

WHITE HOUSE STAFFING MEMORANDUM

DATE: 10/12/90 ACTION/CONCURRENCE/COMMENT DUE BY: NOON Monday 10/15

SUBJECT: H.R. 3657 -- MARKET REFORM ACT OF 1990 and SIGNING STATEMENT

	ACTION FYI			ACTION FYI	
VICE PRESIDENT	<input type="checkbox"/>	<input checked="" type="checkbox"/>	MCCLURE	<input checked="" type="checkbox"/>	<input type="checkbox"/>
SUNUNU	<input type="checkbox"/>	<input checked="" type="checkbox"/>	NEWMAN	<input type="checkbox"/>	<input type="checkbox"/>
SCOWCROFT	<input checked="" type="checkbox"/>	<input type="checkbox"/>	PORTER	<input checked="" type="checkbox"/>	<input type="checkbox"/>
DARMAN	<input type="checkbox"/>	<input type="checkbox"/>	ROGICH	<input type="checkbox"/>	<input type="checkbox"/>
CARD	<input type="checkbox"/>	<input checked="" type="checkbox"/>	UNTERMEYER	<input type="checkbox"/>	<input type="checkbox"/>
CICCONI	<input type="checkbox"/>	<input checked="" type="checkbox"/>	ROGERS	<input checked="" type="checkbox"/>	<input type="checkbox"/>
DEMAREST	<input checked="" type="checkbox"/>	<input type="checkbox"/>	BOSKIN	<input type="checkbox"/>	<input checked="" type="checkbox"/>
FITZWATER	<input type="checkbox"/>	<input checked="" type="checkbox"/>	CLERK	<input type="checkbox"/>	<input checked="" type="checkbox"/>
GRAY	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
HAGIN	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
HOLIDAY	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

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REMARKS:

Please provide any comments/recommendations directly to my office on the enrolled bill memo and the signing statement by NOON on Monday, 10/15. Thanks.

RESPONSE:

James W. Cicconi
 Assistant to the President
 and Deputy to the Chief of Staff
 Ext. 2702



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

SO OCT 12 PM 10:15

October 12, 1990

THE DIRECTOR

MEMORANDUM FOR THE PRESIDENT

SUBJECT: Enrolled Bill H.R. 3657 - Market Reform Act of 1990
Sponsors - Rep. Markey (D) Massachusetts and 5 others

Last Day for Action

October 16, 1990 - Tuesday

Purpose

(1) Authorizes the Securities and Exchange Commission (SEC) to limit practices that result in extraordinary market volatility or manipulation of price levels; (2) authorizes the SEC to suspend securities trading and issue other emergency orders; (3) authorizes SEC reporting requirements for holding companies and for traders of large volumes of securities; (4) directs the SEC to facilitate the establishment of coordinated clearing and settlement systems; and (5) contains miscellaneous provisions related to securities market regulation.

Agency Recommendations

Office of Management and Budget	Approval (Signing statement attached)
Securities and Exchange Commission	Approval
Department of the Treasury	Approval
Department of Justice	Approval
Council of Economic Advisers	Approval (Signing statement attached)
Commodity Futures Trading Commission	No objection (Informally)
Federal Reserve System	No objection (Informally)

Discussion

In its report on H.R. 3657, the House Committee on Energy and Commerce stated that recent market events established the need for legislation to strengthen securities market regulation. These events include the market break of October 1987 and the market decline of October 1989; recurring episodes of market volatility; and the financial failure of Drexel Burnham Lambert Group, Inc.

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H.R. 3657, which passed the House and Senate by voice vote, would expand the SEC's regulatory powers, particularly during market emergencies. Three major provisions -- relating to "program trading," SEC emergency powers, and holding company risk assessment -- are described below. Other significant provisions are summarized in an Attachment.

Major Provisions of H.R. 3657

-- Limitation on Practices (e.g., Program Trading) Which Result in Volatility

H.R. 3657 would authorize the SEC to take actions to "prevent manipulation of price levels of the equity securities market or a substantial segment thereof." It would also allow the SEC to prohibit or constrain certain trading practices during periods of "extraordinary market volatility." The SEC would be required to determine that such practices had previously "contributed significantly to extraordinary levels of volatility" and are "reasonably certain to engender such levels of volatility if not prohibited or constrained." The SEC would be required to minimize the impact of its actions on normal market operations and on individuals' ability to buy or sell securities.

On March 12, 1990, Treasury sent a report to the House Energy and Commerce Committee objecting to this provision of the bill because it could "shut down program trading." (Program trading involves the use of computer programs to implement trading strategies that involve buying or selling large blocks of stock in single orders.) A May 4, 1990, Statement of Administration Policy stated that the Administration supported House passage of H.R. 3657 but would seek Senate amendments to delete the program trading provision.

