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News Release

THE SECURITIES MARKETS IN THE 1990'S

Remarks of

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

New York Financial Writers Association
June 7, 1990

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For most Americans the much discussed "globalization" of the securities markets is probably as pure an abstraction as, say, the formula for rocket fuel. I hope to render this abstraction a bit more concrete this evening, and also to consider with you some of the challenges we face in this new global environment.

GLOBALIZATION

First, it is worth noting that the U.S. securities markets are among the largest and traditionally the most fair markets in the world. Our securities industry has also been internationally competitive. Eleven of the largest 25 securities firms in the world are American, while only one of the largest 25 banks in the world is American. The U.S. securities industry has consistently been a leader in developing innovative new products, and we have one of the most efficient clearance and settlement systems.

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.

Our securities markets were once largely domestic, but this is not the case today. Stocks of numerous major U.S. companies are now listed for trading in Tokyo and London as well as in New York. More than 400 foreign companies have their stocks listed on U.S. exchanges or NASDAQ.

Foreign investors purchase and sell an enormous volume of securities in our markets. Total volume of transactions -- purchases and sales -- in U.S. securities by foreigners (including U.S. government debt) last year was about $4.7 trillion, a 2,300% increase in annual volume since 1980. Foreign transactions in equities alone were over $400 billion.

Similarly, U.S. pension plans and other institutions diversify their portfolios by buying securities around the world. Many individual U.S. investors participate in mutual funds oriented to foreign market areas, or particular countries, thereby distributing their personal portfolios around the world. Every day, tens of billions of dollars in transactions flow back and forth across the Atlantic and Pacific, and also across borders within Europe and Asia.

One of the results of this trend is the daily influence on the U.S. capital markets of developments in financial markets

around the world. Systemic problems in a major foreign market, or the sudden failure of a large foreign firm, would unquestionably have an impact on U.S. markets. Indeed, just yesterday, regulators and securities exchange officials from seven nations were at the SEC to continue ongoing discussions regarding coordination of supervision worldwide.

Developments in Eastern Europe

Another facet of globalization relates to the enormous changes that are occurring in Eastern Europe and the Soviet Union. This past February, the SEC met at length with several high level officials visiting us from the Soviet Union. The Soviets sought information about the structure and regulation of our securities markets, with a view toward establishing a securities market in the Soviet Union. They posed many questions -- about the SEC, our personnel, our budget, and our operating systems. They also asked how we detected fraud, and how we verified all the information filed with us.

The Eastern European countries are also thirsting for free markets, and they are moving far more rapidly than the Soviets. However, establishing successful securities markets is a very difficult undertaking. It is not just a question of building a trading floor, or even of obtaining and installing the necessary computers and telecommunications equipment. In addition to the physical systems, having a market also requires having securities

to trade, a meaningful accounting and disclosure system, trained sales personnel, people to oversee exchange operations and systems to deter abusive practices.

Despite the difficulties, we expect to see a whole new set of markets in Eastern Europe before too long. After being closed for 42 years, Hungary is going to officially reopen the Budapest Stock Exchange later this month, which will represent an enormous milestone on the road to political and economic freedom. We have held several meetings with Hungarian officials, and are currently working on an agreement regarding technical assistance and mutual cooperation between the SEC and Hungarian agencies that we expect to sign in the near future.

The Poles have also asked the SEC for technical assistance relating to establishing capital markets and related supervisory systems. Recently, we had two days of discussions at the SEC with senior officials of the Polish Ministry of Finance responsible for privatization of state owned industries and for creating capital markets. One of these individuals may soon head a new Polish agency paralleling the SEC. He is fluent in both English and economics. Perhaps because of that, only two years ago he was in a prison.

Creating effective market systems in these countries will be made more difficult by the rudimentary level of

telecommunications facilities, and restrictions on the availability of data processing equipment. Lack of an established banking system capable of large-scale electronic transfers will also create obstacles.

To better assist these efforts to create market systems, the SEC has recently formed an Emerging Markets Advisory Committee. The 30 members of the Advisory Committee include some of the best and the brightest from the U.S. financial industry. These leaders of the U.S. financial industry have committed themselves and their organizations to work with the SEC to provide assistance in the development of free capital markets in emerging market economies.

