# FROM THE INDUSTRIAL AGE TO THE INFORMATION AGE:

## RETHINKING THE REGULATION OF SECURITIES MARKETS

BRADLEY D. BELT

FORUM OF FREE ENTERPRISE
PIRAMAL MANSION, 235, DR. D.N. ROAD,
MUMBAI 400 001.

"Free Enterprise was born with man and shall survive as long as man survives".

-**A.D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

# FROM THE INDUSTRIAL AGE TO THE INFORMATION AGE:

## RETHINKING THE REGULATION OF SECURITIES MARKETS*

BY
BRADLEY D. BELT

The Regulatory Framework for U.S. securities markets, which was erected in the shadow of the Great Depression, is outdated and, unless substantially revised, will inhibit the ability of U.S. markets and market participants to compete effectively in an intensely competitive global marketplace. This results from the fact that a variety of forces has fundamentally transformed our securities markets in ways that simply could not have been envisioned by the drafters of the original securities laws.

These laws, and the regulatory structure they established, have served us well and, indeed, have proven to be

---

*The text is reproduced from an article appearing in "The Washington Quarterly" (Summer 1996 issue) with the kind permission of the author. (Copyright© 1996 by the Centre for Strategic and International Studies, Washington, and the Massachusetts Institute of Technology). The author is Director, Capital Markets, at the Centre for Strategic and International Studies (CSIS), Washington, DC, and directs CSIS Capital Markets Regulatory Reform Project. He previously served as Counsel to the SEC and Senate Banking Committee.

The booklet is sponsored by Economics Research Centre, founded by the late Prof. B.R. Shenoy, world-renowned economist, in interest of public education in economic affairs.

remarkably flexible and resilient. As a result, we are blessed with capital markets of unparalleled fairness, depth, and liquidity. The success of U.S. markets is in no small measure attributable to a high quality regulatory system that has been responsibly administered by the Securities and Exchange Commission (SEC) for the past 62 years.

Global capital markets are now characterized by fierce competition, however, and the preeminence of U.S. markets is neither unchallenged nor assured. The extraordinary dynamism of the markets must be buttressed with an equally dynamic regulatory system that reflects market-place realities and is inherently adaptable to change. Unfortunately, this is not the case. The blurring of lines between financial service providers and financial products, the erosion of traditional distinctions between public and private markets, the ready availability of real-time information through electronic means, and the increasing irrelevance of geographic borders are straining a regulatory framework that was designed to address the abuses of the industrial age, not to meet the challenges of the information age.

The evolution of U.S. securities markets, and the growth of global markets, has raised the issue of whether our legal and regualtory structure is optimal to cope with the dramatic pace of change and to respond appropriately and effectively to marketplace developments. While the market participants at the front-lines are able to adapt efficiently and effectively to change -- they go out of business if they do not -- they are increasingly constrained by an anachronistic legal and regulatory structure that is inertially resistant to change, biased against competition, and slow to embrace innovation.

**The Evolution of Securities Markets**

The size, scope, and complexity of the securities markets that concerned Congress in the early 1930s were markedly different from those that confront policymakers today. In the aftermath of World War I, the United States became the dominant economic power and New York usurped London as the center of the financial universe. After the 1929 stock market crash, however, the total equity capitalization of the New York Stock Exchange (NYSE) was just $16 billion -- a small fraction of the market capitalization today and less than the current level of many *individual* companies.

The 130 largest companies accounted for more than 80 percent of the assets represented by listed firms on the NYSE. These largest companies had an aggregate total of approximately five million stockholders of record. In contrast, AT&T alone now has more than two million shareholders. There were some 800 companies listed on the NYSE in 1930 and NASDAQ would not exist for another half century. Trading volume was a million shares a day (the peak had been 16 million shares in October of 1929) -- about the same amount that is traded every *minute* on the NYSE today. Trading hours were from 10 a.m. to 3 p.m., no one was particularly concerned about what was happening in London, and Tokyo would not be on the radar screen for a few more years (and only then for reasons of more traditional -- not economic -- warfare).

