U.S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Advanced Text

Remarks of

David S. Ruder
Chairman
United States Securities and Exchange Commission

Before Keidanren
Tokyo, Japan

February 18, 1988

THE OCTOBER MARKET BREAK: A STIMULANT TO UNITED STATES-JAPANESE COOPERATIVE SECURITIES REGULATION

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

I. Introduction

Thank you for this opportunity to speak before Keidanren. As executives and directors of multi-national companies, you undoubtedly are interested in the extraordinary turmoil that occurred in the United States markets and markets around the world in October. I would like to discuss the "October market break" and recent recommendations made by the Securities and Exchange Commission (SEC) to address market problems. I will also discuss in general the regulation of international securities markets.

II. Summary of the October Market Break

During October 1987, the United States securities markets experienced an extraordinary surge of volume and price volatility. In Japan, the Tokyo Nikkei Index is one of the most widely followed stock market indicators. The most widely followed indicator of the United States stock market's movements is the Dow Jones Industrial Average index of 30 New York Stock Exchange stocks (the "Dow"). The Dow reached an intra-day high of 2746 on August 25, 1987, 851 points (44%) above the closing level of 1896 on December 31, 1986, and on October 2, 1987, closed at 2641. During the week of October 5, the index declined by 159 points. During the week of October 12 it declined by 236 points, including a decline of more than 100 points on Friday, October 16. On October 19, the Dow declined 508 points, and by its low point mid-day on October 20 it had declined to 1709, or over 1,000 points (37%) below its August 25

high. By October 30, after an erratic, but substantial recovery the Dow stood at 1,994, down over 26% from its August high.

Other indexes also declined for the month of October. For example, the composite indexes for the nation's three principal securities markets, the New York Stock Exchange, American Stock Exchange, and the National Association of Securities Dealers Automated Quotation system for over-the-counter stock trading, experienced declines in October of 21.9%, 27%, and 27.2%, respectively.

In the United States, stock indexes are traded on commodity futures exchanges in the form of futures contracts. Futures exchanges are organized markets for trading standardized contracts to buy and sell specific amounts of certain commodities at specified prices on a specified future date. As you may be aware, several United States futures exchanges have asked permission to trade futures based on foreign indexes, including the Tokyo Nikkei Index. In Japan, I understand that the Osaka Stock Exchange already trades a stock index future and the Tokyo Stock Exchange intends to trade stock index futures.

Like the stock markets, the United States' stock index futures markets also experienced large declines in October. Prices for the most actively traded stock index futures -- the S&P 500 futures contract on the Chicago Mercantile Exchange -- experienced more extreme fluctuations than the prices for the

underlying stocks (termed the index's "cash" price). 1/ During the weeks of October 19 and 26 the S&P 500 futures contract reached levels as low as 181, down 44% for the month and equivalent to the Dow reaching 1444. 2/ In addition, from October 19 to October 28 the price relationship between the futures and stocks was inverted, with the futures consistently trading (with a few brief exceptions) at large discounts to the stocks. Normally futures prices are slightly higher than cash prices. Although the discounts eventually disappeared, by the end of October the price of an S&P 500 contract had fallen to 259, roughly in line with the cash market price, and down 24% from its August high point.

The October market break also highlighted the growing interconnections among securities markets internationally. Ripple effects of the market volatility were seen in strong, well capitalized international markets such as Tokyo and London. The Tokyo Nikkei index declined 4456 points (16.9%) on October 19 and 20, closing on October 30 at 23,328.91, down 10%. The London Financial Times-Stock Exchange 100 share index fell 500 points (almost 22%) on October 19 and 20, closing the month at 1749, down 26%. Our review of international trading shows that the

---

1/ Because relevant S&P 500 futures trading during the October market break was limited almost exclusively to the December contract, all references are to this contract unless a different contract is specifically noted.

2/ The Dow closed at 2596.28 on September 30, 1987. Therefore, a 44.4% drop in the Dow for the month of October 1987 would have the Dow reach 1443.53.

stock price changes in various markets during the market break were significantly correlated.

Trading volume in the United States markets during the market break also increased dramatically. Although before October 19th trading volume on the New York Stock Exchange usually had averaged less than 200 million shares and only twice had risen above 300 million shares, two consecutive 600 million share trading sessions took place on the 19th and 20th of October. Other markets also experienced record volume, including the S&P 500 futures. Volume in this contract surged from 82,000 contracts on October 13 to 162,000 on October 19.

