

**MEMO# 35621**

February 20, 2024

# **SEC Institutes Proceedings to Determine Whether to Approve Proposed Change to Categorize Most ETFs at Tier 1 Securities for Purposes of Limit Up-Limit Down**

[35621]

February 20, 2024

TO: ICI Members

Equity Markets Advisory Committee

ETF (Exchange-Traded Funds) Committee SUBJECTS: Exchange-Traded Funds (ETFs)

Trading and Markets RE: SEC Institutes Proceedings to Determine Whether to Approve Proposed Change to Categorize Most ETFs at Tier 1 Securities for Purposes of Limit Up-Limit Down

On February 15, 2024, the Securities and Exchange Commission (SEC) issued an order instituting proceedings (the "Order") to determine whether to approve or disapprove proposed changes to the National Market System (NMS) Plan to Address Extraordinary Market Volatility (the "Plan") filed by the Plan participants, which consists of the national securities exchanges and the Financial Industry Regulatory Authority (FINRA).<sup>[1]</sup> The Plan participants originally filed the proposed changes with the SEC on October 24, 2023.<sup>[2]</sup> Comments are due 21 days after the Order is published in the Federal Register. As of the date of this memorandum, the Order has not yet been published in the Federal Register.

In general, the Plan governs the market-wide limit up-limit down ("LULD") mechanism that sets forth procedures to prevent trades in individual NMS securities from occurring outside of specified price bands. The Plan participants adopted the Plan to address extraordinary volatility in the securities markets, i.e., significant fluctuations in individual securities' prices over a short period of time, such as those experienced during the "Flash Crash" on the afternoon of May 6, 2010. The proposed changes would amend Appendix A to the Plan to provide that all exchange-traded products ("ETPs") will be assigned to Tier 1 of the Plan, except for single stock ETPs, which will be assigned to the same tier as their underlying stock, and in each case adjusted for any leverage factor.

## Background and Current Plan

Appendix A currently provides that Tier 1 includes all NMS stocks included in the S&P 500 Index, the Russell 1000 Index, as well as "eligible" ETPs. To determine eligibility for an ETP to be included as a Tier 1 NMS Stock, all ETPs across multiple asset classes and issuers, including domestic equity, international equity, fixed income, currency, and commodities and futures are identified. Leveraged ETPs are excluded, and the list is sorted by notional consolidated average daily volume ("CADV"). The period used to measure CADV will be from the first day of the previous fiscal half year up until one week before the beginning of the next fiscal half year. Daily volumes will be multiplied by closing prices and then averaged over the period. ETPs, including inverse ETPs, that trade over \$2,000,000 CADV are included as a Tier 1 NMS Stock. The resulting list is reviewed and updated semi-annually. All ETPs that do not meet the "eligibility" definition, including all leveraged ETPs, are assigned to Tier 2.

For Tier 1 NMS Stocks, Appendix A defines the price band as:

- 5% for securities with a reference price of more than \$3.00;[\[3\]](#)
- 20% for securities with a reference price equal to \$0.75 and up to and including \$3.00; and
- The lesser of \$0.15 or 75% for securities with a reference prices less than \$0.75.

For Tier 2 NMS Stocks, Appendix A defines the price band as:

- 10% for securities with a reference price of more than \$3.00;
- 20% for securities with a reference price equal to \$0.75 and up to and including \$3.00; and
- The lesser of \$0.15 or 75% for securities with a reference price less than \$0.75.

The price band for a Tier 2 NMS Stock that is a leveraged ETP is the applicable price band set forth above, multiplied by the leverage ratio of such product.

## Proposed Plan Amendments

The Plan participants propose to amend Appendix A to delete the definition of ETPs "eligible"

for Tier 1, and to specify that all ETPs, except for single-stock ETPs, would be assigned to Tier 1, adjusted for any leverage factor. Single-stock ETPs would be assigned to the same Tier as their underlying stock.

