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ALERT MEMORANDUM

# COVID-19: A Brief Guide to Circuit Breakers and Powers to Close the Market

*March 20, 2020*

In recent weeks, global markets have experienced a dramatic increase in volatility in reaction to the coronavirus (COVID-19) pandemic. In the United States, market declines have triggered market-wide circuit breakers on multiple occasions, and questions have been raised about potential temporary closures in U.S. securities and futures markets and remedies available in the event that securities transactions fail to settle. Below is a summary of key authorities and procedures. More detail is included in the **Annex**.


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## Emergency Powers

Securities and Exchange Commission (SEC) Chairman Jay Clayton and New York Stock Exchange (NYSE) President Stacey Cunningham expressed strong support on March 16 for keeping U.S. equities exchanges open during the crisis. Meanwhile, on March 17, U.S. Treasury Secretary Steven Mnuchin indicated that President Trump's administration "absolutely believe[s] in keeping the markets open," but also that the trading day may be temporarily shortened.

The President and regulators have the authority, however, to impose greater restrictions on the markets, including halting trading for extended periods, such as after the attacks of September 11, 2001 and in the wake of Hurricane Sandy, or taking steps to alter other aspects of the market, such as the prohibition on short sales during the financial crisis in 2008. These emergency powers include:

- **President**. The President has broad emergency powers, especially as regards foreign exchange transactions and other cross-border transfers.
- **SEC**. The SEC can summarily suspend trading of non-exempt securities "on any national securities exchange or otherwise" for a period not to exceed 90 days. This power may be exercised only after the SEC has notified the President of its decision and the President has further notified the SEC that the President does not disapprove of the decision. The President may terminate the SEC's action at any time. The SEC may exercise this power if "in its opinion the public interest and the protection of investors so require." It is expected to consult with the

Federal Reserve, the Secretary of the Treasury and the Commodity Futures Trading Commission (CFTC) unless it is impracticable under the circumstances.

- **CFTC**. If it "has reason to believe that an emergency exists," the CFTC can direct a futures exchange to "take such action as in the [CFTC]'s judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the [CFTC]'s action." An "emergency" includes, among other things, any "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand" for a commodity.
- **Exchanges and FINRA**. The U.S. securities and futures exchanges and Financial Industry Regulatory Authority (FINRA) generally have broad authority to close their markets. For example, the CEO of the NYSE may halt or suspend trading in some or all securities on the exchange if she determines "such action to be necessary or appropriate for the maintenance of a fair and orderly market, or the protection of investors or otherwise in the public interest, due to extraordinary circumstances" including a "request by a government agency or official."

Although it seems unlikely at this point that these powers will be invoked, market participants should consider potential implications, such as:

- Inability to close out short sale positions or effect buy-in purchases for fails.
- Impact on outstanding derivatives transactions that provide for physical settlement.
- Disruption of the valuation of outstanding derivatives transactions that reference market pricing.
- Inability to hedge outstanding securities and derivatives positions.

**<u>Pre-Existing Measures</u>**

The SEC, CFTC, FINRA and securities and futures exchanges have several pre-existing measures in place to address extraordinary market volatility and ensure settlement of securities transactions. These include:

- **Market-Wide Circuit Breakers**. These measures, triggered in response to price declines based on the S&P 500 Index, halt trading for 15 minutes or, if the market decline is more extreme, can halt trading for the remainder of the day. These circuit breakers have been triggered four times since the outbreak of the COVID-19 pandemic, most recently on March 18.
- **Limits Down Procedures**. Individual stocks and futures contracts are generally subject to procedures that limit trading outside of a specified price band relative to the previous day's price, with temporary trading halts (*e.g.*, for five minutes in the case of U.S. listed securities) possible if trading does not resume within the price band after a specified monitoring period.
- **Short Sale Price Test**. Once the price of a security declines 10 percent or more from the previous day's closing price, SEC rules generally prevent the entry of short sales in that security at a price lower than the current best bid.
- **Failed Trades**. FINRA and other self-regulatory organizations (SROs) have rules that prescribe certain "buy-in" procedures for failed securities trades, and market practices prescribe fails charges for failed trades in government securities.

