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Challenges to Harmonizing International Capital Standards Remain

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The Honorable Patrick J. Leahy
Chairman, Committee on Agriculture, Nutrition,
and Forestry
United States Senate

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Committee on Energy
and Commerce
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The Honorable E (Kika) de la Garza
Chairman, Committee on Agriculture
House of Representatives

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance
and Urban Affairs
House of Representatives

This report describes international efforts to harmonize capital standards for securities firms and for banks' securities activities and identifies challenges to achieving harmonization. It also examines the implications of these harmonization efforts for U.S. capital standards. GAO did this assignment because capital standards affect the cost of doing business, the protection for market participants and the stability of markets, and the competitive environment for companies trading securities.

We are sending copies of this report to interested Members of Congress, appropriate committees, executive branch agencies, and foreign financial regulators. Copies will also be made available to others upon request.

Major contributors to this report are listed in appendix III. If there are any questions concerning the contents of this report, please call me at (202) 275-8678.

Sincerely yours,

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

International trading of securities by U.S. and foreign investors increased dramatically during the 1980s. For example, according to the Department of the Treasury, U.S. purchases and sales of foreign securities grew from about $53 billion in 1980 to about $707 billion in 1990. As international trading has increased, so too has concern about the risk to customers, firms, and markets resulting from differences in the rules various countries use to regulate their domestic securities markets.

A primary protection against the financial risks of securities trading within a single country has been a requirement that each firm and bank that buys and sells securities maintain sufficient excess assets, called capital, to satisfy claims by customers and creditors. However, the rules governing the amount of capital required, called capital standards, vary among countries and among different types of institutions dealing with securities. This variance raises concerns about the risks of trading with firms and banks operating in countries with lower capital standards, the risks that financial problems in one country's markets could be transmitted to firms and markets in other countries, and the competitive implications of the differences in standards between countries and between securities firms and banks doing securities business.

International regulators are trying to "harmonize" capital standards; that is, establish an appropriate level of capital for securities firms and banks to maintain. Because of the importance of capital in protecting investors and financial systems from the effects of market disruptions, GAO (1) examined the status of current efforts to obtain harmonization of capital standards for securities activities, and (2) identified the implications of harmonization efforts for U.S. securities markets and the U.S. capital standard.

Background

The amount of capital that securities firms and banks are required to maintain varies among countries. However, these capital standards affect the cost of doing business, the protection for market participants and the stability of markets, and the competitive environment for companies trading securities. The higher the capital standards, the higher the cost of doing business, the greater the protection for market participants, and the greater the stability of markets. Also, a high cost of doing business may restrict new companies' entry into the industry. It may also put companies that must meet higher capital standards at a competitive disadvantage compared to companies in another country or industry with lower capital standards. Thus, establishing capital standards can result in a trade-off between competitive concerns and the protection of customers and the market. In the United States, the Securities and Exchange Commission (SEC), the primary U.S. securities regulator, has established capital standards to provide that firms in the securities business have sufficient capital to cover their obligations to customers. In general, the standards require firms to maintain an amount of capital commensurate with the nature and scope of their financial activities—the riskier the securities activities, the larger the amount of capital that must be maintained.

Three international organizations have taken the lead in harmonizing international capital standards: the International Organization of Securities Commissions, the Basle Committee, and the European Community (EC).

Results in Brief

Generally, regulators and market participants in large, established markets, such as Japan, the United Kingdom, and the United States, support harmonization efforts to encourage fair competition between national marketplaces and between securities firms and banks. U.S. regulators—as members of the International Organization of Securities Commissions and the Basle Committee on Banking Supervision—have taken a lead role in these harmonization efforts to assure that the results will provide adequate protection for U.S. and foreign investors and financial systems in the United States and abroad. However, challenges to achieving harmonization exist.

The International Organization of Securities Commissions, the Basle Committee on Banking Supervision, and the EC have made varying progress but none has completed its work. For these efforts to succeed three challenges must be met: (1) harmonized standards must not inhibit the development of emerging markets, (2) securities and bank capital standards must be integrated to equalize competition for securities firms and for banks doing securities business, and (3) the standards developed must be specific enough to provide acceptable levels of investor protection and safety for all market participants.

So far, international efforts to harmonize securities capital standards have had no effect on U.S. securities markets or U.S. securities capital standards. U.S. standards for securities firms meet general requirements proposed by the International Organization of Securities Commissions. Without knowing the outcome of harmonization efforts, however, it is difficult to predict what changes to U.S. standards, if any, may be needed. Whatever the outcome, as securities markets become more international, the United States may have to adjust its standards and its recognition of expanding foreign securities markets based on the needs of firms competing worldwide.

Principal Findings

Challenges to Harmonization

Securities market regulators and market participants in major markets as well as those in many other countries said that harmonized capital standards would decrease risks to firms and markets and improve competitive equality in the international securities markets. In spite of this strong support, challenges to achieving harmonization remain. Firms in emerging securities markets are concerned that higher capital standards could reduce the number of market participants able to meet the standard. Also, basic differences in the way that securities firms and banks operate—the risks that securities firms take change more rapidly than the risks that banks take—mean that developing capital standards applicable to both is difficult. Also, although many countries have developed risk-based capital standards, the specific standards of some countries are unacceptable to other countries. In addition, international organizations actively working on harmonizing capital standards must reach a consensus among themselves for standards to be adopted, because none of the international organizations alone can impose standards on the world securities and banking community.

International Efforts to Harmonize Capital Standards Continue

The International Organization of Securities Commissions began its efforts to harmonize capital standards in 1987. In 1989 it issued a paper that proposed a general harmonization framework that included setting minimum requirements based on the type of securities firm and adjusting the value of securities to reflect daily price changes. The capital standards of Japan, the United Kingdom, and the United States fit into this framework, despite differences in how they treat capital and how they determine the market values of securities. The International Organization of Securities Commissions is working to address these differences and issue more specific guidelines. The Chairman of SEC is currently head of the committee examining these and other issues.

The Basle Committee, which comprises central bank and supervisory representatives from 12 industrialized nations, faces a challenge to overcome the concern among banks doing securities activities that adding capital standards for these activities onto existing standards for credit-related banking activities will be onerous. The Basle Committee is concerned that it will be more expensive for banks to do securities business than for securities firms to do so. Banks believe they may be required to hold more capital than securities firms for certain types of securities. Basle Committee officials have met with International Organization of Securities Commission officials to discuss common approaches to developing securities capital standards but have not yet reached agreement. The Chairman of the Federal Reserve Bank of New York is the Chairman of the Basle Committee.

The EC, representing 12 European nations, continues to revise its draft directive for capital standards, which it issued in early 1990. The EC wants to conform standards for securities firms and banks doing securities business by January 1993, but it is unlikely to do so given that no agreement has yet been reached. Meeting this objective has been stymied by the wide diversity and strength of opinions among member states as to the future structure of Europe's investment markets.

Implications of Harmonization Efforts for U.S. Securities Markets and U.S. Capital Standards

U.S. securities regulators have not needed to alter U.S. capital standards to satisfy existing international capital harmonization initiatives. Whether or not U.S. standards will need to change depends on the specific requirements of any final harmonized standards. U.S. standards have altered over time, but usually in response to customer protection concerns. For example, in response to a financial and operational crisis in the late 1960s, SEC established minimum financial responsibility requirements for all securities firms. Also, in 1990, SEC changed its capital standards to require a firm to, under certain conditions, notify it when capital is transferred out of the firm and also proposed an increase in minimum capital levels. While the United States has not altered its regulations to respond to international harmonization efforts, it has made certain changes to respond to the needs of U.S. firms doing business in international securities.

According to U.S. firms that GAO interviewed, stringent U.S. capital standards could inhibit the ability of U.S. markets and firms to compete internationally. Although U.S. regulators did not necessarily agree with this contention, they changed capital standards to recognize that it takes longer in some foreign markets to exchange securities and money after a trade is made and to allow the value of these trades to be included in capital calculations. U.S. firms still want the value of many more foreign securities and the value of additional offsetting positions to be recognized.

Until recently, SEC had not changed its standards for recognizing the value of foreign securities since 1975, when it allowed firms to count as capital the securities they held from 12 foreign exchanges. In August 1991, however, SEC recognized selected Mexican securities, but not the whole market. In contrast, the United Kingdom recognizes securities listed on 80 exchanges in 24 countries. Japan recognizes foreign equities listed on the exchanges of all other countries. The EC would recognize securities listed on an exchange in an EC member state or in a country outside the EC that is recognized by a member state. Because of the expansion of international trading, U.S. firms believe more foreign securities should be recognized. SEC officials are currently considering how to account for the risks of holding foreign securities. SEC officials told us that many securities on the remaining foreign exchanges are not liquid enough to be conservatively counted as capital, and recognizing a few securities on each exchange could create administrative difficulties.

Securities firms use many strategies to reduce or hedge their market risks. These range from taking single offsetting positions in different financial instruments to much more complex strategies that may involve several products or markets. For most of these strategies, SEC imposes a capital charge on each position taken. U.S. firms said such a charge is excessive relative to the risks involved, especially considering that other countries recognize a wider variety of strategies than the United States does. However, SEC officials believe that because of the many different strategies used and the difficulty in determining their effectiveness in reducing risks, modifying capital standards generally to recognize the strategies would be difficult. Officials said the U.S. capital standard currently recognizes all legitimate risk reduction strategies. SEC officials said they have no plans to develop new hedging standards but would consider specific industry proposals.

Recommendation

GAO has no recommendation regarding the involvement of U.S. financial market regulators in international organizations seeking to harmonize international securities capital standards. However, with respect to the implications of these international efforts for U.S. securities markets and the U.S. securities capital standards, GAO recommends that the Chairman, SEC, consider revising its capital rule to recognize more foreign markets and more foreign securities as readily marketable under SEC's 1975 criteria and develop a mechanism to recognize additional foreign securities and markets as they develop.

Agency Comments

SEC officials provided written comments on a draft of this report (see app. II). SEC generally agreed with GAO's recommendation and is awaiting the proposals from industry representatives on recognizing more foreign markets and securities. SEC said it would like to see a general concept developed that is consistent with the underlying purposes of the capital rule and is simple to apply to foreign securities now excluded from recognition under the U.S. capital standard.

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Appendixes

Related GAO Products

Figures

Abbreviations

CFTC	Commodity Futures Trading Commission
EC	European Community
FIBV	Federation Internationale Des Bourses De Valeurs
FRS	Federal Reserve System
IOSCO	International Organization of Securities Commissions
NYSE	New York Stock Exchange
OECD	Organization for Economic Cooperation and Development
SEC	Securities and Exchange Commission
U.K.	United Kingdom

Introduction

As international trading of securities has expanded, concern has increased among international organizations and country regulators that differing national approaches to regulation of financial risks in securities markets may put customers, firms, and markets at risk and result in competitive inequalities. The primary protection against the financial risks of securities trading within individual countries has been to require securities firms and banks doing securities business to maintain sufficient excess assets, called capital, to satisfy customer needs. Capital standards for securities markets around the world are set primarily by the country's securities regulators. In the United States the Securities and Exchange Commission (SEC) performs this function.

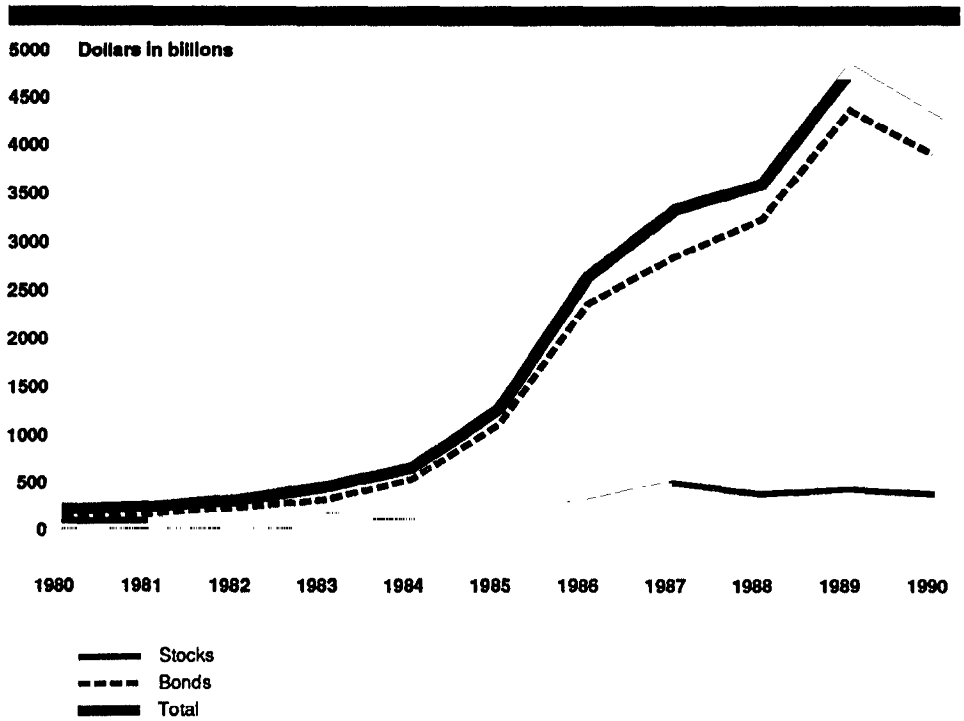
The amount of capital that regulators require varies among countries, and this variation may distort competition and may compromise the overall soundness of the global securities market. To help mitigate these effects, three international organizations—the International Organization of Securities Commissions (IOSCO), the Basle Committee on Banking Supervision, and the European Community (EC)—are trying to "harmonize" capital standards.[1]

Securities Markets Are Becoming International

Economic conditions, technological advances, institutional changes, and deregulation of financial markets have led to the increasing internationalization of securities markets. Favorable economic conditions in the 1980s offered investors opportunities to invest in other countries in order to get better rates of return on their investments. Advances in communications and computer technology enhanced market participants' ability to quickly learn of foreign market conditions and do business worldwide. In addition, individual investors increasingly have money in "managed" or mutual funds, which, because of their size and sophistication, are more likely to invest overseas than would individual investors. Moreover, deregulation of various national securities markets has eased access for foreign firms.

