

SEC Approves Circuit Breaker Rules In Response To “Flash Crash” Of May 6, 2010

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On June 10, the Securities and Exchange Commission (“SEC”) approved circuit breaker rules to be implemented as soon as June 11, that will pause trading for five minutes in certain individual stocks if the price moves ten percent or more in a five-minute period. The rules will be implemented on an expedited basis in response to the so-called “Flash Crash” of May 6, 2010 when prices of a large number of individual securities declined dramatically in a matter of minutes. The events of May 6 have been described by SEC Chairman Mary L. Schapiro as a “sudden evaporation of meaningful prices for many major exchange-listed stocks in the middle of a trading day.” Price volatility was so extreme that day that many trades were subsequently broken by the Exchanges¹ and many were executed at more than 60% away from pre-decline prices.

The new rules have been implemented as a pilot, set to end on December 10, 2010, so that the markets may assess their effects. During this pilot period, the rules apply only to securities included in the S&P 500® Index and do not include small capitalization stocks or exchange-traded funds (“ETFs”). Both the Exchanges and the Financial Industry Regulatory Authority (“FINRA”) expect to file an additional rule proposal in the near future to expand the scope of the pilot.

After review and analysis of the 26 comments received during the two-week comment period following the May 24, 2010 publication in the Federal Register of the proposed rule changes by the Exchanges and FINRA², the SEC approved the rules on an expedited basis. The SEC believes that the market disruption of May 6, 2010 was due in part, to the disparate trading rules across the Exchanges. The new rules aim to develop uniform market-wide standards for individual securities in the S&P 500® Index that experience extraordinarily severe and harmful price volatility. Current market-wide circuit breakers that are tied to the Dow Jones Industrial Average rather than individual stocks, were not triggered by the events of May 6.

The following is a brief discussion of the circuit breaker rules and concerns voiced by commenters about the new rules.

Circuit Breaker Rules

The circuit breaker rules, approved by the SEC on June 10, 2010, operate as follows:

- Listing Markets³ are required to issue five-minute trading pauses for individual securities for which they are the primary Listing Market if the transaction price of the security moves ten percent or more from a price in the preceding five-minute period.

- Listing Markets must immediately disseminate a special indicator over the consolidated tape in order to notify the other Exchanges and market participants of the imposition of a trading pause.
- Once a trading pause is issued by the Listing Market, the other Exchanges must pause trading in that security on their markets.
- FINRA's rules similarly provide for a trading pause in the over-the-counter market by FINRA members when a Listing Market has issued a trading pause.
- The trading pause requirements would apply only from 9:45 a.m. until 3:35 p.m.
- At the end of the five-minute pause, the primary Listing Market may reopen trading in the security in accordance with its own procedures.
- Trading would be permitted to resume on the other Exchanges and in the over-the-counter markets once trading is resumed on the primary Listing Market.
- Should there be a significant imbalance on the primary Listing Market at the end of a trading pause, the primary Listing Market may delay reopening.
- If the primary Listing Market fails to reopen within ten minutes from the beginning of the trading pause, the other Exchanges may, nonetheless, resume trading.
- FINRA's proposed rule permits over-the counter market participants to resume trading only if trading has resumed on at least one Exchange.

Concerns About The New Rules

Many commenters believed that the circuit breaker rules were an appropriate response to the events of May 6, 2010. One commenter opined that "on very rare occasions like May 6 a pause in trading is necessary to give market participants a chance to 'reset' and react appropriately to periods of dislocation." As such, a trading stoppage would give investors an opportunity to evaluate the market events and "commit liquidity at appropriate price levels."

However, not all commenters agreed that the new rules will be adequate. Commenters were primarily concerned about:

- whether the circuit breakers should be expanded beyond S&P 500® stocks, particularly to ETFs and the securities of other smaller capitalization companies that were most severely affected on May 6;
- whether the times when circuit breakers apply should be expanded to include opening and closing periods when volatility is arguably highest;
- whether the threshold events that trigger circuit breakers should be expanded, such to establish triggers of a 5% price move for low volatility stocks and 30% for high volatility stocks;
- whether the length of the pause should be increased to allow small investors to respond;
- whether the procedures for resuming trading after a pause should be altered, such as precluding resumption of trading until the primary listing market has resolved any imbalances; and
- whether alternatives to the circuit breaker mechanism should be established, such as a futures-style "limit down" mechanism rather than a full trading pause to allow trading at prices that reverse a triggering price change.

Critics of the new circuit breaker rules argue that they could favor the fastest computer trading systems that will be able to detect before others when circuit breakers are about to be triggered so that only slower traders will be left with positions in securities that have been paused. In addition, the fact that non-S&P 500® stocks are not as liquid as their S&P 500® counterparts and are therefore more susceptible to large shifts in prices caused concerns that only S&P 500® stocks are subject to the rule. Commenters were also concerned about the adverse consequences to ETFs if circuit breakers cover individual securities that are held by an ETF but not the ETF itself. Concerns that the new rules operate only between 9:45 a.m. and 3:35 p.m., arise from the fact that, according to one commenter, nearly twenty-five percent of daily

trading volume takes place during the first and last fifteen minutes of the trading day. Finally, because the rules establish demonstrable automatic triggers for pausing trading, commenters were concerned that individuals seeking to “game” the system could manipulate the markets by intentionally triggering trading halts.

Conclusion

The so called “Flash Crash” of May 6, 2010 prompted the SEC to investigate not only the causes of the crash, but also to explore remedial options. The circuit breaker rules are only one step in dealing with potentially destabilizing price volatility. The SEC, the Exchanges and FINRA plan to assess the effects of the circuit breaker rules during the pilot period and continue to assess the causes of the May 6 disruption in order to develop additional responses that will help prevent a recurrence

Endnotes:

¹ BATS Exchange, Inc., EDGX Exchange, Inc., NASDAQ OMX BX, Inc., International Securities Exchange LLC, New York Stock Exchange LLC, NYSE Amex LLC, NYSE Arca, Inc., The NASDAQ Stock Market LLC, National Stock Exchange, Inc. and Chicago Board Options Exchange, Incorporated.

² On May 18, 2010 and May 19, 2010 the Exchanges and FINRA, after reaching a consensus, filed proposed circuit breaker rules with the SEC.

³ NYSE, NYSE Amex and NASDAQ.

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