REMARKS OF

COMMISSIONER J. CARTER BEESE, JR.*
U.S. SECURITIES AND EXCHANGE COMMISSION

PATTERNS OF INTEGRATION IN AND AMONG INTERNATIONAL FINANCIAL MARKETS

PROMETHEE/EUROCLEAR SYMPOSIUM

BRUSSELS, BELGIUM
OCTOBER 1, 1993

* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

PATERNS OF INTEGRATION IN AND AMONG INTERNATIONAL FINANCIAL MARKETS

Are electronic markets changing the nature of financial markets? We know that the answer to that question is obvious to everyone in this room. What may not be so obvious is just how fundamental that change has been. In 25 short years, the markets have gone from a paperwork crisis that nearly undermined national economies to having the capacity to handle one-billion share days. The technology that made that possible has become indispensable to every facet of the markets.

Twenty five years ago, trades were both initiated and recorded largely by hand. Today, computer technology has fundamentally altered every step of the investment process. From the moment an order is entered to the exchange of funds for securities, electronic networks are now an integral part of the process.

Investors now often rely on computer research services to make basic investment decisions. They can enter orders with their brokerage firms through their personal computers. Brokers, in turn, can route their customer orders electronically to an exchange or OTC market maker for execution. As many as 30% of all orders are now executed automatically. Customers can get executions -- and reports back -- within a matter of seconds. Today, stocks are often issued, traded, cleared and settled, all without a piece of paper ever changing hands.

Technology has transformed markets around the world and around the clock. U.S. exchanges and the NASD now compete on the basis of their efficiency and speed of execution. And from the disappearance of the floor in London, to the introduction of totally automated systems in Paris and Toronto, we've seen international markets reject the green eye shade in favor of the amber glow of a computer screen. "After-hours" systems have proliferated: Institutions can choose among Instinet, Posit, the Arizona Stock Exchange, the NYSE's "Crossing Sessions", International NASDAQ, Globex and, soon, Tradepoint Financial Networks in London.

Today's markets are not only larger and faster, but also much more complex. Products often no longer fit into neat categories. The terms "stock" and "bond" are becoming increasingly anachronistic. For example, you can now take a bond, and using derivatives, change its interest rate, currency, maturity, credit rating, and give it equity characteristics. Thus, we need to define new financial products not by old monikers, but increasingly by cash flows and volatility characteristics.

The vast array of on and off-balance sheet derivatives has made the markets at once more interrelated and infinitely more complex. Twenty-five years ago, there was nothing like today's computer-directed trading strategies, which take advantage of relatively small disparities in price between derivatives and underlying securities. And today the mere identification of whether a firm is net long or short can be difficult, and quantification of aggregate risk profiles is a major undertaking.

It's also true that investors are no longer satisfied with confining their portfolios to domestic investments. Worldwide, investors now trade $1.1 trillion outside their home countries. In the United States, 559 companies are traded in the public markets, of which 120 have accessed the market for the first time in the last three years.[1]

In the search for higher yields and diversification, U.S. investors are also pouring money into foreign markets: Last year U.S. investors purchased and sold a record high of $270.9 billion of foreign equities in markets around the world and investments in U.S.-based international stock funds were up nearly 50% in the first 6 months of this year over the same period last year.[2] The opportunities presented by privatizations of an estimated $150 billion of state-owned companies worldwide is attracting foreign institutional capital. And who can deny that the trend toward regional trade agreements such as NAFTA and the EC will not fuel even greater cross-border capital flows.

There is no doubt that this embrace of technology has brought enormous benefits to customers, but it has also raised the competitive stakes for U.S. markets. On the domestic side, competition among the exchanges and the OTC market has never been more intense.

The combination of ever more sophisticated technology and the growing dominance of institutional investors has encouraged

---

[1] Schapiro, The SEC's Open Door Policy, WSJ, September 23, 1993, at A17.

[2] U.S. Shares Could Suffer from Foreign-Stock Lure, WSJ, August 23, 1993, at C1. The Investment Company Institute reported that international stock funds captured 10.5% of all stock mutual funds during the first half of this year, compared with 7.5% last year. Id.

entrepreneurs to develop private electronic networks that allow these investors to execute trades quickly, efficiently, and at lower costs than ever before. According to Global Finance magazine, most of the largest U.S. institutions, who account for more 95% of all institutional trading, are linked to at least one of these proprietary trading systems.[3] Add to that, pressure from foreign market operators for access to U.S. markets and the result is a highly competitive environment.

As is so often the case, this competitive struggle has landed in the laps of the regulators. These issues are central to the Division of Market Regulation's Market 2000 study, which will be completed this Fall. The debate has centered on whether regulatory requirements should encourage or require liquidity in a central or core marketplace, or whether market participants should be allowed to create an infinite number of overlapping electronic systems. To some, public policy ought to promote market concentration to maximize liquidity and pricing efficiency. To others, public policy ought to allow innovation and diversification to maximize competition.