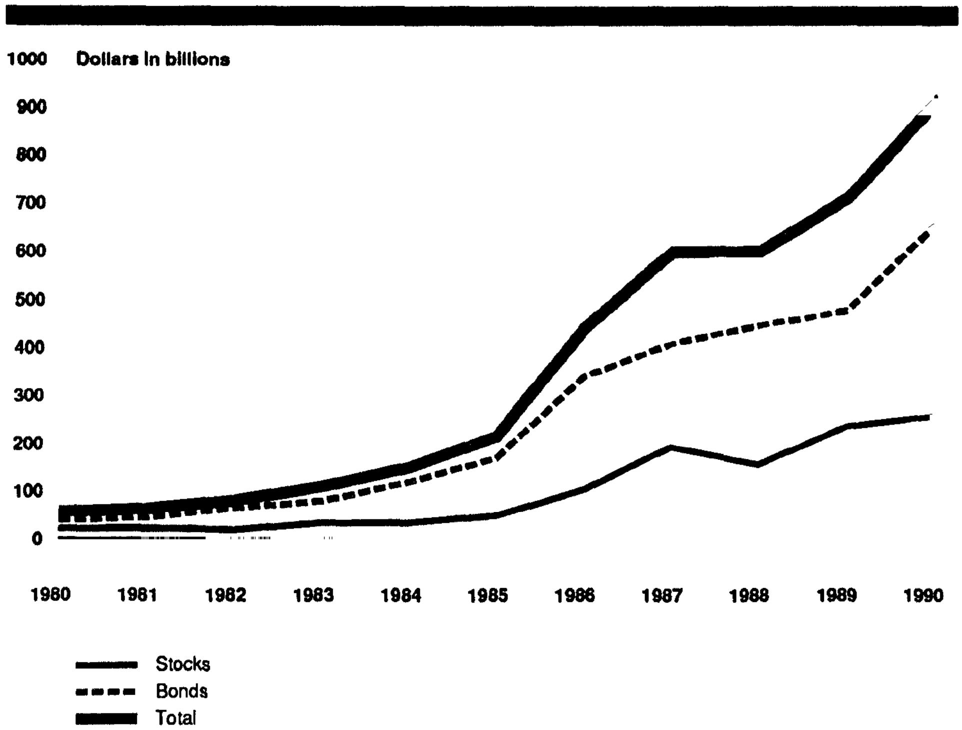
[1] Harmonizing capital standards does not mean that the exact same standard must be established for each country, rather a range of minimum requirements is established within which differences in standards are acceptable. Also, individual regulatory authorities are free to impose more stringent requirements.

Figure 1.1: Foreign Purchases and Sales of U.S. Stocks and Bonds
(Dollars in Billions)



Source: U.S. Treasury Bulletin.

Figure 1.2: U.S. Purchases and Sales of Foreign Stocks and Bonds
(Dollars in Billions)



Source: U.S. Treasury Bulletin.

Foreign purchases and sales of U.S. securities and corresponding U.S. holdings of foreign securities have increased dramatically since 1980 (see figs. 1.1 and 1.2). For example, foreign purchases and sales of U.S. securities have grown from about $198 billion in 1980 to almost $4.2 trillion in 1990. During the same period U.S. purchases and sales of foreign stocks and bonds have grown from about $53 billion to about $904 billion.

Most major markets offer foreign stock to their customers. These offerings are called cross-listings because the stock is listed in at least two countries. For example, as of October 1991, U.S. exchanges listed a number of foreign securities—the New York Stock Exchange (NYSE) listed 105 foreign stocks, the National Association of Securities Dealers' automated quotation system listed 187 foreign issues, and the American Stock Exchange listed 81 foreign issues. Also as of December 1989, the Tokyo Stock Exchange listed 119 foreign companies and traded futures contracts on U.S. Treasury securities, the Stock Exchange of Hong Kong listed 14 foreign stocks, and the Australian Stock Exchange listed 34 foreign stocks. On European exchanges cross-listings are also common. For example, the London Stock

Exchange listed 613 foreign issues in 1990 and the Amsterdam Stock Exchange listed over 238 foreign issues.

Securities firms and banks[2] have participated in this growing internationalization by expanding their activities across international borders. Many large Japanese, United Kingdom (U.K.), and U.S. securities firms and banks have established operations in securities markets outside of their respective countries. In 1990, 51 registered broker-dealers operating in the United States had a parent firm in another country. In 1992, 50 foreign firms had securities licenses in Japan. As of March 1991, 525 (52 percent) of member firms of The Securities and Futures Association in the U.K. were foreign owned. As of November 1991, 210 firm branches were incorporated outside the U.K.[3]

Securities Activities Create Risks

Securities firms and banks doing securities business risk their capital in complex trading strategies involving securities, futures, currencies, and interest rate swap instruments[4] in the international securities markets. Securities activities are subject to a variety of risks. The type and amount of risk depends on the nature and extent of the securities firms' and banks' activities. The most important of these risks are market risk and counterparty risk. To a lesser extent, securities firms and banks doing a securities business may also face other types of risk, such as the risk of reduced revenues and foreign exchange risk.

Market risk, also called "position risk," is the risk of an adverse movement in a security's price. For example, the market value of a security purchased by a firm may fall before it can be resold.[5] In the case of an equity security, or stock, concerns about the financial performance of the corporate issuer may lead to a decline in the price of the security. In the case of a debt security, or bond, the nonpayment of principal or interest by the issuer, or a change in interest rates, may lead to a subsequent decline in the value of the security.

[2]In some countries securities activities are done as part of the banking business.

[3]Of these 210 firm branches, 118 were bank branches undertaking securities business, 64 were branches of securities firms, and 28 were branches of futures commission merchants.

[4]Swaps are exchanges of obligations. Interest rate swaps are exchanges of one kind of interest payment flow for another. They may be based on fixed or floating interest rates and in the same or different currencies.

[5]Alternatively, if a securities firm has a "short" position in a security (i.e., it has contracted to sell a security it does not own and must buy it before the contracted sale date), the market risk is that the price of the security may increase.

Counterparty risk, also called "settlement" risk, is the risk that a firm's trading partner will be either unwilling or unable to meet its contractual obligation. For example, a buyer may contract to purchase a security from a second-party seller and then commit to selling the security to a third party. The original buyer would then be exposed to the risk that the original seller may default and not deliver the security.

Other risk may include the risk to a firm associated with such factors as reduced net revenues, an increased administrative burden, or fraud. For example, a decrease in a firm's transaction volume may result in reduced income, while expenses remain constant or increase. Similarly, an unexpected increase in a firm's business may result in a heavier administrative burden that could lead to recordkeeping problems and, in turn, delays in completing transactions, called settlement delays.

Securities activities are also subject to other kinds of risks, such as foreign exchange risk. Foreign exchange risk is the risk that the value of a financial instrument will change due to currency fluctuations.

Systemic risk is the risk that a disturbance could severely impair the workings of the financial system and, at the extreme, cause a complete breakdown in it. For example, the collapse of securities prices could lead to the default of one or more large securities firms. Because of financial interrelationships, this could lead to further defaults of securities firms and banks. A series of such defaults could extend into the banking system and cause a disruption in the flow of payments in the settlement of financial transactions throughout the world. Shocks could be transmitted from one domestic market to other domestic markets. Such a breakdown in capital markets could disrupt the process of saving and investment, undermine the long-term confidence of private investors, and disrupt the normal course of economic transactions.

Capital Standards Protect Against Risks

The efficient functioning of financial markets requires that members of the financial community have confidence in each other's ability to transact business. This understanding means that each member of the financial community must have, among other things, adequate capital. Because of the high degree of interdependence among firms in the securities industry—where securities firms often buy and sell securities from one another and have contractual commitments with their counterparts—the failure of one firm to meet its obligation to another could affect the financial viability of other firms.

In general, capital standards are designed to protect customers and to ensure a viable financial system by diminishing the chance of a series of interrelated defaults because of risks in securities markets. Capital standards specify the minimum amount of capital a securities firm or a bank doing securities business should maintain and are often based on the nature and scope of its financial activities. This capital should be sufficient to pay customers, counterparties, and creditors.

In the United States, determining compliance with capital standards requires applying a complex formula to a firm's assets and liabilities to calculate the firm's net capital. Assets, for example, include cash, securities held in proprietary trading accounts, and equipment and buildings. Liabilities include, for example, money owed to customers, banks, and the parent company. Net worth is computed by subtracting liabilities from assets. The value of illiquid assets—such as buildings and furniture—is deducted from net worth calculations. Additional adjustments are made for possible losses in the value of liquid assets by providing that securities positions be adjusted to current market prices and that a discount in the value of securities be taken for possible future market fluctuations.

How Capital Is Regulated in Securities Markets

Because of the potential effect on financial markets of the failure of undercapitalized firms, national securities regulators have chosen to enforce "adequate capital levels." Each country has different arrangements for regulating capital. The biggest difference among countries occurs in their treatment of securities and banking activities. In "universal" banking countries, securities business is generally done within banks, and typically one capital standard is applied to both securities and banking activities. In "nonuniversal" banking countries such as the United States, securities firms and banks are separately regulated and subject to distinctly different capital standards.

Another difference among national capital standards is that the objectives of the standards can differ among countries. For example, in the United States the primary emphasis is on providing sufficient liquid assets to meet liabilities, including customer liabilities, and fostering confidence in the securities industry and the financial system; in Japan the emphasis is on preventing a firm's failure or protecting the financial system.

On an average day, firms and banks doing an international securities business hold billions of dollars in capital. For example, as of July 1991 the 10 largest U.S. securities firms were capitalized at $6.7 billion. Total capitalization of the 10 largest U.K. securities firms, which are lead regulated by the Securities and Futures Association, was 2.4 billion pounds, or about $4.5 billion as of January 1992.

In the United States, SEC is the primary regulator of securities firm capital, but the Federal Reserve System (FRS) and the Department of the Treasury also have a role. SEC oversees capital through a strategy of self-regulation. It creates and revises capital standards as well as oversees self-regulatory organizations, such as NYSE, that have primary responsibility for enforcing the compliance of their member firms with the standards. Although firms created under section 20 of the 1933 Glass-Steagall Act[6]—i.e., securities subsidiaries of bank holding companies—must comply with SEC's capital standards, FRS sets other capital levels and approves capital plans for holding companies that own Section 20 companies.[7] FRS requires that firm capital meet securities industry norms, which in turn are well above SEC minimum capital requirements. The Department of the Treasury has rule-making authority for firms registered as government securities dealers,[8] while the securities regulators carry out oversight and enforcement activities.

In general, the capital levels of large U.S. securities firms exceed minimum requirements. As figure 1.3 indicates, the 10 largest U.S. securities firms have capital levels many times the minimum requirement on any given day.[9] There are a variety of reasons why securities firms operate with capital levels in excess of minimum requirements, including (1) the firm needs to conduct large underwritings or other activities that occur periodically, and (2) the firm uses its capital level as a marketing tool to attract both individual and institutional investors.

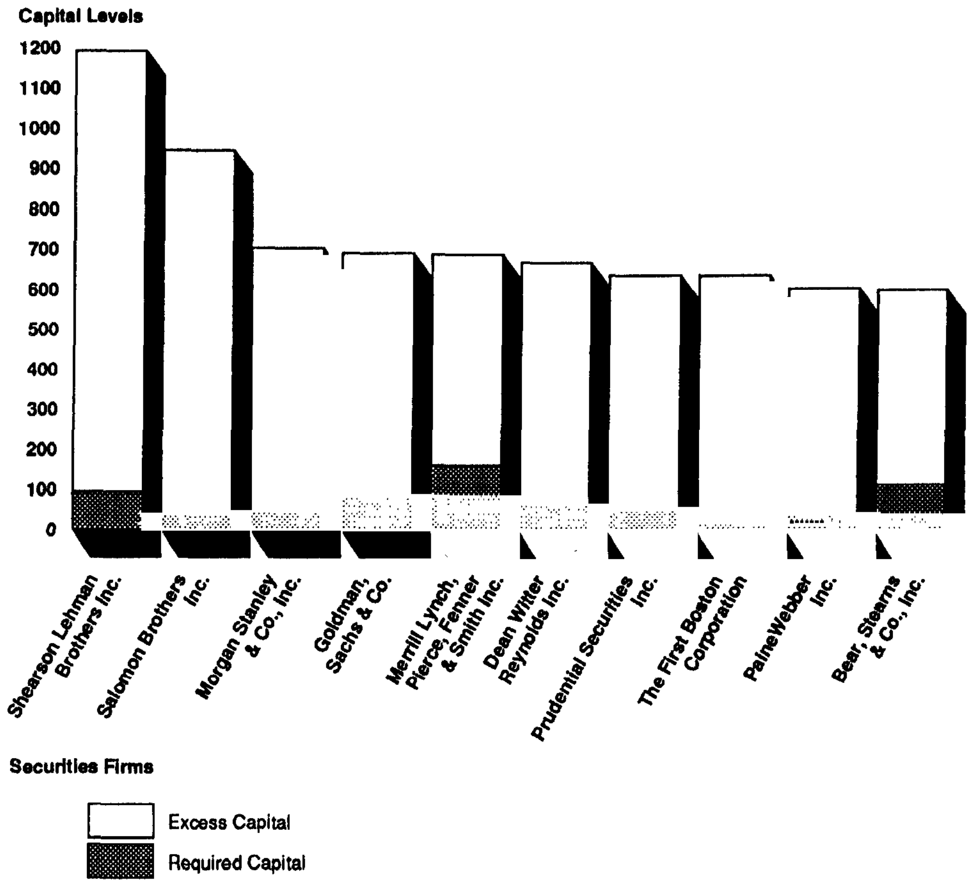
[6]See 12 U.S.C. sec. 377.

[7]Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies (GAO/GGD-90-48, Mar. 14, 1990).

[8]Study of the Effectiveness of the Implementation of the Government Securities Act of 1986, Department of the Treasury, SEC, and Board of Governors of the Federal Reserve System (Washington, D.C.: October 1, 1990).

