STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

CONCERNING THE COMMISSION'S OVERSIGHT
OF THE SECURITIES MARKETS' RECENT
PRICE VOLATILITY AND RECORD VOLUME

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I. Introduction

Chairman Proxmire and Members of the Committee:

I appreciate the opportunity to testify before the Committee concerning the dramatic market events of the past two weeks. The Commission is deeply concerned about the impact of market volatility on public investors, market professionals, and the structure of the market itself. During the past two weeks the Commission has actively monitored the securities markets and has been actively involved in ensuring that appropriate steps were taken to respond to the record volume and volatility. As announced during the week of October 19th, I have instructed the Commission staff to commence an analysis of the recent market events. The study will develop specific recommendations regarding what reforms may be needed in the regulation of the stock and derivative markets. Today, I will summarize the current status of the markets and the Commission's ongoing oversight of the operational and financial integrity of these markets. In addition, I will set out the fundamental issues that our study must address and answer. Finally, I will address, preliminarily, the questions raised in the Committee's letter of invitation to testify.

II. Description of Market Events

The recent market exents have been truly extraordinary. A description of recent market indicators provides a sense of their historic proportions.

On August 21, 1987, the Dow Jones Industrial Average ("DJIA") reached its highest level ever, 2,736. This was over three times its closing value of 773 on August 12, 1982. Markets in other countries were experiencing similar unprecedented rises: In 1987, the Nikkei 225 Index, a leading Japanese market indicator, and the London Financial Times ("FT") Stock Exchange ("SE") 100 Index also reached three times their August 1982 levels. Similarly, price-earnings ratios were at historically high levels, reaching

B. "Black Monday" -- October 19

On Sunday night, October 18, in the first major market trading since the DJIA's 108 point drop on the preceding Friday, the Nikkei 225 dropped substantially. The Japanese markets closed down 2.35% at 1:00 a.m. Monday, New York time. In London, at 4:00 a.m. New York time, the FT-SE 100 Index opened down 5.6%. This Index would close down 10% on the day. In the United States during morning trading, the DJIA first fell over 200 points, then climbed almost 100 points. It then began a steep downward plunge, dropping an additional 400 points by the close of trading. The closing value of 1734 represented a loss of 508 points, or 22%, from Friday's close, and a 36% decline from August's peak. This day's absolute price decline in the DJIA was four times the record set the preceding Friday; the percentage decline was twice the previous record, which was set on October 29, 1929. Six hundred and four million shares were traded on the NYSE this day; this represented three times the NYSE daily average for the year and almost twice the record 338 million traded the preceding Friday.

This decline was not limited to blue chip stocks. The over-the-counter ("OTC") market, as measured by the NASDAQ Composite Index, fell by over 11% on volume that exceeded the previous daily average by 48%. American Stock Exchange ("Amex") prices fell over 12% on volume that exceeded the previous single day record by over 65%.

Monday also was an extraordinary day in the stock index futures and stock index options markets. Volume in the S&P 500 futures reached 162,000 contracts, more than double the average daily volume. On the CBOE, restricted trading procedures were instituted for the S&P 100 index option. Volume on October 18 was a below average 323,291 contracts.

The relationship between the stock and futures market on this day also was unprecedented. The principal measure of this relationship is the difference between the price of the futures contract and the level of the actual index. In normal times the future's value is slightly more than the level of the actual index, and discounts, when they appeared, were considered aberrational if they were as high as five points. On the 19th this discount was as low as 20 and consistently was below 6.

C. Trading Volume and Volatility After October 19

After the NYSE close on Monday, the Nikkei 225 Index declined a record 14%. The decline represented 95% of the maximum the index could fall under the price limits in place on the Tokyo Stock Exchange. The Hong Kong market, which had lost 11% of its value on Monday, closed for the week, and the U.K. markets opened down 9%.

NYSE share volume remained high all week, averaging 281 million even under the shortened hours in effect. Volatility also remained extraordinary, with the DJIA rising 52 points on Tuesday and 91 points on Thursday. For the week, the DJIA gained back 42 points or 2% of its value, closing at 1,993, which was still 743 points and 27% below the August peak and 23% down from October 1.

The OTC and Amex markets also continued to experience high volume, averaging about 202 million and 20.6 million share volume. The NASDAQ Composite Index closed the week down only 5 points at 323, and the Amex closed at exactly the same price at which it closed the previous Friday. The NASDAQ Composite Index was down 27% for the month of October, and the Amex Index was down 25% for this time period.

