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News Release

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Commissioner

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

When Alfred King invited me to address this gathering approximately 6 months ago, he indicated that I could speak on any topic of interest to publicly traded companies. In accepting Mr. King's kind invitation, I decided that it would provide the incentive to study and an opportunity to comment upon the Report of the National Commission on Fraudulent Financial Reporting. Particularly since the last time I addressed this group, I suggested that definitive answers on solutions to certain financial reporting problems should await the Treadway Commission Report.

As important as the work of my friend Jim Treadway is, the events of October 19, 1987 and ensuing weeks of market volatility have managed for some strange reason to overshadow all else. Since the October onslaught of the 1987 stock market crises (I have an idiosyncratic aversion to the terms "Crash of 1987" or "Black Monday") has preoccupied, and for the near future will preoccupy, the Commission's collective mind, I decided to direct my remarks to that subject, trusting that it would be of some marginal interest to you. Although, according to the Wall Street Journal, most publicly traded firms are -- "staying cool" (an easy task with all this snow) and are "unruffled by the crash." 1/

1/ "Staying Cool - Most Firms Say They Are In Shape to Deal With Any Recession" Wall Street Journal, November 6, 1987, p. 1.

I suspect that those of you most directly involved with corporate financial management are just a tad curious about how and why your company's shares could lose 22% of their value overnight when there has been no parallel change in the company's present operations or future prospects. Moreover, in recent years, corporations have increasingly gone to our nation's securities markets, rather than banks, to raise capital. However, it is difficult to find windows of opportunity in today's volatile equity markets so you must be asking yourself when will that change?

The Commission is looking for the answers to the same questions. We are doing so with some sense of urgency since the President of the United States wants an answer by mid-January. Of course, assiting the Brady Commission may be the least of our problems in light of the clamouring for explanations of and proposed solutions to the stock market crises from the members of the Commission's House and Senate Oversight Committees. Since I have to think about these questions, I might as well think out loud about what happened? Why did it happen? And what can or should be done about it?

What Happened? 2/

As Chairman Ruder recently testified, the market events of October 19th and the following weeks have been truly extraordinary. A brief recapitalization of those events provides a

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2/ Facts based on Chairman Ruder's statement before the Senate Committee and Banking, Housing and Urban Affairs.

sense of their historic proportions. On August 21, 1987, the Dow Jones Industrial Average ("DJIA") reached 2,736 its highest level ever. This was over three times its August 12, 1982 levels. Markets in other countries were experiencing similar unprecedented rises: In 1987, the Nikkei 225 Index, and the London Financial Times ("FT") Stock Exchange ("SE") 100 Index also reached three times their August 1982 levels.

Although the October 19, 1987 market crisis was striking in the suddeness with which it occurred it was not as precipitous as one might think. The U.S. markets declined in September, and indeed when the DJIA fell 91 points on October 6 -- then a record drop -- it was at 2,548, or 6.8% off its August high. During the week of October 12th the DJIA declined 235 points, or another 10%, with then record daily price declines of 95 and 108 on Wednesday the 14th and Friday the 16th.

Prior to October 12th the NYSE average daily share volume to date in 1987 had been approximately 180 million. Volume the week of October 12 increased to 338 million shares (another record) on the NYSE on the 16th. Prior to October 16, there had been only one 300 million share day on the NYSE, January 23, 1987, when the DJIA fell a mere 44 points.

There also was very high volume in the stock index options and futures markets during the week of October 12th. 3/ Volume in the principal stock index futures contract, the Standard and

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3/ Stock Prices Plunge Again in Very Heavy Trading - White House Act to Calm Jitters on Rate Increases," Wall Street Journal, October 16, 1987, p. 3. Contracts were being dumped by the then unprecedented "hundreds" by institutions.

Poors ("S&P") 500 contract traded on the Chicago Mercantile Exchange ("CME"), reached 135,000 contracts on Friday, 68% more than the average daily volume. Volume in the most heavily traded stock index option, the S&P 100 option traded on the Chicago Board Options Exchange ("CBOE"), exceeded the average daily volume for the year by approximately 40% to 100% that week.

Crisis Monday -- October 19

This was the week that was. On Sunday night, October 18, in the first major market (Tokyo) 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% and closed down 10% by the end of the day. In the United States during morning trading, the DJIA fell over 200 points, then climbed almost 100 points before beginning a steep downward plunge, dropping an additonal 400 points by the close of trading. The closing value of 1734 represented a loss of 508 points, or 22% from Friday's close. 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. A sobering thought for us all. Six hundred and four million shares were traded on the NYSE this day; a figure that represents three times the NYSE daily average for the year and almsot twice the record 338 million traded the preceding Friday.

This decline was not limited to the NYSE. 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 index option. Volume on October 19 was 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, the discount was a low as 20 and consistently was below 6.