[9]The capital levels shown are those for the broker-dealer only. They do not necessarily reflect the financial condition of the whole securities firm, which may comprise many parts separate and distinct from the broker-dealer.

Figure 1.3: Capital Levels of 10 Largest Securities Firms in the United States
(Dollars in Millions)



Note: Haircuts and illiquid assets have been deducted from the capital levels.

Source: Securities and Exchange Commission, June 28, 1991.

Country Capital Standards Differ

International securities market participants are subject to a wide variety of country-specific capital standards. These differing country capital standards have implications for settlement or counterparty risk, systemic risk, and competition among firms, banks, and markets.

For example, some countries value securities at current market prices ("mark to market"), while other countries value them at their original cost. Further, some countries have settlement risk requirements so that the risk of nonperformance in a timely manner is covered within the capital standards, while other countries do not. Also, some countries set differential capital standards according to the type of business done, while other countries use uniform minimum standards for all types of securities businesses. Appendix I compares capital standards on these and other features for nine selected countries.

If securities firms or banks doing securities business fail, any remaining capital can be used to pay off customers, creditors, and counterparties. If securities firms or banks doing securities business fail when their capital falls to minimum capital standards, the failures are more likely to have adverse consequences for customers, creditors, and counterparties in countries with low minimum standards. Firms and banks that fail with higher minimum capital are more likely to meet their obligations. Poorly capitalized firms and banks that cannot meet their obligations may also cause financial difficulty for other securities firms, banks, clearing systems,[10] and hence securities markets. Widespread failure of these firms and banks may thus, in turn, cause other firms and banks to fail in markets with higher capital standards and result in a ripple effect across international financial markets.

Differing country capital standards may also have competitive effects both within a country where securities firms and banks compete for the same securities business or among countries. For example, if banks have more stringent capital standards than those imposed on competing securities firms within the same country, then banks may be at a competitive disadvantage because of the costs associated with holding the higher capital amounts. For the same reason, countries with higher capital standards could be at a competitive disadvantage to countries with lower capital standards. Alternatively, countries with higher standards might be competitively advantaged if they are viewed as safer places to do business than countries with lower capital standards.

Efforts to Harmonize Are Ongoing

To protect against the risks posed by low capital standards and to minimize competitive differences caused by varying capital standards, international regulators are seeking to harmonize capital standards. IOSCO, whose

[10]Clearing systems capture trade data and guarantee that the trade will settle once the data match. Settlement is the final stage of the process when funds and/or financial instruments are exchanged between parties through the clearing organization. See Clearance and Settlement Reform: The Stock, Options, and Futures Markets Are Still at Risk (GAO/GGD-90-33, Apr. 11, 1990).

members are regulators representing major and minor securities markets, is an active proponent of harmonization.[11] In addition, the Basle Committee on Banking Supervision[12] is working to expand its 1988 capital framework for international banks to include securities activities.[13]

Also, the EC,[14] which is in the process of establishing an integrated European financial market, has circulated various drafts of a capital directive, which will establish EC capital standards. While the EC hoped to agree on the capital directive by December 31, 1992, agreement on a capital directive is now extremely doubtful.[15]

The efforts of these three groups are interdependent because their memberships overlap, and the final capital standards for one group affect the other groups. For example, in countries with universal banking the same official is often the securities and the banking regulator and would typically participate in both IOSCO and Basle Committee meetings.

U.S. regulators have been active members of IOSCO and the Basle Committee. The Chairman of SEC is the Chairman of the Technical Committee of IOSCO—a key policy-setting committee that is working to harmonize capital standards. The Commodity Futures Trading Commission (CFTC) is an associate member of IOSCO and a member of the Technical Committee. FRS, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation are Basle Committee members.[16] In addition, the President of the Federal Reserve Bank of New York is Chairman of the Basle Committee.

[11]IOSCO includes securities administrators from 56 countries as of February 1991. IOSCO facilitates efforts to coordinate international securities transactions. It is, however, a private organization and has no legal powers. The present goals of the organization include exchanging information to promote the development of domestic markets, developing effective surveillance of international securities transactions, providing mutual assistance to assure the integrity of markets, establishing standards, and cooperating to ensure better regulation of domestic and international markets.

[12]The Basle Committee comprises central bank and bank supervisory representatives from 12 leading industrial nations (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the U.K., the U.S., and Luxembourg). The Committee meets under the auspices of the Bank for International Settlements in Basle, Switzerland.

[13]International Convergence of Capital Measurement and Capital Standards, Basle Committee on Banking Regulation and Supervisory Practices (Basle, Switzerland: July 1988).

[14]The EC comprises Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

[15]Draft Proposal for a Council Directive On Capital Adequacy of Investment Firms and Credit Institutions, Commission of the European Communities (Brussels, Belgium: May 23, 1990).

[16]The SEC participates on the Basle Working Group on position risk requirements for traded debt and equity.

Two other international organizations have, to a lesser extent, been involved in harmonizing capital standards—the Federation Internationale Des Bourses De Valeurs (FIBV), an association of stock exchanges from various countries, and the Organization for Economic Cooperation and Development (OECD), an association of 24 countries designed to promote economic growth and world trade. FIBV cooperates with IOSCO, the Basle Committee, and the EC but does not have an initiative of its own to harmonize capital standards. In April 1990, FIBV reached an agreement that firms and banks doing securities business must meet capital standards for ensuring the interests of customers as well as for avoiding systemic risks. In 1991, OECD's Committee on Financial Markets published a report supporting the continued exploration of more consistent international capital standards to enhance stability, liquidity, and confidence in domestic and international markets. The report also supported efforts to achieve broad equivalence in financial responsibility standards for securities firms and banks doing securities business.[17] In addition, OECD is surveying how its members compute capital for securities firms and banks doing securities business. Because FIBV and OECD have not been as actively involved in efforts to develop harmonized capital standards as IOSCO, the Basle Committee, and the EC, we do not discuss them further in this report.

Objectives, Scope, and Methodology

Our objectives were to (1) examine the status of international efforts to obtain harmonization of capital standards for securities activities and (2) discuss the implications of harmonization efforts for U.S. securities markets and U.S. capital standards.[18]

To achieve our objectives we reviewed international organization, government, securities exchange, and firm documents, including correspondence, memoranda, testimony, reports, books, regulations, and laws. Further we interviewed officials from five transnational organizations—the Basle Committee, the EC, FIBV, IOSCO, and OECD. We also interviewed officials representing securities and banking regulators as well as exchanges in Australia, Belgium, France, Germany, Hong Kong, Japan, Singapore, Switzerland, the United Kingdom, and the United States.

[17] Systemic Risk in Securities Markets, OECD (Paris, France: 1991).

[18] This report focuses on securities firms—which we have defined as SEC registered broker-dealers—securities markets, and SEC. We do not discuss futures firms, futures markets, or CFTC. Although some differences exist in the capital standards for securities and futures firms, they are generally coordinated such that major changes in one generate similar changes in the other. Thus, although the discussion focuses on securities markets, the principles discussed also apply to futures markets. Further, CFTC is active in developing international consensus on other issues being considered by IOSCO through its associate membership in IOSCO.

In addition, we interviewed officials of rating agencies in the United States, Japan, and the United Kingdom as well as attorneys who specialize in international securities markets issues. Also, we interviewed officials of 24 securities firms and 18 banks and representatives of securities and banking associations. Most of the securities firms and banks we contacted were recommended to us as among the firms with the most capital in their home countries. They also did an international securities business. Several securities firms we spoke with specialized in regional securities, such as those of the Pacific Rim. In some cases we interviewed officials from both a securities firm or a bank's headquarters and foreign offices and subsidiaries.[19]

We spoke to both policy and operational officials of these organizations about (1) internationalization in securities markets and differences in regulatory structure; (2) the role of capital standards in securities markets; (3) the differences in, and strengths and weaknesses of, the capital standards of individual countries as well as those being drafted by international organizations; (4) prudential, competitive, and operational reasons for and against the harmonization of capital standards; (5) obstacles to harmonization and the status of current initiatives; and (6) implications of harmonization efforts for the United States capital rule and international securities trading in the United States.

We obtained informal comments on a draft of this report from CFTC, FRS, Treasury and regulators in Australia, France, Hong Kong, Japan, Singapore, and the United Kingdom. We obtained formal comments on a draft of this report from SEC (see app. II). We also obtained technical comments from SEC that we have incorporated in the report. We did our work from January 1990 through March 1991 in accordance with generally accepted government auditing standards.

[19]Some firms were both securities firms and banks, in which case we classified them according to the nature of their headquarters office. For example, the German subsidiary of a U.S. securities firm is considered to be a bank, but we classified it as a securities firm.

Challenges to Achieving Harmonization

Securities market regulators in the major markets—Japan, the United Kingdom, and the United States—as well as those in many other countries generally support efforts to harmonize capital standards. These standards aim to make international trading safer and to eliminate any unfair competitive advantage resulting from differing standards. However, no single regulatory body currently has the authority to impose its preferred standard on all marketplaces. Regulators and market participants from countries with emerging markets or with competition for securities business between securities firms and banks admit that there are obstacles to achieving harmonization. They are concerned about how harmonized securities capital standards will affect their development or their efforts to achieve fair competition. Also, even the major regulators state that agreeing on the details of harmonized standards may be difficult.

Major Regulators and Large Firms Support Harmonization

Regulators and securities firms—generally those in countries with large markets, such as Japan, the U.K., and the United States—supported harmonized capital standards. They supported harmonized capital standards for many reasons, including increased confidence by market participants in the operation of financial markets and diminished risk in world financial systems. If firms doing securities business have adequate capital to withstand market disturbances, then market participants will have confidence in the integrity of securities markets. Agreement among international regulators on harmonized capital standards, which adequately reflect risks to firms doing securities business, can help increase market participants' confidence in the firms they deal with internationally.

Proponents also said that harmonization of capital standards will reduce the likelihood of a domino effect, for example, where a failing securities firm located in a country with a low capital standard affects the solvency of its parent, one or more of its subsidiaries in other countries, or its counter-parties. Presumably, harmonized standards would cause countries with low standards to raise their capital requirements, thereby providing a greater financial cushion for firms that fail to pay off their creditors, customers, and counterparties and thus avoiding further potential failures.

Some regulators and securities firm officials told us that in the absence of harmonized capital standards, securities activities will tend to gravitate toward those markets with the least regulated and least costly requirements, a phenomenon called "regulatory arbitrage." SEC officials told us that the potential for regulatory arbitrage is significant given the complex and wide-ranging organizational structures of financial firms.

Internationally active firms doing securities business have branches and subsidiaries linked by sophisticated technology, allowing them to shift their trading or other business activities from one market to another with relative ease. As the securities industry is highly competitive and often operates on very small margins, differences in capital standards that constitute direct costs to market participants can make a difference in where firms choose to locate. For example, many U.S. securities firms include more organizational entities than the SEC registered broker-dealer. These firms do certain transactions in affiliated organizations either in the United States or overseas to avoid the cost of complying with SEC's capital standards, as well as regulation in general. Harmonization can help remove capital standards as a competitive consideration.

International Regulatory Organizations Operate by Consensus

None of the international organizations working to harmonize capital standards has the authority to impose its standards on all sectors of the world financial community. If the standards are accepted in enough key countries, however, all countries may have to meet them to attract international capital. Further, each international organization represents a specific industry or region and not the financial market as a whole or markets in all countries. For example, IOSCO represents the interests of securities regulators and has only recently attempted to integrate viewpoints from the banking community. Similarly, the Basle Committee represents the interests of the banking community and has only recently tried to integrate the views of securities regulators. Moreover, the EC does not represent countries outside Europe.

Thus, to achieve worldwide acceptance of capital standards, each group must rely on the others to reach the entire financial community. Therefore, IOSCO would not want to reach an agreement that would disadvantage the Basle Committee members, and vice versa. Moreover, it would be difficult to gain broad acceptance of an EC capital standard if IOSCO and the Basle Committee developed a second or third distinct capital standard.

Challenges to Be Overcome

Despite strong support for harmonization by securities market regulators and large securities firms, some securities firm officials in emerging markets are concerned about the competitive effects of harmonization. In addition, the capital standards of Japan, the United Kingdom, and the United States are different enough to make agreement on the details of harmonized capital standards difficult. These challenges, which must be faced if harmonization is to occur, involve (1) establishing standards that adequately protect investors and financial systems while still allowing emerging markets to develop, (2) integrating banking and securities capital standards for foreign banks already involved in securities markets and for U.S. banks that are becoming more involved, and (3) making the capital standards specific enough to provide acceptable levels of investor protection and safety for all market participants.

Allowing Emerging Markets to Develop

Most of the regulators and exchange officials and about half of the international and local broker-dealers we contacted in Australia, Hong Kong, Japan, and Singapore supported harmonization of capital standards. However, many officials were concerned about how harmonized standards will affect the firms in emerging markets.

Some private and public sector officials in Australia, Japan, and Singapore expressed several concerns. Among these concerns were that harmonization could (1) act as a barrier to market entry for poorly capitalized securities firms trying to get started in business;[20] and (2) also push other poorly capitalized securities firms, already in operation, out of the market. Similarly, these officials were concerned that harmonization could inhibit the development of emerging Asian markets. They said that these markets may not be able to expand if international capital standards were too high for their members to meet.

Hong Kong regulatory officials told us that harmonization could inhibit the development of emerging Asian markets to the extent that it does not adequately consider all relevant market characteristics. Officials in Hong Kong told us that they have a very large number of small agency brokers who operate almost exclusively in the local market. These brokers provide a useful service; any harmonization of standards that would require them to comply with a complex and expensive capital adequacy test would impose a difficult burden of ongoing costs. However, Hong Kong regulatory officials see merit in harmonizing standards for internationally active firms and are fully supportive of IOSCO's efforts in this area.

[20]Regulatory officials in Singapore told us that in the event that a securities company cannot meet a new international capital standard, the authorities would give the shareholders sufficient time to inject additional capital into the company, failing which its operations could be curtailed or suspended.

