

MEMO# 24415

July 12, 2010

SEC Publishes Proposed Rules for Clearly Erroneous Trades

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 36-10
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 19-10
ETF ADVISORY COMMITTEE No. 27-10
EQUITY MARKETS ADVISORY COMMITTEE No. 26-10
SEC RULES MEMBERS No. 63-10 RE: SEC PUBLISHES PROPOSED RULES FOR CLEARLY
ERRONEOUS TRADES

Following the market disruption of May 6, the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA") have filed proposals with the SEC that would clarify the process for breaking erroneous trades. [\[1\]](#) The proposed rules would establish a set of thresholds for breaking trades when prices diverge from the "Reference Price," typically the last sale before pricing was disrupted. The rules would provide for uniform treatment: (1) in the event transactions occur that result in the issuance of an individual stock trading pause by the primary listing exchange and subsequent transactions that occur before the trading pause is in effect on another exchange; and (2) of clearly erroneous execution reviews in events involving 20 or more stocks. They also would limit the ability of the exchanges and FINRA to deviate from the proposed standards. [\[2\]](#) Lastly, the proposed rules would be in effect on a pilot basis through December 10, 2010.

Stocks Subject to Single Stock Circuit Breakers

With respect to stocks that are subject to single stock circuit breakers, [\[3\]](#) the proposed rules would provide that trades would be broken at the following specified levels:

- For stocks priced \$25 or less, trades would be broken if the trades are at least 10 percent away from the circuit breaker trigger price;
- For stocks priced between \$25 to \$50, trades would be broken if they are 5 percent

away from the circuit breaker trigger price;

- For stocks priced more than \$50, trades would be broken if they are 3 percent away from the circuit breaker trigger price; and
- For leveraged ETF/ETN securities, trades would be broken based on the numerical guidelines multiplied by the leverage multiplier (i.e., 2x).

According to the proposals, an exchange would be allowed to use the price that triggered a trading pause in an individual security ("Trading Pause Trigger Price") as the Reference Price for clearly erroneous execution reviews of a transaction that triggers a trading pause ("Trigger Trade") and transactions that occur immediately after a Trigger Trade but before a trading pause is in effect on the exchange. The Trading Pause Trigger Price would reflect a price calculated by the primary listing exchange over a rolling five-minute period and could differ from the execution price of a transaction that triggered a trading pause. Where a trading pause was triggered by a price decline (rise), an exchange would limit its review to transactions that executed at a price lower (higher) than the Trading Pause Trigger Price.

The proposed rules also would provide that decisions reviewing transactions under the single stock circuit breakers provision would not be subject to appeal when made in conjunction with one or more exchanges.

Stocks Not Subject to Single Stock Circuit Breakers

For those stocks not yet subject to single stock circuit breakers, the proposed rules would provide that trades would be broken at the following specified levels:

- For events involving between 5 and 20 stocks, trades would be broken that are at least 10 percent away from the reference price; and
- For events involving more than 20 stocks whose executions occurred within a period of 5 minutes or less, trades would be broken that are at least 30 percent away from the reference price.

In connection with reviews of events involving twenty or more stocks, the proposals would provide that decisions made by an exchange in consultation with other exchanges may be such that immediate finality is necessary and, thus, the decisions could not be appealed. Further, for such events, an exchange could use a Reference Price other than the consolidated last sale. Finally, according to the proposals, an exchange would need to promptly coordinate with the other exchanges to determine the appropriate review period, which could be greater than the period of 5 minutes or less that triggered application of the proposed rules, and would need to select one or more specific points in time prior to the transactions in question and use transaction prices at or immediately prior to the one or more specific points in time selected as the Reference Price.

Heather L. Traeger
Associate Counsel

endnotes

[1] See SEC Press Release 2010-104, SEC to Publish for Comment Proposed Rules for Clearly Erroneous Trades, June 17, 2010, available at <http://www.sec.gov/news/press/2010/2010-104.htm>. See also, SEC Release No. 62340 (June 21, 2010), File No. SR-BATS-2010-16; SEC Release No. 62336 (June 21, 2010), File No. SR-CHX-2010-13; SEC Release No. 62338 (June 21, 2010), File No. SR-EDGA-2010-03; SEC

Release No. 62339 (June 21, 2010), File No. SR-EDGX-2010-03; SEC Release No. 62330 (June 21, 2010), File No. SR-ISE-2010-62; SEC Release No. 62341 (June 21, 2010), File No. SR-FINRA-2010-32; SEC Release No. 62342 (June 21, 2010), File No. SR-BX-2010-40; SEC Release No. 62334 (June 21, 2010), File No. SR-NASDAQ-2010-76; SEC Release No. 62331 (June 21, 2010), File No. SR-NSX-2010-07 SEC Release No. 62333 (June 21, 2010) File No. SR-NYSE-2010-47; SEC Release No. 62332 (June 21, 2010), File No. SR-NYSEAmex-2010-60; SEC Release No. 62335 (June 21, 2010), File No. SR-NYSEArca-2010-58. Comments are due to the Commission by July 19, 2010.

[\[2\]](#) The proposed rules only would permit an exchange to nullify transactions consistent with the numerical guidelines contained in the rules if there is a disruption or malfunction in the operation of the exchange's system. The rules also would make clear that any officer of an exchange or other senior level employee reviewing transactions on his or her own motion must follow the guidelines set for in the proposed rules with respect to single stock circuit breakers.

[\[3\]](#) Stocks currently subject to single stock circuit breakers include those in the S&P 500 Index.