it was needed. We also should consider the possibility that the interlinkages OTC derivatives create among international financial institutions could have the effect of spreading a crisis across the divisions that separate financial institutions, <u>and</u> across international borders.

The SEC is attacking these issues on two fronts. First, we adopted a risk assessment program last summer that will allow the SEC to get a better picture of the scope and nature of the risks outstanding in these affiliates. We will also get a better idea of the extent of the credit risk firms are assuming.

Second, the information we collect on credit risk will be factored into our discussions on the appropriate capital treatment for these transactions. Right now, our capital rules require a 100% capital charge for unsecured receivables that arise from OTC derivatives. That's because the fundamental principle that underlies the capital rule is that broker-dealers must maintain adequate liquid capital to assure that they can meet their financial obligations to their customers and creditors if they are forced to liquidate. OTC derivatives are, however, highly customized and inherently illiquid.

It seems clear that the appropriate capital charge for OTC derivatives is somewhat lower than 100%. Certainly, the current capital treatment has had the unintended effect of creating an incentive to shift some of these transactions off-shore or to affiliates. It seems to me that the near-term challenge regulators face is to find a way to remove the disincentive to effecting these transactions in the broker-dealer.

Credit risk is not just the regulators' concern. Financial institutions themselves commit substantial capital to controlling and managing risk. In fact, individual firm risk control systems are the first line of defense against a market crisis. The banking report put it well -- "Regulation cannot substitute for effective management."

CEOs and boards of directors need to assure themselves:

-- first, that they really understand these transactions and their risks;

-- second, that firm risk control systems are keeping up with the new types of risks they are creating and assuming. An important part of that process should be making sure that the creators of these products are not also responsible for managing the risk they create.

-- third, that their internal and external auditors, as well as board audit committees, are asking the right questions; and

-- fourth, that they are taking adequate steps to minimize counterparty credit risk. For example, are they accurately marking their positions to market? Are they adequately collateralized? Will the stand-by collateral be there when it is needed?

As part of the risk assessment program, the SEC will get information from broker-dealers about their risk control systems, as well. From my discussions with financial institutions over the last six months, I have come to conclude that, at least since Black Monday, they have made serious commitments to maintaining good risk control systems.

Conclusion

At the SEC, we recognize the many opportunities and challenges internationalization of the markets presents. The United States has the strongest, fairest, and most efficient markets in the world. To date, no country has come close to toppling the U.S. from its perch as the undisputed world champion of the international financial markets.

But times are changing. Around the globe new and old contenders alike are vigorously exploring new ways and means to challenge us for the title. Not so long ago, domestic securities markets were isolated from events outside their borders, and regulators had the luxury of making policy without being concerned about what was going on in foreign markets. Today, however, regulators can no longer regulate unwanted practices and products out of existence. They simply evolve and mature in a more accommodating environment. For the United States, this means we can no longer ignore our challengers and hope for a quick knockout when the competition gets heated.

Moreover, as the reigning champion, the United States can no longer afford to rest on its laurels and hope the international judges grant us the decision. We have to take affirmative steps now to retain our championship belt and our position in the global financial marketplace.

But no mistake about it. We won't engage in competition in laxity or tolerate regulatory arbitrage. Some international regulators have chosen that path, but it's a direct route to disaster. Any short-term market gains from such policies are inevitably given back manyfold when the scandals begin to unfold and investors lose confidence.

The advent of CNN and the explosion of information technology have made the world a much smaller place. The challenge facing all of us -- regulators and market participants alike -- is to respond to these changes in ways that strengthen our capital markets for the long-term benefit of everyone involved.

Thank you.