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**SECURITIES MARKET ISSUES FOR 1989:  
MARKET LIQUIDITY, LARGE TRADER INFORMATION,  
AND HOLDING COMPANY RISK ASSESSMENT**

Remarks of

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United States Securities and Exchange Commission

Before the  
Women's Economic Round Table

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The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

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I. Introduction

It is a great pleasure to speak to the Women's Economic Round Table. As you may be aware, women occupy many of the top positions at the Securities and Exchange Commission. Two of our four major operating divisions are headed by women, and my executive assistant, Linda Fienberg, is the de facto chief operating officer of the Commission.

Since the dramatic events in October 1987 much of my energy has been devoted to monitoring the health of our securities markets. The October 1987 market break stimulated comprehensive analyses of various aspects of our securities markets, and, as the Chairman of the government agency most directly charged with responsibility for regulating those markets, I have directed that there be regular review of their performance.

Following October 1987, many changes were implemented. Looking beyond the significant reforms already instituted and those the markets continue to pursue, there are many areas where changes still should be considered. Three areas of particular importance are: (1) market liquidity; (2) the need for more current information regarding large securities trades; and (3) the Commission's ability to obtain early warning of the potential financial risks to broker-dealers arising from activities of their unregulated affiliates.

## II. The Market Break and Subsequent Reforms

One of the central lessons of the October 1987 market break was that institutional trading strategies can have extreme effects on market volatility. The acceptance of modern finance and diversification theories, the growth in size of institutional portfolios, and lowered trading costs have led to the increasing use of portfolio trading strategies by institutions. In October 1987 simultaneous decisions by institutions pursuing common short-term trading strategies produced a "rush to the exit" that overwhelmed the capacity of our markets. While there has been much debate about the causes of the market break, it seems clear now that deficiencies in operational systems, information transmission, liquidity, and clearance and settlement procedures affected the speed and size of the decline.

Since the market break, many reforms have been instituted by the markets.

### Automation

Automation improvements by the exchanges, the National Association of Securities Dealers (NASD), private vendors, broker-dealers, and investment companies have greatly expanded the operational capacities of our markets. In future periods of market stress, the flow of orders should be handled much more efficiently. Customers should be able to reach their brokers and orders should be executed more quickly.

### Market Makers

Measures to improve market makers' performance have been implemented. The NASD has imposed new market making commitment requirements with respect to its Small Order Execution System that will increase the efficiency of its markets. Improvements in securities exchanges' "reallocation" procedures have helped to strengthen the exchange specialist system. The exchanges have increased specialist capital requirements and, recently, the Commission has proposed that specialists be required to comply with its net capital rule, from which they are currently exempt. 1/ Specialists and other market makers have been encouraged to review and strengthen their lines of credit with banks.

### Communications

Communication, coordination, and contingency planning have been increased. Dedicated telephone lines have been installed between the major markets, and personal lines of communication have been established. Communication between various regulatory agencies has been enhanced at both the staff and agency head level, and the President's Working Group on

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1/ Securities Exchange Act Release No. 26402 (December 28, 1988).

Financial Markets <sup>2/</sup> exists as a communication safety valve and long range planning mechanism.

Clearance and Settlement

Clearance, settlement, and payment facilities have been improved, although much remains to be accomplished in this area. Cross-margining initiatives between the options and stock index futures markets are now underway. At my request, a project has been initiated to deal with state and federal commercial law and bankruptcy law impediments to more efficient clearance and settlement.<sup>3/</sup> The Commission, in conjunction with the self-regulatory organizations (SRO's), including the clearing agencies, continues to work on improvements in the

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<sup>2/</sup> The members of the Working Group are the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Commodity Futures Trading Commission, and the Chairman of the Securities and Exchange Commission. The Secretary of the Treasury, or his designee, acts as Chairman of the Group.

<sup>3/</sup> The American Bar Association Section of Business Law has formed the Advisory Committee on Settlement of Market Transactions. The mission of the Committee is to examine questions arising under the laws governing securities transfers and their impact on the settlement of those transfers. The Committee is composed of representatives of the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, clearing corporations, academia, and practicing attorneys.

clearance and settlement area. 4/ A Commission legislative proposal to facilitate improved coordination of clearance and settlement among securities, options, and futures markets recently was introduced in both the House and Senate. 5/ Moreover, the Group of Thirty, a prestigious group composed of leaders of the international banking and securities industry, recently proposed nine recommendations for standardizing clearance and settlement processes. 6/

