KEEPING THE MARKET OPEN: LESSONS FROM 1987
By Andrea M. Corcoran

Recollections of the event and its aftermath:

In preparing for this event, I wondered how to make the events of 20 years ago seem immediate—especially from the perspective of a regulator of what have been variously described as:

- the markets underpinning the resilience of the economic system's ability to withstand extreme events,
- products permitting the engineering of miracle working strategies to avoid the impact of market downturns, and
- weapons of mass destruction.

In 1987, the CFTC even within the financial community was a little known agency. In fact it may still be a little known agency for some.

But then, before our exchanges were the hottest stocks on the stock exchanges, we knew we were not a household word.

Even our own Congressional Committees weren't sure who we were--sometimes calling us the Commodity Trading Corporation or the FTC and our Chairs—those little ladies from the CFTC, later famously coined by Mark Lakritz, as the "derivatives chicks."

The general public thought we had something to do with consumer safety.

The SEC, however, did know the CFTC and from its creation had us in the cross hairs seeking to limit the scope of CFTC power affecting equity based products—

- perhaps because of the incredibly complex jurisdictional divide between the agencies and
- perhaps because the notion of regulating the future could potentially make the CFTC the regulator of everything.

But we came into our own on October 19, 1987.

The Chairman of the Stock Exchange, John Phelan, blamed the crash on the futures markets. [Many later recalled this as a brilliant political move.]

On October 20, brokers blamed the pay-as-you-go futures settlement system for--- by not assuring immediate finality of a settlement of all claims owing through the market-- fostered gridlock.

Bankers blamed a market that required the Fed wire to be open and transfers to be made at a time when they were just contemplating going to work.

Economists debated whether futures products led the markets down, contributed to herding behavior, or facilitated cascading free falls activated by computers without benefit of human intervention.

The media, having conducted a long campaign against so-called program trading and the triple witching hour, blamed the lack of coordination among the markets and their regulatory authorities, citing program trading and risk arbitrage as likely culprits in the dramatic fall in prices.

Others worried about the withdrawal or withholding of liquidity by scalpers who had no affirmative market-making obligations.

Still others cited the illusion of liquidity behind the assumptions of futures strategies. They cited the lack of technical capacity in the securities markets to keep pace with the faster speed of the futures trading based on equity

prices and to absorb trading volume as responsible for the decoupling of markets that were fundamentally intended to converge.

Some said futures margins were too low; the SEC remembered to say it did not have enough resources and one or more SEC Chairman argued that they did not have enough information from the futures markets and needed equity futures under their direct supervision and control.

DOES ANY OF THIS SEEM FAMILIAR

Perhaps less well known:

The Wall Street Journal wrote a Pulitzer Prize winning article on the activities on the CBOT on October 20, claiming that floor traders trading a clone of the Dow Jones Industrial Average had saved the market, when the MMI went from a discount of nearly 60 points to a premium of about 12 points within five or six minutes.

If nothing else, this was a dramatic, textbook demonstration of bottom fishing or a change in trading psychology—none of the agencies after investigation found manipulation.

A later pundit and seeming conspiracy theorist claimed that this MMI event was evidence of the covert activities of the PPT or Plunge Protection Team, an alleged shadow private sector savior group—with links to the government—that intervened in emergencies to prop up prices.

While there may still be some options pricing claims in the system, there were only 30 odd customer complaints on the futures markets engendered by the crash.

The CFTC was consulted and advised relevant authorities that an infusion of cash liquidity was necessary to avoid further freezing of the payment system in the futures clearing side and that some forbearance on capital and other requirements pending resolution of payments was desirable.

All futures transactions closed on T+1 or less and there were no futures side defaults.

In the follow up after the crash, the CFTC elected to work on those issues usually under the radar.

It dedicated itself to exploring the so-called plumbing or clearing arrangements so central to futures trading and mentioned as different from securities arrangements as recently as the argument before the Supreme Court just this Monday on an arcane issue of standing.

We were a critical part of the clearing and settlement team that wrote the Interim (there never was a final) Presidents Working Group report, and we received assistance from the industry association (Futures Industry Association--FIA) who had supported our cross market information sharing initiatives and had their own post crash inquiries.