Together the countries of Eastern Europe and the Soviet Union represent a potential market of 400 million people. Helping these countries create free economic markets is the right thing to do. It also makes good long term business sense for the U.S. to participate actively in helping to develop these markets. Most importantly, these countries must know that they can count on cooperation over a sustained period of years as their markets develop.

EC 92

The 1990s are already witnessing the elimination of many existing barriers between the financial markets of the European

Community. If EC 92 is successful, a German bank or British securities firm will be able to operate from the Baltic to the Mediterranean, and the Atlantic to the Adriatic, largely under its home country regulatory requirements. The ability to operate throughout the EC in banking, securities, and other financial products solely by complying with "home country" regulation should greatly reduce costs for financial firms. It should also help create much greater liquidity that should reduce the cost of capital to European businesses of all types.

International Regulatory Framework

At the SEC, we are trying hard to help build a strong framework of cooperation among the securities regulators around the world. This cooperation includes coordination when there are market disruptions, sharing information for investigative and prosecutorial purposes, establishing consistent capital and disclosure standards and reducing risk in the clearance and settlement system.

The SEC is also trying to minimize obstacles to the free flow of capital over international borders. Within the past two months, we adopted "Rule 144A" and "Regulation S." Rule 144A should make it easier for foreign companies to access the U.S. market, while Regulation S should allow U.S. companies to raise capital abroad in a more simplified and less costly manner. We have just requested public comment on the concept of allowing

U.S. shareholders to participate in international tender offers in cases where the U.S. shareholders might otherwise be excluded.

ENFORCEMENT

We will make further changes as we go forward to promote the free flow of capital. However, one thing that should never change is our commitment to fair and honest markets. Investors will not want to participate in our markets unless they are free from fraud. We are determined to pursue those who break the securities laws or fail to observe standards of professional conduct.

Modern technology and the ease of international communications make it possible for people to violate the U.S. securities laws without entering our country. Indeed, in a recent insider trading case suspicious purchases of shares and call options in the target's securities originated in Greece, Lebanon, Switzerland and Monaco. Trades were conducted by corporations in Panama, the Cayman Islands and Lebanon, as well as by a French citizen. Boiler room operations have also now gone international, with investors in many countries exposed to fraudulent schemes conducted from outside their national borders. As a result, without international assistance, a single nation is often unable to enforce its most basic antifraud protections, as well as other provisions designed to protect the stability and integrity of its markets.

To help address international enforcement problems, we have developed agreements concerning information sharing and evidence gathering with a number of foreign regulators. These include Switzerland, Japan, the U.K., France, the Netherlands, Brazil and Canada. We are currently working hard to refine new agreements with Mexico, the Scandinavian countries, Australia, Israel and several other nations. These agreements will help ensure that violators cannot use international borders as a shield from being caught and prosecuted under the securities laws.

The SEC has a good overall enforcement record, both internationally and here at home. The criminal and civil prosecutions of Dennis Levine, Ivan Boesky, Drexel Burnham Lambert, and Michael Milken resulted in the recovery of over $1.3 billion for defrauded investors and the U.S. Treasury. Those who think it is acceptable to cheat their fellow citizens <u>should</u> know that we will seek to detect this conduct. When we find it, we will pursue violators of the law and attempt to recover every last stolen dollar for investors -- with interest. We simply will not tolerate stealing the value of someone's retirement savings, or defrauding an investor of his or her economic future.

<u>COMPETITIVENESS OF THE U.S. MARKETS</u>

Looking back to the 1980s, it should be apparent why our country cannot afford to be complacent in the 1990s,

notwithstanding the excellence of our capital markets. In 1980, the U.S. equity market was 4 times the size of the next largest market. In 1990, the U.S. and Japanese markets are nearly identical in size, while the EC as a whole is close behind. Thus, the dawn of the 1990s presents us with three roughly equivalent sized markets, and none of them is assured of predominance.

International competition in financial services will be fierce in the 1990s. By historic standards, the profitability of the U.S. securities industry has not been good over the last three years. Profit margins have been at their lowest level since the 1973-1974 period. After a continuous growth in the NYSE share volume for 11 years, with an accompanying expansion in employment and profits, in 1988, NYSE share volume dropped 15.5 percent. In 1989, share volume showed only a modest recovery (up 2.5 percent). Stock index futures volume fell almost 50 percent over a similar period. Indeed, the U.S. has gone from over 98 percent of world trading in stock index futures to less than 55 percent in only three years.

