



Why This Disruption Is Different—Circuit Breakers

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As central banks now embark on a disjointed unwinding of their balance sheets, we add to these uncharted paths material concerns about the proliferation of [rules-based strategies](#), [the Volcker Rule](#), and uncoordinated circuit breakers, the latter of which is my focus today.

The History of Circuit Breakers

Trading halts in equity markets were introduced in response to the 1987 crash. The idea was to implement “coherent, coordinated circuit breaker mechanisms,” with the argument that “they facilitate price discovery by providing a ‘time-out’ to pause, evaluate, inhibit panic, and publicize order imbalances to attract value traders to cushion violent movements in the market.”¹

Thus, 1987 saw the introduction of a one-hour trading halt if the Dow Jones Industrial Average (DJIA) declined 250 points (down 12%) and a two-hour halt on a 400-point decline (down 20%).²

Circuit breakers have been added to and modified repeatedly since then, typically in response to subsequent crises. Market-wide halts now occur for 15 minutes when the S&P 500 Index drops 7%, another 15 minutes if it declines further to 13%, and for the rest of the day if 20% is breached.

The U.S. landscape of circuit breakers is quite fragmented, with both market-wide and single-stock halts and limits.³

On top of that are price limits, which are pre-specified ranges within which a single stock must trade. Orders outside of that range are rejected, or trading shifts from a continuous market to a call auction market.

Circuit breaker rules are also different between countries, with only 9 out of 29 exchanges coordinated, according to a global survey.⁴

Questionable Efficacy

Academic research on the effects of circuit breakers is inconclusive, but most studies and practitioner reflections suggest that they exacerbate rather than mitigate market declines.

A *Cornell Law Review* article on regulatory overreach describes one way that circuit breakers increase volatility: “If traders fear that a halt will be called before they can submit their orders, they may choose to submit them earlier than otherwise to increase the probability that they are executed. Greater volatility will therefore result as the price limit attracts orders from rationally fearful traders.”⁵

This mechanism is referred to as the “magnet effect.” An SEC report on the October 27-28, 1997, market decline found that “[v]irtually all of the firms interviewed [the largest buyers and sellers] reported that the ... circuit breaker had a strong magnet effect, making the second triggering virtually inevitable.”

A second unintended consequence of circuit breakers is the “spillover effect.” Market forces are like gravity, both inescapable and irrefutable. Declining prices move like water over a cliff, finding ways around obstacles in its path. When the cataclysm finds a land obstruction, it simply shifts to a downward alternative. Ultimately, the water reaches its new level.

Similarly, market forces are only briefly hindered by circuit breakers, shifting execution to the next best alternative. The market may get its desired “time-out,” but trading soon shifts, from market to market, exchange to exchange, and country to country. Prices will reach new levels, even when forced through circuitous routes.

The Problem: Concealing Prices

We are concerned that circuit breakers will conceal the prices that high-frequency traders (HFTs) and other algorithmic traders require to continue active trading, further jeopardizing access to liquidity in a market downturn.

There is no reason to believe that restricting price movement facilitates price discovery. While markets are imperfect, they are the most efficient means of price discovery.

Still, regulators and exchange providers rely on these market obstacles while complicating the work of market actors.

¹ Brady, Nicholas F. et al. 1988. “Report of The Presidential Task Force on Market Mechanisms,” January 1988 p.66.

² These circuit breakers were triggered not much later when the DJIA dropped on October 27, 1997, by 554 points (7.18%) (SEC “Trading Analysis of October 27 and 28, 1997”).

³ The SEC NASDAQ has established single-stock “limit up-limit down” (LULD) rules, which are similar to trading halts, allegedly to “address extraordinary market volatility in U.S. equity markets.” These single-stock halts are predicated not on moves from the prior close, but on price moves that happened over the prior five minutes. A short trading halt occurs if an upper or lower limit is breached for 15 seconds.

⁴ Peter Gomber, Benjamin Clapham, Martin Haferkorn, Sven Panz, Paul Jentsch “Circuit Breakers – A Survey among International Trading Venues,” World Federation of Exchanges, 2016.

⁵ Lawrence Harris, “Dangers of Regulatory Overreaction to the October 1987 Crash”. Cornell Law Review, Volume 74, Issue 5 July 1989, Article 9, p.937.

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