**Market Stability Measures**

The Federal Government and U.S. regulators have multiple tools available in times of severe stress to attempt to stabilize U.S. securities and futures markets. These include market-wide trading suspensions, limit up/down procedures, and restrictions on certain short sale orders, which each carry their own automatic triggers. The President of the United States and regulators, including the SEC, CFTC, and exchanges and other SROs, may also act to suspend trading even in the absence of a specific triggering event.

**Emergency Powers**

| Governmental Authority | Power |
| --- | --- |
| President of the United States | Pursuant to the International Emergency Economic Powers Act, the President of the United States is empowered to declare a national emergency with respect to an "unusual and extraordinary threat, which has its source in whole or in substantial part outside the United States, to the national security, foreign policy, or economy of the United States."[1] Once such an emergency is declared, the president may investigate, regulate, or prohibit cross-border currency or securities transactions by any person, or with respect to any property, subject to the jurisdiction of the United States.[2] |
| SEC | The SEC has broad powers to issue trading suspensions in both individual securities and across U.S. securities markets and to otherwise impose requirements or restrictions on the markets. Most significantly, under Section 12(k) of the Securities Exchange Act of 1934 (Exchange Act):<br>• If the SEC finds it to be in the public interest and protection of investors, it may order the summary suspension of trading in any individual security (other than an exempted security) for up to 10 business days, and to suspend all trading "on any national securities exchange or otherwise in securities other than exempted securities" for up to 90 calendar days. Suspensions of all trading across any exchange or otherwise are subject to notice to and approval or disapproval of the President.<br>• If the SEC finds an "emergency" and that it is in the public interest and protection of investors, it may summarily act to "alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the [SEC] or [an SRO] under the securities laws" for an effective period of up to 10 business days, extendable up to 30 days if the SEC finds it necessary. |
| CFTC | Under Section 8a(9) of the Commodity Exchange Act, if the CFTC "has reason to believe that an emergency exists," it can direct a futures exchange to "take such action as in the [CFTC]'s judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the [CFTC]'s action." An "emergency" includes, among |

[1] 50 U.S.C. § 1701.
[2] 50 U.S.C. § 1702.

| Governmental Authority | Power |
|---|---|
| | other things, any "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand" for a commodity. |
| Exchanges and SROs | Subject to making certain findings, FINRA and U.S. securities and futures exchanges generally have broad authority to halt trading in the over-the-counter securities markets, in the case of FINRA, or their respective individual exchanges. |

**Existing Market Stability Measures**

| Stability Measure | Operation |
|---|---|
| Market-Wide Circuit Breakers | FINRA and all national securities exchanges have adopted uniform market-wide circuit breakers to halt trading in all equity securities once price declines have hit certain thresholds. Under current standards, thresholds are triggered when the S&P 500 Index declines by 7% (Level 1), 13% (Level 2) and 20% (Level 3) in intraday trading. Market declines between 9:30 am ET and 3:25 pm ET at both Level 1 and Level 2 result in a 15-minute halt in all trading in U.S. equity and options markets. Such declines after 3:25 pm in a given trading day do not result in a trading halt. However, where a Level 3 market decline occurs at any point in a given trading day, all equity and options trading will be halted until the next trading day.[3] The Chicago Mercantile Exchange (CME) has parallel procedures for its related futures and options contracts. |
| Limit-Up / Limit-Down | Under the limit-up / limit-down national market system plan, major U.S. securities exchanges[4] and FINRA have adopted procedures to prevent all trading in individual stocks outside of specified price bands determined, depending upon the security, at a specified percentage from either the prior day's closing price or the reopening auction price for the individual stock. Where the national best bid equals the upper price band or the national best offer equals the lower price band for any individual security, that security will enter a "limit state." If all quotes at the price band in question are executed or canceled within 15 seconds, the stock will exit that limit state. However, if the market does not exit the limit state within 15 consecutive seconds and trading cannot occur within that stock's price band, the primary listing exchange will declare a five minute trading halt.[5] The CME and other futures exchanges also have relatively similar price limit procedures for the contracts they list. |
| Short Sale Price Test | Rule 201 of SEC Regulation SHO, which applies to equity securities, generally prevents the execution or display of a short sale at an impermissible price when a stock has triggered a circuit breaker by experiencing a price decline of at least 10 |

