The Economic Club of New York

321st Meeting
81st Year

The Honorable Nicholas F. Brady
Chairman of the President's Task Force
on Market Mechanisms
and
The Honorable John J. Phelan, Jr.
Chairman of the New York Stock Exchange

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Introduction

Chairman Rand V. Araskog

Ladies and gentlemen, welcome to the 321st meeting of the Economic Club of New York in its 81st year. We appreciate the turnout tonight. We're here to review the events of October 19th of last year. And I think the attendance here indicates that the dark shadow of those events continues to be cast upon us.

We have tonight, and I hope they won't mind being presented this way, two speakers who are probably now most closely associated with the events of that day. Not that they caused them, but that they have much to do with controlling them and evaluating them. Our first speaker tonight will be Mr. Nick Brady, the chairman of the President's Task Force on Market Mechanisms. He is the co-chairman and co-Chief Executive Officer of Dillon Read investment banking house, a former Senator from the state of New Jersey. Please welcome Nick Brady. (Applause)

The Honorable Nicholas F. Brady

Chairman of the President's Task Force on Market Mechanisms

Thank you Rand. I welcome this opportunity to talk to the Economic Club. The subject you have chosen is well chosen and I'm honored to be here. Looking around me tonight, I see a lot of

people with years of experience in the securities industry. Most of that recent experience, I am sure, has been unsettling. October 1987 was certainly a month that none of us will forget. The market break jolted everyone and called into question the stability not only of our investments but of the markets themselves.

When President Reagan appointed me to chair the Task Force on Market Mechanisms, I was confident that we would quickly diagnose what ailed the markets. After all, we had the collected wisdom and experience of John Opel, Chairman of the IBM, Howard Stein, Chairman of the Dreyfus Corporation, Jim Cotting, Chairman of Navistar, and Bob Kirby from the West Coast, one of the wisest men in the security business, Chairman of the Capital Guardian Trust. We had cooperation from the leaders in the industry and we had a highly skilled staff of professionals to guide us. But what we discovered stunned us all. We found that we are now playing a new game in which the rules that we have lived by for over half a century have been rendered increasingly obsolete.

What happened? The answer lies in two revolutions that took place in the 1980s. One, financial, and the other technological. On the financial side, this decade has seen an unparalleled profusion of new financial products. In particular, the development of stock index futures and stock derivative products has greatly expanded the equity investment arena. The growth and popularity of these instruments particularly with large institutions has resulted in the adoption of intricate trading strategies and an infinitely more complex investment environment. To give you an idea

of the growth of derivative markets, on a typical day before October 19th the total value of stock underlying the futures contracts in Chicago was twice the total value of stocks traded on the New York Stock Exchange.

The technological revolution has been even more dramatic. We now have simultaneous transmission of financial information to all corners of the United States as well as to a vast global audience. Dazzling new communication networks now connect over 100 stock exchanges through a system of 300,000 informational terminals around the world. For example, for the first time in history, technology enables a trade executed in New York to be recorded in Japan in a matter of seconds.

Our financial news even penetrates the Great Wall. I happened to be in Beijing, China the weekend before October 19th and was informed in a matter of hours after the closing on the New York Stock Exchange that the Dow had dropped over 100 points. I found this information transfer startling, not just from a technological standpoint, but also by its uninterrupted passage through international borders.

The suddenly broadened scope and increased complexity of today's financial market system set the stage for the events of October. In hindsight the misconceptions that fueled the decline were obvious. Many people had pieces of the puzzle but few had the whole puzzle solved. The task force investigation led to a number of discoveries that shed important light on the general nature

of markets.

The central finding was that the supposedly separate equity and futures markets are really one. The markets for stocks and the derivatives move in concert. There are a number of fundamental links between the stock markets in New York and the options and index futures markets in Chicago. The financial instruments are closely related. The same participants are active in each market. Moreover, the quick transmission of information to a wide audience through electronic terminals has resulted in the creation of complex inter-market trading strategies that also link the markets. The result is that what has historically been seen as separate marketplaces for stocks, stock index futures, and options do in fact function as one market. Once the task force reached its conclusion, it was obvious that the financial communities' expectations for their markets had outstripped their capabilities.

Next we found a tulip craze. It is truly amazing that a price insensitive strategy such as portfolio insurance could overwhelm the traditional trading philosophies. Here the general misconceptions of the inter-relationship of markets greatly increased the severity of the break. Whether through myth or blind faith, we came to believe that each marketplace had its separate pool of liquidity and that actions taken in one marketplace did not affect the other.

But in October, the separate pools of liquidity proved to be only an illusion. When this illusion became apparent, it was like yelling fire in a crowded theater. Sellers all ran for the exit but it

was large enough to accommodate only a few. The markets delivered a clear message to us all. Their capacity to absorb massive one-sided sell volume is finite.

Lastly, we found that we have made our equity markets more like our commodity markets. Large institutions hampered by their inability to find equities with market capitalizations large enough to accommodate a meaningful investment have moved away from investing in individual stocks. Instead, large institutions seeking immediate liquidity and execution have invested more and more in the broader stock indices which suit their purposes. The result has been that these institutions have increasingly focused on a shorter and shorter time horizon.

The reality of the current marketplace is that institutions trade more than individuals. We all know that. But the facts show that the stock market is still 60% owned by individuals, yet 80% of the trades are accounted for by institutions. As a result, the system has been skewed toward the big players. The automated DOT system on the New York Stock Exchange which started as a small order transfer system has in practice developed into a large order system for the institutions. In this environment the market has moved away from the individual and market mechanisms have increasingly become oriented towards institutional interests.

