Remarks of
Richard C. Breeden, Chairman *
U.S. Securities and Exchange Commission
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The beginning of the final decade of the century is a good time to pause and evaluate the state of the U.S. financial markets. We should ask ourselves what objectives we seek from our capital markets, and what changes, if any, will help us make the 90's a decade of renewal, strength and prosperity.

The U.S. economy as a whole did exceptionally well in the 1980's. Interest and inflation rates, and unemployment, all fell dramatically. Since 1983, Gross Domestic Product grew about 34% in Japan, 33% in the U.S. and 21% in the European Community ("EC"). In terms of new jobs and total employment, the U.S. led the world, with total job growth of about 18%, compared to about 11% in Japan and 2% in the EC.

Our equity securities markets, which I believe are the "crown jewel" of our financial system, also performed well during the 1980s. The aggregate rate of return for equities over the decade was about 400%, and aggregate market capitalization increased during this period over 140 percent. The mutual fund

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* The views expressed herein are Chairman Breeden's and do not necessarily represent the views of the other Commissioners or the Commission staff.

industry played a major role in the strength of the market. With 36 million shareholders and over a trillion dollars in assets, your industry has become a key segment of our financial markets. Through mutual funds more than one in four American households participates in the U. S. securities market. Service, safety and an excellent return at low cost have been a key to making mutual funds the investment vehicle of choice for millions of Americans. Of course, I hope you don't rest on your laurels. Why not make it one in four households -- even one in ten -- in the world? Ambitious? Yes. Impossible? No.

However good the 80's were for U.S. securities markets, on some measures the Japanese and U.K. markets did even better. Market capitalization in the EC rose by more than 4 times during the 1980's; in Japan, by more than 11 times. As a result of our lower growth in market capitalization, which put us 14th in the world, the U.S. share of global equity market capitalization decreased from 51 percent in 1980 to about 30 percent in 1989. More importantly, the U.S. went from having a securities market 4 times larger than the <u>next largest</u> market, to a situation today in which Japan and the U.S. have very close to the same aggregate values, while the combined EC market is only slightly smaller.

What these figures tell us is fairly simple-- in the 1990s, we must make every effort to make our capital markets more liquid and efficient. We can't <u>assume</u> that investors from around the

world or even those here at home will want to participate in our markets. They will have attractive alternatives in Europe and Asia that may offer greater liquidity and lower transaction costs.

Also disturbing is that the value of equity securities taken out of the U.S. markets in going-private transactions during the last five years exceeded the value of equities issued by nearly $500 billion. At the same time, there was an $867 billion net issuance of corporate debt, and an almost $1.65 trillion net issuance of government securities. These statistics may simply reflect our national love of leverage. However, the hundreds of billions the taxpayers will have to pay in the S&L cleanup, in significant part due to too much leverage -- should give us pause on the wisdom of a systematic conversion of equity into debt.

This trend toward smaller equity markets and much larger debt burdens, if it continues over a longer period, could have serious implications for the long-term health of the U.S. economy if it continues over a larger period. Equity capital is vital to provide the base for companies to invest in long-term research and development, or to have the staying power to succeed in industrial competition on a global scale. Happily, there are a number of steps we can take to reverse these trends and improve the efficiency and competitiveness of our equity markets.

First, we should continue and increase efforts to improve the U.S. savings rate. Our rate last year of 5.7% is better than the 3.3% low we hit in 1987, but it is well below the Japanese rate of about 15%. The rates of saving that prevail in other industrialized countries are higher than our own. Savings rates play a major role in the evolution of equity and other capital markets, because savings are the foundation on which those markets are built. I fully support the President's suggestion of a new program of savings incentives in the form of family savings accounts. Potentially even more important are the budget talks that are about to begin between the Administration and Congress. The ongoing federal deficit voraciously consumes our savings. Progress toward a substantial resolution of this problem would be quite beneficial for our capital market if it is accomplished in a sensible manner.

