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News Release

Remarks of

Richard C. Breeden, Chairman
U.S. Securities and Exchange Commission

The Mid-America Committee
Chicago, Illinois

May 11, 1990

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It is a pleasure to be here today to join with the Mid-America Committee. I bring you greetings from one windy city to another -- but at least Chicago has the excuse of a lake!

It's always a great pleasure to come out and see the business community -- people who know the true meaning of the bottom line. In Washington, the bottom line reads "continued on the next page."

I envy Chicago. Your hockey team is still alive in the Stanley Cup. Chicago's also a big baseball town, with not one, but <u>two</u> teams.

We live in a world of incredibly fast change -- political, economic, technological -- and especially in capital markets. I

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

am sure you would all agree, capital is the lifeblood of our economy -- if we don't allow this lifeblood to circulate freely, then our competitive muscles will atrophy and the health of our economy will falter. We must take great care, therefore, that our institutions keep up with the profound changes in the worldwide capital markets. This means keeping the markets liquid, competitive and free of fraud. It also means strengthening their structure to ensure that the stability of our overall system is maintained.

Today I want to talk about the challenges and opportunities facing us in this new global environment, and what I believe we must do so that our nation can compete and prosper in this new world.

Around the world, economies are becoming more open, more productive, more integrated -- and more competitive. Communist economic systems are being rapidly replaced by a surge toward free markets in Eastern Europe and elsewhere. In the West, substantial trade liberalization continues to occur.

Along with these changes -- which build upon the surge of world growth since World War II -- global capital markets are transforming themselves radically. In the late 1950s, there was no such thing as a "Eurobond" market. It did not exist. Today it's one of the most important debt markets in the world -- more than $210 billion in Eurobonds were issued in 1989 alone.

International transactions in government bonds and equities have increased rapidly. Total foreign purchases and sales of U.S. securities have ballooned during the last decade from $200 billion to $4.7 trillion -- and U.S. purchases and sales of foreign securities climbed from $50 billion to almost $700 billion. Companies around the world issue and list their stocks for trading in multiple countries. Some European companies issue more stock in London than in their home country. In the U.S., mutual funds and institutional investors are increasingly following conscious strategies of international portfolio diversification.

Indeed, the SEC has made several regulatory moves in order to facilitate these efforts, including the recent adoption of Rule 144A. This rule will facilitate institutional investors being able to acquire a larger array of foreign securities in transactions in the U.S.

The global market has become closely linked, and that helps all of us. But, at the same time, the U.S. is lagging in certain key areas. In 1980, the U.S. equity market was worth $1.4 trillion -- about four times larger than that of Japan. A decade later, the U.S. and Japanese markets are almost equal in market capitalization (after a 24% decline in Japan since the beginning of the year), with the combined European Community only slightly behind in size.

Similar developments are occurring with respect to stock index futures. In 1986, U.S. trading in stock index futures accounted for nearly 98% of all such contracts traded worldwide. Last year, in terms of aggregate dollar value of trading, the U.S. represented 49% of global trading. Japan has risen from zero to nearly equal volume to the U.S. virtually overnight.

If our nation is to compete fully, then our financial regulatory system must modernize -- as soon as possible.

A reform of regulatory structure need not involve a choice between the interests of New York and Chicago. We should not compete with each other -- but with the real competition -- London, Frankfurt, Tokyo. Similarly, we need to find a way to rise above the traditional interest group wrangling. Rather than endless disputes between large banks and small banks, banks and securities firms, securities and futures, we need to focus on how to achieve the American national interest in liquid, safe and efficient capital markets. Achieving that goal unquestionably will require a significant overhaul of the antiquated and badly fragmented U.S. regulatory system. Largely designed in the

1930s, this system imposes far too many artificial regulatory costs on U.S. firms that are not paid by foreign competitors.

There are many examples of this problem, but let me cite several that arise out of the unnatural split in legal jurisdiction between the securities market and derivatives on securities -- stock index futures.

Dual Regulation

First, every other competitor nation with a developed capital market has created a "unified" system in which regulation of stocks, options and stock index futures are under the ultimate oversight of a single government agency.

That is true in Japan -- where the Ministry of Finance has authority over all three segments of the equity and equity-related market. That is true in the U.K., where the Department of Trade and Industry, acting through the Securities and Investment Board, has oversight over stocks, options and financial futures -- as well as insurance. It is also true in France, where the MATIF, the very dynamic futures exchange (which, incidentally, is the formal partner of the CME in Globex), is under the direct regulation of the French SEC, which is known as the COB.