Foreign markets continued to be volatile. The Nikkei 225 saw movements between 2% and 4% and closed on Friday the 30th 17% below its 1987 peak. The FT-SE 100 Index lost over 6% on Monday the 26th and closed the week down 33% from its 1987 high. All the major indices, foreign and domestic, however, were rising at week's end. The smaller capitalization stocks continued to decline all week, and closed Friday 38% below their September 30th levels.

S&P 500 futures volume was well below previous levels, averaging 34,000 contracts. Premiums between the futures prices and actual index value reappeared, and, while substantial discounts existed, they were less than those seen on the 19th and 20th. S&P 100 index option daily average volume was well below average, at 125,000 contracts.

The average DJIA daily price movement from the October 16 through October 30 was 121 points, more than the previous single day record. There were twelve 100 point and twenty-one 50 point DJIA intra-day price shifts. The total NYSE share volume on these days was over 4 billion, or 11% of total 1986 volume, and the average daily volume of over 367 million exceeded the previous single day record. Total NASDAQ share volume was over 2.2 billion, or a daily average of over 202 million and almost 10% of total 1986 volume. Amex volume was 280 million, a daily average of 25.4 million that surpassed previous single day records.

III. Commission Action

During the extraordinary market events of October, the Commission expanded its routine monitoring and supervisory functions and engaged in significant decision making activities to respond to the record volume and volatility of the markets. During this period, and continuing up to the present time, the Commission has been in constant communication with the stock

CFTC to initiate a review of trading activity on that day. In addition, the Commission staff interviewed market participants to determine who engaged in trading that day, for what purpose, and in what amounts. The Commission also requested the NYSE to supply trading data that would allow reconstruction of the events of the day. The actions that we took in response to the October 6 decline were subsequently repeated for October 14, 15, and 16, in response to the precipitous drops in the DJIA on those days. Beginning October 14, Commission staff also began to canvas the various SROs concerning the financial condition of the broker-dealers that they examine. At that time the SROs advised the Commission that their firms were not experiencing any financial difficulties.

Because of the significant declines that occurred during the week of October 12, 1987, and in particular the then-record 108 point decline in the DJIA on Friday, October 16, 1987, preparation was begun over the weekend for possible disruptions in Monday's markets. For example, at my request, senior staff of the Division of Market Regulation held weekend discussions to plan for market monitoring on Monday, October 19; previously scheduled business travel was postponed to ensure adequate senior staff supervision of market conditions on Monday; and the Commission arranged with the NYSE to receive pre-opening indications for major stocks on Monday morning to get a sense of market conditions in advance of the opening. This last procedure had been used previously in unusual market environments -- such as in connection with monitoring the recent "Expiration Friday" trading.

As previously noted, on October 19 the Commission received indications of steep price declines in Tokyo and London prior to the opening on the NYSE. In addition, the Commission received indications from the NYSE of significant order imbalances on the sell side -- indicating a significant market decline at the opening. The Commission requested the NYSE surveillance department to keep it informed on an on-going basis of any operational problems at the Exchange. The Commission also requested information on specialist positions and up-dates on order imbalances. Immediately after the opening, I spoke with John Phelan, Chairman of the NYSE, and was briefed as to the size of sell order imbalances that morning. In response to the early sell-off, Commission staff, using in-house automated market information systems, began to monitor the securities and futures markets minute-by-minute.

Throughout the day, and continually, day-by-day, for the next two weeks, Commission staff, working in specialized teams, kept in close contact with the stock exchanges, options markets, clearing agencies, major broker-dealers, and order-routing firms. The Commission monitored the operation of each markets' order entry and automatic execution systems; the operation of the NASDAQ computerized quote system; the capacity of the major

NYSE's automated order routing system did not become more overloaded. Through this action, the NYSE averted potentially long delays in the execution of public investors' orders. Similarly, the Commission supported the NYSE's decision, on Thursday, October 22, to request that member firms voluntarily agree not to execute proprietary index arbitrage orders. Index arbitrage plays an important role in ensuring a proper price relationship between the index future and the securities composing the index. In times of extraordinary volatility, however, that arbitrage may cause further sell pressure in the stock market. Following the NYSE's decision, the Commission canvassed a wide range of institutional investors regarding their compliance with the NYSE's request.

