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News Release

OCTOBER RECOLLECTIONS: THE FUTURE OF THE U.S. SECURITIES MARKETS

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

OCTOBER RECOLLECTIONS: THE FUTURE OF THE U.S. SECURITIES MARKETS

I. Introduction

It is a pleasure to be here to speak before the Economic Club of Chicago. My remarks tonight will focus on directions for the U.S. securities markets after the October 1987 market break. It seems appropriate to make these remarks in Chicago, the home of the world's primary options and futures markets and the place where a little over a year ago I gave my first major address as Chairman of the Securities and Exchange Commission. Ironically, the topic of that speech, which I delivered on October 6, 1987, was the impact of derivative index trading on the securities markets, a phenomenon which has since become a topic of great interest.

In examining our securities markets during the year following October 1987, I have concluded that five areas require close attention: market improvements, clearance and settlement, protection of small investors, information collection systems, and regulatory reform.

II. Market Improvements

To understand what happened in the U.S. securities markets in October 1987, it is necessary to understand changes in institutional trading strategies that took place during the last decade. During this period, the increasing size of many institutional portfolios made it difficult for portfolio managers to trade in the stock of a single company without unduly affecting the price of that stock. In addition, modern

portfolio theory gained increasing acceptance. As a result, many portfolio managers began to shift emphasis from individual stock selection toward trading the market as a whole. Reflective of this development, stock index futures and stock index options were introduced in the early 1980's as a means of satisfying increasing desires to trade portfolios of stocks. At the same time, the stock markets increased their automated systems for routing individual stock orders, and the New York Stock Exchange ("NYSE") introduced facilities for computerized routing of program trades through its Designated Order Turnaround System ("DOT").

Two of the institutional portfolio trading strategies that developed were index arbitrage and portfolio insurance. 1/ The institutional use of portfolio trading strategies during the October market break raised a number of serious questions. As we all know, the primary causes of the break were an "over bought" market and the confluence of some disappointing economic news. Nevertheless, large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance strategies accelerated the market decline. During certain critical trading periods on October 19 and 20, index arbitrage or portfolio insurance, or both, accounted for

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1/ For a description of these strategies, see remarks of David S. Ruder, Chairman, Securities and Exchange Commission, before the 27th Annual Corporate Counsel Institute, October 11, 1988 ("Institutional Responsibility Speech").

between 30% and 65% of total New York Stock Exchange volume in the stocks that comprise the Standard & Poor's 500 index. 2/ The Securities and Exchange Commission concluded that these new trading mechanisms "cause peak volume and volatility that at times overwhelm the capacity of the markets." 3/ The Commission added that on October 19 and 20 the liquidity problems that became apparent as traders attempted to rebalance multi-billion dollar portfolios were exacerbated by information failures that made it difficult for traders to estimate prevailing prices. The combination of intense selling pressure, market mechanism failures, and lack of information exhausted much of the available capital, caused substantial uncertainty, drove down prices, and generated unprecedented volatility. 4/

The role of institutional investors in the October market break bears emphasis. The total dollar value of all NYSE stock traded on October 19 was approximately $21 billion, and the total dollar value of stock index futures traded in the

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2/ See "The October 1987 Market Break," Report by the Division of Market Regulation, U.S. Securities and Exchange Commission, February 1988 ("SEC Staff Report"), at 3-12.

3/ See "Securities and Exchange Commission Recommendations Regarding the October Market Break" contained in February 3, 1988 Testimony of David S. Ruder, Chairman, Securities and Exchange Commission, before the United States Senate Committee on Banking, Housing, and Urban Affairs, ("February 1988 SEC Recommendations"), at 5.

4/ Id. at 5.

futures markets was approximately $20 billion. 5/ The total New York Stock Exchange market value at that time was just over $3 trillion. Thus, the selling activity, while tremendous, still represented only a relatively small percentage of all stock holdings and only a small percentage of the institutional selling suggested by the portfolio insurance formulas. 6/ It should be obvious that even today decisions to sell small percentages of portfolios containing $1 billion or more in NYSE shares can cause enormous downward pressures on the stock market. This simple fact emphasizes the need for markets to cope with institutional trading strategies and the need for institutions to reconsider the utility of some of these strategies. 7/

1. Market Capacity

Since October the Commission has been encouraging the securities markets to address new institutional trading strategies by increasing the capacities of their trading systems. The markets have responded. The NYSE has implemented system enhancements that will allow it to handle a 600 million share day without significant delays. The American Stock Exchange ("Amex") and the regional and options exchanges also

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5/ See Report of the Presidential Task Force on Market Mechanisms, January 1988 ("Brady Task Force Report"), at 36.