Unlike these other countries, the U.S. has erected the financial equivalent of the Berlin Wall between regulation of securities and regulation of derivatives on securities. That Wall is the product of decisions made a decade ago -- for reasons that include unfounded fears, frankly. The result is that U.S. firms like Shearson or Merrill Lynch that want to offer customers products in stocks, options, and stock index futures must pay to maintain two entirely separate systems of regulation, and comply with the rulebooks of two entirely separate agencies. Nomura and Daiwa don't have to do that in Tokyo, and S.G. Warburg and Morgan Grenville don't have to do that in London.

Unfortunately, as a result of the EC92 process, this disadvantage for U.S. firms may get worse. Europe is moving to integrate their financial markets and to dismantle all their barriers, and it appears likely that S.G. Warburg will be able to trade stocks and stock index futures in Italy, France, Germany, Holland, and other EC countries, from Portugal to Greece, solely by complying with regulation of the S.I.B. in the U.K. The same will be true for Deutschebank and the other European banks and financial firms, each of which will earn a "passport" to operate throughout the E.C. by complying with its home country regulation if it meets minimum E.C. standards.

Wouldn't it be nice if Paine Webber or Refco or other U.S. firms could get a passport from a single U.S. regulator to allow trading on both the CME and the NYSE, and sell products from New York to Illinois to California?

Exclusivity

The "exclusivity" clause of the Commodity Exchange Act is a second serious problem created for U.S. capital markets -- especially for U.S. industrial companies seeking to raise capital at the lowest possible cost.

While the futures exchanges have been responsible for the development of extremely valuable and innovative products, the CEA stifles innovation by impeding the development of creative new products in other markets. Under the exclusivity clause of the CEA, a product that is deemed to have elements of a futures contract, even if that product is fully regulated as a securities or banking instrument, cannot trade except on a registered contract market. This "Death Star" provision of the CEA is a long-term recipe for destroying our international competitiveness.

In recent years, various corporate issuers and exchanges have sought to offer innovative and attractive "hybrid" products that cross the boundaries of traditional equity, debt, and derivative issues. This financial creativity, however, is put at risk by a system that can require years of delay and millions in legal fees to determine whether the new product is 100% a security, or only 90%. Sadly, this type of litigation and delay in bringing new products to market is necessary only in the U.S. 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.

Stability

Beyond the problem of the costs imposed by our current system is the issue of market stability.

At present, margins on stocks and options are subject to federal oversight, but margins on stock index futures are not. As a result, futures exchanges have at times set stock index futures margins at levels near zero. During normal market conditions, this may not create a significant problem. But when market conditions become extreme, these low margin requirements create enormous additional risks. The low margins do not cause the market problems, but they have the potential for turning a temporary fall in the market into a much deeper and damaging situation.

Any financial regulatory system has to be designed so that the ship is strong enough to remain afloat in a storm, not just on a bright sunny day. The current margin system for futures doesn't pass that test, with the level of certainty and assurance that we would like.

In testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan made his concerns over the inadequacy of the current system even more blunt. "I was shaken," said Greenspan when describing his reaction to the margin events last October. At that time, the Chicago Mercantile Exchange, having been caught with margins at 2% when the crisis hit, had to raise margins by significant amounts. Indeed, we estimate that between Friday the 13th and Monday October 16th, more than a half billion dollars in higher margin had to be posted, due to the need to sharply raise margin levels. Luckily, these margin calls were met without widespread dumping of portfolios. However, if the banks and other sources of that liquidity had not been so accommodating, margin calls of that magnitude in the midst of a crisis might have resulted in waves of additional futures selling at precisely the time when we wanted the market to bounce back, not resume a plunge.

Of course, I don't want to overstate the risks that this situation creates. Every firm in the stock index futures markets was able to meet its margin calls, and both the securities and futures exchanges demonstrated that substantial improvements to computer capacity and other systems made since 1987 were effective in handling the extraordinarily high volumes of transactions. We worked very closely with the Chicago Mercantile Exchange during those events, and they proved as always to be professionals and effective in overseeing that market.