Although the 1929 market crash is often viewed as the catalytic event leading to enactment of the federal securities laws, as Prof. Joel Seligman notes in his fascinating history of the SEC, *The Transformation of Wall Street,* a more direct reason for congressional action were the findings of the Pecora hearings, named for the

Senate Banking Committee's investigative counsel, which riveted the financial community's attention with disclosures of numerous incidences of large-scale securities fraud and self-dealing by the leading financiers of the day. It was widely perceived that the stock market was a rigged game, and that the existing state securities, or "blue sky", laws were incapable of dealing with fraudulent schemes on a national scale.

Thus was the Securities Act born in 1933, not with the purpose of having the federal government involved in every aspect of the securities business, but rather with the simpler and more laudatory goal of ensuring that securities sold in interstate commerce were accompanied by, in the words of President Franklin D. Roosevelt, "full publicity and information." Indeed, Roosevelt, in his letter to Congress accompanying the introduction of what was to become the Securities Act of 1933, wrote that "the purpose of this legislation... is to protect the public with the least possible interference with honest business."

This proved to be a very workable approach to regulation of the markets, but over the next six decades the markets would grow and evolve in ways that would have been difficult to discern for even the most prescient of 1930s market-sages. Indeed, the contemporary literature and legislative history evinces little sense of the manner in which our markets would expand beyond our borders and become increasingly innovative and dominated by a relatively small number of large investors. A brief review of some of these market-shaping phenomena and their policy implications underscores the need for a comprehensive reexamination of the legal and regulatory structures governing our securities markets.

**Internationalization**

Capital flows ever more freely across national borders in search of the highest return relative to a given level of risk. Companies and governments can now routinely tap virtually any of the world's securities markets to raise necessary investment capital, and investors have demonstrated an increasing willingness to purchase securities of issuers outside their "home" markets. There also has been a substantial increase in cross-border secondary market trading activity. Both formal and informal trading markets operate on a 24-hour basis. The volume of U.S. equities traded by foreign investors grew sixfold over the last decade, from $125 billion in 1984 to more than $700 billion in 1994 (see figure 1). The growth in trading of foreign equities by U.S. investors during this period is even more impressive -- from $30 billion to $815 billion, an average increase of nearly 40 percent per year (see figure 1). Small investors are part of this phenomenon, pouring more than $1 billion per week into international equity funds run by U.S. money managers. While the growth of cross-border debt and equity trading is impressive, the amount of non-securities financial flows is truly staggering, with foreign exchange trading of more than $ 1.3 trillion each day.

By choosing among different markets, borrowers access new sources of capital and do so at lower costs. They also use these markets to hedge currency and interest rate risks. Investors, large and small, look to foreign markets for new profit opportunities and to diversify their portfolios. New opportunities can also bring new risks, however, and as Federal Reserve Chairman Alan Greenspan has noted, they present new challenges to regulators, particularly related to clearance and settlement risks. While U.S. regulators have made a number

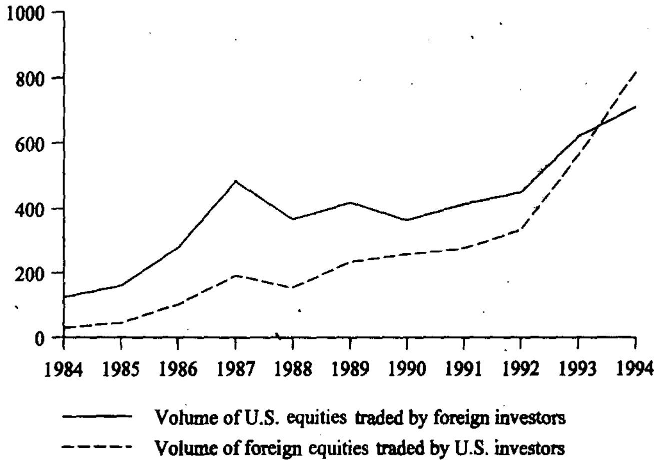
of accommodations to issuers and investors seeking to take advantage of marketplace developments, there is a very real concern as to whether our legal structure, which was designed in contemplation of self-contained national markets, is sufficiently flexible to be able to maximize the benefits and minimize the risks posed by the increased globalization of markets.

**Institutionalization**

Capital markets are now dominated by institutional participants (e.g., mutual funds, public and private pension funds, insurance companies, and bank trust departments). This is in stark contrast to earlier decades, when retail investors accounted for nearly 90 percent of U.S. equity holdings. Today, institutions hold nearly half of all U.S. equities and account for three-quarters of the trading volume on listed exchanges (see figure 2). In fact, block trading, usually trades of 10,000 or more shares, accounted for more than half of reported volume in 1993. Institutions are even more dominant in over-the-counter, debt, and overseas markets. In certain market segments, and with regard to the trading of certain kinds of investment products, market activity is wholly institutional.

