REMARKS OF

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U.S. SECURITIES AND EXCHANGE COMMISSION

MARKET 2000: REGULATING FOR THE FUTURE

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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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Over two hundred years ago, just shortly after the birth of our nation, the first securities exchange was established in Philadelphia. I do not think it was a coincidence that the Declaration of Independence was signed in the same city where our first formal marketplace was established. The virtually concurrent births of our political and financial institutions illustrate what an essential role the marketplace has always played in this country.

During the past two hundred years, the markets have changed considerably. You know that at the Philadelphia Stock Exchange, an exchange that is often referred to as the most diversified in the world. Technology has revolutionized trading. Orders are executed within seconds. Markets are interlinked globally. Market products are also fluid. Instead of investing in plain stocks and bonds, investors are purchasing hybrid products whose values are derived from the price of some underlying asset. But after all, weren't those first pieces of paper traded in Philadelphia also, in a sense, derivative products?

My discussion today focuses on the <u>Market 2000</u> study recently released by the SEC's Division of Market Regulation, and then on one of the challenges to the marketplace that it is very timely to discuss -- oversight of the exploding derivatives market.

<u>MARKET 2000</u>

The SEC has a good history of responding to the ever changing demands of the marketplace. The most recent culmination of this effort has been our <u>Market 2000</u> Study.

If you compare the "Institutional Investor Study" conducted by the SEC in the mid-1970's with the <u>Market 2000</u> Study, you can see how much our equity markets have changed. The Institutional Investor Study led to the un-fixing of commission rates; the development of consolidated quotation and transaction reports among U.S. exchanges; the Intermarket Trading System; and the initiation of transaction reporting for NASDAQ securities. In the twenty years since that study, the U.S. equity markets have enjoyed a tremendous growth in trading volume. In addition, advances have been made in trading technology, institutional investors are increasingly dominating the markets, derivative products are becoming significant instruments in the marketplace, and cross-border transactional activity has boomed.

Although these developments have resulted in significant cost savings, convenience, and variety to the investing public, they also *raise important issues of market transparency, liquidity, efficiency, and domestic and international competition.*

What the Market 2000 Study basically concludes is that today's equity markets operate efficiently within the existing regulatory structure. As a result, the Study does not call for broad structural changes to the regulation of the equity markets. Instead, the Study concludes that the Commission should continue to focus on enhancing competition and allowing economic forces, interacting within a fair regulatory field, to determine that appropriate variations in market practices and services.

Notwithstanding its basic confidence in the integrity of the equity marketplace, however, the Study does contain a number of proposals with respect to improving transparency, fair treatment of investors, fair market competition, and open market access.

TRANSPARENCY

The Study suggests several methods for improving transparency. First, transparency can be improved by displaying all limit orders in listed stocks or NASDAQ stocks when these orders are priced better than the best intermarket quotes or NASDAQ quotes. Displaying the real quotation spread would prevent market fragmentation. Second, intramarket transparency could be improved by eliminating the one-eighth pricing system and reducing the minimum variation permissible for bids and offers to one-sixteenth, for example. In preparing the report, the staff concluded that the current minimum is too wide because much of the trading in stocks on proprietary trading systems is done in stocks quoted in eighths, by parties who trade inside the quotes at prices of one-sixteenth or finer. Third, the Study recommends that the NASD consider ways of improving access to information with respect to orders entered into SelectNet. Competitive pricing of a security is inhibited if there is limited availability of information regarding SelectNet orders.

In addition to intramarket transparency concerns, Market 2000 considered after-hours trading and the feasibility of an order exposure rule. According to the Study, in the first half of 1993 about 17 million shares per day in NYSE and NASDAQ/NMS securities were executed after regular trading hours. Approximately half of these were faxed to off-shore trading desks for execution. The Study recommends that the SRO's develop a transaction reporting system to *capture trades in U.S. equities that are only nominally executed abroad. Finally, with respect to order exposure, the New York Stock Exchange and GAO have recommended that the Commission reconsider implementing an order exposure rule. The Study suggests that the NYSE and other SRO's coordinate the development of such a rule for further Commission consideration.*

__FAIR TREATMENT OF INVESTORS__

With respect to the fair treatment of investors, the Study contains five specific proposals. First, the Study recommends that the Commission require greater disclosure of payment for order flow and broker-dealer order handling practices. As you well know, payment for order flow has deeply divided the securities industry, and has been extensively debated and analyzed. 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.

In anticipation of the Study's proposal, the Commission proposed rules last October that attempt to strike a balance between these competing viewpoints -- and do so in a manner that I believe is wholly consistent with the core principles of the federal securities laws.

In October, the Commission published for comment a proposal regarding Payment for Order Flow. Under this proposal, Rule 10b-10 would be amended to require a broker-dealer to include on the confirmation of each transaction whether payment for order flow was received. If such a payment was received, the broker-dealer must report the amount of any monetary payment or monetary equivalent received with respect to the transaction.

