ALERT

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SEC Addresses Extraordinary Volatility in Stock Market

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On June 1, 2012, the Securities and Exchange Commission (SEC) announced two new initiatives to address extraordinary volatility both in individual stocks and the stock market as a whole. The initiatives were submitted by the Financial Industry Regulatory Authority (FINRA) after the stock market drastically dropped in a matter of minutes and the existing rules failed to stop the plunge. The proposed initiatives include two trigger mechanisms that will be implemented for a one-year pilot period by February 4, 2013.

This alert describes these initiatives as well as several other related rule changes. For more detail, a copy of the SEC release is available here.

Limit-Up, Limit-Down

The first initiative replaces the single-stock circuit breakers with a "limit up-limit down" mechanism, which prohibits trading for individual listed equity securities outside of a designated price band. The price band is set at a percentage above and below the average price of the stock for the previous five-minute period. For more liquid securities, such as those in the S&P 500 Index and the Russell 1000 Index, the price band will be set at 5 percent. For all other listed securities the price band will be set at 10 percent, except securities trading at $3 per share or less which will be subject to an even broader price band. These percentages will be doubled during the first 15 minutes after the market opens and the last 25 minutes before the market closes. To accommodate fundamental price moves, if no trading activity occurs within the price band for 15 seconds, then a five-minute trading pause for the individual security is triggered. As a result of this initiative, trading centers will have to establish policies that prevent trades outside of the appropriate price band and comply with the established trading breaks.

Market-Wide Circuit Breakers

The second initiative revises the current market-wide circuit breaker rules to allow for a trading halt if the market as a whole declines a certain percentage from the prior day's closing price. Under the proposed initiative, the percentage decline, or "trigger threshold," will be calculated daily, as opposed to quarterly. Additionally, the proposed initiative moves the trigger thresholds needed to trigger a circuit breaker from 10, 20, or 30 percent to 7, 13, or 20 percent. The initiative uses the broader S&P 500 Index, as opposed to the Dow Jones Industrial Average, to calculate such thresholds.

Whether trading is halted and for how long also depends on when the percentage decline occurs. Under the proposed initiative, if a trading halt is triggered that does not close the market for the day, then the halt will last for 15 minutes, as opposed to a 30, 60, or 120 minute break. The proposed initiative also simplifies the structure of the circuit breaks so that there are only two relevant triggered time periods, those that occur before 3:25 p.m. and those that occur on or after 3:25 p.m.

Other Changes

The SEC also has undertaken several other initiatives in light of the recent market failures, including adoption of the following:

- New exchange and FINRA rules specifying when and how erroneous trades would be broken;
- New exchange and FINRA rules to strengthen the minimum quotation standards for market makers and the prohibition of "stub quotes" in the U.S. markets;
- Rules requiring broker-dealers to have risk controls in place before granting their customers access to the market; and
- Rules establishing a large trader reporting system to enhance the SEC's ability to identify large market participants and to gather trading activity information.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact:
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