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**ADDRESS BY**

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CHAIRMAN  
U.S. SECURITIES AND EXCHANGE COMMISSION**

**TO THE  
INSTITUTE FOR FINANCIAL AFFAIRS, INC. (KINZAI)  
TOKYO, JAPAN**

**AUGUST 1, 1990**

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

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U.S. SECURITIES AND EXCHANGE COMMISSION

TO THE  
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President Tokuda and distinguished guests. I am pleased to be here to join Kinzai on its fortieth anniversary. This occasion makes it most appropriate to consider the changes that have occurred since the Institute was established, as well as to look forward to the challenges of the future. During these last 40 years, Japan has experienced dramatic growth:

- o Population has grown by almost 50%.
- o GNP has grown at a dramatically higher pace, rising by more than 25,000%. In fact, at Japan's current rate of economic production, it takes you less than 36 hours to exceed Japan's GNP value for the entire year of 1950.

Japan's economic success has also been reflected in dramatic growth in capital markets:

- o In 1950, an average of 2 million shares per day were traded on the Tokyo Stock Exchange. In 1989, share volume averaged 900 million shares per day.

- o While the U.S. remains the largest market in terms of total equity capitalization, the market capitalization of the Tokyo Stock Exchange has grown from \$470 million in 1950 to about \$3.1 trillion today.

Throughout Kinzai's 40 years of existence -- and indeed for almost 135 years -- our two nations have had a unique degree of interaction. During this time we have developed many shared interests. One of the most important of these -- though not reflected in the economic statistics -- is a passion both nations share for the world's greatest sport, baseball. The year that Kinzai was created, the New York Yankees beat the Philadelphia Phillies in four straight games to win the World Series. That historic Yankees team included Joe DiMaggio, Yogi Berra, and Whitey Ford. Mickey Mantle was still only in the minor leagues, and the Dodgers were in Brooklyn, not Los Angeles. Of course in baseball, like in other competitions, you cannot afford to become complacent. This year the Yankees are in last place in the American League's Eastern Division.

The world of 1950 also had more pressing concerns than baseball. In Japan, reconstruction and economic revitalization, including comprehensive land and social reforms, were gathering momentum, and the formal supervision of General MacArthur, then Supreme Commander Allied Powers, was coming to an end.

When Kinzai was created, the world was dominated by a "cold war" that suddenly turned hot in Korea. The United States and her allies, including Japan, stood firm in Korea. We also faced the challenge to preserve freedom in Berlin, when U.S. and Soviet tanks faced each other just a few dozen yards apart at Checkpoint Charlie, as well as on many other occasions around the world.

Now, like a wind of renewal, democratic revolutions are sweeping across Eastern Europe, creating enormous new opportunity for the future of those societies. The Soviet Union is also undergoing massive change, the ultimate impact of which is as yet uncertain.

Only one month ago I stopped in Berlin on my way to the historic re-opening of the Budapest Stock Exchange. At that time passing Checkpoint Charlie required facing not a group of soldiers, but rather a crowd of young entrepreneurs offering to sell visitors pieces of concrete supposedly taken from the Berlin Wall, or to rent them a hammer or chisel. Two days later Checkpoint Charlie was lifted into history by a crane, and sent on its way to the Smithsonian Institution. As much as any single act, this may have symbolized the end of the cold war with the triumph of western values of free societies and free markets.

Over these last forty years, our capital markets have changed almost as much as the political map. Computer and telecommunications technology have revolutionized our financial markets, transforming their size, speed and complexity. Perhaps most importantly, national markets have been linked into a truly international market.

When Kinzai was created in 1950, Japanese financial firms were struggling to overcome the effects of the war, and they were insignificant as a factor in overall global finance. Today, Japan's economic success has been reflected in your financial system, where many of the world's largest and most profitable banks, securities firms and insurance companies are now Japanese.

#### Open and Competitive Markets

It is not enough, however, to celebrate the past, or to praise the current level of achievement. Rather, together we must turn our attention to the challenges of the future. One of the most important goals of the future is to create a sustained commitment to open and competitive markets.

As you know, during the last few years Japan has taken very significant steps to open its capital markets, creating benefits for both Tokyo's stature and role in world finance as well as for the foreign firms that have been able to establish operations here. Credit should go to Japan -- and particularly to the Ministry of

Finance -- for taking many steps to open your financial markets, even where such steps may have been unpopular.

Your progress to date in opening Japanese markets has demonstrated vision, and responsible leadership. However, there are still many areas in which more needs to be done to continue the progress to date. Having enjoyed great success due to open U.S. financial markets, Japanese firms must be able to live with the disciplines of an open financial market at home.

