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Preliminary Observations on the Market Crash of October 1987

Statement of
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and Finance
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United States House of Representatives

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PRELIMINARY OBSERVATIONS ON THE MARKET CRASH OF OCTOBER 1987

SUMMARY OF STATEMENT BY
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In response to a number of requests from several committees of Congress, GAO has begun a broad review of the market crash of October 1987. Based on the early results of its work, GAO concludes that the crash reveals issues, problems, and concerns in three broad areas:

1. Protecting the Rest of the Economy. The Federal Reserve met its responsibilities effectively, but may face difficulties in the future if care is not taken in any relaxation of Glass-Steagall restrictions.

2. Assuring that Markets can Function. Problems were revealed both within markets and between them. Of special importance are the growing linkages between previously separate markets. The equities and futures markets in the U.S. are now closely connected, and there are growing links between U.S. markets and those around the world. Coordinated contingency planning is urgently needed for the U.S. markets. The structure of regulation for these markets needs to be examined, along with the relationship of the federal regulators to the markets. Ways should be sought to harmonize regulation across national boundaries.

Within U.S. markets, problems were revealed with automated trading systems. In addition, the market making process, which broke down in several markets, needs careful examination.

3. Assuring Fair Treatment for Individual Investors. Numerous complaints--while not yet fully evaluated--raise the possibility that there were abuses of risk disclosure and suitability rules. In addition, individual investors may have faced unnecessary difficulties in gaining access to the trading system.

GAO will continue its inquiry in all these areas.

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to appear before you to discuss the preliminary results of our ongoing efforts to examine what happened in the financial markets in October 1987.

You and your colleagues in the House and the Senate have asked us to pursue a wide-ranging set of questions concerning the 1987 crash. Today we are pleased to deliver our preliminary report. The report responds to your questions, but I emphasize that we are still in the early stages of our work on those issues.

I will not attempt to summarize in this statement the voluminous material in our report. Instead, I will discuss some of the key issues that have emerged from our work.

The facts of the October crash have been reported so widely that it seems unnecessary to review them here. The cause of those events is less well understood and there may never be complete agreement on that issue. After all, debate continues today on what "caused" the crash of <u>1929</u>. Despite debate about what triggered the crash and how that trigger event was spread through the marketplace, it seems to me that there is broad agreement on the basic outline of what happened.

There was a long bull market, culminating in what looks very much like a classic speculative bubble. As the market climbed, the prices people were willing to pay for shares lost touch with traditional indicators of value, such as the prospective earning power of the corporations whose stock was being traded. Then the bubble burst and share prices collapsed.

Speculative bubbles of this sort inevitably collapse. If one event doesn't trigger the collapse, another will. To avoid a collapse, you would have to prevent an excessive rise in the market. History tells us that this is difficult. Thus, while we need to search for ways of moderating speculative bubbles, we also need to find ways to handle the collapse of those which may occur and to assure, to the extent we can, that systems are in place to mitigate the effects of a collapse. In this regard, I believe there are three basic objectives.

First, it is of absolutely paramount importance that the rest of the financial system and the economy be protected to the maximum extent possible from the spillover effects of a sudden collapse in share prices.

The first line of defense is the Federal Reserve in its role as manager of the money supply, lender of last resort, and overseer of the nation's financial system. The Federal Reserve appears to have carried out that role effectively in October. It supplied needed liquidity and announced that it was doing so. It is worth noting that the Federal Reserve under Chairman Greenspan's leadership had considered ahead of time how it would handle such a crisis, which may well account for the effectiveness of its response.

The role of the Federal Reserve in the event of a future crisis, however, would become significantly more complex and difficult if Congress should decide to allow greater integration of the commercial banking and securities industries. Our concern for this issue grows out of related work we have been doing in assessing the implications of repealing the Glass-Steagall Act. This issue and others, such as the need for adequate capitalization and assurance of adequate resources for the regulatory authorities are discussed in a separate report. We will be continuing our work in this area in the coming months.

The second broad objective relates to the markets themselves. The markets must continue to function efficiently and investor confidence in the proper functioning of those markets must be maintained or restored as rapidly as possible.

If markets are to function, prices must be free to move. But we should seek to minimize the extent to which a collapse in share prices feeds on itself and on failures in the trading systems. And a collapse in share prices must not permanently undermine the ability of the capital markets to perform their essential role of channeling funds from those who save to those who can invest the savings productively in the economy.

