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News Release

Regulatory Perspectives on Stock Index Trading

Remarks to

The Conference on the Impact of
Stock Index Futures Trading

Columbia Futures Center
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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

REGULATORY PERSPECTIVES ON STOCK INDEX TRADING

I appreciate your invitation today to join the Stock Index Conference, to be part of a distinguished panel of regulators and to have the benefit of the considered research and discussions you have heard today. In my opening remarks for this roundtable, I will briefly discuss the evidence on market volatility, the current efforts by the Securities and Exchange Commission in this area, and some general concerns at the regulatory and political level concerning stock index trading.

The Evidence on Stock Market Volatility

First, let me turn to what is perhaps the fundamental question driving all the current concern: are the markets more volatile? I find that the answer is almost always the same. No matter how many different ways that market volatility is defined, it has not been found to be increasing in recent years. And even if some increase is noted, there is no evidence that trading in derivative products has contributed to it. Professor Edwards provides an excellent summary of past research and valuable new contributions in his paper today. 1/ I find it interesting that there seems to be more of an impact on stock index prices from the change in monetary practices from 1979 to 1982 than from the introduction of stock index futures. Another study currently underway in the Office of the Chief Economist at the SEC studies the difference in volatility between a portfolio composed of stocks of interest in index trading and a portfolio of stocks not so clearly related to index trading. Since 1983, the difference between the volatility of these portfolios has decreased.

Given these conclusions -- that derivative products have not increased the volatility of the market for the underlying products, and indeed that there is no measurable increase in market volatility at all -- we may ask as Professor Edwards does, what is all the fuss about? Can't we just wash our hands of the whole non-problem? For purposes of this Conference, that might be a dangerous question, but fear not, for even a non-existent problem must be studied and researched. The impacts of index trading, even if not disruptive, can still provide fascinating insights into the operation of our capital markets, as we have seen today.

But it is clear we cannot just wash our hands of the non-problem of market volatility. The empirical evidence,

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1/ Edwards, Financial Futures and Cash Market Volatility.

although it finds no overall increase in volatility, also finds that volatility is showing some increase in the very recent past, and that there is a marked increase in volatility on expiration Fridays. Again, Professor Edwards' work is an example. Although the impact of expiration Friday is not large, it has been spectacular. For better or worse, it is the spectacles that create the interest and the demand for action.

Regulatory Responses to Volatility Concerns

With that, let me discuss the specific responses we have made and considered at the Securities and Exchange Commission. I should note that the staff of the Commission's Division of Market Regulation has been thoroughly investigating and studying the issues for at least two years; their work and input have contributed greatly to the Commission's and the public's understanding.

In June 1986, the Commission discussed three possible responses to concerns about volatility on expiration Friday: early exposure of orders, a temporary trading halt at the close, and settlement of index products based on opening instead of closing prices. 2/ The first -- the early exposure program -- will undergo its fourth test a week from Friday. The staff's evaluation to this point is that it has been largely successful in keeping the close orderly. I believe more study is needed before we reach firmer conclusions: for example, can we measure the impact of the early exposure program? If the program is beneficial, should it be extended to more stocks?

The other two alternatives put forth two years ago were a temporary trading halt and settlement based on opening prices. As Professor Stoll points out in his paper prepared for this conference, these two are operationally similar. 3/ It is partly because the NYSE has in place procedures for resolving imbalances at the opening that the staff first suggested moving to opening prices for settlement.

2/ The Commission's decisions were summarized in a June 13, 1986 letter from Shirley Hollis, Acting Secretary, to the American, New York, Pacific and Philadelphia Stock Exchanges, the National Association of Securities Dealers and the Chicago Board Options Exchange.

3/ Stoll, Index Futures, Program Trading and Stock Market Procedures.

Thus, two years later, we have the first settlement at the opening. The Commission, the NYSE and the options exchanges have agreed that certain procedures will be followed to provide early exposure of imbalances and an effort to remove them and open all stocks for trading on time. In addition, the Commission and the exchanges have agreed that particular attention should be paid to information collected on trading at this time. The Commission believes it is imperative during an experiment such as this one that all suspicious trading can be quickly and effectively investigated.

Although most of the volatility evidence centers on expiration days, there have been other trading days that have caused concern at the Commission: the notable days of September 11 and 12, 1986, and January 23, 1987. 4/ In each cases, the Commission thoroughly studied the trading and strategies during each day. If I can be permitted to compress many weeks of staff work into a short summary, trading on each of these days had legitimate economic sources, and the impact of program trading was to bring this information to the market with astonishing efficiency. On none of these days did the staff conclude that program trading produced artificial effects or that manipulation was involved in any way, although I hasten to add that I do not have any particular knowledge of the existence or the lack of any continuing investigations into the conduct of any individual traders on these days. But I do take comfort in the staff's general conclusion that exceptional trading usually has exceptional causes -- they are different in each case, but so far they are not new, uncontrolled or threatening.