(2) <u>The NYSE's Order Imbalance Problems on the 20th</u>

The Commission also was consulted by the NYSE on October 20 about the possibility of calling a temporary trading halt on the NYSE. The Commission discussed in detail with the NYSE the ramifications of implementing such a decision. At that time (mid-day on the 20th), trading in over 90 securities had been halted on the NYSE because of order imbalances. While temporary cessation of trading should be viewed as an extraordinary measure, serious consideration was given to this option. The enormous positions accumulated by specialists to provide liquidity on Monday the 19th and during the previous week would have placed them at extreme financial risk if the onslaught of sell orders had continued. Fortunately, the rebound in buy orders averted the need for any trading halt at that time.

(3) <u>Early Closings</u>

The Commission also participated in the decision made by the NYSE to close its market early from October 23 to November 6 in order to process and resolve unmatched trades that had accumulated due to the dramatic increase in the number of transactions executed during this period. While the number of uncompared trades doubled during the highest volume days, the industry has succeeded in resolving the vast majority of those trades through reduced trading hours and increased working hours. The reduced trading hours have been critical to the accomplishment of this formidable task.

(4) <u>Aquisition of Specialist Firms</u>

The financial condition of the specialists on the floor of the NYSE continued to be a major concern of both the NYSE and the Commission throughout the week of October 19. Accordingly, the Commission took steps to facilitate the acquisition of trading firms experiencing financial difficulty, including specialists units, by well-capitalized institutions. On October 22 the

Act Rule 10b-18 or outside the Rule so long as the issuer did not engage in manipulative practices or purchase at artificial prices. A large number of issuers in fact made or announced stock market purchases, which significantly added to the liquidity and stability of these securities.

(8) Mutual Fund Regulation

The Commission also addressed a series of issues related to mutual funds caused by the extraordinary market events. As an initial matter, early in the week of October 19 funds experienced delays in getting closing price data for securities traded on the NYSE and other major U.S. markets. This caused a number of funds to miss the press deadline established by the AP and the UPI for getting their share prices into the mutual fund share price tables that are normally published in major newspapers throughout the country. While the Commission staff, through the NASD, requested and obtained a 1/2 hour extension of the press deadline for October 19 and 20th, there were still many blanks in the fund share price tables published in the morning newspapers.

Another problem arose for establishing net asset value for mutual funds when the NYSE and other markets decided to close early. Many funds moved the time for pricing their shares up two hours to be consistent with the change in hours of the stock exchanges and NASDAQ. The SEC staff advised funds that it had no objection to this change, provided that a similar change was made in the cut-off time for receipt of shareholder purchase and redemption orders at that day's price.

A further problem was created for funds invested in securities traded in Hong Kong when the Hong Kong Stock Exchange was closed for the week after October 19. A handful of funds investing in securities traded in Hong Kong sought and obtained a no action position from the Commission if they determined to suspend redemptions for up to 48 hours because of difficulty in pricing portfolio securities and computing net asset values while the Hong Kong Stock Exchange remained closed. (Pursuant to SEC rules, those no action letters are not yet public.) Most funds with limited investments in Hong Kong-traded securities continued to price and compute net asset value.

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In sum, the Commission has been, and continues to be, actively involved, in both a consultative and oversight role, in three major areas, among others. First, the Commission has worked to maintain the operational capacity of the trading systems and mutual funds. Second, the Commission has acted to permit an analysis of the impact of each of these trading strategies and how they interacted with other forms of trading and investor sentiment immediately prior to, and during the market break.

In order to develop the market reconstructions necessary to answer these questions, the Commission and the CFTC are coordinating the collection of data from the principal firms active in index-related trading. This process is being supplemented with analyses of audit trail data from the securities and futures markets and interviews with a wide range of key market participants, including "floor" and "upstairs" traders, market makers and specialists in the stock and derivative markets, mutual fund managers, and other institutional investors.

The Commission has been concerned since the market decline of September 11 and 12, 1986 with the impact of index-related trading on the volatility of the nation's securities markets. 7/ Commission staff have performed detailed analyses of the September 1986 market decline and the price volatility experienced on January 23, 1987 6/ and, as previously noted, was in the process of analyzing the 91.5 point drop in the Dow on October 6 when the latest market break occurred. The Commission staff has conducted these reviews with the active assistance and participation of staff at the CFTC and the SROs, and sharing of surveillance information on index-related trading continue on a regular, on-going basis. In addition, the Commission staff has worked with the CFTC and securities and futures exchanges to implement new procedures to minimize the impact of index-related trading on quarterly expirations for index futures, index options, and equity options -- so-called "Triple Witching Fridays."

