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Remarks of

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CRITICAL ISSUES IN THE REGULATION OF OUR NATION'S SECURITIES MARKETS

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

REMARKS TO
THE NATIONAL PRESS CLUB

David S. Ruder
Chairman, Securities and Exchange Commission

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I. Introduction

Thank you. It is a great pleasure to speak to the National Press Club.

I have now been Chairman of the Securities and Exchange Commission for slightly more than three months, and it is time for me to identify publicly those securities regulation issues that I believe should be addressed by the Commission in the months ahead. In doing so I recognize that recent market events are creating their own agenda, impelling the Commission to determine why they occurred and whether they reveal problems that require regulatory changes. But there also are other important matters that demand attention in fulfillment of our responsibilities to maintain the integrity of our capital markets and to protect the investing public.

Let me identify five areas of concern.

First, the need for regulatory changes to meet problems posed by the October market break. Second, matters relating to the internationalization of securities markets. Third, potential repeal of the Glass-Steagall Act. Fourth, the regulation of

insider trading. Finally, means of improving protections for securities industry customers.

By reciting these five areas of interest I do not mean to exclude other important areas, such as our strong enforcement program, tender offer regulation, and the corporate structure questions inherent in the one share/one vote proposal. What I do intend is to point out that we are in a unique time in the Commission's history and in the regulation of securities markets in the United States. I would like to review with you today some portions of a remarkably full agenda.

II. The October Market Break

First, let me discuss the market events of October. As everyone knows, on October 19th the Dow Jones Industrial Average fell a record 508 points. This day was followed by two weeks of extraordinary volatility on the New York Stock Exchange, as well as in the over-the-counter markets, on the American Stock Exchange, and in the rest of the world's leading securities markets. While much attention has been focused on events of the 19th and the following two weeks, it is important to keep in mind that the Dow had already fallen 158 and then 235 points in the two weeks preceding the week of the 19th. At the close on the 16th the Dow was down 23% from its August 1987 high of 2736. On October 19th the Dow closed at 1738, 36% down from August, and on October 30th the Dow closed at 1993, 27% off its 1987 peak. As of last Friday the Dow was at 1914, 30% below August levels. Although these declines were dramatic, it is significant that the

1987 August high in the Dow was almost four times its August 1982 level of 776 and 24% over its January 1987 level.

In addition to the extreme volatility during October the daily volume was extremely high. Prior to Friday, October 16th, the New York Stock Exchange had experienced only one day with volume over 300 million shares. On Friday, October 16th, volume increased to 338 million shares and during the week of October 19th volume was over 600 million shares on two days and averaged 362 million shares on the other three days.

The Commission is deeply concerned about the impact of recent market volatility and large volume on public investors, on market professionals, and on the structure of the market itself. The Commission study now underway will review the roles played by various market participants during October. We will examine the various forms of trading involving stock index options and futures, so-called arbitrage trading and portfolio insurance. Although these new products have benefited institutional investors and the people whose money these institutions manage, they also raise serious concerns. The Commission's study will address a number of important questions in this area, including:

First, to what extent did index-related trading contribute to the market decline? Our preliminary information is that index-related trading occurred in significant amounts on October 16, 19, and 20th. However, it is too early to conclude precisely the extent to which this activity contributed to the market decline.

Second, how have institutional portfolio strategies been affected by the ability to use stock index futures and options to adjust stock positions more quickly and more cheaply than by trading stocks? More specifically, did institutions increase their stock positions to the point that they were more likely to make selling decisions as the market moved downward?

Third, does the ability to take the equivalent of a very large stock position through futures and options with relatively lower initial deposits result in unacceptable levels of speculative activity in the markets? In other words, should higher margin requirements be imposed on derivative index products?

The study also will cover other questions raised by the October events. We will look closely at the adequacy of dealer capital to cope with increased volume and volatility and hope to suggest means for making more capital available. We also will examine the market's operational capacity for order execution, order routing, and clearance functions. Although as a general matter those systems operated well during the market break, we will study the strains that appeared during this period to determine where improvements may be necessary. As part of an examination of operational capacity we will also focus upon the treatment of retail customers during the crisis. Finally, we plan to study the relationships between the various foreign and domestic markets during this time.

During October, we experienced a market-wide sell off accompanied by unprecedented volume. These events tested the efficiencies of the markets' trading systems, personnel, and settlement operations. I believe the systems and the industry

handled this crisis quite well under the circumstances. Nevertheless, we have witnessed the most dramatic and volatile market decline since the SEC was formed. Unraveling and analyzing the events of the past weeks is a high Commission priority. I am committed to determine what course of action should be taken in light of these events in order to ensure the continued protection of investors and the financial and operational soundness of the securities industry.

III. Internationalization

Not only will foreign markets be part of our study of the October market break, but internationalization generally will demand special attention by the Commission in the coming year. 1/ The increasing internationalization of both the markets for offering securities initially and for trading them after their initial issuance is a recognized fact, particularly for debt and increasingly now for equity securities as well.