#### Circuit Breakers

Circuit breakers have been installed by the securities and futures markets. If the Chicago Mercantile Exchange's (CME) S&P 500 index future opens 5 or more points above or below the previous day's close, a ten-minute price limit will be put in place in that market. If the S&P 500 average declines by 12 points (approximately 96 points in the Dow Jones Industrial Average), the CME will employ a 30-minute price limit procedure

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- 4/ The President's Working Group on Financial Markets has also made clearance and settlement a priority. See Interim Report of the Working Group on Financial Markets (May, 1988), at 7-11.
- 5/ S. 648 was introduced by Senators Dodd and Heinz on March 17, 1989. H.R. 1609 was introduced by Congressmen Dingell and Markey on March 23, 1989. Congressmen Cooper and Oxley have co-sponsored H.R. 1609. These bills also contain the Commission's proposed large trader reporting and risk assessment provisions which are discussed below, as well as the Commission's proposed emergency authority provision.
- 6/ See Clearance and Settlement Systems in the World's Securities Markets, Report of the Group of Thirty, March, 1989.

and the New York Stock Exchange (NYSE) will segregate program trade orders for S&P 500 stocks in a separate computer file, with a five-minute trading delay. If the Dow Jones Industrial Average declines by 250 points in one day, all U.S. securities and derivative markets will close for an hour and then reopen.

These improvements and continuing efforts are to be applauded. Nevertheless, we still face potential problems in three areas.

### III. Market Liquidity

Market liquidity is largely a function of the amount of capital available for commitment to market purchases. Concern with the level of market liquidity has increased since the October market break. The system improvements made by the markets have reduced the risk of panic selling based upon fears of system breakdowns. However, these very systems improvements permit institutional orders to reach markets more quickly and may result in even larger liquidity demands on specialists and other market makers. Particularly acute liquidity pressures may exist if a situation again arises where institutions make parallel decisions to sell in large quantities.

The dimensions of the problem are huge. Current NYSE market value is approximately \$2.6 trillion, with institutions owning 45%, or approximately \$1.2 trillion. The portfolios of the large institutional investors are huge in size, with hundreds of institutions holding equity portfolios valued over

\$3 billion. In contrast, net liquid assets committed to NYSE specialist activity are approximately \$675 million and NYSE specialist buying power is approximately \$2.2 billion.

Moreover, the October market break showed that the liquidity provided by upstairs block positioning firms may decrease in the face of a large sell-off, 7/ and structural changes in our markets may be reducing the amount of capital committed by such firms to the trading process. 8/

Given the size of the market relative to total available specialist capital, a "rush to the exit" by institutions could create tremendous pressure on the system. The dangers of such a rush will increase to the extent our markets become overpriced, as they were in the months preceding the October 1987 market break.9/

One response to the problem posed by relative lack of liquidity is to seek to reduce liquidity demands. In this

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7/ See "The October Market Break," A Report by the Division of Market Regulation, U.S. Securities and Exchange Commission (February 1988) ("SEC Staff Report"), at 4-6.

8/ See "Future Issues in Market Regulation," Remarks of Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Commission, before the D.C. Bar Corporation, Finance, and Securities Law Section, March 22, 1989.

9/ A recent report indicated that some industry participants believe that a market "melt-up," that is a rapid "chaotic" rise in prices, is possible. See "Nervous Wall St. Fears a 'Melt-up,'" N.Y. Times May 11, 1989, D.12. Whether or not such a rapid overpricing is possible, if overpricing occurs, it increases the potential for rapid sell-offs.

connection, institutions need to recognize that their attempts to exit the market at the same time may injure their own long term economic interests by exacerbating market declines. <sup>10/</sup> One "rush-to-the-exit" strategy is portfolio insurance, which calls for the sale of futures and stocks as prices decline. Many institutions have abandoned that strategy because of flaws revealed by the October market break. Instead, some institutions have switched to "asset allocation" strategies that utilize the stock and futures markets to maintain certain ratios of stocks, debt, and cash. These strategies have some potential for exacerbating market declines to the extent that they cause substantial numbers of institutions to follow similar strategies at the same time. Institutions still need to review their market objectives and take steps to avoid allowing pre-determined strategies to contribute to excessive market declines.