However, what goes around comes around. The events of October didn't just shake up Wall Street, they shook up the world, and they shook up the US public. Individual investors felt bewildered, caught in the crush and they've been dropping out in droves. In the post-October

investment environment, stock market trades by individuals have fallen off between 30 and 40%.

So who are the villains in this picture? In my eyes, there are plenty of victims, but there really aren't any villains. Previous panics have always had a Jim Fisk or about a million Gates to blame, but October's break was largely triggered by a misunderstanding of the investment environment. We've seen that like everything else, our markets have limits. Understanding that there are already constraints and limitations on our markets will make a difference in the way people do business from hereon.

Since the release of our report six different studies representing a range of market perspectives have analyzed the events of October and recommended changes. We've had the beginning of a serious dialogue on what went wrong and how to correct it. And on some issues we're beginning to see an emerging consensus. There is widespread agreement, for example, that we need better coordination between the equity and derivative markets. Unfortunately, this is where the music stops. There is not yet a consensus on what kind of coordination and by whom. Naturally each interested party tends to approach it from its own perspective. It's understandable. But the wrong way to approach it obviously is to start a turf battle. We must accept the premise that there's really one market and it's from that perspective that we've got to fashion solutions.

Although in the short term we're not likely to have another sudden drop the size of last October's, if only because from today's level the market doesn't have as far to fall. For the

longer term, for the longer term without proper safeguards it could happen again and the consequences could be even more far-reaching.

To be clear, last October we came very close to a financial meltdown. Monday was bad, but on Tuesday, October 20, the country's financial markets were even more severely tested. Just at the right time, we were saved by the Fed. But if the Fed had not come in with a promise to inject liquidity, thus encouraging commercial banks to keep their credit lines open and reassuring the markets, we could very well have had a financial disaster of the first order on our hands. As one task force member said, "we should not take great consolation in the fact that we came within one inch of being hit by the Super Chief."

What this tells me is that we've got to bring our regulatory structures in line with today's new realities. And there are just a few critical issues that cut vitally across the markets of the 1980s. The task force determined that these inter-market issues that needed to be addressed included unified clearing. I'm sure you're all familiar with the fact that there are three clearinghouses in the futures markets, in Chicago, one in New York – New York and Chicago don't keep close track of what the other is doing. In fact, in between the Chicago markets there's not a great close correlation. So I think almost everybody has come to the agreement that in this day of information transfer and electronics that something ought to be done about that.

We ought to harmonize margin requirements. It doesn't make any sense, even though the

instruments are different, to have margins on the New York Stock Exchange 20% of what they are in Chicago. We ought to have, they don't have to be the same, but they ought to be harmonized.

The most controversial thing in the task force report is circuit breakers. I'm sure you'll hear more about it tonight. It refers to the fact that things have gotten so fast in our markets we ought to have some system to slow them down, to let the human mind catch up with what goes on so fast and furiously in the electronic world. We've suggested they can be different. In Chicago, the commodities markets use limits. That's fine. That suits their markets. In New York, on the stock exchanges we have trading halts. That suits their purposes. But they ought to be coordinated and they ought to be recognized ahead of time.

Lastly, and I'm really surprised that this kicked up as much dust after we came forward with our report; we said we ought to have improved information systems. Everybody said, well, that's a terrible invasion of privacy. We don't do that in this country. Well, we're not talking about posting everybody's income tax forms in the local newspapers. What we're talking about is having adequate information. It can be stored at the CFTC with regard to the Chicago markets and at the SEC with regard to the stock exchanges in New York. But we shouldn't have to put together a task force for two months and have four or five different studies on top of that in order to find out what happened at a time that can be so crucial to us as October 19th and 20th were.

The truth of the matter is that the information that the task force received during its study was all turned back to the participants. All of the information that was in that big blue book that some of you may have seen has now gone back to where it resided. If you wanted to recreate it today, you'd have to put another task force together. That doesn't make any sense. We ought to have that on hand so everybody can use it when they need it.

Further, we concluded that it's crucial for some central authority to be given the responsibility to oversee these issues. We examined the alternatives and decided that the weight of evidence suggested that the Federal Reserve with its broad global and domestic expertise was best qualified to fill that role. There's a lot of political discussion on this. And should the choice of the Federal Reserve prove politically unsustainable, it was our opinion that it's still crucial that some agency, whether newly created or existing, take responsibility. If action is not taken, the structural factors that contributed to the October decline will come together again in the form of a different mousetrap. The next time it could be the currency markets, the clearing and settlement systems, or any one of a number of other factors.

The exchanges have already moved to address some of the issues the task force has raised and these are steps in the right direction. As I've expressed to my friend, John Phelan, I firmly believe however that no lasting solution will be arrived at until it is solved by common agreement between New York and Chicago.

But the core problem does not lie with program trading, index arbitrage, portfolio insurance, all of these words that you've heard, or any other kind of trading strategy. Trading strategies come and they go. In fact, portfolio insurance has all but disappeared in the wake of October. These strategies are merely symptoms of a greater disease, the disharmonious nature of a market that was not set up to accommodate what we are currently asking it to do. The central need is to adopt our own regulatory system to the structure of today's markets and to the demands we place on these markets. This we have not done. This we must do.

Recently I heard about a comment by a Fed official that I thought was very pertinent. He said, and I quote, "The problem now is so to shape our policy as to avoid a calamitous break in the stock market, a panicky feeling about money, and a setback to business because of the change in psychology." That was Benjamin Strong, Chairman of the New York Fed in 1928. Now I do not believe that we are entering a period akin to 1928. In fact, I don't think anything could be further from the facts. But what we've got to do now is apply the lessons of 1987, of October 1987, so that the 1990s through inattention do not become the 1930s. This means adopting our market mechanisms and their regulatory structure to those twin revolutions of the past decade – the technological revolution and the financial revolution. If the stock futures and option exchanges do not want to see a solution along the lines of the sweeping reform of the Securities Act of 1933 and 1934, we must come up with responsible answers of our own that address the real problems in realistic terms.

