



**REMARKS BEFORE THE
BOARD OF DIRECTORS
OF THE
OPTIONS CLEARING CORPORATION**

COMMISSIONER RICHARD Y. ROBERTS*

Washington, D.C.

November 14, 1990

***The views expressed herein are those of Commissioner Roberts and do not represent those of the Commission, other Commissioners or the staff.**

**U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

MARKET REFORM

1. INTRODUCTION

At the beginning of my presentation, I would like to note that members of this audience are somewhat fortunate that the same fears about recession and problems in the Middle East that make investors leery of participating in other segments of the securities markets encourage investors to transfer risk through transactions in derivative securities. While transaction volume is down significantly on the equities exchanges, volume on options exchanges appears to be stable and may be improving. Moreover, as a whole, the popularity of derivative securities has been increasing, and, trading in some futures contracts, at least, has reached record levels. In short, the "future of futures and options" appears rosy.

Nevertheless, there is increased competition both domestically and abroad for the same investor dollars. According to the Futures Industry Association, for example, overseas trading of options and futures has grown from 24% of U.S. trading volume in 1986, to 64% in the first eight months of this year,^{1/} due greatly to the presence of

^{1/} Angrist, Overseas Trading in Futures is Surging, Wall St.J., October 15, 1990, at C1.

new futures products offered overseas. In the United States, we also have seen increasing competition in the form of new products, technology and markets. I think that it is important that all participants in the industry be able to compete fairly and, subject to appropriate safeguards, that our current laws be administered in a flexible manner to accommodate the changes taking place in the securities industry. Moreover, our existing regulatory structure, which cleanly divides the world of securities and futures into two spheres, should not become a roadblock to financial innovation.

I intend to focus my prepared discussion today on market reform, including certain provisions of the Market Reform Act, certain improvements made by the options industry, and certain suggestions for additional improvements.

2. MARKET REFORM ACT OF 1990

This year Christmas came early to the Commission when the President signed the Market Reform Act ("Reform Act") last month. The reforms the Commission recommended two years ago, in the wake of the 1987 Market Break, made it through Congress with surprising speed. Three parts of the legislation, provisions dealing with market volatility, emergency authority to halt trading on exchanges, and coordinated clearance and settlement, have particular

significance for this group, and I would like to touch upon them briefly.

A. Market Volatility

Section 6 of the Reform Act allows the Commission to develop rules that are designed to address market volatility and manipulative trading practices. This provision was not part of the original legislative package recommended to Congress by the Commission in 1988, which was referred to as the "four easy pieces." The presence of this provision in the legislation reflects the concern, by Congress, that the large price movements we have experienced in the past few years have made small investors skittish about directly participating in our markets.

Although the legislation would permit the Commission to adopt "circuit breakers," or prohibit program trading, in light of the actions taken by the exchanges to adopt their own circuit breakers, I believe that at this time there is little need for the Commission to exercise its authority under this amendment. Moreover, if the Commission does exercise its authority, I can assure you that the Commission will act with extreme caution.

If we are to have "emergency brakes" in the markets, whether they are imposed by the exchanges or the Commission, it is important

that they be carefully calibrated, so that there is minimal disruption of the markets. Since the implementation of the NYSE's 50 point circuit breaker last July, for example, the limit has been hit 22 times. I don't know whether 22 times is too much, or too little, but I think that we need to continue to monitor circuit breakers to make sure that they perform the function they were intended to perform and do not themselves become the catalyst for market disruption. Equally significant is the need to be conscious of our role in the global markets. We need to make sure that the measures we design to encourage individual investors to come back to our markets do not create unnecessary restrictions on trading that result in institutional transactions flowing offshore.

As long as I am on the subject of circuit breakers, I should also say a word about the coordination of trading halts in the options markets and the resumption of trading. The Division of Market Regulation has advised me that the absence of coordinated price limits for index options and stock index futures has created problems. In addition, during periods of volatility, in the wake of trading halts, the options markets have been slow to reopen trading in index options using normal procedures. The Division is of the opinion that it would be worthwhile for the options exchanges to consider developing procedures to reopen an index option without going through a full

rotation and to examine whether trading halts should be ordered once the S & P 500 index future has hit its 12 point price limit.

