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Preliminary Observations on the Market Crash of October 1987

Statement of
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Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
United States House of Representatives

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Mr. Chairman and Members of the Committee, we are pleased to appear before you today to discuss the preliminary results of our ongoing efforts to examine what happened in the financial markets in October 1987.

The details of our preliminary observations on the October 1987 crash were presented last week in our January 26th report, and I would like to briefly highlight today the essence of that report.

The issues, problems, and concerns that we had fall into three broad areas.

-- We must protect the rest of the economy from the spillover effects of a sudden collapse in share prices. The Federal Reserve met its responsibilities effectively during the crisis but may face difficulties in the future if care is not taken in any relaxation of Glass-Steagall restrictions.

-- We must assure that the equity and futures markets function efficiently and effectively. We found problems both within each market and among them. Of special importance are the growing linkages between previously separate markets. There are also growing linkages between U.S. markets and those around the world. The structure of regulation for these markets needs to be examined, along with the relationship of the federal regulators to the markets. Ways should also be sought to harmonize regulation across national boundaries.

Within the U.S. markets, our work showed problems with automated trading systems. In addition, the market making process was severely strained in several markets and needs careful examination. We probably can never create a system that can withstand the pressures of the 19th and 20th, but there may be ways to improve or correct market capabilities.

-- Finally, treatment of individual investors must be fair. Numerous complaints, while not yet fully evaluated, raise the possibility that there were abuses of risk disclosure and suitability rules. In addition, individual investors probably faced unnecessary difficulties in gaining access to trading systems during October 19th and 20th.

In the short run, two areas deserve immediate attention. First, the automated systems that help the markets function smoothly must be assessed and changed, if necessary, to assure that they can handle the demands of modern markets. Our early work on automated systems concentrated on the New York Stock Exchange because of its pivotal role, but we need to look at evidence of problems in other markets. If the markets' institutional presence continues to evolve in the direction indicated by recent history, there is an urgent need for the private sector, with appropriate federal involvement, to overcome the problems in the automated systems that our January 26th report details.

The New York Stock Exchange was not prepared operationally for the volumes it experienced during the 19th and 20th of October. In the short term, an important question exists as to the extent to which the Exchange can accurately forecast trading volumes and related systems requirements. There are other issues concerning whether the Exchange's planned upgrade of its order processing systems will be capable of handling future traffic during peak periods in a way that is fair and equitable for all market participants.

Coordinated contingency planning is also urgently needed to prepare for any future crises that may occur. As the events of October unfolded, self- and federal regulatory officials maintained communications and made a number of decisions about how to react to market developments. Many market participants we spoke to gave high marks to both self-regulatory officials and federal regulators for their conduct during the crisis. However, most intermarket decisions by the market officials and federal regulators had to be made as events unfolded on essentially an ad hoc basis. Intermarket confusion existed at various times about which stocks were trading, the permissibility of corporations buying back their stocks at particular times, and most significantly, whether the New York Stock Exchange would remain open on Tuesday, October 20th. Although uncertainty in these situations probably can never be completely resolved, it should be reduced to the extent possible.

No intermarket interagency contingency plans existed to help answer the question, "What will happen next?"

Accordingly, we believe the federal regulatory agencies, the SEC, CFTC, the Federal Reserve, and the Treasury, along with the SROs should immediately develop contingency plans that result in

-- Agreement on and dissemination of information about how decisions made by both the CFTC and SEC are made and communicated to markets. These should include agreements on how unilateral decisions by markets will be coordinated and disagreements resolved.

-- Agreements on steps to be taken during crises, and those circumstances that would call for a relaxation or interpretation of rules to facilitate market liquidity. Some steps might include consideration of the various kinds of price limits, trading halts, or other methods which may be needed to give the markets time to obtain and evaluate key information.

-- Agreements on Federal Reserve liquidity support mechanisms for market participants. Because public dissemination of such plans could result in excessive risk taking by market participants, some believe that its specifics should not be revealed.

It may be sufficient that the public knows that such plans exist.

Over the long run, greater efforts are needed to improve the regulation of the linked markets. We need to identify any problems which may be created by differing rules and procedures, such as margins, price limits, trading halts, market pricing mechanisms or trading system shutdowns that affect closely related stocks, stock index futures, and options. The capabilities of the specialists and other market making systems in the new market environment need to be studied, with the objective of strengthening their capabilities.

This concludes my prepared statement. We would be pleased to respond to your questions.