



REMARKS OF

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THE ROLE OF ETHICS IN PROTECTING THE U.S. CAPITAL MARKETS

AIMR CONFERENCE ON ETHICS

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

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*In 1790 Thomas Jefferson had occasion to discuss ethics when he said "I have but one system of ethics for men and for nations -- to be grateful, to be faithful to all engagements and under all circumstances, to be open and generous, promoting in the long run even the interests of both."*

*As usual, and as our friends at AIMR in Charlottesville surely know, Thomas Jefferson was right on target.*

*An understanding of ethics, and the role it plays in the securities markets, ultimately must focus on the long-term. At its core, our markets consist of millions of individuals making conscious decisions about how to invest their capital. These decisions must necessarily involve a large element of trust -- otherwise investors would not make others the custodians of their hopes and dreams. The hopes and dreams embodied in their hard earned life-savings.*

*To maintain this trust, and continue to receive this vote of confidence from individual investors, Wall Street must recognize the long-term advantage of building relationships that benefit all parties over an extended period of time.*

*Coming out of the 80's, some view Wall Street simply as a "den of thieves." A bastion of greed that provides little of value to the productive*

*capacity of America. In my view, this is simply not true. While Wall Street certainly suffers from the same human failings of other institutions, Wall Street provides an invaluable source of strength to our nation.*

*The primary function of securities markets is to facilitate the efficient allocation of resources in the economy. In this regard, Wall Street has no peer. The U.S. capital markets are without question the cleanest, fairest and deepest markets in the world. In this we can all take pride.*

*Fundamental changes are sweeping our markets, however. Markets are near all time highs and capital is moving freely across borders in record volumes at the stroke of a computer key. In fact, advances in technology have led some experts to predict that our ability to compute and to communicate will increase by a factor of one hundred over the next ten years. The field of corporate finance is also undergoing a quantum leap forward. In today's market, it is almost anachronistic to use the term stocks and bonds. Today's complex financial instruments are better defined in terms of cash flow and volatility characteristics.*

*From Shanghai to Budapest to New Delhi, market reforms are also taking hold and creating new demand for capital. This combination of new technology and increased market access provides investors with more opportunities than*

*ever before -- including an estimated \$150 billion in privatizations around the globe. It also will lead to fundamental changes in how markets, both in the U.S. and abroad, operate. And it may lead to changes in the way regulation operates, given the increased opportunity for "regulatory arbitrage" and the increased technological capability to synthetically circumvent regulation.*

### *Continued Success of U.S. Capital Markets*

*In my view, there are three themes to the continued success of the U.S. capital markets: ethics, self-policing and efficient regulation. Each of these areas presents new challenges and responsibilities as we navigate the shifting tides of today's global markets. Our success in meeting these challenges will determine whether we maintain the comparative advantage of our capital markets in the years ahead -- and maintain a long-term relationship with investors that operates to everyone's advantage.*

*The first line of defense in the oversight of our markets is individual, firm-wide and industry-wide ethics. No amount of government regulation can substitute for a high standard of ethics.*

*Ethics means different things to different people. To me, ethics is about personal values. Its about staying true to your beliefs and feeling good about yourself. And in many ways, our ethics define us more than any other trait.*

*Unlike physical characteristics, ethics is something that involves conscious choices by individuals about themselves.*

*And the choices people make have consequences. Unlike other kinds of mistakes that can occur in the life and the business career of an individual, mistakes of character are often irretrievable. Many a person in business and in government have been lured by the sirens song of easy money only to end up on the rocks of despair. These ethical lapses ruin careers, tarnish firm reputations and diminish public confidence in the marketplace. Good ethics is good business if you intend to be around for the long-term in our markets.*

*The second theme to the continued success of our markets is self-policing -- which in my view is another way of saying industry-wide ethics. Unlike banks, securities firms do not operate under the watchful eye of an army of 22,000 regulators. In our markets, we rely extensively on the concept that firms have an enlightened self-interest in maintaining the integrity of the marketplace. This self-interest leads market participants to voluntarily police those that operate at the margin. Failure to provide this policing function will erode public confidence and operate to the disadvantage of all market participants.*

*We have prime examples of effective self-policing. Many of the largest securities firms have discontinued the practice of making political contributions*

*to influence the selection of the firm as an underwriter. With the help of a little bit of moral suasion from Arthur Levitt, and an assist from Frank Zarb of Primerica, these firms sent the message that public confidence in the integrity of the marketplace was paramount. The actions of these firms should serve as a model for all participants in the municipal market. Be it by a voluntary code of conduct or an MSRB rule proposal, the practice of "pay to play" must stop.*