Integrating Securities and Banking Capital Standards

Although securities activities of bank holding companies in the United States, other than government or municipal securities activity, have generally been limited to Section 20 firms—securities subsidiaries of bank holding companies—foreign banks and the foreign operations of U.S. banks, are heavily involved in securities activities. The Basle Committee has already established international capital standards for banks, and these standards differ from the capital standards traditionally applied to securities activities. For example, securities firms are generally required to value their securities at current market values, while banks generally use cost or lower of cost or market. U.S. banks have the option of valuing the securities in their trading portfolios at lower of cost or market, or marking the securities to market. U.S. banks value their investment portfolios at cost. In general, securities firms' standards are designed to provide that the firms have sufficient liquid assets to meet their obligations, while bank standards are designed to ensure that banks remain solvent. Both banks and securities firms are concerned that if securities activities of banks are subject to capital standards different from those of securities firms, the one with the lower standard will have a competitive advantage. Resolving any differences in capital standards is a formidable task, however, because of the differences in operations of banks and securities firms and the resulting variance in the oversight methods securities regulators and bank supervisors use.

Regulators view risks differently for banks and securities firms. Because bank asset turnover is slow and securities firm asset turnover is relatively high, bank risk changes more slowly than securities firm risk. Banks have traditionally invested most of their funds in long-term illiquid assets, such as loans to customers. These funds come from highly liquid customer deposits as well as borrowings and the banks' own capital. Banks have traditionally held these assets to maturity. As a result, bank regulators focus on credit risk as the most important and predominant risk.

Because of their high asset turnover, securities firms must be able to absorb the effect of changing market values of their portfolios as they occur. Consequently, securities regulators emphasize valuing securities positions at market prices—and take a deduction on the market value of the securities position—to provide a margin of safety against potential losses that can be incurred as a result of market fluctuations. Securities regulators place little or no value on illiquid assets. Securities firms holding large concentrated securities positions are more vulnerable to sudden market movements than diversified banks because a large portion of securities firms' net worth can be lost quickly.

Developing Specific Standards

A harmonized capital standard does not necessarily mean that each country must have exactly the same standard. A harmonized standard could establish either a minimum that everyone must meet or a range of minimum values within which differences are acceptable. As noted in chapter 1 and discussed in more detail in chapter 3, IOSCO has proposed a general framework, supported by Japan, the United Kingdom, the United States, and others, which it recommends that countries meet in developing capital standards. As illustrated in appendix I, the capital standards of Japan, the United Kingdom, and the United States conform to this general framework, despite significant differences in individual standards. Regulators in the three countries were concerned that resolving their individual differences would be difficult. They told us that agreement would be hard to achieve regarding the proper balance between the costs of the standards to the securities industry and the need to provide an acceptable level of investor protection and safety to firms and to markets. We focused on Japan, the United Kingdom, and the United States because their dominant market share makes it essential that they resolve the differences in their standards to make harmonized standards meaningful.

Several differences exist in the capital standards of the three countries. For example, variances appear in the "haircuts" required on securities. Haircuts are percentages of the market values of securities that are deducted from net worth to compute capital. They are intended to reflect the market risk of a firm's positions and provide a margin of safety against losses incurred by a firm. The U.S. capital standards require haircuts of either 15 or 30 percent for equity securities depending on which method for calculating net capital is used. The United Kingdom allows haircuts of less than 2 percent for diversified portfolios of highly liquid securities with unrelated buy and sell positions. An SEC analysis of a hypothetical portfolio of unrelated buy and sell positions of highly liquid securities suggests that a 2-percent standard is too low because, in contrast to the U.S. standard, it would not have preserved enough capital to cover price moves during the 1987 and 1989 market breaks. U.K. Securities and Investments Board officials told us that an actual test of portfolios of equities indicated that 2 percent accurately covers the risks in diversified portfolios. SEC officials told us that no agreement exists on the best model of portfolio diversification, and a capital standard based upon portfolio diversification would be difficult and costly to administer.

Certain nonsecurity financial activities conducted by securities firms, such as interest rate swaps, result in high capital charges. Therefore, U.S. firms conduct these trades outside of the registered broker-dealer in unregulated affiliates. In both Japan and the United Kingdom these activities are considered securities business and are subject to both capital standards and securities regulation.

Moreover, different standards exist on when to count subordinated debt as capital. Subordinated debt results when a firm borrows funds under the condition that the debt is subordinate to all other creditors of the firm. That is, should the firm fail, every other creditor of the firm has a claim to its assets before the subordinated debt holder. Although subordinated debt is allowed to count as capital for foreign firms operating in Japan, subordinated debt is not recognized under the Japanese capital standard for Japanese securities firms, according to Japanese regulatory officials. Germany does not allow subordinated debt to be counted as capital because regulators do not believe it is permanent capital. Both the United Kingdom and the United States allow firms to count subordinated debt as capital.

Finally, even when capital standards include the same requirements, such as one for a minimum level of base capital, the details of the requirements vary in each country. The base requirement for the U.S. capital rule is that net capital should be at least 6-2/3 percent of aggregate indebtedness or 2 percent of customer-related receivables. In Japan, the base requirement is 25 percent of a securities firm's adjusted operating expenses from the previous year. In the United Kingdom, the base requirement is the highest of (1) an established minimum for a particular type of firm, or (2) 25 percent (1/12 for clearing firms) of adjusted annual expenditures.

Conclusions

Harmonized capital standards could help protect customers, firms, and world securities markets as well as equalize the costs of carrying capital for firms operating internationally. However, determining what standards will apply to different size markets and resolving the differences that result from the different approaches to capital adequacy used by banks and securities regulators will complicate negotiations. Further, variations among the major markets, such as what can be counted as capital, what the minimum requirements will be, and what activities should be covered by the standards, must be resolved to make the standards meaningful. U.S. regulators are taking a lead role in these negotiations, but whether the difficulties inherent in harmonization can be resolved remains an open question.

International Efforts to Harmonize Capital Standards Continue

Financial market regulators, through a variety of forums, are working to bring about greater harmonization of capital standards for securities activities. While they have brought this issue to the forefront of current international regulatory debate, agreement has been slowed by attempts to develop an equitable and workable framework that would apply to securities firms as well as to banks. IOSCO has been advocating the need for harmonization of capital standards over the past 3 years and has proposed a set of guidelines that each country's capital standards should satisfy. The Basle Committee has been attempting to harmonize capital requirements for the securities activities of international banks by expanding its existing capital standards for banks. And the EC has proposed a plan for harmonizing capital standards in the securities markets of its 12 member countries in response to a self-imposed 1992 deadline for creating a single European internal market.

IOSCO Is Focusing on Developing Capital Standards for Securities Firms

A major goal of IOSCO is to find practical solutions to the principal regulatory problems facing international securities markets. IOSCO is focusing on harmonizing capital standards for securities firms, among other initiatives. One objective of IOSCO is to analyze the risks faced by organizations conducting securities activities and develop uniform capital rules for individual countries. IOSCO recognizes that capital standards foster confidence in the financial markets. According to IOSCO, in the absence of a supervisory authority setting objective capital standards, investors, other securities firms, and financial institutions would be reluctant to deal with securities firms. This is because in an unregulated environment, the financial failure of a firm may lead to the insolvency of other securities firms and could cause serious disruption of the markets. Also, adequate capital demonstrates a sense of commitment and obligation to the securities business and helps promote reliable and responsible operations.

IOSCO's Working Group Three Is Studying Capital Standards

The Technical Committee of IOSCO,[21] comprising representatives of securities regulators of 13 countries,[22] held its first meeting in July 1987.

[21]The Technical Committee focuses on setting standards.

[22]The 13 countries are Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

At that meeting the Technical Committee established six working groups to study various aspects of international securities markets.[23] Working Group Number 3, with representatives from France, Japan, the United Kingdom, and the United States, was to study issues related to capital adequacy for securities firms from an international perspective. Its ultimate objective was to establish a set of capital standards that the world's principal securities regulators would adopt.

The Group divided its work into three stages. The first stage established the general components that countries should include in their capital standards. The second stage produced a series of detailed papers that examined the main elements of the analysis completed in the first stage. And the third stage, yet to be completed, will recommend capital standards which include levels of the various components of capital.

IOSCO Has Proposed a General Framework for Capital Standards

In August 1989, the Technical Committee issued a concept paper[24] that analyzed the need for, and approach securities regulators might take in setting, capital standards. The report concluded that a need exists for a common, worldwide conceptual framework setting capital standards for securities firms. It also emphasized the need for regulators to assess as closely as possible the risks securities firms face and to tailor the capital standards to these risks. The general framework included the following guidelines:

- It suggested that securities regulators set liquidity and solvency standards to ensure that a firm has sufficient liquid assets to meet its obligations given the risks that the firm faces.
- It suggested that regulators require a mark-to-market standard for marketable securities and commodities positions. This standard would require re-evaluating the positions a firm holds as prices change so that a firm's financial position may be known at all times.
- It suggested that regulators devise a risk-based standard requiring firms to hold capital appropriate to the risks they incur. These risk-based standards should cover all of a firm's risks and should contain (1) a base capital requirement reflecting the size and scope of a firm's activities; (2) position

[23]As of October 1991, IOSCO had four groups. Working Group Number 1 is examining multinational offerings and disclosure. Working Group Number 2 is examining the regulation of secondary markets. Working Group Number 3 is examining the regulation of market professionals—including the harmonization of capital standards. Working Group Number 4 is examining enforcement and the exchange of information.

[24]Capital Adequacy Standards for Securities Firms, Technical Committee of the International Organization of Securities Commissions (Montreal: Aug. 10, 1989).

risk requirements (for both on- and off-balance sheet items[25]) reflecting, among other things, the price volatility of individual securities with provisions for concentrated positions and allowances for risk reduction measures such as hedging; and (3) settlement risk requirements reflecting the risk of nonperformance of a contract to buy or sell a security in a timely manner. The capital held by each firm should exceed the sum of the risk-based requirements.

- It suggested that regulators create a standard limiting the amount of financing relative to owner's equity that can be considered as capital. For example, some countries' securities regulators allow bank guarantees, which are agreements to provide capital when needed, to substitute for capital. Others allow certain types of financing, such as subordinated loans, to serve as capital in addition to owners' equity. Still others do not count guarantees and subordinated loans as capital.
- It suggested that regulators develop standard minimum requirements adjusted by the type of business the firm does. Firms entering the business should have sufficient capital to demonstrate a level of commitment to the securities business. At the same time, minimum requirements should not be set so high as to adversely affect competition in the marketplace. Higher minimum capital requirements should be imposed on firms that hold customer funds and securities or that trade for the firm's account.
- It suggested that regulators devise a standard requiring routine examinations of firms by supervisory authorities for compliance with financial responsibility and recordkeeping requirements.

Appendix I contains a matrix that illustrates how various countries' capital standards compared to this framework. It also compares U.S. capital standards to the IOSCO framework.

IOSCO Is Currently Developing More Detailed Capital Standards

At its annual meeting in September 1989, IOSCO endorsed the conclusions of the report and asked the Technical Committee to consider how a more detailed framework could be developed as well as ways in which international financial supervisory arrangements could be improved. IOSCO also said that a more detailed study of the problem of applying appropriate capital standards to the securities activities of banks would be needed.[26]

[25] Off-balance sheet activities do not require booking assets or liabilities on the balance sheet. Examples of off-balance sheet activities include letters of credit, financial swaps, note issuance facilities, revolving underwriting facilities, and options.

[26] Working Group Number 3 was expanded in January 1990 to include representatives of all members of the Technical Committee. Thus, representatives from universal banking countries, such as Germany and Switzerland, became members of the Group. In addition, representatives from the Basle Committee on Banking Supervision have participated in the Working Group's meetings.

In the second stage of its work, the working group prepared four papers addressing (1) the definition of capital, (2) base and minimum capital requirements, (3) position risk for equities, and (4) position risk for debt. These papers examined in detail current capital requirements for nonbank securities firms in France, Japan, the United Kingdom, and the United States to determine the differences between these countries' capital standards.

At the 1990 IOSCO conference in Santiago, Chile, the Chairman of SEC was elected Chairman of the Technical Committee. He designated finishing work on developing capital standards in the international securities markets as his top priority recognizing that IOSCO needed to create standards in view of the work being done by the Basle Committee on Bank Supervision and the EC. His goal was not to develop identical capital standards for bank and nonbank security firms but to devise requirements that were sufficiently harmonized to avoid "unfair competitive advantages."

In July 1991 the Chairman of SEC submitted four papers relating to capital adequacy of securities firms to the Technical Committee of IOSCO. The first paper discusses equity securities and presents recommendations for the appropriate level of position risk requirements for equity securities. The second paper discusses the treatment of arbitrage positions for (1) depository receipts, (2) convertible bonds or convertible preferred stocks,[27] (3) various types of warrants,[28] and (4) stock-index options and futures. Capital charges vary depending on the type of arbitrage positions taken. The third paper discusses capital standards for positions subject to interest rate risk or debt securities. The paper concludes that the Basle Committee proposal for capital charges on debt securities does not provide adequate coverage. The fourth paper discusses capital charges for options positions and recommends an appropriate methodology to haircut options positions. It discusses two methods to haircut options.

IOSCO Is Discussing Capital Standards With the Basle Committee

The final communique of the September 1991 IOSCO conference in Washington, D.C., reported that the Technical Committee is sending its views to the Basle Committee as a basis for a proposed joint meeting. The meeting would be to discuss the possibility of an international capital agreement on a capital adequacy framework covering market risk in traded equities and debt securities as well as the definition of permitted regulatory

[27]Convertible bonds and convertible preferred stocks permit the holder to exchange them for a predetermined number of the issuer's common shares at a predetermined time.

[28]A warrant is an option to buy a share of a security at a specified price for a limited period of time.

capital. The agreement would establish minimum levels of market risk requirements for internationally active securities firms and banks. National authorities would be free to set higher requirements for both international and domestic firms and also to determine which firms are internationally active.