6/ Id. at 36.

7/ See Institutional Responsibility Speech, supra note 1.

have made substantial improvements in this area. 8/ The securities markets are to be commended for their ongoing commitment to increase systems capacities, despite the reduced volume of trading that has occurred so far this year.

2. Market Maker Performance and Capital

Another response to the difficulties related to the large volume surges associated with institutional trading strategies has been to increase market maker performance standards and capital. The Amex and the NYSE have reallocated significant numbers of stocks from specialists that exhibited inadequate performance during the October market break. They have increased their specialist capital requirements, planned higher increases for the future, and changed their rules to allow acquisition of specialist units by large retail firms. Similarly the NYSE has substantially increased the information available to it so that it can more easily engage in early monitoring of specialists firms' financial positions. Finally, the National Association of Securities Dealers, Inc. ("NASD") has imposed market maker commitment requirements that should

8/ These and other responses of the securities markets to the October market break are detailed in an October 18, 1988 Memorandum from Richard G. Ketchum, Director, Division of Market Regulation, to Chairman David S. Ruder ("SEC Staff Update"), available at the Securities and Exchange Commission.

increase the liquidity of the NASD Automated Quotation ("NASDAQ") market during volatile periods. 9/

Despite these improvements, it is fair to say that the specialist system was not designed to cope with large waves of institutional portfolio selling such as occurred on October 19. The specialists as a group did relatively well on that day, but measures to increase additional liquidity for portfolio trades are still needed.

3. Basket Trading

One means of dealing with portfolio trading pressures may come through the development of a variety of stock market portfolio trading vehicles, sometimes called "basket trading" systems. These systems seem to offer the promise of relieving specialists in individual stocks of pressure from some forms of portfolio trading. Stated differently, they offer the possibility that substantial additional capital will be devoted to absorbing portfolio trades.

The Philadelphia ("Phlx") and American Stock Exchanges and the Chicago Board Options Exchange ("CBOE") each have filed proposals with the Commission to trade such products in relatively small units. 10/ The NYSE is considering a basket

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9/ See Report of the Quality of Markets Committee of the NASD's Regulatory Review Task Force, July 1988 ("NASD Report").

10/ The Phlx, Amex, and CBOE proposals have raised jurisdictional questions regarding whether these products are securities subject to SEC regulation or futures (continued...)

product that would allow institutions to trade actual portfolios of securities more efficiently. In addition, the NYSE is discussing the listing of a privately sponsored mutual fund and unit investment trust product that could be split by the holder into different price appreciation, depreciation, and income shares. 11/

The basket trading ideas raise a variety of interesting issues. Concern has been expressed regarding the effect of basket trading on the order flow that would otherwise go to individual stock specialists. Questions exist with regard to whether a specialist or a competing market maker system should be used for such products. The extent of upstairs trading that might be allowed in these products is also at issue. Of course, the crucial questions are whether sufficient market making capacity will exist to support basket trading and whether institutional investors will use such a market. Despite these reservations, basket trading should be pursued by the markets as a potential means of adding liquidity.

10/ (...continued)
subject to CFTC regulation. See letter from Jean A. Webb, Secretary, Commodity Futures Trading Commission, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 29, 1988.

11/ See P. Maher, "Portfolio Insurer May Give Big Board its First Product," Investment Dealer's Digest, September 20, 1988, at 6.

