TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE STATE OF THE SECURITIES INDUSTRY

BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS UNITED STATES SENATE

JANUARY 8, 1991

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Dodd and Members of the Subcommittee:

It is my pleasure to testify today concerning the state of the United States securities industry.

As a preliminary matter, I would like to emphasize that an understanding of the "state of the U.S. securities industry" involves many factors. These include current earnings, the strength of capital reserves and other balance sheet items, the reliability of accounting information, management capabilities, the strength of long-term product demand, the likelihood of unknown sudden problems, and other factors. Measured in terms of current profits, the securities industry has just finished one of its worst years in recent memory. However, the overall condition of the securities industry is considerably stronger than current earnings would indicate.

The securities industry today has near-record levels of capital, and the reserves of the Securities Investor Protection Corporation fund are at an all-time high. In addition to having high levels of stated capital, the securities industry has capital reserves that are real. As this Committee knows, the securities held by broker-dealers are marked to reflect market value every single day. Because the value of these positions is also further discounted to reflect market and liquidity risk, the Commission has a high degree of confidence in these capital levels.

While the final year-end operating results are not yet available, it is quite possible that the securities industry as a whole lost money in 1990. Whether the final result is a slight profit or a slight loss, it is very likely that the results for 1990 will prove to be the worst in many years. In addition, this condition comes on top of relatively poor industry profitability since the market events of October 1987.

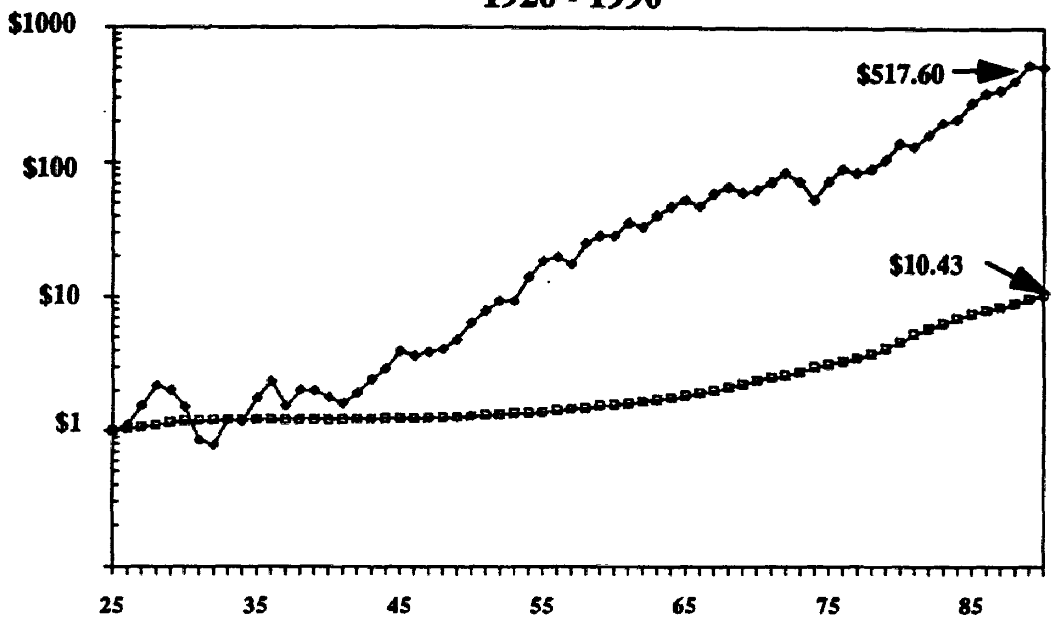
Although a decline in profits is not unusual considering the level of activity of the overall economy, this downward trend in profits is cause for concern. For the longer term, maintaining strong financial condition must involve returning to healthy profitability. Either revenues must be increased, or firms will have to take further steps to reduce expenses. This could involve the reduction of firms' overhead by shrinking their office networks, exiting particular areas of activity, further reducing payroll costs, or other steps. Ultimately, some firms could decide to combine as a step toward reducing costs. Ironically, at a time when many are suggesting bank entry into the securities business, the existing industry is under pressure to shrink, not to grow.

The U.S. Securities Industry During the 1980s

The 1980s were years of phenomenal growth for investors in the U.S. securities markets. From January 1, 1980 to December 31, 1989, the Dow Jones Industrial Average ("DJIA"), the most widely followed indicator of the U.S. stock market's movements, rose 228%, and the broader Standard & Poors 500 Stock Index (the "S&P 500") rose 227%. The DJIA grew from 838.74 on January 1, 1980 to 1895.95 on December 31, 1986 to 2633.66 on December 31, 1990. Aggregate equity market capitalization during the decade grew from $1.5 trillion to about $3.2 trillion at the end of 1990. Taking into account dividends, reinvestment of dividends, and stock repurchases, the "profit" to investors during this period could be as much as $3 trillion. This growth not only benefitted the tens of millions of American investors, but also provided important strength to the U.S. economy.

Investment in equity securities remains by far the best source of return for ordinary Americans' savings for the long term. For example, an investor who put $100 in Treasury bills in 1926 would have $1,043 today. However, if the same person had invested $100 in the stocks that comprise the DJIA in 1926, even after the crash of 1929 and the "breaks" of October 1987 and October 1989, that person would have $51,762 today.

Total Returns of Common Stock and T-Bills
1926 - 1990*



* Logarithmic Scale

Indeed, even in 1990, the U.S. equity security markets outperformed their major foreign competitors. The DJIA declined only 4.3% during 1990. The London stock market declined 11.5% during 1990, and the Japanese market declined 38.7% during the year. Among the major markets, only Hong Kong did better in local currency terms than the United States during 1990.