The staff's previous studies of the market volatility on September 11 and 12, 1986 and January 23, 1987 found that, while index-related trading could not be established as causing this volatility, the rapidity with which programmed orders could affect prices in dozens of bellwether stocks clearly accelerated market movements. At the same time, however, the use of index products had some substantial economic benefits including providing institutional investors with a less expensive and more efficient means to hedge or adjust their market portfolio. Therefore, the Commission staff concluded that any regulatory

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6/ The Commission previously made its non-public report on January 23, 1987 available to its Congressional Oversight Committees.

7/ In my first major speech as Chairman, I spoke about derivative index trading and identified as a major concern the volatility associated with such trading.

Fifth, is greater or more formal coordination between the Commission, the CFTC and other interested regulators needed during times of extreme volatility?

B. Market-Making Capacity

The Commission worked with the NYSE during the October market break to monitor the financial position of the Exchange's specialists and their capacity to maintain fair and orderly markets in their assigned securities in the face of extreme market volatility. While most specialists maintained adequate capital reserves, and, overall, did a reasonably good job of handling staggering order imbalances, the Commission was extremely concerned, immediately after October 19, that another steep decline could cause serious financial difficulties for many specialist units and overwhelm the NYSE's market-making capacity. Moreover, each of the four basic types of market-making systems in the securities markets ("specialists," "competitive market makers," "upstairs market makers" and "competing dealers") experienced severe strains during the market break.

Because of these concerns, the Commission's market study will include a broad overview of the market-making capacity of our securities markets. The Commission is analyzing quotation spreads, price continuity, and market depth statistics for each system, and has staff teams interviewing specialists, market-makers, and other market participants nationwide, to determine whether regulatory initiatives are required. These initiatives might include reducing barriers to mergers of firms, as well as increasing the capital and margin requirements for market makers and their clearing firms.

C. Financial Integrity

The financial regulatory safeguards implemented by the Commission and the SROs are intended to minimize overexposure of broker-dealer financial positions and to protect customer positions. These safeguards proved their merit over the last few weeks. To date, all major securities firms remain in a strong capital position. Nevertheless, a number of smaller firms have had to cease doing business because of firm losses or customer defaults. While no regulatory system can guarantee that such problems will never occur, our market study will analyze the experience of the last few weeks to determine whether the Commission's already strong financial integrity regulations should be made even stronger. In particular, we will examine whether further limitations should be placed on the degree to which a firm can expose itself to one particular form of market risk (so-called "concentration" tests).

There have been numerous opinions reported in the media and elsewhere concerning what factors triggered the market's dramatic decline. Factors of a broad economic nature that have been suggested include investor anxiety concerning the United States involvement in the Persian Gulf; concern about the possible devaluation of the dollar; higher interest rates and higher inflation; and expectation of a world-wide recession. In addition, much attention has been paid by the media and others to the possible influence on the market of the continuing budget and trade deficits and possible tax changes regarding takeovers.

Question No. 2

Did computer trading arbitrage techniques and portfolio insurance cause, deepen and/or speed the decline in stock?

This question is one of the key issues that must be resolved by the Commission's current market study. As discussed earlier, we are currently analyzing preliminary trading data and are compiling, in coordination with the CFTC, detailed program-by-program data from the major firms active in index-trading strategies.

The preliminary information we have received does suggest that both index arbitrage and portfolio insurance activity were significant during the market downturn. Our preliminary information indicates that on October 19 firms may have engaged in arbitrage activity (among other strategies) resulting in the sale of up to fifth-five million shares of stock on the NYSE, approximately 10% of total volume on that day. Similarly, a large number of arbitrage programs apparently were executed during the last hour and a half of trading on Friday, October 16, when the market turned down sharply. In addition, our initial interviews with major firms suggest that institutions employing futures in portfolio insurance strategies accounted for a substantial percentage of futures volume on October 19 and 20, exceeding 24% and 15% of total volume in the S&P 500 futures contract these days, respectively.

Definitive conclusions adverse to index arbitrage and portfolio insurance activity should not be drawn from this preliminary data. While portfolio insurance selling may have been significant, an argument can be made that without the availability of the futures markets all of this sell activity would have been funneled directly to the stock market. Similarly, index arbitrage is critical to ensure that futures prices remain in line with stock prices.

