



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

**BOCCONI UNIVERSITY**  
**MILAN, ITALY**

**NOVEMBER 13, 1992**

U. S. Securities and Exchange Commission  
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SECURITIES MARKETS:  
SOURCE OF CAPITAL FOR THE 1990s AND BEYOND

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Introduction

It is a very great pleasure and an honor for me to be here at Bocconi University. This University has established itself as a global forum for learning concerning financial markets, reflecting the stature of Milano as a center of commerce and finance on a global scale. In addition, there are few countries that are more admired in my country than Italy, the revered birthplace of many millions of American citizens or their parents and grandparents. Italy even contributed our very name, America. While we Americans have sought to bring honor to that name through our efforts, we do not forget from whence we drew that name and the contributions of so many sons and daughters of Italy to our country.

While the assignment to speak before you today is quite humbling, one of Italy's most prominent universities is a very appropriate place for an SEC Chairman to deliver an address concerning financial markets. After all, in 1494 an Italian monk named Paciolo wrote the first published work dealing with bookkeeping. Paciolo codified a system of accounting that later

became known as double-entry bookkeeping, which now serves as the foundation for financial record keeping. Without him we wouldn't have the financial statements that form the backbone of our registration statements or our annual reports. Without him we also wouldn't have securities or securities firms.

Among our responsibilities, the SEC supervises accounting standards (known as "generally accepted accounting principles" or "GAAP") for all industries in the United States, and we oversee the financial disclosures that are regularly made by more than 12,000 publicly traded corporations. We are also responsible for providing oversight of the performance of accountants of publicly traded companies. Accounting rules that produce a clear or "transparent" picture of the financial condition of a company and its results of operations -- whether earnings or losses -- are the bedrock for efficient functioning of a market economy. These accounting rules establish how we measure the signals that the market gives us on who is using financial resources efficiently and who is not. Thus, we trace the roots of our accounting and disclosure responsibilities all the way back to --- Italy.

Of course if Paciolo had been a little faster in his work, he would have finished inventing accounting in time to join his expatriate countryman on Christopher Columbus' first voyage to the Americas. That would have been highly beneficial to us, because

all the early real estate deals in America could have been accounted for properly.

Today I would like to discuss the role of securities markets in financing economic growth, and what I see as the powerful, ongoing trend to greater use of securities markets as our device for financing economic activity. It may not surprise you that, as the senior regulator of by far the world's largest and most liquid securities markets, I see the expansion of securities markets as a triumph of capitalism and free enterprise. Indeed, there is not any other economic area where Adam Smith's "Invisible Hand" more directly and efficiently allocates resources, and where winners are separated from losers every day on the basis of financial performance.

Greater use of securities markets as a tool for both financing economic growth and prioritizing the allocation of capital to its most efficient users on a world-wide basis is, in my view, inevitable in the next few decades. It may also be our best means for modernizing today's economies, which face unprecedented demands for capital to modernize and rationalize their ways of doing business in the face of fierce competition in an increasingly interconnected world. These economies must convert from the Cold War (both East and West were, to some extent, on a wartime footing for the past 50 years) to a peacetime environment where

technological innovations are sometimes measured in weeks rather than years or decades.

The securities markets are increasingly proving to be the method of preference for capital raising for the 1990s. In my view, they are likely to become the predominate method for the future. Alternative sources of capital, such as traditional commercial banking and merchant banking (or venture capital), are not flexible enough or large enough to meet the huge capital demands in the coming years in Eastern Europe and the CIS, South and East Asia, and Latin America, not to mention our own needs in the OECD countries. Commercial banking may have been an appropriate model for capital allocation in the 19th and early 20th centuries. But the world-wide securities markets, which owe so much to the communication revolution, allow users of capital and sources of capital to come together at a lower cost.