The program trading provision was subsequently amended to delete authority for the SEC to impose civil penalties or issue cease-and-desist orders for violations. However, the SEC's basic authority to limit program trading was not substantially changed from the House-passed version.

In its enrolled bill views letter, the Council of Economic Advisers (CEA) states that it opposes this provision. CEA states that prohibiting program trading "during periods of extraordinary volatility, when it is valued most, is likely to reduce liquidity." According to CEA, program trading does not necessarily cause unnecessary volatility, and such volatility should arise "only if market mechanisms are not equipped to deal with the rapid arrival of trade requests" or if there is doubt about the reliability of the market mechanism. CEA concludes that "[r]ather than standing in the way of innovation by restricting particular trading strategies, . . . it would be far

better to focus on the individual market mechanisms that may engender unnecessary volatility."

-- Trading Halts and Emergency Authority

Under current law, the SEC can suspend all trading on any national securities exchange for up to 90 days, after obtaining Presidential approval. H.R. 3657 would provide that such SEC actions would take effect after the SEC was notified that the President "does not disapprove" of its decision. (H.R. 3657 also restates the SEC's current authority to suspend trading in individual securities for 10 days.)

In addition, during a major market disruption, the SEC could take any action necessary within the scope of its regulatory power to maintain orderly markets or assure the clearance and settlement of securities transactions. Such emergency orders could be in effect for no more than 10 business days, and the SEC would not be required to consult in advance with the President.

The SEC could only exercise these authorities when its actions were in the public interest and required for the protection of investors. The President could terminate the SEC's suspensions of exchange-wide trading or actions taken under its emergency powers at any time. Judicial relief would be available only if the SEC's actions were found arbitrary, capricious, an abuse of discretion, or otherwise illegal.

-- Holding Company Risk Assessment

H.R. 3657 would authorize the SEC to obtain information from brokers and dealers in order to monitor risks to their financial condition resulting from the activities of their "associated persons" (i.e., holding companies and affiliates). If the SEC has concerns regarding the financial or operational condition of a broker or dealer, then further reports could be required from such broker's or dealer's associated persons. The SEC could exempt any entity from the reporting requirements. These reports would not be subject to disclosure under the Freedom of Information Act.

The House Committee report states that many major U.S. brokers and dealers are owned by holding companies that also own other subsidiaries engaged in financial and securities activities. Many of their affiliates are not regulated by any financial regulatory agency, and their financial problems can have an immediate adverse effect on the liquidity of brokers and dealers.

In its enrolled bill views letter, the SEC states that this provision "will significantly improve our ability to protect individual customers, as well as to enhance overall systemic

stability." The SEC states that without holding company information, a problem similar to that which struck Drexel "may not become known until shortly before it results in a liquidity or other market problem." According to the SEC, "[e]ven a few days additional warning of a large problem situation can enable us to transfer customer accounts or take other action that will help avoid customer losses."

Agency Views

In its enrolled bill views letter, the SEC calls H.R. 3657 "one of the most important pieces of securities legislation to be passed by Congress in recent years." The SEC states that the enrolled bill was "carefully crafted to avoid intrusive regulation," but will give the SEC early warning of potential danger signs in the market.

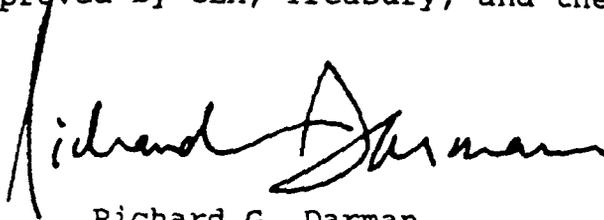
In its views letter, the Department of the Treasury states that the bill is consistent with the recommendations made by the Secretary to Congress, particularly with regard to its four "core provisions." (These provisions concern emergency authority and holding company risk assessment, discussed above, and large trader reporting and clearance and settlement of transactions, discussed in the Attachment.) Treasury notes that the program trading provision in the enrolled bill is "somewhat narrower" than earlier versions, and concludes that it "should not . . . be a basis for opposing this measure."

CEA, in its views letter, states that the enrolled bill's benefits offset the costs of the program trading provision, "particularly if the SEC uses great care in implementing this provision." CEA has prepared a signing statement for your consideration, which is attached to its views letter. The statement expresses concern about the program trading provision and recommends that the SEC study whether a link exists between unnecessary volatility and computer-assisted trading.

Conclusion and Recommendations

As Treasury advises, the enrolled bill is substantially consistent with Administration recommendations. Although the Administration opposed the program trading provision, it did not threaten a veto, and the provision has been narrowed. We, therefore, join Treasury, Justice, CEA, and the SEC in recommending approval of H.R. 3657.

