



**U. S. Securities and Exchange Commission**  
Washington, D. C. 20549 (202) 272-2650

**News  
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**SOME THOUGHTS ON DEVELOPING SECURITIES MARKETS**

**REMARKS OF**

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WASHINGTON, D.C.**

**APRIL 22, 1991**

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**U.S. Securities and Exchange Commission**

**International Institute for Securities Market Development  
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**April 22, 1991**

Good morning, distinguished guests, ladies and gentlemen. Welcome to the first International Institute for Securities Market Development. Shortly after President George Bush appointed me to serve as Chairman of the SEC, I began to plan the Institute as a means by which the United States could help share its knowledge concerning free capital markets in general, and securities markets in particular, with countries that desire to create, enlarge or strengthen their own markets. Therefore, I am very pleased to be able to open the Institute's first session this morning.

Let me start with a word of warning and a request. This is our first effort to conduct a program like this. Like every first effort, this one includes much enthusiasm. We hope that we will do a good job of providing you with useful concepts and information. My request is that you ask many questions. Please help us understand what you would most like to discuss, and we will be very grateful for your input.

### The Importance of Equity Markets

In the United States, our securities markets, and in particular our equity markets, are a keystone of economic development. Equity capital is highly beneficial in supporting long-term investment in research and development, and in providing a base for investments that take time to pay a return. These include efforts to build international market share.

Today nations around the world are seeking to create or to enhance market systems. However, this objective is easier to state than it is to realize. Vigorous financial markets are not the product of desire, or of any one factor. You cannot go to the store, buy a "stock exchange" and plug it in the way you can a television set. Creation of a trading floor and installation of computers alone will not ensure a liquid and efficient market. Establishment of a good regulatory structure is important, but regulators do not usually create a market. Instead, a combination of factors is required to establish and maintain strong financial markets. These include:

- businesses requiring capital--there must be something to trade;
- savings (both individual and institutional)--there must be investors to provide capital;
- laws designed to protect against fraudulent practices and maintain investor and issuer confidence;
- rational commercial laws governing the conduct of business generally, including enforcement of contracts;
- insolvency laws--businesses both succeed and fail;

- a judicial system strong enough to protect corporate ownership rights;
- sensible systems of taxation;
- banking and telecommunications systems to handle transfers of funds; and
- many other factors.

Obviously we will not be able to cover every one of these topics, and you will not necessarily be involved in every such policy area in your country. However, we hope that the Institute will provide a useful overview of how a sophisticated securities market is structured, and how a regulatory system can be operated to complement the growth of a market.

#### The History of U.S. Securities Markets

In the United States, we have seen first-hand that the creation of an immense and highly efficient securities market can start from very modest beginnings.

Almost two centuries ago, in 1792, a group of bankers began meeting daily under a buttonwood tree on New York's Wall Street. A few years later, this group of Wall Street traders signed an agreement binding themselves to certain regulations and restrictions in their dealings with one another, and they acquired a building and moved indoors. On one rather unsuccessful day in the early 1800s, fewer than 50 shares traded

on a single day. Nonetheless, what was to become the New York Stock Exchange continued to grow.

Wall Street was not the only securities market in the early United States. Boston and Philadelphia were the nation's early financial centers, and they had rival securities markets, as they still do today. In general, in these early days, shares of New York companies traded in New York, and shares of Pennsylvania companies in Philadelphia, and so on. With the advent of national companies, particularly the rail companies, it became more common for shares to be listed and traded on multiple exchanges.

Obviously, given the limits on the communications at the time, this created opportunities for arbitrage, buying shares in one market at a low price and then selling them in another at a higher price. Information about share prices in different markets was thus itself a valuable commodity. Today we have a consolidated trade reporting system for all exchanges in the United States trading the same security. It is thus possible to have marketmakers for the same security in New York, Chicago, Los Angeles and Philadelphia all linked by a communication network that ensures that investors get the best possible price when they buy or sell.

Many shares in U.S. canal companies, railroads, and finally industrial firms, were offered and purchased in London, Paris and other foreign financial centers. By 1853, for example, over one quarter of all U.S. railroad bonds were held by foreign investors. International securities investment is thus nothing new. Many U.S. companies that were advertised in London and elsewhere as "sure to succeed" in fact failed spectacularly.

The early U.S. securities markets generally traded first one security and then another through small auctions. Gradually, as more companies and more shares were traded, it became impractical to trade only one security at a time, and there began to be separate trading posts for separate securities. According to the legend, a member of the New York Stock Exchange broke his leg in the 1870s and, to avoid the need to move around the exchange floor trading different securities, took up residence at the Western Union trading post, and began to specialize in buying and selling its shares.

The New York Stock Exchange is now built around its specialists, individuals who remain at a particular location throughout the trading day and "make the market" in one or a few securities. Trades are made either "in the crowd," between two brokers at or near the specialist's post, or between another broker and the specialist. The specialist may be acting for yet another broker, or trading for his own account. The exchange's

rules require the specialist, if an order cannot be found reasonably close to the last preceding sale, to buy or sell the securities for his own account, in order to "smooth out" temporary imbalances in supply and demand.