While securities markets offer the benefits of efficiency in raising capital, they also offer the benefit of open access to capital. However, the essential ingredient for creating a successful securities market is investor confidence. Without confidence in the safety, honesty and basic fairness of a market, investors simply will not participate. Without investors, of course, a market is nothing but a theoretical abstraction. In the long run, confidence is built on basic fairness and openness. That means, among other things, accurate and adequate information about

companies and full transparency of prices and volumes in the trading system. In Italy, the CONSOB has been a strong advocate of steps to promote just this sort of market. In fact, yesterday the SEC and the CONSOB initialled a historic memorandum of understanding that pledges our mutual co-operation to achieve these goals in our respective markets.

### The SEC's Role

At the outset, it might be helpful for me to describe the SEC and its responsibilities to you. While everyone knows about central banks and what they do, the role of a fiercely independent securities regulator like the SEC is not as familiar outside the United States.

The SEC has a total staff of about 2,600 people, operating out of 13 offices around the U.S. We have a budget of about \$250 million, though we take in over \$300 million in fees for the government every year. These fees are collected primarily from companies when they register securities for sale. The key missions of the SEC are to (1) protect investors, (2) maintain the safety and stability of the overall marketplace, and (3) promote efficient capital markets to facilitate economic growth.

The SEC is a government agency, although it is "independent" of the sitting government and reports to both the President and our

oversight committees in Congress. However, the agency does not report to the Treasury, the Federal Reserve or any other body. We set policy for the securities markets of America, and unless Congress changes the law, we have the power to determine the rules of the road.

The SEC is composed of a chairman and 4 other commissioners, all of whom are appointed by the President and confirmed by the Senate. The chairman and the commissioners all have equal votes on the adoption of regulations or the decision to bring cases concerning violations of the law. No more than three commissioners may be from the same political party. This assures that policy is set in a bipartisan manner and probably explains why, from Democrat Franklin D. Roosevelt to Republican George Bush, the SEC's basic policy tenets have remained remarkably constant.

We oversee more than 8,000 securities firms, or "broker-dealers", ranging in size from tiny firms with one or two employees to global giants like Merrill Lynch, Morgan Stanley and Goldman Sachs. Our securities firms have about \$30 billion in capital and handle trading with a value of more than \$5 trillion every year. We also oversee securities exchanges and other "self-regulatory" bodies, such as the NYSE, NASDAQ and the clearing and settlement organizations. We are charged with maintaining the integrity of the market, and also with promoting competition among trading markets and systems.

The SEC regulates more than 3,500 investment companies (popularly known as "mutual funds") with more than \$1.5 trillion in assets held by over 60 million accounts. We also oversee 17,500 investment advisors, who manage or advise over \$5 trillion in assets. We supervise about 1,200 government securities dealers and both the securities offering documents and the regular quarterly and annual filings of more than 12,000 publicly traded companies. As I mentioned earlier, we also establish U.S. GAAP and oversee the behavior of our accountants. Please don't ask me why, but we also oversee some of the activities of gas and electric utility companies that operate on an interstate or international basis.

The SEC is what I would call an "integrated" or "unitary" regulator. That is to say that we write the rules, conduct inspections and review filings to make sure that the rules are being obeyed. We also prosecute in the courts through "civil" actions those who do not comply with the rules. We can seek penalties for violation of the law ranging from closure of a firm or expulsion of an individual from the securities business to fines or other court orders to remedy a problem. Indeed, it is the "enforcement" power of the SEC that truly explains what and who we are, and why we have been given so much independence.



We place so much emphasis on enforcement because without investor confidence that the market is open and honest, there wouldn't be many investors. If people think that prices in a market are driven by back-room agreements rather than supply and demand, they will take their money elsewhere. Similarly, if the only people who profit are "insiders" operating on confidential information known only to them, the general public simply will not participate. Though it is not possible to prevent some people from violating the law where the financial incentives are great enough, we do a very good job of catching those who do and recovering the proceeds of wrongful activity.

#### Growth of Securities Markets and Decline of Bank Lending

The last two decades have demonstrated what a remarkable capital-raising machine securities markets can be. Total market value has grown enormously, with world equity market capitalization rising nearly 15-fold, from \$741 billion in 1980 to over \$11 trillion today. Although the U.S. markets account for about half of this market capitalization, the "emerging" markets in countries like Mexico, Taiwan, Thailand, Argentina and others have grown enormously. Indeed, both Mexico and Taiwan today have equity market capitalizations larger than those of either Spain or Sweden. Companies from these countries have been very successful in tapping world capital markets. Several Mexican companies have raised more than \$1 billion in offerings in the U.S. over the past 2 years, and many have followed their example.