Members of the Technical Committee agreed that subordinated loans must be subject to strict rules concerning their repayment. Subordinated loans should be limited to a maximum of 250 percent of the firm's equity capital. Such loans cannot be repaid even at maturity if they would bring the firm's capital below the required minimum.

All members of the Technical Committee are prepared to accept and implement a building block methodology as a minimum standard in relation to debt securities in place of a comprehensive approach. The building block approach splits out specific risk requirements from those for general market risk. A comprehensive approach, on the other hand, captures both specific and general market risk in a single risk weight. All members of the Technical Committee agree that there would need to be a transitional period of several years before full conformity with the building block methodology was required.

A majority of the Technical Committee is in favor of accepting an approach to equity position risk where the percentage of capital required on the gross position is added to the percentage of capital required on the net position. However, there is a wide diversity of opinion on the exact percentages to set. A majority of the Committee agree that the international minimum standard, expressed in terms of the building block methodology, should be 4 percent for gross positions and 8 percent for net positions in diversified books of highly liquid equities. For other equities the rule would be 8 percent for gross positions and 8 percent for net positions. Individual regulators would be given discretion to define liquid equities and to determine what constitutes a diversified portfolio. Japan, the U.K., and France favor a minimum standard of 2 percent for gross positions and 8 percent for net positions for diversified books of highly liquid equities.

SEC currently uses the comprehensive approach for equities and will not implement the building block approach. SEC believes that the building block approach could result in substantially lower capital requirements for equities than the current SEC capital standard. SEC sees no justification for the substantial reduction in capital requirements that would result from the permissible offsetting under the building block approach of buy equity positions with sell equity positions. SEC will retain its current rule for equity securities and provide capital requirements equal to or greater than the agreed minimum standard in all cases. Japan will only implement the building block approach if all other Technical Committee members do so.

The Basle Committee Is Working to Incorporate Securities Activity Risk Into Its Existing Capital Framework for Banks

The Basle Committee on Banking Supervision, headed by the President of the Federal Reserve Bank of New York, has advanced the concept of internationally harmonized capital standards within financial markets. The Basle Committee is an advisory body that helps to develop policies for regulating the global banking industry. The Committee seeks to strengthen the soundness and stability of the international financial system and diminish sources of competitive inequality among international banks. Its members reached agreement on bank capital standards in 1988 that addressed credit risk and are now working to incorporate a variety of other "market" risks into that capital framework. Because banks outside the United States are often allowed to conduct a broad range of securities activities, the Basle Committee wants to assure that the capital standards cover the principal risks inherent in those activities as well as the credit-related activities normally associated with banks. The committee is also concerned that capital standards proposed by other international regulatory organizations may disadvantage banks that compete with nonbank securities firms.

During the 1980s, the committee sought greater uniformity in bank regulation. It noted the significance of countries' regulatory differences in an internationalized economy and was concerned about banks' declining quality of assets and capital ratios. In 1988 it approved a capital convergence framework,[29] referred to as the Basle Accord, based on an earlier agreement between the United Kingdom and the United States. Although the framework is not legally enforceable as a treaty, Basle Committee members regard the framework as binding.[30]

The primary objectives of the Basle framework were to (1) strengthen the safety and stability of the international banking system by increasing individual banks' capital levels and (2) level the international playing field by increasing the capital requirements of some countries. To accomplish these objectives, the framework focused on the credit risks assumed by banks, weighing banks' on- and off-balance sheet assets according to the

[29]International Convergence of Capital Measurement and Capital Standards Committee on Banking Regulations and Supervisory Practices (Basle, Switzerland: July 1988).

[30]See International Banking: Implementation of Risk-Based Capital Adequacy Standards (GAO/NSIAD-91-80, Jan. 25, 1991).

general riskiness of each asset category.[31] Internationally active banks subject to the framework will be required to maintain minimum capital levels equal to or greater than 8 percent of their risk-adjusted assets.[32] This rule has been applied to all U.S. banks but will not be fully effective until the end of 1992.

While the current framework concentrates on the credit risks of banks, the Basle Committee recognized that banks face many other types of risk as well. The preamble to the 1988 framework noted that "...other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing overall capital adequacy." The Basle Committee subsequently set up individual subgroups to assess the position risk arising from adverse movements in interest rates, foreign exchange rates, and equity securities prices. While some proposals to assess these risks have been drafted, final agreements are not anticipated until late 1991 at the earliest. The committee's progress has been slowed by the complexity involved in assessing banking risks involving sophisticated hedging and risk management strategies. In addition, adding capital requirements to the existing framework has been difficult.

The Building Block Approach Is Being Considered

The approach being considered—the building block approach—would add specific percentages for each type of risk in lieu of the existing 8-percent capital standard. This approach would split the risk faced by a bank or securities firm into component risks, calculating a capital standard for each component, and adding these building blocks together to arrive at an overall capital standard for the bank or securities firm concerned. Another approach—called the "comprehensive approach"—considers the historical price volatility of an instrument, without seeking to separate the price movement into its component parts. Although favored by some parties, this approach was less compatible with the original framework and was not preferred by most members of the subgroup.

The Basle Committee is aware of the competitive consequences of establishing additional capital standards for banks. Distinctions between banks and securities firms are becoming increasingly obscured. Therefore, adding capital standards for banks would not necessarily contribute to

[31]The Basle framework recognizes that even though these activities do not appear on the balance sheet, an obligation, i.e., a contingent liability, still exists.

[32]The base framework divides capital into two tiers. At least half of this capital is required to be Tier I, or core, capital consisting primarily of share capital and reserves. The remaining capital, or Tier II capital, includes subordinated debt and loan loss reserves.

their financial strength if, as a result, they became competitively disadvantaged compared to securities firms. The committee recognizes this, has met with IOSCO officials, and plans to reach an agreement with IOSCO on the treatment of these risks. The agreement will include the risks on positions held by banks in both debt and equity securities. The Basle Committee has also maintained close contact with the EC. Seven members of the Basle Committee are also members of the EC.

The EC Is Also Working on Securities Capital Standards

The EC's goal since 1985 has been to build a single integrated market for the flow of people, capital, goods, and services across national borders. The EC set December 31, 1992, as the deadline for the program's full implementation.[33] An important part of the EC's plan has been to establish an EC-wide regulatory framework for its financial markets. This goal, in turn, has required developing harmonized regulatory requirements, including capital standards, for the 12 member states. Because the main securities dealers in Europe range from universal banks, which dominate the securities business in Germany, to the London-based subsidiaries or branches of American- and Japanese-owned nonbank securities firms, the EC's problem has been reconciling the approaches to capital adequacy proposed by IOSCO and the Basle Committee.[34]

The EC intends that any financial firm authorized in one member state will be able to freely branch and offer its services to any other member state. The EC has issued or plans to issue financial markets directives[35] covering banking, securities, and insurance; it intends to apply the same regulatory framework to all three markets. Capital standards for EC financial firms will become the responsibility of the country that authorizes or licenses them to do business—the home country. In order to ensure the safety and soundness of the EC financial system, the EC is requiring its member states to impose minimum capital requirements. These requirements would apply to that state's firms no matter where they operate in the EC. Any member state may institute higher, but not lower, requirements for its domestically authorized institutions. However, member states probably will not set

[33]See European Community: U.S. Financial Services' Competitiveness Under the Single Market Program (GAO/NSIAD-90-99, May 21, 1990) for a more complete description of the EC and its single market program.

[34]SEC officials told us they have no direct input or involvement in the EC process.

[35]Directives are the EC's most common means of implementing legislation under the single market program. A directive requires member states to ensure that their national regulation conforms to the directive's objectives but leaves member countries free to decide how the objectives can best be implemented.

requirements much in excess of the minimum because such an action could place their firms and banks at a competitive disadvantage.

The EC's banking directives will become effective on January 1, 1993. However, agreement on similar directives for the securities market has not yet been reached. Agreement and implementation of these directives was targeted for the end of 1992, but because agreement still has not been reached within the Community, implementation must take place at some later date.

Agreement on an EC Capital Standard Has Been Difficult to Achieve

Agreement on a capital adequacy directive for investment services in the EC has been considerably more difficult to achieve than the earlier agreement on capital directives for banking services. While the EC was able to duplicate the existing Basle capital framework to arrive at its bank capital standards, it had no pre-established model for investment services. Negotiating a compromise that satisfies the competitive and market safety concerns of member countries and that encompasses a diverse range of financial market structures has been problematic. Consequently, investment services directives are unlikely to go into effect at the same time as banking directives.

During the spring of 1990, several unofficial drafts of the proposed capital adequacy directive were circulated within the European financial community, and they drew considerable criticism. Securities firms and their regulators in the United Kingdom told us that early drafts set minimum required capital too high and did not consider the offsetting effects of risk management techniques. In particular, U.S. securities firms active in London threatened to move offshore if an acceptable compromise were not found. German banks also opposed early drafts, because they considered the proposed requirements too lax. German banks were troubled by the possibility that U.K. firms might freely branch into German financial markets under capital rules that were different, and purportedly lower, from those required for their own banks.[36]

The EC's official proposal for a capital adequacy directive attempted to address various parties' concerns. To better assure competitive equality for banks, the official proposal would apply to all firms doing securities activities for clients, including banks, specialized securities firms, dealers,

[36]Currently, specialized securities firms, such as those from the United Kingdom, may operate in Germany, but they must obtain a banking license and adhere to German banking capital requirements to conduct many securities activities.

brokers, and investment managers. If permitted by their member state regulator,[37] banks would be allowed to apply the investment services requirements for their short-term trading book activities[38] rather than the bank capital requirements. In addition, the directive would give regulators the discretion to apply hedging and diversification allowances in line with the more complex U.K. standards.[39]

U.K., German, and French Concerns About the Capital Adequacy Directive

In general, U.K. regulators as well as securities firm and bank representatives told us they support the current draft of the capital adequacy directive with reservations. Several U.K. regulators told us that the base capital requirement under the capital adequacy directive is still too high, especially because banks would be exempted. Another U.K. regulator said that the proposed directive is too flexible in its specification of position risk requirements and associated allowances for hedging and diversification. This flexibility, in the regulator's opinion, might permit some countries to set capital requirements that were too low and, thus, imprudent. One regulator also noted that while the directive includes financial futures, it excludes commodities futures, which are covered by the U.K. capital requirements. Finally, one U.K. bank representative said that it will be very difficult for universal banks to separately account for their trading books for daily mark-to-market and capital computations because their organizations are so closely integrated.

Regulatory officials and private sector representatives in Germany expressed reservations about the adequacy of the current draft of the financial services directive and said the debate on its provisions must continue. In particular, German officials were unsatisfied with provisions permitting a bank to apply the investment services capital requirements to its trading book instead of the bank capital requirements. They said these provisions might weaken the capital base of German banks and that it would be difficult to separate a bank's securities trading book from its credit-related activities. In addition, officials said that the initial capital requirements for securities firms were too low. They said that banks and securities firms should receive equal regulatory treatment.

[37]A member state could, under the proposed directive, require that its credit institutions adhere to the more stringent bank capital requirements instead of the alternative investment services requirements.

[38]A trading book represents a bank's proprietary positions in transferrable securities or derivative instruments. A bank enters these positions to earn a profit or to hedge other elements of the trading book.

[39]The directive's structure is very similar to existing U.K. capital regulations. It requires initial start-up capital whose amount depends on the firm's activities. It also requires additional capital based on position, counterparty, base, and foreign exchange risk requirements.

Although French regulatory officials did not express strong disagreement with the proposed capital adequacy directive, financial market participants in France told us that it offered too much flexibility to member states. They recognized, however, that bringing the different regulatory schemes of EC members under the same capital framework would be difficult.

Conclusions

IOSCO, the Basle Committee, and the EC have made some progress toward harmonizing capital standards for securities activities. U.S. regulators have been actively involved in IOSCO and Basle initiatives. In spite of the progress made, however, differences remain in each country's approach to determining the appropriate level of securities capital. These differences limit the ability of the three international organizations to reach agreement. Individual countries are reluctant to alter their domestic capital standards to satisfy the concerns of global securities markets. Although the EC has the power to compel its member states to comply with its final capital adequacy directive, IOSCO and the Basle Committee are voluntary organizations. Neither one can compel its members to adopt a capital standard. The failure of the EC, once thought to be setting the agenda on these issues, to reach agreement on investment services and capital directives shifts the burden back on IOSCO and the Basle Committee to reach agreement on a standard. If IOSCO and the Basle Committee reach such an agreement, the EC may follow their lead. In any case, negotiations are ongoing, and it is not clear when an international consensus will develop.

Harmonization Efforts Have Implications for U.S. Securities Markets and U.S. Capital Standards

To date U.S. securities regulators have not had to alter U.S. capital standards to satisfy international harmonization initiatives. Current U.S. standards meet the IOSCO framework, which is the only concrete proposal so far. Exactly what the outcome of these harmonization efforts will be or what changes to U.S. standards may be necessary are hard to predict.

U.S. broker-dealers told us that U.S. standards are too stringent, and therefore too costly, with respect to three issues. These issues involve recognizing the value of (1) uncompleted foreign trades; (2) an increasing number of marketable foreign securities; and (3) offsetting, or hedged, market positions. SEC officials have acknowledged these are problems and have acted to resolve the first issue. SEC is awaiting further industry proposals regarding the second issue. Resolving the third issue will be more complex, and the securities industry may have to take the initiative in proposing rules that recognize the value of offsetting or hedged market positions. However, as securities markets become more international in scope, the United States may have to adjust its capital standards not only to meet the needs of a changing domestic marketplace, but also to meet the competitive demands of international securities trading.

U.S. Capital Standards Have Changed in Response to Customer Protection Concerns, Not International Initiatives

U.S. securities firms hold large amounts of customer funds and securities. To protect these assets and ensure that firms have sufficient liquidity to meet customer demands, the Securities Exchange Act has always imposed a capital requirement on securities firms.[40] The act, as originally passed by Congress, imposed a net capital requirement on certain brokerage businesses. To overcome shortcomings in the statutory requirement, SEC in 1942 relied on more recently enacted statutory authority over securities firm financial responsibility to impose its own capital rule on the over-the-counter market. Over time, SEC modified its capital rule to increase customer protection, and it expanded the rule to apply to virtually all securities firms except members of major securities exchanges whose rules and settled practices imposed minimum capital requirements more comprehensive than those of SEC.

