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Client Alert

Capital Markets

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SEC Approves New Exchange Rules Addressing Extraordinary Stock and Market Volatility

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

Sean O'Malley
Partner, New York
+ 1 212 819 8579
sean.omalley@whitecase.com

Michelle B. Rutta
Partner, New York
+ 1 212 819 7864
mrutta@whitecase.com

On May 31, 2012, the Securities and Exchange Commission (the "Commission") approved two rule proposals made by the national securities exchanges[1] and by the Financial Industry Regulatory Authority ("FINRA") that are designed to address extraordinary volatility in individual exchange-listed securities and the broader US stock market.[2] Among other things, the new rules are designed to address events such as the severe volatility that occurred on May 6, 2010, colloquially known also as the "flash crash," when the Dow Jones Industrial Average lost more than 600 points in five minutes. Once fully implemented, the new exchange rules will make two significant changes: (1) they will update the existing market-wide circuit breakers with lower triggering thresholds and shorter trading halts and (2) they will replace the existing single-stock circuit breakers that halt trading in an individual stock with a new "limit up-limit down" mechanism that requires trades in listed securities to be executed within a range tied to recent prices for that security.

The exchanges and FINRA will have until February 4, 2013 to implement these rule changes pursuant to a one-year pilot period, during which time the exchanges, FINRA and the Commission will decide whether any additional changes to the rules are appropriate.

Market-Wide Circuit Breakers

Existing market-wide circuit breakers, which halt trading in all US exchange-listed securities in the event of extraordinary market volatility, were adopted in October 1988 but have been triggered only once, in 1997. Significantly, the current market-wide circuit breakers were not triggered during the "flash crash" of May 6, 2010. At 2:42 p.m. on that day, with the Dow Jones down more than 300 points for the day, the equity market began to fall rapidly, dropping more than 600 points in five minutes for an almost 1,000-point loss on the day by 2:47 p.m. Twenty minutes later, by 3:07 p.m., the market had regained 500 points, coming to a close down approximately 348 points.[3] The result was that a large number of trades were executed at temporarily depressed prices, many of which were more than 60% off from their pre-decline prices.

A report issued by the Commission and the Commodities Futures Trading Commission determined that the crash was triggered by a US$4.1 billion sell order placed in the futures market on the Chicago Mercantile Exchange by a single seller that was executed rapidly without regard to price or time. High-frequency trading firms that bought these futures positions rapidly traded over 27,000 contracts in a matter of seconds while only accumulating approximately 200 additional net contracts. This extreme volume impacted the equity markets where a large number of firms automatically paused trading at the same time as others sought to sell massive amounts of securities into a relatively illiquid market.

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

The existing market-wide circuit breakers provide for trading halts following certain "Level 1," "Level 2" and "Level 3" market declines. The values of Levels 1, 2 and 3 are calculated at the beginning of each calendar quarter, using 10%, 20%, and 30%, respectively, of the average closing value of the Dow Jones Industrial Average for the month prior to the beginning of the quarter. As part of an effort to accommodate today's high-speed electronic markets, the exchange rule changes approved by the Commission will revise the existing market-wide circuit breakers by (1) lowering the percentage-decline threshold for triggering a market-wide trading halt and (2) shortening the length of time that trading is halted. Specifically, the revised market-wide circuit breaker rules update the existing rules by:

- lowering the market-decline percentage thresholds required to trigger a circuit breaker from 10%, 20% and 30% to 7%, 13% and 20% from the prior day's closing price;
- using the broader S&P 500 Index in lieu of the Dow Jones Industrial Average, as the pricing reference to gauge a market decline;
- reducing the period of trading halts from 30, 60, or 120 minutes to 15 minutes;
- swapping the current six-period time structure for two trigger periods, those occurring before 3:25 p.m. and those occurring on or after 3:25 p.m; and
- requiring the trigger thresholds to be recalculated daily rather than quarterly.

The new market-wide circuit breaker rules will update existing market-wide circuit breakers by modifying them to account for today's high-speed electronic securities markets in an effort to prevent another "flash crash". Accordingly, the new market-wide circuit breakers would be triggered by a smaller market-wide decline and would last for a shorter time period than under the current market-wide circuit breakers. Moreover, the shorter 15-minute trading halt is intended to give market participants sufficient opportunity to judge the market decline and to properly formulate their trading interest, with the added advantage of less disruption to the markets than the trading halts under the existing market-wide circuit breakers.

Limit Up-Limit Down

The second set of exchange rule changes approved by the Commission will establish a "limit up-limit down" plan, as proposed by certain of the national securities exchanges[4] and FINRA. When fully implemented, this plan will replace the existing single-stock circuit breakers that were approved on a pilot basis on June 10, 2010 and which are set to expire on July 31, 2012. The existing single-stock circuit breakers require trading in a security to be halted when the transaction price of the security moves up or down by 10% or more in a five-minute period.