[3] During the current period of high market volatility resulting from the COVID-19 pandemic, Level 1 circuit breakers have been triggered on four separate occasions following the opening of trading on March 9, 12, 16, and 18.
[4] These exchanges are: CBOE BYX Exchange, Inc., CBOE BZX Exchange, Inc., CBOE EDGA Exchange, Inc., CBOE EDGX Exchange, Inc., Chicago Stock Exchange, Inc., Investors Exchange LLC, NASDAQ BX, Inc., NASDAQ PHLX LLC, The NASDAQ Stock Market LLC, NYSE National, Inc., NYSE LLC, NYSE American LLC, and NYSE Arca, Inc.
[5] After five minutes, the primary listing exchange will attempt to reopen trading in that security. If it is unable to do so, it can extend the halt by another five minutes. If the primary listing exchange has not reopened trading after ten minutes, any national securities exchange that trades that security may resume trading.

| Stability Measure | Operation |
|---|---|
| | percent in one day, as calculated based on the stock's prior day's closing on its listing market. If a short sale price test is in effect, then market participants will not be able to execute or display a short sale at a price that is less than or equal to the current national best bid.[6] Once the short sale circuit breaker has been triggered, the price test restriction will apply to short sale orders in that security for the remainder of the day and the following day, unless an exception applies. |

**Resolving Settlement Failures**

Increased volatility and decreased liquidity can also lead to an elevated volume of settlement failures, as market participants are unable to obtain securities to settle transactions (especially short sales). Regulators and markets have adopted rules to resolve settlement failures. In particular, close out procedures such as "buy-in" rules provide mechanisms to encourage settlement and provide participants in failed securities transactions methods to mitigate costs. The SEC, U.S. Department of the Treasury (Treasury), FINRA, the Municipal Securities Rulemaking Board (MSRB) and the clearing agencies have all adopted rules designed to ensure timely settlement and that permit buyers in failed securities transactions to purchase securities in the open market and pass costs for doing so on to the non-performing counterparty. These rules generally govern the settlement of securities between market intermediaries (such as broker-dealers and clearing agencies); delivery of securities between broker-dealers and their customers, with some exceptions, will generally be established by the relevant account agreements.

**Centrally Cleared Securities Transactions**

| Authority | Procedure |
|---|---|
| SEC Rules | Under Rule 204 of SEC Regulation SHO, participants of a registered clearing agency generally must deliver securities to such clearing agency on a long or short sale transaction in any equity security by settlement date, or must close out a fail to deliver in that equity security, by delivery to the clearing agency, by the times set forth in the Rule.<br><br>A fail to deliver for a short sale must be closed out by no later than the beginning of regular trading hours on the settlement day following the settlement date (*i.e.*, T+3). A fail to deliver for a long sale or that is attributable to bona-fide market making activities must be closed out by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date (*i.e.*, T+5). |

[6] This prohibition is accomplished by requiring all "trading centers" to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent either the display or execution of any orders that are equal or less than the current national best bid once the circuit breaker has been triggered. "Trading center" means "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent."

| Authority | Procedure |
|---|---|
| Clearing Agencies | Clearing agencies, such as the National Securities Clearing Corporation (NSCC)[7] and Fixed Income Clearing Corporation (FICC),[8] have adopted rules allowing members to close out fail to receive positions.<br>• NSCC – Under NSCC Procedure X, a participant sends NSCC a notice of intent to execute a buy-in generally two days following delivery of the notice. To execute a buy-in, the participant purchases the undelivered securities in any marketplace of its choosing and provides the purchase details to NSCC. The NSCC participant who failed to deliver the securities assumes the liability for any loss which occurs as a result of the buy-in execution.<br>• FICC – Under FICC Rule 11, a participant sends FICC a notice of buy-in for a failed transaction and FICC sends the notice to one or more other participants with the longest dated open net short positions (i.e., participants who owe securities to FICC). The purchasing party may also buy-in the counterparty outside of FICC and FICC will, in effect, cancel the failed trade in its system. |