For example, there is absolutely no valid reason why U.S. investment management advisors and U.S. mutual fund sponsors should not be fully licensed in Japan for both wholesale and retail sales. Just as the U.S. has been willing to allow over 20% of retail banking assets to be held by foreign firms, so too Japan must be prepared to allow foreign firms to win market share from domestic companies that are not able or willing to be competitive. With more than \$1 trillion in assets under management, with an unblemished safety record and impressive performance, U.S. money market and other mutual funds are entitled to an opportunity to compete here in Japan. The same must be true for other types of wholesale and retail financial services.

Deregulating bank deposits and brokerage commissions in the U.S. allowed competition by foreign firms that led to sharply higher foreign market share. However, the primary beneficiary of

these steps was the U.S. consumer. In the same way that allowing market forces -- not the government -- to set deposit interest rates and brokerage commissions benefitted the U.S. consumer, so too these steps would create enormous benefits for Japanese consumers. The time when struggling Japanese financial firms needed government protection from market forces and de facto subsidies from consumers is long since over.

During the past year, the SEC has taken a number of steps to promote the objective of open and competitive markets. One important step to encourage greater international access to the U.S. market was the adoption just three months ago of Rule 144A, which relates to the U.S. private placement market. During the last decade, the volume of private placements in the U.S. has increased from \$15.8 billion in 1980 to \$170.4 billion in 1989. By expanding the availability of exemptions from normal SEC registration requirements for securities privately sold to qualified institutional purchasers, Rule 144A should make the private placement market more liquid and more efficient.

In addition to lowering the cost of capital, Rule 144A was designed to improve access to the U.S. market. Foreign issuers that previously avoided the U.S. market due to reluctance to comply with complex registration or accounting standards for public offerings should find private placements under Rule 144A to be considerably more convenient and less costly. To date, at least

seven foreign companies have made placements under Rule 144A, mostly of equity securities. However, there have also been offerings of debt or convertible securities, such as the placement of \$100 million in ten-year senior unsecured notes by British Aerospace in the first transaction utilizing the Rule.

The SEC has taken other steps to minimize obstacles to the free flow of capital over international borders. Among these is a multijurisdictional disclosure system that we have proposed to create with Canada. This system would be based on the concept of mutual recognition of each country's disclosure, accounting and auditing requirements. Eligible issuers would be permitted to sell or exchange securities in both the U.S. and Canada using the disclosure document required by the company's home country, subject to minimum necessary reconciliation of accounting differences. If successful, we would hope to expand this approach in the future with other countries.

#### Market Stability

In addition to creating open and competitive markets, a critical objective of public policy must always be to maintain strong and stable markets. Both domestically and internationally, market systems must be strong enough to localize and overcome unexpected shocks.



As our market becomes steadily more international in the 1990s, efforts to create a strong framework of international regulatory principles will be essential. The Securities and Exchange Commission is working to create such a framework of common regulatory standards among the securities regulators around the world.

A valued colleague in these efforts to build a stronger world system for securities regulation is the Securities Bureau of the Ministry of Finance. For more than four years the SEC and Securities Bureau have had an active program of cooperation to achieve many common objectives. In addition to working together on a bilateral basis, we are also working actively with multilateral groups to achieve our goals.

While the SEC will be working hard to strengthen international regulation, we are also taking a number of steps to toughen our domestic standards.

One critically important area affecting overall systemic safety is the clearance and settlement system. Here we are actively working with the Group of 30 process. However, the G-30's objective of trade+3 settlement seems inadequate to me as a long-run goal. At least for institutional trading, date of trade settlement (T+0) would allow us to eliminate all unnecessary credit risk, and should probably represent the ultimate objective.

We are also revising our capital rules for securities firms in light of our experiences with Drexel Burnham Lambert. Among other things we are considering increasing the capital backing that we require for trading of a firm's own account. We are also proposing to require prior notice before a firm can transfer more than a specified percentage of its excess capital reserves to a parent stockholder or to other corporate affiliates.

Finally, we are working hard with the Treasury Department to reduce the excessive dangers now created by the stock index futures market. There the existing leverage and other operating guidelines are substantially weaker than those in place for the securities and options markets.

#### U.S. Regulatory Reform

In addition to the steps that the SEC can take to strengthen U.S. regulation, we also will be working actively with Congress to seek legislation to modernize the overall structure of competition and regulation. Like Japan's current reevaluation of Article 65, changing the U.S. financial structure will necessarily include significant changes to both the Glass-Steagall Act and the Bank Holding Company Act of 1956. Both of these statutes were designed to prevent excessive concentration of banking assets, conflicts of interest, and unfair competition. These are important and realistic concerns, but both statutes restrict competition and

market access more than is necessary. Narrower protections like strong capital rules, accounting and disclosure provisions and segregation of activities in separate corporate affiliates with adequate firewalls could achieve the goals of regulation without unduly eliminating competition.