Another response to liquidity problems is to seek additional sources of liquidity. The supply side of the liquidity problem is not an easy one, since its solution depends not only upon the existence of adequate capital to meet substantial selling pressure in an institutionally dominated market, but also upon the willingness to utilize that capital to purchase securities in a declining market. Of course, the

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<sup>10/</sup> See "The Impact of Institutional Investors on Large Corporations," Remarks of Davis S. Ruder, Chairman, Securities and Exchange Commission, before the 27th Annual Corporate Counsel Institute, October 11, 1988.

assumption behind that willingness is that in the course of a dramatic market decline prices may fall below their eventual equilibrium level, presenting buying opportunities to those who have available capital.

What then are the sources of liquidity?

Specialists

As noted earlier, efforts have been made to increase available capital for specialists, who are obligated by exchange rules to provide market liquidity. The specialist system was not, however, intended to meet the selling pressures coming from waves of portfolio selling by institutions. Indeed, specialists' abilities to provide meaningful prices and a sound market for individual stocks depend upon their awareness of the prospects and market conditions for those individual stocks. When the market as a whole moves dramatically, specialists are faced with non-company specific demand and will be unlikely to be able to provide market continuity.

One way that specialists might improve their ability to commit capital to their stocks is by deploying hedging strategies more extensively. A specialist who buys stocks in a market decline may hedge some of the risk by buying put or selling call options on those stocks. As the price of the

stock declines, the value of the option should increase. 11/ The gain in the option value should help the specialist provide more support to its specialty stocks than the specialist could provide if it were not hedged. General market risk also may be hedged through purchase of index option puts or through sale of index call options or index futures.

#### Market Baskets

The Commission has encouraged the stock exchanges to develop mechanisms for trading stock portfolios by creating "basket trading" systems or products. 12/ Basket trading systems or products would provide investors with the ability to buy or sell a portfolio or group of stocks in one transaction, rather than having to submit separate orders in each stock. Such systems or products could relieve specialists in individual stocks of pressure from some forms of portfolio trading. Stated differently, these systems offer the possibility that substantial additional capital will be devoted to absorbing portfolio trades.

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11/ This assumes efficiently functioning options markets, an assumption that is more valid since the post-market break reforms implemented by the options markets. See, e.g., Memorandum from Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Commission, to Chairman David S. Ruder, dated May 18, 1988.

12/ See "Securities and Exchange Commission Recommendations Regarding the October Market Break," contained in February 3, 1988 Testimony of David S. Ruder, Chairman, Securities and Exchange Commission, before the United States Senate Committee on Banking, Housing, and Urban Affairs ("SEC Recommendations"), at 12.

The Commission recently approved proposals by the Philadelphia (Phlx) and American (Amex) Stock Exchanges and the Chicago Board Options Exchange (CBOE) to trade such products in relatively small units, called generically "Index Participations." 13/ The Amex and Phlx products commenced trading on May 12, 1989. The NYSE is considering a basket product that would allow institutions to trade actual portfolios of securities more efficiently. In addition, the NYSE is discussing the listing of a privately sponsored mutual fund and unit investment trust product that could be split by the holder into different price appreciation, depreciation, and income shares. 14/

The basket trading ideas raise a variety of interesting issues. Concern has been expressed regarding the effect of

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13/ Securities Exchange Act Release No. 26709 (April 11, 1989). The Phlx, Amex, and CBOE proposals raised jurisdictional questions regarding whether these products are securities subject to SEC regulation or futures subject to CFTC regulation. See letter from Jean A. Webb, Secretary, Commodity Futures Trading Commission, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 29, 1988. In addition, the Investment Company Institute (ICI) argued that Index Participations are investment companies. See letter from Matthew Fink, General Counsel, ICI, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 19, 1988. These issues are currently being litigated. See Chicago Mercantile Exchange and Board of Trade of City of Chicago v. SEC, Nos. 89-1538, 1763, and 1786 (filed March 14, April 12 and 14, 1989, 7th Circuit); and ICI v. SEC, No. 89-3315 (filed May 15, 1989, 3rd Circuit, transferred to 7th Circuit on May 17, 1989).

14/ See P. Maher, "Portfolio Insurer May Give Big Board Its First Product," Investment Dealer's Digest, September 20, 1988, at 6.

basket trading on the order flow that would otherwise go to individual stock specialists. Questions exist with regard to whether a specialist or a competing market maker system should be used for such products. The extent of upstairs trading that might be allowed in these products is also at issue. The crucial questions are whether sufficient market making capacity will exist to support basket trading and whether institutional investors will use such a market. Despite these issues, basket trading should be pursued by the markets as a potential means of adding liquidity.