I'd like to think we can do just exactly that. That the private sector itself can provide unified direction for the markets without waiting for Congress to do so. My opinion is, however, that if we don't act, Congress will. It might not be right away, but it's as sure as I'm standing here. Along the way we've got to think hard about the role of the equity markets for the long term future, and we've got to keep their central purpose clearly in view. That central purpose is to raise the investment capital on which the nation's growth and prosperity depend and to provide a wide range of sound investment vehicles for individuals and institutions here and abroad within a stable trading environment.

Also, if individual investors are to remain the backbone of the marketplace, they must have faith in the soundness and safety of the system. Companies of all size must have access to the markets to raise capital. Institutions must be able to invest and recover large amounts of money without unbalancing the markets.

The stock market has always served as a national barometer of confidence in ourselves, the future, and our economy. October went to great lengths to shake that confidence. We've got to restore it. And the way to restore it is to earn it back with modest but effective reforms that correct the markets' weaknesses while preserving their strengths. Thank you very much. (Applause)

Chairman Rand V. Araskog: Ladies and gentlemen, we recently watched the Winter Olympics in

which we rarely heard the words "flawless performance" for one of the athletes. I think that the business and financial community felt that the Chairman of the New York Stock Exchange performed flawlessly in one of the highest pressure periods of time when lesser performance could have led to a whopping mistake. He has been chairman of the exchange since 1984. Prior to that time, for four years, was president of the exchange. And was a specialist many years ago, perhaps in that time period developed the understanding to stay calm and what to do on that critical day. Please welcome John Phelan. (Applause)

The Honorable John J. Phelan, Jr.

Chairman of the New York Stock Exchange

Thank you very much Rand. Now that Nick has given my speech, I suppose we could go on to the question part of the exercise. I was sitting next to Bill Schreyer here tonight eating dinner, and Bill said he was going to warm me up. He said you just shouldn't be allowed to sit there and meditate about things. And as I'm doing this, it reminded me of a story about Bill on an occasion much like this. Bill is a great public speaker. He travels around the country and the world giving talks. And in an organization similar to this, in fact in this very hotel in this very room Bill for 20 years annually has given a talk. And he got off his plane in LaGuardia and a chauffeur picked him up and he said to the chauffeur, "You know I've been giving this talk to the same group for 20 years." He says, "They can't even remember who I am and I hardly know what I'm going to say there tonight." And the chauffeur said, "Mr. Schreyer," He said, "I've been driving you for

20 years to each one of these speeches." And he said, "You think I park out there in the cold and wait for you to come out." He said, "But I don't. I get out of the car, I go in the back of the room and I have a nice meal and I listen to what you say." And he said, "I have to tell you quite frankly, you're not very good." (Laughter) They then began a conversation and when the limousine drove up to the Hilton, the speaker was now the chauffeur and the chauffeur was now the speaker. The speaker went to the private reception and was greeted by a great ensemble.

He had a wonderful time. Came up on the dais, had a wonderful dinner, magnificent conversations. Then he had an absolutely fantastic introduction, delivered a speech that lasted about 20 minutes. So warmed up that the chairman of the dinner said, "Would you take questions from the audience?" And he said, "Oh, I'd be delighted to." And so the questions began and they ran the gamut of the GNP in the country and the relationship of the Deutsch Mark and the yen to the dollar and where interest rates were going and so forth. And suddenly a gentleman sitting right at that table there stood up and he said, "Sir, I want to ask you something." He said, "I understand you've been an advocate of going back to the gold standard." And he said, "I wanted to know what to do...the gold standard in this country up until 1933, or the one in England up until 1905, or the one in Austria up until 1905." The speaker looked at him for about 20 seconds. And he said, "You know, I've been speaking for 20 years. And he said, "Without a doubt that's the stupidest question I've ever been asked." And he said, "To show you how dumb it is, I'm going to ask my chauffeur in the back of the room." (Laughter)

The week before October 19th I was chairing a dinner at the Metropolitan Museum of Art in a magnificent room recreated as an Egyptian temple. And in attendance there were 43 exchanges from all over the world. And they had had a three-day meeting in New York and they had talked about all the problems that exchanges have and the growing markets and the liquidity and the growth in business, in equities and debt and derivative products and currencies and so forth. And they all left there that evening with a great feeling. Several went to Italy to tour Italy. Others went to different parts of the world.

The German exchange was particularly delighted because they said they'd been very prudent. They hadn't had a run-away bull market. Their market was only up 35 or 40% over a period of time. And that was because they were diligent and prudent people and they were not going to be subject to the excesses that might take place when a correction came. By the time that gentleman got home, the German market was down 45%.

The Australians and New Zealanders went to Florence and were cut off from the civilized world for a week. When they finally got to a phone, they found out that their markets were down 40% and still going.

Chairman Li of the Hong Kong Stock Exchange not only attended the gala gathering, but also 450 people from Hong Kong to share all the information about their wonderful companies that are there. Something that we here years ago would have called touting and drumming, but they

call good marketing. One week later, his market didn't open five days. He gave an extraordinary press conference in which he threatened to sue the reporter who asked the question, and ended up being arrested. (Laughter)

I think all this only points out, in another way that we've been talking about for some time, that the markets not only in this country but around the world have been growing. And growing by leaps and bounds, certainly for the last 15 years and absolutely for the last eight. And that they're being linked sometimes every day and sometimes occasionally. Sometimes there's a relationship between the dollar and interest rates and sometimes there's a relationship between other currencies and interest rates and sometimes between interest rates and equities. And as Nick pointed out, over the last two years, certainly a growing relationship between indexed futures and the underlying equities themselves as well. Not only that but obviously a great technological and communications revolution has taken place.

