How will the SEC Respond to the March 9 Trading Halt?

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Increasing fears over the coronavirus have combined with the emerging threat of an oil price war to trigger the first significant market-wide trading halt in 30 years. Circuit breaker rules were originally conceived following another Monday panic: the October 19 crash of 1987.

Already there is discussion about broader SEC intervention. Bloomberg News had a ready-to-go story on tools that SEC might use to halt a panic. [1] Banning short selling is a tried and true favorite of many market pundits. Closing markets, like after the 9/11 attacks, is another. As I write, senior SEC staff are likely huddled around a table on the 10th floor conference room overlooking the capital deciding on what to do. That is where important meetings between the Chairman and division directors are usually convened.

To be sure, this is a significant event. After the markets fell 23% on a single day in 1987, a Presidential task force recommended a market wide circuit breaker to protect the market from future such events. [2] The first appeared shortly thereafter, followed by periodic recalibrations to reflect market learning. [3] The current threshold is a 7% decline in the S&P500 index, which is what triggered the day's (March 9, 2020) halt. This is arguably the first time since 1987 that active trading was halted by a market development of the type that regulators envisioned when establishing the triggers (set aside the 9/11 terrorist attack, a day when markets did not open).

But we are not at the point where more drastic measures should be considered. The circuit breaker did its job. It allowed the market to take a breath. What followed was intense but otherwise orderly changes in prices, commensurate of 'human' reactions to developing news and uncertainty (more on that in a moment).

That said, if my decade of experience at the SEC is any guide, the current Commissioners and senior staff are playing out even worse market scenarios and what to do should they emerge.

Inside 100 F Street on March 9, 2020

In the ordinary course, division directors and their senior staff periodically meet to discuss emerging market risks. The practice formally began following a 2015 recommendation by the IMF to the SEC as part of its Financial Sector Assessment Program [4]. In recent weeks, the periodicity of these meetings has likely increased. And as with the rest of the world, the market impact of coronavirus has undoubtedly been the focus.

In fact, it is unlikely that any other topic has garnered more attention inside the building. Many staff will have been told to continue working on their long term projects, and as of now, there is still an open meeting schedule for Wednesday. But the leadership and key aides are almost

certainly more focused on recent market developments. And if they weren't, they are after today's developments.

Crisis management is typically run out of the Chairman's office. Much like a corporate CEO, the SEC Chairman directs the actions of agency staff. Interestingly, while the other four Commissioners join in the making of key decisions related to rulemaking and enforcement, when it comes to market disruptions, they are often left in the dark. Sunshine laws make it difficult for the Commission to meet without public notice. This is meant to facilitate transparency and accountability in government decision-making. But in a time of crisis, when information moves fast, the rules can inhibit realtime updating and thus participation of the other four political appointees.

It is quite possible that this morning's developments triggered at least some aspect of the agency's crisis response plan. The Commissioners and senior staff routinely practice how to respond to a severe market event. The most extreme scenarios involve a threat to the nation or its infrastructure. For example, a nation state actor attempting to disrupt financial markets through cyber attacks on trading venues and their participants. But these exercises are also relevant to market disruptions emerging by way of non-nefarious means.

Historically, for market events of this nature, staff from the division of trading and markets would take the lead. They would be joined by designated staff from other offices and divisions acting as primary information liaisons within and across the SEC ranks.

During a market event, each division has a primary set of responsibilities. Some are overlapping. Policy divisions who write and interpret rules have the authority to issue relief from those rules during times like these. For example, an investment fund facing extreme investor redemptions due to the market stresses can seek permission from the SEC's Division of Investment Management to suspend them. Doing so could be prudent if remaining investors could be harmed (think run on the bank).

But investment funds facing this type of risk might first be identified by examination staff in the Office of Compliance Inspections and Examinations (a.k.a. OCIE). They are the SEC's boots-on-the-ground and the front line for detecting market issues. And they might receive analytic support from staff in the Division of Economic and Risk Assessment. That's my former division. Experts there are able to run custom algorithms to analyze and interpret market data as it comes in.

The crisis response protocols are intended to facilitate across-Commission teams working together to accelerate the understanding of, and reaction to, a market event.

The closing bell just rang: what now?

My kids are now in bed and I've returned finish the story. Many of my former colleagues are probably doing the same. The end of trading simply marks the beginning of the rest of the day. This is when the dots are connected. Information is shared and digested. And the information collection will continue, particularly with key market participants who were earlier in the day busy fighting fires.