A financial crisis in 1969 and 1970 exposed serious weaknesses in exchange capital requirements.[41] Firms lacked sufficient and permanent capital, but they had almost unrestricted ability to use customer funds to finance their assets. As a result, Congress in 1970 passed the Securities

[40]See 17 C.F.R. Sec. 240.15c3-1.

[41]Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971).

Investor Protection Act and amended the Securities Exchange Act to give SEC express authority to issue rules governing securities firms' custody of customer funds and securities. In addition, Congress later directed SEC to issue a uniform capital rule for all registered securities firms by September 1, 1975.

In 1972 SEC promulgated the customer protection rule.[42] This rule placed restrictions on the use of customer securities and required securities firms to take possession or control of securities. The rule's possession or control and other requirements are meant to provide that in event of a liquidation the firm will have sufficient assets to cover customer accounts. Under the customer protection rule the securities firm must promptly obtain and maintain the physical possession or control of all fully paid and excess margin securities[43] carried for customers. The rule precludes a securities firm from using customer money to finance its business except as related to customer transactions (customer receivables). Firms may not use customer funds to finance their operations or proprietary trading activities. The Securities Investor Protection Act 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.

The SEC, in 1975, after lengthy discussion with industry groups, issued a uniform net capital rule that applied to all registered securities firms, including exchange members.[44] In addition to establishing an absolute minimum level of capital, the rule generally required firms to carry net capital equal to at least 6-2/3 percent of their total debt as defined, with some exceptions. The rule permits firms to use an alternative method of computing their capital requirements. Under the alternative method, a firm must carry net capital equal to at least 2 percent of the total amount of customer-related receivables as defined. Most large firms use the alternative method and carry substantially more than the minimum required capital.

In 1982 SEC adopted several technical amendments to the 1975 capital rules. For example, one change lowered the required minimum percentage

[42]See 17 C.F.R. Sec. 240.15c3-3.

[43]Excess margin securities in customer accounts are securities with a market value in excess of 140 percent of the debit balances (amount customers owe the firm). See Securities Regulation: Customer Protection Rule Oversight Procedures Appear Adequate (GAO/GGD-92-17, Nov. 21, 1991).

[44]17 C.F.R. Sec. 240.15c3-1. Although SEC net capital standards predate 1975 and originate in the Securities Exchange Act of 1934, Securities Exchange Act Release No. 11497 (June 26, 1975) broadened the standards coverage to all broker-dealers. Members of securities exchanges with more comprehensive capital requirements than SEC's were previously exempt from the rule.

of net capital to total customer-related receivables from 4 percent to 2 percent under one method of computing net capital. Another change raised the required capital for debt securities.

In January 1985 the SEC Directorate of Economic and Policy Analysis released an empirical study of the regulatory and business capital needs of securities firms.[45] The study examined how the capital needs of the securities industry have been affected by trends in the industry's financial structure and by regulatory change. It also analyzed the financing and regulatory capital needs of various kinds of securities firms. In addition, it projected that the 1982 amendments would reduce the regulatory capital needs of the industry by over $550 million by the end of 1982.

After the 1987 market crash, SEC concluded that the existing capital standards and the substantial excess capital levels that major firms voluntarily maintained had provided a reasonable safety margin for diversified firms. However, it decided that the following issues needed reexamination:

- the capital standard for options market makers,
- the minimum net capital requirements for different classes of securities firms,
- the level and structure of equity haircuts, and
- the activities of unregulated entities affiliated with registered broker-dealers.[46]

In September 1989 SEC proposed an increase in the absolute minimum net capital required of different types of securities firms. This proposal has not yet been adopted. In May 1991, SEC amended its capital standards to require that, under certain conditions, securities firms notify regulators when capital is transferred out of the firm.

The purpose of the capital standard and, therefore, most amendments to it, is to improve U.S. customer protection. However, in recent years, SEC has also changed the capital standard to enable U.S. securities firms to better compete in international markets. None of the changes previously discussed have been made to meet international capital requirements.

[45]The Financing and Regulatory Capital Needs of the Securities Industry Directorate of Economic and Policy Analysis, SEC (Washington, D.C.: January 1985).

[46]The October 1987 Market Break Division of Market Regulation, SEC (Washington, D.C.: Feb. 1988).

The Ultimate Effect of International Harmonization Efforts on U.S. Standards Is Difficult to Predict

The proposed IOSCO framework is so broad that many countries with capital standards meet all or a majority of the criteria. Nevertheless, many problems have to be overcome to reach agreement, even though IOSCO is negotiating more specific requirements, as is the Basle Committee. Without such specific requirements we cannot predict what effects harmonization will have on U.S. capital standards because we cannot specify the particular elements of the U.S. rule that might need changing. Also, it is unclear what effect maintaining higher or lower standards than specific harmonized international standards would have on the competitiveness of U.S. firms and markets.

Presumably, specific international standards will provide minimum requirements for every country. Because U.S. standards are among the most stringent in the world, and the IOSCO and Basle standards will be a compromise among all members, the international minimum requirements will probably specify less stringent requirements than the U.S. standards. SEC officials told us that it is unlikely that U.S. standards would be lowered to meet minimum international requirements.

Regulators and market participants had differing opinions about the effects of maintaining higher standards than the minimum required. Some suggested that firms and investors would seek markets with low capital standards to minimize their costs of trading. Others said the higher risks associated with lower capital standards would not be worth the costs that could be saved. They would seek markets that provided assurances through strict capital standards that the counterparty with whom they were trading could deliver the cash or securities traded. In any event, to the extent that these minimums will raise capital requirements in some countries, investors trading with firms subject to higher requirements will have less counterparty risk. Whatever the harmonized standards agreed upon, to the extent that U.S. standards provide more stringent requirements, U.S. firms trading internationally will be concerned about increasing costs.

Securities Firm Officials Have Specific Concerns About U.S. Capital Standards

Officials of U.S. securities firms with international operations told us they are concerned that the present stringent U.S. capital standards could inhibit the ability of U.S. markets and firms to compete internationally. They said that large institutional traders will seek international investment opportunities and the lowest possible trading costs.

On the other hand, U.S. regulators emphasized that these capital standards effectively protect investors and the financial system and are a primary reason that U.S. markets are among the strongest and safest in the world. They also said that securities firms are always concerned about costs. Nonetheless, SEC has changed capital standards to respond to industry concerns that the value of uncompleted foreign trades is not recognized in determining capital adequacy. SEC is awaiting further industry proposals regarding the second concern—that the value of foreign securities is not adequately recognized as capital in the U.S. standards. As for the third concern—that the value of offsetting, or hedged, market positions is not adequately recognized in U.S. capital standards—the securities industry also may best resolve the issue through self-initiated efforts.

SEC Has Revised Its Standards to Recognize the Value of Uncompleted Foreign Trades

SEC's current capital standards require firms whose trades in U.S. markets remain unresolved past the normal clearance and settlement cycle to take a capital charge. Thus, it encourages firms to resolve these trades quickly. Trades that U.S. securities firms made in foreign markets, which have longer clearance and settlement cycles, were previously subject to the same time constraint and subsequent charge. Officials of U.S. firms told us this regulation created a disincentive for trading in foreign securities. In response to an industry proposal, SEC changed its capital standards in August 1990 to recognize the longer foreign clearance and settlement cycles.

When a securities trade is made, time elapses between when the trade is arranged and when the money and securities are exchanged. In the United States this period is usually 5 business days. Any delay in the final exchange past the 5-day period increases settlement risk, a risk that the trade cannot be completed at the agreed-upon price. SEC's net capital rule recognizes this risk by requiring firms to take a charge on the value of certain contracts outstanding for longer than 5 business days and a charge to capital for other contracts outstanding for longer than 30 days. This treatment of "fails to deliver" or "fails to receive," as these transactions are called, results from the excessive number of fails that occurred during the financial and operational crisis of the late 1960s and early 1970s. During that period, increased trading volume, coupled with the inability of brokers and dealers to handle the expanded paperwork, caused the number of "fails" to reach unprecedented levels.

In November 1988 the Capital Committee of the Securities Industry Association[47] proposed a change in SEC's capital rule requirements for capital charges related to failed contracts of foreign-issued and foreign-settled securities. The committee noted that several countries with well-established markets had settlement periods substantially longer than those in the United States and that U.S. securities firms trading in some of these markets were assessed capital charges that exceeded the risk involved.[48] The committee recommended that capital charges for fails-to-deliver on a foreign security be based on the timing of the fail—the longer the fail to deliver period, the higher the haircut imposed. The aging period would begin when the issuing country's customary settlement cycle ended. The committee also submitted a similar proposal to SEC in June 1988 for assessing capital charges for fails to receive.

In letters of June 1988, June 1989, and August 1990, SEC modified its treatment of settlement risk. In these letters SEC stated that settlement risk should consider

- the length of the foreign settlement cycle and
- the age of the uncompleted transaction after the customary normal foreign settlement cycle.

SEC Could Change Its Treatment of Foreign Securities

The second issue of concern involving U.S. securities markets and international harmonization efforts involves the treatment of foreign securities. SEC's capital standards presently state that certain securities of a foreign company qualify for haircuts of less than 100 percent of the current market value of the security. These securities must be publicly issued in a principal foreign market and listed on one of the major exchanges outside the U.S.—which SEC defines as a "ready market." Securities of all other foreign companies require a 100-percent haircut, which means they have no value when calculating a firm's net capital. Some U.S. securities firm officials told us that additional foreign securities should be recognized as having ready markets and that not doing so discourages U.S. trading in these securities.

[47]The Securities Industry Association represents over 500 securities firms headquartered throughout the United States and Canada.

[48]For example, the United Kingdom allows 5 days to elapse for a margined transaction. For an equities transaction, firms are required to start holding capital at 25 percent of the market risk after 30 days, with a sliding scale going up to 100 percent after 90 days. One reason for this difference with the U.S. rule is that settlement in the United Kingdom takes up to 14 days.

SEC issued its guidance on foreign securities in December 1975. The guidance defined the term "ready market," specified the criteria to be used in determining which exchanges qualify, and recognized 12 foreign exchanges in 11 countries that met these criteria.[40] Since 1975 new foreign securities markets have been established, and the volume of trading in foreign securities by U.S. securities firms outside these 12 markets has increased significantly. However, more markets may qualify as ready markets under SEC's definition. Opening these markets to U.S. trading would enhance market opportunities.

SEC's 1975 criteria stated that a ready market for equity securities exists when (1) the securities of the foreign issuer are publicly issued in a principal foreign market and (2) the securities are listed on one of the principal exchanges in the major money markets outside the United States.

Because international trading has expanded greatly since 1975, the number of potential principal foreign markets has increased, and more foreign securities may thus be eligible for ready market designation. For example, while the United States recognizes only 12 foreign exchanges as ready markets, the United Kingdom recognizes 80 exchanges from 24 countries. Japan recognizes foreign equities listed on the exchanges of all other countries. The EC would recognize securities listed on an exchange in an EC member state or in a country outside the EC that is recognized by a member state. Other potential ready markets include Italy, Spain, and the Scandinavian countries because active markets for securities from these countries are developing.

Statistics on the number of companies listed, the number of shares traded, and the market value of shares in these countries show their size and trading activity. In Italy, 220 companies were listed and 15.7 billion shares were traded in 1990. The market value of Italian securities was more than $44 billion in 1990. In Spain, 429 companies were listed on the Madrid Exchange and 481 companies were listed on the Barcelona Exchange; 1.8 billion shares were traded on the Madrid Exchange in 1990. The market value of Spanish securities was more than $43 billion. In Sweden, 132 companies were listed and 601 million shares were traded in 1990. The market value of Swedish securities was more than $16 billion.

In November 1989 the Capital Committee of the Securities Industry Association requested a ruling from SEC on the applicability of the capital

[40]These included exchanges in Amsterdam, Brussels, Frankfurt, Johannesburg, London, Luxembourg, Montreal, Paris, Australia, Tokyo, Toronto, and Zurich.

standards to certain foreign securities. The committee said that SEC's interpretation of ready market contained in the 1975 letter disadvantages U.S. broker-dealers in the global marketplace because the interpretation no longer accurately assesses the liquidity of foreign securities. The association said that this interpretation results in onerous haircuts on certain securities that trade in demonstrably liquid markets.

SEC is currently considering how to account for the risk of holding foreign securities. SEC told the Capital Committee that the proposal contained in this letter should be reworked.

SEC officials told us that their approach is a conservative one and they are concerned that simply adding exchanges to the list of approved countries may be problematical because merely listing a security on a foreign exchange does not necessarily mean the security is liquid. They said SEC does not want to recognize illiquid securities and markets. They said that although the exposure of large securities firms to individual foreign securities from one country is small, certain firms specialize in securities from one country. Even though securities from a particular country may be liquid, the prices may be especially volatile, and such volatility may put a specialized firm at risk. SEC officials also told us that they would like to see a general concept developed by the securities industry that would be simple to apply to securities listed outside the countries recognized in the 1975 letter.

On August 6, 1991, SEC recognized a ready market for certain securities from the Mexican Stock Exchange on the basis of volume and market valuation. SEC officials said their concerns about the liquidity of a particular foreign security center around the volume of trading, the existence of quotation and price dissemination systems, the number of financially sound intermediaries trading in the market, the availability of information concerning the issuers of the securities traded in the market, and the nature of the regulation of the market. SEC recognized a ready market for Mexican issues that have both of the following characteristics:

- The average month-end market capitalization for the last 6-month period was at least $750 million, where the market capitalization at any month-end for the previous 12 months was not less than $400 million.
- The average monthly trading value for the last 6 months was at least $10 million, and the monthly trading value during the previous 12 months did not fall below $3 million.

As of August 1991, 11 equity securities listed on the Mexican Stock Exchange qualified for ready market treatment.

