

APR 7 1995

MERIDIAN ADVISORS, LTD.

601 JEFFERSON SUITE 4000

HOUSTON, TEXAS 77002

TEL (713) 651-2310 FAX (713) 651-2390

CHARLES MILLEN
CHAIRMAN

ROBERT T. ARNOLD
PRESIDENT AND
CHIEF EXECUTIVE OFFICER

March 30, 1995

Mr. Steven M. H. Walman
Commissioner
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Steve:

I thought the first meeting of the Securities and Exchange Commission's Advisory Committee on the Capital Formation and Regulatory Processes was very productive in starting a strong dialogue about achieving your objectives. As I stated at the meeting, I have a very positive feeling about the functioning of our capital markets and also about recent federal securities regulation. In the context of "if it's not broke, don't fix it," I think major overhaul is not needed and would indeed be unwise.

Because of the extended rise in financial asset prices since the early 1980s, it is likely that some unsound practices have developed which will surely be uncovered during the next major bear markets. We may be able to identify or anticipate some of these practices, such as how derivatives are being used, but it is usual to have bad developments come to light after sharp price declines. At that time, the enlightened regulatory response would be to not overreact and harm the capital markets long term because of short-term political or business pressures. There are some cogent examples of this type of counter-productive regulatory response during the banking and savings and loan crisis of the 1980s. In contrast, the regulatory response to the 1987 stock and bond market crashes was calm, measured and ultimately sound. An important contribution from our committee would be to develop a framework for the regulatory response to future "crises," an anticipatory mechanism of some kind.

During our session, we discussed some macro-economic problems in the area of U.S. capital formation and competitiveness. There was an implication in some of the comments, or so I thought, that securities regulation as now practiced might be contributing to these problems. I believe exactly the opposite and have tried to spell out my opinions and conclusions in the following comments. I hope these comments will constructively contribute to the dialogue about securities regulation and capital formation.

March 30, 1995
page 2

Capital Formation

In my opinion, capital formation in the United States is not hindered in any measurable way by federal securities laws or regulation: There is a large amount of anecdotal and statistical evidence to support that view.

Breadth and Depth of Capital Markets - Capital can be raised in many forms; by a wide range of issuers; with reasonably low costs; through a large list of agents and institutions; at attractive costs of capital; in a fair manner for investors; and with very few examples of bad, deceptive or illegal practices on the part of issuers or distributors.

Securities Markets Compared to Other Intermediaries and Other Markets - When compared to the distribution practices of other U.S. financial intermediaries such as the real estate or insurance industries, the U.S. securities industry seems to exist in a league by itself--with higher standards of selling practices to the consumer or buyer. When compared with other countries' capital markets, the U.S. financial market clearly excels in information disclosure, liquidity, pace of transactions and investor protection.

However, now that there is active policy consideration of lowering the barriers between the banking and securities industry in the U.S., it may be worthwhile for us to consider whether the banking structures in Japan and continental Europe which allow equity participation by banks--universal banking--actually limit liquidity and flexibility in the capital market. There is very little doubt that entrepreneurial activity is more encouraged by our market and economic structure relative to any other major country. There is also little doubt that the wide range of institutions in the U.S., with different investment objectives and time horizons, provide choices for issuers and a seamless capital market process for virtually all participants. The proposed liberalization of commercial banks' securities market activities would seem to be an important issue for the committee to address.

Savings - References to capital formation at our first meeting seemed to imply that because of the lower personal savings rate in the U.S., that somehow the lower savings rate could be a result of securities market regulation. I believe strongly that we will find limited evidence of that contention.

Even if we begin with the assumption that U.S. savings (investment) is too "low," we should be cautious about how we use that assumption, because most discussions of savings rates are not

complete or are overly simplistic. The proper comparisons of national savings require adding corporate profits to the total (by far the largest form of private savings) and adjusting for pension plan savings (more developed in the U.S. than in Japan, for example), and for personal real estate expenditures (which get tabulated in part as spending rather than a form of investment or savings).

In any case, when one looks at the real economy and the capital markets of the U.S., it is clear that some very positive forces are in place, especially when one considers the following recent circumstances:

- In the late 1980s, Japan went on an investment spending binge. Yet, the Japanese equity market is still down over fifty percent (-50%) in yen terms from its high in 1989, while the U.S. equity market has recently made new all time highs.
- The U. S. economy has outperformed virtually all major economies in recent years, with low inflation and better real growth rates than Europe or Japan.
- U.S. investors have experienced an above average return on financial assets--stocks, bonds and cash equivalents--for over a decade. Long-term U.S. financial assets--stocks and bonds--have also significantly outperformed real estate assets over the same time period.
- U.S. securities markets have experienced a record level of new public equity offerings, as well as privately-raised venture capital funds, indicating that capital is available in large quantities for early stage investors.
- Over the last decade or more, publicly-offered, high-yield debt (junk bonds) has provided access to capital to a large number of secondary corporate issuers and, in spite of difficulties created by S & L regulators' pressure on the high-yield markets in the late '80s, this form of investment has produced a consistently strong return for the investor.
- In recent years, the cost of capital in the U.S. has been very competitive. Real interest rates, while admittedly historically high, are lower than in other major capital markets. Price/earnings ratios in U.S. equity markets have been at historically high levels in recent years, providing a relatively low cost of new equity capital for issuers.

