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**News
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**RECONCILING NATIONAL AND INTERNATIONAL
CONCERNS IN THE REGULATION OF GLOBAL CAPITAL MARKETS**

REMARKS OF

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

**LONDON SCHOOL OF ECONOMICS
LONDON, ENGLAND**

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Distinguished Guests and Ladies and Gentlemen:

At the outset I would like to thank my friend Sir David Walker, your extremely talented Chairman of the Securities and Investment Board, for inviting me to participate in today's conference. The regulation of world capital markets is a timely and important subject, as it does not require any significant feat of intellect to notice that the world's major capital markets have "gone global."

The evidence of that fact is literally all around us:

one out of every seven equity trades worldwide involves a foreign party on one side or the other;

the gross value of purchases and sales of securities of foreign issuers by American investors now averages around \$4 billion every day, an increase of about 1/3 in only the last two years;

more than 350 mutual funds in the United States ("investment trusts" in your English), with combined assets of approximately \$66 billion, invest mainly in foreign securities;

an estimated 10% of all trading in U.S. equities takes place outside the United States;

in the past decade British pensions funds have increased their international investments from an average of 7% to 18%

of their portfolio, and Japanese pension funds have gone from 1% to 16% in the same period;

"BCCI" is as much a household word in the U.S. as it is in Britain, and financial scandals or failures such as Drexel, BCCI, Salomon, Nomura and others have the direct potential for disrupting markets all over the world;

between 1984 through 1990, Japanese investors increased their holdings of foreign securities by 30% per year, German investors increased theirs by 18% per year, U.K. investors by over 17% per year, and U.S. investors by 14% per year;

during the same period, 1984 to 1990, gross cross-border equity flows have increased from about \$300 billion per year to about \$1.7 trillion per year.

This "globalization" of trading and investing patterns has powerfully shaped the development of today's financial markets. It has also enhanced the capital-raising capabilities of businesses around the world. Once rare, multinational offerings of securities in even huge amounts -- like the \$2 billion raised worldwide by Telefonos de Mexico ("Telmex") -- and many similar transactions have demonstrated that businesses now¹ have the option of raising large sums of primary capital in foreign markets irrespective of the ability of the issuer's domestic market to absorb a particular size or type of financing.

¹ Other recent global offerings include: Attwoods PLC, a UK company which has a worldwide offering for \$142 million in progress; Elf Aquitaine, which offered \$183 million worldwide in mid-1991; New Zealand Telecom, which offered \$819 million worldwide in mid-1991; and Tubos de Acero of Mexico, which is in the middle of a global offering of \$65.6 million. Other UK global offerings include: the British water companies, which were sold for a total of \$8 billion in late 1989, and British Airways, which raised \$508 million through a rights offering at about the same time.

Despite the significance of international developments, many of the most powerful forces influencing the size, dynamics and evolution of our securities markets are domestic rather than international in nature. These "domestic" qualities reflect sharply differing patterns of investor demographics, market participation, commercial traditions, tax laws, history and many other factors.

In the U.S., our securities market remains overwhelmingly characterized by the widespread participation of public, or "retail" investors. According to the latest survey by the New York Stock Exchange, there are now more than 50 million individuals who own U.S. equity securities directly or through stock mutual funds. Here in the U.K., you now have 11 million individual shareholders, up from only 3 million in 1980, in large part because of the widespread retail distribution in the recent privatizations. As a result of dramatic growth in the size of holdings of institutional investors like pension funds (a process occurring in many other nations), the percentage of the equity market owned by individuals in the United States has declined from 72% in 1970 to a little less than 50% today. Individual ownership of U.S. public corporations is therefore more than three times greater than is the case in Germany (16% of the German market owned by individuals), and more than two times greater than in the U.K. (21%) or Japan (22%).

The U.S. also has a far-flung market in terms of the number and variety of issues traded. About 8,000 different securities are listed on securities exchanges or traded in NASDAQ in the United States. Another 8000 securities are traded in an over-the-counter market we know as the "pink sheets." The U.K. and Japan, by contrast, each have about 2000 listed domestic companies, and Germany has only about 700 listed domestic companies.

The U.S. market, like that of Japan, also differs sharply from markets in other countries in terms of the nature of the intermediaries. Though the prohibitions of the Glass-Steagall Act have been eroded considerably over the last decade through regulatory actions and judicial decisions, there are still significant barriers to bank participation in the market as an intermediary. In addition, the number and variety of foreign participants in any market, and the number of domestic firms with extensive foreign offices, varies quite widely.

Establishing sensible regulations for the protection of investors, inspection and supervision of securities firms, minimum capital levels, disclosure and accounting standards and other issues inherently requires balancing the steps that would appear most appropriate solely to meet domestic market needs and those that appear best suited to accommodate the realities of international competition.

For example, as a practical matter it is simply not possible to rely solely on foreign regulators for reviewing the condition and practices of a large multinational firm. National regulators differ greatly in their analytic capabilities, level of inspection resources, independence from regulated firms and other critical factors. This is a problem that we have faced in our banking sector, where some of our states that serve as chartering authorities have as few as three or four bank examiners. Here federal agencies must duplicate the examinations of such state agencies in order to produce reliable results.

Candidly, the same problem exists internationally. There is an obvious inefficiency to utilizing the supervisory process in various foreign countries to develop a picture of the condition of a multinational group of companies, rather than each country trying to examine every affiliated company in every country around the world. On the other hand, some of the local authorities may not be capable of detecting the growth of even a very serious problem. Others might detect a problem, but for various reasons might determine not to take any corrective action.

