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By Hand

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

OFFICE OF
THE CHAIRMAN

CHAIRMAN'S OFFICE
MAILED

MAY 31 1988

Signed by: ________

May 31, 1988

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Re: <u>March 31, 1988 Testimony on the October Market Break</u>

Dear Chairman Proxmire:

In response to your letter, dated April 4, 1988, enclosed are responses to questions posed by you and Senator Graham relating to my testimony before your Committee on March 31, 1988. If you should have any further questions or concerns regarding the Commission's or the self-regulatory organizations' work to date on market reforms, please contact me or Richard G. Ketchum, Director, Division of Market Regulation, at (202) 272-3000.

Sincerely,

David S. Ruder

David S. Ruder
Chairman

Enclosure

Questions from Senator William Proxmire

Q.1. Stock market prices have recovered to some extent since the crash. And that is one measure of consumer confidence in our stock markets. The volume of shares and derivative products traded remains substantially below what it was before the crash. Volume is another measure of market confidence. Do you consider that market participants are registering a vote of "no confidence" by avoiding the markets at this time? Could it be that the public is not satisfied with the progress that the regulatory agencies, SROs, the administration and the Congress have made in remedying the deficiencies that the crash revealed in our financial markets?

As you point out in your question, the fact that stock prices have recovered to a degree since the market break evidences the fundamental soundness of our capital markets. The precise reason(s) for the decline in volume on the derivative markets is unclear, however, and it is almost impossible to separate out the causes of such reduced trading activity from more general concerns regarding the economy. Nevertheless, we have been informed by representatives of many firms and the Securities Industry Association that many public customers remain concerned over stock market volatility. It is possible that, to the extent the derivative markets did not perform as well as investors had expected in October, investors now may be less willing to rely on those markets. Moreover, the greater volatility in the markets in general appears to have increased the costs of trading in those markets.

Q.2. The stock exchanges vigilantly police intramarket frontrunning. Every trade is computer-monitored and every suspicious transaction investigated. For the record, please submit the number of intramarket frontrunning investigations undertaken in 1987 along with any resulting penalties and enforcement actions. Given that intramarket frontrunning is a present danger, and that the exchanges commit millions of dollars in computer hardware and manpower to police it, and that you have many enforcement actions, we now assume that this practice spreads between markets. Intermarket frontrunning is just as easy to commit as intramarket frontrunning. Yet, we are aware of only two investigations, and no enforcement actions. Doesn't this demonstrate that you are unable to police this fraud with current law?

During 1986, 1987, and to date in 1988, the securities self-regulatory organizations ("SROs") filed 6 disciplinary actions involving intramarket frontrunning violations (one in 1986, one in 1987, and four in 1988). Four of these violations occurred in the options markets; two occurred in the equities markets. Attached as Appendix A is a detailed list of these actions.

You are correct that opportunities exist for trading abuses between the index futures, options, and securities markets. The Commission and the SROs have worked steadfastly since the late 1970s to enhance surveillance systems at each of the equity and options markets and to improve surveillance sharing capabilities among the SROs. Under the current regulatory scheme, the SROs conduct surveillance for and prosecute intramarket and intermarket frontrunning as violations of SRO rules prohibiting "trading ahead" of customers and violating just and equitable principles of trade.

Routine inspections by Commission staff of SRO surveillance, investigatory, and disciplinary programs have found that, overall, the securities SROs are adequately policing their markets for these trading abuses. For the years 1986 to 1988 (to date), the SROS have filed five disciplinary actions for intermarket violations (three in 1986, one in 1987, and one in 1988). Further enhancements may be needed, however, for the prosecution of intermarket frontrunning between the futures and equities markets. In this regard, we are pleased to note that the Chicago Mercantile Exchange and Chicago Board of Trade participated in the most recent Intermarket Surveillance Group meeting. Participation by the futures exchanges in this group would permit the automated access for surveillance purposes of both stock and futures information. The Commission also notes that the NYSE recently announced its intention to file a proposed rule change with the Commission that explicitly would prohibit its members from frontrunning between these two markets.

