MEMO# 35870

October 1, 2024

SEC Order Disapproves Proposed Changes to Limit Up-Limit Down NMS Plan to Categorize Most ETFs as Tier 1

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TO: ICI Members
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee SUBJECTS: Exchange-Traded Funds (ETFs)
Trading and Markets RE: SEC Order Disapproves Proposed Changes to Limit Up-Limit Down NMS Plan to Categorize Most ETFs as Tier 1

On September 16, 2024, the SEC issued an order disapproving 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).[1] The Plan, in general, 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 proposal would have tightened the LULD trigger price bands for exchange-traded products ("ETPs") currently classified as Tier 2 ETPs, with certain exceptions for applicable single stock ETPs. A summary of the proposal, ICI's comment letter, and the SEC's disapproval is below.

The Proposal

The Plan participants originally filed the proposed changes with the SEC on October 24, 2023.[2] The proposed amendments would have amended Appendix A to the Plan to provide that all ETPs be assigned to Tier 1 of the Plan, except for single stock ETPs which would be assigned to the same tier as their underlying stock, and in each case adjusted for any leverage factor. 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, with Tier 1 ETP eligibility covering non-leveraged ETPs that trade over $2,000,000 notional consolidated average daily volume ("CADV") during a specified half year period. Non-eligible ETPs are classified as Tier 2. Tier 1 and Tier 2 classification results in different price bands for LULD trading halts, with Tier 1 ETPs having a 5% price band and Tier 2 ETPs having a 10% price band.[3]

ICI's Comment Letter

ICI submitted a letter supporting the proposed amendments,[4] believing the proposed amendments to be incremental and measured amendments to market structure that protect retail investors and strengthen investor reliance on US markets. ICI's reasoning underlying its support aligned with the letter previously submitted jointly by multiple market participants (the "Joint Letter).[5] In its letter, ICI stated that it does not believe the proposed amendments would have imposed any burden on market competition and would likely result in improved competition as all ETPs, other than single-security ETPs, would have consistent LULD parameters. Finally, in response to the SEC's question on leveraged ETPs, ICI emphasized the importance of maintaining the leverage factor adjustment.

SEC's Disapproval

While Participants contended, and ICI agreed, that the Proposal would improve market quality, more effectively dampen volatility, and provide greater investor protection, the SEC did not believe that the data provided and assertions made by Participants in the Proposal carried the burden of demonstrating consistency with Rule 608.[6] In particular, the SEC found that the aggregate statistical analysis of the potential costs and benefits of designating Tier 2 ETPs as Tier 1 securities provided by the Participants did not provide sufficient detail and specificity concerning the different trading characteristics of individual ETPs, with single reference asset-based Tier 2 ETPs being cited as a particular SEC concern. The SEC stated its concern that the data did not reflect all potential effects of the proposed changes and posited hypotheticals about how a more granular statistical analysis could show that moving certain Tier 2 ETPs to Tier 1 could unduly interrupt trading activity driven by fundamental value changes as opposed to trading activity driven by transitory gaps in liquidity. Additionally, in response to the Participants' supplemental analysis related to volatility and price reversion that was later submitted, the SEC believed such data was neither robust nor compelling.[7] Due to concerns that the Proposal could cause excessive straddle states, limit states, and trading pauses in certain affected ETPs due to proposed tighter price bands, the SEC disapproved the Proposal.

Kevin Ercoline
Assistant General Counsel

Notes

[1] Order Disapproving the Twenty-Third Amendment to the National Market System Plan to Address Extraordinary Market Volatility, Exchange Act Release No. 34-101036 (Sep. 16, 2024), available at https://www.sec.gov/files/rules/other/2024/34-101036.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 ("Proposal").

[3] These price bands apply to ETPs with a reference price of more than $3. During the last

25 minutes of the trading day, the Tier 1 price band for securities with a reference price of more than $3 increases to 10%. Price bands for Tier 1 and Tier 2 securities with a reference price of $3 or less are the same, with the price bands being broader based on the security's reference price.

[4] Letter from Kenneth Fang, Associate General Counsel, and Kevin Ercoline, Assistant General Counsel, Investment Company Institute, to Vanessa Countryman, Secretary, SEC (Mar. 14, 2023), available at https://www.sec.gov/comments/4-631/4631-445919-1140962.pdf.

[5] Letter from Samara Cohen, Chief Investment Officer of ETF and Index Investments, BlackRock, et al., to Vanessa Countryman, Secretary, SEC (Dec. 18, 2023), available at https://www.sec.gov/comments/4-631/4631-316879-826042.pdf.

[6] 17 CFR 242.608(b)(2). Rule 608(b)(2) conditions approval of proposed amendments on a finding that they are "necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the Exchange Act."

[7] The SEC found the price reversion analysis to be flawed because (1) the analysis was done on an aggregate basis for all Tier 2 ETPs, (2) the analysis compared trade prices that occurred outside of the theoretical Tier 1 bands to subsequent midpoint prices, and (3) the SEC did not believe that the analysis supported the Participants' statement that investors would have been protected by the tighter band. The SEC found the volatility analysis to be flawed because (1) it was insufficiently granular and (2) that volatility is an imprecise metric for determining price bands.