4. Circuit Breakers

To address the potential for another sharp decline, the President's Working Group on Financial Markets 12/ recommended adoption of a "circuit breaker." Under this circuit breaker, the securities and derivative index markets will close for an hour after a 250 point Dow Jones Industrial Average ("DJIA") decline below the previous day's closing value, and will also close for two hours (the rest of the day for futures markets) after an additional 150 point decline. The purpose of the circuit breaker is to establish a pre-determined point at which the markets will know that a temporary closing will occur. During a short stopping point, credit arrangements can be checked, order imbalances can be identified, and the level of uncertainty can be reduced. Although the suggestion has been criticized by those who believe the markets should never close, the proposal has been implemented by the NYSE, the Amex, the CBOE, the NASD, and the stock index futures markets. 13/ Other

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12/ See Interim Report of the Working Group on Financial Markets, May 1988 ("Working Group Report"), at 4-5. The Working Group was composed of George D. Gould, Under Secretary for Finance of the Department of Treasury (acting as Chairman, designee of Secretary of Treasury James Baker); Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System; Wendy Gramm, Chairman of the Commodity Futures Trading Commission; and David S. Ruder, Chairman of the Securities and Exchange Commission.

13/ See Securities Exchange Act Release No. 26198 (October 19, 1988).

U.S. stock exchanges are expected to approve the proposal during their upcoming board meetings. 14/

Acting by agreement, the NYSE and the Chicago Mercantile Exchange ("CME") also have adopted "shock absorber" procedures under which the CME will not permit the price of the Standard & Poor's 500 futures contract to fall for thirty minutes after a 12 point decline in that index. A 12 point Standard & Poor's 500 decline is the approximate equivalent of a 96 point DJIA decline. Simultaneously, the NYSE will re-route market orders in each of the stocks underlying the Standard & Poor's 500 futures contract that involve portfolio trading from the Exchange's automated order routing system into a separate file for each of the S&P 500 stocks traded on the NYSE (approximately 460 in number). Buy and sell orders will then be paired in the files, and five minutes later the orders in each of the files, and the order imbalances (if any), will be reported to the specialists for the stocks. At that point, the orders will be eligible for execution. If there is not sufficient trading

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14/ In this connection, I also note that the markets have taken steps to create a better communications network so market participants can obtain timely information in a market emergency about individual stock trading halts, delayed openings, and other market conditions not revealed through trade and quotation reporting systems. For example, the markets have created an intermarket communications system to facilitate joint discussion among the market participants in an emergency. See SEC Staff Update, supra note 8. Through the Working Group the regulators also have enhanced interagency contingency planning.

interest to allow for an orderly execution of a transaction in a stock, trading in that stock will halt.

These new procedures replace the NYSE's pilot rule limiting the use of the NYSE's automated order routing systems for index arbitrage trading after 50 point DJIA movements. This six-month NYSE pilot expired on October 19, 1988.

5. Market Information

When new institutional trading strategies result in volume such as last October's, it is difficult for market observers to determine how much volume is related to purely technical considerations and how much is driven by fundamental re-evaluations of the market. In order to reduce this information uncertainty, the NYSE is working on methods to require disclosure of the aggregate levels of program trading in its market on a real-time basis. It also is considering proposals for public disclosure of orders on the specialists' limit order books, thus providing the public with more information about demand for particular stocks.

6. Continued Adaptation

The markets must continue to adapt to new institutional trading strategies. The stock markets should continue to experiment with portfolio trading products and systems, and should continue to improve information dissemination procedures. The additional increases in specialist capital the NYSE and Amex have under consideration also seem desirable. The futures markets should consider suggestions that they adopt

blocking trading procedures to accommodate the larger sized trades associated with new institutional trading strategies. 15/

At the same time that the markets are making necessary accommodations to new institutional trading strategies, institutions also should recognize that excessive reliance upon short-term trading strategies may not be in their own or their beneficiaries best interests. Instead of engaging in strategies that may have disruptive market effects, these institutions should adopt a longer-term approach to their participation in the equity markets. 16/

III. Clearance and Settlement

"Clearance and settlement" has emerged as one of the most significant problems revealed by the October market break. "Clearance and settlement" refers to the procedures used in the various markets for reaching binding agreement on the terms of a trade and then satisfying payment or delivery obligations.

In the futures and options markets, clearance and settlement involves initial agreement on the terms of the trade, the payment of options premium and initial margin obligations, and subsequent payments of daily variation margin to reflect changes in the value of positions. In the options market, the writer of an option is required to make daily

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15/ *See*, *e.g.*, February 1988 SEC Recommendations, *supra* note 3, at 13.