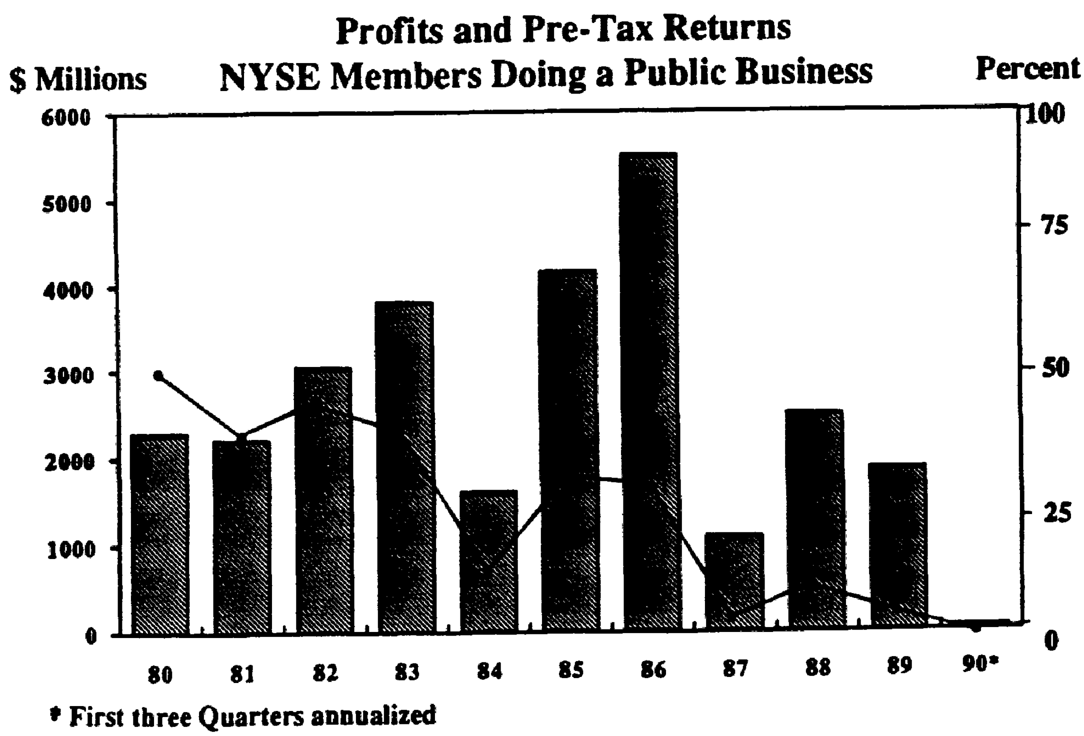
Although investors were well served by the U.S. securities markets during the last ten years, the 1980s were a rollercoaster decade for the United States securities industry.[1] From 1980 through 1986, industry volume reached record highs. The average number of shares traded on a daily basis on the New York Stock Exchange ("NYSE") rose from 44.9 million to 141.0 million. Volume on the National Association of Securities Dealers Automated Quotation

[1] Unless otherwise specified, "industry" figures herein are figures for New York Stock Exchange member firms doing a public business. These firms have 84% of total industry assets and 76% of total industry capital, and are responsible for 77% of total industry revenues.

("NASDAQ") system, meanwhile, rose from 26.5 million shares per day to 113.6 million shares per day.

In addition to the growth in brokerage volume, there was strong growth in the volume of securities offerings. This growth was most pronounced in the markets for debt securities. New issuances in the market for straight corporate debt skyrocketed from $35.2 billion during 1980 to $119.4 billion during 1986. Issuances in markets that had barely existed prior to the 1980s, meanwhile, such as asset-backed bonds and high-yield debt securities, grew rapidly as well. New issuances of asset-backed bonds, for example, rose from $0.5 billion in 1980 to $68.4 billion in 1986. Issuances of high-yield debt securities grew from $4.3 billion to $40.8 billion over the same period. While offerings of debt securities were more active, underwritings of equity securities grew from $16.0 billion in 1980 to $57.1 billion in 1986.

The growth in brokerage volume, new offerings, merger and acquisition and other transaction fees fueled tremendous profits for the securities industry. Industry pre-tax return on equity was 49.2% in 1980, 13.2% in 1984, and 28.5% in 1986. From 1980 to 1986, the average pre-tax return on equity for the securities industry was 33.4%



Lured by those returns and the competitive realities of international securities markets, new capital flooded into the securities industry. Total industry capital rose from $6.8 billion in 1980 to $30.1 billion in 1986 and $36.1 billion by the end of September 1990.

In 1987, however, the industry reached a turning point. Although the DJIA reached a then-record high in August, the nation's securities markets experienced an extraordinary surge of volume and price volatility in the month of October. During the week of October 5, the DJIA declined by 158.78 points, followed by a further descent of 235.47 points during the week of October 12. Then, on October 19, 1987, the DJIA plummeted 508.32 points. By its mid-day low point on October 20, the DJIA stood at 1708.70, down 35.3% from where it had closed a mere 18 days earlier.

Demonstrating enormous resiliency and underlying strength, the market was able to rebound from the 1987 collapse in prices. As of December 31, 1990, despite substantial uncertainty about potential hostilities in the Persian Gulf, the state of the economy generally, and serious concerns regarding particular sectors such as commercial real estate, the DJIA closed at 2633.66, 54% higher than its low in October 1987 of 1708.70. Total market capitalization, as noted above, has also continued to increase, to a total of about $3.2 trillion as of the end of 1990.

Though the <u>value</u> of equity securities has more than recovered from October 1987, the securities <u>industry</u> has experienced a series of adverse developments in recent years. Indeed, almost every major area of activity has declined since 1987. For example, volume on the NYSE in 1990 was down approximately 17% from 1987. Volume on the NASDAQ was down approximately 12% over the same period. Compounding the decline in trading volume has been a significant decline in commission rates. For example, institutional commission rates have been reduced from approximately 12 to 15 cents per share in 1980 to often less than five cents per share today. Total securities firm revenue from brokerage transactions has thus fallen substantially.