We should also eliminate barriers to investment caused by conflicting and duplicative regulatory structures. One critical issue is the dual regulation of equity-based products at the federal level by the SEC and the Commodity Futures Trading Commission ("CFTC"). We are the <u>only country in the world</u> with developed markets that divides regulation of equity securities from the regulation of derivatives on those securities. The inefficiency and potential dangers inherent in this system should be of particular concern to institutions, which are the dominant

investors in S&P 500 stock index futures, as well as individual investors.

Contrary to some of the arguments, current regulatory system stifles innovation and competition. As a result of the Commodity Exchange Act's exclusivity clause, any U.S. securities exchange that wants to trade, or any corporate issuer that wants to issue, any new security that may even arguably contain any element of a futures contract will be exposed to the peril of years of delay and millions in legal fees to litigate over whether such an instrument is 100% a security, or merely 90 or 95% a security -- in which case the product may violate the "exclusivity" clause. This provision of the commodities laws could do incalculable damage to the U.S. equity markets. It means that investors will be denied access to some of the most innovative products our markets have to offer, and U.S. issuers will have less flexibility than their foreign competitors to issue hybrid securities. Other major markets do not exalt the proper regulatory classification of products over their economic usefulness. British Petroleum, Olivetti, Hitachi, Hyundai, Westpac, Volvo, Hong Kong Telecom, and other competitors around the world can issue hybrid securities in markets outside the United States without having to pay the costs of litigating over the exclusivity of commodities regulation.

Indeed, we will never know, and as investors you will never know, how many new products will <u>never</u> come to the markets because exchanges or issuers are unwilling to face litigation over the exclusivity clause. If we wish to maintain our global leadership in innovation and creativity - finding new ways to lower the cost of capital - then we have to let new products be tested in the market, not the courthouse. I don't know whether the <u>IPs</u> product that was recently invalidated by the Seventh Circuit in another of a long line of exclusivity cases brought by the futures exchanges would have been successful over the long run - even though 74 million were purchased in only about 4-6 months of trading. What I do know is that we will never find out -- because the market wasn't allowed to make that judgment. Instead, the legal version of a Death Star obliterated that product from the U.S. market - and the only place you can buy a similar product today is Toronto -- not New York <u>or</u> Chicago.

Because of this regulatory fragmentation, margin requirements in the stock and stock index futures markets are governed in completely different ways. In the case of the securities markets, the federal government oversees the establishment of prudent margin levels. In fact, a limit on speculation with borrowed funds was one of the key safeguards for stability adopted in the wake of the stock market crash of 1929.

In contrast, margin levels on futures contracts, including stock index futures, are generally <u>not</u> subject to federal regulation. The CFTC does not have authority to set futures margins. Instead, the power to set margin levels for futures contracts, including stock index futures, is explicitly assigned to the futures exchanges.

At the time of the market breaks in both 1987 and in 1989, the margins on stock index futures were set at levels that allowed futures market participants almost 22 times greater leverage than permitted for securities purchases. Because the margin levels were so close to zero, at the first sign of serious market stress stock index futures margins were sharply <u>raised</u>, resulting in more than a half-billion dollars in margin calls. This removed liquidity from the markets at the worst possible time, and it exposed the market to the risk that firms unable to meet margin calls would have to dump portfolios on the market. Thus, a new risk of massive selling was created at the very time the danger of a further fall in the market was the greatest. We were fortunate that the banks and others provided the necessary liquidity, and that we did not experience a new wave of futures-driven selling on Monday, October 16. But, the risk was there, and it was significant. Fed Chairman Alan Greenspan has testified that he was "shaken" by the risk created by the stock index futures margin situation. This is not theory -- it happened, and it happened not once but twice.

Congress should act swiftly to reform the system of margin regulation to reduce the disparities in levels of permissible leverage among all equity products -- stock, stock options, and stock index futures. The approximately 50 million direct and indirect public shareholders in this country, and others who would be impacted by a systemic problem with the clearance and settlement system, are entitled to expect that the job of protecting the public interest will be handled by a public agency - not traders on an exchange.

