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News Release

OPEN BORDERS, and STRONG CAPITAL MARKETS

Remarks of

Richard C. Breeden, Chairman
U.S. Securities and Exchange Commission

Investment Dealers Association of Canada
Whistler, British Columbia

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Canada and the United States share far more than the world's longest undefended border. A significant part of both countries started as England's North American colonies, and we both owe much to the English political and legal system. Of course in the 1700s, the early Americans treated all Canadians equally -- we fought both French Canadians and English Canadians. Happily, in more recent centuries, Canadians and Americans have been consistently on the same side, fighting together from the seas of the North Atlantic to the skies over Kuwait. We share the Rocky Mountains and many other natural beauties of our continent. We also share many happy pastimes, such as three of the greatest sports in the world -- baseball, football and hockey.

Both Canada and the United States also have important historic ties to other nations, most notably to Spain in our case and to France in yours. The French heritage of Quebec is well-known, and a justifiable source of great pride for its residents. It is perhaps less well-known that the United States has a French heritage as well. The

French legacy in New Orleans and the State of Louisiana is manifested in many ways, including language, architecture, and even the civil law rather than the common law.

Indeed, we have the fiscal needs of Napoleon to thank for almost doubling the total area of the United States in 1803. The Louisiana Purchase actually provoked a fierce constitutional argument, since Jefferson had to go beyond the enumerated powers of the federal government to enter into the transaction. Jefferson was probably the strongest proponent of the limited powers of the federal government, yet he couldn't let the constitutional issue stand in the way of what he thought was a unique opportunity. Indeed, the $15 million purchase price for more than 800,000 square miles of land works out to about 2 cents per acre. That's about what you can pay today for some of our former S&L holdings, but it was still a pretty good deal.

America's ties to France are not limited to Louisiana. Every American schoolchild knows the name of Lafayette, and a few have even heard of Rochambeau and De Grasse. Of course, many of those children would probably identify these Frenchmen who played a crucial role in our struggle for independence as defensemen for the Montreal Canadians. Actually, you shouldn't feel bad about that, because some of our schoolchildren would probably identify Washington and Jefferson as forwards for the L.A. Lakers.

Along with our traditional strongly shared beliefs in political, intellectual, religious and economic freedom, the United States and Canada share a general belief in the benefits of trade. Even before the free trade agreement between our nations, there was

more trade between our two nations than between any two others in the world. That trade will make the economies of both our countries stronger at a time when international economic competitiveness is an imperative for every nation wishing to build the standard of living of its people.

Perhaps no other area of economic activity is as "international" as securities markets. Hundreds of billions of dollars of investment in both debt and equity securities flows across national borders in response to changing economic conditions in different countries, as well as in response to tax laws, currency rates and just plain investment opportunities. If anything, international capital flows will probably have an even greater impact on our economics in the 1990s.

The political and economic revolution in Eastern Europe has led to a strong demand for capital in all the former Soviet satellites, but particularly in Poland, Hungary, Czechoslovakia and the former East Germany. Financing modern communications, transportation, energy and environmental systems in these countries, to say nothing of manufacturing facilities capable of meeting enormous pent-up consumer demands, will involve vast capital investment.

In addition, the nations of the Gulf also will have substantial needs for capital investment. Enormous sums will be needed to repair the destruction caused by the war and the Iraqi occupation in Kuwait, including cleaning up its massive environmental destruction.

A further possible, though at present somewhat imponderable, need for substantial capital investment comes from the Soviet Union. As you may know a group of experts at Harvard's Kennedy School has proposed a massive program of more than $100 billion in Western investment in the Soviet Union during the next few years, assuming that the Soviets would in turn commit themselves to a program of genuine and far-reaching political and economic reforms to totally restructure the Soviet system.

Another potentially enormous area of capital investment is the development of Latin American nations that President Bush has proposed in his "Enterprise for the Americas" initiative. Mexico alone represents a country with vast needs. However, it also is a neighbor with enormous potential and a very strong political determination to move rapidly toward private ownership, free markets and open trade as the path to strong economic growth.

The only slight problem with all these needs for capital investment is the fact that world savings rates are unlikely to show a comparable increase in the near term to match the growth in demand for investment. Formerly an exporter of net savings, Germany's savings may well be fully committed to the integration and rebuilding of the former GDR for the next few years. Capital surpluses of Saudia Arabia and other Gulf nations may similarly stay close to home. Of course this investment activity should result in strong real economic growth, which will generate new savings. However, that will take time. and in the interim the demand for investment capital globally could well be tighter.

Many companies or governmental entities seeking funds won't sit at home waiting for investors to find them, either. As you know, last month the Government of Mexico completed a worldwide offering of a large portion of its holdings of the stock of Telefonos de Mexico, or "Telmex." That offering raised more than $2 billion, with more than $1 billion coming from the U.S. For countries with a small (or nonexistent) domestic securities market, offerings in the U.S. and Canadian equity securities markets may be one of the most attractive routes to accomplishing privatizations, and as a device for raising capital.