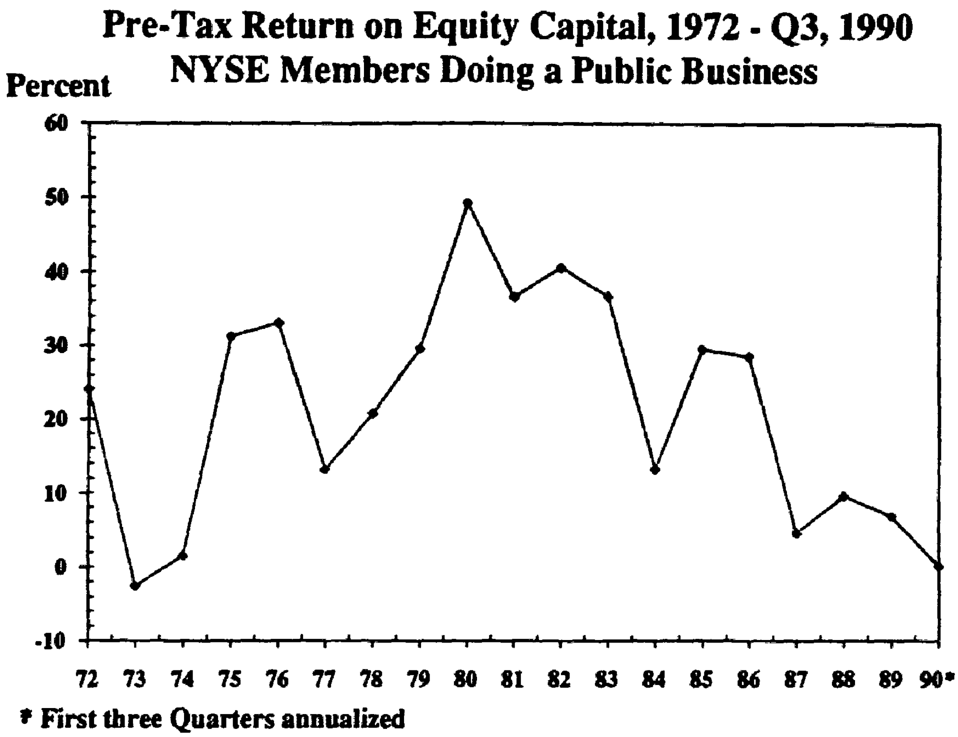
Initial public equity offerings fell from 247 offerings for $13.8 billion in 1989 to 209 offerings for $10.1 billion in 1990. Equity offerings by seasoned issuers fell from $15.2 billion in 1987 to $9.3 billion in 1989 to $9.0 billion in 1990. There were 41% fewer private placements of both debt and equity during the first half of 1990 as compared to the first half of 1989. Total public debt offerings rose, however, from $278.3 billion in 1989 to $293.2 billion in 1990. Overall, revenues from securities offerings have also fallen sharply, from $5.2 billion in 1987 to an annualized[2] $3.3 billion in 1990.

One response to these trends has been an increase in the degree of reliance of some firms on principal activities for a larger percentage of revenue. The Commission is watching this trend carefully because this shift may expose securities firms to risks that are different in character and greater in magnitude than the risks that they have traditionally undertaken. Among other responses, the Commission is in the final stages of amending its capital regulations to adjust our current minimum capital and "early warning" requirements with respect to firms in which principal activities are the main profit center.

Profitability

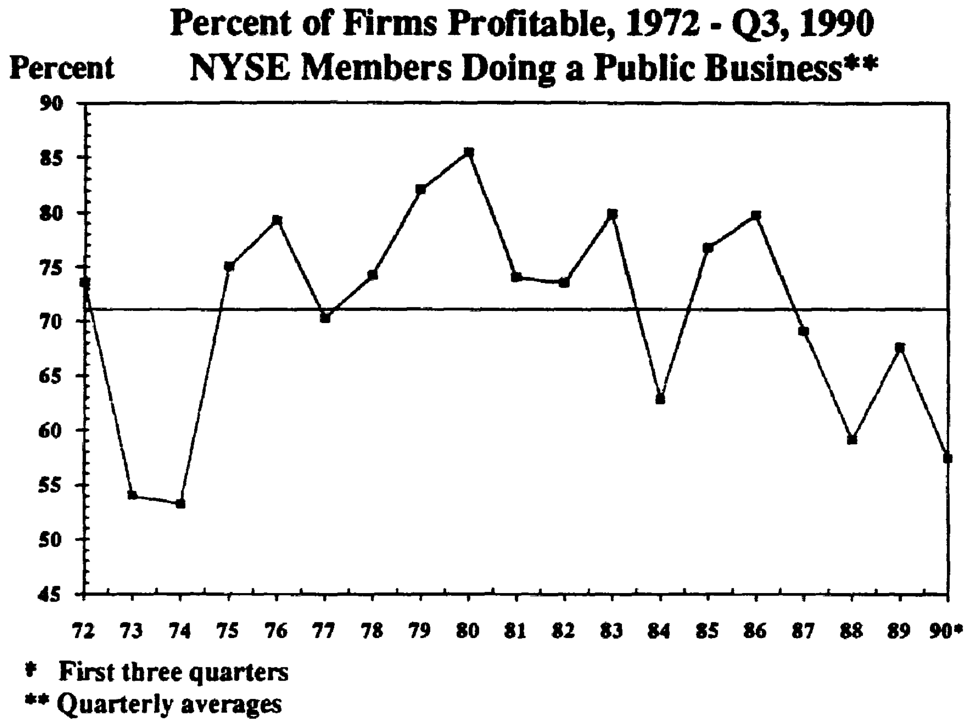
From 1987 to 1989, the pre-tax return on equity of the securities industry averaged only 7%, and in each year was less than the worst year from 1980 to 1986. In 1990, the securities industry's profitability deteriorated even further. For the first three quarters of 1990, the industry's aggregate pre-tax net income was only $34 million. Pre-tax return on equity for the first three quarters of 1990 was 0.2% on an annualized basis. As the following table shows, return on equity has not been this low in the securities industry since 1973-74.

[2]Unless otherwise stated, "annualized" figures are based on the first three quarters of 1990.



The trend in profits continues to head downward. The industry has had only had six losing quarters since 1975, and three of them have occurred in the last four quarters -- the last quarter of 1989, the first quarter of 1990, and the third quarter of 1990. If the securities industry experienced a loss in the fourth quarter of 1990, it is likely that pre-tax net income will be negative for the year. In any event, the industry's pre-tax net income will almost certainly fall far short of the $1.8 billion profit the industry earned in 1989 and the record $5.5 billion earned in 1986.

As might be expected, the fall-off in industry profitability has been felt by a large number of U.S. securities firms. On average, in each of the last 17 years, fully 71% of securities firms have operated profitably. Since October 1987, however, that percentage has fallen dramatically. As the next table shows, only 57.5% of securities firms were profitable in the first three quarters of 1990. Less than half of the industry's members were profitable in the third quarter.



The results of the largest U.S. securities firms generally mirrored that of the industry as a whole. As of the end of the third quarter of 1990, the largest 13 NYSE member firms (measured by capital)[3] reported aggregate pre-tax losses of $15 million, which translates into an average annualized return on equity of -0.21%.

The poor profitability performance has not been felt equally by all sectors of the securities industry, however. From 1987 through 1989, for example, large investment banks had an average annual return on equity of 12.2%, and discount brokers 13.1%. National full-line firms, in contrast, had an average return on equity of -0.1% during that three-year period. These trends have continued during the first nine months of 1990, as large investment banks had an

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[3]These firms are Bear Stearns & Co., Inc., Dean Witter Reynolds Inc., The First Boston Corporation, Goldman Sachs & Co., Inc., J.P. Morgan Securities Inc., Kidder Peabody & Co. Inc., Merrill Lynch Pierce Fenner & Smith Inc., Morgan Stanley & Co. Inc., PaineWebber Inc., Prudential-Bache Securities Inc., Salomon Brothers Inc, Shearson Lehman Brothers Inc., and Smith Barney Harris Upham & Co.

average return on equity of 10.6%, discount brokers 19.0%, and national full-line firms -7.9%, on an annualized basis.