In addition, the release also proposed to add new Rule 11Ac1-3 that would require a firm to disclose its policies regarding payment for order flow practices in exchange-listed and NASDAQ national market system securities on each new account statement and on the annual account statement. The proposed rule also would require these statements to include information regarding the firm's aggregate amount of monetary-based payment for order flow.

By advancing the notion of a disclosure-based solution, the Commission steered clear of picking "winners" and "lowers" between *competing market participants. Instead, by requiring relevant disclosure, investors will have the information necessary to make informed decisions for themselves. As Justice Douglas once said, "Government should keep the shotgun, so to speak behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."*

Market 2000's second proposal with respect to the fair treatment of investors relates to soft dollar practices. The Study suggests that disclosure of such practices should be improved. In many respects, soft dollar 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 compensation for allocating business among market participants.

Third, the Study recommends that broker-dealers using automatic routing procedures assess market quality on a periodic basis. By regularly examining the quality of competing markets to verify that order flow is directed to markets that provide the most advantageous prices and speed of execution for customer orders, broker-dealers will better fulfill their duty of obtaining the best execution for customer orders.

Fourth, the Study suggests that market and market makers in listed stock offer price improvement. This addresses the concern that automated, quote-based executions favor speedier executions at the cost of price improvement.

Finally, the Study recommends that the NASD amend its rule proposal to prohibit broker-dealers from trading ahead of customer limit orders for NASDAQ/NMS securities. The NASD's current proposal would prevent a NASDAQ market maker from trading ahead of its own customers' limit orders. However, the proposal does not protect customers from this practice when their orders are routed from the first market maker to another for order handling.

FAIR MARKET COMPETITION

The Market 2000 Study makes three proposals with respect to fair market competition. First, the Study recommends strengthening the surveillance and order handling responsibilities for third market trading. Currently, third market makers and firms executing their own *order flow off the exchanges handle almost 10 percent of the orders in listed stocks. The Study suggests that the NASD develop and submit to the Commission a comprehensive program for examining third market activity. In addition, the Study recommends that the NASD adopt rules with respect to third market trading to ensure that such trading does not affect adversely the integrity or fairness of the price discovery process.*

Second, Market 2000 suggests that the Commission propose a new record-keeping and reporting rule for broker-dealers that operate certain automated trading systems, including proprietary trading systems. This would provide the Commission with additional information with which to monitor the impact of automation on the market.

Third, the Study suggests that transaction fees apply equally to both listed and NASDAQ securities. Currently, under the Exchange Act a transaction fee is imposed on all national securities exchanges, and on broker-dealers effecting OTC trades in exchange-listed stock. The Study contends that such a distinction provides the OTC market with an unfair competitive advantage because NASDAQ is now the second largest market in the world. Accordingly, the Study recommends such transaction fees be extended to NASDAQ securities.

Finally, the Study recommends that the Commission expedite the process of reviewing SRO system changes.

OPEN MARKET ACCESS

Recognizing that the increased competition for order flow may result in marketplaces attempting to restrict the activities of their competitors, Market 2000 proposes three ways of opening market access. First, it recommends that off-board trading restrictions be removed for after-hours trading. Second, the Study concludes that NYSE Rule 500 and Amex Rule 18 should be modified to provide companies with a reasonable opportunity to move to another market. Finally, it recommends extending the ITS-CAES link to all listed stocks, rather than only to securities covered by Rule 19c-3 under the Exchange Act.

DERIVATIVES

One of the greatest challenges facing the marketplace and regulators alike is concerns over the recent explosion in the use of derivatives. This $7.5 trillion market clearly fills a market-place demand. Last year, a Sunday New York Times article called derivatives the greatest growth industry ever.

Not surprisingly, derivatives are becoming an increasingly important source of revenue for financial entities. According to the Office of the Comptroller, 626 banks had positions in derivatives as of the end of last September. In its annual report, Chemical Bank disclosed that derivatives accounted for approximately 40 percent of its $1.1 billion in total trading revenue last year. Merrill Lynch's recently issued annual report revealed that its revenue in 1993 from derivatives was greater than from stocks. Its revenue from trading swaps and derivatives rose to $761 million, a 57 percent increase from 1992.

Derivatives are so attractive because of their versatile uses. They can be used to hedge a portfolio against loss, as well as to enhance the return of mutual funds. Municipalities have found that using them can lower financing costs. For instance, New York City's deputy comptroller for finance estimates that derivatives, primarily interest rate swaps, have saved the city $10.8 million in financing costs.

However, increased use of these instruments is raising concerns about their impact on the stability of the financial markets and the health of the banking system. Some commentators are blaming the recent sharp drop in bond and stock prices to traders who borrowed heavily or leveraged through derivatives and then liquidated their holdings when they received direct or indirect margin calls. Moreover, recent reports of billion dollar losses resulting from derivatives usage have not improved public confidence in these markets. For instance, the press reports that Metallgesellschaft posted a $1.35 billion loss late last year on its U.S. oil derivatives trading. Such stories are becoming commonplace.