B. Emergency Authority

The second part of the Reform Act that I mentioned expands the Commission's current authority to take action in the event of a market "emergency," which is defined as: (a) a sudden and excessive fluctuation of securities prices that threaten fair and orderly markets, or (b) a substantial disruption of the safe or efficient operation of the national system of clearance and settlement of securities transactions.

The amendments provide that, in the event of an emergency, the Commission has the authority, among other things, to halt all trading on a national securities exchange, subject to Presidential review. Prior to this provision, only the President could halt trading.

Obviously, this provision gives the Commission very broad authority. I am keenly aware of the disruption that would be caused by an unexpected closing of our markets, for even a brief period. I can assure you that the Commission would not consider the exercise of this authority except in extreme circumstances. Perhaps more significantly, therefore, the legislation also granted the Commission surgical authority to address problems that may arise in a market emergency, by, among other things, temporarily altering or suspending

specific Commission rules or the rules established by SROs, such as the OCC.

C. Coordinated Clearance And Settlement

Of particular interest to this group, the Reform Act also amended Section 17 of the Securities Exchange Act to direct the Commission to facilitate the establishment of linked and coordinated facilities for clearance and settlement of transactions in securities, options, futures, and commodity options.

While the legislation does not mandate any particular settlement structure, the Commission is required to coordinate with the CFTC and consult with the Board of Governors of the Federal Reserve System to facilitate the establishment of such a system.

Finally, the Reform Act gives the Commission authority to eliminate some of the current uncertainty and inconsistency concerning the transfer and pledge of uncertificated securities by adopting rules that will override state U.C.C. laws to the extent necessary to promote the safe and efficient operation of the national system for the clearance and settlement of securities transactions. Within the next few months, the Commission is required to establish an Advisory Committee that, among other things, will make recommendations to the Commission concerning the areas of state

and related federal laws that need to be improved in order to provide certainty to the participants in a securities transaction.

The OCC already has played an important and constructive role in securing this authority for the Commission. In 1982, the OCC was among the first issuers to eliminate certificates and use, exclusively, uncertificated securities. Thereafter, the OCC identified many of the pitfalls of issuing, transferring, and pledging uncertificated securities and discovered creative and effective ways to resolve those pitfalls.

The OCC has shared its expertise with Commission staff during the last few years, which proved to be critical in framing the arguments why the Commission should be vested with preemptive rulemaking authority, and the OCC has been an essential participant in efforts by the legal profession, including the ABA's Haydock Committee, to improve the legal framework for settlement and financing market transactions. The passage of the Reform Act was a first step. The OCC's continued participation and leadership in this area will be crucial to improvements.

3. IMPROVEMENTS BY THE INDUSTRY

After saying a few words about the Commission's new powers under the Reform Act, I also should comment on how far the industry already has come toward solving many of the problems the Reform

Act was designed to address. The Division of Market Regulation has advised me that improvements implemented since October 1987 in the clearance and settlement process have helped clearing organizations handle the increased volatility and accompanying surge in volume on October 13th and 16th, 1989, without difficulty.

I think it is noteworthy that the additional safeguards the OCC already has implemented minimize the need for further Commission action. In particular, the Division has pointed to the OCC's significant increase in member capital and clearing fund requirements and the enhancement of the Concentration Monitoring System, so that the OCC is now able to identify and protect against the risk posed by members' positions in deep out-of-the-money naked short options. In addition, the formal and informal information-sharing arrangements entered into with other SROs provide the OCC with a better assessment of the financial condition of common members. Finally, the changes in margin methodology and increased margin levels implemented by the OCC are commendable.

4. CONCLUSION

Although you have come a long way, further steps may need to be taken. We should all remain aware that trading volume in excess of that experienced in 1987 could occur in the future. I would

encourage you to redouble your efforts to develop the safest, most efficient clearance and settlement facilities for transactions in options. In addition, you should continue to devote the resources necessary to protect the options clearing system by maintaining the highest caliber staff and the latest technology and analytical tools to identify and protect against risks.