UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

February 24, 1988

Honorable Thomas J. Tauke
U.S. House of Representatives
2244 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Tauke:

Thank you for your inquiry concerning possible trading abuses involving the securities and index futures markets. Please accept my apology for the delay in responding to your letter, but the completion of the October 1987 Market Break Study demanded the full attention of our staff over the last several weeks. While the particular scenario cited by the "Anonymous Commentator" is subject to a number of limitations discussed below, it serves as a useful illustration of the types of intermarket regulatory concerns which the Commission is seeking to address.

As you recognize, functionally similar financial instruments currently are regulated by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), and, as a result, in some instances are subject to different regulatory treatment. Trading strategies, however, increasingly treat financial derivative instruments (i.e., options and futures) and underlying securities as equivalent. With the increasing integration of these markets, it has become possible for activities in one market to influence the marketplaces for other functionally equivalent instruments. This integration also provides for opportunities to engage in manipulative or other abusive practices across markets. Recent market events such as the October market break have highlighted further the increasingly integrated nature of these markets and have renewed concerns over intermarket trading abuses. The SEC has been and continues to be concerned with addressing abusive cross-market trading practices. As noted in the recent report by the Division of Market Regulation on the October market break, securities and commodities regulatory authorities currently are examining the adequacy of intermarket surveillance and seeking ways to improve communications and sharing of surveillance information with the ultimate goal of coordinating investigations and, where appropriate, enforcement actions.

We have carefully reviewed the hypothetical scenario raised by the Anonymous Commentator. This scenario properly focuses our attention on the potential for using the leverage available in the derivative index markets to profit by questionable actions in the securities markets and on the jurisdictional problems raised by such cross-market activities. Without minimizing these concerns or prejudging the likelihood of this and other scenarios, it is important to recognize the limitations inherent in the particular scenario cited in your inquiry. First, it would require one firm's buy/sell recommendations on four major index component stocks both to have a significant price effect on each of the stocks and that these price effects all be in one direction (positive or negative). Given the number of analyses and recommendations to which such bellwether stocks are subject, the potential influence of one firm's recommendations may be somewhat overstated. Second, if such an effect was actually realized, aggrieved market participants (i.e., parties who bought/sold the index futures or options) almost certainly would have an incentive to complain to their regulators and would have the sophistication to focus the regulators' attention on the suspicious timing of the firm's recommendations. In its final report on the October 1987 market break, the staff of the Commodity Futures Trading Commission indicated that the index futures exchanges recognize "frontrunning" (a trading abuse that would encompass the hypothetical scenario) as a violation of the exchanges' rules of just and equitable principles of trade. Third, as the Commentator recognizes, most large integrated broker-dealers have implemented Chinese wall procedures to minimize the potential misuse of confidential, proprietary information such as the recommendations in the scenario. While such procedures were not developed with trading in index futures or options in mind, most Chinese walls are explicitly or implicitly based upon a "need-to-know" criterion for confidential information -- restricting access to information to as few departments and individuals as practicable. A firm would be hard pressed to justify sharing such corporate information with index traders.

While these and other limitations in the hypothetical scenario should be recognized, we do not minimize the valid concerns it raises and the need for further review of possible cross-market trading abuses.

Sincerely,

Alton S. Harvey
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