One alternative being debated in the U.S. is the universal banking system currently utilized in Germany. Under this system, banks are able to engage directly in securities dealing and underwriting without having to establish special securities subsidiaries or holding company affiliates.

Universal banking would represent a radical regulatory shift for the U.S. Because of our deposit insurance system, any losses that banks might incur in securities would ultimately be guaranteed by U.S. taxpayers. Also, a universal banking system would make the respective credit risks and market risks less transparent to regulators, and therefore more difficult to monitor and evaluate. Trading on inside information and other misuse of confidential information would be much harder to police. Therefore, I do not believe that universal banking will prove to be acceptable in the U.S., and I do not think it should be tried.

Instead of mingling banking and securities activities inside a bank, it would be better to allow a single entity to own separately capitalized bank and securities companies. Such a

"holding company" structure will need to include strong and realistic "firewall" provisions designed to create certain limits on the relationship between banks, securities firms and other companies under common ownership. A primary objective of these "firewalls" should be to enforce the capital requirements applicable to the bank or securities firm. Thus, capital in a bank or broker-dealer could not be transferred directly, by making uncollateralized loans, to a parent or affiliated company, or creditors, without regulatory approval. Firewalls would also be needed to prevent bank credits from being extended at concessionary terms to customers of a securities affiliate, thereby distorting competition. Other firewalls would be needed to limit misuse of confidential data.

Firewalls cannot prevent losses in a bank or a securities firm from affecting the solvency of the overall firm. Serious solvency questions about one affiliate will inevitably raise the cost or lower the availability of liquidity for all its related companies.

Though firewalls cannot protect against insolvency if the losses in one part of a firm are large enough, they are still critical in allowing regulators to be able to manage such a situation in order to minimize losses to otherwise healthy parts of a firm. For example, if a bank and a securities firm are owned by a common parent, massive underwriting losses in the securities firm would not cause the simultaneous collapse of the bank if the

bank had not made or guaranteed loans to the securities firm. If the bank had separate and adequate capital, it could continue operating safely for a period of time even if the securities firm or parent firm went into bankruptcy. This would give bank regulators time to sell the bank to a healthy firm before insolvency spread to the bank.

Closely related to the issue of firewalls in any action to revise Glass-Steagall will be the issue of the scope of deposit insurance. U.S. taxpayers are now being called upon to pay the massive cost of the savings and loan disaster. Public resentment at paying for the abuses of the S&Ls is justifiably very high. If removal of Glass-Steagall had the effect of adding the \$3.5 trillion in securities assets to the \$3 trillion in insured bank assets as public guarantees, such a step would be unacceptable.

Thus, in my opinion, revision of Glass-Steagall will have to be coupled with both strong firewalls and a program to lower substantially the taxpayer obligations to pay for bank losses. At a minimum, it will have to be absolutely clear that the costs of a bank entering the securities business, and all resulting losses, will be paid for by the shareholders of the bank, not the FDIC or the taxpayers.

Finally, in addition to firewalls and deposit insurance, revising Glass-Steagall will also require careful change in the

system of supervision of the overall holding company. In my view, the current Bank Holding Company Act is not an adequate or acceptable basis for a future system for many reasons.

The thrift nightmare does not mean that reform of Glass-Steagall and the Bank Holding Company Acts should not occur. However, the S&L disaster will make it more difficult to convince Congress to move forward. Reform will depend on creating a very credible means of limiting taxpayer risks through the deposit insurance system, adequate firewalls and a sensible structure for regulation.

In sum, U.S. regulators have a busy agenda ahead. It would be all too easy to find excuses why modernization should never occur. Yet, as philosopher George Santayana once observed, "A man's feet should be planted in his country, but his eyes should survey the world." So it should be with the United States. American leadership over four decades has ensured worldwide stability, security and prosperity. And like Santayana, our feet will remain planted in that ideal. However, in "surveying the world," it is clear that there is much to be done to assure that our financial markets will incorporate the best features of openness, competitiveness and safety.

As the U.S. and Japan each move forward in considering financial modernization, it will be very important to do so on the

basis of close cooperation. Close ties between U.S. and Japanese regulators will be important in making sure that we can achieve both an open and competitive international market, and also a strong and safe overall market system. I am confident that Kinzai and its members will play a strong and constructive role in this process, as you have in the past. Therefore, let me congratulate you on your anniversary, and welcome your future participation in meeting the many challenges that lie ahead.

Thank you very much.