Statement of the Shadow Financial Regulatory Committee

on

Proposals to Curb Stock Market Volatility

December 4, 1989

The Committee believes that recent proposals to reduce stock market volatility are misdirected and counterproductive. Increased reliance on circuit-breakers (automatic trading halts) is inadvisable, and granting additional power to the SEC to close markets will be counterproductive. The Committee also believes that criticisms of index arbitrage are misdirected and that such arbitrage should not be restricted.

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Under pressure from the threat of restrictive legislation and regulation, first advanced by the Brady Commission in its report on the 1987 stock market crash, exchanges have adopted a variety of circuit-breakers for the purpose of moderating market volatility. These actions were taken despite the absence of any evidence that circuit-breakers will reduce market volatility.

The experience on October 13, 1987 in fact suggests that circuit-breakers do not work. Twice during the afternoon of October 13 circuit-breakers were triggered that resulted in the closure of the S&P 500 futures market. Despite these actions, the stock market continued its precipitous fall. Futures exchanges have responded by increasing their reliance on circuit-breakers by reducing the permissible price change that can occur before circuit-breakers are triggered.

Circuit-breakers are not an effective solution to stock market volatility. They are unlikely to result in less volatility in most instances and will reduce the liquidity of markets. The ultimate result will be to make U.S. markets less efficient than foreign markets and to drive business to foreign markets.

In addition, proposals have been made to give the SEC authority to close equity markets to prevent "excessive" volatility. The Committee is also opposed to granting this
power to the SEC. Such authority should remain with the exchanges. Exchanges themselves are in the best position to judge whether closure is beneficial, and such exchange actions are already subject to regulatory approval.

Finally, the Committee believes that proposals to bar or curb equity index arbitrage are misdirected. There is no evidence that index arbitrage has been the cause of market volatility. Such arbitrage provides an essential link between equity futures and cash markets. Without it these markets would operate less efficiently.