Commentary: New Circuit Breakers Let Markets Call 'Time Out'

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On June 10, 2010, the SEC approved new single-stock circuit breakers in response to the market "flash crash" of May 6, 2010. The SEC action permits the national securities exchanges and FINRA to implement uniform, market-wide "circuit-breakers" so that U.S. equity markets can take a "pause" in the event that there are rapid, excessive price movements in certain individual stocks.

These new rules will supplement the existing market-wide circuit breakers, which halt trading for varying periods of time if the Dow Jones Industrial Average falls 10%, 20% or 30% from the previous day's closing price. Those market-wide circuit breakers were not tripped during the "flash crash," even though a number of individual securities dropped precipitously (and almost as suddenly reversed the plunge). The new circuit breakers are intended as a more targeted mechanism that will not depend on overall market declines.

The single-stock circuit breakers will pause trading in any component stock of the S&P 500 Index in the event that the price of that stock has moved 10% or more in the preceding 5 minutes. The pause generally will last 5 minutes, and is intended to give the markets a hiatus to attract trading interest at the last price, as well as to give traders time to think rationally.

The new circuit breakers will be effective on a pilot basis through December 10, 2010. In order to begin this pilot program promptly, the single-stock circuit breakers initially will apply only to S&P 500 component stocks. As currently adopted, these single-stock circuit breaker rules will not be in effect during market opening and closing, but only from 9:45 am until 3:35 pm. They are expected to be rapidly expanded (by additional rule proposals) to include ETF and other securities before the end of the pilot period. Several exchanges already have filed for rule amendments to halt trading in options when an underlying security is the subject of a trading pause.

The mechanics of the new rules provide that if a covered stock experiences a 10% change in price in a 5-minute period, the stock's primary listing market will issue a 5-minute trading pause and will immediately notify the other exchanges, FINRA, and market participants by disseminating a special indicator over the consolidated tape. Once the primary market issues the trading pause, each other exchange also will pause trading and FINRA will pause trading by FINRA members in the OTC markets (including trading on alternative trading systems and by market-makers).

At the end of the 5-minute pause, the primary listing market will reopen trading. However, in the event of a significant imbalance on the primary listing market, it may delay reopening for up to an additional 5 minutes. Trading on the other exchanges and in the OTC markets will resume once trading has resumed in the primary listing market or, if the primarily listing market has not resumed trading within 10 minutes, the other exchanges may resume trading without waiting for the primary listing market. FINRA's rule permits OTC participants to resume trading only if trading has resumed on at least one exchange.

The SEC is hoping these single-stock circuit breakers will be a starting point in the effort to prevent another "flash crash" or runaway market. During the trial period, the SEC will consider, among other things, whether the 10% threshold is the proper measure for all securities (or whether the threshold should be commensurate with a stock's volatility), whether the length of the pause is sufficient to restore rationality to the market (if in fact it does that at all), whether these circuit breakers also should be in effect during the high volume periods of market opening and closing, and whether the reopening procedures work well. They may also be considering proposed alternatives to the circuit breaker mechanism.

Will the new circuit breakers be effective? Only time will tell. It's likely that at some point in the next 6 months, the circuit breakers will trip in at least some stocks. However, since they are starting with only the S&P 500 stocks, which historically have not had as much volatility as non-S&P 500 stocks, we may not see many circuit breakers tripping. The markets will most likely react to these temporary pauses rationally, and the regulators will declare these rules a victory.

It is more difficult to imagine how well the circuit breakers will work when thousands of stocks are included, especially if broader crashes cause large numbers of circuit breakers to trip simultaneously. Will 5- and 10-minute pauses allow the markets to discover correct prices? Of course, it would be easier to make predictions about the next "flash crash" if we knew what caused the last one, and the cause is still largely a mystery.

We now live in a world where high-frequency trading has gone a long way toward replacing human traders with computers. In some sense, single-stock circuit breakers provide an automated replacement for the now-defunct "specialists," who used to be able to call for trading "breathers" if there were rapid and irrational price movements. Slowing trading, with circuit breakers or by other means, may seem like a step backward. But sometimes you have to take one step back to move two steps forward. The hope is that single-stock circuit breakers will give computerized markets the time to cure temporary market imbalances, rather than instantaneously executing automated trades at irrational prices.

We can expect to see much more rulemaking in this area, possibly including a recalibration of the market-wide circuit breakers that were not triggered on May 6. The SEC continues to look for the cause of the "flash crash" and if they find it, new and improved regulation is likely to result.