From a regulator's perspective, there are two things we must ensure: First, we must ensure that regulation does not inhibit automation; that it does not stifle innovation and creativity. Second, regulators should find ways to ensure that innovations are designed to be fair to investors and not unduly destabilizing. To me that means that we must find the right balance between investor protection and investor opportunity.

Although proprietary trading systems still account for a small percentage of total volume in the United States, their rapid growth has shaken the established markets to their cores. The exchanges and the NASD decry what they perceive to be an inequitable regulatory system that imposes many more requirements and responsibilities on them than it does on these private sector systems.

It is true that proprietary trading systems are subject to much more flexible regulatory requirements than the exchanges and the NASD. The Commission has struggled long and hard to determine how to regulate this new type of trading system. As a legal matter, the SEC has determined that many proprietary trading systems are not "exchanges" under our laws. The fundamental difference between

---

[3] Ellie Winninghoff, Off-Exchange Electronic Trading is Hot, Global Finance, May, 1993, at 56.

exchanges and these proprietary systems seems to be that proprietary trading systems do not provide customers an expectation that they will be able to regularly execute transactions at the quotes displayed in the system.

To some, that distinction is at best, nebulous. They argue that it ignores the reality that proprietary trading systems perform the same functions as the more heavily regulated exchanges and associations. They argue, somewhat persuasively, for a level playing field.

The entrepreneurs who operate proprietary trading systems strongly disagree with this view. They argue that proprietary trading systems are merely applying technology to the traditional activities of a broker. Because they offer significantly lower commissions, anonymity, little or no market price effect, and no dealer spread, they argue that they provide healthy competition to the primary markets. In short, different markets are needed to serve different trading needs.

There are two ways the Commission can respond to this issue. First, we could impose greater obligations on proprietary trading systems. Or second, we could examine whether it is possible to streamline the review process we have established for exchange and NASD proposals.

I have never believed that the best way to level the competitive playing field is to simply heap additional burdens on the less-regulated. On the other hand, it's pretty clear, at least to everyone except the proprietary trading systems operators, that there are limitations to the current Commission review process. Recognizing this, the Commission proposed a rule four years ago, Rule 15c2-10, to formalize the approval and oversight of proprietary trading systems, which is being considered in Market 2000. Among other things, the rule would require that proprietary trading systems file plans of operation and periodic reports with the SEC.

The limited requirements of proposed Rule 15c2-10 are intended to provide the SEC with an effective means of monitoring the activities of proprietary trading systems to assure that they are complying with U.S. federal securities laws; and that investors who use these systems are adequately protected. At the same time, the SEC recognized that subjecting proprietary trading systems to registration requirements along the lines of exchange regulation would substantially deter development of innovative trading systems.

Proposed Rule 15c2-10 is intended to strike the middle ground by providing the SEC with a balanced means of overseeing the activities of proprietary systems.

The second way the Commission could respond to this issue is try to ease some burdens now imposed on the exchanges and the NASD. That approach has been recommended by a number of commenters, including the Securities Industry Association and the New York Stock Exchange. It's got some appeal and deserves some consideration. It may well be that we are micromanaging the exchanges' and the NASD's operation more than is necessary to meet our mandate to protect investors.

As it now stands, any changes the exchanges and the NASD choose to make to their systems, products, or operations -- even minor ones -- must be reviewed by the Commission. And the vast majority of those changes must be reviewed prior to their implementation. Maybe its time to look seriously at whether the review process could be streamlined somewhat.

Market 2000 presents the Commission with the opportunity to break new ground; to re-examine the rules of the game for both the exchanges and the NASD on the one hand and proprietary trading systems on the other hand. No one should be surprised, however, if we eventually adopt the proposed proprietary trading systems rule that has been under consideration for some time. That rule should go a long way toward addressing the growing gap in the Commission's authority to oversee the development of this aspect of the market. I hope the study will also look at the rule approval process.

It is quite striking that the approval process for an exchange traded derivative may take a year and a half, while an OTC derivative can be approved in a week and a half, or even an hour and a half, by an external commitment committee.

Of course, as we resolve the issue of how to "regulate" proprietary trading systems in the United States, we are also grappling with the difficult issue of how to regulate foreign exchanges that wish to operate in the United States. Fitting proprietary trading systems into our current regulatory structure is getting increasingly difficult. The fit is even more difficult for foreign electronic systems.

