

U.S. house of Representatives
Committee on Energy and Commerce
Room 2125, Rayburn house Office Building
Washington, DC 20515

March 4, 1988

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

Dear Chairman Ruder:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of the federal securities laws and markets, we request that the Commission provide further clarification and information regarding two particular issues addressed in the February 1988 report by the Commission's Division of Market Regulation and your testimony on the October market crash. These issues are short selling and frontrunning. We will be asking your assistance on other issues in future correspondence.

Concerning short selling, you noted in your testimony of February 3, 1988 that "...the existing restrictions on the short sale of stocks are ineffective to retard large price declines....Current short sale regulation should be reevaluated in light of contemporary market conditions." The SEC market crash report notes in part that "[t]he Division believes the Commission should review whether reducing price volatility should remain a goal of the Rule and, if so, whether steps should be taken to increase its effectiveness." In light of these comments, please provide the Subcommittees with answers to the following:

- 1) Explain the rationale for the existence of the regulation restricting short sales and for each exception to the short sale regulation, including but not limited to the SEC staff interpretive position of December 17, 1986 concerning "certain liquidations of index arbitrage positions."
- 2) Provide all staff or outside studies, memoranda or any other documents which provided analytical support for the rationales put forward in your

answer to # 1. Include studies which demonstrate why short selling is or is not beneficial to the markets.

- 3) Provide a list and short summary of all enforcement actions taken pursuant to short sale restrictions. Describe surveillance procedures which are undertaken to enforce the short sale regulation.
- 4) State whether the staff interpretive position of December 17, 1986 was discussed with the CFTC prior to its issuance. Provide all documents relating to any communication, verbal or written, with the CFTC on this issue.
- 5) Explain the concerns addressed in the staff interpretive position of December 17, 1986. Include in your answer an analysis of how the staff interpretive position increases the efficiency of the markets. In addition, to the extent possible, quantify and evaluate the level of index arbitrage activity which typically would be foregone but for the staff decision of December 17, 1986.
- 6) How has the Commission been able to track compliance with the December 17, 1986 staff interpretive position?
- 7) In the context of the staff interpretive position of December 17, 1986, define and differentiate the following terms: bona fide arbitrage, risk arbitrage, and index arbitrage. In addition, define bona fide hedging and distinguish it in relation to other types of hedging.
- 8) It has been suggested that since index arbitrage activity is essential to keeping the stock index futures market in alignment with the cash market that short sale prohibitions should not apply to index arbitrage activity. Do you agree or disagree with this proposition? Explain your position. What do you believe could have been the possible consequences on October 19 and 20, 1987 had such limitations on index arbitrage not been in existence?
- 9) What changes in the short sale rule and associated interpretations should be made in light of the findings of your staff study of the market crash?

Concerning frontrunning, in January 1988, the CFTC's Division of Economic Analysis and Division of Trading and Markets released its final report on stock index futures and cash market activity. The CFTC staff suggests that standards be established to identify potential intermarket frontrunning patterns and a mechanism be established to effectively communicate market surveillance data to all exchanges related to possible frontrunning activities. CFTC staff also is considering the possibility of regulatory action on frontrunning. Please provide the Subcommittees with answers to the following:

- 1) According to your testimony of February 3, 1988,

“[f]rontrunning generally involves trading a stock, option, or future while in possession of non-public information regarding an imminent block transaction that is likely to affect significantly the price of the stock, option, or future.” Please identify and summarize all enforcement actions taken to date regarding frontrunning.
- 2) Your testimony of February 3, 1988 states that prohibitions against frontrunning “should be made express, strengthened if necessary, and effectively enforced.”
 - a) Identify the current federal or SRO regulations or rules which prohibit frontrunning in stocks, futures, and options.
 - b) Set forth specifically the Commission's views as to how prohibitions against frontrunning should be made express, strengthened and more effectively enforced.
- 3) How many instances of possible frontrunning have you identified during October, 1987? For each such instance, without disclosing the identity of the participants, please describe the nature and magnitude of such instances.
- 4) Describe the surveillance methods used to detect frontrunning. Include in your answer a detailed description of joint surveillance efforts existing between the SEC and the CFTC.
- 5) Does the Commission view frontrunning as a form of insider trading? Should it be covered in any statutory definitions which are currently being considered?
- 6) Provide copies of written statements from the exchanges to member firms concerning prohibitions on frontrunning.

- 7) The SEC report on the market crash notes that “[f]rontrunning in the futures markets is not subject to the same regulatory scheme as exists in the options markets.” Explain how the regulation of frontrunning differs between these two markets.

- 8) The SEC report on the market crash states the following:

[B]ecause proprietary trades executed through another CME member clearing firm would be reported as customer trades, the Division is not able to exclude the possibility that some firms may have traded ahead in this manner. In addition, the Division is not able to identify from the data supplied to the Commission the trading of portfolio insurance vendors who are not CME member firms.

 - a) Does the SEC plan to examine proprietary trades carried out through another CME member clearing firm in order to determine if frontrunning occurred? Did the SEC request an identification of all proprietary stock index futures trades by investment firms?

 - b) Explain in detail how your surveillance of possible frontrunning activity is hampered by the current jurisdictional relationship that exists between the SEC and the CFTC over the stock index futures market.

 - c) Explain why “using a one minute time-frame may artificially narrow the scope of identified activity.”

 - d) Explain whether the CME audit trail should not only include the identity of the clearing member and executing broker but, in addition, the identity of the end customer.

 - e) What access does the SEC currently have to futures trading information? Ideally, what access does the SEC need to such information in order to detect frontrunning abuses?

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Your response should be delivered to the Subcommittees no later than the close of business on Thursday, March 31, 1988. If you should have any questions concerning this request, please do not hesitate to contact us immediately. Thank you for your cooperation.

Sincerely,

JOHN D. DINGELL
CHAIRMAN
Subcommittee on Oversight
and Investigations

EDWARD J. MARKEY
CHAIRMAN
Subcommittee on
Telecommunications and
Finance