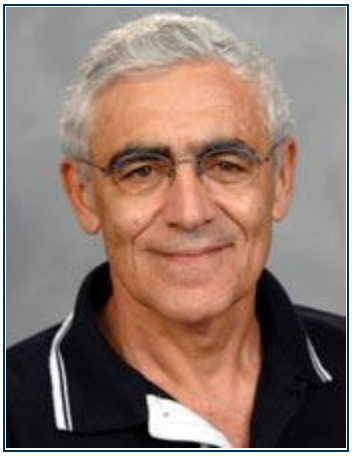
Commentary

Circuit Breakers Don't Hold Answer To Market Glitches

Menachem Brenner, 05.12.10, 04:16 PM EDT

Let the exchanges decide their trading rules for their customers.



After the Dow dropped 1,000 points on May 6--including 30% to nearly 100% drops from stocks like **Procter & Gamble** and **Accenture**--the SEC acted swiftly, forcing the electronic exchanges to initiate a uniform 10% individual stock circuit breaker. As the NYSE already had an individual stock circuit breaker, the big drop actually occurred on the exchanges that did not have one in place.

As of now there is no coherent explanation (computer glitch, super big order) for how this precipitous drop in market prices happened. The complexities and nuances of fast inter-market trading are not that easy to decipher. To the SEC the solution is simple: Let's trade slowly. While the SEC introduced a rule to encourage the move to faster electronic trading platforms--the Reg NMS trade-through Rule--it now seems it "needs" to slow trading. This is a paradox.

The 10% price drop circuit breakers across all markets will most likely prevent another glitch of last week's magnitude, but placing an across-the-board circuit breaker will distort the market in unplanned ways. Price circuit breakers will actually cause higher volatility as trading habits will shift to allow for this "circuit breaker" as in the old "magnet effect." Circuit breakers are a form of the old price limits that existed mainly in futures exchanges and some stock exchanges.

Suppose a stock price declined by 5% to 6% in a short time period and that the "circuit breaker" limit was 10%--traders who had long positions and did not plan to sell at current prices will become concerned that if they don't act now the price will hit the 10% limit and trading is halted. Without the circuit breaker they may not rush to sell. An arbitrary circuit breaker price will exacerbate the decline by stimulating selling as a price approaches the circuit limit. Thus the price will approach the limit

faster than it would without the stop limit. There will be more volatility with the adoption of mandatory, uniform circuit breakers across multiple U.S. exchanges.

But there is a better solution. I propose that we do not force any exchange to adopt circuit breakers and let the exchanges decide their trading rules for their customers. At the same time, eliminate the Reg NMS trade-through Rule so no exchange is at a disadvantage. Let exchanges compete across all trading dimensions: a "hybrid system" (NYSE) vs. a fully "electronic" one (Direct Edge); a "quote driven" (market making) system vs. an "order driven" one; a system that uses circuit breakers vs. one that does not use them. Buyers and sellers need to be able to direct their orders to the exchange of their choice based on their trading strategies--and not necessarily the one with the best bid and offer prices. Such a system will be less vulnerable to "glitches" of the sort we witnessed, less volatile and more efficient.

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