November 2, 1987

To: Senators and staff, Senate Banking Committee

From: Rob Johnson, Bart Naylor

Re: Hearing on securities market volatility, Nov. 4, 1987

Extraordinary market volatility of recent weeks has raised a number of important questions about securities market regulation. In preparation for hearings, enclosed is a selection of memos that cover:

1. A chronology of events

2. Views of experts on the causes of the volatility;

3. A primer on "program trading," together with a glossary, a description of markets and regulatory oversight.

Here are some of the issues:

* What is the purpose of the capital market system? To the extent that its purpose is to raise capital for economic growth, how does securities regulation promote this goal.

* What role did the derivative products that are part of futures arbitrage and portfolio insurance play in the volatility of the markets? What was the role of the margin requirements in these derivitive products? What led to the decision to limit access by firms to the NYSE's computers for program trade executions?

* What was the nature of coordination between the SEC, the New York Exchanges and the Chicago commodities exchanges? What would be the benefits of merging the SEC and Commodities Futures Trading Commission authority? What led to the decision not to close any of these markets? What led to the decision to limit the hours of the exchange?

* What is the nature of influence of the foreign markets in American market volatility? Are there inherent differences in market behavior in London, Tokyo or Hong Kong? Why did the Hong Kong market close? What are the benefits and how practical is closer regulatory cooperation with foreign exchange markets?

CHRONOLOGY

Oct. 14: Dow plunges 95 points, a record, on news of a smaller-than-expected improvement in the August trade deficit. Earnings improve at several major banks.

Oct 18: Treasury Secretary Baker meets with West German officials and complains of high interest rates there.

Oct. 19: Dow crashes a record 508 points, or 22 percent, nearly double the percentage loss of Oct. 28, 1929. Volume doubles previous record of 605 million shares. U.S. attacks Iranian oil rig in Persian Gulf. In Chicago, Merc officials make three margin calls.

Oct 20: Blue chips rally, closing up record 102 points on record volume. Fed chairman Greenspan signals switch to anti-recession policy, making Fed discount window available to securities firms. Three small securities firms fail

Oct 21: Stocks rebound, setting Dow record gain of 186 points. Market-making firm A.B. Tompane & Co. fails, and under emergency authority, SEC arranges sale to Merrill Lynch.

Oct 22: Dow skids 77 points, with heavy selling by foreigners and U.S. investors being forced to sell to meet margin calls. Major banks cut prime rate to 9 percent from 9-1/4 percent. Reagan offers to negotiate budget differences with Congress. Continental Illinois extends loan to options clearing subsidiary.

Oct 26: Stocks collapse again with Dow blue chips losing 156 points, second steepest fall. OTC stocks fall below 1985 levels.

Oct. 27: Dow gains 52 points, though the OTC and Amex fall. Bond prices tumble. IBM announces stock repurchase program. Numerous takeover bids scratched.

Oct. 28: Stocks stabilize, with the blue chip Dow recovering 52 points, but other American exchanges slipping. Soviet ambassador Shevardnadze promises U.S. visit.

Oct. 29: Dow rises 91 points. Discount brokerage giant Schwab announces $22 million loss because of clients failing to meet margin calls. Britain decides to proceed with $12 billion British Petroleum underwriting, which threatens losses for American underwriters.