<u>Q.3. Hayne Leland of the University of California at Berkeley, and the theorist behind portfolio insurance, recently suggested in an interview in Barron's Magazine that the specialist system at the NYSE be amended to use an open outcry auction, rather than the specialist book system. Professor Leland characterizes this proposed change as a movement toward "sunshine markets." The Freedom of Information Act has been valuable in achieving democracy in government in the United States. Do you not agree with Professor Leland, that greater dissemination of information would benefit all traders, big and small, in our stock markets?</u>

As the Committee is aware, when the Commission was charged with facilitating the development of a national market system it explored at great length the feasibility of developing a central limit order file (what is today referred to as an "open book"). That exploration involved a protracted and voluminous review of the various institutional issues raised by such a proposal. 1/ Some of the questions included: Would market orders be disclosed? Would time priority be required? How would blocks be negotiated?

Ultimately, the Commission concluded that such a radical change in the markets was unnecessary. The Commission, however, supported a number of private initiatives designed to experiment with such an approach. For example, the Commission has approved the Cincinnati Stock Exchange's National Securities Trading System ("NSTS"), a fully automated electronic trading system. 2/ Orders, which are priced before they are entered into the system, are stored, queued and executed by the system's computer according to price and time priorities. Another example of a private initiative is the trading system operated by the Instinet Corporation. 3/ This system allows subscribers to enter buy and sell orders and indications of interest, negotiate with other subscribers in the system, and execute trades. The Commission also understands that the National Association of Security Dealers, Inc. ("NASD") is currently developing a limit order file for use in conjunction with its small order execution system, "SOES". 4/

Regarding Professor Leland's suggestion, it is unclear what his specific proposal would entail or what his responses would have been to the various questions which were posed during the late 1970s and early 1980s when these issues were last addressed. The Commission's Division of Market Regulation would welcome discussing with Professor Leland specific proposals he may have.

In this regard it should be noted that "sunshine markets" exist to a greater degree in the stock market than in the open outcry system. Accurate, continuously updated stock quotations

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1/ *See*, *e.g.*, Securities Exchange Act Release No. 15770 (April 26, 1979) (proposing a rule to provide for price protection of public limit orders).

2/ *See* Securities Exchange Act Release No. 19315 (December 9, 1982), 47 FR 56236.

3/ *See* Letter from Richard G. Ketchum, Director, Division of Market Regulation, Commission, to Daniel T. Brooks, Cadwalader, Wickersham & Taft, dated August 8, 1986 (staff no-action position regarding Instinet's non-registration with the Commission as an exchange, an association, or a clearing agency).

4/ NASD 1987 Annual Report at 5.

are disseminated, and such quotations must reflect at-the-market trading interest on the limit order book as well as in the trading crowd. Unlike in the futures markets, 5/ firms can "shop" blocks either off the floor or on the floor, and can pre-announce buying or selling intentions. Further, limit orders away from the market can be sent to the floor and exposed to the specialist, while such orders in an open outcry system would remain with a floor broker or not be sent to the floor.

Finally, we do not believe that opening up the specialist's book on October 19 would have had any significant impact. The lack of buying interest on that day was due to other factors, such as the huge sell imbalances, large futures discounts, and unwillingness of upstairs firms to provide buying support in a rapidly declining market.

Nevertheless, the Commission recognizes the importance of the central point raised by Professor Leland -- how to provide liquidity for portfolio-sized transactions. To that end, the Commission has supported the development of "basket" trading facilities for stocks. The Philadelphia ("Phlx") and American ("Amex") Stock Exchanges have proposed one such approach. 6/ In addition, the Commission understands that the Midwest Stock Exchange is exploring a related product.

Question on Purpose Credit and the Crash from Senator Graham

Q.1. In light of the March 30, 1988 article by Martin Mayer which appeared in the American Banker, Senator Graham raised a number of questions about the role that credit played in the Market Break. Specifically, he raised the following questions:

1. What is purpose credit?

Purpose credit is a term used in the securities industry to refer to credit that is extended to purchase or sell

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5/ See In the Matter of Kidder, Peabody & Co. et al., Complaint and Notice of Hearing before the Commodity Futures Trading Commission, CFTC Docket No. 88-6 (January 29, 1988).

6/ See Securities Exchange Act Release No. 25495 (March 23, 1988), 53 FR 10311 (File No. Phlx-88-7), and File No. SR-Amex-88-10.

securities. 7/ The Board of Governors of the Federal Reserve System ("FRB") regulates the use of purpose credit pursuant to Regulations G, T and U.