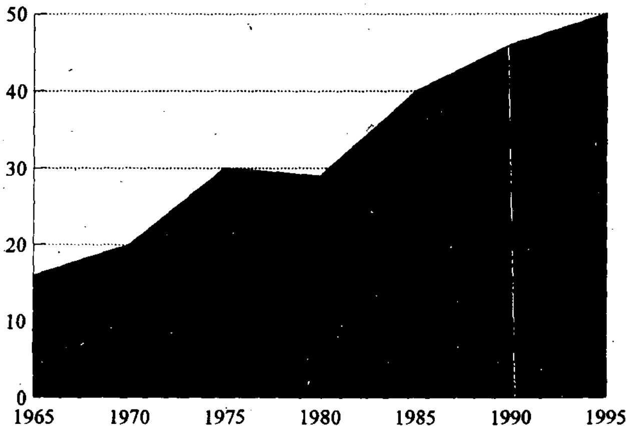
The increasingly dominant presence of institutional investors has had a profound impact on U.S. capital markets, affecting volatility, liquidity, allocation of resources, and corporate governance. As a result, the question arises whether laws and regulations that are principally intended to benefit retail investors are unnecessary for institutional investors, and, more importantly, whether they result in more costly and inefficient markets. Nobel-laureate economist Merton Miller has argued that there is *no* justification for regulating wholesale markets. Others commentators would

Figure 1
Growth in Cross-Border Equities Transactions
($ in billions)




*Source:* Securities Industry Association Fact Book 1995.

Figure 2
Institutional Ownership of U.S. Equities
(Measured as percent of all equities)




*Source: Financial Times*, April 3, 1995, p. 21.

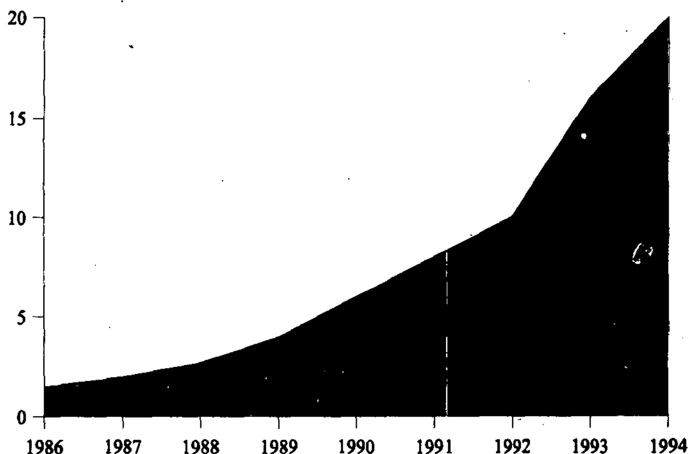
not go so far, but they have nonetheless, suggested a tiered regulatory structure, with much greater regulatory scrutiny given to retail than to wholesale markets. To some extent, the SEC has fostered the development of a limited two-tier market through Rule 144A by encouraging foreign issuers to sell to qualified institutional buyers (specifically excluding retail investors) without registration under the federal securities laws.

**Product Innovation**

The past two and a half decades have seen the introduction of a dizzying array of new financial products and trading strategies. Plain vanilla stocks and bonds have given way to sways, options, futures, and forwards, and hundreds of exotic variations on these themes. Growth in volume of these derivative financial products transactions is staggering. The total outstanding notional value of derivative markets has grown from just over $1 trillion in 1986 to more than $20 trillion in 1994 (see figure 3). Derivatives, and the trading strategies employing them, have become an important risk-management tool enabling money managers to hedge currency and interest-rate risks, tactically allocate assets, and increase or decrease their underlying equity exposure more rapidly and at a much lower cost than had the managers affected these strategies in the cash market.