Trading volume has grown even more than absolute market value. In fact, when John F. Kennedy was inaugurated President of the United States in 1960, on average about 3 million shares were traded each day on the New York Stock Exchange. Today that much volume occurs on average within the first 6 minutes of trading on the NYSE, though on Black Monday in 1987 we traded that many shares every 90 seconds. In addition, today the NASDAQ market - which didn't exist in Kennedy's time - is the third largest equity market in the world and accounts for nearly as much volume as the NYSE.

The U.S. market has witnessed many changes in the 1980s beyond mere size of the equity markets and their volume. There has been a continued shift toward institutional ownership, mainly public and private pension funds. In 1955, institutions held 23% of total equities; in 1975, 30%; and in 1992, 54%. In addition to their ownership positions, institutional investors today dominate trading volume, representing 75-80% of the average daily volume on the NYSE.

Though they have declined in percentage terms, stockholdings by individuals in the U.S. have continued to climb dramatically. Since 1980 the number of individuals owning equity securities has risen from around 30 million to 50-55 million today. The value of those individual holdings now exceeds \$2 trillion. Thus, in the U.S. we have "democratized" ownership of the economy to an unparalleled degree. In addition to the economics, this

democratization of the economy is one of the considerable benefits of a strong and widely diversified stock market. Indeed, individual ownership of U.S. corporate assets today is nearly three times the 16% ownership by individuals in Germany, and more than double the 22% in Japan and 21% in the United Kingdom. This strong "retail" character of the U.S. market is one reason why the U.S. has tended to place greater emphasis on regulations to protect individual investors than many other countries.

During the past few decades, we have seen a surge of many new products -- like securitized mortgages -- into the markets. Banks used to finance mortgages in America. Today, banks "originate" the loans, but they are funded by the market through mortgage-backed securities. We have also seen new technologies and new market participants.

One of the most striking trends, however, has been an enormous increase in the volume of primary capital offerings. In 1989, the year I became SEC Chairman, there were just under \$310 billion in public offerings of debt and equity securities of all types. In 1991, there were \$600 billion in public offerings of all types. This year, we expect to finish the year with \$900 billion in public offerings. These volumes do not count over \$100 billion in private placements and \$500 billion in commercial paper outstanding continuously.

These numbers make it clear that in America, unlike Europe, it is the securities markets, not the banking system, that provide most of the financing for the general economy. Indeed, during the entire period from 1989-1992, total commercial loans to businesses in the U.S. fell more than \$30 billion to a total of just under \$600 billion outstanding. During this same period more than \$2.1 trillion of medium and long-term securities have been issued through roughly 15,000 offerings. At current rates the securities market is providing businesses almost \$20 billion in fresh financing every week. That is a stark contrast to the net liquidation of almost \$200 million in commercial loans that has occurred on average every week in the U.S. banking system for the past three and one half years.

We have certainly seen our share of both stability and enforcement problems in the securities markets -- like the insider trading scandals of the 1980s and the collapse of Drexel Burnham. However, on the whole the U.S. securities market has been remarkably resilient and stable throughout an era of unprecedented political and economic upheaval. An investment in equities still provides a higher overall return than a bank deposit. Indeed, \$100 invested in 1925 in stocks that comprise the Dow Jones Industrial Average would be worth around \$60,000 today, despite the stock market tumbles of 1929 and 1987. The same \$100 put into a bank savings account or Treasury bonds would only be worth \$1000 to \$2000 today.

### Capital Availability

The consistent decline in commercial lending and the explosive growth of the securities markets is empirical evidence of the "disintermediation" phenomenon that began in the 1970s and continues to this day. The users of capital have realized that they can bypass banks and tap sources of capital less expensively by cutting out the bank as a middleman. The investors that are the sources of capital have realized that the government "safety net" offered by the banks comes at a very high price, since it requires forgoing the return that equity markets have provided.