That was only the beginning of a mind-boggling week. On Tuesday, the markets continued their global roller coaster ride of high volume and volatility. Stock markets around the world (except Hong Kong which closed for the week after round one) continued to have unprecedented volume and extraordianry volatility. Two hundred point declines after 100 point rises became the rule not the exception.

The average DJIA daily price movement from the October 16 through October 30 was 121 points, more than the previous single day record. 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 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.

For the week, the DJIA gained 2% of its value, closing at 1,993, which was still 27% below the August peak and 23% down from October 1. 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 also continued to be volatile. The Nikkei 225 closed on Friday the 30th 17% below its 1987 peak. The FT-SE 100 Index closed the week down 33% from its 1987 high. However, all the major indices, foreign and domestic, were rising at week's end.

Why Did it Happen?

I think it is fair to say that as many opinions are expressed as persons to whom the question is put. The most obvious answer is that investors lost confidence in the Bull market that had been raging for 5 years. But there is still the question of why? And why on October 19, 1987? If one adheres to efficient market theory there should be an identifiable change in one or more economic fundamentals to which one could attribute the market's response. 4/ A number of candidates for this dubious honor have been identified in news articles, editorials and commentary published during the past three weeks. The ones most frequently mentioned are the U.S.'s (1) trade deficits and budget deficits, (2) falling value of the dollar and fear of recession, (3) rising interest rates and fear of inflation, (4) the U. S. bombing of an Iran military installation in the Persian Gulf, and (5) pending legislation on foreign trade and takeover taxation.

4/ "Efficient Market Theorists are Puzzled by Recent Gyrations in Stock Market," Wall Street Journal, October 23, 1987, p. 7. See generally, Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970).

A. Trade and Budget Deficits have been identified by a great many as the cause of the stock market crises. 5/ While there is no doubt that the trade and budget deficits constitute major problems for the U.S. economy, however, if you adhere to the efficient market hypothesis, I think one has to discount the probability that they were the or even a principal cause of the October 19th crises for several reasons.

-- First: The huge U.S. trade and budget deficits have been a constant economic fundamental for years. In fact, they apparently were largely ignored while the market tripled in value during 1982 to 1987.

-- Second: The crises was global in nature and had significant effects in markets such as Japan and Germany which both have trade and deficit surpluses.

-- Third: As was pointed out by Arthur Laffer, an economist, among others, reductions in the trade deficit would logically encourage the market yet the market hit an all time high a year ago when the budget deficit was $220 billion and crashes when it was at $150 billion. 6/

5/ William Freund, "Our Foreign Debt Makes the Job Difficult," New York Times, October 25, 1987 Sect. F, p. 2; Sen. Lloyd Bentsen, "Don't Rule Out Tax Increases," New York Times, November 1, 1987, Sect. F, p. 2; "Extradordinary Butchery," The Economist, October 24, 1987, p. 75-76; "Nation's Twin Deficits Finally Takes A Toll," Washington Post, October 20, 1987, Sect. C, p. 1, etc.

6/ Irving Kristol, "Look at 1962, Not 1929," Wall Street Journal, October 28, 1987, p. 32; Arthur Laffer, "A Time to Undo," New York Times, November 1, 1987, Sect. F, p. 6.

B. Currency Problems.

Many commentators, economists and analysts argued immediately after the crash that Treasury Secretary Baker's fued with the West Germans over fiscal policy which led to his hint that the United States may allow the dollar to decline further against the mark contributed greatly to the market's crisis. The Wall Street Journal, for example, in an editorial the day after the crash used the crash and Treasury Secretary Baker's comments as ammunition with which to make its standard argument that there must be a summit to stabilize exchange rates. 7/

Regardless of what, should be done to either stabilize exchange rates or not, nearly all observers felt that the debate over what to be done with the dollar contributed to the market's decline. An article in the New York Times, the day after Monday's crash noted that "many experts seem to think that a major catalyst was the apparent unraveling of accords to maintain trading and currency stability between the United States and its major trading partners." 8/ New York Times, October 20, 1987, p. Al. Clearly, a fall in the value of the dollar would hurt foreign investors as directly as an actual decline in the price of stocks they have invested in American markets would. The Economist

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7/ "In Our Hands," Wall Street Journal, October 20, 1987, p. 36.

8/ "Worldwide Impact - Frenzied Trading Raises Fears of Recession," New York Times, October 20, 1987, Sect. A, p.l.

Magazine in its October 24 issue argues that Secretary of Treasury Baker's feud with the Germans was one of the primary causes of the market's decline. I will not reiterate the characterization given to the Secretary's remarks by the Economist but it is pertinent to note its conclusion that "American officials could [not] get away with talking down the dollar at the same time as expecting foreigners to go on lending it money. To the markets, the trilemna became clear: either there must be a higher American interest rates, or a weaker dollar, or chaos." 9/

This is an interesting point of view on what caused the market crisis. Verification of it will have to await studies identifying more precisely who was selling in U.S. markets during the crisis. A treasury bond futures trader during a recent speech in Washington suggested that the big sellers during the week of October 19th were U.S. mutual funds not foreign investors. 10/ Moreover, on October 19th, the value of the dollar changed insignificantly vis a vis the yen and the German mark. Furthermore the currency futures market was predicting an increase in the value of the dollar. 11/

9/ "Extraordinary Butchery," The Economist, October 24, 1987, p. 76.