16/ *See* Institutional Responsibility Speech, *supra* note 1.

payments to reflect adverse market movements. In the futures market, the side of the contract losing value due to market movements is required to pay in cash each day a margin amount reflecting the amount of that day's loss. This cash is in turn received by the party whose position has gained. In times of large movements in the futures or options markets, intraday margin payments are frequently required and increases in initial margins sometimes require additional payment.

Clearance and settlement in the futures, stock, and options markets occurs through central clearing organizations that facilitate trade comparison and then stand as guarantors of the settlement obligations of the counter parties to the trade. These clearing organizations interact directly and indirectly with the banking system, through which clearing members and their customers make their settlement payments. A more accurate description of the entire system would therefore add the word "payments" to "clearance and settlement." The entire structure has been aptly described as a pyramid, with the traders at the top, the clearing organizations on the next lower level, and the bank payment system at the bottom. 17/

In October 1987, the massive volume and market movements put the clearance, settlement, and payment system under great

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17/ See "Reducing Risks in the System for Clearing and Settlement," May 25, 1988 Speech by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, to the Federal Reserve Bank of Richmond system symposium, reprinted in the American Banker, June 14, 1988.

stress. On October 19 alone initial and variation margin payments on the Chicago Mercantile Exchange were $2.5 billion, including funds collected by means of three intraday margin calls totalling more than $1.6 billion. 18/ The Options Clearing Corporation ("OCC") handled gross premium settlements of $1.8 billion on October 19, and $2 billion on October 20. 19/ On October 19, OCC issued four intraday margin calls totalling $1.2 billion. 20/ On October 20, there were delays of several hours in paying futures margin credits of $916 million to one firm and $678 million to another firm. 21/ Both of these firms were major participants in the stock market. These firms were obligated to make large payments to clearing organizations and had chosen to pass through payments to their customers prior to receiving clearing organization payments. The size of the payments involved and the delays caused great uncertainty and concern in the stock and futures markets and in the banking system.

18/ See Follow-up Report on Financial Oversight of Stock Index Futures Markets During October 1987, Division of Trading and Markets, Commodity Futures Trading Commission ("CFTC Follow-up Report"), January 6, 1988, at 39.

19/ See "The Options Clearing Corporation, The Backup System," Subcommittee of the Margin Committee of the Options Clearing Corporation ("OCC Backup System Study"), August 31, 1988, at 11.

20/ Id.

21/ CFTC Follow-up Report, supra note 18, at 54.

In the options market, the tremendous price movements put severe financial strain on First Options Clearing corporation, a major clearing firm. Without the infusion of significant amounts of capital from that firm's parent company, Continental Bank, First Options might have been forced to close temporarily. Since it was the clearing firm for approximately 40 percent of the options firms in the CBOE, the closing of First Options would have had serious repercussions.

A related problem in October 1987 arose from the inability to credit the value of positions in the options markets against the value of positions in the futures markets in determining the required amount of margin payments. Thus, a firm with a long position in an index option that had increased substantially in value received no credit reflecting this increase. When the futures clearing organizations increased initial margin payments on related index futures positions, it could not offset the option put position. Nor, with the exception of a few institutions, were major national banks willing to accept long put positions as security for financing broker-dealer positions. The inability to give credit across markets for various options and futures positions drained liquidity from the system at a time when it was most needed.

The sheer size of payments required during the October market break also put great strains on the banks making payments on behalf of firms to the clearing organizations. There was considerable doubt among banks, clearing

organizations, and clearing members as to when commitments to make payments were binding. In the options markets, late confirmations of money settlements by clearing banks were so numerous and involved settlements of such magnitude on October 20 that OCC delayed its payments to clearing members. 22/

The size of payment flows and the increased participation in futures, options, and stock markets of almost all major securities firms demonstrated that a major failure in any one of these clearing systems, or of a major firm, has the potential to affect all the other systems, other participants, and even the banking system. With this background, it is understandable that clearing, settlement, and payment systems are regarded as a major area in need of improvement. A common theme for improvement has been efforts to increase the intermarket coordination of clearance and settlement information and cash flows. 23/

1. Initial Margin Increases

Since the October market break, the options markets have tripled the amount of margin required to be paid when a position initially is acquired, and the CME, the most active

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22/ OCC Backup System Study, supra note 19, at 11.