Because the enforcement of our regulations and the surveillance of our markets are more complex tasks in an international environment, the Commission already has completed negotiations of bilateral information sharing and enforcement assistance agreements with regulatory authorities in the United Kingdom, Japan, and Switzerland. We expect to work out more such

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1/ See, "The Regulation of International Securities Markets," (Remarks of Chairman David S. Ruder at U.S. Perspectives VII) (October 19, 1987).

agreements in the coming year.

The clearance and settlement of transnational trades -- that is the exchange of money for securities after a trade has been agreed to -- has lagged behind the development of active trading markets, and there are still considerable delays in clearing and settling trades in many countries. This has been an area of Commission attention in recent years, and we will continue to do all we can to facilitate further improvements in this area.

An equally significant internationalization problem is that caused by the differences between our regulations and those of the growing foreign markets. In this area, the Commission's primary responsibility must be to maintain the investor protection regulations that make our markets fair and efficient, and therefore competitive, while adapting our regulations to an environment where as a technological matter trading can move anywhere in the world.

The major prospective regulatory initiative in this area will be Commission consideration of proposals to permit active trading in the United States among large institutions of certain securities of foreign issuers without requiring additional disclosures. This initiative will be coupled with continuing attempts to develop internationally compatible accounting and auditing, disclosure, insider trading, general antifraud, and manipulation standards.

In a larger sense internationalization is one of the several major developments that has emerged in the past 20 years as we

have witnessed changes in the fundamental nature of securities markets. Beginning in the 1960's and into the early 1970's, the markets became, in the industry jargon, "institutionalized." This means that during this period trading in securities gradually became dominated by large institutions, such as pension funds. Institutional trading generally involves the more frequent trading of larger blocks of securities than does individual trading.

The late 1970's and early 1980's witnessed increasing innovation in securities industry services, such as automated and computerized trading systems, as well as in securities-related products, such as stock index futures and even more complex, hybrid instruments. Markets also became increasingly internationalized during this time. These factors all interrelate in a complex way. Thus, institutionalization and automation of markets have in part caused increasing product innovation and internationalization, in turn creating increasing interaction between markets.

These very fundamental changes in the nature of securities markets may have found their ultimate negative expression in the events of October. It would be counterproductive to go back in time to abolish or limit institutionalization, innovation, or internationalization of markets. In any event, these factors should not be considered individually. Responding solely to internationalization or to innovation is no longer sufficient. Rather, the responsible regulator's task in the coming year will be to determine whether the changing nature of securities markets -- as a result of the combination of these factors -- requires

adaptations to our regulations, including adaptations that might make the regulations among domestic and foreign futures and securities markets more compatible with one another.

IV. Glass-Steagall

One fact of life in international securities markets is that, except here and in Japan, banks are free to engage in the securities business. Our restrictions on banks may soon be alleviated, however, since the Glass-Steagall Act, which erected strict barriers between commercial and investment banking as a response to the depression of the 1930's, is now under serious attack.

Since the passage of this law, developments in the financial markets have eroded commercial banking's traditional lines of business, and have brought securities firms increasingly into competition with commercial banks in these areas. In addition, because Glass-Steagall applies only to activities within the United States, some United States banks are engaged in broad investment banking activities overseas.

Pointing to the increased competitive pressures on banks and to banks' extensive overseas securities activities, some have advocated that United States banks should be allowed to engage in full-service investment banking in this country. They argue that allowing banks to engage in all securities activities will actually improve the safety and soundness of the banking system by allowing banks to diversify their business and increase their capital.

They also argue that bank entry into securities activities will increase competition in financial services, benefitting consumers. Some also assert that relaxation or repeal of the Glass-Steagall Act is necessary to make United States banks competitive with foreign banks.

Opponents of Glass-Steagall Act repeal argue that it will increase the level of risk in the banking system and result in an unacceptable concentration of economic power. Opponents also argue that repeal will create serious investor protection concerns, concerns of great importance to the Commission. Advocates of increased bank securities powers respond that the protections of the federal securities laws, which also were enacted largely in response to the Stock Market Crash of 1929, are adequate to deal with any concerns regarding investor protection and the securities markets.

Just last week, two versions of proposed financial restructuring legislation were introduced in the Senate. Both bills would amend portions of the Glass-Steagall Act. The Securities and Exchange Commission will testify on these bills on December 3, and our testimony necessarily will reflect our views as the federal agency with responsibility for the protection of investors and the maintenance of fair and orderly securities markets. As the federal agency with this responsibility, we have a crucial interest in the proper regulation of the securities activities of all participants in our Nation's capital markets, including depository institutions.

