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Exchanges Revamp U.S. Curbs to Limit Stock Moves Instead of Halting Trades

By Nina Mehta - Apr 6, 2011

Concern that halting stocks to limit price volatility does more harm than good spurred the biggest U.S. exchanges to propose modifying the program.

They backed a plan, known as limit-up/limit down, that prevents prices from moving beyond specified bands based on a security's average level during the previous five minutes. On Feb. 18, advisers to the Securities and Exchange Commission and the Commodity Futures Trading Commission recommended adopting the technique in lieu of immediately halting shares. The SEC announced the joint proposal, which also extends the program to all exchange-listed stocks and funds, in a statement yesterday.

Exchanges began the single-stock circuit breakers after the 20-minute rout on May 6 erased \$862 billion from the value of U.S. equities before prices rebounded. The current system halts Standard & Poor's 500 Index and Russell 1000 Index (RIY) companies as well as more than 300 exchange-traded funds for five minutes when they rise or fall at least 10 percent in five minutes. Exchanges and the Financial Industry Regulatory Authority want price bands instead.

"This is an enhancement to what's in the market already," said Randy Snook, New York-based executive vice president for business policy and practices at the Securities Industry and Financial Markets Association. "It's critically important to adopt these kinds of changes to the market infrastructure to ensure that individual and institutional investors have confidence in the marketplace and the valuation of stocks."

Retain Confidence

Regulators are trying to balance the lower trading costs associated with electronic trading with the increased risk of computer-driven slumps. SEC Chairman Mary L. Schapiro said in yesterday's statement that "upgrading our trading parameters will help our markets retain the confidence of investors and companies."

The new plan will be implemented in two phases, the exchanges said in their joint proposal. For companies already covered by the circuit breakers adopted last year, trades wouldn't be able to occur 5 percent higher or lower than the average price over the prior five minutes, the SEC said. For all other securities, the band would be set at 10 percent. Wider collars would apply for shares trading below \$1. The thresholds would initially be doubled between 9:30 a.m. and 9:45 a.m. as well as 3:35 p.m. to 4 p.m.

Public Comment

The second phase, which will begin after six months, would apply the 5 percent trigger to all securities from 9:30 a.m. to 4 p.m., according to the proposal. The program will begin 120 days after the SEC's approval notice is published in the Federal Register. The public will have 21 days to comment.

"If a market's prices can only move within a certain band, that's price control," said Tim Quast, founder and managing director at ModernNetworks IR LLC in Denver. "This is supposed to be a free market with stocks priced according to the willing activity of buyers and sellers. I understand the rationale, but it's at loggerheads with rules that say the markets should be free and unimpeded."

High-frequency trading firms and arbitrageurs are likely to benefit from the rules at the expense of longer-term investors, Quast said.

“When you can count on exchanges to control the movement of price, you can program algorithms to that,” including through momentum-based strategies designed to profit from changes in the relative prices of two securities or baskets of stock, he said. “Traders could try to move less-liquid stocks to the upper or lower limits.”

Halts Still Possible

The new program curtailing volatility also allows securities to stop trading. If a stock price rises or falls to the threshold and trades are “unable to occur within the price band for more than 15 seconds,” a five-minute pause will be imposed, according to the SEC statement. The halt will give investors time to respond to “fundamental price moves” driven by news about companies, the SEC said.

The five-minute halt imposed by the current circuit breakers “has been particularly problematic in a number of situations in which a single erroneous trade triggered the pause,” the Feb. 18 report from the SEC-CFTC advisers said.

“This is a band-aid,” said **Joseph Saluzzi**, partner and co-head of equity trading at **Themis Trading LLC** in Chatham, New Jersey. “It improves the static circuit breakers, which have saved the day a few times, by making them more dynamic, but we can still have quick declines.” He said the proposed rules don’t address the reason for rapid plunges. “This treats the symptom but not the sickness,” he said.

Rapid Orders

Regulatory changes over the past 15 years and the growth of high-frequency trading contributed to the May 6 plunge, **Saluzzi** said. More than half of U.S. equities volume comes from high-frequency firms that buy and sell stocks rapidly and usually don’t hold positions overnight, according to the SEC. **Saluzzi** said the agency should consider rules that limit some of their activity such as high levels of quotations relative to trades and the rapid submission and cancellation of bids and offers.

The new circuit breaker proposal would affect trading on all exchanges including those run by NYSE Euronext (NYSE), Nasdaq OMX Group Inc. (NASDAQ), Bats Global Markets and Direct Edge Holdings LLC, as well as private venues such as dark pools and brokerages that execute orders within their own walls.

“We’ve been waiting for this,” said George Hessler, president and chief executive officer of Stock USA Execution Services Inc., a Carmel, New York-based electronic brokerage firm that trades between 3 billion and 4 billion shares a month. “This should be a good step in improving market structure in the equity marketplace.”

‘Runaway’ Order

The initiative should eliminate problems involving “the runaway market order or mistakes with a limit order” that triggered circuit breakers in the past, Hessler said. Market orders are requests to buy or sell shares immediately regardless of the price. Limit orders are trade requests that specify the highest or lowest price the investor will accept.

“We respectfully disagree with the viewpoint that volatility should be regulated or mandated out of existence, or that we should introduce safeguards to protect market participants from periods of high volatility,” Leonard Amoruso, general counsel at Jersey City, New Jersey-based Knight Capital Group Inc., told the SEC on June 4. Volatility “is a byproduct of the dynamism of our capital markets and reflects periods of strongly differing views on valuation.”