The member firms of the New York Stock Exchange and the New York Stock Exchange have a communications network that is second only to the Defense Department of the United States. It spans the entire world almost instantaneously and you can wire unbelievable amounts of money from one section of the world to the other. In each section of the world the markets have been developing in their own way, not identical, but almost like grids, and those grids being linked together by communications and by the fuel that drives all markets which is money.
And in this country in the late 70s and early 80s all the equity markets in the United States were

linked together to something called ITS, the Intermarket Trading System. It started in 1978 with 78 stocks. In that year, it did about a million shares and it took two and a half minutes to execute an order between New York and San Francisco or between San Francisco and Chicago. In 1987, that system had 1,300 stocks on it. It took exactly 27 seconds to execute an order between any one of the markets, and as a balancing system did almost 3 billion shares through that system. That was an equity grid that was formed in this country. Each with different rules, each with different governing practices, but linked together so that anywhere, anywhere in this country coming into that market could get the benefit of the best bid or best bid and offer into that market as well.

In the last two years we've had developing an enormous grid in the futures markets. We've always had them in commodities. In 1978 because of a desire for the government bond dealers to be able to hedge because of the increased volatility in that market, the Board of Trade created a 30-year government bond future. And that soon became an active and indispensable instrument in the conducting of the government bond business in this country today.

In 1982 and in 1983, the Chicago Merc and then ourselves developed, one, an index on the Standard & Poor's for the Merc, and for ourselves an index on the New York Stock Exchange index. I'm a living testimony to, in this game you don't want to be second because second you can hardly find. The Chicago Merc developed an extraordinary contract and between that and the developments of various products, and an arbitrage between the markets, became certainly more

and more linked together over a period of time. Arbitrage between New York and London takes place.

And so what has developed all around the world in any number of financial products has been all these grids. What has been forgotten in all this, and what was forgotten in that Egyptian temple at the museum is why these markets exist. The equity markets in this country and around the world, and sometimes you have to remind people in exchanges and in our business, exist to raise capital.

Raise capital for existing companies and for emerging companies so they can invest in plant, equipment, people, and services, so their businesses can grow, so that we can find the kinds of dynamic economic growth that we've had in this country in the last eight or ten years.

Since 1980, 14 million new jobs have been created in this country. It's the absolute wonder of the world. Europe has lost a million and Japan has created only 4 million. They do that because we have a magnificent market system both for equity and debt that functions reasonably well. And it's also an efficient allocation of capital and assets, going and bringing money into the stronger industries and weeding out the weaker ones as well.

The second major function of the market is asset management. When those funds, and those securities have been sold, the market has always served as an efficient tracking mechanism for

the managements of assets. And in time, that has become almost as important, it would seem, as the capital raising function.

And the third part of that is the professional trading and speculation which provides the lubricant to make the rest of that market run. And taken in a balance, the markets work very well. But after the episode of October 19th you asked almost anybody on the streets around the world, not only in this country, the speculative plot of the market, the speculative function of the market had almost taken over the entire market and was in the process or fear of the process of driving everyone out, both institutional as well as individual.

So we must do something to restore that balance that we have today. And part of that balance and restoration really comes about with another phenomenon that has taken place in this country and that is the change in the behavior of how institutions manage money. And I think that greatly manifested itself in the week of October 19th. Pointed out both in the Brady Commission Report and in the SEC Report in which a very few institutions, the SEC said one, I think the Brady Commission said 12 or 15 or something like that, had an enormous impact on the imbalances in the market in that week. But that change had been growing for perhaps ten or fifteen years. In the bear market between 1970 and 1974 equity portfolios of institutions had been marked down 50 to 60%. They tried to find some way, if indeed they were going to stay in equities to hedge against a future decline, and then began to develop the kinds of formulas that, based on what the market was doing, moved stocks first to cash, then to money market funds, and vice versa back

from cash to equities.

But in 1982 and '83 with the development of a future on a broad-based indice, they began to think instead of moving to cash that you, in fact, could ensure your risk in your portfolio by taking positions in these derivative products. And that developed because they wanted to stay in equities, they wanted to ensure themselves against the kinds of down drafts that had occurred in the 70s and they had seen also occur in the bond market in the late 70s and early 80s. And so began a, almost a sea change in how some institutions managed their portfolios.

I think because the Brady Commission had only 60 days in which to get their results in, they polled about 12 or 15 institutions all of whom used derivative products. After the October break, we went out to a number of constituent groups including institutions and we took a sample of 300 institutions, the composite of which managed about a trillion dollars. And of those institutions only 9% used a derivative product in some way, and the money value was slightly larger than 9%. So you might come to the conclusion then, well, what is all this stuff about linking in markets and institutional participation? That would be the wrong conclusion to come to. Because if you had taken that survey two years before, it would have been less than 1% of the institutions using that product. And so within that short period of time you had an exponential use in derivative products, in trying to hedge against risk, and to protect what they were trying to do in the markets.

At the same time, in the last 18 months in all our markets we've had three major dislocations, all having to do with imperfect hedges. In April and May of 1986 there was a dislocation in the bond market, the government bond market, which caused considerable loss in the industry. In April of 1987 you had problems in the mortgage-backed securities market including the strips in that market which resulted in gross losses to the industry of some $2 billion. That loss in 1980 would have shut the entire securities industry down. In 1987 it hardly caused a ripple.

