SEC Announces Proposed Circuit Breaker Rules for Individual Stocks

On May 18, 2010, the Securities and Exchange Commission ("SEC") announced that the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA") proposed rules that would temporarily cease trading in individual stocks if the price moves 10 percent or more in a five-minute period.[1] During a pilot period that would last through December 10, 2010, the proposed rules would apply only to individual stocks in the S&P 500 Index. The proposed rules are a reaction to the market disruption of May 6, 2010, in which 30 stocks in the S&P 500 Index fell at least 10 percent in the span of five minutes.

I. Background

On May 6, 2010, the Dow Jones Industrial Average plummeted nearly 1,000 points in a matter of minutes before staging a partial rebound. A meeting between SEC Chairman Mary Schapiro, exchange leaders and FINRA, held days after this market disruption, yielded a consensus on proposed rules aimed in part at lessening the impact of sudden stock price declines.

II. Proposed Rules

A. Exchange Proposed Rule

Under the proposed rules, "trading in a stock would pause across U.S. equity markets for a five-minute period in the event that the stock experiences a 10 percent change in price over the preceding five minutes."[2] The New York Stock Exchange ("NYSE"), one of several national securities exchanges filing these proposed rules, proposes to add Rule 80C, which would allow it to issue such a five-minute "Trading Pause" for individual securities for which the NYSE is the primary listing market (and would authorize it to delay the re-opening of the security beyond five minutes "in the event of a significant imbalance").[3] Following a Trading Pause, the Designated Market Makers ("DMM") would maintain responsibility to re-open trading in a manner similar to procedures under Rule 123D, subject to certain specified revisions. The NYSE proposes that the circuit breaker rule be in effect from 9:45 a.m. to 3:35 p.m., Eastern Time, in order to allow the market to absorb the opening price of a security and to participate in the close. During this period, the movement in stock price would be calculated every second "by comparing each last consolidated sale price of a security ('Trigger Trade') during the preceding second to a reference price (the 'Calculation Time')"; the reference price is defined as "any transaction in that security printed to the Consolidated Tape during the five-minute period before the Calculation Time."[4]

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1 *See* SEC to Publish for Public Comment Stock-by-Stock Circuit Breaker Rule Proposals (May 18, 2010), available at http://www.sec.gov/news/press/2010/2010-80.htm.

2 *Id*.

3 SEC Release No. 34-62126; SR-NYSE-2010-39 (May 19, 2010) at 2-3, available at http://www.sec.gov/rules/sro/nyse/2010/34-62126.pdf. Other exchanges filing similar proposals were: the Chicago Stock Exchange; NASDAQ OMX BX, Inc. (formerly the Boston Stock Exchange); NASDAQ Stock Market LLC; National Stock Exchange (formerly the Cincinnati Stock Exchange); NYSE Arca; and NYSE Amex.

4 *Id*. at 4.

Reference prices would begin at 9:45 a.m., such that "in the first five minutes of the calculation period, the reference prices for a Trigger Trade [would] not be based on five minutes of trading in that security," and the last Trigger Trade would be at 3:35 p.m., so that the last possible Trading Pause would end at 3:40 p.m.[5] Under the NYSE's proposal, only regular way, in-sequence transactions could qualify as a Trigger Trade or a reference price; the NYSE would exclude from use as a reference price or Trigger Trade transaction prices deemed to have resulted from an erroneous execution.

B. FINRA Proposed Rule

Consistent with the exchanges' proposals, FINRA proposes to amend Rule 6121 "to provide that if a primary listing market has issued an individual stock trading pause under its rules, FINRA will halt trading by FINRA members otherwise than on an exchange in that security until trading has resumed on the primary listing market."[6] However, where trading has not resumed on the primary listing market, FINRA may allow trading by FINRA members otherwise than on an exchange to resume if trading of the security has re-opened on at least one national securities exchange and if either (1) ten minutes have passed since the stock trading pause message has been received, or (2) the primary listing market has provided notification that it cannot resume trading for reasons other than a significant imbalance.

C. Reasons for the Proposals

The ability to pause trading upon sudden stock price changes would allow the markets "to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion."[7] The SEC, the exchanges and FINRA believe that the market commotion of May 6 was exacerbated by the exchanges' differing trading rules and conventions, and that the proposed rules would establish "uniform market-wide standards" for those securities in the S&P 500 Index that endure a rapid price movement.[8] In addition to promoting uniformity, the SEC, the exchanges and FINRA expect the proposed circuit breaker to curtail market volatility, enhance market transparency, and bolster investor protection.

The exchanges and FINRA propose to put the new rules into effect on a pilot basis through December 10, 2010, during which time the rules would apply only to securities in the S&P 500 Index. The pilot period would allow the exchanges to assess the effect of the new rules and to adjust the parameters or operation of the circuit breaker, as needed, and to determine whether and when to make the circuit breaker applicable to securities beyond the S&P 500. Moreover, during this period, the SEC staff plans to study market orders and their ability to contribute to sudden price movements, consider ways to deter or prohibit the use of "stub" quotes,[9] and examine the impact of the exchanges' other trading protocols (including trading pauses and self-help rules).

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5 *Id*.

6 SEC Release No. 34-62133; SR-FINRA-2010-025 (May 19, 2010) at 3, available at http://www.sec.gov/rules/sro/finra/2010/34-62133.pdf.

7 SEC to Publish for Public Comment Stock-by-Stock Circuit Breaker Rule Proposals, *supra* note 1.

8 *Id*; *see also* SEC Release No. 34-62126, *supra* note 3, at 5; SEC Release No. 34-62133, *supra* note 6, at 3.

9 "Stub quotes" are quotes which are designed to technically meet a requirement to provide a "two sided quote" but are at such low or high prices that they are not intended to be executed. *Preliminary Findings Regarding the Market Events of*

The NYSE and FINRA have requested that the SEC approve the proposed rules on an accelerated basis, such that the rules may begin to operate on a pilot basis on June 7, 2010, and be applied to all eligible securities by June 14, 2010. The SEC is currently seeking public comment on the proposed rules, shortly after which it will decide whether to approve them.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Yafit Cohn at 212.701.3089 or ycohn@cahill.com.

May 6, 2010, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (May 18, 2010) at 3, available at http://www.sec.gov/sec-cftc-prelimreport.pdf. Stub quotes are sometimes used by market makers who are required to trade, but do not wish to do so at a given moment. Some have theorized that the May 6th market disruption may have been caused in part by the inadvertent execution of trades using stub quotes. See *The Wall Street Journal* (May 25, 2010) at C3.