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News Release


REMARKS OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

THE EXECUTIVES' CLUB OF CHICAGO
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Remarks of

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

The Executives' Club of Chicago
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Chicago, Illinois

Ladies and gentlemen, good afternoon.

Developing Securities Markets

As everyone following the situation in the Middle East, the federal budget talks, and the fortunes of the Boston Red Sox knows, we live in very challenging times. Only three months ago I had the chance to deliver personally President Bush's congratulations to the people of Hungary on the occasion of the reopening, after 42 years, of the Budapest Stock Exchange. On that same trip, I visited East Berlin and discussed privatization of industry and how to create free capital markets in the shadow of the Berlin Wall, once a grim symbol of the denial of human liberty.

Despite how fast the Communist system ultimately crumbled, the job of replacing that system with functioning western political, legal and economic systems will be long and difficult. To establish workable capital markets, these countries will have to develop accounting, disclosure and regulatory systems. They will also need improved communications systems, general commercial laws, and an independent judiciary to enforce property rights. Perhaps most importantly, widespread privatization of industrial and service sectors must take place as quickly as possible in order to make real economic growth possible.

The SEC has already begun an active program of technical assistance to Eastern European countries that are seeking to establish capital markets. We have signed a formal understanding to provide technical assistance to Hungary. We have also been working with the Treasury Department and other governmental agencies to develop a program of advice and assistance for other countries in the region, including Poland.

We are also working with Mexico and other emerging markets outside of Europe. In fact, I expect to sign an agreement of cooperation and technical assistance with Mexico's Comision Nacional de Valores

next month. This agreement will represent a major improvement in our level of cooperation in enforcement and other matters with Mexican authorities. We hope to follow the agreement with exchanges of personnel between the SEC and the CNV as a further spur to mutual trust and understanding.

To help us in all of these efforts, the SEC has created an Emerging Markets Advisory Committee ("EMAC") composed of chief executive officers and other senior representatives from over 30 of the nation's leading financial market firms and organizations. The EMAC is working with us to advise countries concerning trading systems, clearance and settlement processes, techniques for privatization of industry and other important issues. It demonstrates the willingness of private American citizens and organizations to help build securities markets and assist economic growth in Eastern Europe and around the world.

This winter, the SEC will host a two-week Institute for Securities Market Development in Washington. The Institute will be an intensive training course in the design and operation of securities markets and their related operational and regulatory systems. We expect that several dozen officials will attend, from many different countries that are seeking to create or to strengthen and expand securities markets. Experts from

the International Finance Corporation, an affiliate of the World Bank, the Treasury Department and the private sector will all be participating as instructors in the Institute. Following the Institute, each participant will have an opportunity for an internship with private firms and organizations.

The expertise of the United States in operating markets that are among the most free and most competitive in the world can prove extremely beneficial to these countries. By furthering the growth of securities markets, we can enhance the prospects for local economic development, as well as the growing world capital market.

Cooperation Among Securities Regulators

Earlier this week, I spent two days in the Virginia countryside outside Washington hosting the first Trilateral Talks between the SEC, the Securities Bureau of the Ministry of Finance of Japan, and the Department of Trade and Industry and the Securities and Investments Board of the United Kingdom. These agencies regulate the three largest securities markets, which together represent more than two-thirds of total world equity market capitalization. Actually, the group wasn't limited to securities regulators, because our colleagues in both Japan

and Great Britain regulate stocks, options <u>and</u> stock index futures, as well as other financial products.

For the first time the regulators of these three markets met together as a group to review common problems. We also sought to chart a course for developing a more effective system for managing risks to the stability of these critical markets. This meeting reflected our common view that, in a global market, none of our agencies can enforce our domestic laws against fraud, market manipulation or unsafe practices without the cooperation of each other in conducting investigations, pursuing enforcement actions and setting common minimum safety standards.

At the conclusion of our meeting, we resolved to increase the speed of efforts to develop common minimum capital standards for securities firms, and to develop consistent world accounting principles. We agreed to pursue mutual recognition of disclosure requirements, and to increase our support for efforts to speed up and enhance the domestic and international clearance and settlement systems.