#### Corporate Issuers

One identifiable entity with a clear interest in providing market support during a sharp decline is the corporate issuer. During the October 1987 market break, issuers recognized that interest by purchasing almost 90 million shares of their stock. <sup>15/</sup> In this connection, it should be noted that concern over the possibility that issuers would engage in trading activity intended to manipulate the price of their securities led to the adoption of Rule 10b-18 in 1982. <sup>16/</sup> This rule provides a safe harbor from liability for issuer repurchasers meeting pricing, timing, and volume limitations. During the October 1987 market break, the Commission's staff emphasized that Rule 10b-18 is

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<sup>15/</sup> See SEC Staff Report, supra note 7, at 6-3.

<sup>16/</sup> Rule 10b-18 under the Securities Exchange Act of 1934, 17 CFR 240.10b-18 (1988), adopted in Securities Exchange Act Release No. 19244 (November 17, 1982).

not a prohibition, but instead is a safe harbor that contains no presumption that issuer purchases outside the rule are necessarily manipulative. The staff made it clear that an issuer's attempt to provide support to its stock in the midst of a market wide decline was legitimate. Of course, that view does not mean that issuers suddenly may seek to establish or raise prices of their shares for reasons unrelated to overall market volatility. Nonetheless, during times of market crisis the issuer's support function is not only legitimate, but welcome.

#### Institutions

Just as institutions may exacerbate market declines by engaging in unusual, converging selling activity, so they can be natural suppliers of liquidity by using their large pools of capital to purchase stocks. The same self-interest that should keep institutions from selling when dramatic declines are occurring should also induce them to buy during such periods, at least when prices appear to have dropped below fundamental values.

In sum, continued future attention must be devoted to the need both to decrease demand for liquidity and to increase the supply of liquidity.

#### IV. The Commission's Information Needs

Two other critical issues in the market area, large trader reporting and holding company risk assessment, share a common theme: the Commission's need for more timely

information in order to perform its market monitoring responsibilities. The market break made it clear that regulators and self-regulators need to have and share timely and accurate information. Much progress has been made since October 1987 in information sharing and coordination among regulators and markets. There remain, however, two types of critical information that are not currently available to securities market regulators and self-regulators in a timely fashion: 1) information with respect to large trader activity; and 2) information with respect to the financial exposure to broker-dealers created by financial activities of unregulated affiliates. Without more timely availability of large trader-information, securities market regulators lack the ability to monitor adequately the very institutional trading activity that can trigger severe market liquidity pressures. Without information concerning potential impingements on the availability of large broker-dealer capital due to financial activities of unregulated affiliates, regulators lack the necessary early warning of potential incremental capital problems.

A. Large Trader Reporting

With block and portfolio trading and other institutional strategies accounting for an increasing proportion of total market activity, it becomes increasingly important for regulators to have timely access to data concerning these trades. In 1988, block trades - trades of 10,000 or more

shares - constituted 54% of NYSE volume. 17/ Since July 1988, portfolio trading (defined here to include a wide range of strategies involving the purchase and sale of a basket of 15 or more stocks) has accounted for over 10% of NYSE volume. 18/ One type of portfolio trading is index arbitrage. Today, a single index arbitrage trade can include from 180,000 to 437,000 shares in 215 to 493 stocks, with a value of \$7.6 to \$18.1 million. The sheer magnitude of this trading, both absolute and in relation to total market volume and value, dramatically demonstrates the need for the Commission and the SRO's to have timely access to large trader information.

Large trader information is essential to the Commission's ability to promote market stability. When significant price movements occur, the Commission must be able to reconstruct quickly the trading activity of the largest market participants. After large market movements in September 1986 and January 1987, and the October 1987 market break, the Commission's Division of Market Regulation attempted to reconstruct trading activities in order to understand the causes of the large and sudden price movements. Unfortunately, in each instance the simple first step of obtaining trade data concerning block and program trade activity took an inordinate

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17/ NYSE Fact Book 1989.

18/ Id. The NYSE began publishing this data in July 1988.

amount of time. This circumstance alone suggests changes are needed.

More significantly, although most block and portfolio trade activity is legitimate, trade activity in large size inevitably involves the potential for unfair and manipulative activity. One type of unfair trading potentially associated with block or portfolio trading is called "frontrunning." In its simplest form frontrunning involves a broker executing trades for its own account knowing that a customer order it will soon execute will be likely to have a market impact. The customer's order may impact either a particular stock or the market itself.