It should be clear that the objective is not to have identical margins for stocks and stock index futures. There are many legitimate differences in clearance, mark to market, and other practices that justify differences. However, for both options and index futures, we should have a system of federal oversight that can overrule any extreme decisions by an SRO. Margins that are too high waste capital, but margins that are too low could help turn a problem into a public disaster. Therefore, public oversight of margins to maintain some minimum standards -- even at a 10 or 15% level -- would be a big improvement.

Fraud

Another problem area with the current system is protection against intermarket fraud. It is now possible to attempt to rig moves in one market by using another market. Unfortunately, we have two different policemen patrolling each side of our Berlin Wall on foot, while those seeking to engage in fraud are free to fly above the wall by helicopter. Not only does each agency only see half of the relevant transactions, but they also bring different approaches and intensity to efforts to control fraud.

At the SEC, we believe that good regulation best serves the public interest by promoting a competitive market. At the same time, we are fiercely determined to create a clean market. Whether from the East Coast, Midwest, Britain or Japan, whether they are small investors or institutions, no one wants to become a victim of fraud or manipulation. Even the perception of widespread fraud in the markets will make participation in the markets much less likely, whether it's by a small rancher or farmer selling agricultural futures, or a giant pension plan selling stock or hedging a portfolio. By narrowing participation, fraud severely damages any market's liquidity, and thereby its efficiency.

Those who think it is acceptable to rig markets or cheat their customers should expect that there is a significant chance that they will be detected. If we detect conduct violating the law, such persons should also expect that they will be relentlessly pursued.

Indeed, I take great pride that in the Dennis Levine, Ivan Boesky, Drexel Burnham and Michael Milken series of cases, the SEC, working in complete cooperation with the U.S. Attorney's Office for the Southern District of New York, has recovered approximately $1.3 billion from those who engaged in deliberate fraud, insider trading, manipulation and other violations of the law. These funds were paid in both fines and restitution, with over $700 million being recovered by the SEC in disgorgement for cheated customers. This is only one example of numerous cases in which the SEC has been successful in recovering amounts stolen from investors. We also frequently seek to bar individuals who have engaged in serious violations of the law from future participation in the securities markets.

The end result of a strong enforcement program is a more liquid and efficient market with a lower cost of capital for companies that are seeking to raise capital for tomorrow's prosperity.

By helping to eliminate these problems, a consolidation of jurisdiction over stocks, options, and stock index futures would reduce costs, improve stability, strengthen the fight against fraud <u>and</u> permit greater competition. To achieve these goals, President Bush plans to submit a three-point legislative program to Congress soon, and the SEC will strongly support the Administration's proposal.

These proposals will help make the financial regulatory system more efficient, more stable and more creative. We believe it is a "futures" policy for the future -- one that will make the U.S. economy better equipped for creating jobs at home and competing abroad. Indeed, if the Germans can dismantle the real

Berlin Wall, we ought to be able to remove our financial version of it.

One thing should be clear in considering the Administration's proposal, and that is that it is designed to <u>improve</u>, not damage, the stock index futures market. In any issue like this, salvoes of rhetoric are inevitably fired by many groups. As far as I am concerned, financial futures markets in general, and stock index futures markets in particular, are valuable parts of our overall capital market. By permitting hedging of risk, transactions that might not otherwise occur -- including investments in the stock market -- are facilitated. Those markets have made many valuable contributions to the speed, liquidity and efficiency of our overall market. Like every market, futures need an appropriate level of regulation to prevent problems. But, like every market, futures should not be overregulated either. The financial futures markets of the United States are a national asset, and our objective going forward is to create the strongest possible markets in the U.S. -- both securities <u>and</u> futures.

So let us together focus on making our system stronger and less costly. Let's take a good hard look at our regulatory system together.

By relying on two different agencies, Harry Truman's famous "buck" never stops here -- or there. We get two different answers to every question -- one from each side, naturally, even though both sides of our Berlin Wall are part of a single economic market.

This structure can be compared to having two sets of air controllers for O'Hare Airport -- with one tower controlling take-offs and another tower controlling landings. You would have a lot of crashes that way. The current system is in fact a self-inflicted wound on our own cost of capital -- an anchor that only American companies have to drag through the water.

If we work together -- business leaders of Chicago, regulators from the federal government, concerned citizens of America -- I believe we can create a strong and fair financial system for the 21st century. If we combine resources and face the future together, we can create a dynamic America for our children, and a healthy economy for our future -- and theirs.