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Remarks of

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SEC RESPONSES TO SECURITIES MARKET PROBLEMS AFTER OCTOBER 1987

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SEC RESPONSES TO SECURITIES MARKET PROBLEMS AFTER OCTOBER 1987

It is a great pleasure to be here today to address the Conference Board on the issues being considered in the wake of the market events of last October. Needless to say, the recent disruptions in the world's securities markets have placed special responsibilities upon all of us who are charged with market regulation duties. I welcome the opportunity to describe what we have learned from recent market events, to describe some of the measures the Securities and Exchange Commission thinks will help to make our markets more efficient, and to give you some views regarding the future of securities markets worldwide.

I. Review of October Decline

Understanding of the market break will be aided by a description of current institutional investing practices in our markets. During the last decade, institutions have amassed ever larger portfolios of equity securities. Increasingly they desire to trade in the equivalent of all or a portion of their portfolios. This desire has been satisfied in part by the creation of index trading. It is now possible to buy or sell the equivalent of a portfolio of securities by buying or selling an option or futures index product. It is also possible to do so by buying or selling a portfolio or "basket" of stocks directly by routing orders to buy or sell up to 3,000 shares of as many as 450 listed stocks to the New York Stock Exchange through the Exchange's automated Designated Order Turnaround system, called DOT.

In connection with portfolio trading (sometimes called "program trading"), some large institutions also have developed sophisticated index arbitrage and portfolio insurance strategies.

Index arbitrage is the purchase (or sale) of stocks that comprise an index and the simultaneous sale (or purchase) of futures or options on that index. The purpose of such trading is to capture the difference between the value of the index and the collective value of the portfolio of stocks comprising the index. Arbitrage usually reduces differences in prices between the stock index futures and stock markets by pushing up prices in the market where the buying occurs and pushing down prices where the selling occurs. By helping to achieve closer price correlations between the stock index futures and stock markets, arbitrage facilitates the use of futures to protect or "hedge" the value of stock portfolios. The most obvious hedging technique involving futures is the sale of a stock index future by the owner of a portfolio of stocks. The stock index futures position will increase in value as the prices of the underlying stocks decline, thus protecting the portfolio owner against market decreases without requiring the sale of the portfolio securities.

"Portfolio insurance" is a hedging strategy that was in widespread use in the United States before the October market break. Under one version of this strategy, stock index futures are sold when the value of the portfolio decreases a certain percentage. The sales of futures are thought to be easier and quicker than the sale of stocks, thereby offering a means of controlling risk for a broad-based portfolio in a declining market. If the futures markets become congested and too costly, some portfolio insurance plans call for the sales of stock instead of futures.

With this brief description of current trading practices by some large institutions in mind, let me describe the markets of last October. During the week preceding October 19, so-called Black Monday, the Dow Jones Industrial Average (the "Dow") dropped 250 points. On Friday, October 16, the stock market had its first triple-digit loss, as the Dow declined 108 points on then-record volume of 344 million shares. Then, on Monday, October 19, the Dow fell 508 points on record volume of more than 600 million shares. On October 20, volume also exceeded 600 million shares, in an extremely volatile market. On the 20th the market rallied to close up 103 points, but only after a mid-day crisis during which the Dow Jones dropped to a 1987 low of 1,708, more than 1,000 points and 37 percent below the August 25, 1987 all-time high of 2,722. During this mid-day period, a large number of blue chip stocks were closed for trading on the New York Stock Exchange, with large imbalances on the sell side.

What caused the market break? According to the Presidential Task Force on Market Mechanisms, selling during the week of October 12th was triggered primarily by "disappointingly poor merchandise trade figures, which put downward pressure on the dollar in currency markets and upward pressure on long term interest rates; and the filing of anti-takeover tax legislation...."1/

These factors, in conjunction with other economic news and the Friday stock price decline, created great selling pressure on Monday, October 19th. These pressures were exacerbated on October 19th and 20th by large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance strategies. During certain critical trading periods on October 19 and 20, index arbitrage or portfolio insurance or both accounted for between 30% and 65% of total New York Stock Exchange volume in the stocks that comprise the S&P 500 index. These figures lead to the conclusion that on October 19 and 20, institutions holding multi-billion dollar portfolios simultaneously pursued similar strategies in a declining market, causing a rush for the exits that accelerated the decline and most probably extended it beyond levels that can be accounted for by fundamental economic factors alone.