I should also mention one other area of unanimous agreement among these three regulatory agencies. Our final communique stated that:

> "The Authorities reviewed the interrelationship of trading in stock index futures and other derivative instruments and the trading in the related cash markets for individual equity securities. They agreed that there is a need to maintain balance between the stock and derivative markets in order to avoid adverse effects on the stability of the stock markets. The Authorities agreed that excessive leverage in derivative markets may affect the stability of the securities markets, including the frequency of extreme price movements. The Authorities believe that margin levels in derivative instruments should reflect the public interest in safe and resilient markets. One objective of margin policy should be to maintain at all times margin levels for derivative instruments that would be adequately high in the event of a sharp market decline." (emphasis added)

Thus, the regulators of securities and futures markets in Great Britain and Japan have indicated concerns, paralleling those of Treasury Secretary Brady and myself, that unrestricted leverage practices in stock index futures markets can jeopardize the stability of world securities markets. We jointly agreed that market safety would be enhanced if our

futures margin policies were designed to make sure that margins would never be set so low that they would have to be raised abruptly in a market crisis as occurred in 1987 and 1989.

In the global financial marketplace of the next decade, there will continue to be many differences in how financial systems are structured and regulated. However, I believe that protection of the more than 50 million investors in U.S. securities (more than 4 million of them living here in Illinois), as well as millions of investors around the world, will require a strong commitment to sensible international standards, mutual understanding, and effective cooperation.

Lowering the Cost of Capital for U.S. Companies

While the strength of global financial regulation will be important to the health of U.S. financial markets, an equally important issue is the challenge of competition in the 1990s for all U.S. companies, especially in our vital manufacturing sector. For U.S. firms to be successful in creating jobs and economic growth, we obviously will need people who can design, engineer and build high quality products. However, in addition to these skills, our companies, regardless of their line of business, must have low costs and strong balance sheets. In the competitive economic environment of the next decade, success will not

come to those who make a mediocre product at a high cost. Trying to operate while leveraged to the ceiling, without financial staying power, will also be a risky strategy.

Our financial system will have to play a part in helping U.S. companies to be competitive by helping them lower their cost of capital. However, this is an area where we have real problems. Indeed, the Federal Reserve Bank of New York has calculated that the real, after-tax cost of capital during the 1980's in the United States ranged between 2 to 4 times the cost of capital in Japan and Germany.

Those numbers are not very encouraging in the aggregate, or in specific applications. For example, as of 1988, the cost of funding a ten-year R&D program in the U.S. was 20.3%, while in Japan it was 8.7% and in Germany 14.8%.

What do these figures mean? Well, assume that a U.S. company and a Japanese company are each considering investing in new technology that will decrease the cost of manufacturing and improve the quality of a specific product, like a new telephone switch. Both companies project that the program will cost $50 million, and that the resulting technology will increase their cash flows by $10 million

annually for 10 years. Solely because of its much higher capital cost, on a net present value basis the U.S. company would lose $8.7 million on that investment, while the Japanese company would have an overall profit of $15 million. Therefore, it would not be financially sound for the U.S. company to make the investment to enhance productivity and quality, while the Japanese company could make a profit while creating a technological edge over its U.S. counterpart.

The high cost of capital in the U.S. is also severely disadvantageous for longer term projects. Financing construction of a new $100 million factory with a 40-year life in the U.S. would cost $10.2 million per year, requiring an expected annual rate of return of at least 10.2%. In Japan, this same project could be financed at a cost of only $5 million per year, requiring an expected annual return of only 5%. Thus, for the amount that it would cost an American company to finance that one new factory, its Japanese competitor could finance construction of two new factories.

As these simple examples suggest, the difference in the U.S. cost of capital can have a powerful impact on the level of investment by U.S. companies for R&D, for new plant and equipment, and for other improvements that can mean the difference between productivity and

growing obsolescence. This may explain why aggregate U.S. corporate spending for non-defense R&D averaged 1.9% of U.S. GDP during the 1980s, far less than the 2.6% of GDP devoted to such R&D by Japan.

The higher cost of capital also helps to explain why less new plant and equipment is brought on line in the U.S. than in some of our major competitors. Indeed, U.S. gross fixed investment spending, excluding residential housing, as a percent of GDP from 1980-1989 was only about half that of Japan, and was lower than Italy, West Germany, France and Canada. Given a high cost of capital, it will be economically rational -- and unavoidable -- for U.S. firms gradually to forego productivity improvements and to lose business opportunities that do not offer extraordinarily high rates of return. Over time the cumulative effect of tnis tendency will be for the U.S. to become less and less competitive in more and more industries -- exactly the opposite of our long-term economic interest.

Thus, I think it is not only desirable, but also imperative, for us to focus our energies and creativity on improving the availability and reducing the cost of capital in the U.S. What kinds of steps would this effort entail?