March 30, 1995
page 4

This evidence certainly indicates a well-functioning capital market system, regardless whether or not savings is adequate.

The Public Policy Driver for Capital Formation - The main public policy driver affecting capital formation in the U.S. is tax policy, not securities regulation.

First, the capital gains tax is widely understood to reduce incentives for long-term capital investment. Furthermore, it tends to lock investors into holding assets in order to avoid payment of taxes instead of allowing them to re-invest more efficiently. That is, in terms of economic theory, this lock-up effect is considered to create a less efficient allocation of capital into the most productive or competitive sectors of the economy. Also, by taxing capital gains without adjusting for inflationary effects on capital, taxes are essentially being levied on gains which are inflation, not real in economic terms. And, other countries with which the U.S. competes globally have little or no tax on capital gains. A reduction, indexation or elimination of the capital gains tax would sharply improve the amount and effectiveness of capital formation in the U.S. economy. It should also, as a byproduct, improve liquidity in the capital markets.

Second, the double taxation of corporate earnings, affected by the process of taxing corporate earnings and then also taxing dividends paid to taxable investors from those same earnings, also reduces the return on equity investments in a manner which is inefficient and inequitable for capital formation.

Third, the tax policy for depreciation of assets purchased for business purposes generally penalizes businesses by not allowing rapid enough charge-offs to account for true economic life or the effects of inflation.

Each of these tax policies can significantly reduce the return on capital, thus discouraging capital formation or creating disincentives to the proper allocation of capital.

Finally, fiscal and monetary policies can have powerful effects on capital formation in two primary ways. The creation of excessive inflation in the economic system by inappropriate monetary policy thereby damages financial assets and securities markets for most investors. Inflation is widely understood to create a serious misallocation of capital in any economic system, but even more importantly, inflation has a general destabilizing effect on the economy. In fiscal policy terms, high taxes or high levels of government borrowing take private savings which would likely be used more productively and efficiently in the private sector.

March 30, 1995
page 5

The potential impact from these tax and economic policies is far more critical in the capital formation process than securities regulation as it is practiced today. In fact, it might be difficult for the Committee to even identify securities regulations which would clearly enhance capital formation without at the same time losing some other important goal of such regulation, in my opinion.

Competitiveness

In my opinion, there has been a gigantic improvement in U.S. competitiveness in terms of global trade. This new competitiveness is hidden by too much focus on the large trade deficit, rather than other factors equally important, such as the following:

- U.S. exports have been growing very rapidly in recent years (double digit growth rates) in spite of weak economies overseas. This is powerful evidence of U.S. competitiveness. It has been a result of significant structural adjustments made by U.S. industry over the last two decades and by the decline in the value of the dollar in the last decade. This competitiveness is underlined by exceptionally strong gains in manufacturing productivity in recent years. The U.S. has been especially competitive in complex technologies, such as avionics and computer hardware, and dominant in software and applications.
- The U.S. trade deficit is a function of many factors, especially the relative current economic growth rates of competing countries. However, if the specific trade deficits with Japan and China and our oil imports are excluded, we are more than competitive. It is clear that Japan, China and oil are unique cases, not an indication of trade weakness or a broad lack of competitiveness.
- The U.S. economy is already highly competitive in many--perhaps most--service industries, especially including the securities industry. And it is a service economy. Along with the recently enhanced manufacturing productivity growth, the U.S. economy is still the economy with the highest level of overall productivity in the entire world, by a margin of more than 25% over Japan or Germany.

March 30, 1995
page 6

- The "huge" trade deficit represents approximately 1.5% - 2.5% of the G.D.P. of the United States. It is certainly not a level which threatens economic growth or stability. If the U.S. economy were to slow and the other major economies begin to grow somewhat faster--which is probably the current consensus--it is very likely that the U.S. trade deficit would shrink significantly.

The Committee needs to address the issue of "competitiveness" only through the obvious connection with "capital formation." An ample and widely distributed supply of capital at reasonable prices is what is needed for the U.S. economy to be competitive, and should be addressed directly by the Committee.

Once again, I want to commend you and the other commissioners for engaging in this discussion. At a time when there is a wide-ranging debate about regulation in general, it seems to me that federal securities regulations stands in a positive class by itself, needing fine-tuning as always, but no major overhaul. My primary concerns today might be the further integration of banks into the securities industry and the efficacy of state securities regulation.

Respectfully,



Charles Miller

CM/fw

cc Chairman Arthur Levitt
Commissioner Richard Y. Roberts
Mr. David A. Sirignano, Committee Staff Director
Advisory Committee Members
Ms. Nancy Smith