In support of the proposed changes, Plan participants submitted data, covering trading and quoting in all ETPs during the period from Q4 of 2019 through Q2 of 2021, demonstrating proposed market impacts. During market periods of extreme volatility, such as March 2020 during the COVID pandemic, the narrower price bands did result in more trading halts. However, over the entire study period, a median of nine ETPs per day were impacted by the narrower price bands. Regarding periods of extreme volatility, the Plan participants note that the narrower price bands may prevent retail investors from executing trades at inferior prices that could be occurring due to transitory gaps in liquidity, and thus prevent unnecessary volatility as LULD was intended to do.

The data further demonstrated that after five minutes more than 70% of the trades and nearly 75% of the shares that would have triggered a LULD trading pause had their last quote return to price levels prior to the move that caused the breach of the theoretical Tier

1 price band. Thus, a trading pause would have prevented investors from executing at those inferior prices. The Plan participants note that during the study period, only 7.1% of the trades that executed beyond the narrower theoretical Tier 1 price bands (4.6% of shares executed across the entire study period) ultimately resulted in a trading pause under the price bands currently in place. The Plan participants argue that in such cases, it may be beneficial to trigger a trading pause that will permit a reopening auction, which can more efficiently aggregate liquidity, determine equilibrium prices, reset the price bands, and further mitigate volatility.

The Plan participants provided additional in-depth data analysis that is available in their original filing. An additional point worth noting is that, when the Plan participants analyzed ETPs that had been reclassified from Tier 2 to Tier 1, market quality improved, which was evidenced by the lower quote volatility, tighter spreads, and increased liquidity for such ETPs. However, under current standards a move from Tier 2 to Tier 1 requires increased trading volume, so the move to Tier 1 alone may not be the reason behind such changes.

## **Comments and Solicitation of Questions**

In response to the original filing by Plan participants, the SEC received six comment letters. One was a joint letter by a wide variety of market participants that was in favor of the proposed amendments. The others were short comments, with all but one being no more than a few sentences, from investors that were opposed to the proposed changes. The SEC used this disagreement in the comments to institute proceedings to determine whether to approve or disapprove the proposed amendments.

As part of instituting proceedings, the SEC solicited nine questions. One question related to commenters' view of the proposed changes generally while two questions solicited comments about the potential burdens on competition in the market. Four questions related to particular data presented by the Plan participants or called for additional data. One question related to whether leveraged ETPs should be moved to Tier 1. Another question related to the impact moving all ETPs to Tier 1, other than single security ETPs, would have on ETPs that trade one commodity reference asset, either directly or indirectly through derivative contracts.

Kevin Ercoline  
Assistant General Counsel

## **Notes**

[1] Order Instituting Proceedings to Determine Whether to Approve or Disapprove the Twenty-Third Amendment to the National Market System Plan to Address Extraordinary Market Volatility by Cboe BYX Exchange, Inc., Cboe BZX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., The Financial Industry Regulatory Authority, Inc., Investors Exchange LLC, Long-Term Stock Exchange, Inc., MEMX LLC, MIAX Pearl, LLC, NASDAQ BX, Inc., NASDAQ PHLX LLC, The NASDAQ Stock Market LLC, New York Stock Exchange LLC, NYSE American LLC, NYSE Arca, Inc., NYSE Chicago, Inc., and NYSE National, Inc., Exchange Act Release No. 99545 (Feb. 15, 2024), available at <https://www.sec.gov/files/rules/sro/nms/2024/34-99545.pdf> ("Order").

[2] Notice of Filing of the Twenty-Third Amendment to the National Market System Plan to

Address Extraordinary Market Volatility by Cboe BYX Exchange, Inc., Cboe BZX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., Investors Exchange LLC, Long-Term Stock Exchange, Inc., MEMX LLC, MIAX Pearl, LLC, NASDAQ BX, Inc., NASDAQ PHLX LLC, The NASDAQ Stock Market LLC, New York Stock Exchange LLC, NYSE American LLC, NYSE Arca, Inc., NYSE Chicago, Inc., and NYSE National, Inc., Exchange Act Release No. 98928, 88 Fed. Reg. 81131 (Nov. 21, 2023), available at <https://www.govinfo.gov/content/pkg/FR-2023-11-21/pdf/2023-25543.pdf>.

[3] During the last 25 minutes of the trading day, the price band increases to 10%.

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