From this perspective, I believe that banks should not be allowed to engage in the securities business unless they are subject to Securities and Exchange Commission regulation. To this end, the Commission has strongly supported the proposed Bank Broker-Dealer Act, which would require that banks engaging in broker-dealer activities do so through separate affiliates subject to Commission regulation. It also supports the Bush Task Group recommendations to consolidate in the Commission administration and enforcement of the securities registration and reporting requirements for all publicly-owned banks and thrifts. We are currently examining the various issues involved in proposed Glass-Steagall repeal, including issues related to the recent market events. The Commission has important regulatory responsibilities in the securities area and we must continue to be able to fulfill these responsibilities should banks be allowed to participate more broadly in the securities industry.

V. Insider Trading

Yet another issue critical to the fairness of our securities markets and the protection of investors is the regulation of insider trading.

In its early development, insider trading referred generally to the act of purchasing or selling securities by persons who possess material nonpublic information about a corporation or its securities in breach of a fiduciary duty to the corporation and its shareholders. Recently, insider trading concerns have been

expanded to encompass a broader range of activity including trading while in possession of material nonpublic information that has been misappropriated.

Insider trading prohibitions are extremely important to the operation of our securities markets because they improve confidence in the fairness and integrity of the securities markets. The investing public has legitimate expectations that the prices of actively traded securities reflect publicly available information about the financial condition and prospects of issuers, and that persons with access to material nonpublic information will not abuse their trust by trading before such information is publicly disclosed. 2/

The Commission in recent years has aggressively pursued insider trading violations. We have brought insider trading cases not only against so-called traditional insiders, such as corporate officers and directors, but also against professionals, such as investment bankers, risk arbitrageurs, brokers, attorneys, other law firm employees, accountants, and bank officers. We have also actively pursued cases involving tipping of associates, relatives, and friends.

Last week, two highly significant events occurred in the development of the law against insider trading. First, on Monday the Supreme Court announced its decision in the Winans case

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2/ See In re Cady Roberts & Co., 40 S.E.C. 907 (1961).

involving misuse of confidential information by an employee of the Wall Street Journal. 3/ In that case, the Court left undisturbed a Federal Circuit Court holding that trading on the basis of misappropriated nonpublic material information violates the federal securities laws. The Winans decision is a significant victory for investors and the integrity of our markets.

Second, on Wednesday of last week the Commission transmitted to Senators Riegle and D'Amato a Commission-approved bill that codifies traditional insider trading prohibitions and also incorporates a misappropriation theory based upon breach of duty concepts. The Commission's proposed bill would prohibit the use of inside information that is wrongfully obtained or used, and would broadly define such wrongful conduct. It includes a definition of insider trading that reaches not only insider trading by corporate employees, but also insider trading by brokers and other persons associated with the market, by friends and relatives of insiders and by other persons who knowingly violate relationships of trust and confidence by utilizing insider information for their benefit.

Congressional action on the pending insider trading legislation will determine for a substantial time into the future the content of federal regulation of insider trading. I hope the end result of these deliberations will be a determination that it is wrong

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3/ U.S. v. Carpenter, ___ U.S.L.W. ___ (Nov. 16, 1987).

to benefit oneself by breaching a duty to keep information confidential. When this breach threatens the fairness and integrity of our securities markets, a legitimate federal regulatory interest arises.

VI. Customer Protection

Another area of particular concern is that adequate protections be offered to customers of broker-dealers. One of the first proposals that came before the Commission after I became Chairman related to the arbitration process governing disputes between brokers and their customers. The Commission voted to approve the many recommendations for improvement of this arbitration process.

The arbitration recommendations the Commission made were aimed at the ability of customers to have disputes with their brokers resolved with procedural fairness. The Commission's concern with the integrity and fairness of the securities market also reaches substantive customer protections, and in this regard the Commission will seek to ensure the strict enforcement of prohibitions against sales practice abuses and other forms of overreaching by brokers. These essential customer protections are found in federal securities laws and rules, as well as in the rules of the exchanges and the National Association of Securities Dealers, which operate as the ethical guidelines of the industry. These rules reflect the fact that brokers occupy a special position of trust and confidence in their relationships with their customers. Among other means of improving customer protections, I intend to

heighten the Commission's enforcement efforts in this area; to encourage the industry to enforce its own ethical proscriptions in a diligent way; and to cooperate more with the states in the performance of their critical role in this area. One of my major concerns as Chairman will be that customers be treated fairly and believe they are being treated fairly.

VII. Conclusion

As I stated at the outset, by setting forth five areas of concern I do not mean to diminish the importance of other issues to which the Commission will be devoting its attention in the coming year. These include tender offer regulation; the one share/one vote issue; competition in the options markets; disclosure in the municipal securities markets; legislative initiatives, including amendments to the Trust Indenture Act; a variety of accounting issues, including opinion shopping, mandatory peer review and the recommendations of the National Commission on Fraudulent Financial Reporting; proxy regulations; and mutual fund advertising. All these issues are significant. Fortunately, the current Commissioners and the Commission staff possess the high levels of knowledge, competence, and judgment necessary to address this agenda. I consider it a privilege to serve on this Commission at this time, and to have an opportunity to help develop with the other Commissioners, the staff and Congress the overall regulatory approach that will best serve our Nation's interests.