Unlike U.S. securities firms, the profitability of Japanese securities firms expanded rapidly throughout the 1980s. In 1989, about two-thirds of U.S. securities industry revenue was risk-based, and only 10 percent came from brokerage commissions. In Japan, securities commissions are fixed, the industry is heavily

concentrated at the top, and Japanese securities firms receive more than half their revenue from securities commissions.

Far more important than differences in structure is the difference in the bottom line. During the 1985-1988 period, U.S. securities firms had real (inflation adjusted) return on equity of 11.4 percent, which was only half the 21.1 percent of Japanese securities firms. Meanwhile, the profitability of U.S. banks lagged even further behind our international competitors over this period, with U.S. banks coming in dead last among those of seven major industrial countries in return on equity. Profits are a key to today's stability, and to tomorrow's growth and competitiveness. As U.S. firms square off against the giant global banks of Japan, Germany, and other countries, ingenuity and a proud history will not be sufficient to maintain, much less to expand, market share at home or internationally.

Another serious concern is the impact of high cost capital on future R&D, investment in new plant and equipment, and ultimately the creation of jobs. Consider the international race underway in building the next generation of computers, with billions of dollars in revenue from sales of data processing equipment and software at stake. Two prime competitors--IBM and Hitachi--may have to make billions of dollars in research expenditures to be successful. It is not comforting that IBM can raise equity capital at a current price earnings multiple of

12.3, while Hitachi can match IBM's equity at an average 1989 P/E ratio of 47.4. Think of it as a race in which the U.S. athlete has to do four "earnings" laps for every lap its Japanese competitor has to run. Sadly--that real life example is not an aberration. Comparing General Electric's 1989 average P/E of 12.2 to NEC Corp's 1989 average P/E of 51.7 underscores the magnitude of the competitive disadvantage in the cost of capital that U.S. firms can face.

One of our disadvantages in competing internationally is that the basic structure of the U.S. financial regulatory system was created in the 1930s. Because it never contemplated current problems and is highly fragmented, the costs of regulation are extremely high, while reliability and effectiveness in some parts of the system have proven completely inadequate. When our current laws were designed, for example, we did not have to worry about the issue of whether program trading hurt market stability. Nor did we have to worry about competition in international securities from large, well capitalized foreign banks. At that time, there weren't any computers, or stock index futures either. Of course, we didn't worry about Eurobonds, mortgage backed securities, the safety of government-sponsored enterprises or the risks of electronic funds systems--because none of these things existed either.

Laws that placed impenetrable barriers to banks entering the securities markets or subjected issuers and securities firms to fifty separate state regulators may have been a good idea in the 1930s, but they call for serious reexamination today. Despite much industry handwringing, the FIRREA legislation marked a significant step in returning sanity to our regulation of depository institutions. A second major step toward rationalizing financial industry regulation has recently been taken. This week, the Administration sent proposed legislation to the Congress to reform the fragmented system under which we regulate stocks, options, and stock index futures. For the first time, this legislation would establish public oversight over margin levels in stock index futures. It would amend the "exclusivity clause" of the Commodity Exchange Act that prevents new "hybrid" products from coming to market without extended litigation. The legislation also would transfer enforcement of the Commodity Exchange Act as to stock index futures from the CFTC to the SEC. This legislation would be an enormous step toward reducing the vulnerability of our markets, as well as reducing costs and promoting U.S. competitiveness.

The U.S. system of different regulators for what is a single market for stocks, options, and stock index futures is not found in any other industrialized country. Firms like Merrill Lynch or Shearson that want to conduct trading 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 do not have to do that in Tokyo. S.G. Warburg and Morgan Grenfell don't have to do that in London. Thus, we alone suffer from a fragmented system that reduces effectiveness and raises costs -- just the opposite of what should occur. Indeed, the stock index futures market may be hurt as much as the securities market by the current inability to prevent intermarket fraud, to achieve intermarket synergies like cross margining and escrow receipts and to assure greater stability.

