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2020 hindsight: Regulatory responses to recent market volatility

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March 2020 was one of the most volatile months ever measured by the CBOE Volatility Index, largely as a result of the COVID-19 pandemic, and volatility has remained elevated compared to historic norms. Regulators such as the SEC, FINRA, the CFTC, the NYSE and Nasdaq have tools available to help them and the firms they regulate respond to market volatility.

Our aim is to highlight how regulators used their existing regulatory authority effectively during this period to promote market stability, to examine certain limitations of these tools, and to provide some historical context for these actions. Moreover, with continuing uncertainty as to the future economic effects of COVID-19 and regulatory, public health, and consumer responses thereto, markets may continue to experience volatility.

> Market-wide circuit breakers were previously triggered only once, in 1997. In March 2020, they were triggered four times.

Market participants should revisit these considerations whenever volatile conditions arise.

I. TRADING HALTS AND SUSPENSIONS FOR SECURITIES AND DERIVATIVES

U.S. securities regulators have several tools to halt trading in times of significant volatility, including market-wide circuit breakers, individual stock circuit breakers, and trading suspension authority.[1]

Market-wide and individual stock circuit breakers

Market-wide circuit breakers to halt trading in U.S. equities were first adopted in October 1988[2] in response to the 1987 equity market crash known as Black Monday.

Subsequently, following the May 2010 "flash crash," during which major equity indices fell by 5-6% in a matter of minutes before rebounding almost as quickly, the SEC adopted the national market system (NMS) Plan to Address Extraordinary Market Volatility, also known as the "Limit-Up Limit-Down Plan" (LULD Plan).[3]

The LULD Plan includes parameters that trigger a pause in exchange and over-the-counter (OTC)[4] trading in NMS stocks, as described below.

***Market-wide circuit breakers*:**

To halt trading across the entire market, a decline in the price of the S&P 500 index as compared to the previous day's closing price for the index at one of three price levels must have occurred:

- 7% Market Decline (Level 1) and 13% Market Decline (Level 2): each causes a 15-minute halt during trading between 9:30 a.m. and 3:25 p.m. ET and only one halt per trading day.
- 20% Market Decline (Level 3): causes a halt in all trading for the remainder of the trading day.

***Individual stock circuit breakers*:**

The LULD Plan provides for additional trading limits and trading pauses for individual securities whose prices cross certain bands relative to their average price over the preceding five minutes of trading.

While options, futures, and derivatives are not subject to the LULD Plan, options exchanges and designated contract markets (DCMs) may halt trading of such instruments upon the triggering of the LULD Plan or when certain price limits are reached.[5]

Trading suspensions

The SEC has authority to suspend trading for 10 days in any security, for 90 days on all exchanges or otherwise in securities (provided that the President is notified and does not disapprove), and for up to 10 days in an "emergency" as necessary in the public interest and to protect investors.[6]

This latter authority can be used, for example, to suspend trading in securities of companies that are not current in their periodic reporting, where there are questions as to the accuracy of a company's disclosures, or where concerns have arisen regarding the trading of the stock, including around trading by insiders and market manipulation.

Following a suspension, quoting will not automatically resume with respect to stocks that trade OTC; SEC regulations require a broker-dealer first to review specific information about the company.[7] The SEC's authority extends to futures as well, provided the SEC consults with and considers the views of the CFTC.

Securities exchanges, FINRA, the CFTC, and DCMs also have broad authority to suspend trading or to take other action to maintain orderly trading in the instruments they regulate when extraordinary circumstances or emergencies arise that affect market activity.[8]

Recent events

***Market-wide circuit breakers*:**

Market-wide circuit breakers were previously triggered only once, in 1997. In March 2020, they were triggered four times, each time involving a Level 1 market decline resulting in a 15-minute trading pause.

On Monday, March 9, the S&P 500 fell more than 7% upon opening, immediately triggering the pause. When trading resumed, prices rebounded slightly before falling again later in the day and ultimately closing even lower for the day. This pattern repeated on March 12 and March 16. On March 18, the circuit breaker was triggered midday; prices rose slightly thereafter but the S&P 500 still closed down over 5% for the day.