This is where the SEC turns its long-established supervisory relationships into information collection conduits. Last week an examination team might have been at a large broker-dealer assessing compliance. Today that same team might be asking the broker-dealer about what they

saw in the market and how they weathered the events. Everyone's incentive is to mitigate issues, and the tone of the conversations can be atypical.

Many of the inquiries will fall into common concerns categories. Staff in the Division of Trading and Markets will want to know if there were any exacerbating factors to the sell off beyond the obvious. For instance, were there any large trades or particular actions that triggered the rapid decline. From a distance it appears that the coronavirus plus oil price fears were sufficient to explain the day. But if there are other factors known to the market participants, secrets are hard to keep for long. Although the truth can also take time to separate from the crazy, confused, and conspiracists.

Goldilocks and Bear Markets - did the SEC find the right market break recipe?

Staff in the Division of Trading and Markets will also be assessing the continuity of trading throughout the day. Here is where some SEC staff might be pleased. Decades have been spent trying to optimize market circuit breakers. And the SEC might have finally discovered the Goldilock's threshold. Intra-day trading of securities in the S&P 500 reveals a composite price path that looks like what the SEC might have drawn up in its playbook for how a market circuit breaker should work. The morning began with a free fall in prices. After a 7% decline in the index value, a 15-minute market-wide trading pause was trigged. As securities resumed trading, what followed was volatile, but not precipitous, price changes. Picture perfect.

Whether or not the SEC determines this to be a Goldilocks success, and future days may yet prove otherwise, one question that will be on the mind of many is whether the market break curtailed deleterious algorithmic trading. Several past market disruptions have questioned the role of high frequency trading. The speed of execution strategies can put markets and traders into questionable situations before humans have time to fully evaluate. The May 2010 Flash Crash, the 2012 Knight Capital code glitch, and 2014 Treasury market flash rally are notable examples. The million-dollar question for March 9: did the price halt work because it served as a kill switch to algo-trading?

Finally, the SEC will need to assess and report out on how well stocks re-opened, the extent to which the limit-up limit-down trading pauses were triggered, and the role that ETFs played in the day’s events. In particular, index ETFs are a favorite hedging instrument of institutional traders. They have shown to be the main shock absorbers for the market during times of stress, and thus potential points of market fragility. [5]

Fund risks from investor redemptions - will the SEC regret its N-Port decision?

SEC staff will also be focused on issues that otherwise escape general market attention. Most notably, staff in the Division of Investment Management will be closely monitoring fund exposures to volatile assets (e.g., energy, transportation, healthcare). The purpose is to understand which funds might be susceptible to investor redemptions, and among these, which might have the hardest time meeting those redemptions.

The SEC learned during the financial crisis that funds could experience runs, just like banks. At that time is was money funds. Today the concern is fixed income funds, where the underlying assets can be relatively illiquid. If forced to sell due to excessive investor redemptions, the funds may realize prices below intrinsic values, engendering further redemption pressures. This is what happened to the Third Avenue Focused Credit Fund in 2015, forcing it to request permission

from the SEC to suspend redemptions.

It is likely that the analytic staff at the SEC already have a target list of funds to monitor. If potential risks are perceived to be acute, they may even initiate a dialogue with the funds. And to the extent that funds have reached out to the SEC about concerns they face, then their holdings become a catalyst for identifying other (similar) funds that may be at risk.

All of this analysis, of course, depends on having current data and the ability to process it. Here is where the SEC may be regretting a decision last year to change course on an Obama-era rule that was set to confidentially collect monthly holdings data from investment funds. Instead, the Commission voted to delay the collection until two months after a quarter end, citing as the reason the ability to reduce the SEC's cyber risk profile without impacting its ability to fulfill its mission. [6] This amounts to a reporting delay of up to five months. So, SEC staff can tell you what funds held last fall as opposed to last month. Query whether the Commission would make the same tradeoff between cyber threats and market stability if the vote were to occur today.

The role of SEC Economists - they should be ready to advise on the consequences of a short selling ban

Many economists at the SEC specialize in market risk assessment, both in support of the detection of misconduct and identification of issues related to market stability. They are often key to understanding the mathematical underpinnings of market instruments and practices that give rise to market concerns. And their ability to process and analyze large scale data is invaluable. In general, they are exceptional problem solvers. For these reasons, they can be used in various ways to combat a crisis, often depending on the particular expertise needed.