However, the increased use of derivatives has raised a number of issues concerning appropriate regulatory policy. Many derivative financial products are complex and extremely sensitive to changes in the prices of the underlying asset. Failure to understand the dynamic nature of these products and to employ appropriate risk-management systems can lead to extraordinarily large losses in a short period of time, especially with

**Figure 3**
**Financial Derivatives: Notional Principal Outstanding**
**($ in trillions)**




*Source:* Bank for International Settlements (BIS).

leveraged positions. Losses of larger magnitude not only threaten the viability of individual institutions, but they raise systemic concerns as well.

Moreover, as financial engineers continue to slice, dice and reconfigure financial instruments to create derivative products tailored to meet the risk-reward demands of investors and issuers, it is increasingly apparent that these instruments do not fit easily into traditional product classifications, i.e., within the definition of a "security", no matter how expansively read, and regardless of traditional notions of what constitutes debt and equity instruments, banking products, or futures contracts. Products innovation already has engineered a series of

regulatory crises, the most notable of which gave rise to the Shad-Johnson accord in 1982, a jurisdictional battle between the Commodity Futures Trading Commission (CFTC) and the SEC over index participations; to continued squabbling among regulatory agencies over variations in bank investment products and annuities; and to a substantial amount of litigation. Continuing uncertainty over the legal status of many hybrid financial products raises costs and chills innovation.

**Technological Advances**

Technology has been the principal driver of the transformation of securities markets. Advances in computer and telecommunications technology have enhanced information gathering, storage and dissemination capabilities, improved transparency and price discovery, and enabled the development of complex financial products and risk management strategies. In the 1930s, customer orders were carried by runners across the street or sent by pneumatic tube to a floor broker. Today, technology permits financial transactions - tens to thousands of transactions, with values of more than a trillion dollars - to occur electronically, instantaneously, at all hours of the day. Private sector firms are investing hundreds of millions of dollars in cutting-edge technologies in order to stay competitive. Information is disseminated on a real-time basis and markets can react in a matter of minutes or seconds.

Given the increasing importance of technology, it is questionable whether the SEC and other financial regulators have the willingness of means to be "competitive" and match the technological capabilities of the private sector. In some cases, when presented with a technological "threat" to their authority, such as

program trading, the reaction of regulators sometimes has been to "throw sand in the gears" of innovation in a futile attempt to maintain the relevance of existing regulatory structures and policies. This approach was exemplified by the so-called "circuit breakers" that were implemented in the aftermath of the 1987 market crash. As to means, it is worth noting that the private sector is investing hundreds of millions of dollars to upgrade their technological capabilities -- for example, CS First Boston has spent an estimated $800 million on technology enhancements during the past three years and the New York Stock Exchange has installed more than $1 billion on new technology since 1985 -- while the SEC's entire annual budget is just $300 million and certainly has not kept pace with the tremendous growth of the markets.

**The Coming Revolution in Securities Markets**

As significant as these changes have been, however, we are on the precipice of a brave new world of "cyber-commerce", "nuclear markets," and "particle finance." These phenomena promise to revolutionize the way in which capital markets operate in the next century and challenge long-held concepts of the nature of markets, the function of financial intermediaries, the relevance of national borders, and the role of regulators.

**Cyber-Commerce**

We are rapidly entering an era of cyber-commerce in which issuers, intermediaries, and investors will be fully linked electronically. Brick and mortar edifices will give way to virtual banks and brokerage firms. Leading financial services firms have been acquiring, or entering into joint ventures with, telecommunications firms and computer software companies to best position themselves to take advantage of the information superhighway.

Securities firms, both old-line wirehouses and newer entrepreneurial enterprises, are racing to take advantage of the promise of electronic commerce. Smith Barney plans to allow its clients to execute stock trades over the Internet. Accutrade, a discount broker, has introduced a new product that will allow investors to execute program and basket trades of stock, options, and mutual funds from personal computers. E*Trade Securities, a computerized on-line stock brokerage, introduced a service that lets customers trade stocks and options on the World Wide Web (WWW). Spring Street Brewing, a small New York microbrewery, has launched a WWW trading site -- believed to be the first of its kind -- that allows on-line investors to trade in its shares. Looking into the future, D.E. Shaw & Co., an investment banking firm that specializes in quantitative trading, plans to introduce an on-line personal finance service, the aptly named Farsight, which would allow the firm to become the user's on-line money manager simply by having users access their Web site.