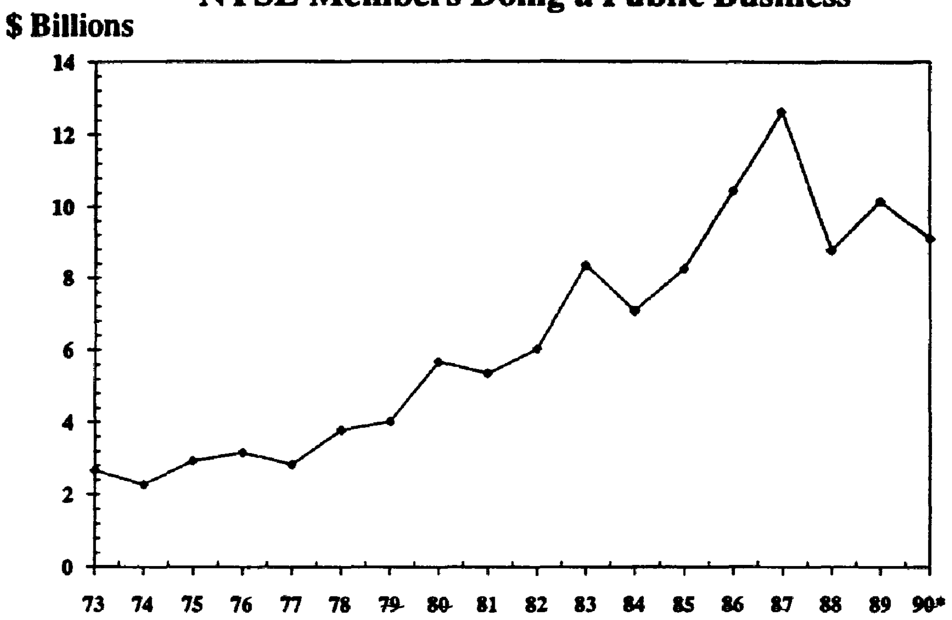
The profitability data of different industry sectors suggest that well-run, specialized firms that identify and exploit particular market sectors -- such as investment banks, discount brokers, and regional broker-dealers -- may be able to compete effectively with or even out-compete larger, more diversified, nationwide firms. This may suggest that the business strategy of building "financial supermarkets" has not to date proven universally successful. Specialized firms with an area of strong expertise and low costs may be proving more effective market participants than national full-line firms.

Revenues and Expenses

Although the industry's net income fell dramatically from 1987 through 1989, total industry revenue continued to rise during that period. The data from the first three quarters of 1990, however, suggest that total industry revenue will decrease significantly for the full year.

As noted above, the effects of the October 1987 Market Break were felt first, and most dramatically, in the area of commission revenue. Total commission revenue in 1988 declined by almost a third, from $12.6 billion to $8.8 billion. While commission revenue bounced back to $10.2 billion in 1989, annualized commission revenue for 1990 was only $9.1 billion.

Commission Revenues, 1973 - Q3, 1990
NYSE Members Doing a Public Business



* First three quarters annualized

Securities underwriting revenue remained relatively stable in 1988, but underwriting revenue declined by 20% in 1989. It appears that underwriting revenue fell even further in 1990. If the results from the first three quarters of 1990 are annualized, underwriting revenue in 1990 declined by another 20.2% to $3.3 billion. This would be the lowest level since 1984.[4]

It also appears that "other securities-related revenue," which is now the largest component of securities industry revenue,[5] declined significantly in 1990. This category, which includes such diverse activities as interest from repurchase agreements, merger and acquisition-

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[4]The prime growth area for underwriting revenue related to the emergence of a new product, index warrants. Over 78 million index warrants were issued, and trading in index warrants amounted to 13.85% of the Amex's total volume in 1990.

[5] The relative size of other securities-related revenue can be deceptive, however, because interest income from matched repurchase transactions frequently is reported on a gross, not a net, basis. The offsetting cost is then included in expenses as interest expense, which explains why interest expense is also the largest expense category.

related fees, and private placement fees, decreased by 14.4% in 1990, based on the first three quarters' results.

The only industry revenues that rose in 1990 were revenues from trading and investment activities. Annualized revenues from these activities were $13.1 billion, higher than any previous year except for 1986. Thus, it appears that many securities firms are becoming more dependent on principal activities, including index arbitrage, for the bulk of their profits as we enter the 1990s. Many of these activities are both risky and highly capital-intensive.

Not all principal activities have been successful, however. During the mid-1980s, some large investment banks began to facilitate acquisitions by their clients by providing them with "bridge loans" to complete such acquisitions. These very large loans were sometimes extended through the regulated entity, but more often through its immediate parent. These loans were intended to be repaid after the acquisition was completed by the proceeds from a subsequent issue of high-yield debt securities. By December 31, 1989, the ten NYSE firms willing to make bridge loans had aggregate bridge loans of $4.2 billion outstanding. In some cases these firms had made bridge loans far in excess of their capital.

As the market for high-yield debt securities collapsed following a series of issuer bankruptcies, these securities firms sought to reduce their aggregate bridge loan exposure.[6] As a result, the total volume of bridge loans outstanding fell to $2.3 billion as of November 30, 1990. There is very little new bridge lending at the present time.

Unfortunately, the decline in industry revenues has not been matched by an equivalent decline in expenses. In part, that is because many of the industry's largest costs cannot be reduced quickly. The major firms have made large investments in computer and communications equipment, which has greatly increased firm overhead levels. Leases on office space cannot be abandoned, and firms understandably are reluctant to dismiss talented staff. As a result,

[6] On September 13, 1990, Campeau Corporation and its affiliates defaulted on the bridge loans that they had received from three broker-dealer holding companies. In addition, due to the uncertainty of the creditworthiness of some of their counterparties, several broker-dealers have restructured the terms of their existing bridge loans and created reserves for potential losses.

expenses historically have tended to decline much more slowly than associated revenues. Nevertheless, in 1990 aggregate costs fell by 5.9% on an annualized basis, with every category of costs registering a decline.

