United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

WASHINGTON, DC 20510-6075

April 4, 1988

The Honorable David S. Ruder
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Chairman Ruder:

Thank you for testifying before the Committee on March 31, 1988.

In order to complete the hearing record, the Committee would appreciate your answers to the enclosed questions as soon as possible.

Again, I thank you for appearing before the Committee.

Sincerely,

William Proxmire
Chairman

WP:md

Enclosure

For Ruder from Senator Proxmire

Question on Differential Leverage Between Stocks and Futures

In your March 18th letter to me (Senator Proxmire) you make a series of assertions about the role of margins. I would like to ask you about several of these.

1. How do you define "open interest" in the market for derivative instruments? Are there not twos sides to every trade precisely because this is a derivative instrument?

2. You assert on page 29 that "there is no evidence that leveraged futures positions contributed to the collapse of stock prices in mid-October." That may be. But did leveraged futures positions contribute to the bubble in stock prices that led to the crash?

3. You assert on Page 30 that, "the S&P 500 futures contract is primarily an institutional market, and its principal users do not have leveraged positions." How can this be? Isn't a futures contract leveraged by definition? You put down a margin deposit that is not equal to 100 percent of the underlying contract do you not?

4. On page 31 you say, "since the stock index futures market is primarily an institutional market, the 50 percent initial margin requirement of the Federal Reserve Board for public customers is not generally the pertinent figure for comparison to futures margin levels from the standpoint of relative market leverage".

    - Are you not confusing the terms "institutional" and "market maker"?

    - What does Dreyfus or Fidelity have to pay per $100 of stock if they use margin to purchase that stock?

    - What did Dreyfus have to put down per $100 dollars of face value in the futures market?

    - Institutions, meaning pension funds, endowments and mutual funds, have very different speculative leverage possibilities in the stock and futures markets do they not?

QUESTIONS FOR THE RECORD FOR DAVID S. RUDER

FROM SENATOR WILLIAM PROXMIRE

Q.1. Stock market prices have recovered to some extent since the crash. And that is one measure of consumer confidence in our stock markets. The volume of shares and derivative produces traded remains substantially below what it was before the crash. Volume is another measure of market confidence. Do you consider that market participants are registering a vote of "no confidence" by avoiding the markets at this time? Could it be that the public is not satisfied with the progress that the regulatory agencies, SROs, the administration and the Congress has made in remedying the deficiencies that the crash revealed in our financial markets?

Q.2. The stock exchanges vigilently police intramarket frontrunning. Every trade is computer-monitored and every suspicious transaction investigated. For the record, please submit for the record the number of intramarket frontrunning investigations undertaken in 1987 along with any resulting penalties and enforcement actions. Given that intramarket frontrunning is a present danger, and that the exchanges commit millions of dollars in computer hardware and manpower to policy it, and that you have many enforcement actions, we now assume that this practice spreads between markets. Intermarket frontrunning is just as easy to commit as intramarket frontrunning. Yet we are aware of only two investigations, and no enforcement actions. Doesn't this demonstrate that you are unable to police this fraud with current law?

Q.3. Hayne Leland of the University of California at Berkeley, and the theorist behind portfolio insurance, recently suggested in an interview in <u>Barron's</u> Magazine that the specialist system at the NYSE be amended to use an open outcry auction, rather than specialist book system. Professor Leland characterizes this proposed change as a movement toward "sunshine markets". The Freedom of Information Act has been valuable in achieving democracy in government in the United States. Do you not agree with Professor Leland, that greater dissemination of information would benefit all traders, big and small, on our stock markets?

For David Ruder

<u>Question on Purpose Credit and the Crash from Senator Graham</u>

In the March 30, 1988 issue of the American Banker, there is a very disturbing article by Martin Mayer on the role that margins and credit played in the crash of October 1987. It appears that many market participants received exemptions from margin requirements in the stock market.

What is disturbing about the article is the notion that neither the Federal Reserve, nor the SEC appeared to be in complete control of the situation. The SEC was granting exemptions under their rule 3b-8 and the Fed did not know about it.

From the article it appears that it was not until the Brady Report uncovered this situation that the Fed found out about this problem. The Fed was reported to have been “shocked” to learn of something called “purpose credit”.

- What is purpose credit?

- Is the article correct in saying that arbitraguers in takeover bids are part of this exempt group which is not bound by margin requirements?

- Did the severity of the crash in part result from a pull back of credit by banks who had insufficient margin because of these rule exemptions?

- Doesn’t this SEC-FED coordination breakdown defeat the anti-speculative purpose margin restrictions?

- What does your agency propose to do to address this problem?

- Would you please provide for the record the file of interpretative letters that you have received on this issue together with your agencies response to each of them?