The Securities Industry Must Take the Initiative to Alter the Treatment of Hedged Market Positions

The third issue of concern involves the treatment of hedged market positions. Securities firms use many strategies to reduce or hedge their market risks. These strategies range from taking single offsetting positions in two different financial instruments to much more complex strategies involving several products or markets. The purpose of these strategies is to limit the losses that might occur if market prices move in the opposite direction from the one the firm anticipated. SEC's capital standards recognize fewer hedging strategies than the securities industry would like. For most of these risk reduction techniques, SEC requires haircuts or "capital charges" for each position taken. SEC officials told us that because of the many strategies used and the difficulty in determining their effectiveness in reducing market risk, modifying the capital standards to generally recognize these hedged positions would be difficult. They said they have no plans themselves to develop general capital standards for hedging but would consider specific securities industry proposals.

SEC has recognized some hedging strategies. For example, individual and institutional investors maintain stock portfolios of various combinations and quantities of stocks. Hedging with futures and options provides investors with a means to reduce their exposure to market risk when portfolio turnover is constrained by transaction costs, investment policy, or tax considerations. Investors hedge these portfolios by buying or selling futures or options contracts. One common hedging strategy for a portfolio manager who does not wish to liquidate stocks in anticipation of a market decline is to protect the value of a portfolio by selling stock index futures or buying stock index put options. Another common hedging strategy for a portfolio manager who is awaiting cash flows to make stock purchases and who is anticipating a stock market rally is to buy index futures or stock index call options to lock in current prices. Stock portfolios may not exactly mirror the index futures or options product used in the hedge. In a February 1986 letter, SEC recognized the percentage of the position that is offsetting by lowering the amount of capital required and requiring a haircut on the remaining percentage as if it was unhedged.

Sophisticated investors use much more complex hedging strategies. Determining the value of these and the capital needed to support the risks involved is a complicated task. Establishing capital standards that would apply generally to a wide variety of hedging strategies has been difficult. If firms want the capital standards to recognize these hedging strategies, they will have to give SEC information on the particular hedge, suggest how it might be valued, and provide an analysis of the risks involved and the capital needed to support those risks.

According to some U.S. market participants, SEC's limited acceptance of hedging has resulted in haircuts that are excessive relative to the risks incurred and, therefore, fails to recognize the benefit of hedging strategies. The firms we talked to, however, pointed out that some foreign standards—particularly those in the United Kingdom—recognize a wider variety of hedging strategies than the U.S. standards and might encourage U.S. firms to move their hedging activities overseas.

Although SEC has not revised its hedging standards since 1982, SEC has made a number of technical changes to the requirements. In December 1984 SEC issued a letter to NYSE, the Chicago Board Options Exchange, and the American Stock Exchange in which it recognized, by lowering the amount of capital required, the risk-reducing features of maintaining cross-hedged[50] and spread positions[51] among such products as security options on stock market indexes and commodity options on futures contracts.

In February 1986 SEC issued a letter to the Philadelphia Stock Exchange that recognized the risk-reducing features of maintaining offsetting positions in forward contracts[52] obtained in the interbank market and options in the seven major foreign currencies. And in November 1986 SEC approved amendments to the net capital rule that, among other things, recognized hedged positions between nonconvertible fixed-income securities and U.S. government bond futures.

In May 1991, the Options Clearing Corporation[53] submitted a proposal and supporting documentation for risk-based haircuts on certain classes of options positions. SEC officials told us they are examining the proposal. In July 1991, SEC recognized certain positions in foreign currency options and foreign currency futures as offsetting. SEC officials told us they currently

[50]Cross-hedged positions consist of offsetting stock index options and futures.

[51]Spread positions are the simultaneous buying of one derivative contract (i.e., options or futures contract) and the selling of another derivative contract in the expectation that the relationship will change and yield a profit upon offsetting.

[52]A forward contract is a transaction in which the buyer and seller agree upon delivery of a specified quality and quantity of goods at a specified future date at a specified price.

[53]The Options Clearing Corporation clears all options contracts on the six options exchanges.

recognize what they consider to be legitimate hedges, but they are willing to consider evidence that other trading strategies not currently considered under the capital standard are legitimate hedges.

Balancing Customer Protection and Competitive Considerations

U.S. regulators have emphasized customer protection in establishing and modifying their capital standards. As a result, U.S. standards impose greater costs on firms than the capital standards of some other countries. The U.S. standards have had little effect on domestic competition because all firms are subject to the same regulatory costs. However, without harmonized international capital standards and with increased international trading, the U.S. capital standard may become an important competitive issue. Some firms seeking lower operating costs, and willing to accept the increased risks, can do business in countries with less costly capital requirements. Although the cost of maintaining capital to satisfy capital requirements is only one of many factors that securities firms and banks consider when locating a securities business, they told us it is an important consideration.

If efforts to harmonize standards internationally are unsuccessful, future deliberations about changes to U.S. capital standards may not only have to consider customer protection issues but also may have to consider the competitive implications. Strong U.S. capital standards are critical to the stability of U.S. securities markets. They help provide market integrity and attract securities business to the United States. Yet if U.S. standards are so stringent as to be onerous, they may encourage securities businesses to operate in other, perhaps less well-regulated, environments. It is not clear, however, whether and how much securities business is done outside the United States as a result of its strong capital standards.

Conclusion

Determining the extent to which U.S. capital standards become an important competitive issue as international trading develops and expands depends on whether standards can be harmonized internationally and what those standards are. To the extent that international harmonization efforts are successful, and U.S. standards are close to the harmonized standards, the competitive issue may not be of great importance. Investors will continue to seek safe and sound markets in which to invest their money, and capital standards that contribute to such markets will continue to provide important incentives to invest. However, for U.S. markets to remain competitive as international trading increases, the U.S. securities industry and its regulators will need to continually reassess whether, in light of increased international trading and of different international capital standards, U.S. capital standards are appropriate. This reassessment may include readjusting the balance between the need for more customer protection against the need to minimize the costs of trading.

At the industry's request, SEC has adjusted its capital standards to recognize the value of uncompleted foreign trades. It also needs to consider revising its capital rules to recognize the increasing marketability of foreign securities.

Industry participants continue to express concerns about the capital standards' treatment of hedging techniques as risk-reducing mechanisms. Because of the complexity of these techniques, it is probably not possible to deal comprehensively with the question of how best to accommodate the risk-reducing effects of such techniques into the capital standards. The industry will need to continue to make specific proposals that are designed to better align the standards with risks actually posed by hedging techniques.

Recommendation

We have no recommendation regarding the involvement of U.S. financial market regulators in international organizations seeking to harmonize international securities capital standards. However, with respect to the implications of these international efforts for U.S. securities markets and the U.S. securities capital standards, we recommend that the Chairman, SEC, consider revising its capital rule to recognize more foreign markets and more foreign securities as readily marketable under SEC's 1975 criteria and develop a mechanism to recognize additional foreign securities and markets as they develop.

Agency Comments and Our Evaluation

SEC generally agreed with our recommendation and is awaiting the proposal of the Securities Industry Association's Capital Committee on recognizing more foreign markets and securities. SEC said it would like to see a general concept developed that is consistent with the underlying purposes of the capital rule and is simple to apply to foreign securities now excluded from recognition under the U.S. capital standard. Given the increasing transnational activity in securities markets and the interests of U.S. securities firms competing globally, such a proposal and SEC action to update its treatment of the ready market issue should be submitted and completed as soon as possible.

Comparison of Capital Standards for Nine Countries Using IOSCO Framework

	Major markets		
Framework standard	**United States**	**Japan**	**United Kingdom**
Does the capital rule cover liquidity and solvency?	YES. A broker-dealer must have sufficient capital to close its business within a short period of time and to have sufficient liquid assets to meet liabilities including liabilities to customers. Assets not readily convertible into cash are given no value when computing net capital.	YES. In managing liquid assets a firm must maintain sufficient net worth to meet the obligations associated with any losses without having to suspend any operations or sell off any fixed assets.	YES. Rules are intended to (1) protect customers if the member fails, (2) link the capital required to the risk exposure occurring in daily operations, and (3) provide sufficient capital for a firm to withstand a period of reduced revenue.
Does the capital rule revalue positions based on current market prices (i.e., mark to market)?	YES. A securities firm must mark accounts to market at least daily. To determine net worth, all buy and sell positions of securities, options, and futures must be marked to market.	SOME. Listed securities are priced at market value before haircuts. Unlisted securities are priced at book value if an objective market price can't be determined.	YES. The Securities and Futures Association requires all positions to be marked to market.
Does the capital rule have a base requirement?	YES. A securities firm must maintain specified amounts of capital in relation to either its liabilities or its securities customer-related receivables. The basic method requires a securities firm to have net capital equal to at least 6-2/3% of aggregate indebtedness. The alternate method requires a broker-dealer to maintain net capital equal to the greater of 2% of customer-related receivables or 4% of required segregated funds. Under either method, there is a minimum requirement.	YES. The basic requirement is 1/4 of a securities firm's fiscal year operating expenses, excluding (1) prior rebates paid to nonmember brokers for handling their exchange trades and the portion of agents' commissions remitted abroad and (2) accrued interest paid on bonds. Also, total liabilities must not be more than 10 times net worth.	YES. The base requirement is the highest of (1) an established minimum for a particular type of firm, and (2) 1/4 (or 1/12 for clearing firms) of adjusted annual expenditures.

	Pacific markets		
Framework standard	**Australia**	**Hong Kong**[a]	**Singapore**
Does the capital rule cover liquidity and solvency?	YES. A securities firm must have sufficient liquid assets to cover existing liabilities. Generally, liquid assets must equal 105% of liabilities or meet a dollar minimum requirement, whichever is greater. Assets that cannot be liquidated within 30 days are excluded when calculating liquid capital.	YES. There are separate tests to cover liquidity and solvency. The solvency test requires "acceptable" assets to exceed liabilities by not less than a specified minimum; the liquidity test requires that net liquid assets exceed 10% of the base requirement for the solvency test.	YES. Only current assets are included in the adjusted net capital requirement computation. Fixed assets and overdue accounts are excluded.
Does the capital rule mark positions to market?	YES. Equity securities are marked to market daily or at least when adjusted liquid capital is calculated. All other assets, including loaned securities (such as bonds), are valued at the lower of cost or market value.	YES. Securities are marked to market for the measurement of house positions in the capital calculations.	YES. Securities are marked to market.
Does the capital rule have a base requirement?	YES. An exchange member is required to maintain adjusted liquid capital (excluding total liabilities) at 5% of aggregate indebtedness or meet a dollar threshold based on the corporate structure of the exchange member, whichever is greater.	YES. There is a minimum capital requirement and a liquidity margin requirement of 10% of capital. The fixed minimum capital requirement for corporations is currently 5 million Hong Kong dollars and approved assets must exceed liabilities by this amount. Liquidity margin is 10% of this minimum and liquid assets must exceed liabilities by this amount.	YES. The adjusted net capital shall not be less than 3 million Singapore dollars at all times. Aggregate indebtedness cannot exceed five times the adjusted net capital.

[a]The Hong Kong Securities and Futures Commission is currently redrafting its capital standard, and new proposals were due to be distributed in a consultation paper in January 1992.

Framework standard	European markets: France[b]	Germany	Switzerland
Does the capital rule cover liquidity and solvency?	YES. Capital must exceed both liquidity and solvency ratios. The purpose of the capital adequacy requirement is to link risk coverage to proprietary positions and to link the risk to the level of the broker's activity.	YES. As a universal banking country Germany's capital requirements apply only to banks. Their purpose is to protect depositors. The Banking Act requires banks to place their funds so that solvency is always assured.	YES. As a universal banking country, Switzerland has its securities activities done primarily by banks. The primary purpose of capital is to protect depositors; the secondary purpose is to ensure that banks retain an emergency supply of liquidity lasting 1 or 2 weeks.
Does the capital rule mark positions to market?	YES. All positions are recognized on a trade date basis and required to be marked to market.	NO. Capital is conservatively defined as reserves. Banks maintain assets and securities at book value or acquisition costs.	NO. Banks maintain assets and securities at book value and do not mark to market.
Does the capital rule have a base requirement?	YES. It is based on business volume and equals 66% of the clients' total position.	NO. There is no base requirement for the securities activities of German banks. The intent is to develop an exchange entry requirement.	YES. The base requirement is 2-1/2% of average short-term liabilities.

[b]The French financial market system is a mixed system. Although it is a universal banking country, France has a separate securities regulator and separate securities regulations. The capital standard described in this appendix is the Societe Des Bourses Francaises rule for French brokerage firms and does not apply to the securities activities of banks. The capital standard for the securities activities of banks is under a separate set of banking capital rules.

	Major markets		
Framework standard	**United States**	**Japan**	**United Kingdom**
Does the capital rule have a position risk requirement?	YES. A firm must deduct specific percentages from the market values of marketable securities and futures contracts to provide a margin of safety against losses incurred as a result of market fluctuations.	YES. Specific risk requirements, based on specific risk weights, are deducted from the market value of equities and appraised value of bonds, as well as off-balance-sheet items, such as underwriting and guarantees. Additional risk requirements are deducted based on concentrated securities holdings in a single issuer and in a single stock. Hedging transactions may be netted against the underlying assets.	YES. The requirement provides a measure of capital needed to absorb losses arising from adverse changes in market prices that reduce the value of a firm's position.
Does the capital rule have a settlement risk requirement?	YES. This requirement is addressed through "fails to deliver and fails to receive."After a certain number of days the difference between the market value of the security and the contract value is deducted, and in the case of a fail to deliver, a further deduction is made.	YES. Settlement risk is calculated for principal-to-principal transactions by deducting the results of applying counterparty risk weights to credit extended under each instrument.	YES. The requirement depends on the type of transaction (e.g., debt, equity, warrant, etc.) and the time elapsed since the original settlement date. This risk is calculated by applying certain percentages to the difference between the value of the balance and the current market value of securities underlying the transaction where a firm is exposed to a potential loss and where the balance has been outstanding for more than a specified period.
Does the capital rule require that capital should exceed the sum of risk-based requirements?	YES. Net worth–less illiquid assets, market risk, and counterparty risk–must exceed the base requirement.	YES. Net worth minus illiquid assets must exceed the market, counterparty, and basic risk requirements.	YES. Firms must maintain an excess of qualifying capital over total capital. Qualifying capital is used to support daily operations and should cover the risk associated with the business.