Because of high fixed overhead, these cost reductions have regrettably come primarily through reductions in the size and compensation of the securities industry work force. In 1990, total employee compensation, the largest component of industry expense other than interest expense, fell to $18.1 billion, down 11.6% from its 1987 level. As of June 30, 1990, aggregate employment in the securities industry is now down by more than 45,000 jobs, 18% lower than its pre-October 1987 high. Despite the tremendous costs and personal pain associated with these layoffs, however, further cuts may occur.

The decline in revenues has left the U.S. securities industry with a great deal of overcapacity. In part, that is because the industry historically has been prone to developing excess capacity during boom periods, only to shed that capacity when business slackens. As profitability and volume have declined since 1987, the industry has been contracting in an effort to reach a more efficient size and structure.

One result of this process has been the reduction in the number of firms engaged in the securities business. Since 1986, the number of NYSE member firms has declined in each year, from 611 at the end of 1986 to 525 in October 1990. Similarly, the number of NASD member firms had declined from 6658 to 5827 during the period from the end of 1986 to the end of 1990. Drexel Burnham Lambert Inc., one of the nation's largest securities firms, was forced into liquidation proceedings and left the securities business during 1990. However, though the number of firms has been declining, the overall number of failures of securities firms has been extremely small compared with the number of failed depository institutions. The FDIC and FSLIC handled 1266 bank and thrift failures from 1980 through 1990; SIPC handled only 82 securities firm failures in the same period.

The decline in revenues, and the consequent overcapacity problem in the securities industry, has implications for the overall restructuring of the financial services industry that

Congress is expected to undertake in 1991. Inexperienced firms without market share that enter the business are likely to lose money, at least in the short term, as existing firms fight to retain their market share. Thus, significant losses, not profits, could be the short term result of banks entering the securities business.

Effect on the Securities Industry of a General Recession

As we have discussed, the causes of the current difficulties in the securities industry date mainly from late 1987, long before the beginning of the current general economic downturn or recession. It is possible for the securities industry and individual firms to suffer losses even during a period of general economic growth, as occurred with many firms in late 1987. It is also possible for the securities industry to earn profits during a general recession. Indeed, during the last two recessions (February 1980-July 1980 and August 1981-November 1982) the average pretax return on equity for the securities industry was 32.6% per annum. One has to return to the period of December 1973 to March 1975 to find a time when there was both a general recession and substantially reduced securities industry profits. Even then, if one looks at the entire period, the industry's average return on equity was 13.3% per annum.

This is not to say, of course, that a general recession would have no effect on the securities industry. A recession would likely reduce individual interest in equity securities purchases and reduce corporate issuance of equity securities, two of the prime bases of securities industry revenues. A recession would likely lead to an increase in issuer defaults on debt, particularly junk bonds, although the total holdings by securities firms, other than Drexel Burnham, of junk bonds are now rather small, only about $2 billion. In part because of these factors, industry experts are predicting that 1991 will be another difficult year for the securities industry. If past recessions are any guide, however, we can expect an increase in industry profits before the end of the recession. Indeed, in past recessions stock prices have generally increased appreciably during the last three months of the recession.

International Competition

The United States securities industry's profitability problems have also been affected by the tremendous increase in international competition in the securities business. Most major foreign securities firms now have U.S. affiliates and/or engage in business in the United States markets. In particular, seven of the 100 largest U.S. broker-dealers were established by foreign securities firms.[7] These firms do not yet appear to be profitable in the U.S. market. In the third quarter of 1990, for example, they lost an aggregate of $10.1 million after taxes, for an after-tax return on equity of -1.3%. Nevertheless, these firms have over $750 million in net capital, and they have invested even greater economic and human resources in their effort to compete successfully in the U.S. securities industry.

Until recently, the increased level of foreign competition has been accompanied by a tremendous inflow of foreign investment in the U.S. securities markets. In 1989, for example, purchases and sales of U.S. securities by foreign persons were $4.76 trillion. This was almost seven times the $707 billion in purchases and sales of foreign securities by U.S. persons. In 1990, however, foreign investment in the U.S. securities markets has fallen sharply. On an annualized basis in 1990, foreign portfolio activity in the U.S. securities markets fell 11.4% to $4.22 trillion.

The internationalization of the securities markets, of course, also has provided U.S. securities firms with new competitive opportunities. In particular, liberalized access in the United Kingdom and Japan has led U.S. firms to make major investments in those countries.

Unfortunately, the markets in London and Japan have encountered, if anything, even greater problems than those in the United States. Ever since the "Big Bang," in which the London markets were opened to the world, the securities industry in the United Kingdom has been plagued by overcapacity, and many firms that sought to establish a foothold in the London

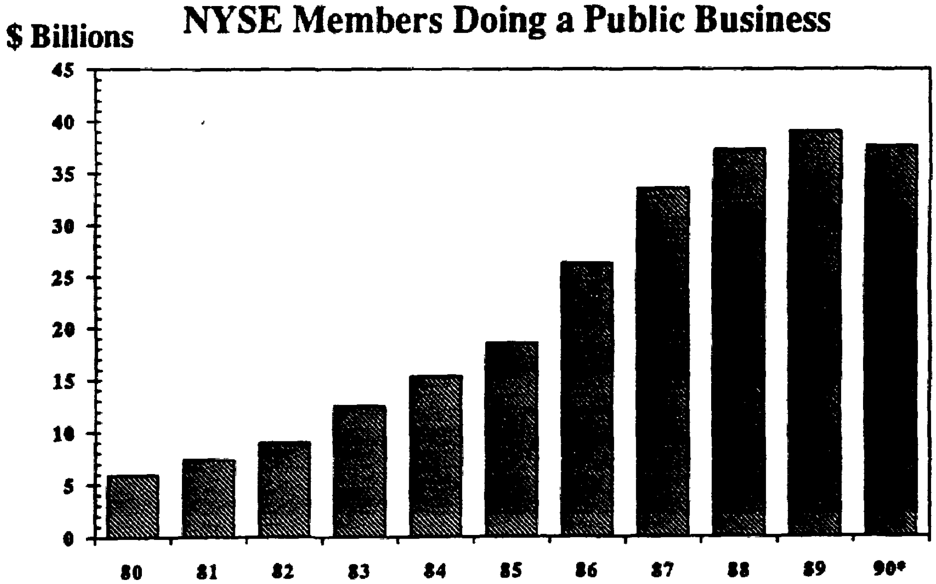
[7]These firms are Daiwa Securities America, Inc., Deutsche Bank Capital Corporation, New Japan Securities International, Inc., Nikko Securities Co. International, Inc., Nomura Securities International, Inc., SBCI Swiss Bank Corporation Investment Banking, Inc., and Yamaichi International (America), Inc.

markets have since closed their London operations. In Japan, the Nikkei 225 Stock Average fell almost 39% in 1990, and average trading volume on the Tokyo Stock Exchange has decreased from 894 million shares per day in 1989 to 507 million shares per day in 1990 (through November 30).

