For Ruder

Market Study
Derivative Product

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July 23, 1987

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SEC. & EXCH. COMM.

David Ruder
Chairman Designate
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear David:

Enclosed for your information is a copy of testimony given by the New York Stock Exchange before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce of the House of Representatives on July 23, 1987, on the subject of program trading.

I hope that this testimony will be of interest to you, and if you have any further questions concerning its contents, please do not hesitate to contact me.

Sincerely,

Stephen J. Paradise

Enclosure

TESTIMONY PREPARED FOR THE RECORD BY

RICHARD A. GRASSO

EXECUTIVE VICE PRESIDENT, CAPITAL MARKETS

NEW YORK STOCK EXCHANGE

BEFORE THE HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON

TELECOMMUNICATIONS AND FINANCE

WASHINGTON, D.C.

JULY 23, 1987

Mr. Chairman, members of the Subcommittee.

The NYSE appreciates the opportunity to participate in this hearing.

The subject of program trading is one which has attracted considerable attention over the past year from the financial community, the media and regulators. It is a concept which traces its origins to the mid-1970s when institutional investors first began implementing large-scale changes in portfolio composition in a relatively short time span.

The current-day form of program trading as described in detail by various market professionals earlier in these hearings was born in 1982 as a result of the origin of cash-settled index products. The introduction of these products spawned the wider use by money managers of a concept of investing which allowed for the tracking and matching of index performance, such as the NYSE Composite or the S&P 500, with the opportunity to enhance total return above index results through the use of the stock index future.

A large number of institutional investors and brokerage houses employ the strategy broadly defined as program trading. Estimates suggest that this involves as much as 100-175 billion dollars of managed money in this country.

The New York Stock Exchange has been a large beneficiary of the growth in program trading. The birth of program trading has contributed significantly to the the billion-share week, 300-million-share day, and the 86-million-share minute.

The Exchange is proud of its performance under these most extraordinary conditions. Our long-range planning and technological investments have permitted these levels of volume to be processed quickly, efficiently and in a manner that is cost effective for our customers.

That same kind of forward-looking strategy, in both technology and operating systems, continues. Naturally, our planning includes among its parameters the trends in program trading. We are investing to expand capacity based on the totality of the market, including program trading and the projected increases in equity interest in future years.

Despite the fact that the Exchange has benefitted greatly from this innovative new money management tool, we have publicly voiced concerns about its exceptional growth.

Our first concern is related to "Expiration Friday," which has been labeled by the media as the "Triple Witching Hour." This event, which occurs four times annually, is the simultaneous expiration of the index futures contracts, index options contracts and individual stock options contracts.

This convergence of expirations produced market events which in the last minute of trading on those four Fridays could trigger enormous imbalances of supply or demand in a large number of stocks with virtually little or no time left in the trading session.

Our greatest concern when markets exhibit these types of imbalances and potential volatility is that such imbalances be widely disseminated to the broadest possible range of investors, both large and small. And most importantly, that potential market participants be afforded ample time to participate if major price changes are likely. In sum, our concern about the triple witching hour at the close of trading was one of fairness.

Few investors, large or small, could be expected to react to such large imbalances within the last few moments prior to the close of trading.

This concern caused us to publicly advocate a change in the expiration day procedures to permit expiration of index contracts at the opening rather than the closing. This change would permit imbalances to be identified and communicated to the entire investor community with ample time afforded for a fair and orderly opening, one which reflected the maximum opportunity for investor participation.

The Exchange joined with the Chicago Mercantile Exchange and the New York Futures Exchange in agreeing to redefine the index contracts traded on those markets to expire at the opening of trading rather than at the close.

The first expiration day utilizing the new expiration-at-opening contract occurred on June 19. To accommodate the new contracts, the Exchange instituted auxiliary procedures which were designed to ensure a timely and fair opening of trading. Specifically, we opened our order routing network one hour earlier than normal (7:30 am vs. our normal 8:30 am). And we required that all orders related to index contracts expiring at the opening be on the floor or in the electronic network by 9:00 am.

By doing so, we were able to disseminate over the news service net imbalances in the 50 largest market-capitalized issues within seven minutes. Having done so, sunlight was cast on the pre-opening supply or demand in those issues; and potential market participants enjoyed the benefit of approximately 25 minutes notice prior to the commencement of trading.

In fact, all 50 stocks in this disclosure pilot were opened within five minutes after trading commenced; and the entire 500 issues in the S&P averages opened within 17 minutes.

The Chicago Mercantile Exchange and the New York Futures Exchange have led the way. They are to be commended. Their leadership role must now be followed by the other options and futures markets.

Our second concern is one which is relevant to any new innovative financial product. Specifically, does the instrument increase the overall level of risk system-wide? Could program trading in the face of a bear market set off a chain reaction equivalent to a financial meltdown?

Consider the following scenario.

Natural forces cause the market to drop. Fund managers using portfolio insurance then begin selling index futures to hedge downside exposure.

That, in turn, leads to a drop in the price of the index underlying the futures to the point that it begins selling at a discount to the stocks in the index.

Index arbitrageurs then begin buying the futures and selling the stocks. The price of the stock drops further, prompting another wave of index futures selling by fund managers using portfolio insurance.

Could such a financial cascading occur? No one knows for sure. Many professionals believe the market would provide a natural cushion against such an occurrence.

Congressmen Lent and Rinaldo, in their recently introduced bill, seek to head off such a downward spiral by imposing a temporary trading halt. During such a halt, information about imbalances would be disseminated to all buyers and sellers in order to arrive at a new price equilibrium.

And finally, there's the concern of possible market manipulation.

The NYSE operates a sophisticated surveillance system comprising skilled analysts supported by a large data base and a comprehensive array of computer-based programs. Complex computer software tracks each trade, recording the number of shares traded, the price, the time, and the identification of the buying and selling brokers.

At the same time, other programs using the some of the same data are tracking movements in price on a real-time basis. They alert market trading analysts to look into unusual activity that might indicate a trading irregularity. On a broader basis, still other programs provide capabilities for intermarket surveillance.

Nevertheless, whenever one sees waves of buying and selling in the index futures market which in turn trigger movements in the underlying securities, one has to wonder whether it's possible to manipulate one sector of the market in order to move the other.

On the other hand, there are those who maintain that the sheer size of the market mitigates the possibility of manipulation.

It is clear to us that the time has come to expand the analysis of the impact of program trading on the market. For this reason, the Exchange recently commissioned a study of the long-term effects of program trading on securities markets.

The study is being conducted by Nicholas Katzenbach. Mr. Katzenbach, former United States Attorney General and retired general counsel of IBM, has the mandate is to explore the full range of program trading and its structural implications for the marketplace. A report is due at the end of this year. We would be happy to share the results of this study with the subcommittee.

In our judgment, the problem is not program trading. Rather -- as with any new financial product -- the problem is one of helping the market and market participants adjust to it.

In the last five years, some 450 new financial products have been introduced into the marketplace. What many of them mean for the market in the long term remains to be seen.

At the same time, the allure of new financial products will remain strong as long as investors seek to enhance their investment returns and more prudently manage risk.

Accordingly, it's the responsibility of all of us to help the market accommodate new financial products.

That's why we've commissioned the study by Nicholas Katzenbach.

It's why we are working with users such as institutions, individuals and member firms to continue to refine the product.

It's also why we are working diligently with other markets to enable the system to work more smoothly and specifically to apply the most efficient and effective procedures on expiration days.

And it's why we are eager to work with the Congress, the SEC and all other interested parties to better understand the full range of new financial products now in use and their implications for our securities markets in the future.

Thank you.