But one way they can be of particular help today is by dusting off all the "lessons learned memos" generated after the financial crises of 2008 and 2009 subsided. They should start with their analysis of the short sale ban on financial stocks. Former Chairman Cox listed this as one of his major regrets, one that he told Congress that he would not repeat if he were to do it over again. [7]

There were a number of unintended and costly consequences worth remembering. I learned of one first hand, beginning the day after Lehman failed. On that morning, a line of black cars crowded the front of the SEC building. The who's who of market participants made their way down from NY and elsewhere to engage SEC staff. But there weren't enough staff to go around, so they were placed in conference rooms and told to wait.

I was eventually assigned to a room housing a large hedge fund that specialized in convertible bond arbitrage. They explained how we successfully took away the last funding option available to banks: convertible bonds. Banks were already too weak to issue equity, and they couldn't support the issuance of straight debt, so only these hybrid instrument remained. But by banning short selling, they could no longer hedge out the equity risk, making the trade economically unviable (notably, the hedging is done by shorting when prices go up).

What should the market expect from the SEC going forward?

Market pundits are already talking about how the government should respond to today's events and those leading up to it. Most of the economic discussion is focused on the Fed and potential rate changes, facilitating liquidity through the repurchase (repo) market, or use of language that will calm the markets and restore confidence.

The Fed has these powers as a merit regulator, and can intervene in markets to affect level of risk when deemed necessary. In contrast, the SEC is a transparency regulatory, focused on letting investors take informed risks without unduly affecting those decisions. Beyond reassuring statements and actions about maintaining market integrity (i.e., preventing market manipulation and other misconduct), there is not much that the SEC can do to improve the current situation.

Market events like today are mostly a test of what the SEC has already done. High marks are received when market trading rules permit the continuation of price discovery even (and especially) when markets enter periods of stress. Like the best advice to a buy-and-hold investor, doing nothing can be in the long term best interest.

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[1] Jesse Westbrook, "SEC Tools to Halt Panics Include Banning Shorts, Shutting Market," Bloomberg, March 9, 2020. https://www.bloomberg.com/news/articles/2020-03-09/ban-shorts-and-shut-markets-the-sec-s-toolkit-to-halt-a-panic

[2] Report of the Presidential Task Force on Market Mechanisms: submitted to The President of the United States, The Secretary of the Treasury, and The Chairman of the Federal Reserve Board (a.k.a. the Brady Report), 1988, found at: https://archive.org/stream/reportofpresiden01unit/reportofpresiden01unit_djvu.txt

[3] Rules were first adopted pursuant Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637 (October 24, 1988). The original triggers were based on point changes that became too restrictive as markets rose over time. A 1997 trading halt triggered by a 350 point change to the Dow prompted, represented a 4.5% decline compared to what would have been 16% in 1987. Following this, the first halt threshold was set to 10% change to the DJIA. When a halt was not triggered by the May 5, 2010 flash crash, the first halt was reduced to 7%, which is the current trigger that generated a halt today, on March 9, 2020.

[4] The SEC formalized emerging risk discussions among senior leaders of the agencies in response to the IMF's April, 2015 detailed assessment report of U.S. securities regulation, where is stated: "The SEC should consider enhancing mechanisms to ensure a holistic view of emerging and systemic risk, for example by making more formal arrangements for discussions on risk, ensuring participation of the Commission as a whole, and establishing a more formal accountability framework." see, https://www.treasury.gov/resource-center/international/Documents/cr1591.pdf

[5] For example, on August 24, 2015, ETFs were disproportionately affected by LULD trading pauses, particularly those most correlated with the S&P500. See, Division of Trading and Markets, "Research note: Equity Market Volatility on August 24, 2015," December 2015, found at https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf; Austin Gerig and Keegan Murphy, "The Determinants of ETF Trading Pauses on August 24th, 2015," February 2016. https://www.sec.gov/dera/staff-papers/white-papers/feb2016-dera-white-paper-etf-volatility.html

[6] In it's February 27, 2019 press release, the SEC stated: "As part of its approach to data management and cybersecurity, the Commission periodically assesses whether alternatives exist that would allow the Commission to fulfill its mission while reducing the sensitivity of the data that it collects. The Commission has determined that allowing funds to report this monthly data

at quarter end – while not changing the amount or substance of the data – will allow the Commission to fulfill its mission while reducing its cyber risk profile." see, https://www.sec.gov/news/press-release/2019-23.

[7] see, Rachelle Younglai, "SEC chief has regrets over short-selling ban," Reuters, December 2008, found at https://www.reuters.com/article/us-sec-cox/sec-chief-has-regrets-over-short-selling-ban-idUSTRE4BU3GG20081231