Industry Capital

Despite all of these difficulties, however, the United States securities industry still has a strong capital position. Total capital -- including both equity and subordinated debt -- at the end of the third quarter was $36.1 billion. As the next table shows, although the industry's total capital has not changed materially in the past two years, it is still higher than it was at year-end 1987 ($33.5 billion), and it is more than six times its 1980 level of $5.9 billion.

Capital, 1980 - Q3, 1990
NYSE Members Doing a Public Business



* First three quarters
NOTE: Figures are averages for periods

Similarly, the major markets and self-regulatory organizations remain strong and resilient. Indeed, the NYSE and the NASD have total members' equity and retained earnings of $248 million and $146 million, respectively. Moreover, both the NYSE and the NASD have made multimillion dollar commitments to upgrade their computer and communications systems capacity since 1987. Accordingly, the exchange and over-the-counter markets in the United States are well-positioned to compete internationally and to ensure fast and efficient execution of public investors' orders. Like the rest of the securities industry, the 13 largest NYSE members have a solid capital foundation. These firms have total capital of $25.3 billion, of which $15.4 billion is equity capital and $9.9 billion is subordinated debt.

The securities industry's capital position has been strengthened through the affiliation of many large broker-dealers with large, diversified, well-capitalized parent holding companies. Unlike banks or thrifts, securities firms are permitted to be affiliated with commercial enterprises, regardless of the lines of business in which they are engaged. Indeed, the 14 largest broker-dealer holding companies have total assets of over $1 trillion. In many cases, these firms have proven to have the resources necessary to support their broker-dealer subsidiaries when they encounter financial turbulence.

The value of these affiliations was demonstrated in 1990. During the course of the year, parent holding companies bolstered their broker-dealer subsidiaries' capital position, either by direct capital infusions or by purchasing risky or illiquid assets from the broker-dealer. For example, American Express contributed $450 million in new capital to Shearson Lehman Hutton, and $300 million more to Shearson's immediate holding company, an American Express subsidiary. General Electric purchased $750 million of high-yield bonds and bridge loans from Kidder Peabody. Credit Suisse contributed $300 million in capital to, and purchased a $250 million bridge loan from, First Boston's immediate parent, which in turn reduced its bridge loan exposure by over $700 million by, among other things, transferring three bridge loans to a new entity that it owns jointly with Credit Suisse. Prudential Insurance Company provided $200 million in capital to Prudential-Bache's immediate parent and bought $600 million in bridge loans from a Prudential-Bache affiliate.

While some parent holding companies provided valuable support to their subsidiary broker-dealers, others have created exposures for their subsidiary broker-dealers. The Drexel failure, for example, began at the holding company level, and then spread to the broker-dealer when the parent sought to withdraw capital from the broker-dealer to resolve its own financial difficulties. In addition, it appears that some broker-dealers have transferred some of their riskier and non-traditional principal activities to their parent holding company or another affiliate. In so doing, these broker-dealers reduced their overall risk exposure, but at the same time prevented the Commission from overseeing these activities to ensure that they would not have a material financial impact on the broker-dealers' financial condition.

The Market Reform Act of 1990 has given the Commission new authority to monitor, on a consolidated, world-wide basis, the activities of broker-dealers' parents and affiliates in holding company structures. Such authority will enable the Commission to assess the potential exposure of regulated broker-dealers to adverse occurrences or circumstances affecting the broker-dealers' related entities. With such information, the Commission will be in a better position to plan possible responsive actions in the event problems at the holding company level threaten to cause a failure of the subsidiary broker-dealer. The Commission staff is in the process of drafting proposed rules to implement the "risk assessment" provisions of the Market Reform Act, and we expect those rules to be published for public comment sometime in the first quarter of this year.

The industry's strong capital position is buttressed by the Commission's net capital requirement, which mandates that each broker-dealer must maintain liquidity in excess of liabilities in order to cover potential market and credit risk associated with the broker-dealer's assets.[8] By requiring broker-dealers to maintain liquid assets sufficient to satisfy their

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[8]The Commission's rule provides two alternative methods for computing compliance with the net capital requirement. Under the basic method, a broker-dealer must have net capital equal to at least 6 2/3% of aggregate indebtedness (defined to exclude liabilities that are adequately collateralized by an asset). Under the alternative method of computing net capital, a broker- dealer must maintain net capital equal to at least 2% of its customer-related receivables.

obligations, the net capital requirement provides a protective cushion without drying up the liquidity necessary to ensure the orderly operation of the securities market.

In addition to the basic net capital requirement, the net capital rule ensures the continued liquidity of broker-dealers by requiring them to mark their securities positions to market value, instead of carrying those positions at historic cost. Requiring broker-dealers to use market values for securities positions ensures that regulators and investors alike receive meaningful, up-to-date data by which to assess the real economic values and risk exposures of broker-dealers. At the same time, the use of market-based accounting protects creditors and the Securities Investor Protection Corporation ("SIPC") fund by ensuring that, if a broker-dealer fails, the value of its assets will not disappear during liquidation proceedings in a puff of accounting smoke.

Even after securities positions are marked to reflect market value, the net capital requirement affords further protection by providing that a broker-dealer may not include in its net worth calculation certain assets not readily convertible into cash. In addition, the broker-dealer must deduct a certain percentage of the market value of all proprietary securities positions. These percentage deductions, known as "haircuts," are intended to reflect the actual liquidity of the broker-dealer's proprietary positions by providing a cushion for possible future market losses in liquidating the positions.

As of June 30, 1990, after deducting illiquid assets of $13 billion, industry members were required to take cumulative deductions of $7.9 billion for securities positions ($6.8 billion by the 13 largest NYSE members). After these deductions, these firms had cumulative liquid capital of $14.7 billion, far in excess of the $1.1 billion that constituted required minimum net capital.

If a broker-dealer fails to meet its minimum net capital requirement, it immediately must cease to conduct a securities business. By requiring a broker-dealer to shut down its securities operations as soon as its net capital falls below the mandated amount, the net capital requirement reduces the cost of securities firm failures to creditors. It also reduces the likelihood that the

SIPC fund will experience any loss.