In October you had another dislocation in the market. Not through massive liquidations by institutions all over this country and all over the world, but by an imperfect hedging mechanism that didn't work and caused enormous selling by a very few institutions. What all this has done is to make us go back and look again at what the markets are, how they react, and what kinds of volumes can we safely plan for in the future?

And our conclusion is this, that we had thought based on the continuing trend in volume that perhaps in 1991 or '92 we'd have done 600 million shares on the New York Stock Exchange – 1992 came in October of 1987. But more importantly, if a small number of institutions seeking to make a profit at the margin, seeking almost to become speculative daylight in and out traders, in order to make that extra eighth or that extra percent, could cause that kind of dislocation, what would 50 or 100 or 200 out of the 2,000 major institutions do? What kind of an impact could that have on the market?

After October, we greatly enhanced our systems. We're trying now to make 600 million shares look like 200 million shares, and we're planning for a billion shares a day. But really, is a billion shares enough? Because I'm not sure if we didn't have the capacity for a billion shares in October, we would have gotten it and some more.

And so the basic question I think we're asking ourselves today is not only how we can effectively smooth over the communications between the equity markets domestically and worldwide and the derivative markets as well, but the primary question too is, is this habit and behavior that was noticed in October by institutions, is that an aberration? Is that something that the markets would have changed in and of themselves? Or is it really a major sea change in how money management is going to take place in this country and around the world? And if it is a major sea change, then enormous changes in structure, in systems, in markets, in liquidity, are going to be demanded beyond which we, anything that we have thought about before.

And so when I get to the Brady Report and its conclusions, for a variety of reasons I think it's absolutely essential that they be put in place. Whether the Fed is regulator or not, officially, unofficially, I suppose is unimportant. But the fact of the matter is in market crises which are liquidity crises, they are participant and that has to be recognized in some way.

Some sort of unified regulation must come down the track because you've got three or four or five different groups of markets and players, all with different rules and regulations, all with

statutory requirements to protect different kinds of constitutions that when they sit down at the table and talk about the problem, it's not that they're bad people, it's not that they don't want to make things work, they're not talking the same language. It's almost like a Tower of Babel.

The clearinghouses certainly is one of the easier things that could be done, the exchange of information, cross-margining. The exchanges in Chicago and several in New York own their own clearinghouses. The equities markets in this country, in New York, basically come through the national clearing system, and they need to be strengthened. Whether they're called circuit breakers or whether they're called other things, I think that everybody in the different equity grids and futures grids in this country need to know what those rules are.

In the exchange we have any number of ways of handling illiquidity and we kind of dim things out. We don't shut 1,600 stocks down, but we do selectively shut those stocks that are having problems, illiquidity problems, down, re-indicate them, try to reestablish a new equilibrium price and then open them up again.

In Chicago they use limits. But because their index, which is really basically one stock, is made up of a component of 500 stocks, in some cases they think maybe all the 500 stocks should be shut down at one point in time. Options had an incredibly difficult time in October because of the complexity of their structure and their trading strategies. They would also like some coordination when they have a problem to shut things down.

I think it is possible to develop a number of circuit breakers. I think it is possible, as we've done in the collar, when the Dow fluctuates more than 50 points in either direction to take some of that arbitrage off the system, although that's not a solution to anything. It's merely a short-term, put your finger in the dike, kind of thing. I think circuit breakers can be worked out in some way.

And I certainly think that we all learned that it takes us too long to find out what goes on not only in our markets but in the world as well. And in this day of instant communications, we need almost overnight to be able to reconstruct what's happened all around the world and in all different markets.

So something has to be done. We're not going to have exactly the same thing we had on October 19th, but the world markets are going to continue to grow. They're going to continue to grow in number of different constituent groups out there. They're going to continue to do the kinds of jobs that they are founded for to do, to raise capital, to participate in the asset management. And somehow we have to keep that stability – enough speculation in the system so that it makes it work, not too much that it drives everybody out.

So I think the conclusion is that none of these things are going away. Futures are not going to go away. Corrections are not going to go away. Hedging is not going to go away. Technology and communications are not going to go away. So we have to learn to live with them, to adjust with

them, to adapt to them, to use the best of what they've got and discard the worst. And all of that is used for one reason and one reason only. Because markets like everything else are made to provide goods and services and more important, jobs, and more important a standard of living for this country and for the rest of the world and a quality of life that none of us can achieve unless we understand change, we handle change, and we think not of the past, but we think of the future. Thank you.

QUESTION AND ANSWER PERIOD

CHAIRMAN RAND V. ARASKOG: Ladies and gentlemen, at this time we have two distinguished questioners who need very little identification. On my left, Felix Rohatyn, partner of Lazard Frerers. On my right, Anthony Solomon, who is the Chairman of S.G. Warburg (USA) and the former president of the Federal Bank of the State of New York, or the district of New York. We will, as is traditional, have each questioner ask one question of one of the two speakers, then alternate to the other questioner. And hopefully between the two questioners, they'll give the speakers equal treatment. We'll start with Mr. Rohatyn.

FELIX ROHATYN: My question is, my first question is to Nick Brady. Nick, since you discussed the reality of there existing one market really for futures as well as for securities, why not, recognizing the political problem, still why not try to go all the way and have the SEC regulate all options and futures together with securities and have the Fed regulate all margin

requirements and capital requirements?

THE HONORABLE NICHOLAS F. BRADY: Felix, if I understand your question, it would be to have the SEC regulate the options and the stock market and the...excuse me, I didn't get the second part of it...