In order to monitor markets for this type of activity, the Commission needs improved audit trail information. An audit trail consists of reports of essential information concerning a trade. These reports are made contemporaneously with trade execution and are recorded electronically by the SRO's. Currently, the audit trails available in the securities markets include the identification of the brokers who effected the trade, but do not include any information identifying the customer for whose account the trade was effected. It is current information regarding the identity of large traders that is needed in order to create the audit trail detail necessary to monitor markets adequately for unfair or manipulative activity.

In response to considerations such as these, the Presidential Task Force on Market Mechanisms recommended the establishment of a large trader reporting system for the stock markets similar to the one used in the futures markets. 19/ In June 1988, the Commission transmitted to Congress legislation that would provide it with clear rulemaking authority to create a large trader reporting system, 20/ and Senators Dodd and Heinz and Congressmen Dingell and Markey recently introduced that legislation. 21/

The legislation would permit the Commission to require any person who engaged in a large volume of trading to report those trades to the SEC or to an SRO within 24 hours of the trade. The volume of trades that would trigger the reporting requirement, the information about the trade that must be reported, the identity of those subject to the reporting requirements, and other details would be determined in rulemaking proceedings that would be authorized by the legislation.

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19/ See Report of the Presidential Task Force on Market Mechanisms (January, 1988), at 67.

20/ See Letter from David S. Ruder, Chairman, Securities and Exchange Commission, to the Honorable George Bush, President of the United States Senate, June 23, 1988.

21/ See S. 648 and H.R. 1609, supra note 5.

Several concerns have been raised about this legislation. Foremost among these concerns is that reports to regulators that include the identification of trade participants will place our markets at a competitive disadvantage to foreign markets. In addition, concern has been expressed about the costs to broker-dealers of implementing large trader reporting requirements.

These concerns certainly deserve consideration. But it bears emphasis that the legislation only authorizes the Commission to create a reporting system. It does not mandate the details of that system. In exercising its rulemaking authority the Commission would seek comment from interested parties and would seek to address concerns.

For example, as a first step to addressing both confidentiality and cost concerns, it might be adequate to limit routine reporting to the name of the customer identified in a broker's records rather than to require the identity of the ultimate real party in interest to be disclosed. Moreover, it is important to emphasize that the Commission does not intend to employ any reporting requirement to usurp the SROs' position as the first line of detection of illegal activity. Indeed, the Commission expects to place reliance upon the SROs to integrate large trader data with their existing audit trail information. Finally, the legislation would specifically allow the Commission to reject Freedom of Information Act requests

for large trader information obtained by the Commission under the authority of the legislation.

In light of the increased importance of institutional trading activity, the Commission needs more timely access to large trading information. With regard to competitive concerns, the knowledge that U.S. regulators have access to large trader information might provide increased assurances of the honesty and integrity of our markets that will increase rather than decrease the competitiveness of our markets. Indeed, the securities industry has long recognized that its own interests are best promoted by effective regulation of securities markets. I am confident that the industry will continue to work with the Commission to find a way to provide the Commission, or the SRO's, with this information in a manner that addresses its legitimate concerns as well as the important regulatory considerations.

B.  Holding Company Risk Assessment

The other important informational gap that should be addressed concerns the potential financial exposure to broker-dealers that can result from unregulated financial activities of their affiliates. This concern arises because major U.S. broker-dealers are owned by holding companies that also own other subsidiaries engaged in financial activities. Each of the 25 largest U.S. broker-dealers in terms of capital is part of a holding company structure.

Some unregulated affiliates of these broker-dealers engage in financial activities that expose them to the risk of large losses. For example, an affiliate may engage in "swap" trading. In its simplest form, this involves an entity with a fixed rate loan liability exchanging the payments on that loan for floating rate liability payments. Where the swap intermediary cannot immediately find a counterparty, it will temporarily own the loan instrument constituting the other side of the swap and thus assume the risk of default or interest rate changes. Where the other side is found, the swap intermediary, which interposes itself as principal between the two end-users, is exposed to the risk of payment default by either party. These risks can be tremendous. Other potentially risky activities include bridge loan financing, 22/ merchant banking, 23/ foreign currency trading, and activities by affiliates in foreign markets.

If affiliate losses occur, there is the potential for injury to the securities markets in two regards. First, large affiliate losses may jeopardize the financial solvency of the entire holding system, including the broker-dealer affiliate. Second, even if the broker-dealer's solvency is not threatened,

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22/ Bridge loan financing is the financing, usually through short-term lending, of corporate acquisitions that typically involve leveraged buy-outs by incumbent management.