The cost of capital is a reflection of the sum total of many factors, including the forces of supply and demand. In the U.S., our demand for funds is relatively high, but our supply of savings is relatively low. The best opportunity to reduce demand would be to reduce the federal budget deficit, which voraciously consumes our pool of savings. This is why it is so important for the Congress and the Administration to agree on a program of substantial and sustained reductions in the federal deficit. Various other policies can affect the demand for capital.

Another way to reduce the cost of capital is to increase supply by increasing savings. Our national savings rate declined in the 1980s, and it is far below that of Germany or Japan. In 1989, our national savings rate was only 5.6%, compared to 12.2% in Germany and 15.3% in Japan.

Part of the reason for our low savings rate lies in our tax system. Many of our major competitors encourage investment and entrepreneurship with a zero capital gains tax rate. Others have a capital gains rate that is about half of that in the United States. This problem is compounded by the fact that the U.S. is the only industrial country in the world that does not have any form of relief with respect to the double taxation of dividends.

Other tax code provisions encourage indebtedness and channel investment into residential real estate. For example, gains from selling a residence can be rolled over into a more expensive home, yet it is not possible to roll over any part of such gains into an IRA account, much less to roll over gains from selling G.E. stock into a purchase of IBM. Unfortunately, construction of a new house produces jobs mainly in the first year when it is built, while construction of a new factory produces jobs every year.

SEC Initiatives

Obviously there are many things that should be considered to lower the cost of capital, including measures to stimulate an increased U.S. savings rate and to reduce the federal deficit. At the SEC, most of these measures are beyond our control. However, we are trying to take steps available to us to reduce the cost of raising capital. A few months ago we approved a new rule called 144A, which was designed to simplify the rules, and thus reduce the costs, of raising funds in the private placement market.

Later this fall we hope to finalize a multijurisdictional offering system with Canada. This would permit a U.S. company to go to

market in Canada simultaneously with going to market in the U.S., and using the same prospectus. Canadian issuers would have the same flexibility to issue into the U.S. market. We have already begun to discuss extending this approach to other countries. Through this and other means we will seek to make it possible for U.S. companies to raise capital around the world with the lowest transaction costs possible.

Later this year we will be considering reforms to our proxy rules as part of a broader review of corporate governance. We will be reviewing a number of problems. Among these will be making sure that top corporate managers should be accountable for producing good performance.

Probably the most important element in fostering the supply of equity capital is public confidence. Individual and institutional investors, both domestic and foreign, must have the confidence that they can participate safely in our securities markets. Without that confidence, investors will spend their funds on consumption, use alternative forms of savings, or even seek out foreign markets that appear to be more attractive.

Thus, any factor that undercuts public confidence in our markets also strikes directly at the ability of our equity markets to provide the affordable funds necessary to fuel economic growth and tomorrow's prosperity.

The vital role of public confidence is also why we work so hard to establish effective capital rules, and to have competent inspectors and strong self-regulatory organizations to detect capital violations. Lack of adequate capital can lead to pilfering of customer funds, losses to counterparties and, ultimately, clearance and settlement problems. Public confidence also explains why we care so much about keeping our enforcement program strong and vigilant. Whether it is a broker churning customer accounts or making speculative investments for an unsophisticated client, or an investment banker seeking to manipulate prices of an entire market, fraud on investors is an attack on the health of our markets and the strength of our economy.

Therefore, those who seek to enrich themselves by manipulating markets or defrauding investors should know that the SEC will seek to detect and to prosecute these unlawful activities. Indeed, next week we hope to see final passage by Congress of the Enforcement Remedies Act of 1990. This extremely important bill will, for the first time, allow

the SEC to fine those who violate the securities laws in areas other than insider trading, as well as to pursue "cease and desist" orders to stop practices that may create a serious danger of loss for customers.

For the future, we intend to keep doing everything we can to keep our $3.5 trillion securities market clean and honest, and functioning on the basis of market forces rather than manipulation. We intend to set and enforce standards that will permit innovation, but also promote the strength and resilience of our entire marketplace. In promoting stability, we will seek to forge a framework of strong international cooperation. Most importantly, we will seek to promote the competitiveness and vitality of U.S. business, and overall growth in jobs and productivity, by trying to reduce as much as possible the cost of capital to U.S. firms. Over the long haul, it is vital to ensure that we have large and thriving capital markets that will remain what they have traditionally been -- the finest and fairest markets anywhere in the world.