In addition, the net capital rule contains early warning provisions, specifying levels below which a firm's net capital should not fall.[9] When a broker-dealer's net capital drops below the early warning levels, a broker-dealer must notify the Commission and must refrain from paying dividends or withdrawing equity capital in any form to pay shareholders or partners. The rules of some self-regulatory organizations also contain provisions restricting a broker-dealer's securities business when its net capital reaches early warning levels. These Commission and self-regulatory restrictions are designed to prevent a broker-dealer from depleting its capital to the point that it cannot satisfy its minimum net capital requirement.

Although the net capital requirement has worked well to date, the Commission is taking steps to enhance its effectiveness. For example, the Commission has proposed an amendment to its net capital rule that would require a broker-dealer to give prior written notice to the Commission and the appropriate self-regulatory organization of its intention to disburse more than a specified percentage of its capital to its parents, shareholders, and related entities. This proposal would also permit the Commission to block withdrawals that would expose the broker-dealer to an unacceptable level of financial risk. If adopted, these amendments would help give the Commission more time to take measures that may be necessary in response to the sudden withdrawal of capital from a major firm.

In addition, the Commission is considering amendments to the net capital rule to allow the Commission to prohibit withdrawals when the effect of the withdrawal is to reduce the registered broker-dealer's net capital in an amount in excess of certain percentages of the broker-dealer's haircuts on its securities positions. This additional "early warning" standard would reflect the shift of many firms toward an increased focus on proprietary positions.

The Commission is also seeking public comments on the desirability of increasing the capital requirement of firms that have minimal amounts of customer-related receivables, by

[9]The early warning level is 10% of aggregate indebtedness for firms electing the basic method, and 5% of aggregate debit items for firms using the alternative method.

basing minimum capital on the level of proprietary positions in such cases. Currently, many large broker-dealers elect to use an alternative method of computing net capital, which bases the required net capital on the level of the firm's customer-related receivables. If the broker-dealer does not carry a significant amount of those receivables, its net capital requirement may be low in relation to the degree of leverage it has attained.

The Commission's customer protection rule provides further protection in the event of a broker-dealer insolvency by requiring broker-dealers to have possession or control of all fully paid and excess margin securities[10] of customers and by prohibiting broker-dealers from using customer free credit balances to finance their own inventory positions, fixed assets or operating expenses. All customer fully-paid and excess margin securities are required to be maintained free of all claims or liens.

As a result of the Commission's regulatory program, the Commission frequently has been able to wind down the operations of a failing broker-dealer without putting the broker-dealer or its customers through the time and expense of a SIPC liquidation. The most recent and most vivid example involved Drexel. When Drexel's holding company filed for bankruptcy in 1990, the Commission worked with Drexel and other regulators to close its securities operations and to transfer remaining customer accounts and securities positions to other broker-dealers. This entire program was completed without any cost to the SIPC fund or the U.S. taxpayer.

In addition to the successful handling of the Drexel situation, the Commission and the self-regulatory organizations have wound down the operations of many other broker-dealers without SIPC intervention. For example, Thomson McKinnon Securities Inc. ("TMS") shut its doors without a SIPC liquidation. With the help and supervision of the Commission and the NYSE, TMS transferred over 450,000 customer accounts with property totalling approximately $10 billion to other broker- dealers.

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[10]Generally speaking, excess margin securities are the portion of securities bought by a customer on credit that are in excess of the amount of the securities that the broker-dealer may use to finance the customer's purchase (*i.e.*, the margin securities).

The State of the SIPC Fund

SIPC was created by Congress pursuant to the Securities Investor Protection Act of 1970 to provide protection to customers of broker-dealers, and thereby to promote investor confidence in the nation's securities markets. SIPC accomplishes this goal by ensuring that customers of SIPC members receive back their cash and securities in the event of a SIPC member's liquidation. SIPC does not protect a customer against the risk that securities may decline in value during liquidation.

SIPC is a non-profit membership corporation of which all registered broker-dealers, with some limited exceptions, are members. Although expressly not a governmental entity, five of SIPC's seven directors are appointed by the President. Three of the five are from the securities industry, and two are from the general public. The President designates the Chairman and Vice-Chairman from the two public directors. Of the remaining two directors, one is appointed by the Secretary of the Treasury and one is appointed by the Federal Reserve Board from their respective staffs.

SIPC protects each customer up to $500,000 for claims for cash and securities, except that claims for cash are limited to $100,000 per customer. Some broker-dealers also offer privately- arranged insurance coverage for securities above SIPC limits to $5 million or more.

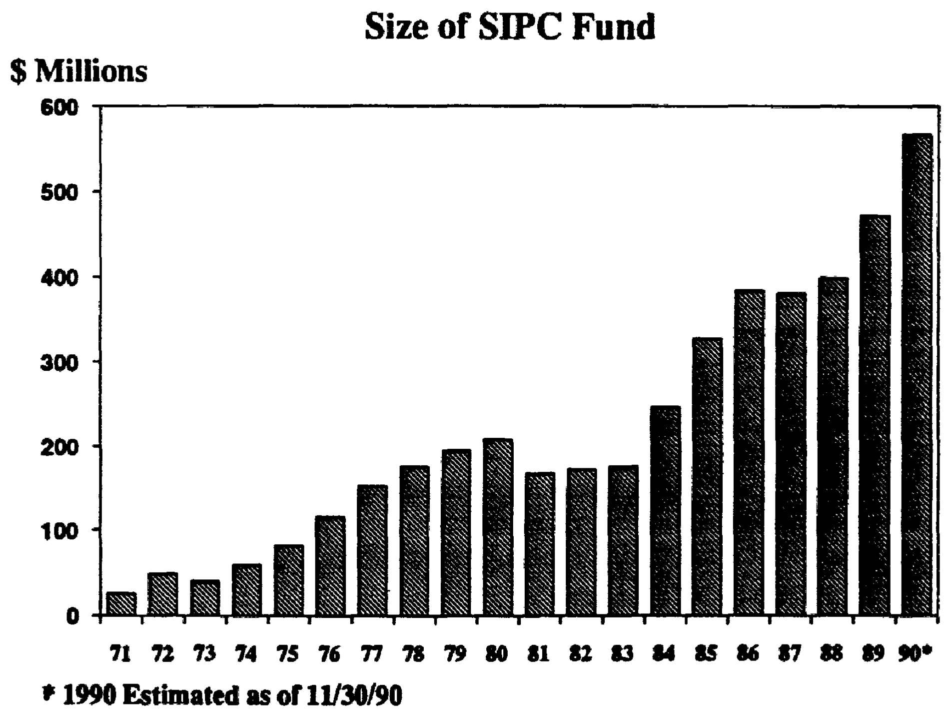
Under the statute, SIPC must file with the Commission proposed rule changes, which require Commission approval, and proposed by-law changes, which are effective thirty days after filing unless disapproved by the Commission. The Commission may require SIPC to adopt, amend, or repeal any by-law or rule. For reasons that are not entirely apparent, however, the SEC is not represented on the SIPC board.