23/ Merchant banks, among other things, may be investing in long-term equity positions in operating companies.

the market may believe it to be threatened and treat the broker-dealer affiliate accordingly. This "reputational risk contagion" can occur because the affiliated entity experiencing financial problems can cause lenders and counterparties of the broker-dealer to have reduced confidence in the continued ability of the broker-dealer to meet its obligations even though in fact the broker-dealer is unaffected.

Either actual risk effects or reputational risk contagion can result in reductions in the amount of credit lenders are willing to provide the broker-dealer, and in the willingness of counterparties to trade with the broker-dealer. In the worst case this unwillingness could threaten the broker-dealer's ability to satisfy pre-existing obligations. The resulting chain reaction involving failures by counterparties of the broker-dealer and their counterparties are potentially dramatic. 24/

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24/ The Commission's rule establishing minimum net capital requirements does not address these risk concerns. The net capital rule is designed, among other things, to protect the customers of the firm by requiring that the firm maintain sufficient liquid assets, over and above its net worth to satisfy obligations to customers. This rule and its early warning requirements are not designed to address the potential market effects of reductions in firm capital, borrowing power, and trading ability that do not directly threaten the firm's customers. One of the lessons of the October market break is that, even if a firm has sufficient regulatory capital to meet customer liquidation needs, that capital level may not be sufficient to protect the firm against its proprietary market risks or those of its affiliates. It is the potential reductions in capital or credit to levels that meet minimum customer protection levels but do not provide risk protections that are of concern here.

The Commission does not currently have adequate capacity to obtain early warning of financial events affecting corporate affiliates that threaten harm to the broker-dealer affiliates either directly or through reputational risk contagion. The Commission must be able to obtain early warning of affiliate problems so it can consult with the SRO's and domestic and foreign government agencies in order to plan possible responsive action, including encouraging the broker-dealer affiliates to seek additional capital or announcing that despite affiliate problems the broker-dealer affiliate remains sound. Similar early warning ability is possessed by bank regulators in the U.S. and by most foreign regulators, but not by the Securities and Exchange Commission.

In June 1988, the Commission transmitted to Congress legislation that would give the Commission authority to obtain from a broker-dealer information about financial events or circumstances that have occurred in corporate affiliates that might materially affect the operations of broker-dealers. 25/ Senators Dodd and Heinz and Congressmen Dingell and Markey recently introduced this legislation.26/

The legislation would exclude from its coverage information concerning broker-dealer affiliates from which some

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25/ See Letter from David S. Ruder, Chairman, Securities and Exchange Commission, to the Honorable George Bush, President of the United States Senate, June 23, 1988.

26/ See S. 648 and H.R. 1609, supra note 5.

other government agency, such as the Federal Reserve Board or the Commodity Futures Trading Commission, can obtain equivalent information. Similarly, the legislation would exclude insurance companies from its coverage. Thus, the legislation is intended to relate only to unregulated broker-dealer affiliates about which no U.S. government agency currently can obtain the financial information of concern here.

Moreover, the broker-dealer affiliates upon which the proposal would be focused are those engaged in financial activities. As proposed, the Commission would have authority to exempt a broker-dealer from reporting information concerning financial events or circumstances regarding an industrial, commercial, or other non-financial parent or corporate affiliate. The legislation also would expressly allow the Commission to exempt information regarding diversified holding companies and international financial organizations that do not devote a significant portion of their consolidated assets to activities in U.S. securities markets.

As with large trader information, consideration must be given to the sensitive and confidential nature of the information that the Commission would receive under this proposal and to the costs of any new reporting requirements. The legislation is limited to address these concerns. Thus, the SEC could obtain information only from the broker-dealer, and only about unregulated affiliates engaged in financial activities. Moreover, the legislation specifically permits the

Commission to reject Freedom of Information Act requests for information obtained by the Commission under the authority of this legislation. As with the large trader reporting proposal, I am confident that the Commission can work with the interested parties to design the legislation and any resulting Commission rules in ways that accommodate legitimate industry concerns.

V. Conclusion

Market reforms implemented in response to the October 1987 market break have made our securities markets more efficient operationally and less vulnerable to the mechanical failures experienced during the October 1987 market decline.

Improvements also have been made in the clearance and settlement area, and there is a clear commitment to continue these initiatives. Despite efforts to improve market liquidity, including continuing efforts to create basket trading products and procedures, the adequacy of market liquidity remains of concern. More attention must be paid to this area in the future. Finally, the Securities and Exchange Commission must be given the tools necessary to monitor the large trading and broker-dealer risk that are a fact of life in our markets today.