Fundamentally, raising capital through securities is more efficient than "intermediated" lending. There is not any need for the balance sheet of a bank to be placed -- at high cost -- between the ultimate saver of funds, like a pension plan, and the ultimate user of funds. This allows businesses to raise funds much less expensively, which is why major U.S. businesses now raise all of their short-term funds from commercial paper, not bank financings.

In addition, securities markets are more open than banking systems in who gets access to capital. In a universal banking system like Germany's, for example, there are a few giant banks that serve as "gate-keepers" in terms of access to capital. By contrast, in the U.S. capital market any small company with a good idea can be financed through the securities markets. In my view,

that is why Apple Computer, Microsoft, and biotechnology companies have originated in the U.S., because our system lets the small company have access to the capital it needs to replace the older and larger companies.

Growth of the market depends on the confidence of millions of investors that they may invest their money in the securities markets. With adequate disclosure and reliability of financial statements, investors can have the confidence to focus directly on the financial statements of their investment, rather than rely on the government guarantee of their bank deposit. This shift to the disciplines of the marketplace relieves the government from its role as guarantor of a bank's lending decisions. For the U.S., this means that the 43,000 people and more than \$2 billion used by the government annually to monitor bank portfolios could be redirected to more productive uses in the economy.

The world's experience with Latin American loans in the 1970s and the U.S. experience with our own savings and loan crisis in the 1980s clearly showed that an economy cannot rely solely on banks to make financing decisions. Asia and Latin America companies have shown a strong trend to turn to this lower-cost source of financing, and many of them have come to the largest and deepest market in the world -- the United States. In the last 3 years alone, more than 140 new foreign issuers from 26 countries have entered the U.S. public securities markets. This number is more

than the total of foreign issuers listed in Tokyo today. Foreign issuers, old and new, have raised more than \$60 billion in the U.S. public securities markets during the same period. This increase occurred at the same time that London actually had a net loss of foreign listings.

Systems dependent on bank financing are in danger of being left behind in this explosive growth of securities markets. Universal banks may not be nimble enough or have enough capital to compete in the current financial marketplace, basically because they depend on government guarantees and are subject to regulation that stifles their flexibility. Bank regulatory practices during the past several decades have clearly demonstrated the problems that can arise if the regulations disregard market disciplines.

Bank regulation, because of the explicit or implicit government guarantee that is always present, depends on avoiding systemic risk and bolstering capital. The traditional motto of a bank regulator is "No news is good news," because the government's interest as guarantor in safety and soundness is thought to supersede the investors' interests. Traditionally in the U.S., it has been thought that public confidence could be achieved by keeping the public from learning about any problems with a bank. Consequently, bank shareholders at times have been the last to know of the true condition of a bank's assets -- they may find out only after regulators have closed the bank and wiped out shareholder

equity. By contrast, in securities markets we believe that true public confidence comes from giving investors all the news -- both good and bad.

This tension between disclosure of information to the market and "managed" information is reflected in the current debate in the U.S. over whether to reflect securities holdings on bank balance sheets at current market value, instead of historic cost. It is also seen in Europe where investors in German companies must contend with the concept of "hidden reserves," which withholds from shareholders the full information about the value of assets of their company.

#### The Basle Accords

A case in point of ignoring market forces in favor of old-style regulation is the adoption by bank regulators of the so-called "Basle Standards." These standards were implemented in 1989 after almost 15 years of attempts to develop international minimum capital standards for banks. Unfortunately, after all that time the world's leading bank regulators were only able to agree on the measurement and capitalization requirements for "credit" or default risk. Interest rate (or market) risks and currency risks were left until another day. Thus, the new rules required, when fully implemented, 8% capital to be held against loans to businesses, but 0% capital for holdings of government bonds and only 1.6% for home mortgages and related securities.



