REMARKS OF

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MARKET 2000 AND THE FUTURE OF U.S. CAPITAL MARKETS

SECURITY TRADERS ASSOCIATION ANNUAL MEETING

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

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I've been told by technology experts that the world's collective capacity to compute and to communicate increase by an average factor of <u>ten</u> from one decade to the next. In other words, in 1990 our computers and telecommunications systems were ten times faster than they were in 1980. All that is about to change, however. According to techies, the world now stands on the edge of a quantum leap forward. During the next ten years, our ability to compute and to communicate will increase by a factor of <u>one hundred</u>.

This explosion in new technology will have profound implications for the world's capital markets -- markets that are already inextricably linked. Technology now permits capital to move with the speed of a computer stroke in and out of new opportunities. The great surge in merger activity that Wall Street has been engaged in recently is a direct result of companies trying to position themselves for the next wave of this technological revolution.

From Shanghai to Budapest to New Delhi, market reforms are also taking hold and creating new demand for capital. This combination of new technology and increased market access provides investors with more opportunities than ever before, including an estimated $150 billion in anticipated privatizations around the globe. It also will lead to fundamental changes in how markets, *both in the U.S. and abroad, operate. And it may lead to changes in the way regulation operates, given the increased opportunity for "regulatory arbitrage" and the increased technological capability to synthetically circumvent regulation.*

MARKET 2000

At the SEC, efforts are underway to prepare for these changing markets. The centerpiece of our effort is our "Market 2000" study -- a study which I am pleased to report is nearing completion. As many of you know, Market 2000 is a comprehensive analysis of the competitive and market structure issues affecting the equity market. It is my hope that Market 2000 will deal not only with the current "hot issues," but also with how technology, institutionalization, derivatives and globalization are impacting the market and how these forces will change the marketplace by the year 2000. And perhaps most importantly, how the U.S. markets will be positioned versus other increasingly competitive world markets.

Market 2000 represents the first comprehensive study of our markets since the so-called "Institutional Investor Study" done in the mid-1970's. The Institutional Investor Study led to the un-fixing of commission rates; the development of consolidated quotation and transaction reports among U.S.

exchanges; the Intermarket Trading System; and the initiation of transaction reporting for NASDAQ securities.

Since that time, the U.S. equity markets have undergone dramatic changes, not the least of which are the growth in trading volume, advances in trading technology, the increasing dominance of institutional investors, the introduction of standardized and OTC derivative products, and the explosion of cross border activity.

While these developments have resulted in significant cost savings, convenience, and variety to the investing public, they also raised important questions of market transparency, liquidity, efficiency, and domestic and international competition. As a result, the Commission, as well as market participants, have been confronted with issues such as payment for order flow, proprietary trading systems, the growth of third and fourth market trading, and fair competition between the exchanges and NASDAQ.

While in a perfect world, a resolution of these and other market questions would await the official release of the Market 2000 study, the Commission has initiated action on a number of fronts.

PAYMENT FOR ORDER FLOW

Three weeks ago, the Commission published for comment a proposed rule regarding Payment for Order Flow. Specifically, the release proposes to amend Rule 10b-10 to require a broker-dealer to include on the confirmation of each transaction whether payment for order flow was received, and, if so, the amount of any monetary payment or monetary equivalent received in connection with the transaction.

The release also proposes to add new Rule 11Ac1-3, to require disclosure on each new account statement and on a yearly basis thereafter on the annual account statement, the firm's policies regarding payment for order flow practices in exchange listed and NASDAQ national market system securities; and information regarding the firm's aggregate amount of monetary-based payment for order flow.

As the people in this room know, payment for order flow is an issue that deeply divides segments of the securities industry and has been the subject of extensive debate and analysis. Opponents of payment for order flow liken this practice to a payoff, while proponents consider it a legitimate business practice in a highly competitive market. Like most of these disputes, I suspect the truth lies somewhere in the middle.

The Commission's recent rule proposal attempts to strike a balance between these competing viewpoints -- and does so in a manner that I believe is wholly consistent with the core principles of the federal securities laws.

By advancing the notion of a disclosure based solution, the Commission has steered clear of picking "winners" and "losers" between competing market participants. Instead, by requiring relevant disclosure, investors will have the information necessary to make informed decisions for themselves.