We believe that the October crash revealed an urgent need for leadership to overcome some serious problems. The problems fall into two broad categories:

- -- Problems within markets, such as failures of the market making process and inadequate computer capacity; and
- -- Problems between markets, such as the effect of trading halts in the cash market on operations in the futures market.

In understanding the events of October 1987, it is of special importance to recognize the growing linkages between markets previously considered separate.

The report of the Presidential Task Force (the Brady report) and our own work going back several years have documented the links that have developed between the equities and futures markets. Also of growing importance are the links between U.S. markets and those around the world. We believe these developments reveal the need for an integrated regulatory structure for the linked markets within the U.S. and the need to search for ways of harmonizing regulation across national boundaries.

In the short run, coordinated contingency planning is urgently needed to prepare for any future crises that may occur. Next, it will be necessary to reexamine the regulatory structure to assure the required degree of integration. It will be equally necessary to reexamine the relationship between the federal regulatory authorities and the self regulatory organizations they oversee to determine whether the existing balance is appropriate.

Greater efforts are also needed to improve the regulation of linked markets. We need to identify any problems which may be created by widely differing rules and procedures (e.g., margins, price limits, trading halts, market pricing mechanisms, etc.) for trading such closely related instruments as stocks, stock index futures, and options.

The October crash also revealed problems within the markets themselves. One of these was the clear inability of the automated trading and communications network to handle the volume of transactions which was attempted on October 19 and 20. Problems arose in several markets, but are typified by the capacity constraints in the card printers on the floor of the New York Stock Exchange. As these printers became overloaded, the delays backed up into other segments of the system and then reverberated through other markets, as well.

Our early work on the automated systems has concentrated on the New York Stock Exchange because of its pivotal role, but there is evidence of similar problems in other markets. If the markets are to continue evolving in the directions indicated by recent history, there is an urgent need for leadership in the private sector, with appropriate involvement by the regulatory authorities, to overcome these problems in automated systems.

A second, even more serious concern is with the market making process which lies at the heart of any financial market. Much of the public discussion has centered on the inability of the New York Stock Exchange specialists to cope with enormous order imbalances. But severe problems arose in other markets, as well. Dealing with this issue will be very difficult, but it is of central importance for the continued effective operation of the markets. We plan to continue concentrating on it.

The third basic objective in preparing for any possible future crisis is to assure fair treatment for individual investors. It is impractical and undesirable to prevent individual investors from taking risks. But the regulatory authorities have long recognized a responsibility to assure that individuals are fully informed about investment risks to which they are exposing themselves and their families. And the private sector has recognized a responsibility to discourage investors from taking risks which are inappropriate for their circumstances.

The evidence already available suggests the need for securities firms to show leadership in more aggressive enforcement of these risk disclosure and suitability requirements. There have been numerous complaints about abuses that cause me concern and we will be continuing our investigation of this matter.

It is also important that individual investors not be unnecessarily disadvantaged in access to the trading systems as compared to large institutions. The securities firms and the markets need to take a hard look at the difficulties which individual investors may face in times of market stress. These may include capacity constraints on access to brokers, on the automated support systems of the brokerage firms, and on brokerage firms' ability to move individual investors' orders to the market.

It may be that large institutional investors have inherent advantages because of the investments they have made in automated access to information and trading systems as well as because of the expertise they have developed. But these natural advantages should not be amplified by unnecessary limitations on access by individual investors.

* * *

The October crash was a crisis that nearly became a disaster. We will probably never know how close we came to the disaster. If there is another crisis in the financial markets, we can never be sure what form it will take and where it will arise. But we can--and must--learn from the last crisis; we can--and must--better equip ourselves to manage the next.

Some actions should begin immediately. These include upgrading the automated trading support systems and building reliable intermarket contingency planning mechanisms.

Other issues are critically important, but they must be examined very carefully before action is taken. The history of the last 60 years makes clear the pivotal role in our economy which is played by the financial markets. The Federal Government cannot escape responsibility for assuring that such a vital mechanism performs effectively in the public interest. Thus, the key issue for Congress is how best to regulate these rapidly evolving markets.

-- What structure is best for regulating the linked markets within our borders?
-- What should be the relationship between the regulatory authorities and the markets?
-- What can be done to harmonize regulation of markets which are linked across national boundaries?

-- Will the present mechanisms to assure liquidity in times of market stress be sufficient if Congress decides to relax the boundaries between commercial banking and the securities industry?

We don't have the answers to these questions today. But we, and others, will continue looking for them.

That completes my prepared statement, Mr. Chairman. My colleagues and I would be pleased to respond to your questions.