Remarks of

Richard G. Ketchum *
Director
Division of Market Regulation
Securities and Exchange Commission

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FUTURE ISSUES IN MARKET REGULATION

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It is a pleasure to be here with you today. There is an amazing diversity of market regulation issues before the Commission today. The Commission has outstanding rule proposals in the areas of municipal securities underwriter obligations, registration requirements for foreign broker-dealers, specialists' net capital requirements, the regulation of proprietary trading systems and fraudulent practices in the penny stock market. I would be pleased to respond to questions you may have regarding any of these regulatory initiatives. I would like to focus this talk, however, on the broader topic of the structural issues which I believe face the Commission's market regulation program in the future.

I. October Market Crash Retrospective

A discussion of the future regulation of the markets must begin with the October 1987 crash. Analyses of the crash has kept multiple agencies busily at work and provided sustenance for an entire generation of Chicago school economists. It strikes me, however, that those retrospectives have either been too close to the flame to provide perspective or purposefully aligned with an ideological side of the argument.

Stepping back, it seems to me that the crash underlined a profound development in the securities market -- the shift of a substantial portion of institutional activity from investment in individual securities to "trading the market." The development of passive investment strategies and the shift by active investors to tactical asset strategies that look to broad based shifts of portfolios from stock to bonds and from country to country has taken economic portfolio theory to its logical conclusion. That shift has changed, I believe, forever, the nature and character of the U.S. equity markets.

Portfolio traders create imbalances in the market as a whole, not in an individual stock. Similarly, portfolio traders depend on trading in derivative index markets to provide them the ability to shift whole portfolios quickly and at low cost. These characteristics of portfolio trading change radically the structure of our securities markets. First, the futures markets, as the markets currently offering the greatest speed and liquidity for portfolio trading, often become the pricing

mechanism for the securities markets, particularly at the opening and when the market as a whole is responding to macro-economic news. Second, the specialist is required to respond to bursts of seriatim program orders delivered through the Designated Order Turnaround List System, with little ability to identify (other than through trading solely off futures pricing), the source or reason for the sudden selling or buying surge.

Most importantly, the market has not yet developed a means to effectively employ available capital to cushion market imbalances caused by portfolio trading. Unlike large blocks in individual stocks, which are positioned by the major upstairs firms, portfolio orders are so large in aggregate as to discourage positioning by upstairs firms and small enough in the size of each stock order to encourage the perception that the exchange auction market can efficiently absorb those orders. And so it can, except in situations of substantial market volatility when the total number of programs generated simply overwhelm the willingness and capital of downstairs market makers.

In large part, the debate over this phenomena and its impact in October 1987, has focused on the disagreements over the impact of the index futures in contributing to portfolio trading volatility. Speaking personally, I continue to believe that the exceptionally high leverage resulting from low speculative and hedge futures margin levels helped to create the Alice in Wonderland view of strategies, such as portfolio insurance, that

an institution could plan on shifting 25 to 50% of its portfolio out of securities in a short period of time. I continue to believe that index futures trading in October, 1987 concentrated and exacerbated stock market volatility and that higher index futures margin levels would be prudent to address concerns over both stock market volatility and financial risk in the securities markets.

I would ask you, however, to shift that argument to the back of your mind because I believe it colors over the larger consensus that has emerged after October. No agency or any house of Congress has concluded that steps should be taken to seriously restrict derivative trading in the U.S. That consensus, I would suggest to you, arises out of an understanding of how critically important index futures and options products have become to institutions as a hedging and market timing vehicle. More importantly, however, that consensus arises from an understanding that index futures are important because institutions want to trade portfolios not vice versa. In essence, the shift to market basket trading reflects a shift in institutional strategy which can only be turned back by regulatory actions which would radically restrict institutional investment discretion.

The acceptance of portfolio trading as a principal part of institutional activity, however, will continue to have significant ramifications. Yes, institutions have learned from October, 1987 and hopefully will never again throw their assets into programs calling for arithmetic liquidations of large

percentages of the stock portfolios. Portfolio trading, however, will continue to impose profound new pressures on liquidity on the stock and the derivative markets and, until those pressures are met, create the potential for substantial volatility in the stock market.

A wide number of important regulatory responses to the October Market Break have occurred. These responses have ranged from increasing order handling and system capacity in each of the market places, increasing market making capital and implementing "system wide" circuit breakers intended to provide the market place a breathing space and an opportunity to more efficiently offset imbalances in supply and demand. I would like to focus the remainder of my talk, however, on a personal perspective of what remains to be done to address the fundamental shift in the market to portfolio trading. I believe that developing proper responses to that phenomenon is the greatest challenge facing the Commission's Market Regulation Program today.

