COMMENTS

Opinion by Leo Melamed

Black Monday: *What we know a year after the fact*

Facts don't lie. As Alfred North Whitehead, the noted British mathematician and philosopher, once put it, facts are "irreducible and stubborn." Wise men who utter such profundities ought to be taken at their word. Alas, they seldom are. And so, from time to time, cataclysmic events—such as last October's 508-point stock market plunge—occur and emphatically drive the point home.

FACT: The October 19th crash was inevitable. It was not caused by computers, stock index futures or any of a host of the modern trading techniques that have become commonplace in recent years. Rather, where the stock market was concerned, global mania simply pushed good sense aside. Stock prices, as Federal Reserve Board Chairman Alan Greenspan would assert later, had been "stretched to incredulity."

Simultaneously, a wide assortment of macroeconomic maladies came to the fore: Huge U.S. budget and trade deficits had not abated; the national debt was spiraling; bond yields were ascending rapidly; and, all the while, the dollar was reeling. Nor was all well geopolitically: The U.S. Department of the Treasury was in open disagreement with the Bundesbank about West German economic expansion, and early on October 19th, at 8:05 a.m., news reports indicated that the U.S. Navy had responded to an Iranian attack on a Kuwaiti tanker by destroying several Iranian oil platforms in the Persian Gulf.

On Black Monday, the markets had seen enough. In an unprecedented wave of global selling, a bull market that had raged for more than six years came to an end.

If the demise of the bull market was foreseeable, the speed and intensity with which it all unfolded was not. October 19th taught us a crucial lesson, albeit an extremely expensive one. The disparity between market mechanics and those who make market decisions was dramatic. Most of our traditional markets were operating on a technological standard roughly equivalent to the steamboat. But market decision-makers were flying F-16s. Moreover, for the better part of a decade the financial world had become highly specialized, increasingly becoming the realm of professional managers. When the crash occurred, it was investment managers (who controlled nearly $2 trillion in assets—up from $400 billion just a decade earlier), and not individual investors, who were in the pilots' seats.

H.L. Mencken was only partially correct when he observed that "The public...demands certainties, but there *are* no certainties." To be sure, a collection of ad hoc and official commissions and committees searched for certainties by painstakingly sifting through the ashes of Black Monday. All were looking for the culprit that caused the crash. Many, particularly those with preset opinions, thought they knew just where to find it: in Chicago's stock index futures pits. There were some tense moments (at one point on Capitol Hill, at a Senate Banking Committee hearing, there was a near-hysterical call to ban index arbitrage, a valuable futures-oriented trading strategy), but they were frustrated on every score.

FACT: Despite the fervent prayers and wishes of some, the march of technology will not cease. Instead, it will continue inexorably. As Joseph Grundfest, a commissioner of the Securities and Exchange Commission expressed it last July: "Some participants in the policy debate have a perfectly rational incentive to continue to confuse the message with the messenger in order to forestall technological progress that threatens traditional trading mechanisms that generate substantial rents for certain market participants. Put more bluntly, some people are making money off the system as it operates today, and measures designed to make our markets more efficient by improving information, expanding capacity and enhancing liquidity are not necessarily in everyone's personal financial best interests."

Support for Chicago's futures markets emanated from other quarters as well. Alan Greenspan, commenting on the vital function of index arbitrage in maintaining efficient capital markets, declared, "Arbitrage activity acts to ensure that values in the cash market do not lag behind." And the *Chicago Fed Letter* wrote that attempts to curb the futures markets "overlook the fact that such curbs would also reduce an investor's ability to sell off unwanted risk by hedging."

There still are not many certainties. Yet the public does deserve answers. Could there be another crash? There's always the chance that the market could drop. The market is, after all, just a messenger, a gauge of what its millions of participants are thinking about the economy at any given point in time. So its fate rests largely with global economic policy makers. However, where efficiency, capacity and liquidity are concerned, the Chicago Mercantile Exchange (CME) and the New York Stock Exchange (NYSE) already have taken important steps to mitigate any replay of last October's market disconnection.

In an unprecedented show of cooperation, the two exchanges, as well as other futures and securities exchanges, initiated steps that would result in coordinated "circuit breakers." These represent set price floors that, if reached, would result in coordinated trading halts. (Here's how they work: If the Dow Jones Industrial average (DJIA) falls 250 points, or if the S & P 500 stock index future falls 30 points, there would be an automatic one-hour trading halt to allow the market to regroup; if, after reopening, the market falls an additional 150 DJIA points or 20 S & P 500 index points, the market would be halted once again.) In addition, CME and NYSE have agreed to a set of coordinated "shock absorbers" to allow for a more efficient and equitable flow of orders in the event of market imbalances.

FACT: As was forcefully demonstrated one year ago, capital flows no longer have any allegiances to geographical regions or time zones. Indeed, in today's global economy, capital is an insomniac. When there's a reason for a money manager to execute a trade, he or she punches a button and it's made, regardless of the hour. While this fact is "stubborn and irreducible" to us, some policymakers either have failed to discern it or have refused to acknowledge it. Thus, even as CME, in concert with Reuters Holdings PLC, prepares to launch "GLOBEX," a 24-hour trading system that will revolutionize the industry by embracing reality, proposed federal legislation is threatening to drive U.S. futures business to foreign shores.

Due in large part to the efforts of the Civic Committee, this city's financial exchanges have come to be appreciated in Chicago. We now are viewed as fundamental components of the capital formation process and as vital economic assets in this city. The idea behind "GLOBEX" is to maintain CME's position as one of the linchpins of Chicago's economy by making it possible for investors in any corner of the globe to execute a trade in futures contracts, day or night. But if legislation resembling the "Securities Market Reform Act of 1988" is enacted some time next year, this may change.

Futures trading, which exists in numerous financial centers around the world, will not be curtailed by legislation because it can move elsewhere with astonishing ease. At present, our customers have decided it makes sense to trade in Chicago,

but a significant boost in transaction costs could change that. The final stubborn fact is that the need to hedge risk remains constant. And on that fact rests at least one imperative: Chicago must protect its precious invention.

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