23/ The following discussion focuses on improvements by the securities clearance and settlement organizations. The futures markets also have made changes to their settlement procedures in response to the October market break, including the institution of routine intraday margin calls and increases in the size of clearing funds. See Working Group Report, supra note 12, at Appendix E.

stock index futures market, has increased its initial speculative margin requirement from approximately 8% to approximately 15%. These increases in initial margin reflect the increased market volatility observed last October and during the immediately following months. They serve to provide futures commission merchants, broker-dealers, and the clearing organizations greater protection against customer default in the event of large market movements. These larger initial margin requirements also reduce somewhat the size of the variation margin payments that need to be made in the event of large price movements, while substantially increasing the cash under the control of clearing organizations to cushion any broker-dealer or futures commission merchant failure.

On the negative side, the CME, which shortly after the market break raised initial margins on hedged positions from approximately 3% to approximately 10%, has now returned to the 3% margin level for initial hedged positions.

2. Cross-Margining

Cross-margining is a system for giving credit to the value of options positions in determining futures margin and vice versa. During volatile market periods, cross-margining reduces initial margin requirements for new hedged positions and also offsets the substantially greater requirements imposed as clearing organizations increase their initial margin payments after volatile price movements.

Several initiatives have been undertaken since the October market break to increase the ability to cross-margin. On October 3, 1988, the Commission approved a cross-margin system developed by the OCC and the Intermarket Clearing Corporation ("ICC"). Under that system the ICC, which is a subsidiary of the OCC, will calculate and collect a single clearing system margin requirement for proprietary intermarket portfolios consisting of securities options and futures positions. 24/ On September 23, the CME and OCC announced an agreement to pursue arrangements to provide cross-margining of options and futures on stock index products that are issued and cleared by both organizations.

3. Stock Transaction Comparison

In the stock markets, agreement on the terms of the trade is called "comparison." Comparison in the stock market currently occurs from one to three days after the trade. During this comparison period, major firms or floor participants may be uncertain as to precisely what their proprietary risk positions are and may therefore reduce their willingness to commit firm capital to the market in volatile markets. The NYSE will soon file a proposed rule change to establish for itself and member firms the goal of next-day comparison of all stock trades. The NASD also has acted to facilitate same-day or next-day comparison of all NASDAQ trades

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24/ *See* Securities Exchange Act Release Nos. 26153 and 26154 (October 3, 1988).

through various enhancements to its automated systems. Earlier comparisons will be an important improvement, since stock market participants will know their net positions two days earlier than is now the case. This information will reduce uncertainty regarding the size of positions in the market.

4. OCC Backup System Study

In response to concerns raised by the October market break, the OCC conducted a study of its backup systems, including its membership standards, margin requirements, financial surveillance criteria, and clearing fund, settlement, and liquidation procedures. 25/ While concluding that the OCC systems operated effectively during the October market break, this study also made several recommendations for change. In addition to recommendations concerning cross-margining, the study suggests increasing OCC's membership requirements from $150,000 to $1 million of initial capital, enhancing financial surveillance procedures, considering coordinating OCC's morning settlement with those of other clearing organizations, 26/ and making a variety of technical margin changes.

5. Information Sharing

One of the primary means of guarding against panic in the payments system is improved information sharing. To that end,

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25/ See OCC Backup System Study, supra note 19.

26/ OCC's morning settlement occurs at 10:00 a.m. CT and the futures markets' morning settlements occur at 7:00 a.m. CT.

securities clearing organizations have established a formal information sharing group, called the Securities Clearing Group ("SCG"). The SCG has formalized existing information sharing arrangements among securities clearing organizations, including sharing of settlement, margin, and position information. The SCG has agreed to investigate important initiatives such as a central database containing financial data on clearing firms, improvements in reporting of clearing agency surveillance information, and the routine sharing of settlement information among SCG participants and futures clearing organizations. Separately, the OCC and the National Securities Clearing Corporation also have had discussions with the Chicago Board of Trade ("CBT") regarding participation in the CBT Clearing Corporation's information sharing system that currently includes the various futures markets.