Extreme stock price volatility continued through the end of October. While the markets are more stable now than last October, they remain more volatile than before the market crash, as the 140 point loss on January 8, 1988, vividly demonstrated.

II. SEC's Recommendations

During the week of October 19, I asked the Commission's Division of Market Regulation to conduct a study of the market break. On February 2, the staff released a six-pound tome

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1/ Report of Presidential Task Force on Market Mechanisms, p.29 (January 1988).

containing a detailed reconstruction of trading in the stock, options, and futures markets during October and a discussion of the impact of that trading on market facilities and participants. The study also contains staff suggestions addressing problems in our market systems during October, as well as suggestions regarding steps that could be taken to dampen market volatility.

The day after the staff study was released, I appeared before the Senate Banking, Housing and Urban Affairs Committee and described the Commission's recommendations regarding the October market break. I reported the Commission's conclusions that our current market for securities is a linked market formed by stock index futures, stock index options, and stocks, and that under current conditions new institutional trading mechanisms and strategies in this linked market can cause extraordinary peak volume and volatility.

The Commission has recommended three broad approaches for reform of the markets: (1) expanding the capacities of the markets; (2) increasing the coordination among the markets; and (3) retarding the volatility and volume of trading during crisis periods.

The Commission intends to emphasize the first two approaches: that is, expanding the capacities of our markets and increasing intermarket coordination. The Commission believes that in normal times the derivative index markets perform an important economic function. They provide a means by which institutions may adjust their portfolio positions quickly and efficiently. By focusing on its two primary recommendations for expansion and coordination, the Commission is suggesting that the interlinked market should be made more efficient. We do acknowledge, however, that steps need to be taken in the near term to decrease liquidity demands and avoid the selling excesses that have caused such unusual volume and volatility.

A. Enhance Stock Market Automated Systems

What specific steps can we take to expand the capacities of this new unified, and often turbulent, market? One of the first things we can do is enhance the ability of our markets to handle trading volume surges. The 600 million share volume on the New York Stock Exchange on October 19 and again on October 20 was nearly double the previous one-day high for trading volume. Prior projections that trading volume on the New York Stock Exchange would increase steadily from daily averages of less than 200 million shares to daily averages of about 300 million shares have been shattered, and we have been put on notice that systems must be expanded to cope with large volume.

The key to improvement will be the expansion of the stock exchange systems that are designed to receive orders electronically from brokerage firms and in some cases to execute these orders automatically. With the exception of basket trades, most of the orders handled by these systems are small orders for retail customers. The New York Stock Exchange's Designated Order

Turnaround, or DOT, system, to which I referred earlier,2/ accounts for over two-thirds of the average daily order volume at the New York Stock Exchange. As I have indicated, in addition to being used to route small orders, DOT is used by institutions to route very large stock orders associated with program trading and index arbitrage. During October 19 and 20, the automated systems on the New York Stock Exchange were clogged by the increased volume. The NYSE systems as well as those of the regional exchanges had back-ups of orders for execution, sometimes as long as two hours. As a result, individual investors had difficulty getting smaller stock orders executed during this period.

In a sense the advent of automated trading systems for stocks has increased risks for our markets. Increased reliance on automation means there is a greater need to increase efficiency, because when automation breaks down the entire market is affected. The Commission has recommended that the exchanges modify order routing and support systems to improve the efficiency of their systems during peak volume periods and enhance communications regarding trading delays. Our job is to assure that the markets enhance the capacities of their automation facilities so that markets do not falter due to lack of physical capacity. I am pleased to report that a number of the stock exchanges already have

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2/ The American (PER), Cincinnati (NSTS), Midwest (MAX), Pacific (SCOREX), and Philadelphia (PACE) Stock Exchanges, and the National Association of Securities Dealers (SOES) also operate automatic order routing or execution systems for stocks.

increased the number of trades their automatic order routing and execution systems can accommodate, or will do so shortly.