FELIX ROHATYN: And the Fed regulates margin requirements and the securities industry capital requirement.

THE HONORABLE NICHOLAS F. BRADY: Well, I think one thing that you've got to recognize is that there's a political problem involved here. The Chicago markets, they have a very strong connection with their own representatives in Congress and with the CFTC. Very early in the game we decided that there wasn't any point in trying to break down the system and start it all over again, that we would try to let the information come up from both sides, through the futures markets, through the CFTC, and the stock markets from the SEC. We thought that you could put the Fed over both of these and have them do, they already have margins both for stocks and it's little known but for options as well. So you'd pick up the margin part out of the Chicago markets and put them in under the Fed. But we thought with regard to the information that could come up from the two constituent organizations, with regard to circuit breakers, that could do the same thing, but the Fed certainly ought to have control over the clearing and settlement mechanism which they already do for commercial banks. It just made sense; they

have all of this machinery in place, people competent to do it, people that do it every day. So that's where we got where we were.

ANTHONY SOLOMON: This question is for Mr. Phelan. John, following up on the first question, you know the power struggle that goes on in the Hill among committees for jurisdiction and the campaign contributions that flow from jurisdictions. I have difficulty in understanding how these recommendations on a unified regulatory agency, etc., are going to handle the problem on the Hill. Do you have any thoughts on that?

THE HONORABLE JOHN J. PHELAN, JR.: Could I ask my chauffeur to answer that question? I think in all these things that, I think the answer is with great difficulty. But with all these things I think when you do study events, that you have a responsibility to at least put on the table what you think is right. And whether or not it's politically feasible today, you never know what tomorrow and the next day brings. And so I think you've got to put those things on the table and I think you've got to keep pushing them and hopefully over a period of time without too many dislocations more and more people will in fact see the wisdom of at least bringing them under one shield and one umbrella. And I don't think it's going to happen in 1988, but I think you've got to keep talking about it and I think you've got to keep pushing it. And hopefully in the interim some kind of consensus in between will arrive where you get a working relationship between the different regulatory organizations and the different markets and then hopefully that will evolve into a more formal structure that will produce the results that we talked about tonight.

FELIX ROHATYN: I have another question for John Phelan. John, in view of the role of the Fed on October 19th and 20th and the urgent need for the banks to cooperate with the securities industry, could you tell us how you view the capital adequacy of the securities industry and of the firms in view of the much larger commitments that are presently made in such areas as bridge loans, very large trading positions, principal transactions, and the possible removal of Glass-Steagall in terms of the competitive position of the securities industry?

THE HONORABLE JOHN J. PHELAN, JR.: I think if you take any financial institutions around the world, everybody is strained for capital today. There are so many things to be done, so many markets to service, and so many services to be provided, that certainly there is, I don't think there is ever enough ample capital to do so. On the other hand, in the securities industry if you take a look at 1980 and you take a look at 1988, an incredible amount of capital has been brought into the system since then, an enormous amount of money has stayed within the firm in retained earnings and other things. And the types of dislocations that we talked about in the last year or two, if that hadn't been done, would have brought the whole industry down. And so I think that the securities industry learned a good lesson from the Silver Crisis of 1980 in which maybe a $10 billion problem almost overwhelmed several industries and several banks. That is not to say that the more capital they get, the more uses they find for it. But I think today they're probably finding an efficient use for their capital, but I don't think any of us could be sanguine about the total capital in the system because it just needs to grow and it's really being asked to do too

much.

ANTHONY SOLOMON: Mr. Brady, I suppose that a truly international effort toward harmonization in the equity markets has to wait until we can get through our, correct our domestic fragmentation – the fragmentation that you and John Phelan have spoken about. But in the meantime, is there anything we can learn from what other countries are doing? Is there anything that the UK is doing regarding its markets that we can learn from? Or do you share the view that seems to be widely held in the SEC that there's nothing we can learn from anybody else?

THE HONORABLE NICHOLAS F. BRADY: No. And I want to give my speech to John Phelan in exchange for the traveling rights to his chauffeur joke. Tony, we didn't really go across the world and try to study, you know, the best of all of the systems that existed in other countries. We simply didn't have the time and we, of course, the commission disbanded. But the question has come up a number of times. Well, you know, you could fix, you could come to some kind of an accommodation between New York and Chicago, between the equity and the derivative markets, but you've got Tokyo, London, Milan, wherever. And how can you possibly think that the system is fixed with this kind of an international access to it? And I think the answer really is that in the United States we're still an enormously big part of the total world market, and it's arrogant – Gerry Corrigan had a meeting of people from around the world about two weeks ago when this problem was discussed at a roundtable that he conducted – and it is arrogant to say that

if we do it right in this country, frankly the rest of the world is probably going to have to follow because they can't be ignorant of the enormous one-sided volume that develops when the market gets slanted one way or the other. There's no way in the world, in my opinion, I think it's true that the listings of US stocks on the London Stock Exchange are roughly equivalent, and there's only about 100 or 150 of them, are roughly equivalent to the total market value of all the English stocks. Well, you can't have the US markets operating with certain circuit breakers in this country and have all of that volume show up over there. They'll simply have to accommodate themselves, in my opinion, to the way we do it in this country. That's the best answer I can give you at this time.

FELIX ROHATYN: Nick, I have another question for you which is, would you give us your judgment with respect to the politics of the securities industry reform at this point as they tie into the politics of Glass-Steagall and the obvious split within the SEC with respect to which direction to go into? And whether you expect ultimately that you will get strong political support from the administration and in the Congress for your very, very forthright and extremely important report?

