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Traders, Start Your Engines: After August 24, Exchanges Need to Coordinate

By Jennifer Choi and George Gilbert

The extraordinary volatility in U.S. equity markets on August 24, 2015, exposed a significant deficiency in the rules governing these markets' structure: a lack of harmonization across securities exchanges for reopening trading after a "limit up–limit down" trading halt in a security.

In a nutshell, marketwide rules implemented after the May 2010 "flash crash" succeeded in moderating the U.S. markets' response to the day's bad economic news and turmoil in Asian markets. But the rules left out a key element: they don't require exchanges to harmonize their rules for reopening trading after a trading halt. The lack of coordination across exchanges after a trading pause may have contributed to that day's volatility. To fix that problem, the securities exchanges must work together to establish a uniform process for reopening trading in a security after a limit up–limit down trading halt.

A Bad Start That Got Worse

Monday, August 24 began with bad news: a sell-off in Asian equities that spread to other markets. Many investors in U.S. equity markets knew they could be in for a rough day, but few envisioned the chaos that the first hour of trading would bring. Severe price moves in hundreds of securities—including exchange-traded products (ETPs)—triggered more than 1,300 trading halts. In some cases, these halts occurred within a minute of the commencement or reopening of trading.

The halts were the result of limit up–limit down rules implemented in the aftermath of the flash crash of May 6, 2010. These rules are intended to prevent a security from trading at a price outside specified price bands, and are coupled with trading pauses to accommodate more fundamental price moves.

Because many of the halts involved ETPs, some market participants and observers have raised questions over whether the structure of ETPs somehow contributed to the day's extreme volatility. But exchange leaders—including Thomas Farley, president of NYSE Group, and Chris Concannon, president and CEO of BATS Global Markets—have concluded that flaws in the trading rules for U.S. equity markets, rather than the design of the affected ETPs, were responsible for the wild ride of August 24. We agree with this growing consensus.

A Different Story

The limit up–limit down rules did work—they provided an effective, uniform mechanism for halting trading in specific securities during a time of market volatility. But reopening trading was quite a different story.

The limit up–limit down rules rely on the exchanges to reopen trading, but the rules of the securities exchanges are not coordinated. For example, the NYSE Arca uses an auction to reopen trading in a security following a trading halt, and imposes "collars" on the reopening price to ensure that it falls within a specified range of the last price for that security. Other exchanges use different methods to establish the reopening price. Moreover, different exchanges have different rules on how to handle orders after a trading halt: some send orders back to brokers, while others hold the orders until the primary market reopens trading in the security.

These varied processes affect the trading of a security immediately after a reopening, adding to confusion and uncertainty during times of stress—exactly when clarity and certainty are most important.

As the unnerving events of August 24 demonstrated, this source of unpredictability must be addressed. Securities exchanges must get together to work out a uniform process to reopen trading in a security after a limit up–limit down trading halt. The exchanges also must adopt a uniform method of handling orders after a trading halt. And to improve price discovery after a trading halt, all orders should be routed to the primary market that is reopening the halted security.

ICI and its members stand ready to assist the SEC and the exchanges in making the necessary adjustments to market structure that will best serve investors.

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