As a general matter, Regulation U, which applies to loans by banks, limits the amount of purpose credit that can be extended to customers. For equity securities listed on an exchange, or certain over-the-counter securities, the maximum credit that may be extended is 50% of the market value of the security. Regulation U provides exemptions from the maximum loan limitations that permit banks to make special purpose loans to broker-dealers, on a good faith basis, where the loans are secured by hypothecated customer securities, are used to finance the purchase of securities for prompt delivery with repayment to the bank, or where certain emergency conditions exist. In addition, there are specific exemptions in Regulation U that permit banks to lend on a good faith basis to finance the positions of block positioners, specialists, and over-the-counter market markers. Because the collateral requirement under Regulation U for loans to finance specialists' and market markers' positions is not specific, banks individually determine the maximum amount they will lend against particular classes of securities. While there is a range of collateral value provided by the banks that depends upon the creditworthiness of the particular customer, the advance rates (i.e., the amount a bank will lend against collateral) tend to range from 75-90% of the value of the securities.

Q.2. The preface to Senator Graham's question relates the idea that the SEC was granting exemptions under Rule 3b-8 of which the FRB was unaware. Senator Graham asks if Mr. Mayer's article is correct in saying that arbitrageurs in takeover bids are part of an exempt group that is not bound by margin requirements. In addition, Senator Graham requests that the Commission provide copies of interpretive or exemptive letters on Rule 3b-8.

Rule 3b-8 defines the terms "Qualified OTC Market Maker," "Qualified Third Market Maker," and "Qualified Block Positioner," for use in Regulation U. These terms, which had been used in three separate Commission rules (Rules 17a-12, 16, and 17), were consolidated in Rule 3b-8, and the separate rules

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7/ The term "purpose credit" is defined in the definitional sections of Regulations G, T and U, which are promulgated and administered by the FRB. See 12 C.F.R. §§ 207.2(l), 220.2(u); 221.2(k).

were rescinded. 8/ Rules 17a-12, 16, and 17 had required that broker-dealers notify the Commission when they began acting as, or ceased acting as, OTC market makers, qualified third market makers, or block positioners in particular securities. The rules had also required that these firms file quarterly reports indicating the amount of exempt credit they held at the beginning and end of the reporting period. The reporting requirements were eliminated because of concerns that the costs to broker-dealers were not offset by any substantial regulatory benefits. In particular, it was believed that the same information could be obtained by the Commission and SROs through their inspection programs. Nevertheless, broker-dealers qualifying for any of the exemptions still must provide written notification of their status to the bank that extends them credit.

Since Rule 3b-8 is merely definitional, the Commission does not grant exemptions from its provisions. Moreover, contrary to the statements in Mr. Mayer's article, our review reveals that no written interpretations of the rule have been offered by the Commission's staff since it was adopted in 1983.

Major investment banks are among the largest participants in the risk arbitrage field. These firms borrow from a number of sources to finance their positions in the U.S. securities markets, as well as their non-securities activities in the U.S. and abroad. A major source of borrowing can be the sale of commercial paper through their holding companies. In addition, banks frequently lend on an unsecured basis to broker-dealers or their holding companies. In these instances, the credit may be used for any number of purposes that would not fall within the definition of purpose credit.

The exemptions in Regulation U for specialists and qualified OTC market makers generally are not available for risk arbitragers, because the specialists' and market makers' activities contemplate continuity of activity and in particular maintenance of two-sided market quotes. As a general matter, risk arbitragers also would not qualify for the exemption in Regulation U for block positioners. In contrast to block positioners, who acquire large positions for short periods of time in order to facilitate a transaction, risk arbitrage normally involves the commitment of capital as an investment, with the expectation that the broker-dealer will profit from holding securities of an issuer that is subject to a merger, acquisition, tender offer, or similar recapitalization. Finally, most risk arbitragers would not qualify as third market makers under Regulation U, because they

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8/ See Securities Exchange Act Release No. 20121 (August 26, 1983), 48 FR 39604.

do not quote competitive bids and offers on a regular and continuous basis.