Unfortunately, the Basle standards are a good example of the danger of disregarding market forces in favor of well-intentioned regulation. The underlying logic of the Basle accords was sound: bolster safety and soundness by increasing capital standards. However, the Basle rules created incentives for banks to shun the activity for which they are best suited and most needed: evaluating potential borrowers and extending credit to them. The Basle rules instead created a very strong and quite artificial incentive for banks to use their deposits to purchase government bonds. As a result, in the U.S. banks are becoming government bond mutual funds with a commercial lending operation on the side.

Implementation of the Basle capital rules has been one of the major factors that caused a sharp drop in bank lending in the United States, now popularly known as the "credit crunch." Between March, 1989 and September, 1992 the level of bank lending to businesses fell a precipitous 5 percent (\$31 billion). At the same time, bank assets increased by 18 percent (\$545 billion), and bank holdings of U.S. Government securities grew a startling 71 percent (\$263 billion).

There is not any mystery as to what is going on here. Prior to March 1989, U.S. banks were required to hold six percent capital against both Government securities and business loans. In contrast, the Basle rules assigned different risk weights to

different assets, so that the capital required to hold a Treasury bond dropped to zero. Of course, this is only possible by arbitrarily limiting the rules solely to credit risk, and completely ignoring what can be massive interest rate risk. These standards unambiguously encourage banks to buy Treasuries rather than make business loans. Thus these rules are in fact credit allocation dressed up as bank supervision.

The ultimate result for the U.S. banking industry may be the opposite of that which was intended. Treasury bonds carry substantial interest rate risk that is ignored in the Basle framework. Today's low interest rates may not be with us forever. After all, using overnight publicly insured deposits to buy fixed-rate long term bonds involves virtually the same risk as using such short term deposits to acquire 30-year fixed rate mortgages. To encourage banks worldwide to take on massive interest rate risk by exempting bond portfolios from capital requirements is both bad supervision and bad economic policy. That has certainly been the result in the United States.

Thus, the bank regulators broke the cardinal rule that capital standards should be "allocation neutral." Politicians and regulators should not dictate how capital should be allocated. It is ironic that at the same time that we were telling the Russians and Latin Americans that markets, not ministries, should govern, bank regulators are acting in exactly the opposite manner.

Although the Basle Committee should be praised for trying to raise levels of bank capital (which is a vital cushion against economic downturns), they should be strongly faulted for ignoring interest rate risk.

### Conclusion

The events of the past decade have been instructive. We have learned -- and in some cases relearned -- about the capacity of free, competitive markets to promote economic well-being. We have seen that rapid economic, financial, and technological change occurs naturally, with minimal disruptions, in a market economy. And we have regained our confidence that modern industrial economies can produce low inflation, low unemployment, and solid economic growth simultaneously, over a sustained period. At least if we avoid deflation -- one of the greatest present dangers -- we can achieve economic growth.

The economic landscape itself has changed dramatically. For example, who could have foreseen that the Eastern European and formerly Soviet economies would have rejected central planning and embraced free market approaches? This will place great demands on the financial services industry to provide technical expertise and on world capital markets to assure the allocation of funds to productive activities in those countries yearning to share in the growth potential of market economies.

These developments have occurred alongside an evolution in thinking about the appropriate role of government in the economy. Along with the developments in Eastern Europe and the former USSR, many West European governments are privatizing State enterprises, rolling back industrial subsidies, and moving toward internally freer flows of goods, capital, and labor. Italy is certainly faced with both the challenges and the opportunities that this process offers.

Through it all, capital will be king. We do not have enough capital to be able to afford to use it inefficiently. Countries that do not have an efficient capital market will not prosper economically over the long term. Thus, the source of capital -- investors -- and how to maintain their confidence in investing are very important considerations. Because investors demand openness, transparency and fair markets as the price of their investment, governments eventually will respond. This will be a far lesser price to pay than coddling regulation that attempts to defy market forces.

Together, as the SEC and the CONSOB have done yesterday, we can work to build investor confidence in the world-wide securities marketplace. Investor confidence must be built on full and open information, rigorously enforced rules against fraud and open access to the marketplace. Investor confidence requires that large, powerful and well-connected participants in the market will

be held to the same standards as all other investors. All these factors and more go into producing quality markets for investors.