THE HONORABLE NICHOLAS F. BRADY: Felix, politically the bills that are in Congress now don't link up the conclusions or recommendations of the task force with what's going on with the Glass-Steagall. I don't really know too much more about the status of Glass-Steagall than appears in the papers. But I do know that there's no attempt at this point in time to tie one to

the other. The status with respect to the recommendations that the task force made which are simply unified clearing, unified margins, circuit breakers across markets that make sense, and more information is this, the White House has put together a task force which I think will be announced in the next day or so with Secretary Baker at the head of it and the chairman of the CFTC, the SEC, and perhaps an official from the Fed, I don't know, Gerry, I can't remember whether there was one or not. But these, this task force is supposed to look and see whether any of the recommendations or how many of the recommendations that came out of the report can be put in practice on an administrative basis and to report back to the White House what then is left to be handled by law. So there was a lot of guesswork when the report was handed in that the administration was backing away. I don't think that's the case. They got handed a 400-page report that weighed about two and a half pounds and they did what anybody would do, they said they'd like to read it. Everybody took that as an indication that they were backing away. I don't find any of that. I find an orderly process to see how much of it can be done administratively and then perhaps to turn to legislative remedies.

ANTHONY SOLOMON: John, both you and Nick Brady have talked about the importance of the Fed action on October 19th assuring sufficient liquidity. Questions arose before then about access to bank lines, about solvency of the clearing system for futures and options. And I'm very aware of all your efforts in these areas and the recommendations of the Brady Commission. But are we in any better shape today, five months later, to withstand another episode? What have we done? What can be done realistically, particularly if the Congress takes a very long time to cope

with this problem?

THE HONORABLE JOHN J. PHELAN, JR.: Well, I think the experience as a self-teaching mechanism that you don't know how far it's gone until the next one comes. Secondly, I don't think you're going to get exactly the same thing again, certainly not for a while because the excesses or the perceived excesses that were there certainly have been wrung out of the system. From our point of view what we did is to analyze all the things that happened to us on the week of the 19th and to try to make some cost corrections. We've spent a lot of time on systems. We had five major system upgrades going on when this thing hit us. Since then we put on 20% more trading space. We have completely converted the odd lot system. We have opened the capacity of the switch. And we have put on another 80 electronic books. And I really do think if we got 600 million today it would cause us very little problems as far as systems are concerned. As far as looking at our dealer system, which are the specialists, we think that a number of specialists performed in an extraordinary manner, that most of them performed in a manner in which we would require of them, but there were some that I guess we wish had stayed home and come back another day. Those, we've reallocated seven securities, which I think in the modern history of the exchange has not happened, for what we would call poor business judgment. We've taken other actions. We will increase the capital requirements of the specialists, I think, in a group of stages. The first one will be to double it. We will also, I think, begin to require position requirements as well as money requirements. And then in conjunction with the SEC and the CFTC we've had a number of conversations with the Board of Trade and particularly the CME

to see if in fact we couldn't get some more coordination to better understand each other's problems, to take a look at what in fact kinds of slowdowns in illiquidity might take place. What would happen if the risk in each of our markets became more than we could handle? We have tried to put a collar around the arbitrage, not to prohibit it as most people had urged us to do, but to say that you have to accept it as a fact of life – it is not going away – and that the arbitrage between the two markets will continue and probably grow over a period of time. But we need to learn more how, in periods of crisis, to control the risk that flows in from market to another. I think also the participants in the market have learned something from the 19th, and hopefully if you do get another period like that, they will learn how to access the markets in different ways than they have before. So I think that a lot of things have been done between October and the present time. I think that in the world markets people have looked at their problems as well and sorted them out. The long-term problem, though, is getting everybody, I think as Nick says, to view it as one global market. And that's going to take time, and that's going to take patience, and that's going to take a few more mishaps along the way. But hopefully nothing so severe that the system can't survive it. But I think we learn by each experience and so I think that from my perspective the universe has not been inactive. And that yes, you have to rely on Congress to do a couple of things, but the most important thing in life is to take care of your own house and then try to help others take care of their own as well. And I see that kind of activity at a very high pitch after October and continuing now.

FELIX ROHATYN: I have a question, I guess either for John or for Nick. I'll address it to Nick

since John was just standing up. And that is really to look a little bit broadly, Nick, how do you see the changing role of the institutional investor in this country, both as a now potentially destabilizing factor of enormous size playing in the takeover game, playing with derivative instruments, playing with proxy fights, playing with restructurings. I mean this is a whole different ball game than what you and I grew up in. And these are no longer sort of benign elephants walking in a zoo, but something much more predatory and much more dangerous to the system it seems to me in terms of at least what we learned from the experience and from your own report. And how do you see that going forward?

THE HONORABLE NICHOLAS F. BRADY: Where's the chauffeur? Felix, I think you've stated part of the answer to the question in the question itself. There's no question that things have changed, that institutions are fulfilling a vastly different role today than they were when you and I first got into business. Frankly, with regard to just skipping the ethics of it all or the propriety of it all, institutions do have a problem. They've grown so big that individual securities don't make a real big difference to them. In a manner of speaking, they've been driven to using broad indexes. However, I think that, and it's a subject for a whole other evening's dinner, the attention to short-term results by institutions has driven the corporations of this country to conduct their businesses in a way where we're going to, in the long run, not put the research down, not put the product development down that we're going to need to compete with the rest of the countries of the world. I don't have a very good way of solving that problem. I think it ought to be talked about a lot more. I'm frank to say that the corporate executives in the country

aren't blameless either. It seems to me that they picked their investment managers to some degree with how well they've been doing currently, rather than picking people that invest for the long term. So I think we've all got to, we've all got a seat at this table. It isn't one person. It isn't one group. It isn't institutions. It isn't corporate executives. Certainly it isn't Wall Street. But I, like you, am amazed at the change of roles over the past 20 years that we've been watching it.

