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

DIVISION OF
MARKET REGULATION

January 19, 1990

Mrs. Earl S. French
Route 2, Box 268
River Road
Claremont, New Hampshire 03743

Dear Mrs. French:

Thank you for your recent note to John Sununu expressing concern about program trading and its relationship to stock market volatility. The White House has asked us to provide additional information on your concerns. The Commission shares many of your concerns about current market trends and is taking active steps to address those concerns.

As you know, program trading is a term generally used to describe trading strategies that involve the purchase or sale of a portfolio of stocks, often in connection with the purchase or sale of stock index futures or options. These strategies, which include "index arbitrage" and "tactical asset allocation," usually are executed by institutions with the help of computer programs.

The Commission believes that trading of stock index futures and options, such as futures on the S&P 500 and options on the S&P 100, provides institutions, including pension funds and mutual funds, with valuable hedging capabilities. Nevertheless, the Commission for some time has been concerned about market volatility associated with such trading. The market's performance during October 1987 heightened this concern. Indeed, a Commission staff study of the October 1987 market break concluded that program trading strategies involving stock index futures were a significant factor in accelerating and exacerbating the decline.

Since October 1987, the Commission has worked actively with the securities and futures exchanges, relevant government agencies, and other stock market participants to strengthen our securities markets. For example, trading capacities have been expanded significantly on the national, as well as the regional, securities exchanges. Coordination among markets and regulators has been increased. Attempts have been made to dampen excessive market volatility through implementation of pre-disclosed, non-discretionary trading halts known as "circuit breakers." The New York Stock Exchange ("NYSE") has improved its ability to monitor program trading by requiring that members disclose information concerning their use of particular program trading strategies. The NYSE also has taken action to protect individual investors' interests by requiring priority delivery of their orders entered through the Exchange's automated order routing system.

The events of October 13 and 16, 1989 demonstrated the value of many of the market reforms instituted since October 1987. Securities exchanges and firms handled periods of concentrated trading volume and rapid price movement on those two days in an orderly and efficient manner, while generally avoiding the operational and capital problems that characterized the October 1987 market break. Communication among the markets and regulators was excellent. In addition, circuit breaker procedures were implemented without operational difficulty and may have tempered the market's decline.

Recent market events also demonstrated that we can do more to improve the efficiency and stability of our securities markets. The Commission believes that one very important step is prompt passage of market reform legislation pending before Congress (H.R. 3657; S. 648). The proposed legislation is largely in the form recommended to Congress by the Commission in June 1988, and includes provisions that would provide the Commission with (1) enhanced ability to assess the risk positions of securities firms; (2) the ability to collect information about large securities trades; and (3) increased authority to halt trading on the securities markets during emergencies.

The Commission continues to examine the role of certain trading strategies in relation to market volatility and to explore the necessity and feasibility of additional regulatory measures. We are preparing an analysis of trading on October 13 and 16, and continue to assess the market impact of factors such as the Commission's short sale rule. At the same time, it is important to note that the Commission does not have regulatory jurisdiction over a number of areas, including futures margin, that have been the subject of recent debate.

The Commission believes that continued individual investor participation is essential to the long-term success of the nation's capital markets. Those markets must be efficient and reasonably stable if they are to continue to attract individual investor participation. Please be assured that the Commission is doing all it can in this regard.

Thank you for your thoughts on these important issues. We are tracking carefully the views and comments received from investors and other interested parties.

Sincerely,

Howard L. Kramer

Howard L. Kramer
Assistant Director