As an aside, let me call your attention to the fact that the payment for order flow release also contains language directing the Commission staff to report back within 45 days on the need for enhanced disclosure by investment advisers in the area of soft dollar arrangements. In many respects, soft dollars and payment for order flow are two sides of the same coin. While there certainly are technical differences between the two practices, both represent payment of cash and non-cash compensation for allocating business among market participants. Once we have the staff report, it is my hope the Commission can move swiftly in this area as well.

T+3 CLEARANCE AND SETTLEMENT

Another area where the Commission has recently taken action is on the adoption of a T+3 settlement timeframe for most broker-dealer securities transactions. Under new Rule 15c6-1, most transactions that now settle on T+5 will be required, effective June 1, 1995, to settle on T+3.

Once again, this was not an issue that proceeded without significant debate. All told, 1,941 comment letters were received, and many commenters opposed to the Rule raised legitimate concerns regarding the needs and preferences of retail investors.

After weighing these concerns, however, the Commission believed that it was important to proceed with T+3. As I mentioned earlier, the last 20 years have seen unprecedented changes in the world's securities markets. Not only has volume grown exponentially, but market participants now routinely operate in multiple markets -- foreign and domestic -- equity, debt and derivative. With this has come an unprecedented, but inevitable, linkage among the world's securities markets. Previously, disruptions in one market were not necessarily felt in other markets. Now, however, if New York sneezes, London catches a cold and some smaller markets get pneumonia.

In light of these linkages, the clearance and settlement system must be prepared to absorb shocks from more remote sources than ever before. Since the 1987 Market Break there has been a near universally held view, first expressed in the Brady Report, that improvements needed to be made in domestic clearance and settlement systems.

Subsequently, the Bachmann Report quantified for the first time what we all knew intuitively about the clearance and settlement system: time = risk. Or, to put it another way, nothing good happens between trade date and settlement. After all, a five-day post-trade settlement cycle is like giving the Phillies five days to decide whether they would like to replay last night's game against the Blue Jays -- even though the City of Toronto has already banked the transaction.

By adopting T+3 the Commission attempted to strike a reasonable balance between the needs of the retail customer and the structural changes necessary to adapt to the technological world we now live in. It is my hope that the technological developments that will be spawned from adopting T+3 will eventually enable us to further curb systemic risk with an even shorter settlement cycle.

The move to T+3 has brought into focus a question that I believe will need to be addressed in the future. As we shorten the settlement cycle, do we in fact deemphasize the significance of the confirmation statement? And if that is a side-effect of our action, should we begin to look at front-loading more disclosure in account opening statements and annual statements? I don't have answers for these questions today, but I do think the Commission and the industry need to rethink the entire approach to providing certain types of disclosure, and the timing of that disclosure, to make it more meaningful to retail investors.

DERIVATIVES

In the financial world, probably the "hottest" issue in Washington these days is derivatives -- and during the next two weeks there won't be a shortage of press coverage in this area. Next Wednesday the CFTC will be sponsoring a symposium on Capitol Hill to unveil their most recent study, on Thursday the House Banking Committee will hold hearings on the regulatory oversight of the derivatives market, and Congressman Markey recently announced his intention to hold hearings to coincide with the release of the much anticipated GAO study on derivatives which should be out by year-end.

As a rule of thumb, it seems to me that when Washington pays this much attention to an issue the marketplace should fasten its' seat belt. One GAO representative has already testified that derivatives could be the next S&L crisis. Since I will be testifying on behalf of the Commission next Thursday in the House Banking Committee, let me give you a little sneak preview of coming attractions.

From a regulatory perspective, derivatives, and in particular OTC derivatives, raise issues with respect to counterparty credit risk, leverage, systemic impact, suitability, and internal control mechanisms.

To date, the SEC is making significant strides in addressing these potential areas of concern. With regard to monitoring and evaluating firm risk assessment and internal controls, the Commission adopted a risk assessment program that required firms to provide us with comprehensive information about their risk management systems. Our objective is not to limit the amount of risk firms may assume or how they should manage it. Instead, we are focusing on assuring ourselves that senior management has a handle on the risk control systems and were monitoring their effectiveness.