This is not, however, the only way to trade securities, or indeed the only way they are traded in the United States. You will visit in a few days the central facilities of our "over the counter" market at the National Association of Securities Dealers. On the NASDAQ system there is not a trading floor; there are not any auctions; and there are not any specialists. In fact, all the trades are made between brokers who never leave their offices. Yet, because all the participants have immediate access by computer to centralized information about prior transactions and current quotations, the result is an extremely efficient national market.

Needless to say, the United States has had securities markets far longer than it has had securities firms and markets linked by telephones and computers. Indeed, many U.S. securities firms were slow to use computers to do the tedious but critical work of comparing trades after they are made and arranging the exchange of securities and cash. In the late 1960s, we experienced a serious "back office crisis," in which the clearance and settlement system was unable to keep pace with the trading on the New York and American stock exchange floors.

In response, securities firms have developed impressive computer capabilities to keep track of their trades, and the securities exchanges have developed equally impressive centralized and automated clearance and settlement facilities, such as the Depository Trust Corporation and the National Securities Clearing Corporation. As a result, most transactions in U.S. equities do not involve any delivery of physical share certificates, and most institutional and interbroker settlements are made simply by computer entries on the records of DTC and the National Securities Clearing Corporation. By interposing the clearing corporation between the brokers, and by continuous netting and deposit arrangements, the system minimizes the number and amount of payments that are required, making the system more efficient and more secure for all involved.

Today, we trade equity securities with a total value of approximately \$3.5 trillion. Our trading systems are capable of handling nearly a billion shares in a single day. Our equity markets serve as a vital source of capital for our economic growth and prosperity. The hard work and perseverance of those who met under the buttonwood tree -- and of other market participants over the past 200 years -- has been worth the effort.

## History of U.S. Securities Regulation

Just as our markets have a long history, so our securities laws and securities regulatory agencies have histories that may be relevant to newer securities agencies.

Railroads and other companies issuing stock in the late nineteenth and early twentieth centuries sometimes exaggerated, to use a mild word, their prospects for success and their financial condition. Indeed, they often sold what was referred to as "watered stock" to the public. The early regulation of these practices came from a combination of state corporation laws, shareholder suits and self regulation by the exchanges. Much later, some of the states began to enact securities statutes. The first state securities statute was passed in Kansas in 1911, aimed at promoters who would "sell building lots in the blue sky." Ever since, these state laws have been known as "blue sky" laws. In general, these early state laws required that, before selling securities in a state, the initial disclosure documents had to be filed and approved with the state securities commission.

With the great stock market crash in 1929, and the Great Depression that followed, it became clear that problems in securities markets could affect the entire country. Passage of federal securities legislation was deemed essential. The question, though, was what kind of law? Some argued that the

federal law, like the New York law at that time, should only prohibit securities fraud in general terms. Others argued that the federal law, like the Kansas and other state laws of the time, should create a strong federal securities agency with the power to review the merit of each securities offering. Under a merit system the government must determine whether particular securities are "good" or "bad," and only securities approved by the government can be offered to the investing public.

In the end, Congress passed a compromise measure known as the Securities Act of 1933. The Act requires that, prior to any public offering of securities, the securities offering documents be filed with the SEC for its review. Its philosophy is that full and fair disclosure will allow informed decisionmaking by investors. The Act is truly a disclosure statute, however, and the SEC does not have any authority to review or pass upon the merits of securities. As long as an investor is fully informed, he or she is free to make a good or a bad investment decision. Similarly, under the Securities Exchange Act of 1934, companies are required periodically to report to their investors on their financial condition and all other material events. The SEC, however, has no authority under the Exchange Act to shut down a company in financial difficulty. We can only make the company report its financial difficulties fairly and fully to its investors.

The SEC has been administering these statutes for almost sixty years and we believe they work well. We strongly believe that companies, both when they first offer securities to the public and for as long as their securities are traded on public markets, should disclose to the public what they are doing, and how they are doing. Public confidence that "the full story has been told" is a key part of any company's ability to attract investment.

One crucial factor concerning our securities laws has been their adaptability. For example, the initial securities laws did not contain any prohibition on insider trading. Indeed, even today, there is no section of the federal securities laws that defines and prohibits insider trading. What we have is a rule, Rule 10b-5, which has its own interesting history.

One day in 1942, when the SEC's main office was in Philadelphia, a call came in from the Boston regional office. The president of some company in Boston was buying up the stock of his company at \$4.00 a share and telling people that the company was doing very badly. In fact, though, the company was doing very well and was about to announce that its earnings would quadruple in the next year.

