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News Release

COLLOQUY ON GLOBALIZATION OF SECURITIES AND FINANCIAL MARKET REGULATION IN THE 1990s

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

Before the
Administrative Conference of the
United States
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I am pleased to be here today to consider with you some of the challenges we face in the global securities markets of the 1990s.

Globalization

First, it is worth noting that the U.S. securities markets are among the largest and most fair markets in the world. Our securities industry has also been extremely competitive internationally. 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

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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.

products. We also have one of the most efficient clearance and settlement systems.

Our securities markets were once largely domestic markets, but this is not the case today. Stocks of 70 major U.S. companies are now listed for trading in Tokyo as well as New York, and 185 U.S. companies are listed in London. More than 400 foreign companies have their stocks listed on U.S. exchanges or NASDAQ, and more than 1,100 others trade in the so-called "pink sheet" market.

Foreign investors purchase and sell an enormous volume of both equity and debt 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.

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 portfolio around the world. Everyday, tens of billions of dollars in transactions flow back and forth across the Atlantic and Pacific, and also across borders within Europe and Asia.

As a result, 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. Just last week, 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 delegations 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 for stocks modeled after a U.S. stock exchange, 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 48 years, Hungary is going to officially reopen the Budapest Stock Exchange next week, which will represent an enormous milestone on the road to political and economic freedom. Poland also plans to establish a stock market, and has asked the SEC for technical assistance relating to establishing capital markets and supervisory systems.

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, which had its inaugural meeting just this past Tuesday, include some of the best and the brightest from the U.S. financial industry. These financial industry leaders 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 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.

EC 92

The 1990s are already witnessing the elimination of many existing barriers between the financial markets of the European Community. What was a group of smaller competing markets could become a powerful single market. For the EC securities markets, this could mean a lowering of the costs of raising capital in the European markets and more efficiency. 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 will greatly reduce costs for financial firms. It should also help create much greater liquidity, which would 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 the use of foreign tender offer documents in the U.S. where U.S. shareholders of a foreign target constitute a small percentage of the total shareholder base of the target company. While foreign tender offer documents might not provide all the protections of U.S. law, in such transactions shareholders might otherwise be completely 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 participate in our markets unless they are reasonably confident they will not become the victims of fraud.

Modern technology and the ease of international communications make it possible for people to violate the U.S. securities laws without entering our country. 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.

Competitiveness of the U.S. Markets

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.

One of our disadvantages in competing internationally results from the basic structure of the U.S. financial regulatory system, which 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 hurts market stability. 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 a good idea in the 1930s, but they call for serious reexamination today. The Glass-Steagall and Bank Holding Company Acts impose arbitrary barriers to the entry of banks into securities activities and securities firms into banking activities. The effect is to stifle competition and innovation in the financial services industry in the U.S.

Our dual federal-state regulatory system also impedes efficient capital raising. In stark contrast to the unified market that is likely to emerge from EC 92, the states are erecting, rather than tearing down, roadblocks to capital raising. State anti-takeover laws enacted in Ohio, Pennsylvania, and Massachusetts just within the past few months make it less attractive for investors to buy shares of companies chartered in those states. Generally, these laws have the effect of diminishing shareholder rights when the corporation is facing a change of control. Of equal concern are the 50 different sets of blue sky laws, and 50 different corporate governance and professional licensing schemes. Practically speaking, this means that each of the 50 states can set different standards for the sale of securities within its borders. Unless this situation is reversed, in two years time, it may be easier to complete a distribution of stock by an Italian company from Portugal to Greece than for Morgan Stanley to do a comparable offering throughout the

U.S.

Despite the tragic dimensions of the thrift nightmare, the FIRREA legislation marked a significant step in returning sanity to our regulation of depository institutions. Higher capital levels, sound accounting rules, and stiff penalties for financial fraud were long overdue, and they were all put in place by that legislation.

A second major step toward rationalizing financial industry regulation would be the proposed Administration legislation 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 Dean Witter 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. More than a hundred billion dollars were 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, 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 of Savings Institutions 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.

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.

Changes to our regulatory structure are necessary to increase liquidity and to reduce the costs of capital. We must 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.