Pure reliance on foreign oversight is therefore not likely to prevent periodic large shocks, and protection of the home country market may require some level of review of supervisory

information already submitted to one or more foreign agencies. Such duplication should ideally be minimized to the greatest possible extent to prevent excessive costs to either regulated firms or to national supervisory authorities. This issue of how to organize and conduct the supervision of a group of banks or securities firms operation in numerous countries is one very good example of a problem that requires difficult tradeoffs between domestic and foreign concerns. In most such issues, there is certainly not any clearly defined "right answer".

There are a great many common risks that regulators of securities markets around the world must face, each of which raises potentially significant issues of reconciling our respective approaches. Without even attempting a comprehensive list, these challenges for regulators would include:

- o Fraud. The insider trading, market manipulation, parking and other forms of fraud engaged in by Michael Milken and Dennis Levine damaged numerous innocent market participants, and constituted an attack on the viability and credibility of public securities markets. Detecting and punishing "penny stock" manipulations and financial reporting frauds of every imaginable permutation represent a constant ongoing challenge. Obviously the Salomon case shows the degree to which

financial fraud can undercut the perceived fairness of an entire market.

- o **Insolvency.** As bad as market frauds can be for investors or creditors, the insolvency of a major firm is certainly capable of adversely affecting a huge number of "innocent" depositors, counterparties and other market participants. The failure of BCCI here in the U.K., and the Bank of New England in the U.S. (the latter failure cost investors more than \$2 billion) demonstrate the potential costs of insolvencies of firms. Here improvements in both the Basle Capital rule and that of securities markets, better financial disclosure and accounting, and improved analysis of overall risk portfolios --including derivatives positions -- may all be important areas for future action.

- o **Market Disturbances.** The market crash in 1987, and its smaller cousin in 1989, demonstrated that a major market decline has the potential for producing failures among clearing member firms that could spread through the clearance and settlement system, as well as producing sharp reductions in investor participation. The failure of a clearance system, or a major firm, coupled with a market disturbance could prove extremely

damaging to financial markets and economic activity more broadly.

- o **Rigged Markets.** As long as markets exist, people will try to rig them. Markets that are driven by secret deals and planned concerted action rather than market forces will result in large losses to investors, such as the roughly \$30 billion in market values suffered by investors in high yield securities when Milken's market shams were finally ended. Rigged markets undercut economic efficiency and create the risk of potentially far-reaching loss of public participation.

- o **Uncompetitive markets.** Barriers to competition can arise through very obvious structural restrictions like Glass-Steagall (and Article 65 in Japan) and interstate banking laws. Other restrictions may be equally damaging to competitive markets, yet less apparent on their face as protectionism. Italy's statutory requirements of a local office through which to book trades involving Italian nationals, Germany's requirement that a multinational broker -dealer must have a data processing center in Germany, Japan's structural requirements for conducting a mutual fund business and other similar provisions can sharply reduce the competitiveness of international firms.

- o Disclosure and Financial Reporting. Investors, analysts, rating agencies and others need to be able to obtain clear, reliable and accurate information concerning public companies. This information enables the market to work efficiently in valuing the shares of companies. The level of detail in required disclosure, and whether it is delivered through a prospectus used as a selling document, through periodic disclosures like our annual report 10-K or otherwise, can of course vary from country to country.

- o Sales practices. The practices of intermediaries in selling stock to retail customers are vulnerable to abuses that are generally addressed through governmental standards, self-regulatory body standards, or both. Rules against placing "unsuitable" securities, "churning" (or "swapping") accounts excessively, making unauthorized trades, excessive markups on securities sold by a dealer from inventory and other practices are designed to meet standards of ethical conduct in the securities business. Though these rules vary somewhat in their specifics, most major markets have standards designed to address the conduct of sales personnel of banks or brokers in this area.

Each of the major markets must in its own way face each of these problems and many more. The specific form of regulations to address these issues has to reflect the conditions in the local market. At the same time, the aggregate cost of regulation and the effect of particular regulations on the efficiency of cross-border transactions must be watched carefully. Here regulations must be framed to accomplish domestic needs in a manner that does not damage the efficiency or reduce the safety of the larger world trading markets.

Conclusion

This is obviously just a small sample of the international issues facing securities regulators in every market. Reconciling the complexity of laws and rules (both of governments and SROs) in numerous countries is a daunting task. In addressing these issues we need to recognize several realities. First, the issues are difficult and complex, so the rules will also be somewhat complex no matter what level of coordination exists. Second, even with substantial international cooperation, fundamental differences among markets in terms of investors, issuers, intermediaries, government credit underwriting, volatility and many other factors justify differences in regulation. Therefore, "common" global standards, if read to mean identical, is an illusory and unobtainable goal. However, seeking to achieve similar objectives and to address in an effective way similar problems is a realistic goal. Third, there are many issues where

scholars and academics can make significant contributions in improving our understanding of the economic forces at work and the best ways to achieve our goals.

In the last decade our markets changed dramatically, and I do not expect that the next decade will prove any different. However, we made enormous strides in regulatory harmonization in the last decade, and I also expect that to continue in the coming decade. Through direct bilateral discussions, groups like the "Trilateral Talks" between the U.S., U.K. and Japan, and multilateral groups ranging from the European Community to the International Organization of Securities Commissions, we must continue to explore and redefine our national and international tools for dealing with a whole range of common problems. Ultimately our efforts will be critical to allowing continued growth and development of a world capital market that can help deliver the most efficient allocation of goods and services to a rapidly changing world community for the benefit of peoples all over the world.