On a related front, the Commission issued a concept release last spring on the appropriate capital treatment to apply to OTC derivative positions. In the *concept release we solicited the markets' views on the kinds and level of risk that dealers in this market are assuming. In addition, we asked for commenters' thoughts on how the SEC should respond to the risks these products introduce to firms' balance sheets. Also, along with focusing on the risk profile, we seek to address the unintended disincentives that exist in our current capital rule to effecting these transactions in the registered broker-dealer. The current 100% capital charge for these "unsecured receivables" is forcing these transactions off-balance sheet and sometimes off-shore. The SEC has extended its comment period until December and in particular we are awaiting the comment letter from the SIA and ISDA.*

The SEC's efforts to date have focused primarily on quantifying and controlling systemic risks. To me, however, the best defense against the risks in this market are strong and well-implemented risk management systems at the individual firm level. Clearly, if individual firms are managing their risks well, they substantially reduce the chances that they will become the first domino to fall and threaten the rest of the system.

The recent released Group of Thirty report makes a significant contribution to the better understanding and management of the derivatives market. To the extent market participants voluntarily follow the *recommendations contained in this report, they greatly enhance the quality of the story they will be telling Congress in the coming weeks and months.*

I suppose, in a nutshell, the Commission's view with regard to derivatives is that the risks posed by new and innovative products can be addressed by the existing securities regulatory system -- and that the Commission is committed to addressing these concerns head-on.

__OTHER ISSUES__

While probably not the "hottest" issues in Washington, there are certainly other issues that are of concern to market participants, and in particular, people in this room.

As many of you know, the SEC is currently involved in litigation over rule changes to "SOES," the Small Order Execution System. In approving the Professional Trading Rule and the 15-Second Rule, the Commission sought to provide some protection to market makers from being picked-off. Certainly, in my view, the end result of not providing some protection would be reduced liquidity because market makers would either widen their spreads or ultimately cease to make markets in certain securities. You have to ask yourself, who wants to stay in a market where you are constantly getting your pocket picked?

In August, the U.S. Court of Appeals for the District of Columbia gave the Commission a partial victory. The Court upheld the "15-Second Rule," which established a 15-second update period following a SOES execution, and remanded the Professional Trading Rule back to the Commission for further consideration.

Last week, the NASD filed a proposed rule change with the Commission to eliminate the definition of "Professional Trading Account" that the Court had difficulty with. The NASD also had out for comment new comprehensive rule proposals in this area which generated over 600 comment letters. We expect some action by the Commission staff on these proposals in the next 30 days. Needless to say, I don't think we've heard the last of this issue yet.

I know the NASD's proposed short sale rule is also of interest to many of you. Designed to protect against real or perceived "bear raids" on growth stocks, the current debate revolves around whether to provide an exemption for options market makers similar to that provided to NASDAQ market makers. The NASD has been working with the options market makers to address their concerns about being at a competitive disadvantage. We were expecting an agreement in mid-September, but I understand that negotiations are still underway.

After reading the recent Forbes article on NASDAQ, it's probably appropriate to comment briefly on my view of the current status of NASDAQ and its' role for the future. Certainly, as NASDAQ has grown the battle for listings and trading volume has gotten more aggressive. That said, I certainly don't want to get involved in a family feud between NASDAQ, the exchanges and Forbes. I do think, however, that vigorous competition is what makes our capital markets the largest, most efficient and fairest in the world. My larger concern is that this vigorous competition between our various market systems -- that has been so constructive in the past -- is now threatening to become destructive given the tenor of the debate on issues such as payment for order flow, soft dollars, and SOES. We all must guard against this tendency because the failure to do so will only lead to decreased investor confidence in our markets.

CONCLUSION

Issues involving "turf" and trading practices aside, these are exciting times for securities professionals. The markets are at all time highs, new and innovative products are being developed that meet investor demands, individual investors are returning to Wall Street in record numbers, and capital is flowing relatively unimpeded across numerous international borders.

The current challenge for regulators and market participants is to validate this overwhelming vote of confidence that we have received from investors. Market 2000 is the SEC's primary effort in this regard, and hopefully will allow us to adapt to the new demands of tomorrow's markets. This is certainly no time to be complacent.

I'm reminded of the old Texas adage that "only a fool rolls up his pants before he gets to the creek." That's certainly true, and there is no need to be alarmist about the current state of U.S. capital markets, they truly are an American success story. By the same token, however, let's not wait until the water starts rising before we take action to relieve some of the "stress points" in our regulatory structure.

Working together, we will ensure that the United States continues to have the most efficient means of allocating capital in the world. And that investors know that our markets are liquid, transparent and fair. And let's not forget that some of our current "hot" issues are indeed family feuds. At one level, we are all in this together. We all have an interest in ensuring that the U.S. market system remains the model for the rest of the world.

Thank you very much.