The SEC staff in Philadelphia looked at the securities statutes and the rules, and they decided that there was nothing

in them that precisely covered the situation. They also decided, however, that there should be something to prohibit this kind of insider trading. As a result, the staff members drafted a rule and took it to the Commission that same day. That is how the SEC passed Rule 10b-5, on which all our subsequent insider trading cases have been based.

There are many lessons in that little story. One of them is that is important not only to have sound securities laws, but to have some ability for some administrative agency to "fill in the gaps" with administrative rules. Our administrative agency, the SEC, like the securities laws, has a history. Again, it may be of some interest, particularly for those of you engaged in the process of creating a securities agency in your own countries.

The SEC was not created in the Securities Act of 1933, but in the Securities Exchange Act of 1934. Before the SEC was created, the Securities Act was administered by a small division within the Federal Trade Commission. The securities exchanges, and particularly the New York Stock Exchange, bitterly opposed the 1934 Act, which for the first time allowed for regulation of securities exchanges as well as securities offerings. The securities exchanges were particularly concerned about giving any regulatory authority over the exchanges to the Federal Trade Commission, which they believed was filled with people who did not understand and did not like the exchanges. Again, as a

compromise, Congress decided to create a new agency, the Securities and Exchange Commission, and to give the SEC rather than the FTC the new regulatory authority over the exchanges.

The SEC of course started small, with just the Chairman and the four Commissioners. It has grown to just under 2500 employees in the intervening years. Our staff and statutes have changed somewhat, and yet our basic tasks have not changed. We still seek to protect investors, to maintain market stability and to promote efficiency.

#### The Role of Regulators

The development of financial markets in the United States has been, to a great extent, left in private hands. That is the essence of private enterprise and equity markets. Economic growth and innovation spring not from markets that are designed and controlled by regulators, but from the efforts of private enterprises freely competing with each other.

We have also learned, however, that some regulation is required to ensure the vitality of financial markets because investor confidence is critical to vigorous markets. Regulators play an important role in maintaining fair and honest markets and in ensuring that brokers and dealers treat their customers fairly. It is our responsibility to prosecute fraudulent practices such as market manipulation and insider trading.

Our job as regulators is a difficult one. We must exercise the power that we have been given judiciously. Too much regulation can kill our markets, because it will stifle private innovation and competition. But too little regulation can also kill our markets, because investors will flee markets that are not fair and honest.

Just as there is no certain recipe for building strong financial markets, so there is no recipe for regulating markets properly. No individual or country has all the answers as to how its markets should be regulated, and the answers are not the same in every country. In each of our countries, regulating the markets involves ongoing efforts to change and to improve upon what we have done in the past. Certainly we have not finished revising and improving upon our system here in the United States.

#### The SEC's Readiness to Help

The International Institute for Securities Market Development has been born out of the belief that securities regulators from around the world must cooperate with each other. The Institute is an important way for us to share our experiences with you and to hear about your experiences. It is also a chance for you to hear about each other's experiences.

We have put together programs and materials for this first session of the Institute that we hope you will find interesting and useful. During the next two weeks, the Institute's speakers and panelists will address a variety of subjects related to the development of securities markets. You will hear about the economic underpinning of securities markets, privatization of enterprises, investment banking, disclosure requirements, accounting and auditing standards, regulation of markets, prevention of fraud, and many other topics. Each of these topics is designed to give you a better understanding of the factors required to establish and maintain strong financial markets.

You will hear from senior officials of the SEC and other U.S. government agencies and international organizations. You will attend briefings at the White House and the U.S. Congress. You will hear from distinguished members of the SEC's Emerging Markets Advisory Committee, a committee of chief executive officers and senior representatives from over 30 leading financial market firms and organizations. The Emerging Markets Advisory Committee was formed to advise the SEC on the rendering of technical assistance to emerging securities markets and to assist the SEC in providing such assistance. Hopefully, the opportunity to hear from a wide variety of members of both the public and private sectors will be useful to you in sorting out the roles of regulators and private participants in the U.S.

markets and in determining what those roles might be in your countries.

Your participation in the Institute will be crucial to its success. We have set apart time for discussion of your experiences in regulating the markets in your countries. In my mind at least, one major goal of the Institute is to develop friendships that will last long after the Institute. The success of our common work as market regulators depends on the efforts of all of us. Our joint dialogue throughout this Institute session can be an important basis for our future joint efforts.

Many of you will participate in internships sponsored by our Emerging Markets Advisory Committee members after the conclusion of this two-week Institute session. We hope that this will be a valuable way for you to gain insight into the role of private participants in our markets.

### Conclusion

I hope you come away from the Institute with knowledge that will help you facilitate the growth of your financial markets. I hope that you will share this knowledge with others in your countries. But I hope you will also come away from the Institute knowing that what we have shared during this brief time is just a beginning. At the SEC we stand ready to help you, learn from

you, and cooperate with you throughout the coming years in the difficult work of regulating the world's financial markets.

Together, we can succeed in the task of creating vigorous, fair, and honest financial markets throughout the world.