*Municipal market participants must also probe new ways of bringing increased transparency to the municipal market. Of course, transparency is defined as the degree to which real-time trade, quotation and other market related information is available to all market participants. In a completely transparent market, market participants have equal and immediate access to all quotations and to reports of prices and volumes.*

*Transparency is important in our markets because investors need to have confidence that they are playing on a level playing field. Through market transparency, investors can judge the quality of service they get from their broker because they will be able to have virtually instantaneous information on quotes and the details of completed transactions.*

*Transparency in the municipal securities market today is simply inadequate. Currently, municipal market participants, including both investors*

*and dealers, lack access to indications of buying and selling interest for most municipal securities. In the interest of protecting the integrity and continued success of this market, market participants should take the lead in addressing this shortfall.*

*Other tenets of our self-policing model are our sales practices, suitability and supervisory standards. I'm sure most of you are familiar with the series of articles in the L.A. Times in 1992 which highlighted the issue of how many "bites at the apple" a rogue broker should get before being barred from the industry. The series prompted an internal staff investigation at the SEC which is nearing completion, and also raised the interest of some on Capital Hill. Last week Chairman Dingell wrote the SEC and indicated a desire to hold hearings on the subject in the near future and possibly to introduce legislation to adopt a "three strikes and you're out" policy for rogue brokers. I think it is safe to say that none of us wants to see rogue brokers in the business. I also think it is safe to say that none of us wants to resort to legislation to achieve this goal.*

*The subject of broker and supervisory pay is also receiving a heightened level of scrutiny. With regard to brokers, some have called for a rethinking of the way that brokers are compensated. Arguing that the current commission structure creates an inherent conflict of interest, these commentators advocate an asset-based compensation method. Similar concerns have been raised with*

*regard to the compensation of branch managers with supervisory responsibility. For example, when firms compensate branch managers largely on the basis of the volume of business conducted by brokers in the branch, there is a potential disincentive for that manager to vigorously supervise the brokers under his command. Here again, the industry needs to get ahead of the curve and address these concerns before they receive heightened regulatory or legislative attention.*

*A final area of self-policing that warrants discussion is the area of investor education. In recent times, those that were traditional savers have become first-time investors. Unwilling to live with the anemic 2-3% returns available on bank certificates of deposit, more and more Americans have turned to Wall Street. The vehicle of choice for these new investors is mutual funds, and individual mutual fund shareholders now total over 38 million people.*

*Many of these investors are unfamiliar with the risks involved with their marketable securities. Formerly the holders of government-insured instruments, these investors now find themselves chasing yields in a market with no federal safety net. According to a recent survey conducted by the SEC, 36% of the respondents thought that mutual funds purchased from a stockbroker were federally insured. Clearly, this perception has got to change. The return of the small investor to Wall Street represents a tremendous vote of confidence. But*



*these investors can, and will, vote with their feet at the first sign of a Bear market. Market participants have a vested interest in trying to educate new investors on the risks inherent in owning marketable securities and the advantages of having a long-term investment horizon.*

*The third theme to the continued success of the U.S. capital markets is efficient regulation. In those instances where ethics and self-policing do not adequately promote investor protection and public confidence, the SEC has an obligation to advance cost-effective regulation to achieve these goals.*

*In many respects, the need for SEC regulatory action represents a failure of the ethics and self-policing functions in our markets. Let me briefly describe three examples of SEC action, or proposed action, designed to ensure the integrity of the securities markets -- insider trading prohibitions, restrictions on payment for order flow and the accounting treatment of derivatives.*

*One of the fundamental elements of successful capital markets is that investors must believe that they are not being taken advantage of by insiders. In the United States, we have a long tradition of prosecuting insider trading - - and this has accrued to the success and vitality of our market. In certain other countries, however, insider trading is not viewed as a crime, but as an acceptable business practice. For example, a common belief that certain*

*investors have access to confidential information and profit from it is a major reason why comparatively few Europeans own stock. In the United States 35% of adults own stock, while only 7% in Germany, 14% in France and 20% in Britain own stock. As these numbers illustrate, the perceived fairness of our markets serves as a significant competitive advantage.*

*Other regulations promote market fairness as well. Recently, the Commission published for comment a proposed rule regarding "inducements," and in particular, the practice of Payment for Order Flow. Specifically, the release proposes to require a broker-dealer to include on the confirmation of each transaction whether payment for order flow or other "inducements" were received in connection with the transaction.*

*As the people in this room know, the subject of "inducements," including payment for order flow, is an issue that deeply divides segments of the securities industry and has been the subject of extensive debate and analysis. Opponents of payment for order flow liken this practice to a payoff, while proponents consider it a legitimate business practice in a highly competitive market.*

