Cornell Law Review

Volume 74
Issue 5 *July 1989*

Article 10

Comment on the Harris Paper

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COMMENT ON THE HARRIS PAPER

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One cannot dispute, first, that government overreaction to any event is socially harmful, and, second, that many of the proposals for government regulation made in response to the dramatic October 1987 market reversal fall into this category. As several of today's papers have argued, restricting index arbitrage harms the price functioning of our markets, restricting portfolio insurance is unnecessary—as market players now recognize that its performance was overvalued, increasing margin requirements on futures does not reduce market volatility. As for trading halts—and here my position is a bit different than those that have been proposed today—they are not helpful unless we better figure out how to get markets opened more efficiently.

Bloody Monday reminded us of what we already know: our markets are at their most inefficient at their openings. On October 19th and 20th, the rotation opening system for options[1] and specialist price setting in the stock exchanges[2] were sources of major pricing breakdowns. We would have done better on the 20th had we run the markets through the previous night rather than close them. Automatic trading halts, based either on volume or price, make openings more problematic, since the market must be restarted after each halt.

The October crash revealed some mechanical weaknesses in the microstructure of our capital markets. For each weakness, at issue is not only how it should be corrected, but also who ought we rely upon, to correct it: individual traders, professional associations of traders, SEC, or Congress. Some of the answers already have been provided: the NASD has moved swiftly to correct several problems in the OTC automated quotation and small order execution systems,[3] and the NYSE has moved to increase the capacity of its computerized offer and trade reporting systems. Other mechanical

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1 *See* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS VI-69 to VI-70 [hereinafter BRADY REPORT]; DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION, THE OCTOBER 1987 MARKET BREAK 8-5 to 8-7 (1988) [hereinafter SEC REPORT].

2 BRADY REPORT, *supra* note 1, at VI-45 to VI-46; SEC REPORT, *supra* note 1, at 4-8 to 4-9.

3 *See* SEC REPORT, *supra* note 1, at 9-24 to 9-25.

deficiencies will bc more difficult to correct, primarily because they involve cross-market arrangements. I want to address briefly the most poignant of these—the liquidity problems created by the different cash flow systems in our various financial markets.

Futures and options markets are settled on a same-day or next day basis, while stocks settle in five business days (with the initial margin payment collected by the seventh day). Settlement payments refer to the final payment of funds between the clearing house for trade registered to a specific point in time. Normally this means paying for stocks and long options, or providing variation margin deposits for futures and short options.[4] As a consequence, intermarket hedged positions consisting of stocks or options combined with futures will require continuous financing, as cash demands in one market are not matched with cash payments in another. If banks get nervous about the solvency of the central clearing houses in any one of the markets (on October 19 an options clearing house was rumored to be in trouble), this financing can dry up unexpectedly.[5] Once it does, an investor can be sold out to meet margin requirements in one market although he is solvent in a second. At present, our solution is to rely on last minute reprieves from margin requirements by individual clearing corporations[6] and calls from the Chairman of the Federal Reserve to our banks in which he provides assurances that stimulate bank lending to our market makers.[7]

Several proposals are circulating that aim to head off a similar liquidity crisis in the future. The best of these, and the hardest to implement, aim at changing the different cash flow systems in the various markets so that they all work on the same basis cycles. The President's Working Group, for example, suggest "future-style margining for options." Conceivably, individual stocks as well as options on stocks could be marked-to-market and settled daily in cash like futures.[8] Or, in the other direction, we could accrue gains and losses on futures for five days rather than paying out and collecting cash on a daily basis.

Neither alternative seems feasible. Although it is possible for

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4 Variation margin refers to settlement payments, other than the final settlement payment that a clearing house may call to reduce the magnitude of the final settlement payment.

5 Banks are particularly skitterish in chaotic times because at present it is very difficult, if not impossible, to perfect a security interest on an intermarket position. For a description of the role of the banks on October 20, 1987, see T. METZ, BLACK MONDAY: THE CATASTROPHE OF OCTOBER 19, 1987 AND BEYOND 176-77 (1988).

6 SEC REPORT, *supra* note 1, at 10-47, 10-48.

7 Wall St. J., Nov. 20, 1987, at 1, 7.

8 In the early 1900's, stock was settled on a same-day basis.

"street side" transactions—contracts among brokers and dealers—to settle on a same or next day basis, it is not possible for "customer side" transactions—broker and dealer settlements with customers—to do this.[9] Disconnecting street side and customer side settlement limits would merely shift the liquidity crunch to those handling customer accounts, not solve it. On the other hand, eliminating daily settlement of futures would make those instruments significantly more risky and less attractive investment vehicles.