Conversations with clearing firms also revealed that some firms' automated systems are designed to handle routine trade volume no greater than 250 million to 300 million share days. Volume greater than 400 million shares created processing stresses for many of these firms. Should extremely high volume continue on a sustained basis, systems upgrades and expansions will be required.

We are continuing to assess clearance and settlement systems to identify manually-intensive aspects, such as QT resolution, that impede smooth processing. In particular, we intend to examine closely the adequacy of certificate handling by broker-dealers, clearing agencies, and transfer agents. Preliminary reports from these entities indicate that the volume of certificates being processed is well above normal. We intend to examine brokers' response to customers' requests for certificates, tracking carefully how long brokers hold certificates before turning them over to depositories and transfer agents for processing. We also intend to monitor closely transfer agents' turnaround performance during this high volume period.

<u>Question No. 4</u>

> Did the margin requirements in the markets for derivative instruments, which are significantly below those required for purchasing common stocks, exacerbate the stock market's decline? Would it be advisable to institute higher margin requirements and stricter position limits in these markets after the crisis subsides?

While it is not clear what role derivative product trading played in recent market volatility, the Commission will examine the effects, if any, of the ability of a stock index futures or options purchaser or seller to control a very large dollar-equivalent stock position with a minimal initial margin payment. For example, before October 19, a hedged purchaser or seller of a S&P 500 Stock Index futures contract trading at an index value of 300 was able to acquire (or sell) approximately $150,000 worth of stock for an initial margin payment of $5,000, or only 3% of the contract's value. A seller of an index option was required to put down the premium received plus 5% of the contract value.

Accordingly, the Commission will reexamine the assumptions underlying index options and futures margin levels and the effects of the leveraging capabilities associated with current margin levels. Index futures margin levels, which are set by the individual futures exchanges, have been raised in response to recent events. In addition, the Commission earlier this week approved an increase of index option margin to premium plus 10% of the contract value. The Commission will actively consider

The issues relating to OTC market making capital are similar: a market maker only can be expected to commit so much capital to acquire an inventory of stock in a declining market. At least in two respects, however, the OTC market does differ from the exchange market. First, because the OTC market depends on individual market makers to update their quotations, if those market makers are physically unable to update their quotes in a timely manner or decline to update their quotes, the integrity of the NASDAQ System to perform its pricing functions may be impaired. In turn, if the NASDAQ quotes are unreliable, firms faced with increasing volume may be forced to rely on more manually intensive methods of pricing securities and executing orders. Second, if, as appears to be the case here, investors sell their OTC securities in order to meet margin calls on listed stocks, there may be a delayed effect in the OTC market and greater cumulative selling pressure in that market. The Commission understands that the NASD is currently examining these and related issues.

Question No. 6

> What were the reasons for the prolonged interruption of trading in the Hong Kong market last week? Are domestic securities markets disrupted by malfunctions or protracted interruptions in foreign markets?

The Hong Kong market was closed for much of the week of October 19, apparently due to unprecedented futures and stock sell order imbalances and the perceived inability of many market participants to survive in the face of panic selling. The Commission, as part of its study of recent market activity, will examine trading on several foreign exchanges. One of the areas we will be studying is the impact of overseas market developments on domestic securities markets. While it is too early to say definitively, we do not believe that the interruption of trading in Hong Kong had a significant impact on U.S. market activity as a whole.

Question No. 7

> Would it be advantageous to have all regulation of securities-related instruments focused in the Securities and Exchange Commission?

The Commission has an effective working relationship with the CFTC. In addition, the various SROs -- both futures and securities -- regularly share surveillance information with one another and work together on matters of mutual concern. Indeed, we have been in close contact with the CFTC and the CME throughout the market break. Accordingly, it would be premature to speculate on whether a unified regulatory structure for securities-related products is necessary at this time.

industry and the protection of investors. As I outlined, the Commission's study will respond to the questions of the Committee that were submitted to the Commission last week. I believe that the facts and analysis derived from this study as well as the ongoing study of the Brady Task Force will be instrumental to address the causes of the stock market decline and any appropriate regulatory or legislative action.

Appendix I

Options and Futures Trading Primer

A. Glossary

The following definitions describe the characteristics of futures and options contracts.