6. Arrangements with Clearing Banks

During the past year, OCC has reviewed its contractual arrangements with clearing banks concerning payments between OCC and its members and confirmed with those banks the terms of those arrangements. Current arrangements now set forth in unambiguous terms obligations of clearing banks to pay member obligations through irrevocable credits to OCC's account or to inform OCC promptly that such payment will not be made.

One of the danger areas identified during the market break was the existence of confusion at banks regarding the extent of credit that would be available to clearing members during a

market emergency, and the security required for extension of that credit. This uncertainty was particularly great with regard to financing market maker positions in options on stock indexes, which were not well understood in the banking community. To address this concern OCC and its members have been educating bankers about the nature and risks of these products. It remains to be seen, however, whether increased knowledge about options will cause bankers to increase or to decrease their lending commitments in times of stress.

7. Additional Improvements

Despite the substantial progress that I have described, more remains to be done. The goal of greater coordination of clearance and settlement among the futures, options, and stock markets is paramount in light of the risks to all clearing organizations and firms created by increasing interrelationships of the markets and by common participation by firms in these markets. While cross-margining initiatives already begun are good first steps, extension of those initiatives to all derivative markets is extremely desirable. Information sharing among futures, stock, and options systems also can and should be increased. The reduction in trade comparison times in the stock market already set in motion is another important step. Implementation of many of the recommendations contained in the OCC Backup System Study would also be helpful.

Yet another area requiring further attention involves inconsistencies in state commercial and federal bankruptcy

laws. Present inconsistencies in these laws may have increased the reluctance of banks to lend money during the market break. In response, I believe a study should be undertaken by a group of experts in securities, commodities, and commercial law for the purpose of formulating a coordinated approach for bankruptcies of futures commission merchants and broker-dealers. These experts should also consider ways to harmonize state commercial laws establishing transfer, delivery, and pledge requirements for options and uncertificated securities.

In June of 1987 the Commission made a legislative recommendation that would give the Commission rulemaking authority to establish rules for the transfer and pledge of securities transactions. This recommendation was a part of a broader legislative proposal to give the Commission and the Commodity Futures Trading Commission ("CFTC") authority to increase coordination of clearance and settlement among the stock, options, and futures markets. While, as I have just described, the markets have made great progress in this area, enactment of this legislation would give the SEC and the CFTC the authority and indeed the mandate to facilitate coordinated clearance and settlement across markets.

The October market break led some observers to propose the centralization of all futures, stock, and options clearing. 27/ This goal is probably unachievable in the short term and

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27/ See,e.g., Brady Task Force Report, supra note 5, at 64.

perhaps even in the long term, primarily because of the different characteristics of stocks and futures. Increased unification of options and futures clearance and settlement through expanded cross-margining programs, however, is practicable. Unified options and futures clearance and settlement facilities could then join with stock clearing organizations to form a network of interfaced, coordinated clearing organizations serving each of the different stock, options, and futures markets.

IV. Protection of Small Investors

During the last year one constant refrain in our securities markets has been that the small investor seems to have left the market. One response is that the small (non-institutional) investor has historically refrained from participation in the market for substantial time periods after major market breaks. This theory suggests that the small investor will eventually return to the market.

Another response is that small investors expect too much from the markets. Some of these investors seem to see the stock market as a place to make a quick profit. With near-term profits in mind, a sharp correction in the market will inevitably cause unhappiness. On the other hand, a longer-term attitude may yield a pleasing result. For instance, an investor who purchased a portfolio in August of 1982 when the DJIA was at approximately 750 should not have been disappointed to find that the Dow stood at 1938 on December 31, 1987.

A third response is that U.S. equity markets are evolving into institutionally dominated markets, with the result that the small investor suffers from informational handicaps and lack of market power. One answer to this response is that the small investor has the power to enter the markets through an institution such as an investment company, and can also seek the counsel of a reputable broker-dealer.