If coordinating the settlement cycles of options, futures, and stocks is impractical—as it appears to be—a second best solution may be to implement intermarket cross-margining. In intermarket cross-margining, participants in one market that have offsetting positions in another market are allowed to receive credit in meeting their margin requirements. On October 19, the separate clearing houses for stock, options, and futures markets did not recognize the value of positions held by the others. As a consequence, several investors found themselves unable to meet margin calls in futures even though they were racking up profits in put options.[10] The futures clearing house would not consider the option profits in its calculation of the investor's margins on the futures.

Cross-margining allows institutional traders and market makers to post lower margins for intermargin positions that are commensurate with their lower risk of default.[11] This would increase intermarket arbitrage trading and reduce the spreads that currently exist between the markets. In short, cross-margining does not solve the problem of the markets' disjointed cash flow cycles, but it may lessen the liquidity problems they create. The Brady Commission Report, the SEC Report, and the President's Working Group endorsed cross-margining.[12]

Moreover, any cross-margining system will have substantial side benefits. A successful cross-margining system necessitates a continuous sharing of information among the various markets on the positions of single traders. Banks would be more willing to lend funds

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9 *See* SEC REPORT, *supra* note 1, at 10-26. Customer side settlement recently has been automated with the National Institutional Delivery System (NIDS). Widespread use of the system is very recent, and 25% of all confirmed trades still fail to settle in five days or are settled outside securities depositories. *Id.*

10 Wall St. J., Nov. 11, 1988, at C1, col. 3.

11 For a critique of cross-margining see Rutz, *The Myth & Reality of Intermarket Cross-Margining*, Intermarket at 18 (Aug. 1988). Mr. Rutz is president and chief executive officer of the Board of Trade Clearing Corporation in Chicago. He worried about the effect of cross-margining on reducing the cash position of the various market clearing houses. The answer to his concerns seems to be in a revision of net capital requirements for clearing house members, in penalizing solvent trades.

12 BRADY REPORT, *supra* note 1, at 65-66; SEC REPORT, *supra* note 1, at xxv, 10-56 to 10-58.

on intermarket positions because they can more confidently perfect security interests on intermarket positions. Individual exchanges would be able to more quickly assess and interdict the strategic behavior of unfortunate traders who, because they find themselves deeply in debt on obligations in one exchange, attempt to take extremely risky positions in other markets in order to "make it all back."

In any event, vested interests in the health of individual markets may make these cross-market changes unlikely if the markets are left to negotiate them on their own. Some promising steps have been taken. The Chicago Board of Trade and the Chicago Board Options Exchange have established a new vehicle for cross-margining options and futures—the new CBOE 250 index futures contract.[13] The Chicago Mercantile Exchange and the Options Clearing Corporation have agreed to develop a cross-margin system for stock index futures and stock index options,[14] but so far the Chicago Board of Trade has refused to join in. The major clearing corporation for our stock exchanges, the National Securities Clearing Corporation, is not yet included in any cross-margining understanding. While these are positive beginnings, some form of heavy-handed government intervention may be necessary to, at minimum, mediate more comprehensive cross-market arrangements and, perhaps, to impose arrangements on otherwise deadlocked parties.[15]

Congress, in 1975, added section 17(a) to the Securities Exchange Act of 1934, and required the SEC "to use its authority to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities." The SEC has not carried out this mandate and ought to do so, particularly to alleviate intermarket cash flow discrepancies. I am not urging that we develop a single clearing house for all the markets, as some have. Such a system would eliminate healthy competition among clearing houses that would encourage innovation. More-

[13] Wall St. J., Nov. 11, 1988, at C1, col. 3. Though the new contract is a Chicago Board of Trade futures contract, it is traded on the Chicago Board Options Exchange, which also trades the most popular stock index option on the S&P 100. This allows the two exchanges to cooperate on margin requirements. Profits on the stock index option are used in computing maintenance margins on the futures and vice versa. Moreover, initial margin requirements are lower for fully hedged positions. The Chicago Mercantile Exchange, which trades options on the S&P 500, may soon follow, having signed a letter of intent with the Options Clearing House to develop a system of cross-margining. *Id.*

[14] "Clearing Houses Plan Cross-Margining System," J. COMMERCE at 20A (Sept. 28, 1988).

[15] *See* Cohen, *Comments & Zecher*, in AFTER THE CRASH 15, 49 (1988) (Joel Cohen was general counsel for the Brady Commission; Richard Zecher is a Senior Vice President of the Chase Manhattan Bank).

over, a single clearing house could consolidate enormous risk in one entity, too much for private ownership perhaps. On the other hand, the SEC could facilitate (mandate?) linkages among the existing separate clearing houses that enable effective cross-margining among members of more than one house.[16]

16 *See* Brodsky, *Comments* in AFTER THE CRASH 57 (1988) (William Brodsky is the President and Chief Executive Officer of the Chicago Mercantile Exchange) (noting "technical and political" problems standing in the way of cross margining).