Equity trading volumes throughout March 2020 were also significantly higher than average, averaging more than twice the average daily trading volumes in March 2019 across several exchanges.[9]

***Trading suspensions*:**

From March 1, 2020 through July 7, 2020, trading in 48 individual stocks was suspended by the SEC,[10] reflecting the SEC's focused pursuit of actors it perceives to be exploiting the pandemic and related market disruptions, such as companies making false statements about testing tools.[11]

Stephanie Avakian, Co-Director of the SEC's Division of Enforcement, stated recently that "[the SEC is] actively monitoring the markets to detect potential fraudsters who seek to use the COVID-19 crisis as a basis for investment scams."[12] While trading suspensions are prophylactic in nature and do not represent a finding of fraud or misconduct, such suspensions regularly lead to later Enforcement action.

Takeaways

The circuit breakers functioned as intended in March and may have helped prevent or delay some selling spurred by the panic incited by a rapidly declining market, as well as some algorithmic trades that may have exacerbated the declines. These are the problems that circuit breakers were designed in part to address: panic selling and short-term issues internal to the markets.

However, the March 2020 market decline was driven — at least in part — by longer term concerns about fundamentals caused by exogenous factors (i.e. the pandemic and falling oil prices). The circuit breakers' ability to arrest or mitigate declines or volatility in the markets on a broader basis was limited. But this is not unexpected.

Indeed, it is not desirable to prevent markets from reacting rationally to real world events and changing economic conditions; accordingly, the circuit breakers functioned as intended under these circumstances and were likely successful in lessening the negative feedback loops that often arise in sell-offs.

II. RESTRICTIONS ON SHORT SELLING

Bans on short sales

Market instability has caused regulators to consider restrictions on short selling, with different approaches taken in the United States versus certain European countries.

> Certain European regulators have imposed restrictions or bans on short selling in the midst of the current global market instability.

In the United States, Chairman Clayton stated that the SEC is not considering banning short selling at this time, and that short selling is necessary to facilitate ordinary market trading.[13] Market participants in the United States appear largely to agree with this position.

By contrast, certain European regulators have imposed restrictions or bans on short selling in the midst of the current global market instability. For example, in mid-March 2020, the national regulators of Austria, Belgium, France, Greece, Italy and Spain announced bans on short positions in relation to shares traded on their national exchanges.[14] These bans were lifted in May 2020.

Regulation SHO

One reason blanket bans or long-term restrictions on short selling are not regarded as necessary in the United States is that Regulation SHO already operates to restrict short sales for short periods during market declines.

Regulation SHO was originally adopted to address concerns regarding persistent failures to deliver and abusive naked short sales.[15] Because interest in short selling and execution difficulties and failures associated with short sales may simultaneously increase in a volatile or falling market environment, market participants should carefully consider the restrictions imposed by this regulation at such times.

Under Regulation SHO, a person (including both natural and legal persons) is deemed to own a security only to the extent that the person has a net long position across all accounts in such security. If a person has a net position in a security that is less than the quantity of shares that person seeks to sell, then such sale is deemed to be a "short sale".

Regulation SHO imposes four general requirements with respect to short sales of equity securities: a marking requirement, a short sale price test circuit breaker, a locate requirement, and a close-out requirement.

In the context of volatile markets, securityholders should be particularly mindful of the short sale price test circuit breaker.

***Short sale price test circuit breaker*:**

Securities exchanges, ATSs, OTC market makers, and other trading centers that execute orders as agent or principal are required to establish and enforce policies and procedures to prevent the execution or display of a short sale at a price that is less than or equal to the current national best bid when a stock has triggered a circuit breaker by experiencing a price decline of at least 10% in one day.

Once the circuit breaker has been triggered, the price test restriction will apply to short sale orders in that security for the remainder of the day and the following day, unless an exception applies.

Recent events

For several days during the peak of the March 2020 sell-off, a *majority* of U.S.-listed stocks were restricted from short sales under Regulation SHO as a result of the short sale price test circuit breaker rules.[16]

Takeaways

Like the market-wide circuit breakers discussed above, Regulation SHO's short sale price test circuit breaker rules work to lessen the effects of negative feedback loops that arise in falling markets by preventing short sellers from pushing down the price of a security that has already lost significant value since the prior day's close. Appropriately, the effect is relatively short lived, and normal trading in a security may resume after the completion of the next full trading day.

This rule, together with Regulation SHO's locate and close-out requirements and the trading halts and suspension tools discussed above, largely obviates the need in the United States for blanket bans on short selling, such as those adopted by certain European regulators, by curbing abusive practices and ensuring that short selling does not exacerbate market declines.

