Statement of the Shadow Financial Regulatory Committee
on
Policy Responses to the Stock Market Crash

May 16, 1988

The Committee continues to be concerned about the
direction and the quality of the debate generated by last
October's stock market collapse. During the past few weeks
several prominent business representatives have called for
a ban on either stock index arbitrage or on all stock index
futures trading. Intense pressure has been put on large
broker-dealers to cease index arbitrage for their own
account; and, as a consequence, some firms have acceded to
these demands and have voluntarily stopped their index
arbitrage activities. Both stock and futures exchanges
also have instituted various "circuit breaker" mechanisms
to halt trading and close their markets whenever prices
move by more than a certain amount in either direction.

Recent discussion appears to be driven by a concern
about current stock market volatility and the reluctance of
investors, especially smaller investors, to trade stocks as
actively as they did prior to the stock market crash.
Those concerns confuse and cloud the events of last October
19, and have resulted in remedies being proposed which are
not responsive to the events of last October.

None of the extensive reports and analyses of the
Crash, including the Brady Commission report, provide
persuasive evidence that stock index futures trading in
general, and stock index arbitrage in particular, caused
the crash. None of the studies even claims, let alone
shows, that the continued volatility in the stock market is
the result of futures trading. Without any substantive
analysis, a widespread belief seems to have emerged that
stock index arbitrage and program trading are responsible
for the current volatility and for frightening small
investors into leaving the market.

The Committee believes that regulatory and legislative
action is premature. It is clear that neither we nor
others know which factors were responsible for the crash.
Similarly, no one understands the causes of the stock
market volatility and the reluctance of small investors to
trade stocks. Remedies designed to curb activities that
are not clearly linked to the purported ills are more
likely to be harmful than beneficial.
Much of the discussion about proposed solutions fails to recognize a few key facts. First, the stock market collapse was not unique to the United States. Stock markets collapsed throughout the world, many by more than in the United States. Second, several foreign stock markets began to fall prior to the opening of our markets on October 19. Third, since the crash, volatility has been higher and trading volume lower in many stock markets throughout the world. Finally, trading in stock index futures is significant only in the United States. Such trading does not even take place in most foreign markets. It is difficult for the Committee to accept, therefore, the notion that stock index trading is the culprit.

Despite these facts, it appears that regulatory proposals to institute circuit mechanisms may be forthcoming. If we must have such mechanisms, the Committee urges that they not be in the form of "price limit" trading halts. We believe that price limits will cause investors to try to exit the market when such limits are being approached, for fear that a halt in trading will result in increased uncertainty about whether and at what prices it will be resumed. More rather than less chaotic markets and greater investor uncertainty are likely to result.

To the extent that circuit breakers are used they should be designed to cope with order imbalances, preferably before large price changes occur. They should be designed to resolve order imbalances by disseminating information about the nature of the order imbalance to a wide variety of market participants so that greater market liquidity can be generated.

Finally, the Committee continues to believe that we must examine all of our market-making systems to determine whether we can either improve these systems or find superior ones. The growth of institutional and large "basket" trading requires that we consider market-making systems that can accommodate them. The recent discussion and debate, unfortunately, has not focused on these long-run issues, but instead has sought to advance band-aid solutions that either are responses to certain private interests or are "political" circuit breakers intended to head-off even more harmful legislative remedies.

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr., abstained from participation in this statement.