Among other things, CFTC explicitly advocated:

- extending Fed wire hours-- for securities as well as cash,
- considering limited purpose access to the discount window,
- clarifying settlement agreements to prevent the claw back of funds,
- elimination of agreements to pledge,
- resolving the ambiguities about a futures broker/securities broker bankruptcy,
- better cross market and sector sharing of information offering their own inter-exchange model of cross market exposures,
- changes in tolerances, and losses as a possible means of identifying problems in adverse market situations
- enhanced cross margining, and
- went head to head with Alan Greenspan on whether futures markets margin was equivalent in risk protection to securities that then had a five-day (or longer) settlement period.

Interestingly, even the SEC's economist found that because of the ad hoc structural collapse of the markets there was less than usual program trading—and that the largest price changes during the day occurred in the afternoon or otherwise tended to occur when index arbitrage volume was below average.

Others noted that a large proportion of cash selling occurred through institutions for positions for which there was no futures counterpart.

Finally, the Brady Commission and the subsequent PWG Interim Report relied on trading data provided electronically by the CFTC. That data even contained beneficial ownership information.

Some of the then existing powers of the CFTC (which largely is a market integrity not a disclosure agency), such as the ability to impose emergency intervention actions like imposing position limits, were only granted to the SEC by the Market Reform Act of 1990.

In going back to the press articles at the time, I noted with bemusement (as some already mentioned here) that contemporaneous to the crash there was a flood of bad press about meteorologists whose models had failed to predict whether the storm on October 15th that closed London's markets on the 16th and felled 6 of the 7 Kew Garden Oaks had failed to predict whether this would be a 30-year storm or a 300-year storm leading to untold additional loss.

This led me to think about the problem of modeling tail risk more generally. Where so-called 100-year events have been happening every year in financial parlance, it seems that risk management must be directed at how to contain the damage from outliers not just on the daily round—

— indeed that in financial markets risk management is basically the art of managing the unpredictable.

Finally, while many focused on the lack of cooperation among devoted public servants, I would emphasize just the opposite.

The CFTC then under Acting Chairman Heineman had a market surveillance meeting every Friday, looking at the exposures of the largest counterparties in the market, especially those on the wrong side. I seem to recall that on that Friday, the 16th we had invited other financial regulators.

Moreover, because of the information coming off the wires on global markets and the hurricane after effects in London, and prices going haywire in Japan and Hong Kong, we also had arranged over the weekend for a meeting the morning of the 19th.

While some exasperation among colleagues was expressed during the 19th and 20th, I was in constant touch with Rich Ketchum and, of course, after the event there was consensus support for the creation by Executive Order of the Presidents Working Group on Financial Markets and a Herculean effort of all the agencies to produce a single report—the capstone of which was a circuit breaker system similar to the speed bumps and price limits typical of futures markets.

Indeed, though having different points of view, each of the agencies agreed not to accept the more far reaching recommendations of the Brady Commission and faced the Wrath of Senator Proxmire in open hearing.

The Honorable Member opined that the PWG Interim Report was a pitiful effort.

Today this comment seems amazing when one realizes that so many of the issues surfaced are just as relevant as they were at the time.

Further, as in Washington there is only turf to fight over, it should be pointed out that to the extent marking one's territory and marketing one's territory make the world go round—there was some "nationalism" or healthy competition on the part of all exchanges and markets.

For example, before the crash, the CME's then President Brodsky had announced the triple witch was dead, although there was one securities market that did not go along with the resetting of the settlement time.

And, while the final futures exchange signed up to our cross market sharing arrangement on the 20th of October, the OCC did not make it until 1989 after the mini-crash.

In fact, the crash also demonstrated that cooperation was possible and might be preferred to a single monolithic regulator in a crisis. Indeed, there was an advantage in having the capacity to improvise ad hoc solutions—to "cope"—as the Japanese would say and for each of the various sectoral and national regulators manning its own watch to be fully accountable for that watch with coordinated interchange of relevant information among them.

I am looking forward to the discussion going forward as the issues of 1987 were revisited in 1997 and the capacity to share information among regulators is now the acknowledged ticket to good citizenship in the financial community.