Notes

1 More detail regarding these rules is available here: https://bit.ly/3dTZLAk.

2 Securities Exchange Act Release No. 26198 (Oct. 19, 1988), 53 Fed Reg. 41,637 (Oct. 24, 1988).

3 The LULD Plan is available at https://bit.ly/2NSf6Xy.

4 *See* FINRA Rule 6121 (Trading Halts Due to Extraordinary Market Volatility). FINRA will also halt trading in OTC Equity Securities whenever it has halted trading in all National Market System stocks for the duration of the halt. FINRA Rule 6440.03.

5 *See,e.g.*, Cboe BZX Rule 20.5; Chicago Mercantile Exchange (CME) Rule 358; Cboe Futures Exchange (CFE) Rule 417A (providing that the exchange shall halt trading upon the triggering of a market-wide circuit breaker under the LULD Plan).

6 15 U.S.C. 78*l*(k). The SEC is also required to consult with and consider the views of the Secretary of the Treasury, the Board of Governors of the Federal Reserve System and the CFTC unless such consultation is impracticable in light of the emergency. 15 U.S.C. 78*l*(k)(6). Certain securities are exempt from this rule. For example, trading of exempted securities may not be suspended under this rule. The term "exempted securities" generally includes government securities (e.g., U.S. treasuries), municipal securities and certain other securities excluded from the definition of an "investment company" (15 U.S.C. 80a-3(c)) under the Investment Company Act of 1940. 15 U.S.C 78c(a)(12).

7 *See* Exchange Act Rule 15c2-11 and FINRA Rule 6432.

8 *See,e.g.*, 17 CFR 240.12d2-1 (this authority is often used to pause trading for pending material news or, in the case of the NYSE, when there is a significant imbalance in the pending buy and sell orders); FINRA Rules 6120 (Trading Halts), 6121 (Trading Halts Due to Extraordinary Market Volatility), and 6440 (Trading and Quotation Halt in OTC Equity Securities); 15 U.S.C. 12a(9) (the CFTC's authority under this provision includes setting temporary emergency margin levels on any futures contract and fixing limits that may apply to a market position acquired before the emergency); Nasdaq Futures Exchange (NFX) Rules, Section 13; CME Rule 579A; 17 CFR 38.255.

9 *See* Cboe Global Markets, Inc., "Cboe Global Markets Reports March 2020 Trading Volume" (Apr. 3, 2020), https://prn.to/2YQGbAQ (accessed May 26, 2020). Volumes started to return to normal historical levels in April 2020, but remained elevated compared to April 2019. *See* Nasdaq, "Cboe Global Markets Reports April 2020 Trading Volume" (May 5, 2020), https://bit.ly/3gn8PzI (accessed May 26, 2020).

10 A list of trading suspensions pursuant to this authority is available here: https://bit.ly/2ZxMBUv.

11 Note, for example, the suspensions relating to Applied BioSciences Corp. on April 13, 2020 ("because questions have arisen concerning the accuracy and adequacy of publicly-available information concerning [the company]. The questions relate to statements that [the company] made about selling coronavirus test kits for home use in a March 31, 2020 press release issued by the Company") and Turbo Global Partners, Inc. on April 9, 2020 ("because of questions that have been raised about the accuracy and adequacy of information in the marketplace relating to [the company's] common stock, including statements to address the COVID-19 pandemic that were contained in press releases issued by [the company] …").

12 SEC, "Press Release: SEC Charges Companies and CEO for Misleading COVID-19 Claims" (May 14, 2020), https://bit.ly/2Zz1RAR.

13 Matthew J. Belvedere, CNBC, "SEC chair: We shouldn't ban short selling — it's needed for properly functioning market" (Mar. 30, 2020), https://cnb.cx/38iB6EG.

14 *Id.*

15 *See Short Sales*, 69 Fed. Reg. 48,008 (Aug. 6, 2004), *available at* https://bit.ly/2D64eDH.

16 Phil Mackintosh, Nasdaq, "Markets Enter The Eye of the Coronavirus Storm" (Apr. 2, 2020), https://bit.ly/31JRtZo.

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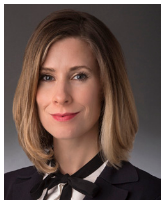


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