The new limit-up-limit-down plan prevents trades in individual listed equity securities from occurring outside of a specified price band and differs from the existing single-stock circuit breakers in the following ways:

- the price band would be set at a percentage level above and below the average price of the security over the immediately preceding five-minute period;
- each stock will be permitted to move a specified percentage from its five-minute average, with the amount differing based on its closing price from the previous day;
- for more liquid securities (those in the S&P 500 Index, Russell 1000 Index and certain exchange-traded products), the level will be 5%;and for all other listed securities, the level will be 10%. These percentages will be doubled during the opening and closing periods,[5] due to increased volatility during those times;
- broader price bands[6] are established for securities priced at US$3 per share or less; and
- the markets will have a 15-second window to trade back within the band before trading in the security is halted; as such, trading will not be immediately halted when a stock price moves outside of a designated band in one trade.

More specifically, the plan provides a mechanism to halt trading as follows: when one side of the market for an individual security is outside the applicable price band, securities information processors[7] must disseminate the National Best Bid or National Best Offer[8] with a flag classifying it as non-executable. When the other side of the market reaches the applicable price band, the market for an individual security enters a Limit State[9] and the processors must disseminate such National Best Offer or National Best Bid with a flag identifying it as a Limit State Quotation (when a National Best Offer is equal to the lower price band or a National Best Bid is equal to the upper price band for a National Market System Stock[10]). If, within 15 seconds of entering this Limit State, all Limit State Quotations are executed or canceled in their entirety, trading for the NMS Stock exits the Limit State. If the market does not exit the Limit State within fifteen seconds, a five-minute trading pause ensues and would be applicable to all markets trading the security. The Commission stated that it believes the limit up-limit down plan is more reasonably designed to reduce the number of erroneous trades in comparison to the current single-stock circuit breaker rules.

The plan will be implemented in a year-long pilot in two phases. Phase 1, which must be implemented no later than February 4, 2013, will apply to stocks included in the S&P 500 and Russell 1000 stocks and certain exchange-traded funds and exchange-traded notes,[11] with price bands calculated from 9:45 a.m. New York time until 3:30 p.m. Phase 2 begins six months after the end of Phase 1 and will operate from the start of trading at 9:30 a.m. until the close at 4:00 p.m. and apply to all stock and exchange-traded products in the United States. There may be a gap between the expiration of the single-stock circuit breakers and the implementation of Phase 1, unless the Commission extends the current single-stock circuit breaker rules at the end of July.

1 BATS Exchange, Inc. ("BATS"), BATS Y-Exchange, Inc. ("BYX"), Nasdaq OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), C2 Options Exchange, Incorporated ("C2"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc. ("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("Nasdaq"), National Stock Exchange, Inc. ("NSX"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), NYSE Arca, Inc. ("NYSE Arca"), Nasdaq OMX PHLX LLC ("Phlx").

2 *See* Securities Exchange Act Release No. Release No. 34-67091; File No. 4-631 (May 31, 2012) and Securities Exchange Act Release No. 34-67090; File Nos. SR-BATS-2011-038; SR-BYX-2011-025; SR-BX-2011-068; SR-CBOE-2011-087; SR-C2-2011-024; SR-CHX-2011-30; SR-EDGA-2011-31; SR-EDGX-2011-30; SR-FINRA-2011-054; SR-ISE-2011-61; SR-NASDAQ-2011-131; SR-NSX-2011-11; SR-NYSE-2011-48; SR-NYSEAmex-2011-73; SR-NYSEArca-2011-68; SR-Phlx-2011-129 (May 31, 2012).

3 Lauricella, Tom (May 7, 2010). "Market Plunge Baffles Wall Street—Trading Glitch Suspected in 'Mayhem' as Dow Falls Nearly 1,000, Then Bounces". *The Wall Street Journal:* p. 1.

4 These exchanges are BATS, BX, BYX, CBOE, CHX, EDGA, EDGX, Nasdaq, NSX, NYSE, NYSE MKT LLC (f/k/a NYSE Amex LLC), NYSE Arca, and Phlx.

5 The opening period is 9:30 a.m. and 9:45 a.m. ET and the closing period is 3:35 p.m. and 4:00 p.m. ET.

6 On May 24, 2012, the proposal was amended to create a 20% price band for Tier 1 (stocks in the S&P 500 Index or Russell 1000 Index and certain exchange-traded products) and Tier 2 (all National Market System stocks other than those in Tier 1) stocks with a Reference Price of US$0.75 or more and up to and including US$3.00.

7 A "securities information processor" is any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations.

8 "National best bid" and "national best offer" mean, with respect to quotations for an NMS security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time).

9 A stock enters the Limit State if the National Best Offer equals the lower price band and does not cross the National Best Bid, or the National Best Bid equals the upper price band and does not cross the National Best Offer.

10 "NMS stock" is any security or class of securities, other than an option, for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options; thus, NMS Stocks essentially include all equities listed for trading on a registered national securities exchange.

11 For a list of the relevant exchange-traded funds and exchange-traded notes, see Schedule 1 to the National Market System Plan Approval Order, available at http://www.sec.gov/rules/sro/nms/2012/34-67091.pdf.

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