SAY GOODBYE TO AN 8/24 CULPRIT

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This blog post is relevant to institutional investors interested in trading exchange-traded funds (ETFs) in significant volume. Individual investors do not always have access to liquidity providers to trade ETFs as referenced below. Extreme volatility, limit up-limit down regulation, market orders, stop-loss orders and NYSE Rule 48 all contributed to the last major market volatility event seen on August 24, 2015. Although not the cause of the issues on 8/24, many exchange-traded funds (ETFs) were affected by a collision between market volatility and market structure. One of the key factors in why market participants had difficulty pricing ETFs during the opening minutes of 8/24 centered on a little-known and antiquated rule by the NYSE, called Rule 48. As industry leaders and regulators continue their post mortem on the events of 8/24, the NYSE recently announced that the SEC approved its proposal to eliminate Rule 48. This comes as little surprise to market participants, as many felt the rule only exacerbated the issues seen during the first hour of trading on 8/24. **What Is Rule 48?** Rule 48 is enacted in times of high volatility and is designed to open the market quickly. Market makers are not required to give opening indications in single stocks, in hopes of speeding up the opening process by letting natural buyers and sellers define price discovery. However, on 8/24, Rule 48 actually caused the opposite of its intended purpose: many stocks listed on the NYSE did not open for trading until after 9:45 a.m. EST. The reason for this was that these stocks had very large opening sell imbalances. If an equilibrium price cannot be determined by the market open, then the intervention of a floor specialist is required to open the stock, and on 8/24 over 1,000 stocks experienced a delayed opening.[1] After its implementation on January 22, 2008, Rule 48 was invoked at least 77 times between September 2008 and September 2015. Why was August 24, 2015, different from the rest? Besides it being an extremely volatile day, the markets are becoming more electronic with each passing day. Rule 48 can require the intervention of humans, and on 8/24, there simply were not enough floor specialists left in an almost entirely electronic market to handle the amount of manual stock openings required. This human element of Rule 48 is why the rule has become antiquated in an electronic marketplace. **How Rule 48 Affected ETFs** It's important to remember that ETFs are just a wrapper around a basket of securities. They are built and priced around the notion of transparency. On 8/24, Rule 48's absence of opening price indications and the effect the rule had in delaying stock openings only added to the lack of price transparency in many assets that ETFs track. This lack of pricing transparency in underlying assets translated to extreme risk for market makers, which resulted in wide bid/offer spreads in ETFs being quoted from their electronic quoting systems. 8/24 is a great real-time example of why it is so important to control the price of your execution by *always* using limit orders when trading in the secondary market, especially in times of high volatility. Should an investor have used a market order or stop-loss order (that turns into a market order when its stop price is reached) during the first 30 minutes of trading on 8/24, they would have had their orders execute immediately at whatever potentially wide bid or offer was in place at that time. In hindsight, Rule 48 was one of the contributing factors to the events that caused pricing issues in ETFs on 8/24. We think the decision to eliminate Rule 48 is a step in the right direction, as this can only create better market quality, not only for ETFs but for all exchange-traded securities. [1]Source: J.P. Morgan 9/16/15 – Market Structure Update: Focus on August 24, 2015.

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DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Limit up-limit down rule (LULD) : FINRA mechanism to prevent trades in NMS stocks from occurring outside of specified price bands, coupled with trading pauses to accommodate more fundamental price moves.

Market Orders : An order that an investor makes through a broker or brokerage service to buy or sell an investment immediately at the best available current price.

Stop-loss market orders : an order whereby the investor instructs the broker to automatically sell the stock if it drops to a certain price.

NYSE Rule 48 : is a mechanism used by the New York Stock Exchange to ease market opening while volatility is high. It may have the effect of pre-empting trading at disrupted prices, as the designated market makers do not have to disseminate price indications prior to the market open.

SEC : U.S. Securities and Exchange Commissio.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

Opening Indications : the supply and demand of both investors and market makers in an individual security prior to the market open.

Price Discovery : The process of the market finding a fair price for an asset through the process of bringing together buyers and sellers.

Equilibrium Price : the optimal price where supply meets depend in a security.

Limit Orders : An order placed with a brokerage to buy or sell a set number of shares at a specified price or better.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.