These financial press reports have done much to fan the flames of public concern over use of derivatives; last month the cover of Fortune, this week the cover of Time. Congress has become so concerned lately about the impact of derivatives on the markets, that *several legislators have raised a clarion call for action. Two weeks ago, committee aides to Representative Henry Gonzalez announced that he intends to introduce a bill on derivatives later this month. Last January, Representative Leach introduced a bill to create a Federal Derivatives Commission to oversee this market.*

In addition to Congressional initiatives, regulators have focused their attention on overseeing the derivatives market. Since Gerry Corrigan sounded his initial warning about two years ago, representatives of the Board of the Fed, the CFTC, the Treasury, the SEC and the New York Fed have met regularly to discuss derivatives regulation as part of the Working Group on Financial Markets. The Working Group is quite concerned about enhancing the disclosures available for dealers and end-users both in the United States and abroad. It also is attempting to devise a uniform international format for reporting derivatives activity to regulators. Finally, the Working Group is concentrating on internal controls for the different types of dealers present. Historically, bank regulators looking at banking institutions have had different concerns than securities regulators looking at securities firms. With both entities now actively participating in the same market, regulators should compare notes to see how their requirements stack up against other objective standards, such as the Group of 30 Report.

Derivatives are not just a "hot" topic domestically. Regulators are focusing on these issues in the international context. Just last month, the SEC, the CFTC and the British Securities and Investments Board took the first formal step toward international cooperation in the regulation of the derivatives market. We issued a Joint Statement that establishes an agenda for oversight of the OTC derivatives market.

Some of the goals set forth in the Joint Statement are regulatory in nature. For instance, the three agencies have agreed to enhance the existing arrangements for the exchange of financial and operational information regarding the major securities and futures firms they each regulate. The motivating force behind this arrangement is simple: You can't regulate effectively what you don't know. If our goal is to address the potential for systemic risk, we must first know its source and its size.

Another regulatory goal is the establishment of capital standards that encourage incentives for good risk management. The agencies *are continuing to review and modify, as appropriate, their capital standards, in the hopes of creating prudent risk-based charges for firms.*

The Joint Statement also addressed netting arrangements, and their impact on capital standards. Legally enforceable netting arrangements are important to market players who are trying to control and manage their counterparty credit exposure. After all, credit risk can be just as dangerous as market risk. The agencies agreed that applicable capital standards should reflect the risk-reducing characteristics of legally enforceable netting arrangements.

In addition to these regulatory goals, the Joint Statement addressed what I term as market or industry goals. Among these goals are the desire to promote the development of sound management controls, to encourage greater standards for customer protection, to improve accounting and disclosure standards and to establish a framework for multilateral clearing arrangements.

Although these regulatory initiatives will improve the stability of the derivatives market, I believe that the industry and the market participants hold the key to meeting the concerns that have prompted the regulators to call for action in these areas. The best way to control the systemic risk presented by the increased use of derivatives is for the industry itself to take bigger steps to self-police and self-discipline market participants. Systemic risk control begins with market participants controlling risk at the firm level. This is why the Joint Statement spotlights this issue, and why the agencies involved are committed to working with industry groups to improve systems for monitoring and controlling derivatives activities.

Reading between the lines of the Joint Statement, I think it is fair to say that the SEC is committed to following up with the appropriate SRO's to see if some type of industry code of conduct is feasible, as others have suggested. Clearly, we are concerned about suitability and whether the "know thy customer" rule is being applied in the derivatives marketplace. If the industry moves forward to address these concerns, then both Congress and the SEC will have less to worry about.

Similarly, the Joint Statement calls for consideration of a regulatory framework to apply to clearinghouses and other multilateral arrangements OTC derivatives transactions. This represents another *area where the industry can act and suggest a solution, rather than react to a government requirement.*

For the industry to effectively police this market, however, it must ensure that the users of derivatives fully understand these products. According to a survey recently released by the Group of 30, the boards of many dealers and users of derivatives do not have this firsthand knowledge. The senior management of a firm needs to have a firm grasp of its firms derivatives activities.

CONCLUSION

As derivatives devour an ever increasing share of the marketplace, regulation, by either the industry or government, becomes a certainty. To ensure that the well-intended efforts of regulators do not unduly burden the market, market participants must take an aggressive role in controlling the risk, and the public's perception of the risk, in this market.

Indeed, as the Market 2000 Study points out, competition and economic forces, within a stable regulatory framework, should determine appropriate market practices. Although Market 2000 offers several proposals to improve investor confidence in the marketplace, these proposals cannot succeed without input and cooperation from the market players. That's not an idle observation. I say that possibly because I have now worked on both sides of the fence. It is now clearer to me than ever before that, at least at one level, we are all in this together. That level is how U.S. markets are going to be positioned globally . . . and how competitive we will be.

I look forward to working with you to keep U.S. capital markets the pre-eminent markets in the world -- this century and the next.