

AUGUST 24 REVISITED: WHAT HAS CHANGED?

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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. As we mark the [one-year anniversary of August 24](#), investors may be asking what has been done since that [volatile](#) and chaotic day and if it could happen again. One year ago, on August 24, 2015, U.S. [futures](#) hit [limit down](#) before the U.S. markets opened, followed by more than 1,200 halts that morning across all listed U.S. securities. As a result of the tremendous amount of trading halts, all market participants were struggling to find clarity of value for both futures and individual stocks. The lack of clarity in turn caused a large cross-section of ETFs to trade at much wider [spreads](#) than normal. ETFs are meant to reflect the value of their underlying components so that when market structure rules impact individual stocks, they also directly impact their ETF wrapper, which was extremely evident on August 24. Over the past year, ETF issuers, trading firms, regulators and key ETF industry leaders have met numerous times to discuss the day and what improvements could be implemented to avoid a similar disruptive event. The events of August 24, 2015, occurred as a result of previous attempts by the Securities and Exchange Commission (SEC) to curb market volatility. The primary attempt approved on May 31, 2012, was the National Market System Plan to Address Extraordinary Market Volatility, also known as the [Limit Up-Limit, Down, or LULD Plan](#). This had been authorized after the sudden and extreme price movements that the market experienced on the afternoon of May 6, 2010. The plan was designed both to prevent trading in individual securities outside of specified price bands, or "LULD bands," and also to invoke trading pauses when significant price movements occurred in short time periods. The goal was to protect investors and promote fair and orderly markets. While in theory this was ideal, its first large-scale test was the infamous morning of August 24, 2015. Over the past year, the exchanges have worked tirelessly with all relevant players to learn from August 24 and to pinpoint areas for market structure improvement and harmonization. Just a few weeks back, [NYSE eliminated Rule 48](#) as a step toward amending antiquated market structure practices. Furthermore, as announced on August 11, all three exchanges will file with the SEC a set of exchange rules as well as an update to the LULD Plan in the coming weeks. There are four key areas of focus: **1) Eliminating the time periods in which securities could trade without LULD bands in place 2) Reducing the number of trading pauses 3) Standardization of primary exchange automated reopenings following a trading pause 4) Elimination of clearly erroneous execution rules when LULD bands are in effect***

Let's elaborate on each of these focuses. First, the three exchanges have or are in the process of implementing systematic "leaky band protections" following a trading pause. At the moment, there is a small two- to three-millisecond window for securities to trade with no LULD bands in place between the trade resumption and the publication of the new reference LULD bands after moving out of that halt. While small, this can cause price dislocation and even new trading halts, and it's a loophole that needs to be closed. Going forward, all exchanges must calculate the bands themselves or wait until the new bands are disseminated to begin continuous trading. Second, the exchanges already implemented coordinated changes by adding Amendment 10 to the LULD Plan. Amendment 10 uses the previous day's closing price as the reference price at the open on occasions when there is no opening print on the primary exchange. Previously, the reference price would be the midpoint of the national best bid and best offer, which could be extremely wide and therefore inaccurate, causing price dislocations and halts. Since the addition of Amendment 10, there has been a more than 75% reduction in the number of spurious trading pauses. Prior to Amendment 10, spurious pauses occurred in thinly traded securities that lacked trading activity and then halted because of the adverse effect of setting LULD bands based on skewed quotes. Third, all three exchanges have finalized changes to the LULD Plan via Amendment 11. When a halt auction reopening cannot be conducted, there will be harmonized and specific rules across the exchanges to rationally and methodically reopen a security. Previously, each exchange had different reopening methodologies that would often result in reopenings that subsequently caused further halts and price dislocations. Lastly, the exchanges are currently conducting further data-driven analysis and are considering market participant feedback to recommend changes to, or

elimination of, clearly erroneous execution rules. Research on security-tier classifications and LULD band widths is also in progress. This is just the beginning of a series of changes and filings to further improve market structure and key functions of the U.S. equity markets, especially during times of extreme volatility. The primary goal is to increase the resiliency of such an electronic marketplace and to protect the investor. While many investors would like to see more rapid change, it is vital that changes be implemented incrementally. August 24 illustrated how a set of market structure rules, tested in theory but not in practice, can cause unintended consequences in the marketplace. What is paramount to know is that countless hours, personnel, teams and focus have been put toward creating an improved and harmonized marketplace.

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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.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.