With the largest equity capital market in the world in the U.S., and the fourth largest in the world in Canada, North America has the potential for remaining the most attractive venue for financings from around the world notwithstanding the integration of the European markets. Meanwhile, the U.S. and Canada will continue to have large domestic investment demands to maintain and enhance our manufacturing, energy, transportation and other economic sectors in the face of intense global competition.

After literally years of work, on July 1 of this year the SEC and our colleagues at the Ontario and Quebec securities commissions will put in place new rules that will begin removing many of the barriers between the equity markets of our two nations. What we call the "multijurisdictional disclosure system," or "MJDS," will allow a qualifying Canadian company to sell its securities in the United States using its Canadian prospectus and to make its periodic filings of disclosure documents, like annual reports to investors, solely to its Canadian regulatory agency.

Similarly, there will be a single set of Canadian documents and procedures in most tender and exchange offers involving Canadian companies with U.S. shareholders, rather than the old system of requiring filings in the U.S. on SEC forms in addition to filings made here in Canada. Canadian companies will be able to appoint a single trustee for debt issues here in Canada, without the need for a separate co-trustee in the U.S. The timing of issues will also be determined by the home country, with no review of the transaction and documents in the receiving jurisdiction. As we gain experience with the system, we hope that we will be able to broaden its availability to companies with smaller market capitalizations or public float, or lower investment ratings, than would be eligible for MJDS in the initial phases.

As part of the process we also eliminated some unnecessary burdens on Canadian issuers. Up until now, Canadian issuers were the only non-U.S. companies that were subjected to the U.S. proxy rules and the U.S. "short-swing" profits test known as Section 16(b) of the Securities Exchange Act of 1934. As part of the MJDS process the SEC has exempted Canadian companies from complying with these provisions of U.S. law even where their shares are traded on NASDAQ or listed on an exchange in the U.S.

To be candid, there are still some genuinely important issues that need to be solved, including the impact of the Glass-Steagall Act on Canadian dealers. The SEC has long favored changing U.S. law to allow banking organizations to own a separately capitalized securities firm operating under the normal system of oversight of broker-dealers. We also have supported the "Section 20" applications of Canadian firms, though only the Federal Reserve can grant these applications. We have agreed with our

colleagues here in Canada to monitor closely the impact of Glass-Steagall on Canadian firms, and we will do everything that we can to make sure that the system does not have an unfair competitive impact among securities dealers.

Despite the remaining challenges to perfecting MJDS, I believe that the final system should benefit issuers and investors substantially. The system should reduce the cost of capital for both U.S. and Canadian issuers, making it easier for them to invest and to expand. The system should also make it far easier for investors in both countries to participate in the opportunities available in the other country's market. As we go forward, I hope that the members of the Canadian investment community will let us know your perceptions of how the system is working, and that we can work together to solve any problems that may arise as we seek to maximize the potential for our combined market.

MJDS comes at a time of looming financial change in the United States. As everyone knows, the disaster of our savings and loan industry has produced almost unimaginable losses for the U.S. taxpayer. When President Bush was inaugurated, we inherited an industry with more than $1 trillion in deposits from about 110 million people backed by an insurance fund that had been chronically underfunded. Literally hundreds of thrifts that were insolvent were continuing to operate, and to incur operating losses of tens of millions of dollars per day. Depositors were withdrawing tens of billions in deposits every month, and there was not any money available for closing the failed firms.

In August of 1989, Congress passed legislation designed to begin the task of closing the insolvent firms and disposing of their assets. That legislation also put in place a series of very important reforms such as requiring thrifts to meet the same capital and accounting requirements as the banks, and dramatically increasing the penalties for illegal conduct relating to thrifts. The regulatory reforms of the bill have been successful in putting an end to the reckless growth of insolvent or undercapitalized firms, and eliminating the use of goodwill and other non-tangible assets as a base for leveraging asset growth.

This law contained many sensible provisions to protect our overall financial system, but it came at least ten years too late. High inflation rates in the late 1970s caused massive losses among the thrifts. Sadly, the response of their regulators was to try to conceal the problem by slashing capital requirements and adopting accounting policies that would have seemed more appropriate in Alice in Wonderland. For example, the regulators decreed that thrifts could book the losses that they actually realized on sale of mortgages and other assets as an asset called a "deferred loan loss." That allowed several hundred billion of dollars in loans to be backed by "capital" that consisted solely of an accounting entry for "accumulated losses."

In a modern attempt at alchemy, our thrift regulators also allowed vast quantities of "goodwill" to be booked on mergers among groups of insolvent firms. Where one day there were five firms with an aggregate negative net worth of $1 billion, the very next day a merger would be deemed to have created a "solvent" new firm based on turning the negative net worth into "goodwill." Indeed, about 80% of industry "net worth" in the

mid-1980s was goodwill, which the regulators allowed to be leveraged to support about one half trillion dollars in deposits. Needless to say, a completely insolvent industry could not have attracted more than $600 billion in new deposits during the 1980s absent phony accounting and unlimited quantities of federal deposit insurance. Sadly, the disposition of the thrift assets is a very slow and very costly process that has already consumed tens of billions of taxpayer dollars.