B. Increased Capital

Another step that should be taken to enhance the trading capacities of our securities markets is to increase the amount of capital for certain market professionals. Stock specialists, who are required by exchange rules to help maintain fair and orderly markets for their assigned stocks, assumed large positions during the market's fall on October 19. In some cases specialists did not have capital sufficient to allow them to continue buying. Accordingly, the Commission is examining the need to increase minimum specialist capital requirements.

Another important aspect of the specialist capital problem is that specialists' capital alone may not be sufficient to provide adequate liquidity when a massive sell-off occurs. It is important that all market participants, and particularly specialists, review with their bankers and other lenders the availability of additional liquid funds in emergency situations. It is especially important that market participants take steps to see that bank lending officers thoroughly understand the intricacies of our securities markets, including the fact that the term "volatility" implies price recovery as well as price declines.

If my last point is correct, capital needs of specialists caused by market volatility will be relatively temporary. The Commission has recommended exploration of creation of a new private pool of capital that will be available to specialists in times of emergency. This proposal is not without its difficulties, but it seems reasonable that a capital fund to provide loans to specialists in rapidly declining markets would serve an important function.

A third method of increasing liquidity may be to encourage specialists to hedge their positions through the options markets. A specialist who buys stocks in a market decline should be able to hedge some of the risk of holding those stocks by buying put or selling call options on his individual specialty stocks. General market risk also can be hedged through purchase of index option puts or through sale of index call options or index futures. One might note here that the ability to engage in hedging transactions in the options and futures markets depends upon the effective functioning of those markets and also upon the efficient linkage of the stock, options, and futures markets. This point further emphasizes the need to improve market systems.

A fourth aspect of the capital problem relates to the availability of intra-day capital in the stock, options, and futures markets. In the options and futures markets intra-day margin calls can create liquidity problems for market participants and their clearing firms. If payments are not made promptly, those relying on those payments may in turn experience liquidity problems. Attention to this aspect of the payments system as well as to questions of general capital availability will be pursued by the SEC and the Commodities Futures Trading Commission through consultation with the Federal Reserve Board.

Fifth, the Commission has suggested that the New York Stock Exchange consider creating special areas on its floor for the trading of entire baskets of stocks, such as those that comprise popular indexes. This would relieve some of the strain on the capital of the specialists responsible for trading those individual stocks.3/

C. Enhance Futures Market Capacity

In discussing hedging, I indicated that, because futures markets provide another source of liquidity, the capacity of these markets should also be enhanced. Liquidity problems arose at futures exchanges during critical periods of the October market break, forcing some large institutions to transfer their selling to the stock market. One possible way to increase futures market capacity would be to facilitate block trading of futures. In the securities markets, large stock trades often are arranged by brokerage firms and then sent to an exchange floor for execution. In this way, exchange specialists are not overwhelmed by huge stock buy or sell orders. There is no similar procedure for handling large index futures orders. Given the increasing role played by stock index futures in our linked markets, block trading of the futures markets would provide valuable added capacity.