One area of concern during the market break was that small investors had difficulty in achieving transaction execution. Although execution problems in October were not limited to small investors, our markets should not be perceived as favoring one group due to avoidable and correctable system limitations. Small investors should be able to have their trades executed in a timely fashion. They should be able to reach their brokers and investment companies in times of market stress.

In the long run the systems improvements already implemented should improve investors' confidence that execution of their orders will not be delayed due to influxes of institutional order flow. In addition, the NYSE recently has adopted a rule that would give small customer orders (2,099 shares or less) preferential routing to the specialists' books on the floor of the Exchange after any 25 point DJIA movement. 28/ The NASD has also made substantial improvements to its

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28/ Securities Exchange Act Release No. 26198 (October 19, 1988).

automated execution systems and market maker commitment rules that should help assure that market makers are available for the execution of small customer orders even in the event of substantial market turmoil. 29/

V. Information Collection Systems

As described above, the market break made prominent institutional trading strategies that involve very large trades. It also made clear that information regarding large risk positions assumed by broker-dealers and their various affiliates is not always readily available to regulators. Indeed, the generation of the massive report on the market crash by the Commission staff made clear that information on the trading activity of broker-dealers and their large customers can be collected only with a great deal of time and effort.

In response to these concerns, the Commission in June authorized and transmitted to Congress two legislative proposals. The first would give the Commission large trader reporting authority -- the authority to require individuals as well as broker-dealers to make regular reports of their large transactions. These reports could either be filed with a self-regulatory organization or with the Commission. In exercising this authority the Commission would consider the adequacy of any large trader reporting systems developed by self-regulatory

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29/ See NASD Report, supra note 9.

organizations, and it appears that the NYSE is developing such a system. 30/ In addition, in transmitting its legislation, the Commission made clear that it would attempt to reach further agreement with foreign jurisdictions concerning the exchange of large trader information to reduce the need to impose reporting requirements directly on foreign customer accounts.

The Commission's second legislative proposal in the information area would give it authority under which it could require broker-dealers to report material financial activity and risk positions of their unregulated affiliates. While the Commission's net capital rules generally are effective in insulating the capital of broker-dealers from losses occurring in affiliated organizations, it is also possible that the failure of a holding company or unregulated affiliate may have a dramatic effect on the ability of the broker-dealer to receive financing and remain in business. Accordingly, there is a need for information on risk activities in affiliates that might ultimately affect the financial situation of the broker-dealer. 31/

30/ See "Big Board Wants Firms to Name Clients," Wall Street Journal, October 7, 1988, at C.1; and NYSE October 12, 1988 Information Memorandum to Members.

31/ The proposed legislation would exempt from these requirements affiliates of a broker-dealer that are subject to the jurisdiction of a regulatory organization that has the authority to collect this type of information from that affiliate.

Both of these legislative proposals reflect the Commission's growing awareness of its duties to monitor risk related activities of market participants. The Commission has long been a disclosure and enforcement agency. The events of the last year have indicated dramatically that its responsibilities to preserve healthy capital markets in the United States mandate increasing attention to the financial viability of the financial markets and of market participants.

VI. Regulatory Reform

The October market break market and the resulting realization that the securities and derivative markets are linked into a single market has led some observers to question whether the current United States structure for regulation of these markets is sound. For example, the Brady Task Force suggested that the October market break demonstrates that "one agency must have the authority to coordinate a few but critical intermarket regulatory issues, monitor intermarket activities and mediate intermarket concerns." 32/ The Securities and Exchange Commission subsequently suggested that all jurisdiction over equity products, including stock index futures, should be united in the Securities and Exchange Commission. 33/

The President's Working Group on Financial Markets did not address the larger jurisdiction issue, but it did focus on

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32/ See Brady Task Force Report, supra note 5, at 59.