With this as a backdrop, the Congress is now facing the need to restructure the U.S. banking system. Largely as a result of losses on real estate lending, large numbers of U.S. banks have failed, and an apparently large number are in great danger of failure during the near term. The reserves of the FDIC will be exhausted by the end of this year, making action by Congress at least to replenish the fund an absolute necessity.

Like continuing to pour water into a bucket with a hole in the bottom, simply putting more money into the FDIC is not a viable solution for the serious problems of our banking system. Much more will be needed to put the system on a long term path to earnings and stability. There is, of course, a very strong debate over just exactly what is needed to accomplish this rejuvenation process.

Bankers have long argued that they should have the ability to engage in other types of financial activities such as securities and insurance. Certainly as the market for intermediated loans has become uncompetitive to many types of securitized products such as commercial paper, banks frequently found themselves barred by Glass-Steagall from following the evolution of their customer's financial needs.

While Glass-Steagall restricted product offerings, the interstate banking prohibitions contained in the McFadden Act and the Bank Holding Company Act made it impossible for many banks to develop a low cost regional or national branching system. As a result, we have far more banks per person than other major countries. We have over 12,000 banks in the United States, which works out to one bank for every 20,000 people. That compares with one bank for every 300,000 people here in Canada. The result of our system is very high cost and inefficiency.

Another serious problem with our banking system is the deposit insurance system. We insure far too much, and charge far too little for the coverage. Because we in effect insure all deposits, even uninsured funds, in our large banks, the system creates competitive inequities and precludes any real semblance of market discipline against excessive risk-taking.

Banks are not only shielded from competing with each other by the interstate banking laws, they are also shielded from acquisition by other types of firms. While banks want to be able to acquire securities and insurance firms, in its current form the Bank Holding Company Act would not allow most securities firms and insurance companies to own banks.

The capital and accounting controls of the U.S. banks are much stronger than was true for the S&Ls, as is the bank regulatory system. However, banks can count unrealized losses on securities as part of their capital base, as they do with loan loss

reserves. Because of the permissibility of historical cost accounting for investment securities, banks are able to engage in what we call "gains trading." Securities that have risen in value are sold and taken into income, while securities that have fallen are held and accounted for at their original cost. This obviously produces an overstatement of what actual operating results were, and the resulting portfolio may be composed of nothing but embedded losses by the time the FDIC takes over.

The Administration has proposed a very sensible and far-reaching proposal to overhaul virtually every aspect of this structure. While many dismissed its prospects, over the last two months the bill has picked up strength in the Congress in large part due to strong personal support from President Bush. It is of course too early to know what will result, but there is now a fair chance of seeing a bill that includes much more than a simple recapitalization of the deposit insurance fund. Repeal of all interstate barriers is probably the strongest candidate for inclusion in the legislation, along with many supervisory enhancements such as authority to move more quickly into failing banks.

While I support an overhaul of Glass-Steagall, I do not know whether that change will pass this year. The benefits would be potentially important for larger, well-capitalized banks though in the aggregate they have been vastly overstated. The U.S. securities industry lost $160 million last year, so it is not able to provide "extra" profits to solve the problems of banks that are not able to run a profitable banking business. Repeal of the restrictions against banks owning securities firms should, in my view, be accompanied by freedom for all securities firms to acquire banks. It must also be accompanied by strong provisions to prevent the use of publicly-insured funds in

underwriting, trading and other securities activities. Securities firms owned by banks should also be regulated under the same system that is utilized for existing securities firms.

Whether or not Glass-Steagall is changed, the U.S. banking system ultimately must undergo a very significant consolidation to eliminate excess capacity. Too much in insured funds has been chasing too few quality borrowers, with the result of more failures in the last decade than in the previous half century. There is no "magic bullet" or painless antidote for solving this problem. As always, the market must ultimately be allowed to adjust supply and demand into equilibrium. Hopefully the removal of long outdated arbitrary restrictions on competition will allow this process to move forward in the most economically rational manner. Along the way the distortions caused by trillions of dollars in taxpayer underwriting of private risk-taking must be controlled in order to reach long-run stability.

As you can see, there are many changes brewing south of the border, and 1991 could turn out to be the year in which very significant structural reforms are made to the U.S. financial system. Hopefully the end result will promote sound economics, and make it easier for Canadian firms to compete fully and vigorously in the U.S. capital markets without regulatory barriers. Obviously we hope to see U.S. firms also able to operate within what may well become the world's largest free trade zone.

I began these remarks noting our longstanding friendship. It has never been more important, and potentially more beneficial, for U.S. and Canadian financial firms and

their regulators to work closely together for the common good of our two great countries. I pledge to you that the SEC will be an active and constructive participant in that process.

Thank you.