	Pacific markets		
Framework standard	**Australia**	**Hong Kong**	**Singapore**
Does the capital rule have a position risk requirement?	YES. A 15% haircut is applied to equity securities. Equity securities having no ready market value receive no value for liquid capital determination. No tiered approach exists to deal with degrees of liquidity. No haircuts are applied to loaned securities. No allowances are made for risk reduction measures. No provisions are made for risk reduction for concentrated positions.	YES. Haircuts based on the type of positions held, with different percentages being applied to different types of positions as a result of the risk deemed to attach to such positions, are provided for.	NO. Securities held by exchange members for their own account are marked to market. In addition, the amount of securities that an exchange member can hold for its own account is limited to a certain percentage of its adjusted net capital.
Does the capital rule have a settlement risk requirement?	YES. The 15% haircut applied to equity securities covers both position and settlement risk. The Australian Stock Exchange told us that the National Guarantee Fund eliminates the default risk among brokers.	YES. A 100% haircut on all 5-day-old receivables. The exchanges also have a fidelity fund to cover default risk among brokers. Further a 24-hour settlement period exists in Hong Kong and there are buying-in and selling-out provisions at the Hong Kong Stock Exchange.	NO. Client accounts that are 7 days overdue are marked to market with the deficit arising therefrom deducted against the member company's adjusted net capital. In addition, there is a limit on the member company's exposure to a single client.
Does the capital rule require that capital should exceed the sum of risk-based requirements?	NO. The Australian Stock Exchange capital standard does not address this concept.	YES. The capital rules have a series of adjustments and discounts to account for risk. These adjustments are made to the various assets, to allow for both position and counterparty risk. These reduced assets are then incorporated into the computations, which must exceed the minimum requirements.	NO. The capital standard does not address this concept.

	European markets		
Framework standard	**France**	**Germany**	**Switzerland**
Does the capital rule have a position risk requirement?	YES. Position risk is linked to house positions and is the total of equity positions (20% haircut; 8% haircut if cleared and hedged) and bond positions (4% haircut; .8% haircut if hedged).	YES. Basle credit risk requirements apply with an 8% charge for corporate securities and no charge for government securities.	YES. Basle credit risk requirements apply with an 8% charge for corporate securities and no charge for government securities.
Does the capital rule have a settlement risk requirement?	YES. On October 25, 1991, the rule was changed to account for settlement risk.	NO.[c] The capital NO. standard does not address this concept.	The capital standard does not address this concept.
Does the capital rule require that capital should exceed the sum of risk-based requirements?	YES. Required capital comprises minimum capital requirements, a base requirement, and position risk requirements. Capital requirements are then split into house and broker positions and subject to a ratio. The minimum capital required must exceed the greater of the computed house and the computed broker position, i.e., capital must exceed each account separately.	YES. Assets weighted for their risk cannot exceed 18 times (i.e., 5.5%) liable capital.	YES. Computation is based on assets and off-balance-sheet positions multiplied by applicable categories (i.e., each asset category has a capital charge ranging from 0% to 100%, based on the risk of the assets.)

[c]Under universal banking, settlement or counterparty risk is subsumed by bank credit risk, which applies to all bank activities, including securities activities.

	Major markets		
Framework standard	**United States**	**Japan**	**United Kingdom**
Does the capital rule set limits on subordinated debt?	YES. Capital requirements allow firms to use both short- and long-term subordinated loans as capital. Subordinated loans are limited relative to the owners' equity.	YES. Subordinated debt is not addressed in the capital rule because Japanese firms have not traditionally used subordinated debt. However, foreign firms are granted permission, on a case-by-case basis, to include subordinated debts as long as supplemental capital does not exceed base capital.	YES. Capital requirements allow qualifying short- and long-term subordinated loans and "permitted undertakings," which are a form of guarantee from a third party. Short-term subordinated loans can contribute to qualifying capital but not to base capital. Permitted undertakings must not exceed 30% of the base requirement.
Does the capital rule provide for differential minimum requirements?	YES. Under the SEC capital rule, the minimum capital requirement varies depending on the nature of the firm's activities. SEC has proposed new minimum requirements.	YES. Minimum levels of capitalization are required for securities companies according to the type of licenses they are granted and the kind of services they provide.	YES. The absolute minimum for most firms is 10,000 U.K. pounds. Clearing firms, which clear for other firms and assume responsibility for settlement with those firms' counterparts and inter-dealer brokers, are subject to minimum requirements of 250,000 U.K. pounds.
Does the capital rule provide for recordkeeping, reporting, and examination programs?	YES. A securities firm has various recordkeeping requirements documenting transactions and finances. A securities firm submits financial reports on a monthly basis. All firms are audited annually by their independent public accountant and are subject to periodic inspections.	YES. A securities firm has recordkeeping requirements concerning transactions and finances. Dealers submit monthly capital reports. No self-reporting of noncompliance is required. Firms are audited annually by an auditing authority and are subject to periodic inspections.	YES. The Securities and Futures Association has various requirements to monitor member capital, including submission of numerous reporting returns and requirements for immediate notification when excess firm capital moves more than a specified percent in an adverse direction.

Framework standard	Pacific markets: Australia	Hong Kong	Singapore
Does the capital rule set limits on subordinated debt?	NO. No limits exist on subordinated debt financing. However, all such financing and authority for repayment must be approved through an agreement among the Australian Stock Exchange, the lender, and the lendee.	YES. Subordinated loans are approved by the Securities and Futures Commission and the Stock Exchange for members of the Exchange and by the Securities and Futures Commission for nonmembers. Limits on subordinated debt financing do exist and are applied on a case-by-case basis by the Commission; a guideline is that subordinated loans would not be permitted to exceed 250% of shareholders funds.	YES. Limitations are placed on approved subordinated loans in that they cannot exceed 100% of a member's paid-up capital.
Does the capital rule provide for differential minimum requirements?	NO. The minimum capital requirements vary by exchange membership category. However, categories are based on organizational structure and not on the type of business conducted.	YES. There are different minimum requirements for corporations, sole proprietors, and partnerships. The rules are the same for both Stock Exchange members and non-Stock Exchange members.	NO. The same adjusted net capital requirement of 3 million Singapore dollars is applicable to all exchange members.
Does the capital rule provide for recordkeeping, reporting, and examination programs?	YES. A securities firm has recordkeeping requirements for documenting transactions and finances. Securities firms must submit monthly reports on liquid capital levels and detailed quarterly reports of balance sheet accounts and statistical data. Self-reporting of noncompliance is required. Firms are audited annually by an auditing authority and are subject to periodic inspections.	YES. A securities firm has recordkeeping requirements for transactions and finances. Securities firms must submit quarterly financial reports if they are exchange members and report annually if they are not exchange members. Self-reporting of noncompliance is required. Firms are audited annually by an auditing authority and are subject to periodic inspections.	YES. A securities firm has recordkeeping requirements for documenting transactions and finances. Securities firms must submit monthly reports on capital levels. Self-reporting of noncompliance is Required. Firms are audited annually by an auditing authority and are subject to periodic inspections.

	European markets		
Framework standard	**France**	**Germany**	**Switzerland**
Does the capital rule set limits on subordinated debt?	YES. Capital consists of share capital plus reserves plus debt minus intangible fixed assets. Capital includes subordinated loans, which must be approved regulatory capital and must not exceed 300% of net worth. Capital also includes guarantees from banks for the members of the stock exchange and the futures exchange. Guarantees may not exceed 3 times net worth.	YES. Current law does not allow subordinated debt.	YES. Subordinated debt can be no more than 25% of required capital.
Does the capital rule provide for differential minimum requirements?	YES. There is a 12.5 million French franc requirement for broker/agency activity only. There is a 25 million French franc requirement for brokering and trading on a proprietary account. There is a 37.5 million French franc requirement for proprietary trading and clearing for self and others, and an additional 12.5 million French franc requirement for each account cleared. There is a 50 million French franc requirement if brokering, trading on own account, and clearing for self and others and an additional 12.5 million French franc requirement for each account cleared.	NO. All banks have a 6 million German mark requirement.	NO. All banks have a minimum requirement of 2 million Swiss francs. It is suggested that international banks have 20 million Swiss francs. Regulators suggest that bank-like finance companies have 2 million Swiss francs.
Does the capital rule provide for record keeping, reporting, and examination programs?	YES. Capital is computed daily and reported monthly. The regulatory authority examines and compares financial ratios.	YES. A bank has to comply with a wide range of reporting requirements, including a monthly report on on- and off-balance-sheet items, solvency, and liquidity.	YES. Banks and finance companies must comply with numerous reporting requirements, including monthly, quarterly, and annual liquidity computations. Capital calculations must be made semiannually and filed with a consolidated balance sheet, but capital is required to be maintained permanently.

Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

December 18, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am writing in response to your November 8, 1991 letter to Chairman Richard C. Breeden requesting the comments of the Securities and Exchange Commission ("Commission" or "SEC") on the General Accounting Office's ("GAO") draft report entitled Securities Markets: Challenges to Harmonizing International Capital Standards Remain.

The draft report indicates that the SEC, through its participation in international organizations, has taken a lead role in international efforts to harmonize capital standards for securities activities worldwide to assure that the results will provide adequate protection for investors and financial systems. It states that Mr. Breeden is "Chairman of the Technical Committee of the [International Organization of Securities Commissions ("IOSCO")] -- a key policy-setting committee that is working to harmonize capital standards." It notes that the SEC is an active participant in working groups of IOSCO and the Basle Committee on Banking Supervision that are working on harmonization efforts. The draft report makes "no recommendation regarding the involvements of U.S. financial market regulators in international organizations seeking to harmonize international securities capital standards."

The draft report, however, recommends that the SEC "consider revising its capital rule to recognize more foreign markets and more foreign securities as readily marketable under SEC's 1975 criteria and develop a mechanism to recognize additional foreign securities and markets as they develop."

I welcome the opportunity to address the recommendation suggested in the draft report.

As the draft report indicates, the Commission's net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 (the "Rule"), is a liquidity-based standard designed to provide that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers and counterparties and to cover

Mr. Richard L. Fogel
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potential market and credit risks. The Rule helps promote the financial viability of, and public confidence in, the securities industry and the financial system by protecting both customers and other broker-dealers from risks and exposures in the broker-dealer.

In determining a broker-dealer's net capital under the Rule, the broker-dealer deducts from net worth, as computed in accordance with generally accepted accounting principles, assets not readily convertible into cash, unsecured receivables and certain percentage deductions related to the securities positions that it carries. The Rule includes a 100 percent deduction for securities held by the broker-dealer for which there is not a ready market.

Generally, for domestic equity securities, the Rule has recognized as liquid those securities which are traded on the United States securities exchanges, National Association of Securities Dealers Automated Quotation System securities and in addition certain other over-the-counter securities where the broker-dealer can demonstrate that there are independent market makers for the security who quote the securities in an inter-dealer network.

In December, 1975, the Division of Market Regulation (the "Division") issued an interpretive letter in which it stated, among other things, that only foreign equity securities that are publicly issued in a principal foreign market and are listed on one of the principal exchanges in the major money markets outside the United States are deemed to have ready markets and receive haircuts similar to comparable United States securities traded on United States markets. The Amsterdam, Brussels, Frankfurt, Johannesburg, London, Luxembourg, Montreal, Paris, Sydney, Tokyo, Toronto, and Zurich Exchanges were deemed to be "principal exchanges in the major money markets."

In August 1991, the Division recognized eleven Mexican securities, listed on the Mexican Stock Exchange as having a ready market, based on market valuation and trading activity as measured in both shares traded and dollar volume (i.e., trading value). In making this determination, the Division was primarily concerned with the liquidity and the reliability of the particular market and reviewed such factors as the volume of trading, the existence of quotation and price dissemination systems, the number of financially sound intermediaries trading in the market, the availability of information concerning the issuers of the securities traded in the market, and the nature of the regulation of the market.

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As noted in the draft report, in November 1989, the Securities Industry Association's ("SIA") Capital Committee submitted a proposal to the Division setting forth standards for determining the marketability of foreign securities for purposes of satisfying the requirements for a ready market. After examining the proposal, the Division staff asked the SIA Capital Committee to rework its proposal and resubmit it. After the SIA Capital Committee has resubmitted its proposal, we will consider whether to recognize more foreign markets and more foreign securities as readily marketable and the appropriateness of whether to develop a mechanism to recognize additional foreign securities and markets as they develop.

The draft report indicates that "[s]ome U.S. securities firm officials told [the GAO] that additional foreign securities should be recognized as having ready markets and that not doing so discourages U.S. trading in these securities." The draft report also indicates that designating more markets as readily marketable would open these markets to U.S. trading and would enhance market opportunities.

See ch. 4, p. 91.

The Division is cognizant of these concerns. On the other hand, the capital rule protects investors, the securities industry and the financial system. It is one of the reasons the U.S. markets are the strongest, safest, and most liquid in the world. The focus of the Rule is on liquidity and the Division does not want to recognize illiquid securities and markets. While the exposure of large securities firms to individual foreign securities from one country may be small, certain firms specialize in securities from one country. Even though securities from a particular country may be liquid, the prices may be especially volatile, and such volatility may put a specialized firm at risk. The Division would like to see a general concept consistent with the underlying purposes of the Rule developed by the SIA Capital Committee which would be simple to apply to securities listed outside the countries recognized in the 1975 letter and in our 1991 letter.

The Division appreciates the opportunity to comment on the draft report. We would be happy to meet with GAO staff at your convenience to discuss our comments further. If you have any questions regarding this letter, please feel free to telephone me at (202) 272-3000.

Sincerely,

William H. Heyman

William H. Heyman
Director

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Related GAO Products

Bank Powers: Bank Holding Company Securities Subsidiaries' Market Activities Update (GAO/GGD-91-131, Sept. 20, 1991).

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

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Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation (GAO/GGD-86-83, Sept. 30, 1986).

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