II. Liquidity

The growth and change in institutional trading patterns historically has placed new liquidity strains on the stock market. As the size and activity of institutional accounts increased qualitatively in the late 1960's the exchange markets were placed under great pressure to provide liquidity to large institutional orders. In response, member firms developed block positioning capabilities to avoid having large orders routed directly to the exchange where they might overwhelm the

specialists' market making capabilities. As discussed earlier, increased portfolio trading has imposed new order flow pressures on specialists which they are not able effectively to respond to during volatile market periods. Yet because of the size of the program orders and the number of stocks involved, block positioning firms are not employing their capital to cushion the blow on the market of those orders.

The Commission has suggested that the development of market basket trading might help address this concern. Specifically, the Division's October Market Break Report encouraged the establishment of a market basket trading system which would permit trades in standardized market portfolios to occur in a single transaction rather than in multiple transactions spread throughout the trading floor. It was our hope that market basket trading might sufficiently increase the efficiency and decrease the risks of portfolio trading that member firms might be willing to employ their capital in positioning their customers' trades. I am pleased to note that both the New York Stock Exchange and the Chicago Board Options Exchange have indicated that they are exploring the many complexities involved in developing market basket trading. I continue to believe that it is a concept which deserves experimentation within the market place.

With or without a market basket trading post, however, I am concerned that a market place trend has developed which is antithetical to any efforts to increase market liquidity. Recently, Morgan Stanley announced that it was radically reducing

the number of accounts which it would treat as institutional for purposes of positioning trades. This dramatic step reflects what is becoming to be an accepted truism on the Street -- firms are not making money in institutional trading. While the reasons for this are myriad, one factor often cited is the impact of soft dollar activity.

As I believe most of you know, Section 28(e) of the Exchange Act provides money managers a safe harbor from liability for "paying up" for research or order execution services. The Section was a response to concerns over the impact of the removal of fixed commissions in 1975 on boutique broker-dealers providing specialized research services and on the liability of money managers employing such services. For years, the Commission struggled with interpretations regarding the definition of what was research and how such research might be provided to money managers. Eventually, faced with the complexities of computer driven trading strategies and portfolio valuation systems, the Commission succumbed and announced that money managers receiving products or services that provide any "lawful and appropriate assistance" to their investment decision making for one or more of their accounts could fit within the Section 28(e) safe harbor.

I believe third party providers of research information have provided important competition for the major firms in attracting institutional customers. I am concerned, however, over the structural imbalance which may occur in this competition, an imbalance which may act as a disservice to the ultimate

beneficiaries. The Commission in taking its interpretive position emphasized the obligations of fiduciaries to obtain best execution. It is very easy, however, for a fiduciary to calculate the value of research or services provided and the commission charged. At the same time evaluating the relative quality of executions provided by competing firms is a substantially more difficult task. With the broader interpretive flexibility provided by the Commission and the expanded provision of soft dollar products directly to pension plan sponsors, the result has been an inexorable movement of business from firms who offer positioning capabilities to firms who do not. The reduction of trading volume since October 1987 has served to underline this trend.

I do not have sufficient information at the present time to reach any conclusions regarding present soft dollar activity. But the reduced willingness of major firms to put their capital at risk in block positioning as well as the continued complaints by institutions over a more adversarial stance taken by those firms in dealing with them are not healthy signs. Accordingly, this is an area in which I expect the Division to review carefully in the coming year.

While I firmly believe that the Commission should consider steps to create a market environment which encourages firms to commit additional capital to market making and positioning activities, progress in this area is not a cure-all for market volatility concerns. During a market situation, where volume

trebles and market uncertainties are the greatest, intermediaries will never be willing to risk sufficient capital to ensure that panic liquidations are not triggered. [To some extent this structural fact of life underlies the implementation of circuit breakers. It also explains why the short sale rule, despite its somewhat illogical asymmetricalness, most likely will remain a part of the exchange market landscape. Simply put, the world is "net long" with a theoretical overhang of trillions of dollars in stock. Given the potential for massive institutional selling, there must be fail safes built into the system that allow market participants to step back, and without the pressure of a continuing price decline evaluate all available market and credit information: Hopefully, this market pause will reduce panic selling and encourage new orders offsetting large sell imbalances.

While stop gap measures and retardants are important during a market break situation, they beg the question of where you find buyers in a market under pressure.] In large part, the only persons who have a clear interest in providing such market support are the corporate issuers themselves. By definition, issuers must have a long-term viewpoint regarding the value of their securities and an interest in accepting short-term market risks. Indeed, major corporate issuers did respond to the Market Break by purchasing during that week, approximately 90 million shares. While still a small fraction of total volume during that week, I believe issuer repurchase activity had a

psychological calming effect on the market and encouraged other potential purchasers to reenter the market.

Issuer purchasing activity is, however, a two-edged sword. The Commission has always been concerned over the potential incentives for issuers to engage in trading activity intended to artificially manipulate the price of their securities. For this reason, the Commission adopted Rule 10b-18 which provides a safe harbor from liability for issuer repurchases meeting pricing, timing and volume limitations. During the market break, the Commission staff emphasized that Rule 10b-18 was what it advertised, a safe harbor with no presumption that issuer purchases outside the rule were fraudulent. We emphasized the common sense point that an issuer's desire to provide support to its stock in the midst of a market wide earthquake was legitimate. That does not mean that issuers' suddenly have a free pass to trade with abandon during periods of market volatility. Their role can only be to provide market support, not lead the price of the stock back upward. But we should be very clear that during times of market crisis that the issuer's support function is not only legitimate, but welcome.