33/ See February 1988 SEC Recommendations, supra note 3, at 31.

margin regulation. The Treasury Department, Chairman Greenspan, and I agreed that the Commodity Futures Trading Commission should have the authority to disapprove futures margins, and I also suggested that the Federal Reserve Board should have residual authority to adjust securities and futures margin. Chairman Gramm argued for the continuation of the current situation, with futures margins set by the markets and the Commodity Futures Trading Commission having authority to change these margins only in an emergency. 34/

In July the Commission transmitted to Congress a legislative proposal for restructuring margin regulation and a separate legislative proposal for unifying jurisdiction over equity related products in the Commission. 35/ The margin

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34/ See Working Group Report, supra note 12, at 7. The members of the Working Group also disagreed on the relationship between margin and stock market volatility. I adhered to the view that increased stock index futures margin might decrease stock market volatility, and the other members of the Working Group disagreed. Id. at 6. Interestingly, a new study by an economist at the Federal Reserve Bank of New York concludes that "higher initial margin requirements are statistically associated with a reduction in both actual and excess stock market volatility." See G. Hardouvelis, "Margin Requirements and Stock Market Volatility," Federal Reserve Bank of New York Quarterly Review, Summer 1988, at 89. While this new evidence will no doubt be a part of the continuing debate on this issue, the need for further increases in stock index futures margin beyond their current 15% levels has abated in view of the currently somewhat reduced levels of stock market volatility, reduced use of portfolio insurance, the clearing and settlement advances, and increases in exchange capacity since the market break.

35/ See July 6 and 7, 1988 letters to George Bush, President of the United States Senate, from David S. Ruder, Chairman, Securities and Exchange Commission.

legislation would give the Commodity Futures Trading Commission authority to review futures margin to assure that these margins are "prudential," that is that they are designed adequately to protect futures commission merchants from the consequences of customer defaults. This legislation also would give the securities markets authority to set initial stock margin, with the Securities and Exchange Commission having authority to review these margins, as well as maintenance margins, to assure that they are prudential. Under this legislation, the Federal Reserve Board would have residual authority to review stock and futures margins for any appropriate purpose.

I believe the current system under which the CFTC, the SEC, and the markets coordinate with one another works satisfactorily. The progress within the markets and the increased coordination among markets since the October market break have been great and are encouraging. Nonetheless, I continue to believe that in the long term there needs to be an ability to look beyond the parochial concerns of each of the separate stock and futures markets. The jurisdictional arrangements currently in effect inhibit consideration of important cross-market policies. The ultimate concern is not only the effective operation of all markets, but the facilitation of capital formation in this country. Thus, I continue to believe that in the long run unified jurisdiction over these increasingly linked and unified markets will prove to be desirable.

VII. The Future of the U.S. Securities Markets

The October 1987 market break revealed weaknesses in the U.S. securities markets that continue to require attention. In responding to the need to improve the functioning of the markets the self-regulatory organizations in both the securities and futures markets have worked constructively with the SEC and the CFTC to make desirable changes. In the long run I believe that the October market break will prove to have been a catalyst for tremendous improvements in our markets.

What predictions can be made regarding the U.S. securities markets in the future?

I believe the capacity improvements made in response to the market break will permit our markets to operate more efficiently. The improvements should permit better transmission and execution of small orders as well as helping the markets to deal more effectively with institutional needs to engage in portfolio transactions. In turn I am hopeful that institutional investors will take care to see that their portfolio transactions do not have dramatic disruptive effects on our markets.

I am confident that the system for options and futures clearance and settlement eventually will be more unified and that these systems will be closely integrated with a more efficient and timely system for the clearance and settlement of stocks. I believe our clearance and settlement systems will continue to serve as models for such systems worldwide.

One important conclusion arising from the October market break was that the operation and regulation of our markets would benefit from additional information. I look forward to increased market information in several areas, including exchange of information between markets and display of information regarding portfolio trading and limit orders. Regulation of our markets will benefit from reports by large traders and information allowing assessment of securities holding company risk positions.

Although I believe that the best arrangement for regulating the linked market between securities, options, and derivative index futures is to have the Securities and Exchange Commission serve as a single regulator, I foresee instead a growing willingness by the SEC and the CFTC to act cooperatively in improving an increasingly connected securities and futures market.

The increasing interrelationship of markets internationally will be a dominant influence on our markets. I believe the existence of large and increasingly automated worldwide markets will have effects on our markets that are not easy to predict. I am confident, however, that cooperation between market regulators worldwide will increase, and I expect the Securities and Exchange Commission to exercise leadership internationally.

Healthy securities markets are essential for our nation's economy. I am pleased to report that I foresee that health for the future.