1. Option -- An option is a legal contract that provides the buyer or holder the right to buy or sell a specified amount of the underlying interest at a fixed price (called the exercise or strike price) for a limited period of time. The buyer of an option pays a premium to the option seller for the rights conveyed by the option. If an option is exercised by the holder of the option, it is assigned to an option seller or writer who is obligated to perform according to the contract terms. Option contracts are of two general types: a call option conveys the right, but not the obligation, to buy the underlying interest; a put option conveys the right, but not the obligation, to sell the underlying interest. Instead of exercising an option, a buyer (or seller) can close out his position by selling (or buying) the option in the secondary market. All options that are traded on exchanges are called Standardized Options. The Options Clearing Corporation is both the issuer of all standardized options, and a nominal intermediary between the buyer and seller of these options.

2. Stock Option -- A stock option is a contract that provides the buyer the right to buy or sell a specified quantity of a particular stock (usually 100 shares) at a determinable price at or before expiration of the option. When a buyer exercises the stock option, the option seller must settle the exercise by the delivery or purchase of stock.

3. Index -- An index is a measure of the value of a group of stocks or other interests. Stock index values generally are calculated in two ways: weighted by capital or weighted by price. In a capitalization-weighted index, generally the capitalizations (total dollar value of shares outstanding at the current market price) of all stocks in the index are computed and added together to produce the total market value of the index. This total sum is divided by a divisor to produce the final index value. A price-weighted index contains an equal number of shares of each stock in the index. The index value generally is computed by adding together the prices of the various stocks in the index and then dividing that sum by a divisor.

limitation on the opportunities for appreciation. Typically, portfolio insurance seeks to assure a minimum value for a portfolio over a specified time period. To achieve this, stock index futures are sold when the value of the portfolio decreases a certain percentage, and are repurchased when the portfolio regains this loss.

B. Options and Futures Strategies

The following examples are provided to illustrate the use of index options and futures, as well as the margin required for these trades.

1. Sale of a S&P 500 future. -- Assume that on October 1, 1987, the S&P 500 future was trading at 250. On that day an investor might sell (or buy) one futures contracts at 250. The sale or purchase of a futures contract requires a margin deposit that can be drawn upon to cover any losses incurred in the course of futures trading. Prior to the week of October 19, the initial margin payment that the investor must deposit in order tm sell (or buy) this contract, which represents approximately $125,000 worth of stock, would have been $10,000 or 8% of the contract value (or only $5,000 if the purchase qualified as a bona fide hedging transaction). After October 19, the amount of initial margin required was raised. Today an investor who wanted to sell (or buy) in a non-hedging transaction, one S&P 500 future trading at 250 would have to deposit $20,000 or 16% of the contract value (or $15,000 and 12% if a hedger). The seller also would have to "mark the position to market" each day by depositing the amount of any daily losses.

2. Sale of a S&P 500 option. -- Assume that on October 1, 1987, the S&P 500 index value was 250, which means the option contract value would be $25,000. On that day an investor might sell a call exercisable at 250 for a premium of 3-1/2. A margin deposit will be required when an option is sold; option purchasers are not required to deposit margin. Option margin deposits serve as collateral for the option seller's obligation to pay the cash settlement price, if assigned an exercise. Prior to the week of October 19, the option seller would be required to deposit margin in the amount of $1,600 or 5% of the index value ($1,250) plus the call premium received ($350). This margin deposit represents 6.4% of the contract value. Shortly after October 19, index option margin was increased, so that a deposit of $2,850 would now be required to sell the S&P 250 call at 3-1/2, or 10% of the index value ($2,500) plus the call premium received. This increased margin deposit represents 11.4% of the contract value.

Appendix II

SEC/CFTC Regulatory Jurisdiction

The Commodity Futures Trading Commission Act of 1974, which created the Commodity Futures Trading Commission ("CFTC") as an independent agency to administer the Commodity Exchange Act ("CEA"), also amended the definition of "commodity" in the CEA to include all contracts for future delivery involving tangible goods and articles, as well as intangible services, rights and interest. Before this amendment, the term "commodity" in the CEA was limited to certain specifically enumerated agricultural products. The CEA, as amended, provided the CFTC with exclusive jurisdiction not only over futures contracts but also over certain related instruments, such as commodity options. The amendment brought under the CFTC's exclusive jurisdiction previously unregulated commodities such as coffee, gold, and foreign currencies. The amendment also was intended to assure CFTC jursidiction over new futures contracts, such as futures on government-guaranteed, mortgage-backed securities ("GNMAs"), contemplated at the time but not yet traded. A provision preserving the preexisting authority of the Securities and Exchange Commission ("SEC") over securities trading and the securities markets was contained in the CFTC Act. 1/

The broad statutory language in the CFTC Act soon led to a dispute between the SEC and the CFTC as to its intended meaning. In 1975, CFTC approval of a Chicago Board of Trade ("CBT") application for designation as a contract market for the trading of GNMA futures contracts precipitated an exchange of letters between the SEC and the CFTC. The SEC asserted that futures on GNMAs were securities, within the SEC's jurisdiction, and the CFTC responded that these instruments were within the exclusive jurisdiction of the CFTC.

