OPENING STATEMENT

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SECURITIES AND EXCHANGE COMMISSION RECOMMENDATIONS REGARDING THE OCTOBER 1987 MARKET BREAK

Before the
United States Senate Committee
on Banking, Housing and Urban Affairs

February 3, 1988

Chairman Proxmire and Members of the Senate Banking Committee: the Commission appreciates the opportunity to testify here this morning on the subject of the October Market Break.

I have submitted to the Committee a copy of written testimony of the Securities and Exchange Commission dated February 3, 1988, under the title "Securities and Exchange Commission Recommendations Regarding the October 1987 Market Break." Except for one small section, that testimony represents the views of all five members of the Commission.

I also have submitted to the Committee a Report by the Division of Market Regulation of the Securities and Exchange Commission, released February 2, 1988. That Staff Report contains an excellent analysis of the October 1987 market break, as well as many detailed recommendations regarding the operation of the securities industry. In accordance with its usual practice the Commission has authorized the staff to release the report as a Commission staff report. I ask that both the Commission's testimony and the Staff Report be included in the record of these hearings.

May I add that the Staff Report was prepared by approximately 110 able and dedicated staff members under the leadership of Richard Ketchum, the Director of our Division of Market Regulation, and two Associate Directors, Mark Fitterman and Brandon Becker. These staff members worked tirelessly to finish their report within a very short time period. On behalf of the Commission may I record our thanks for their fine work.

The events of the October market break are well known to you. In summary, the market break involved extreme volatility, unprecedented volume, and the largest market decline in the nation's history. This market decline was triggered by changes in perceptions regarding investment fundamentals, and by economic conditions. In part they represented a response to a market that had reached unprecedented heights and that was widely regarded as subject to a downturn.

The expected downturn occurred. It is the size and rapidity of that downturn that concerns all of us. The task of the Securities and Exchange Commission is not to find fault, but to seek ways to prevent repetition of the October 1987 market break.

Understanding of market events will be aided by a description of current institutional investing practices. During the last decade institutions have amassed increasingly large portfolios of securities, and increasingly desire to trade in the equivalent of all or a portion of an entire portfolio. This desire was 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 of stocks directly. The automated method for routing orders to buy or sell a portfolio of securities to the New York Stock Exchange is the Exchange's Designated Order Turnaround system, called DOT. In connection with their portfolio trading (sometimes called "program trading") the large institutions have also developed sophisticated index arbitrage, index substitution, and portfolio insurance strategies.

A significant factor in the October market break was large stock and futures sales by institutions pursuing a variety of these 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 S&P 500 stocks. 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 may have extended it beyond levels that can be accounted for by fundamental economic factors alone.

The Commission has concluded that the current market for securities is a linked market formed by stock index futures, stock index options and stocks. Under current conditions, new institutional trading mechanisms and strategies in this linked market can cause extraordinary peak volume and volatility.

The Commission recommends three broad approaches for reform: expanding capacities of the markets, increasing the coordination among the markets, and retarding the volatility and volume of trading during crises periods.

May I emphasize the importance of the first two approaches.

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 our primary recommendations on expanding and coordinating the futures, options, and stock markets, the Commission is suggesting that the interlinked market should be made more efficient. Given the increasing automation and competition from foreign markets, the Commission believes that this must be our first task.

We do acknowledge, however, that steps need to be taken in the near term to decrease liquidity demands and avoid the selling excesses that caused such unusual volume and volatility.

The Commission has set forth many specific recommendations in its written testimony. First, with regard to the New York Stock Exchange, the Commission is recommending implementation or review of the following five measures to increase the New York Stock Exchange's capacity to manage increased volume and volatility: (1) enhancing DOT; (2) increasing specialist capital; (3) improving specialist performance procedures; (4) creating basket trading posts on the New York Stock Exchange; and (5) publicly disseminating program trading information. In addition to these measures, the Commission recommends a reevaluation of current short sale regulation in light of the changed market conditions and new trading strategies.

The Commission also is making recommendations regarding the stock index futures markets. First, it recommends that block trading procedures similar to those used in the stock markets be considered as a means of increasing the futures markets capacity to trade large blocks of futures.

Second, to reduce liquidity demands on the markets, the Commission recommends that the futures exchanges temporarily increase initial margin levels for stock index futures for market participants, other than floor traders, to approximately 20-25%.

Third, the Commission is recommending that the CFTC and the futures markets make express, strengthen if necessary, and effectively enforce the prohibition against frontrunning, a practice in which a firm, for its own profit, trades on the futures exchange ahead of its customer's large orders.

To improve the operations of the markets, the Commission believes that the creation of a coordinated clearing, credit and settlement system across markets should be an immediate priority. The Commission also recommends consideration of the benefits and costs of coordinated market opening and closing procedures.

The Commission also commends to the Committee's attention a series of recommendations aimed at the weaknesses revealed during the market break in the operation of the over-the-counter markets, the American Stock Exchange, the regional exchanges, the Intermarket Trading System, and the options exchanges, and recommendations for improvement of clearance and settlement procedures. Independently the Commission will be examining its own capital adequacy rules.

To increase the Commission's and the SRO's surveillance abilities, the Commission recommends increased reporting requirements that would require the timely reporting of large amounts of trading, including index arbitrage, index substitution, portfolio insurance, and other program trading.

In the area of regulatory authority and structure, the Commission recommends that it be given additional authority to take a variety of steps in a market emergency. Such authority should be roughly equivalent to the emergency authority the CFTC already possesses.

The Commission also recommends that immediate steps be taken to increase regulatory coordination. As a first step, the Commission is recommending that with SEC and CFTC oversight the self-regulatory organizations for stock, options, and futures markets meet immediately to coordinate plans to deal with volatility problems. Additionally, the Commission and the CFTC should immediately undertake a joint review of their proposals and those of the Presidential Task Force and others to determine what steps must be taken to implement them. The Commission also recommends consultation by the Commission, the CFTC, the Federal Reserve Board, and the Federal Reserve Banks of New York and Chicago regarding credit, capital, and liquidity concerns.

As a second step, the Commission believes that the SEC, the agency with the expertise and direct responsibility for the equity markets, should be given final regulatory authority for equity-related products at least with respect to critical intermarket decisions such as coordinated trading halts, manipulation, and frontrunning rules. In addition the Commission should have expanded review authority over both new and existing future equity-related contracts.

Third, although giving the SEC final authority over certain matters may be desirable in the near term, the Commission believes that the market events of October demonstrate that the SEC should have direct regulatory authority over all equity-related futures products. I should indicate here that two Commissioners specifically do not join in the latter two Commission recommendations "to the extent they suggest that improved coordination is not the appropriate approach to intermarket regulatory issues and that the Commission alone possesses adequate and responsible expertise."

Because the October events also demonstrated that the linked market now includes many foreign markets, the Commission intends to intensify its ongoing coordination efforts with foreign regulators and markets.

Finally, the Commission believes that price limits on stocks, either individual or marketwide, are not a preferable way to deal with the complicated issues of cutting off stock trading. The Commission also believes that position limits should continue to serve their anti-manipulation function, but that decreasing these limits is not necessary at this time in order to address volatility.

The Commission strongly believes that the nation's securities markets must be allowed to evolve if they are to remain healthy. Although both the Staff Report and the Commission's recommendations suggest that changes are needed, the most salient point that has emerged is that our securities markets withstood the October 1987 pressures and continue as the best and strongest in the world.