Glass-Steagall reform is another important issue we need to tackle in the 1990's. The debate isn't whether Glass-Steagall should be changed, but how it should be changed. I am personally comfortable with greater affiliations between banks and securities firms, but only where securities activities are conducted through securities firms that are regulated in the same manner as securities firms not affiliated with banks. In addition, the existing special exemptions for banks and thrifts under the 1933 and 1934 Acts should be repealed. From the perspective of protecting investors, there is not any justification for giving banks and thrifts different treatment than bank and thrift holding companies, and all other types of issuers.

If Congress addresses Glass-Steagall, I would suggest that it must simultaneously address the "flip side" of the coin -- the Bank Holding Company Act. If we lower the barriers against bank holding companies buying broker-dealers, we must also lower the barriers against broker-dealer or investment adviser holding companies buying banks. That, of course, will require us to design an efficient and effective system for oversight of holding companies with subsidiaries that are active in both banking and securities.

The role of state regulation in a rapidly evolving global marketplace is another important consideration for the 1990s. The states have played an important and constructive role in our financial markets. However, as we compete with unified markets in Europe and Japan, we must do everything reasonably possible to eliminate unnecessary costs and paperwork in the U.S. market. When our markets were far and away the most liquid and efficient in the world, we perhaps could afford more restrictions and complexities than we will conclude are advisable in the future.

I believe that there are significant opportunities to streamline the way we regulate investment companies. As mutual funds become steadily more popular as a means of investing by millions of citizens, we have to make sure that we are fully confident that the law and regulations are sufficiently strong and effective. At the same time, we should look carefully to see how the current law and administrative requirements can be

streamlined after a half century on the books. We have assembled a Study Group in the Division of Investment Management to perform a thorough review of the current system.

As a first step, we will ask for public comment on a number of issues we have identified. But we also want to encourage people to raise any other points they believe merit study.

To give you a preview, and, I hope, to inspire you to give us your ideas and insights, let me list a few areas the Study will reexamine.

Globalization of the securities markets has led to increased interest in marketing U. S. investment company shares and other money management services abroad, and in opening our markets to foreign investment companies. The Study Group will look at how we can facilitate cross-border sales of fund shares and investment advisory services. They will also look at whether there is a need for alternative regulatory structures to accommodate more varieties of investment companies and other pooled investment vehicles. Since our global competitors frequently operate in trust rather than corporate format, we intend to look carefully at the pluses and minuses of creating more flexibility than we now have on how these products and their providers must be organized.

Distribution of investment company shares will also be reviewed fully. The Study also will consider whether closed-end funds should be permitted to offer holders some rights of redemption, as, for example, quarterly; how to regulate variable insurance and bank-sponsored products, as well as funds sold only to large institutional investors. The Study Group will recommend reforms to the Commission early next year.

While this study is ongoing, we will continue various rulemaking projects, including a reexamination of Investment Company Act Rule 2a-7, which governs most money market funds.

Money market funds have continued to be very popular with investors. At the end of March, money market fund assets reached $464 billion, up $100 billion from a year earlier. Investors appear to consider money market funds one of the most convenient and risk free investments available. Good investment returns, features such as checkwriting and a solid track record of paying back one dollar for each dollar invested have contributed to investor confidence in money funds over the past 15 years.

By placing quality and maturity conditions on the securities which money market funds can buy, Rule 2a-7 is intended to limit credit risk, interest rate risk and currency exchange risk, and to permit money market funds to maintain a stable net asset value per share. The Rule has done much to keep

money fund investments reasonably conservative. However, the money markets have changed significantly since the late 1970's when the standards in the rule were originally developed.

Our goal in any revision that we propose will be to help ensure that money market funds continue to limit their exposure to risk -- which investors expect -- without unnecessarily impairing the ability of fund managers to operate the fund efficiently and earn a good return, which investors also expect.

I have attempted to outline a few of the important international and domestic issues we must focus on to ensure that our securities markets remain vigorous, competitive, and safe during the coming decade and to preserve investor confidence in U.S. investment companies. The Commission will do everything it can to achieve these goals. I hope we can count on your support in ensuring the well-being of the vital national asset of strong and efficient capital markets.