D. Raise Futures Margins

Even after the capacity of our integrated markets is enhanced, there still may be times when market mechanisms are

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3/ The Commission noted in its testimony to Congress last month that many questions need to be examined concerning the feasibility and design of any such basket trading.

under severe strain. The Commission is considering measures designed to retard the increased velocity and concentration of inter- and intra-market trading that in turn has increased the probability of wild price swings. To an extent, the increased intensity of market trading is due to the greater leverage of futures products. Due to lower margins, large stock index futures positions can be established with a relatively small capital infusion, and then can be liquidated very quickly.4/ While the extent to which futures market leverage exacerbated the market decline is uncertain, its impact was significant. Initial margin on stock index futures for non-market makers should be raised, at least temporarily, to levels harmonious with stock margin levels applicable to stock market professionals. This would mean initial futures margins of 20 to 25 percent.5/

E. Consider Other Measures

In addition, during peak volume and volatility periods we may need to consider other measures proposed by the Presidential Task

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4/ Cash settlement of futures products also increases leverage because futures sellers are obligated to pay cash differences rather than deliver a portfolio of stocks.

5/ Regulation T and Regulation U of the Federal Reserve Board provide that specialists on the floor of an exchange and over-the-counter market makers may obtain loans collateralized by their specialty or market-making securities on a "good faith" basis, without regard to the normal margin requirements. The loans may be obtained either from another broker-dealer or from a bank. The banks and broker-dealers usually require margin in the 20-25% range as collateral for these loans. At current index levels (@ 264), the value of one S&P 500 stock index futures contract is $132,000, and 20% initial margin would be $26,400. The current margin requirement for this contract is $15,000 ($10,000 for hedgers).

Force, the SEC staff and others. While the Commission does not endorse daily stock price limits, we note that a number of futures exchanges, including the Chicago Mercantile Exchange, already have adopted daily price limits for their stock index futures contracts. The Commission will continue to consider the efficacy of these and other measures, including the possibility of delayed openings of the futures markets.

F. Regulatory Cooperation

May I emphasize to you the Commission's commitment to work closely with other regulators to formulate responses to current market conditions. Because the stock, options, and futures markets are interlinked, increasing intermarket coordination is of utmost importance. In my recent Senate Banking Committee testimony, I stated that the SEC and the CFTC must devise joint plans to respond to market volatility. These efforts have already begun. During the week of February 8, CFTC Acting Chairman Kalo Hineman and I met, together with our staffs, to discuss a wide range of market related topics. During that week we also met jointly with representatives of stock and commodities exchanges to explore means of reducing market volatility. These discussions, as well as discussions with the Federal Reserve Board, will continue as we attempt to avoid a repetition of the October events.

III. International Markets

Thus far, I have discussed only our domestic markets. The October market turbulence was not limited to the U.S. markets, but was a world-wide phenomenon. The world's major stock markets all experienced downturns similar in scale to those in the U.S. Thus, the October market break pointed clearly to the emergence of what is becoming a truly global market, and any examination of the extent to which today's markets are interconnected must include recognizing that those connections also extend across national boundaries. International automation of quotation, routing, execution, clearance, and settlement systems is inevitable, and the time has come to increase efforts toward a coordinated global market regulatory system.

I have just returned from Tokyo, where I had constructive conversations with Japanese regulatory officials about the need for greater coordination, and I will soon leave for London to pursue similar conversations with U.K. officials. While in Japan I stated that the key to sound international capital markets is to adapt the best rules and policies of all nations to new market structures and trading strategies. In that regard, I recommended that the following regulatory principles be considered by market regulators throughout the world:

1. Sound standards for disclosure, including mutually agreeable auditing and accounting standards;
2. Promotion of market fairness, including prohibitions against insider trading, market manipulation, and misrepresentations to the market place;
3. The widespread availability of quotation and price information;

4. Efficient and compatible national and international clearance and settlement systems;
5. Broker-dealer registration qualifications and conduct requirements designed to promote integrity and honesty in the profession;
6. Improvement of capital adequacy standards in order to provide greater stability and liquidity for national and international markets; and
7. Establishment of international surveillance and enforcement agreements.

IV. Conclusion

It is clear that today's capital markets are evolving at a rapid pace. The October market break demonstrated that in the United States we have a unified market for stocks, stock index options, and stock index futures. These markets are and increasingly will be linked internationally. I can assure you that the Securities and Exchange Commission is committed to moving forward with initiatives designed to meet the challenges presented by the evolving nature of our national and international markets.