A signing statement is attached for your consideration, which has been reviewed and approved by CEA, Treasury, and the SEC.

A handwritten signature in black ink, appearing to read "Richard Darman". The signature is written in a cursive style with a large, prominent initial "R".

Richard G. Darman
Director

Enclosures

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Attachment

Other Provisions of H.R. 3657

Large Trader Reporting

H.R. 3657 would authorize the SEC to establish a two-tiered information gathering and reporting system for monitoring large securities transactions. The first tier would require large traders to report their identity and all the accounts used to effect such transactions. The second tier would require every registered broker or dealer to keep records of large trader transactions and provide such records to the SEC upon request. Information reported to the SEC would not be subject to release under the Freedom of Information Act.

The SEC could prescribe rules governing the manner in which transactions and accounts would be aggregated for reporting purposes. It could also exempt any person or class of transactions from these reporting requirements. Foreign central banks would be exempt from the reporting requirements.

Coordinated Clearing

H.R. 3657 would direct the SEC to facilitate the establishment of: (1) a national system for clearing and settling securities transactions; and (2) linked or coordinated facilities for the clearance and settlement of securities and commodities transactions. The SEC would carry out the latter duty in coordination with the Commodity Futures Trading Commission (CFTC) and the Federal Reserve.

The enrolled bill would also allow the SEC to preempt State law where necessary to facilitate the transfer and pledge of securities. This authority would be subject to consultation with Treasury, the Federal Reserve, and the advisory committee discussed below. States could override the SEC rules by statute within two years of their issuance.

H.R. 3657 would direct the SEC to establish a 15-member advisory committee. This committee would report to the SEC on issues related to uniformity of State and Federal securities laws. Eleven members of the committee would be appointed by the SEC and two each by Treasury and the Federal Reserve.

Coordination of Risk Analysis Between SEC and Federal Banking Agencies

The enrolled bill would require Federal banking agencies to notify the SEC of their concerns regarding certain financial or operational risks to SEC-regulated entities. These risks would be those resulting from the activities of depository institutions or other entities related to brokers and dealers.

Reports to Congress

H.R. 3657 would require the Secretary of the Treasury and the Chairmen of the Federal Reserve, the SEC, and the CFTC to report to Congress no later than May 31, 1991, and then annually until 1995. The agencies would report on issues relating to the soundness, stability, and integrity of domestic and international capital markets. These issues would include the agencies' coordination of regulatory activities to ensure market integrity and competitiveness, and their formulation of coordinated mechanisms for protection during market emergencies.

H.R. 3657 would also require the SEC to report to congressional committees on progress toward establishing linked or coordinated clearance and settlement facilities for securities and commodities transactions. The report would be due within two years of enactment. The SEC would be required to consult with the CFTC, the Federal Reserve, and other regulators.

STATEMENT BY THE PRESIDENT

I am today signing H.R. 3657, the "Market Reform Act of 1990." This bill addresses concerns with regard to the stability of U.S. securities markets as a result of many factors, including the extraordinary volatility that transpired in the market break in 1987 and the less severe break in 1989. The bill provides a number of worthwhile measures to enhance financial market stability that have been strongly recommended by the Securities and Exchange Commission (SEC). Many of these measures were also suggested in the 1988 report of President Reagan's Task Force on Market Mechanisms.

Overall, H.R. 3657 is consistent with recommendations the Administration has made to Congress over the last two years. In particular, I welcome the following features of the bill:

- o the authorization for increased monitoring of risks that are posed to SEC-regulated firms by their holding company and other affiliates;
- o the provision for the institution of a large trader reporting system by the SEC that could facilitate analysis of market developments; and
- o the authorization for the SEC to facilitate the establishment of a coordinated national system for safe and accurate clearance and settlement.

One provision of this legislation to enhance market stability was of significant concern in its original formulation, and is still troubling. Under certain limited circumstances, the bill permits the SEC during "periods of extraordinary volatility" to "prohibit or constrain" certain trading practices. The final language of the bill gives the SEC only carefully limited and narrow authority to control trading practices, and is an improvement over earlier versions of the legislation. However, it is still important that this authority be carefully and judiciously exercised to prevent any interference with technological innovations in financial markets that can enhance market liquidity. We must be careful not to damage the vitality of America's markets at the same time that we protect market stability.

I have one more observation to make regarding the financial markets. Earlier this year the Administration transmitted to Congress the "Capital Markets Competition, Stability, and Fairness Act of 1990." This important legislation would mandate badly needed reform of the stock index futures market by clarifying the jurisdictions of the Commodity Futures Trading Commission and the SEC. I strongly support this legislation and urge Congress to complete the job of market reform by enacting the Administration's bill.

I am particularly pleased to sign H.R. 3657 into law, and thereby to improve the stability of America's vital securities markets and the protection of tens of millions of investors.