The potential impact of this problem on the public is enormous. Hundreds of billions of dollars have been lost in the thrift disaster because, among other reasons, federal regulators set an acceptable leverage standard of 97 percent. Together with an accounting system that was unique to the thrifts and seriously overstated values of thrifts, this encouraged wanton speculation and helped to fuel rampant criminality.

Last October 13, in less than two hours that afternoon, 50 million Americans lost $160 billion in the value of their IRAs, mutual funds, pensions, college funds and other investments. One factor in the speed of the market's fall was excess speculation fueled by grossly inadequate margins in the stock index futures markets, where 97.8 percent leverage was in effect for many market participants as the plunge began. Sharp increases in

margins necessary to correct for the inadequate margins left the Chairman of the Federal Reserve--in his word--"shaken" at the risk that was unnecessarily created.

E. Gerald Corrigan, President of the Federal Reserve Bank of New York, recently observed that if you are forced to raise margins in a crisis, the margins were inadequate in the first place to do their job of protecting the payments system. In President Corrigan's words, the margins in the S & P 500 futures market have been "systematically" too low.

After the debacle of the thrift industry, the public wisely demanded that capital levels be set by an agency not under the domination of the regulated industry. Imagine the outcry had the U.S. League been authorized to set the capital levels. Yet, the futures industry is battling furiously to maintain the industry's power to set margin levels without any restriction or public oversight. In 1987 (when margins at the time of that crash were also as low as 2.2 percent), the public lost $1 trillion in investment capital between August and October. The Administration, Secretary Brady, Chairman Greenspan and President Corrigan have all called for Congress to act now, before a disaster, to reduce our market risks. President Lincoln rightly pointed out that a house divided against itself cannot stand. In this case, $3 trillion of the American public's money is in the house, and there are not any sound policy reasons for taking

unnecessary chances with the investment savings of 50 million Americans.

One interesting argument that I have never understood in the debate over stock index futures is the attempt to promote the virtues of a regulatory system designed to produce a zero sum game--or "price neutral" risk shifting. The SEC is criticized in this debate for allegedly favoring a steady upward trend in prices. Of course, it is true that if you're selling potatoes, there is a direct trade off between the interests of the farmer and the interests of the people who love french fries.

However, with stocks, the entire country gains from the creation of wealth that results from steady and sustainable growth in prices. Even the people who are short to the greatest degree -corporate issuers - don't complain if the price at which they sold stock rises after they sold it. It simply makes it easier to raise new capital for tomorrow.

For many reasons, I believe it would be good public policy to create public oversight of margins, eliminate exclusivity and unify regulation of stocks, options, and futures. At the same time, it is also good public policy to build a strong and vibrant futures market. I would strongly oppose efforts to effectively abolish the stock index future through unnecessarily high margins. Prudence, not punitiveness, should be our goal.

Indeed, given the appropriate legislative authority, among our *first* steps would be to extend cross margining and escrow programs across stocks, options, and futures markets; to begin to develop mutual recognition of licensing and oversight and to require immediate steps to control intermarket fraud. All of these steps would improve market stability, reduce costs and increase participation in all three market segments. These changes would also benefit agricultural producers by allowing the CFTC to concentrate more attention on agricultural markets.

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 agency. This weakens the effectiveness of regulation and increases costs. In a market crisis, weakened and divided regulatory authority makes it more likely that a serious problem could turn into a public disaster.

This structure can be compared to having two sets of air controllers for La Guardia Airport -- with one tower controlling take-offs and another tower controlling landings. You would be very lucky to escape with near-misses under that system, and eventually you would have quite a few crashes.

If we work together -- business leaders of Chicago, New York, Los Angeles, -- regulators from the federal and state

governments, 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.

The goal of changes to our regulatory structure should be to increase liquidity and to reduce the costs of capital. We need to try to eliminate domestic barriers to free flows of capital, and to eliminate legal complexities that drive up the cost of bringing new products to market. America's economic future is dependent on our efforts to create and maintain the most efficient possible means for raising capital. Making savings and investment attractive is not merely desirable -- it is essential to our future in a competitive world economy. Accomplishing our objectives will have to be done with international considerations very much in mind. However, if we have the vision and will, U.S. markets will remain a source of pride, economic strength and stability -- envy of the world.