SIPC is funded by assessments on SIPC members as set by the SIPC board as a by-law amendment after consultation with the self-regulatory organizations.[11] Under the statute, SIPC may set assessments at up to 1/2 of one percent of securities revenues of SIPC members. In

[11]SIPC is also funded by interest on investments of the SIPC fund.

addition, the statute provides that SIPC may increase the assessment to a full one percent of securities revenues if it finds that such assessment will not have a material adverse effect on the financial condition of its members or their customers. The present SIPC assessment is 3/16 of 1% of securities revenues.

The SIPC fund appears to be well-capitalized in comparison with any reasonably foreseeable broker-dealer failures. As of November 30, 1990, the SIPC fund totalled $567.2 million of cash and U.S. government securities. This was its highest level since SIPC's inception in 1970. As the next table demonstrates, the value of the fund has been increasing steadily over time.



In addition, SIPC has access to a $500 million line of credit established by SIPC with a consortium of banks. SIPC has the statutory authority to borrow up to $1 billion from the United States Treasury Department, through the Commission. As a result, a recent study[12] concludes that SIPC has sufficient resources and liquidity to handle multiple broker-dealer

[12]Deloitte & Touche, Special Study of the SIPC Fund and Funding Requirements, October 8, 1990. The Special Study used a very conservative "worst case analysis" which we believe substantially overstates the SIPC advances likely required in liquidating a large broker-dealer.

failures, including the unlikely event of a large broker-dealer failure. For the future, the Commission would like to see the size of the fund continue its recent satisfying growth.

The number of broker-dealers that must be liquidated through SIPC has always been very small in comparison to the number of bank or thrift insolvencies. In part, that is a function of tough capital standards, as well as the fact that broker-dealers are shut down quickly when they fall below mandated capital levels. Thus, since its creation in 1970, SIPC has handled only 219 broker-dealer insolvencies. By way of comparison, over 1200 bank and thrift failures have occurred in the last ten years alone.

Moreover, because of the net capital requirement and the limitations on the use of customer funds and securities, broker- dealer failures typically cost the SIPC fund far less than bank or thrift failures cost the deposit insurance funds. From SIPC's inception through December 31, 1989, only $1.5 billion in cash and securities were distributed for accounts of customers, and only $178 million of that amount came from the SIPC fund. The remainder came from assets recovered from debtors' estates. The largest single payout in the history of SIPC was only <u>$32.5 million</u>. A single bank failure can, and has, cost the bank insurance fund many times that amount. As described earlier, the multi-billion dollar liquidation of Drexel had a zero cost to the SIPC.

The State of the Investment Management Industry

I would also like to discuss briefly the state of the investment management industry, which for tens of millions of U.S. investors is now the critical link to the securities markets. One in four American households participates in the U.S. securities market through approximately 2500 mutual funds, which have 58.2 million shareholder accounts and $1.1 trillion in assets. If closed-end funds and unit investment trusts are included, the total asset figure rises to more than $1.3 trillion.

The principles of safety and soundness fundamental to the Investment Company Act provide enormous protection to mutual fund customers, without relying on any federal insurance. Among other things, the Investment Company Act requires the safekeeping of fund assets, limits leveraging, and prohibits self-dealing. The Act also requires that 40% of a fund's board be composed of independent directors and mandates purchase of a specified level of fidelity insurance for protection against larceny and embezzlement. In addition, most mutual funds must mark their portfolios to market and stand ready to redeem their shares at their market value each business day.

The Investment Company Act provides for routine and special inspections of investment companies. Routine, on-site examinations of all investment companies are an important part of the Commission's role in protecting the savings of investors managed by these companies. At my direction, during 1991 the staff will examine the operations of most money market funds and most funds that are part of the industry's hundred largest fund families. These mutual fund families account for about 90% of all mutual fund assets.

In 1989, the mutual fund industry grew by almost $172 billion, the second largest annual increase on record, exceeded only in 1986. Through November 1990, the industry grew by another $96.3 billion. The Investment Company Institute ("ICI") has predicted that mutual fund assets will grow at a rate of 12.1% per year in the 1990s, down from the 26.8% annual growth experienced for the period 1975 through 1989. The ICI predicts that mutual fund assets will reach $3.5 trillion by the year 2000, and will account for 18% of household discretionary financial assets by the end of the 1990s, up from 14% today.

Money market funds now account for about 48% of total mutual fund assets. In 1984, there were 329 money market funds with assets of $209 billion in 13.5 million shareholder accounts. Today there are approximately 725 money market funds with more than $494 billion in assets in 21.4 million shareholder accounts.

Many investors have come to view money market funds as alternatives to bank checking and savings accounts, despite the lack of government insurance. Good investment returns, the ease with which investments can be made and tax consequences recorded, features such as check writing, and a solid track record of paying back one dollar for each dollar invested have contributed to investor confidence in money market funds over the past 15 years.

This solid track record is not accidental. The Commission continues to monitor money market funds carefully. Recently, following several defaults in the commercial paper market, the Commission proposed amendments to rules relating to these money market fund investments to reduce further the risks to which a money market fund could be subject. I expect the Commission to approve final amendments to the money market fund rules in the very near future.

Not all mutual funds, of course, have the stable asset values of money market funds. Assets of high yield bond funds declined from their peak, $35.8 billion in June 1989, to only $19.9 billion in November 1990. About 74% of this decline was due to decreases in the market value of the high yield securities in the funds' portfolios, with the rest caused by shareholder redemptions. The Commission is also closely monitoring this sector of the mutual fund industry.

Conclusion

In conclusion, the Commission is concerned about the reduced profitability of securities firms in 1990. Our concern is tempered, however, by our confidence that the industry will, as it always has, bring expenses and revenues into line, and return to profitability. Moreover, we believe that the securities industry, despite its current profit problems, is serving well its basic functions of providing capital to companies and opportunities for investment to individuals. Finally, and most important, the Commission is confident that securities firms have adequate capital, and that the SIPC fund has adequate reserves, to handle this period of adversity without any losses to brokerage customers due to brokerage failures, and without any call on the federal government line of credit to the SIPC fund.