The SEC's current approach is to apply national treatment to any foreign system that seeks to do business in the United States. In other words, a foreign exchange or a foreign proprietary trading system may enter U.S. markets on an equal footing with its U.S. counterparts by registering as an exchange, regardless of how limited the foreign market's activities are in the United States. This can be very burdensome for a foreign market and may not be the only approach to protect U.S. investors.[4]

At the very least, requiring U.S. registration for an entity already regulated in its home country could result in overlapping requirements. After all, even the most ideologically attuned regulatory schemes often impose redundant or conflicting requirements. If the foreign exchange is regulated under a regulatory scheme that affords protection similar to that provided by the U.S., and if there is an effective information sharing and investigative assistance agreement, then it may not be necessary to require the same form of registration as is required for a domestic exchange.

Of course, this is the age old debate. Should an exchange operating in a foreign country be expected to adhere to the host country's regulatory scheme? Is reliance on the home country's oversight adequate? Or is some blending of the two appropriate, as my colleague, Mr. Saint-Geours, has described as "co-regulation."[5] Clearly, where a system is subject to adequate foreign country regulation the case for applying the full U.S. regulatory regime is not too compelling.

Relying solely on home country regulation, however, has its pitfalls. One of the more serious is that relying on home country regulation may indirectly undermine the host country's regulatory system: It's very difficult to explain to U.S. exchanges that you are going to allow direct competitors to enter their market, without requiring them to play by the same rules.

I think that the answer lies somewhere between these two extremes. It is not readily apparent, however, whether we can achieve a more moderate approach under our current law. In the SEC's request for comment on proposed Rule 15c2-10 there are references to the unsatisfactory situation that the current regulatory

---

4 See Division of Market Regulation, Automated Securities Trading: A Discussion of Selected Critical Issues, September 26, 1991, at 8.

5 See J. Saint-Geours, Preface to, Promethee, Networks & Markets: More than a Marriage of Convenience 3, 3-4 (Promethee 1992).

structure presents for foreign exchanges; just as the current structure creates difficulty in regulating proprietary trading systems.

Adopting a proprietary trading system model for foreign exchanges, however, will be difficult. That approach is premised on the fact that most proprietary trading systems are not "exchanges," as defined in our law. Many, if not all, foreign exchanges, however, would probably meet the definition and, as I mentioned earlier, our law offers us only a little flexibility in exempting an exchange from registration.

The cleanest approach would be for the Commission to adopt a rule that is specifically applicable to foreign exchanges, perhaps similar to the United Kingdom's recognized investment exchange concept, which relies primarily on home country regulation. Such a rule would require legislation from the U.S. Congress, however.

However we resolve the registration issue, it seems that the price a foreign market may have to pay for access is to play by at least some of the home team's rules. I believe that it is probably not necessary to require full exchange registration. The issue of product regulation, however, is a different and infinitely more complex issue. The issue of foreign securities registration has been a very thorny issue for us in the United States. The U.S. exchanges see this as one of the most important competitive issues they face today. And few issues have been as incendiary as this one has been in the last few years. Any resolution of how to regulate cross-border trading systems will require a resolution of foreign security registration first.

There are substantial unresolved issues with respect to the regulation of foreign exchanges in the United States. Nevertheless, we have to find a viable solution. The alternative is to continue to force U.S. investors to satisfy their demand for foreign investments off-shore rather than on-shore. That will force them to incur the expense, inconvenience and uncertainty of going all the way to Paris, Frankfurt or London to invest in foreign companies. Another alternative is to further encourage the development of the OTC derivatives market as the surrogate for direct investment in the cash markets. But is that the role of regulation? To regulate one segment of the market at the expense of another? We can and must harness the horsepower of these networks for our collective good.

The question of how to open up our borders to allow capital to flow freely across them is a prime issue for the nineties. The demand for foreign investment is growing exponentially and will be filled somehow -- or should I say somewhere. Either in the cash or the derivatives markets. To resolve these issues, we have to be willing to consider rejecting our old ways of thinking and analyze these issues with a fresh perspective. Our U.S. regulatory structure, including regulation of exchanges, was imposed in the 1930's, when our horizons extended only as far as our borders. In those days cross-border capital flows paled by comparison to today's. In sum, many of the assumptions on which our regulatory scheme was based simply are no longer true.

One truth that we are all coming to terms with is that no national regulator ultimately has control over the institutional, multi-national pool of capital that now flows easily across borders in pursuit of the highest risk-adjusted return. It's only when we recognize that fact that we can arrive at solutions that serve the public interest. And by serving the public interest I mean protecting investors and ensuring that the broadest possible range of both foreign and domestic investment opportunities are available to them. They are going to find the opportunities in any event. It makes sense to me that they have the opportunity to take advantage of them within the borders of the United States, where they are accustomed to the regulatory scheme and where they understand the investor protections they are provided.

Conclusion

At the SEC, experience tells us that we cannot be overly cautious or too zealous in pursuing our mandate to protect investors. Putting the brakes on innovation and creativity because we are unsure what will result is short-sighted. We must constantly ask ourselves whether we are protecting investors from the unscrupulous or whether we are protecting investors from themselves.