*The Commission's recent rule proposal attempts to strike a balance between these competing viewpoints -- and does so in a manner that I believe is wholly consistent with the core principles of the federal securities laws.*

*By advancing the notion of a disclosure based solution, the Commission has steered clear of picking "winners" and "losers" between competing market participants. Instead, by requiring relevant disclosure, investors will have the information necessary to make informed decisions for themselves. And if investors determine that payment for order flow is an unfair practice, savvy market participants will use the absence of payment for order flow practices to their competitive advantage.*

*As an aside, let me call your attention to the fact that the payment for order flow release also contains language directing the Commission staff to report back promptly on the need for enhanced disclosure by investment advisers in the area of soft dollar arrangements. In many respects, soft dollars and payment for order flow are two sides of the same coin. While there certainly are technical differences between the two practices, both represent payment of cash and non-cash inducements for allocating business among market participants. But enough about soft dollars, because I know you have a panel this afternoon that will discuss this topic in detail.*

*Without question, one of the dominant forces in our markets today is the explosive growth in the use of derivative products. As I'm sure many of you are aware, some have called for severe restrictions on derivatives activities warning*

*that derivatives will be the "next S&L crisis." I disagree. As a regulator, I don't believe you can navigate the road ahead by looking exclusively in the rear-view mirror. While there certainly are lessons to be learned from prior experiences, including the S&L crisis, there are cops on the beat with regard to derivatives.*

*Is this to say I am unconcerned with the explosive growth of the derivatives market. Absolutely not. As a regulator, it's my job to be concerned. To address these concerns there are four basic themes to SEC oversight of derivatives activities -- risk assessment, capital, accounting and coordination.*

*Let me briefly discuss accounting, because it is axiomatic that good accounting is the underpinning of good risk management -- good regulatory oversight -- and continued public confidence in this market.*

*To the extent that settlement values under derivatives contracts are largely contingent, which is often the case throughout the life of a derivatives contract, current accounting standards do not require settlement values to be reflected in the firms' balance sheets. As a result, the financial statements of entities with OTC derivatives books far in excess of their capital are, for all intents and purposes, opaque. For the first time in recent memory, simply reading a firms'*

*balance sheet does not necessarily give the reader a clear understanding of the firms' business or health.*

*The rapid growth of the derivatives market, and in particular the introduction of complex new products and strategies, has left the accounting profession behind the curve. At the present time, GAAP simply does not comprehensively address the manner in which public companies must account for and disclose their derivatives activities. While some footnote disclosure and MD&A discussion is presently required, the FASB and the SEC must do more in this area. It is my understanding that the FASB is currently considering a "fast-track" study on derivatives to address these concerns -- and I fully support this step.*

*But industry should not wait for regulatory action. Investors need assurances that derivatives are not a house of cards -- assembled by Wall Street -- for the sole benefit of Wall Street. By voluntarily adopting enhanced accounting standards, as proposed in the Group of Thirty report on derivatives, the industry can bolster market transparency and reassure the investing public.*

*But the growth of the derivatives market highlights a larger trend. We live in a world where new products and cross-border electronic networks are challenging the traditional geographic and jurisdictional boundaries. Standards*

*of doing business are being increasingly developed by the markets, rather than imposed by regulators.*

*The development of international electronic networks has spawned markets such as Forex, OTC derivatives and Globex -- and is ushering in a brave new world in finance. In this new environment, business parties must increasingly rely more on trust and business ethics than on regulation.*

*In a sense, however, this brave new world is really just going "back to the future" -- and the way business used to be conducted. When the founders of Wall Street met under the buttonwood trees 200 years ago they didn't have an army of lawyers and regulators to dictate business practices -- they relied on enlightened self interest, a common code of conduct, and a handshake.*

### Conclusion

*The increased stress these trends place on regulators dictates that ethics and self-policing assume a larger role in today's markets. Why is this the case? Because investors demand clean markets. Investors have more choices than ever before, and they will exercise alternate choices if they perceive a market to be unfair.*

*Emerson once said that "the only reward for virtue is virtue." In my view, that's only partly correct -- virtue is also good business. But perhaps virtue is the wrong term. A better term may be enlightened self interest.*

*Our markets are built upon a foundation of trust. Trust is what attracts issuers to our markets. And more importantly, trust is what attracts investors to our markets. As market participants, maintaining that trust is tantamount to maintaining our livelihood. And as a nation, maintaining that trust in our capital markets is vital to fostering economic growth and prosperity.*

*Thank you.*