As a general matter, credit extended to finance the purchase and sale of securities by broker-dealers solely engaged in risk arbitrage would not be exempt from Regulation U. Consequently, firms borrowing from banks to finance positions for risk arbitrage would generally be subject to a 50% collateral requirement. Nevertheless, firms which engage in risk arbitrage also may engage in other activities for which there is an exemption. Under Regulation U, it is the bank's obligation to assure that the credit is used solely for the purpose for which the exemption has been granted. A broker-dealer that causes a bank to violate Regulation U would itself be liable under Regulation X.

Q.3. Did the severity of the crash in part result from a pull back of credit by banks who had insufficient margin because of these rule exemptions? Doesn't this SEC-FED coordination breakdown defeat the anti-speculative purpose of margin regulation?

Although some newspapers reported that the severity of the market break was influenced by a withdrawal of credit by banks, the Division of Market Regulation indicated in its Staff Report 9/ that it did not find any generalized restriction of credit during the market break. There was, however, some tightening of credit to broker-dealers by individual banks, including regional and foreign banks. While the decline in stock prices prompted some banks to reduce the amount of funds they were willing to lend against securities pledged as collateral, the staff's interviews suggest that the major New York City banks continued to provide the liquidity necessary to finance the positions of market makers and specialists. Those specialists or market makers that were not well capitalized were perceived to be a source of credit exposure by banks. The banks, however, indicated that during the market break they made lending decisions on a case-by-case basis and that the demand for credit did not exceed the banks' internal lending guidelines.

Banks that lend to firms that focus any significant portion of their capital on risk arbitrage activities generally require that the loans be secured by a perfected interest in a basket of securities maintained at the Depository Trust Company, or pursuant to agreements to pledge, in which the broker-dealer segregates securities on its books and records for the benefit of the lien holder. When banks lend to broker-

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9/ SEC Staff Report, The October 1987 Market Break, at pp. 5-19 to 5-32.

dealers on a secured basis, they receive lists each day indicating which securities are being used to collateralize their loans. Broker-dealers are not permitted by the banks to provide collateral with a concentration of any particular issuer's securities, so it is unlikely that a decline in a particular issuer's securities would significantly impair a bank's security interest or require an intra-day margin call. These daily collateral lists inform the bank of the securities it has extended credit to finance, and are closely reviewed to assure compliance with the lending agreements.

During the market break, firms that devoted significant portions of capital to risk arbitrage were a concern to banks. However, although collateral for these firms was diversified, the banks were aware that market-wide declines may have affected their capital. To adjust for this risk, some banks made intra-day margin calls, which required the broker-dealers to provide more collateral to secure their loans. Despite significant declines in the market, we are unaware of any banks that had defaults on loans to risk arbitragers. Moreover, our subsequent conversations with banks and broker-dealers have not suggested the need for any new regulation in this area.

Appendix A

FRONTRUNNING - SRO Enforcement Actions Reported to the Commission under Rule 19d-1 during 1986, 1987, to 4/15/88*

INTRAMARKET FRONTRUNNING

Year	#	SRO	Member and Sanction
1988	1	Amex	Berkman & Leff, Inc., fined $1,500.
	3	CBOE	Trader/Members Rudnik, Ruschli and Rusinak, each fined $1,500.
(TOTAL 1988	4)		
1987	1	MSE	Member Andrews Equities, Inc., fined $2,000. President/Trader J.D. Andrews, fined $8,000 and suspended 3 weeks.
1986	1	CBOE	Trader/Member B. Fatoorachi, fined $500.
	6 =	TOTAL Intramarket frontrunning	

INTERMARKET FRONTRUNNING

Year	#	SRO	Member and Sanction
1988	1	CBOE	K & M Investment Co. and trader W. Johnson, fined $5,000 and censured/fined $7,500 respectively
1987	1	CBOE	PruBache, Inc. censured, fined $15,000.
1986	1	Phlx	Member/Traders DeMartino and Vendette, fined $10,000 jointly & severally.
	1	CBOE	Saloman Brothers, Inc., fined $5,000.
	1	CBOE	Gruntal & Co., Inc. and trader, fined $7,500 jointly and severally
(TOTAL 1986	3)		
	5 =	TOTAL Intermarket frontrunning	

TOTAL FRONTRUNNING completed actions for 1986, 1987, 1988 = 11

*As frontrunning violations frequently take several months to investigate and prosecute, some of these final disciplinary actions reported to the Commission under Rule 19d-1 were opened as early as 1984.