After October 19 and 20, the securities and futures markets did not return to a status even approaching "normal" until the end of the month. The final eight trading sessions in October included six sessions in which the Dow moved (as measured by closing prices) more than 50 points, including the largest one-day rise in the index (187 points or 10.1% on October 21), and the second-largest one-day decline in the index (157 points on October 26). In addition, although six of these sessions were shortened to close at 2:00 p.m. (Eastern Time in the United States), 3/ daily New York Stock Exchange volume for the

---

3/ After the 4:00 close on October 22, the New York Stock Exchange announced that the exchange's trading hours would be temporarily reduced, with the close moved to 2:00, to permit members to process the enormous trading volume during the market break. All major securities and index futures similarly reduced trading hours. Starting on November 2, trading hours were gradually extended and returned to normal on November 12.

remainder of October exceeded 240 million shares (including a 449 million share day on October 21 and a 392 million share day on October 22). Finally, it was not until October 29 that the aberrational discount to cash in the S&P 500 futures contract abated.

The increased market volatility continues to be worrisome. By some estimates, the 1987 volatility for S&P stocks was roughly equivalent to 35% of the stock prices -- more than twice the annual level of volatility for the period 1983 through 1986. Moreover, on January 8, 1988, the Dow fell 140 points, exhibiting dramatically the continuing increased levels of volatility in our markets.

III. SEC Analysis of the Market Break

Understanding of the market break will be aided by a description of current institutional investing practices in our markets. During the last decade institutions have amassed increasingly large portfolios of securities, and increasingly they desire to trade in the equivalent of all or a portion of an entire portfolio. This desire has been 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 by routing orders to buy or sell between 1,000 and 3,000 shares of approximately 450 corporations to the New York Stock Exchange through the Exchange's automated Designated Order Turnaround

system, called DOT. In connection with portfolio trading (sometimes called "program trading") the large institutions have also developed sophisticated index arbitrage and portfolio insurance strategies.

Index arbitrage is the purchase (or sale) of stocks that comprise an index and the simultaneous sale (or purchase) of futures or options on that index. The purpose of such trading is to capture the difference between the value of the index and the collective value of the portfolio of stock comprising the index. Arbitrage usually reduces differences in prices between the stock index futures and stock markets by pushing up prices in the market where the buying occurs and pushing down prices where the selling occurs. By helping to achieve closer price correlations between the stock index futures and stock markets, arbitrage will facilitate the use of futures to protect or "hedge" the value of stock portfolios. The most obvious hedging technique involving futures is the sale of a stock index future by the owner of a portfolio of stocks. The stock index futures position will increase in value as the prices of the underlying stocks decline, thus protecting the portfolio owner against market decreases without requiring the sale of the portfolio securities.

"Portfolio insurance" is a hedging strategy that was in widespread use in the United States before the October market break. Under one version of this strategy, stock index futures are sold when the value of the portfolio decreases a certain percentage. The sales of futures are thought to be easier and

quicker than the sale of stocks, thereby offering a means of controlling risk for a broad-based portfolio in a declining market. If the futures markets become congested and too costly, some portfolio insurance plans call for the sales of stock instead of futures.

During the week of October 12th the United States markets declined more than 250 points. As I have indicated earlier, on Friday October 16th, the Dow declined more than 100 points. According to the Presidential Task Force on Market Mechanisms (The Brady Report) selling at the end of the week of October 20th was triggered primarily by "disappointingly poor merchandise trade figures, which put downward pressure on the dollar in currency markets and upward pressure on long term interest rates; and the filing of anti-takeover tax legislation . . .."

The above factors, other economic news, and the Friday decline created great selling pressure on Monday, October 19th. These pressures were exacerbated on October 19th and 20th by large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance 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 most probably extended it beyond levels that can be accounted for by fundamental economic factors alone.

The SEC has concluded that the current United States 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. In addition, because of the increasing internationalization of markets, this linked market affects foreign equity markets.

IV. SEC's Recommendations

In response to these events, the SEC has recommended three broad approaches for reform: (1) expanding capacities of the markets; (2) increasing the coordination among the markets; and (3) retarding the volatility and volume of trading during crisis periods.

The SEC intends to emphasize the first two approaches: expanding the capacity of our markets and increasing intermarket coordination. 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 its two primary recommendations for expansion and coordination, the SEC is suggesting that the interlinked market should be made more efficient. 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 SEC has also made many specific recommendations. First, with regard to the New York Stock Exchange, the SEC recommends implementation or review of five measures to increase the New York Stock Exchange's capacity to manage increased volume and volatility. To understand these recommendations, you should know that the specialist is the individual on the New York Stock Exchange responsible for conducting the auction in each stock. As agent the specialist trades public customer orders. The specialist also trades for his own account and when doing so has the responsibility of maintaining a fair and orderly market. The specialist is sometimes compared to the "saitori" on the Tokyo Stock Exchange, but unlike the saitori the specialist is primarily a market maker, with special responsibilities to buy when the market is falling and to sell when the market is rising. The Commission's recommendations regarding the New York Stock Exchange are: (1) increasing specialist capital; (2) improving specialist performance procedures; (3) enlarging DOT; (4) creating an opportunity to trade portfolios on the New York Stock Exchange; and (5) publicly disseminating portfolio trading information. In addition to these measures, the Commission is reevaluating current short sale regulation in light of the changed market conditions and new trading strategies.