**Non-Centrally Cleared Securities Transactions**

Bilateral transactions are generally subject to buy-in and close-out rules and procedures depending on the type of product that is the subject of the transaction. FINRA rules are generally applicable to transactions in securities other than government or municipal securities, which are governed by regulations adopted by the Treasury and MSRB, respectively.

| Authority | Procedure |
|---|---|
| FINRA – Equities and Corporate Debt Securities | FINRA Rule 11810 generally provides that a buyer in a failed securities transaction may deliver a written notice of buy-in to the failing seller two business days before the execution of the proposed buy-in date.[9] The buy-in notice is deemed to be accepted unless the seller affirmatively rejects the notice. Failure to deliver at the buy-in date allows the buyer to close the securities contract by purchasing all or part of the securities necessary to satisfy the amount requested in the buy-in notice.<br>FINRA also provides a process to "sell out" under FINRA Rule 11820. which is not restricted to a certain kind of securities transaction. Specifically, a selling broker-dealer to a failed securities transaction may, without notice, sell the relevant securities, or any portion of the securities, due under the contract in the best available market and for the account and liability of the defaulting buyer. The seller must, as promptly as possible, notify the broker-dealer for whose account and risk such securities were sold on the execution date. |

[7] NSCC acts as the central counterparty for most broker-to-broker trades involving equities, corporate and municipal debt, American depositary receipts, exchange traded funds and unit investments trusts.
[8] FICC acts as the central counterparty for transactions in government securities.
[9] FINRA's buy-in rules do not apply to transactions in municipal securities, securities exempt under Section 3(a)(12) of the Exchange Act, primary issuances in redeemable securities issued by registered investment companies, Direct Participation Program securities or securities subject to the buy-in requirements of a national securities exchange or registered clearing agency.

| Authority | Procedure |
|---|---|
| Treasury – Government Securities | Treasury's buy-in rules are found in Rule 403.4 (for registered government securities broker-dealers) and Rule 403.5 (for financial institutions):<br>• For fail to receive buy-ins, these firms must take prompt steps to obtain possession or control of government securities included on their books as "failed to receive" for more than 30 calendar days for government securities that are not mortgage-backed securities (MBS) and 60 calendar days for MBS through a buy-in procedure or otherwise.<br>• For sell order buy-ins, firms that execute customer sell orders but have not obtained possession of non-MBS within 30 calendar days or MBS within 60 calendar days must immediately close the transaction with the customer by purchasing, or otherwise obtaining, securities of like kind and quantity.  This sell order buy-in rule does not apply to customer short sales.<br>• In addition, the Treasury Market Practices Group, a group of market participants sponsored by the Federal Reserve Bank of New York that issues recommendations for best practices in government securities markets, recommends that government securities market participants assess and pay "fails charges" for failed deliveries of government securities.[10]  Fails charges are penalties that accrue over the life of a delivery failure and become due upon delivery.  The charge amount is based upon the value of the underlying securities and is designed to partially compensate the buyer for losses and encourage timely delivery by the seller.  Market participants that have adopted the practice agree to the charges as a matter of contract. |
| MSRB – Municipal Securities | MSRB Rule G-12(h) provides for buy-in in the case of failed inter-dealer municipal securities transactions no later than ten calendar days after settlement.  On the first day after the missed settlement, the purchasing dealer may send a buy-in notice to the seller.  The buy-in may then be executed, at the earliest, on the fourth calendar day after the notice has been delivered. |

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[10] Treasury Market Practices Group and Securities Industry and Financial Markets Association, *U.S. Treasury Securities Fails Charge Trading Practice* (July 27, 2018), https://www.sifma.org/wp-content/uploads/2017/06/TMPG_UST-fails-charge-trading-practice_04-23-18.pdf; Treasury Market Practices Group and Securities Industry and Financial Markets Association, *Agency Debt and Agency Mortgage-Backed Securities Fails Charge Trading Practice* (July 27, 2018), https://www.sifma.org/wp-content/uploads/2017/06/TMPG_Agency-fails-charge-trading-practice_04-23-18.pdf.  FICC also imposes substantially similar fails charges on failed transactions in government securities where it acts as counterparty.