—NASD—

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

March 3, 1988

Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Proxmire:

When I testified before your Committee on February 4, 1988 I indicated that I would provide the Committee with the formal response of the NASD to the five primary recommendations of the Presidential Task Force on Market Mechanisms (the Brady Report). This letter provides responses to these recommendations in the order presented in the Brady Report.

1. <u>One agency should coordinate the few, but critical, regulatory issues which have an impact across the related market segments and throughout the financial system.</u>

The NASD does not believe that the designation of a single "super" regulatory agency to oversee intermarket issues is appropriate or necessary at this time. We recognize that greater coordination of regulatory responsibilities is essential to prevent disparities in the regulatory framework between underlying equity markets and derivative securities from accentuating price movements in equity markets. October 19 and 20 demonstrated how the market for index futures and options depend for their ultimate liquidity on the market for the underlying equity securities. We believe, however, that the appropriate response is not the creation of a single "super regulator," but rather a formal, direct effort by the SEC and the CFTC to coordinate and integrate regulatory programs for their respective markets, with particular emphasis on intermarket issues. This coordination and integration should encompass the regulatory programs of all self-regulatory organizations for both the securities and futures markets. Only if such efforts were unsuccessful within a reasonable time frame (e.g. six months) would we consider the vesting of authority in a single regulatory agency to be appropriate. Should such action be required, we feel it would be appropriate to concentrate regulatory authority for all equity related products in the SEC which already regulates the underlying equity and options markets.

2. Clearing systems should be unified across the marketplaces to reduce financial risk.

In theory, the concept of a "unified" clearing system has considerable merit. If the term contemplates a single system which will clear transactions for all markets, however, we do not believe this is a practical solution in the foreseeable future. The markets for equities, options, and futures each function differently and transactions are settled using different time frames and different market structures. For example, equity transactions generally settle on a five-day basis, while futures transactions settle the next day. In an equity transaction, another dealer, a specialist, or a customer would typically be the contra party to the transaction while in the options market, the Options Clearing Corporation is on the other side of each trade. Given the differences in the way the markets function, and in the underlying investment products, we believe it would be impractical to create a single clearing entity for all markets at this time.

The Brady Report's recommendation on clearing systems, however, could produce beneficial results in two respects. First, the clearing entities for all markets should share meaningful information on the credit exposure, operating condition and potential surveillance problems of firms trading in the various markets. Without timely, complete information on a firm's exposure in all markets, no one clearing entity can assess that firm's creditworthiness on an ongoing basis. A similar need for information may be faced by banks that extend credit to firms. If those banks had access, with each firm's prior agreement, to information on firms' exposure in all markets, the banks should be in a better position to respond to the needs of market participants. To the extent that the unification sought by the Brady Report will result in coordination among clearing entities for all markets and the sharing of credit, operating and surveillance information, we support that recommendation.

Secondly, a linkage of clearing facilities among futures markets should be considered. As noted in the Brady Report, the clearing facilities for equities have been linked since the mid 1970s. Clearing for all options transactions are handled by a single entity. A similar linkage or single processor for the futures markets would facilitate the linkage of clearing facilities for all markets and eventually could serve as the basis for unification.

3. Margins should be made consistent across marketplaces to control speculation and financial leverage.

The NASD supports the view that performance or maintenance margins on various types of securities should be set on a consistent basis in all markets. This does not mean that such margins should identical, but only that the amount of financial leverage available in the various markets should be consistent. The NASD believes that an important element of the coordination referenced in our response to the first Brady recommendation would be the oversight of margin performance or maintenance requirements by the appropriate regulatory agency and coordination between those agencies to insure that the margining requirements of the various markets do not give rise to disparate levels of risk and leverage among market segments. If that coordination is not achievable, the authority to establish performance or maintenance margin requirements for securities and their derivatives should be placed in one entity.

4. <u>Circuit breaker mechanisms (such as price limits and coordinated trading halts) should be formulated and implemented to protect the market system.</u>

The NASD does not agree that "circuit breaker" mechanisms are the appropriate response to market volatility. Indeed, mechanisms such as price limits or trading halts are more likely to accelerate upward or downward trends before and after their imposition. Rather, we believe that the most appropriate course of action during such periods is to keep the markets open and functioning at all times. The approach to correcting market inadequacies is not the establishment of artificial price limits which will halt trading when prices decline sharply or by halting all trading, but rather by correcting the problems of market access and the problems which restricted the ability of investors to execute trades. This is the goal of those changes that the NASD is implementing in its market. We believe that facilitating investor access to the markets and insuring that the markets continue to function will have a far more beneficial effect than the imposition of circuit breaker mechanisms. In addition, any consideration of introducing circuit breaker mechanisms should include a careful review of the potential impact of such changes on the liquidity needs of individuals, mutual funds, pension funds and many other intermediaries and investors that are dependent upon the markets for the liquidity of their portfolios.

Under extreme conditions in which there may be a human inability to cope or to facilitate the processing of overwhelming volume, consideration can and should be given to shortening the trading day for all markets as was done from October 23 to November 12.

5. <u>Information systems should be established to monitor transactions and conditions in related markets.</u>

The NASD agrees with the Brady Report's conclusion that the markets for equities, options, and financial futures while functioning differently are in fact all part of the same market. Accordingly, the NASD supports the establishment of improved intermarket information systems, both among the securities markets and between the securities and futures markets. As indicated in our testimony before the Committee, those responsible for operating the securities markets must plan, communicate and coordinate with each other on important intermarket issues. We believe that this coordination can be delivered within the existing regulatory framework. The existing Intermarket Surveillance Group (ISG) can provide this coordination on surveillance and compliance matters. Other similar groups can and should be established for financial, operational and technology matters which together with the ISG, could be placed under the umbrella of a broad inter-market self-regulatory coordinating policy group. The intermarket coordinating policy group would be charged with, among others, the responsibility to establish procedures to ensure direct communication among all markets and to provide the management of each major market and each regulatory agency with real time information on the conditions of all markets. Any decision to change trading hours or access to particular systems, for example, could then be coordinated among all securities markets.

In this regard, the NASD embraces the recommendation of the General Accounting Office that the relevant federal regulators, acting together with the marketplaces, should formulate contingency plans providing for coordinated decisionmaking and dissemination of information in the event of a future market crisis.

The NASD appreciates the opportunity to provide the Committee with these responses to the recommendations of the Brady Task Force and we wish to assure the Committee of our cooperation in carrying out the changes needed to respond appropriately to the October 19th market crisis.

Very truly yours,

Joseph R. Hardiman
President

CGA:L-Proxmire