The issue was not resolved, and, in 1978, it became the subject of Congressional attention during the CFTC's reauthorization hearings. SEC Chairman Williams, representatives of the securities industry, and others testified that the SEC's interest in the securities underlying futures contracts, and its more extensive experience in regulating the trading of options, warranted SEC regulation of futures and options on securities

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1/ The amendments to the CEA were adopted in the CFTC Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974).

the side of the SEC, while the CFTC filed an amicus curiae brief in support of the CBT position. The Seventh Circuit stayed the CBOE from trading GNMA options until it rendered its decision. On March 24, 1982, the Seventh Circuit ruled that the SEC did not have jurisdiction to oversee the trading of option contracts on GNMA certificates and that the CEA governed the contracts, Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982).

Under these circumstances, and in an effort to end jurisdictional uncertainty over which agency would regulate specific financial instruments, in October 1981, during the pendency of the litigation, the Chairmen of the SEC and CFTC -- Chairman Shad and Chairman Johnson, respectively -- entered into an agreement (the "Accord") to clarify the respective jurisdictional responsibilities of the agencies. Under the Accord, certain specified instruments would be regulated by the CFTC, while others would be regulated by the SEC.

The SEC, in addition to retaining regulatory authority over securities, would have jurisdiction over options on securities, including exempted securities (such as GNMA certificates); options on a group or index of securities; options on foreign currency traded on a national securities exchange; and options on certificates of deposit. The CFTC, in addition to retaining regulatory authority over futures contracts, would have jurisdiction to regulate futures (and options on futures) on exempted securities 7/ (except municipal securities) traded on a contract market (such as futures on GNMA certificates, on Treasury bonds, notes, and bills, and on certificates of deposit); futures (and options on futures) on "broad-based" groups or indexes of securities; options on foreign currency not traded on a national securities exchange; and options on commodities.

The Accord also established three basic criteria a securities index futures contract (or an option on a futures contract) must meet in order for it to be eligible for trading: (1) the futures contract must be settled in cash; (2) it must not be readily susceptible to manipulation; and (3) the underlying index must be broad-based, i.e., it must reflect the market for all or a substantial segment of publicly traded equity or debt securities or a comparable measure thereof.

7/ Section 2(a)(1)(B)(v) of the CEA prohibits the trading of futures contracts on individual securities other than exempted securities. In addition, futures contracts on individual municipal securities, even though exempted securities under the Securities Exchange Act of 1934, also are prohibited.

contract will not function as a surrogate for trading in individual securities or options on those securities. 11/

B. Securities Index Futures Products

The SEC has applied the Accord criteria in reviewing and approving more than 20 stock index futures contracts since 1982. Of that number, the following futures contracts are actively traded: the Standard & Poor's 500 Stock Index ("S&P 500") traded on the Chicago Mercantile Exchange ("CME"); the Major Market Index, the Institutional Index, and the Municipal Bond Buyer Index, traded on the Chicago Board of Trade ("CBT"); the New York Stock Exchange Composite Index ("NYSECI") and the Russell Indexes, traded on the New York Futures Exchange ("NYFE"); the Value Line Index, traded on the Kansas City Board of Trade; and the Philadelphia Stock Exchange National Over-the-Counter Index, traded on the Philadelphia Board of Trade. The SEC and the CFTC recently approved two corporate bond indexes that recently began trading: the Long-Term Corporate Bond Index, traded on the CBT, and the Moody's Investment-Grade Corporate Bond Index, traded on the Commodity Exchange. The SEC and the CFTC approved the following actively-traded options on stock index futures contracts: options on futures contracts based on the S&P 500 traded on the CME, and options on futures contracts based on the NYSECI traded on the NYSE.

11/ Attached is a chart setting forth the major futures and options stock indices, some of their characteristics and the exchanges on which they are traded.