Consumers thus will have a single point of access to banking, credit and debit card services, brokerage, and financial planning. Nor will market access and definition issues be limited to our own borders; *Business Week* recently ran a story titled "On-line Investing" in which the reporter noted that he began every day by logging onto the Zagreb Stock Exchange to peruse "prospectuses" of local issuers. A British company plans to establish the first organized stock exchange on the Internet.

While virtual markets hold great promise, there are a number of unsettled issues, especially with regard to privacy, security, standard-setting and jurisdictional concerns, which pose potentially enormous problems for

regulators. For example, what regulatory standards apply in cyberspace? What is the situs of a transaction that occurs on the Internet? Does the SEC have any jurisdiction over a Bolivian coffee company that posts a prospectus on its World Wide Web site and allows investors to purchase its securities through the Internet?

**Nuclear Markets**

In *The Vandals's Crown,* author Gregory Millman compares the revolution in finance during the past 20 years to the discovery of nuclear power in physics. Given the immense power and volatile nature of private capital flows in today's markets, as evidenced by the Mexican peso crisis in 1994, the comparision is appropriate. Moreover, the power of renegade financiers to, with a few keystrokes, roil markets and undermine national economies that pursue unsound fiscal policies, conjures up images of cold war warriors who. with the turn of a key, could launch intercontinental weapons of mass destruction on their enemies. And these financiers, driven by a profit motive and seemingly unconstrained by political or moral considerations, are more than willing to use their power -- as George Soros demonstrated in his assault on the pound sterling in 1992 that drove Great Britain out of the European Monetary System's Exchange Rate Mechanism.

The threat of global money managers moving billions of dollars of capital in or out of markets within a matter of minutes is further amplified by the risk that disturbances in one market will spread like a contagion to other markets. This extraordinary power calls into question the continued ability of national regulators to exercise authority over global markets and market participants, of national policymakers to manage macroeconomic policy, and of national and international regulators to cushion liquidity crises and prevent the spread of contagion to multiple markets.

**Particle Finance**

For the past decade or more, financial engineers have been reconfiguring traditional financial instruments into new products that are tailored to meet the risk-reward demands of market participants. Now, new advances in financial theory, including portfolio, asset pricing, option pricing, volatility, and market efficiency theories, are leading to a more rigorous study of the nature, measurement, and management of risk. This, in turn, is pushing the envelope of current accounting and financial reporting constructs.

Issuer risks bundled in traditional equity and debt instruments are being disaggregated into more discrete units. The ability to disaggregate, describe, and repackage issuer risks potentially enables investors to more precisely price issuer risks -- not only credit, interest rate, and currency risks, but operational, management, economic, market, country, and legal risks, as well as more esoteric "alpha" risks. This "atomization" of risk raises issues not only with regard to accounting and disclosure policies, but also with respect to the current system of corporate governance -- if equities are unbundled, who then "owns" the company?

**Policy Implications : Pressure Points and Stress Fractures**

The implications of these developments both for market participants and the SEC are profound. Two broad policy ramifications are clear: Competitive pressures will intensify, heightening the impact of over-regulation, and the capacity of the SEC, indeed all financial regulators, to provide meaningful oversight of market activity will be significantly eroded.

**Competitive Pressures**

Previously, the issue of high-cost regulation was not an important consideration -- in a domestic, insular market

environment, participants had little choice but to adhere to the strictures of the SEC. However, the global financial arena is now distinguished by fierce competition among markets that service buyers and sellers of capital worldwide. Market participants are more willing, and able, to move to other, less onerous regulatory regimes. As a result, the preeminence of U.S. markets is no longer assured. Buyers and sellers of capital can access markets around the globe, both in established markets such as Kuala Lumpur in Malaysia. Along with market depth, the cost and quality of regulation are key competitive factors.

Past experience has demonstrated how quickly foreign markets will capitalize on overregulation in the United States. In the 1960s, Congress enacted the Interest Equalization Tax, which imposed a 30 percent withholding tax on interest paid on bonds sold in the United States to foreign investors. Although this tax did produce some short-term revenue gains for the federal treasury, more importantly, it served as a catalyst for the development of the Eurobond market. Despite later repeal of the legislation, this market has remained overseas.