10/ Thomas Kelly, speech at seminar sponsored by Chicago Board of Trade, October 28, 1987.

11/ Office of the Chief Economist, Preliminary Report, October 23, 1987, p. 1.

D. Interest Rates, Fears of Inflation, and Monetary Policy

As noted previously, prior to the Monday October 19 crisis there were fears among the investing public that interest rates were going up. Indeed, the bond market dive from the Spring of this year to a point where the yield on 30-year treasury bills were now greater than 10%, fueled these suspicions. Also, the Fed in early September raised its discount rate by 1/2% to 6%. 12/ While interest rates were clearly of concern to some, certain experts suggest that fear of higher interest rates was an unlikely cause of the October 19th decline in the market. They point to the fact that such an explanation seems inconsistent with the data. The bond market had rallied that week, in part because of the reallocation of funds from the equity market to the bond market. If the reason for the decline in the equity market was the anticipation of higher interest rates, the bond market should have declined with the stock market. Evidence from the financial futures market is also inconsistent with the "interest rate theory" of the market's decline - the market is not predicting an increase in interest rates one year out.

I rather suspect that all of the economic fundamentals I have mentioned are contributing factors to the overall sense of unease in the investing public driving it to sell rather than to

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12/ Henry Kaufman, "History Lessons We Failed to Learn," New York Times, October 25, 1987, Sect. F, p. 3.

buy. But taken together, they do not seem to hold up to what the lawyers call the proximate cause or immediate cause of a particular event. I am confident that many books will be written on the cause of the stock market crises of October, 1987. Many of those will offer cogent and perhaps even definitive answers as we gain distance from the event and therefore historical perspective. In the meantime, I shall remain fascinated and even a little amused by the fact that analysts and economists much more learned than I about the economy, economic theory and free market dynamics have not found an answer on which they agree.

However amusing or fascinating I find the lack of consensus between the experts, I am still lacking a response for those who are looking to the Commission for one. Based on a practical analysis of the events and available commentary, my personal preliminary thoughts are that --

(1) Those who have been saying since last summer that the market was overvalued and due for a correction were right on target. The stage was set for a turn "but it did need a spark" as John Phelan was noted as saying in a recent New York Times article. 13/

13/ "The Events that Changed the World of Wall Street," New York Times, October 26, 1987, Sect. A, p. 1.

(2) The spark may have been news of the tax bill passed by the House Ways and Means Committee during the week of October 12, 1987 followed by a sell off of takeover stocks by arbitragers.
As you know the tax bill, among other things, would particularly disadvantage leveraged acquisitions making them considerably less attractive. It also imposed an excise tax on greenmail payments.

However, the most thoughtful of the commentaries on the tax bill was an article by Edward Yardeni, director of economics at Prudential-Bache appearing in the October 28th Wall Street Journal. 14/ Mr. Yardeni demonstrates that the prices of takeover stocks fell dramatically in the period immediately following the announcement of the tax bill, and then asks the question, how can a decline in the prices of a few takeover stocks provoke a crash? The answer lies in the nature of the activity that has driven the bull market in the last few years. Noting that acquisitions and stock repurchases accounted for dramatic reductions in the supply of stocks, Yardeni quite plausibly suggests, that the bull market was largely fueled by mergers, acquisitions and buy backs. This activity resulted in a new pricing mechanism where "price earnings ratios rose closer to valuations based on majority rather than minority ownership." 15/ Simply put, more of the "control premium"

14/ Edward Yardeni, "That M & A Tax Scare Rattling the Markets," Wall Street Journal, October 28, 1987, p. 32.

15/ Id.

came to be reflected in the prices of publicly traded stocks. Thus, when it was perceived that these transactions might be more difficult to complete, given tax hits on debt and the increased cost of capital (remember interest rates were rising) the market returned to more traditional pricing models to value stock.

(3) With the tone set by the arbs on October 16, with psychology or panic and program trading -- more precisely portfolio insurance and perhaps index arbitrage contributed to the precipitous decline.

My three-part analysis may be totally, partially or only slightly wrong, anything less than totally would be a triumph. But I would like to leave you with this thought -- whatever the final answer is, I am persuaded we will not find it if we approach our analysis with a one dimensional view of our capital markets. They are not 100% rational or irrational, omniscient or ignorant. Therefore, no one process, theory or approach will explain them or provide the framework for a solution.

We must remember we are not looking for a scapegoat but answers and solutions.