III. Risk Control

While providing an environment that encourages market liquidity must be a continuing goal of the Commission, the October Market Break underlined the fact that the most critical task facing regulators and industry participants is ensuring the financial responsibility of the securities marketplace. New

financial products, increased firm proprietary activity and the internationalization of the securities markets has substantially increased the complexity of this task. I see two particular exposures in the present environment: unregulated entities and clearance and settlement.

A. Holding Company Regulation

Financial regulation for securities firms evolved from a very different philosophical premise than did banking regulation. Rather than looking towards the safety and soundness of the institution, the Exchange Act focused on protection of the investors, or customers, of the broker dealer. Accordingly, the rules attempt to ensure that customer securities are not misappropriated, and that the firm can be liquidated without loss of customer funds or securities.

From this philosophical premise it is not surprising that securities regulation looks inward only to the registered broker-dealer and attempts to build, in effect, a Maginot line to ensure that the firm does not jeopardize its customers. While true to the underlying philosophy of the Act, this insular approach may no longer be tenable in modern securities markets. Simply put, the failure of a Salomon Bros. or Merrill Lynch can have nearly as profound an impact on the U.S. financial system as the failure of Citibank. And we should not kid ourselves as to ease in which Merrill Lynch, U.S. could borrow funds and meet its short term obligations if Merrill Lynch, London, or Merrill's Interest Rate Swap Affiliate cannot open their doors one morning.

The Commission took an initial step to address this concern by proposing legislation which would have given the SEC authority to collect key financial information regarding non-bank financial affiliates of U.S. broker-dealers. The information collected would not be used to increase the capital requirement of any broker-dealer. It would allow us, however, to identify more effectively firms with substantial exposures in their foreign and unregulated financial affiliates and therefore more effectively evaluate the risks a particular firm might be subject to during periods of market volatility. At a minimum, legislation such as this would reduce the risk of the SEC being caught unprepared by financial problems of a major broker-dealer.

B. Clearing

If there was one consensus among the Market Break Reports it was that the greatest exposures during the week of October 19, 1987 arose from the clearance and settlements systems for stock, options and futures. As those reports detail, the absence of coordinated clearance and settlement systems imposed enormous payment obligations on broker-dealers which in turn required immediate financing determinations from their banks. While the existing system made it through, the potential for financial gridlock was simply too great.

Substantial progress subsequently has been made in the clearance and settlement area. The New York Stock Exchange and the NASD have committed to implement next day comparison in both the exchange and over-the-counter markets. This change will

eliminate uncertainties which, during volatile market periods, can substantially increase a firm's risks and decrease its willingness to take new securities positions. In addition, the Options Clearing Corporation and Chicago Mercantile Exchange have announced a joint cross-margining program which will give credit to firms holding hedged futures and options positions and, as a result, reduce the initial margin payment obligations of those firms. Cross margining, therefore, may reduce some of the financing pressures on firms which occurred during the market break.

There remains, however, much to be done. At Chairman Ruder's request, an ABA task force has been created to address inconsistencies and gaps in state commercial law which may increase risks or impede the efficient clearance and settlement of futures and options. It is simply untenable in today's financial markets to have the requirements to perfect a lien in uncertificated securities or in a repurchase agreement be unclear. These and other questions must be addressed and I urge all of you to provide the Task Force with your input and support.

Finally, no area more directly impacts the risks of securities firms operating in an internationalized environment than clearance and settlement. It is nice to identify value in a particular market, but if settlement is routinely delayed and there are not adequate provisions for the marking of contra parties than the risks may exceed the rewards.

The time has come for united efforts to implement minimum clearance and settlement standards for active trading markets. In that connection, I was delighted to see the publication this week by the Group of 30, of its Study of Securities Clearance and Settlement. This Report represents a remarkable consensus among major securities market participants that present systems for clearance and settlement must be changed and conformed on a world wide basis. Among the critical areas identified in the Report are the need to standardize and reduce comparison and settlement periods (including in the U.S.); to implement in all active trading markets automated book-entry depository systems which provide for both institutional and street side settlement; and to provide that delivery vs. payment becomes the standard mode of settling institutional trades throughout the world.

I believe the Group of 30 Report is must reading for all of you with either broker-dealer or banking clients. It offers a road map for profound change in international clearance and settlement which could greatly reduce risks and increase the efficiency of the securities markets.

IV. <u>Conclusion</u>

If I have any summary message for you it is that the securities markets have become vastly more complex and fast moving. It is the responsibility of the Commission's Market Regulation Program to craft regulatory responses to those change which both protect investors and help eliminate system risks.