In some areas, U.S. markets already are being usurped. For example, the case can be made that London is the leading *international* capital market, with 464 foreign issuers listed on the London Stock Exchange with an aggregate market capitalization of more than $3 trillion (compared with fewer than 300 on the NYSE with market capitalization of just over $200 billion), despite the fact that it has a relatively small domestic capital base. London is also the leading foreign exchange market, with daily trading volume that exceeds New York and Tokyo combined.

While it is almost certainly the case that the U.S. capital markets will continue to be the market of choice for U.S. and many foreign issuers for the forseeable future, we must be careful to recognize and respond to the changing marketplace environment to ensure the continued health and vibrancy of U.S. markets.

**Constraints on Regulatory Authority**

One of the basic issues that must be addressed is whether in the future securities markets can, or should, be regulated in the traditional sense. Several factors will operate to constrain severely the capacity of the SEC to provide meaningful oversight of securities markets in the years ahead.

The first constraint is the substantial and growing power of global financial markets and market participants discussed above. My colleague at CSIS, Erik Peterson, has characterized international financial markets as the "new global hegemon" that is forcing governments and financial authorities to progressively "surrender important economic policy-making prerogatives to the markets."

A second, related constraint is the ability, and willingness of market participants to engage in regulatory arbitrage. To the extent that regulation in one market becomes too costly, they will move to less onerous regulatory regimes. Moreover, as former SEC Commissioner Carter Beese has noted, issuers and investors "are able increasingly to circumvent national boundaries and regulations through financial engineering, using derivatives to create synthetic risk exposure in virtually any market."

A third constraint is resources. As noted earlier, it is doubtful that the SEC has the staff resources or the

technological capabilities to keep pace with the growth of markets and private sector resources. The annual budget of the SEC (just over $300 million) is about the same as the volume of daily cross-border securities trading. Given budgetary constraints at the federal level, this is a situation that will worsen before it gets better.

A fourth constraint is competence. This is not to impugn the talent and commitment of the SEC's staff, which is generally acknowledged to be the federal government's finest agency, but given the rapid pace of change in the markets and the increasing influence of technology, it will be increasingly important for the SEC to attract individuals who have experience on the front lines and are familiar with the latest technologies, trading systems, and risk management techniques. Financial firms are aggressively recruiting world-class computer scientists, mathematicians, and financial theorists and offering them six-figure starting salaries. Given the extraordinary disparity between the pay levels on Wall Street and in government, it is questionable whether the agency will be able to compete effectively for the best and brightest.

A fifth constraint is temporal. The decision-making cycles of regulators are inevitably much longer than those of the private sector, which is able to adapt to change very quickly -- the markets extract a heavy price for failure to do so. This is a double-edged sword, however. While precipitous regulatory intervention could have disastrous consequences, a slow regulatory response, which has been the norm, will likely result in addressing yesterday's problem. The setting of accounting and financial reporting policy, which the SEC has delegated to the Financial Accouting Standards Board, has been particularly

problematic in this regard. For example, FASB's hedge accounting proposals have been in development for more than four years.

## Regulating Securities Markets in the Twenty-first Century

These considerations underscore the need for a fundamental reexamination of the existing scheme for regulating securities markets. To their credit, both Congress and the SEC have begun to grapple with some of the difficult and complex issues presented.

The "Capital Markets Deregulation and Liberalization Act" introduced by the chairman of the Telecommunications and Finance Subcommittee, which has jurisdiction over the federal securities laws, represents the most serious effort by Congress to address marketplace changes since the 1975 Securities Act Amendments. The provisions of the legislation that deal with the allocation of regulatory responsibilities at the state and federal levels and that broaden the SEC's statutory mandate to include the promotion of competition, capital formation, and efficient markets are especially constructive.

Similarly, Chairman Arthur Levitt and the SEC deserve credit for launching a number of laudable initiatives intended to improve the capital formation process while safeguarding the integrity of the markets. Particularly promising are the efforts of two *ad hoc* groups, the Advisory Committee on Capital Formation and Regulatory Processes, which is considering a company registration model, and the Task Force on Disclosure Simplification, led by Philip Howard, the author of the anti-regulatory manifesto, *The Death of Common Sense*.

