U.S. House of Representatives

Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515

LAWRENCE R. SIDMAN
CHIEF COUNSEL AND STAFF DIRECTOR

October 23, 1987

The Honorable David S. Ruder
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Ruder:

We write in reference to Monday's historic 508 point drop in the Dow Jones Industrial Average. As you know, the Subcommittee is undertaking a full scale investigation into the causes and implications of Monday's record drop, with the goal of determining whether legislative or regulatory changes may be necessary.

This drop follows a series of less spectacular but nonetheless noteworthy declines which prompted the sending of several letters to you requesting the Commission's views on the stock market's current degree of stability, the factors that contribute to whatever degree of instability you may determine exists, and the effects of foreign investment on the stability of our markets. We believe the market's more recent volatility makes the call for such an inquiry even more pertinent and far more urgent. Accordingly, we are initiating a comprehensive and intensive inquiry into Monday's drop in the Dow.

We have long felt -- and expressed -- concern about the volatility in the stock market occasioned, at least in part, by the use of program trading devices. Although we tend to believe that the events of this past week are deeply troubling, we recognize that it is still too early to reach a definite conclusion about all of the causes of the drop. Accordingly, it is imperative that we proceed immediately both to isolate the factors responsible for the decline and to analyze the synergy among those factors. In order to isolate those factors and to understand the consequences of this kind of roller-coaster market behavior, we are enclosing a set of questions for your expeditious review and response.

In addition, we would like to be kept informed, on a frequent and continuing basis, of the status and interim results of the internal review into these matters the Commission announced today. More particularly, we feel that it is important that the Commission release no formal study, report or set of conclusions until after having reported to and conferred with this Subcommittee, which has oversight responsibility for the securities markets.

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We would like to receive the Commission's responses to the attached questions, along with all pertinent underlying documentation, no later than November 6, 1987. It may be useful, in addition, for your staff to brief the Subcommittee staff periodically as to its progress in the intervening days.

Sincerely,

Ed Markey
Edward J. Markey
Chairman

Matt Rinaldo
Matthew J. Rinaldo
Ranking Minority Member

Enclosure

QUESTIONS FOR THE SEC

1) In your March 1987 report entitled, "The Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986," the Commission concluded the following:

> ...[T]he Division recognizes that continued evolution of the markets carries with it a potential for disruptions, including temporary increases in volatility. The Division has identified specific scenarios that may warrant further analysis. In particular, there is a possibility that dynamic hedging strategies, such as portfolio insurance, combined with other market events, could trigger selling that temporarily exceeds market liquidity. This could result in imbalances that could cause short-term volatility.

In addition, a June 13, 1986 letter from the SEC to Chairman Dingell, described the intent of the SEC to monitor program trading:

> ...[N]one of the reporting obligations of market participants requires activity related to program trading to be individually segregated from other types of trading activity....Nevertheless, we intend to request market participants to voluntarily submit this information to use in our attempt to closely monitor the derivative markets.

In reference to the above comments, and program trading in general, the following questions are posed:

a) Provide an analysis of the various strategies composing program trading, including portfolio insurance and stock index arbitrage, and quantify each of the strategies' impact on the Dow's decline on October 19, 1987.

b) Assemble a sequence by every ten minutes which shows the trading of the largest 5% of players in the stock market on October 19, 1987 which were also trading in the stock index futures market. Identify whether individual transactions were the result of program trading strategies.

c) Provide an analysis of trading activity on the NYSE from October 12 to October 23, 1987 including an identification of the largest participants and the nature of their activities. Breakdown by category of market participant the percentage of trading attributable to each category, (i.e. floor traders, institutional, proprietary, retail customers, etc.).

d) Concerning your letter of June 13, 1986, what actions has the SEC undertaken "to closely monitor the derivative markets?" Describe the information which you have received voluntarily from the firms and provide such information to the Subcommittee?

e) What are the benefits and the risks of stock index futures trading to the American economy?

f) Were you consulted by the NYSE concerning restraints on program trading during this last week? What was your advice?

g) Provide a detailed chronology which shows your recent involvement in implementing restraints on program trading at the NYSE.

h) Explain the mechanism which the NYSE employed to restrain program trading on the week of October 19, 1987. Do you believe such restraint was necessary? If so, explain why.

i) Should any components of program trading be restricted or banned during periods of excessive volatility? If so, at what level of volatility should such restrictions be implemented?

j) Explain the regulatory responsibilities and the relationship between the SEC and the CFTC concerning all aspects of program trading. Is there a jurisdictional "hole" between the SEC and the CFTC which makes the regulation of program trading more difficult? Should regulation of stocks and stock index futures be regulated by the same agency?

k) What authority exists for the SEC, CFTC, the exchanges or the President to order a halt to program trading or to otherwise discourage its implementation in a volatile market?

l) Have low margin requirements for futures trading contributed to market instability during the week of October 19, 1987? Should position limits be imposed?

m) Provide detailed recommendations for improving the regulation of program trading.

2) a) What weaknesses in the overall regulatory scheme were identified as a result of the October 19, 1987 decline?

b) What recommendations, if any, do you propose?

c) Describe the scope and time frame for completing SEC studies concerning the October 19, 1987 decline.

3) Concerning foreign investments in our markets:

a) To what extent does activity by foreign investors in the U.S. stock markets account for recent market swings?

b) Has investor composition with respect to nationality changed since the October 19, 1987 drop? What factors have contributed to or will contribute to any such change?

c) To what extent does activity by U.S. investors in foreign stock markets account for the market volatility in the International and Tokyo Stock Exchanges?

d) To what extent can we anticipate a flight of foreign investors from U.S. markets based upon recent market activity?

f) Does a firewall exist among nations to prevent a precipitous drop in one market from causing a similar drop in another country's market?

g) What statutory or regulatory authority exists in Japan or the U.K. to limit market swings or their effects, which are not available in our country?

h) Is program trading employed by traders in the London and

Tokyo stock markets? Are programs manned by U.S. traders used to trade shares overseas? If so, to what degree is it employed? Are there restrictions on its use in those markets?

4) a) What is the short-term index?

b) How is it computed?

c) Please detail the movement of the index from the beginning of trading on October 19, 1987 to the close of trading October 23, 1987.

5) a) Is there any indication that bidders were amassing blocks of stocks at prices of October 19, 1987 in order to launch a new wave of takeover activity?

b) Do we have any mechanism to detect such activity other than the Schedule 13D filings?

The Subcommittee will be submitting additional questions concerning the Dow's drop and subsequent related market activity in the days ahead.