While the Commodity Futures Trading Commission is primarily responsible for stock index futures markets in the United States,

the SEC also has made recommendations regarding these markets. First, we recommend block trading procedures similar to those used in the United States stock markets. On United States stock exchanges blocks can be negotiated off-floor and then crossed on the exchange under procedures designed to protect public orders. Similar procedures on the futures markets might increase the capacity of those exchanges to trade large blocks of futures without market disruption.

Second, the SEC believes that the relatively low amounts that must be deposited by futures buyers and sellers -- called "margin" -- may have encouraged investors to have unreasonable expectations regarding their ability to exit the market quickly by engaging in stock index futures sales. In order to reduce the unrealistic peak liquidity expectations these margins may help create the SEC is recommending that the futures exchanges temporarily increase initial margin levels for stock index futures for market participants, other than floor traders, to approximately 20-25%, or approximately U.S. $25,700 for one S&P 500 contract valued at U.S. $128,500. Currently initial margin for this contract is U.S. $15,000.

Third, the SEC has recommended that the Commodity Futures Trading Commission and the futures markets effectively enforce prohibitions 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 SEC believes that the creation of a coordinated clearing, credit and settlement system across stock, options, and futures markets should be an immediate priority. The SEC also recommends consideration of the benefits and costs of coordinated stock, options and futures markets' opening and closing procedures.

The SEC also has made a series of recommendations aimed at the weaknesses revealed during the market break in the operations of the over-the-counter markets, the American Stock Exchange, the regional exchanges, and the options exchanges. Independently the SEC will be examining its own capital adequacy rules, which set forth the amount of readily available capital broker-dealers must maintain.

To increase the SEC's and the markets' surveillance abilities, the SEC is recommending increased reporting requirements that would require the timely reporting of large amounts of trading, including index arbitrage, portfolio insurance, and other portfolio trading. In the area of regulatory authority and structure, the SEC recommends that it be given additional authority to take a variety of steps in a market emergency and that it have the authority to make final decisions when disputes arise regarding regulation of the linked stock and stock index futures markets.

V. Internationalization Concerns

The October events also demonstrate the need to examine the relationship between the United States and foreign markets. In

recognition of this fact the Commission intends to intensify its ongoing coordination efforts with foreign regulators and markets. My visit here is an important step in this process. I believe that sound regulation enhances the vitality of markets and I am here to engage in discussions with the Ministry of Finance and the Tokyo Stock Exchange regarding regulatory matters. The key to sound international capital markets is to adapt the best rules and policies of each nation to new market structures and trading strategies.

I believe that the following regulatory principles should be considered by the markets throughout the world as they seek to adapt to internationalization:

(1) Sound standards for disclosure, including mutually agreeable auditing and accounting standards;

(2) Promotion of market fairness, including prohibitions against insider trading, market manipulation, and misrepresentations to the market place;

(3) The widespread availability of quotation and price information;

(4) Efficient and compatible national and international clearance and settlement systems;

(5) Broker-dealer registration qualifications and conduct requirements designed to promote integrity and honesty in the profession;

(6) Improvement of capital adequacy standards in order to provide greater stability and liquidity for national and international markets; and

(7) Establishment of international surveillance and enforcement agreements. 4/

In the latter regard I note that the SEC has developed cooperative agreements -- "Memorandum of Understanding" -- designed to assist the information gathering and enforcement process with several countries, including Japan. Under our Memorandum of Understanding with the Ministry of Finance, the SEC and the Ministry have agreed to "facilitate each agency's respective requests for surveillance and investigatory information on a case-by-case basis." One of the principal purposes of my trip here is to continue our discussions with the Ministry of Finance on the operation of the Memorandum of Understanding.

VI. Conclusion

The SEC strongly believes that the world's securities markets must be allowed to evolve if they are to remain healthy. Although the SEC's recommendations on the market break suggest that changes are needed, the most salient point that has emerged is that the world's securities markets withstood the October 1987 pressures. We believe that with increased cooperation within the United States and internationally, our markets and those of other

---

4/ See, The Regulation of International Securities Markets, (October 19, 1987).

nations will remain strong and healthy. Most particularly we seek a harmonious relationship between the Japanese and United States securities markets, a relationship that can lead to increased efficiency and capital availability for both countries. My visit to Japan this week demonstrates the desire of the United States Securities and Exchange Commission to cooperate with Japanese regulators to accomplish our joint goals.