ANTHONY SOLOMON: I guess this should go to John. You both have talked about the importance of the Fed assuring adequate liquidity in times of stress in the markets, in the equity markets. Are you saying, John, that you think it's a good idea for the Fed to explicitly assume that responsibility, that some kind of carefully worked out policy statement in this area ahead of time, rather than an ad hoc reaction to a crisis situation, is better?

THE HONORABLE JOHN J. PHELAN, JR.: No, I'm not saying it's better. I think that each country has its own peculiarities. The Central Bank in England has just made a move by putting one of its people on as the head of the regulatory organization in England. And so that has said a couple of things about what's been happening in the English markets. England, for instance, went through so much deregulation that they practically had no regulation and then got worried about it and began to put a regulatory scheme back in place and were going to end up as the most regulated market in the world, when I think the Bank of England and a few other people stepped in and did that. They do, they are active participants in every market. Their size is a lot smaller. The size of their banking community is smaller. What concerns me is not, and I understand the

problems with saying the Fed is there, and I understand the problems with insurance, and I understand the problems with irresponsibility by anybody in the system who thinks that if things get bad, the Fed will bail them out. On the other hand, it does disturb me greatly to think that anybody would think that when you get to a liquidity crisis like on the week of the 19th that you can survive it without the participation of the central bank. And indeed, aside from picking up the phone and getting my regulator, the second one I tried to get was Corrigan because they've got to be brought in the scheme in some way. So whether it is by law, whether it is an implicit arrangement that takes place between the participants of the market, whatever it is, that entity is vital to the functioning in times of crisis. And I don't know how you deal with it. I suppose, and the easiest way as Nick suggested, was to give it some regulatory authority. If, for whatever reason, I think there's as much political problems with that in this country, as practical problems. But if that is not practical, then I think that whatever other schemes we set up we have to remember that they have to be included in the loop when we begin to talk about or enter crises. And I'm not sure how that's done in a more formal manner.

THE HONORABLE NICHOLAS F. BRADY: Could I just add to what John has said, because I think that it probably won't happen. But it's obvious as the nose on your face that the person that ought to be in charge of the clearing and settlement system for the securities industry is the Federal Reserve. They do it for the commercial banks. We've had an enormous national discussion about the fact that investment banks and commercial banks all do the same thing. Well, if that's accurate and we're about to change the Glass-Steagall laws in order to, the Glass-

Steagall Act, in order to put commercial banks and investment banks together, then what in the name of heaven is the sense of creating some new, different institution to handle the money flows inside the investment banking system. It simply doesn't make any sense. Now I completely understand Alan Greenspan's position because in testifying before Congress, the first thing that happened the day I testified was two or three of the senators got up and hammered the Fed. And that doesn't make it sensible, it just makes, it's politics raising its ugly head. But we have an enormously competent organization dealing with fund flows. This country almost came apart on account of fund flows and settlements in the days around October. It simply doesn't make any sense not to have the Fed in the center of that. Now we're going to probably make a political accommodation and not do it exactly that way. But I would bet you a new hat that within five years the settlement system and the clearing system for the securities industry will be right where it belongs inside the Federal Reserve System.

CHAIRMAN RAND V. ARASKOG: Could we go one final question from each questioner.

FELIX ROHATYN: I'd like to ask John Phelan as a follow up to the earlier discussion of the role of the Fed, and since it's my last question I want to thank John Phelan, Alan Greenspan, and Gerry Corrigan for saving all of us on October 19th and 20th. (Applause) John, the Bank of England played a critical role in the underwriting and the ability to go forward with the BP underwriting. Would you see the role of the Fed in any way as a potential buyer of last resort the way the Bank of England operated within your scheme of things? Now that we have Gerry here,

he's clearly willing to take everything. (Laughter)

THE HONORABLE JOHN J. PHELAN, JR.: Gerry doesn't look like he has his buyer of last resort hat on. No, I think this country's financial system is much more complicated than that in England, and I don't think it's the proper role for that. I think the central bank in this country, as I think Nick has stated, you need it in times of absolute crisis but you cannot have it there every time so that somebody always thinks there's a bailout there. And if you're going to let the free markets work, and you get all the good things from them, you also have to let the markets punish the system once in a while as well. And I think that's how you get a good learning experience and something that everybody remembers. And if every time something goes wrong you think the Fed is going to jump in and bail you out, then I think that causes all other kinds of problems and what you do then is come back to an enormous regulatory scheme again. I would think that investment banking and other things ought to pay attention to underwritings and how they work. I think the Fed ought to be there for that one or two crises in a decade that takes place in which you absolutely need them and there is no other recourse because it is the only source of major flow of funds at that point in time.

FELIX ROHATYN: You'll guarantee it's only one or two in a decade.

THE HONORABLE JOHN J. PHELAN, JR.: Well, I was going to make it three, but I think it's only two.

ANTHONY SOLOMON: Rand, I've run out of innocuous questions, and I'll pass.

CHAIRMAN RAND V. ARASKOG: That's a first, Tony. Well, it's also traditional at the Economic Club of New York to present our speakers with a Steuben Apple for the Big Apple in New York. And I have one for you, Nick, and thank you very much for coming. It's been a tremendous evening. I'd like to remind all of you that on April 14, Former President Richard Nixon has agreed to speak to the Economic Club, and for all of you who would like to be here, I'd get your reservations in early. And thank you very much for being here tonight. Goodnight.

End of Meeting