Although these are important initiatives, they really represent improvements within the four corners of the existing regulatory scheme. Moreover, as Chairman Levitt has noted, in many areas regulatory authorities have "hit a statutory wall"--they lack the statutory authority to respond to new developments. In order to accommodate the capital markets of the twenty-first century, policy makers need to construct a new regulatory framework reflective of market practices and inherently adaptable to change. This will require policymakers to "step outside the box" and rethink both the way markets function and what constitutes an optional regulatory paradigm. This entails not only a review of existing laws and regulations to identify those that are duplicative and unnecessary, but also a reexamination of regulatory *structure,* and perhaps most importantly, the *approach* to regulation. In this latter regard, the role of the regulators must evolve along with the markets. When dealing with cutting-edge marketplace activities, the approach of financial regulators should be to monitor developments, engage in an ongoing dialogue with market participants, and, where appropriate, encourage responsible behaviour-while vigorously prosecuting those who commit fraud.

It will be up to Congress to construct the statutory framework and establish the overarching policy objectives. It will be the responsibility of the SEC to promulgate appropriate rules and provide guidance in the context of a rapidly changing marketplace environment. A regulatory framework that incorporates the following design principles will be flexible and sturdy enough to withstand the pressures of change and accommodate the needs of both issuers and investors.

*Regulation should facilitate capital formation, not impede it.* However basic, this is the more fundamental regulatory

principle. The purpose of capital markets is not to beget regulation, but rather to transfer capital from suppliers to users, from investors to business. Regulation should facilitate this process by ensuring that markets operate in an efficient, cost-effective, and fair manner. The SEC's view of its role as a regulator is of particular concern in this regard. The agency has traditionally considered investor protection to be its primary, if not sole, responsibility. But the issue is not what the SEC's statutory mission *is* under current law, but rather, *what should it be.* Without question, protecting the interests of investors, at least those who are less capable of fending for themselves, is vitally important to ensuring their continued faith and confidence in the integrity of markets. But, it is important to recognize that investor protection is only a means to an end, not an end in itself. Moreover, the SEC should not be just a consumer protection agency. The nature of today's markets demands that it also factor in the impact of its actions on the efficiency of markets and the competitive posture of the markets and market participants.

*Regulation should strike a balance among often competing goals and objectives.* Striking the proper balance between the needs of investors and the needs of issures should be the primary role of regulators in today's markets. As noted above, the SEC's traditional mandate has been to protect investors. In contrast, banking regulators have been principally concerned with the safety and soundness of the banking system. The CFTC has had more of a market efficiency orientation. Overeliance on one policy approach may come at the expense of other considerations. For example, the banking regulators' insistance on the confidentiality of bank examinations for safety and soundness reasons detracts from both market efficiency

and investor protection. Each financial regulator should have a statutory mandate to balance investor protection, systemic risk, market efficiency and competition concerns. Where regulation is cost-effective, properly balancing investor protection, efficiency, and competition concerns, markets will flourish. Where regulation imposes costly and unnecessary barriers to capital formation, markets will whither and fail.

*The benefits of regulation should exceed the costs.* By nature, regulation imposes costs on the regulated. Nonetheless, there is ample evidence that responsible regulation is beneficial and fosters the process of capital formation. A well-designed and administered regualtory system instills investor confidence, preserves a broad public interest in efficient markets, and safeguards against fraud and misconduct. Unregulated, or poorly regulated, markets have not been as successful in attracting investors as have U.S. markets. Yet, a market characterized by regulatory overreach dissuades issuers by raising the cost of capital beyond what would allow an optimal rate of return. In short, overregulation prices participants out of the market or into other markets.

Although it is often difficult to quantify the costs, and even more so the benefits, of a proposed rule, the SEC should make every reasonable effort to do so prior to adopting one. Unfortunately, while the Commission has been a good steward of our securities markets, it too often has given only passing consideration to the costs of proposed regualtions and their impact on the regulated community. The Commission rarely engages in a rigorous cost-benefit analysis prior to proposing rule changes, and statutes such as the Regulatory Flexibility Act and Paperwork Reduction Act are sometimes given superficial

attention even in rule proposals that likely would have a substantial impact on market functions. A prime example is the SEC's proposed rules regarding the handling of customer order by broker-dealers. Aside from the substantive issues raised by the rule proposal, the proposed rules could fundamentally alter the nature of trading markets and have profound implications for the future of dealer markets and proprietary trading systems. Yet, While the Commission has requested comment on the effects of competition and the costs of the proposed rules, it does not appear to have examined these issues in any detail. It should.