Political and Regulatory Concerns

This brings me to my third point: what is the proper regulatory response to a suspected but as yet insignificant

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4/ See Division of Market Regulation, Securities and Exchange Commission, Report on the Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986 (Mar. 1987), reporting on the trading on those two days. The staff's study of trading on January 23, 1987, was not published, but was submitted to the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, but the Commodity Futures Trading Commission staff did publish a report. See Division of Economic Analysis, Commodity Futures Trading Commission, A Review of Stock Index Futures Trading on January 23, 1987 (July 1987).

problem? Even the concern about expiration Friday could be called a tempest in a teapot; the impact is small and it disappears quickly. In remarks to the Northwest Securities Institute in February this year, I noted with some disbelief the persistence of the notion that our markets have been destabilized by program trading. 5/

Although it is tempting, I do not believe that the proper regulatory response is inaction. I am afraid that securities market regulators often are made to appear as captains of the Titanic as they calmly proclaim all is well. I believe there are certain areas that would benefit from carefully limited regulatory initiatives.

First, we cannot calmly assure everyone that program trading is not destabilizing our financial markets unless we have done enough investigation to document it. Therefore, it is imperative that surveillance, oversight and monitoring procedures be constructed to permit us to keep tabs on the incidence and effects of program trading. Perhaps the one greatest concern that arose from staff studies of the market activity in September and January was the length of time it took to reconstruct accurate trading histories. Whether or not program trading continues to be a focus of public attention, it must be a new and permanent focus of regulatory attention.

Next, we must also consider the need for coordinated modification of market procedures. To date, the stock, options and futures markets have been very cooperative in implementing officially "voluntary" programs. The early order exposure program and the move of some products to settlement on the opening have come about in part through the efforts of individual markets. Each of these initiatives must be thoroughly studied to determine their impact on trading. If they prove to be effective in removing problems and preventing new ones, then we should examine ways to ensure that they are fully implemented.

Finally, in Washington, we know appearance is important. It is the appearance of program trading as unfair to the individual investor that generates most concern by our friends in the Congress, and it is important to respond to those concerns. The Commission staff has discussed program trading, its effects and our responses with Chairman John Dingell and others on the Hill, in an effort to maintain a helpful dialogue in this area. It

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5/ See Cox, The Uncertain Future of Market Confidence (Feb. 21, 1987) (Remarks to the Seventh Annual Northwest Securities Institute, Vancouver, B.C.).

seems that if markets appear volatile or unfair, then they are, empirical evidence notwithstanding.

One of the most persistent concerns in this area appears to be that program trading makes the markets inaccessible to the small investor. Professor Edwards also notes this point, discussing the individual investor's concern over determining the present or future value of his wealth. The staff and the Commission are greatly concerned that the best response currently available to individual investors is "they'd better learn to stay away from the market on expiration Friday." Again, I should emphasize we are dealing with an appearance of unfairness, especially for those individuals who do not find a need to trade at expiration. The individual investor who holds the now somewhat archaic notion that you can make money buying and selling stock on its fundamentals is not worse off because of program trading. To date the evidence suggests that the impact of fundamental changes overwhelms the occasional arbitrage. In the wake of the hectic trading on September 11 and 12, 1986, some advisers in the popular press predicted that investors buying based on intrinsic value would not be affected by programs, and in fact recommended such a strategy. 6/

The flip-side of this concern is that the individual investor cannot participate in the gains reaped from the program trading game. I am less concerned by this problem. In the first place, we were just told in the previous situation that the individual wants to avoid the programs. But taking this schizophrenia for granted, can the little guy trade programs? Not directly, of course, unless the little guy is extremely wealthy. But I don't believe that this is any indictment of our market system. Index products can be viewed as having been created to serve the institutional investor. They are useful tools to hedge without large disruptive trading, and arbitrage keeps those tools sharp and efficient. They are tools for the institutions, who are becoming the predominant traders in the securities markets. The little guy is certainly precluded from running their business for them, but he is not precluded from sharing in the reward through collective investment vehicles which employ index strategies. Index trading is not an individual's game, so there's no reason they should be participants rather than spectators. Although there is concern that the spectators could be injured by the game, to date we have little suggestive evidence.

6/ Playing a Roller-Coaster Market, Bus. Week, Sept. 29, 1986, at 94.

In conclusion, I would note that despite the lack of evidence of destabilizing market volatility due to index products, they still pose fascinating issues in financial economics, and I applaud you for addressing them. I believe our regulatory response should be that such study can and should continue. We must see that surveillance and oversight is in place to ensure that sufficient and timely information is made available. Above all, we should respond with considered incremental modifications, but only where such study has proved it necessary. And I believe it is to this effort that we have seen valuable contributions today.