*Regulation should be integrated and integrative.* The regulatory scheme for U.S. securities markets comprises federal statutes and rules, interpretative releases, no-action letters, self-regulatory organization rules and guidelines, and state securities and corporate laws. In addition, there are fundamental inconsistencies with the Commodity Exchange Act and underlying rules, with federal and state banking laws, with federal and state tax laws, and with the regulatory standards of other countries. Beyond being absurdly more cumbersome than necessary, this Rube Goldberg-like scheme raises costs, leads to legal uncertainty, and frustrates competition.

As a first step, the statutory corpus should be pruned and regulatory underbrush cleared out. Laws and regulations that are unnecessary, duplicative, or contradictory should be eliminated. Consideration should be given to integrating the federal securities law statutes into a single comprehensive and cohesive statutory body, perhaps as proposed by the American Law Institute. From a domestic perspective, the legal and regulatory standards of the cash and derivative markets should be integrated or

harmonized, and consideration should be given to merging the SEC and CFTC. As SEC Chairman Levitt has noted, there should be a more rational division of responsibility between federal and state regulators. In an era of global markets, it simply does not make sense to have sets of standards. Tax policy can have a significant impact on the health and competitiveness of U.S. capital markets. Unfortunately, however, far too little attention has been paid to the frequent consistency in policy objectives between substantive financial law and federal tax law. Finally, and most importantly, given the increasing level of cross-border activity, it is imperative that legal and regulatory standards of the developed capital markets--particularly in the accounting and clearance and settlement areas--be harmonized. This will necessarily require compromise and accommodation among disparate regulatory systems-but not a race to the bottom. Consideration should be given to the creation of supranational regulatory framework.

*Regulation should provide clarity and certainty to market participants.* In many cases, regulation, by design, engenders confusion among market participants as to what conduct is and is not permissible. This succeeds only in forcing market participants to retain regions of specialized lawyers to render legal opinions or to obtain no-action letters, and often generates needless litigation. A disturbing manifestation of this problem is the tendency of the SEC to regulate by prosecution. Instead of promulgating an understandable rule or issuing an interpretative release clearly spelling out parameters of conduct, regulators wait for an opportunity to commence an enforcement proceeding not only to punish what they perceive to be misconduct, but also to deliver a "message" to market participants.

*Regulation should be based on performance standards, not command-and control edicts.* Too much regulation entails micromanagement and proscriptions against activities that potentially may be abusive. As former SEC Commissioner Edward Fleischman has noted, "the very presence of a performance-standard-based general rule affords a safeguard against, and an alternative to, the extremes of intrusiveness of command-and-control requirements". Market participants should be given latitude to conduct business in a manner dictated by economic considerations. By the same token, when market participants step over clearly delineated lines, it should be understood that the regulators will prosecute transgressions vigorously.

**Conclusion :** U.S. Securities markets have undergone a remarkable transformation in recent years, and the pace of change is accelerating. Although the markets have been characterized by extraordinary dynamism, however, the regulatory framework is substantially the same as it was more than 60 years ago. We have turbo-charged markets, but a Model-T regulatory system. We need a new regulatory framework that moves us into the fast lane and enables both market participants and regulators to meet the challenges of the information age.

Designing and implementing a new framework for regulating securities markets would obviously be an undertaking of historical proportions. The difficulty of the task should not discourage Congress and the regulators from proceeding down this path. In an increasingly competitive and dynamic global marketplace, where nothing endures but change, those who stand in the middle of the road for too long are bound to get run over.

---

*The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise*

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

# FORUM OF FREE ENTERPRISE

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual Membership fee is Rs.50/- (entrance fee Rs.50/-) and Associate Membership fee Rs.20/- (entrance fee Rs.10/-). Graduate course students can get our booklets and leaflets by becoming Student Associates on payment of Rs.10/- only (no entrance fee).

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box No.209, Mumbai 400 001.

---

Published by M.R. Pai for the Forum of Free Enterprise,
"Piramal Mansion", 235, Dr. D.N. Road, Mumbai 400 001.
Laser Typesetting by GRAPHTECH, Tel.: 261 7479, 267 8060
and printed at Vijay Printing Press,
9-10, 3rd Floor, Mahalaxmi Industrial Estate,
Gandhi Nagar, Lower Parel, Mumbai 400 013.

15/Nov./Dec./1996