The US Securities and Exchange Commission released anticipated rules effectively banning market makers from using “stub quotes”, part of a focus on the obligations of market makers to maintain orderly markets.

Quotes to trade shares at extreme prices, such as a penny or $100,000, were at the heart of the “flash crash” in May. When market makers stopped trading, these resting quotes, never intended to be executed, were the only prices remaining, and led the S&P 500 index to suddenly drop 6 per cent.

In the wake of the event, exchanges and their self-regulatory bodies had proposed a ban on stub quotes, which the SEC approved on Monday.

Part of market makers’ mandate is to maintain a two-sided market at all times. Stub quotes may have met the letter of the rules, but violated their spirit of maintaining orderly markets, the SEC said.

“By prohibiting stub quotes, we are reducing the risk that trades will be executed at irrational prices, and then need to be broken, if the markets become volatile,” said Mary Schapiro, SEC chairman, in a statement.

“We continue to look at other potential obligations for market participants,” she said

The agency also said that it is considering adding a so-called “limit-up/limit-down” rule, which would prohibit trades a certain distance away from the market price, rather than simply pause trading, as the current circuit breaker programme does.

The SEC has been reviewing the obligations of market makers that have to maintain orderly markets. In the past, human specialists on the floor of the exchanges were tasked with slowing trading to halting bizarre orders, and some believe human monitoring is still necessary.

The new stub-quote rules, effective as of December 6, will require that a two-sided market must be maintained at prices within a certain band – proposed at 8 per cent on either side of the current price – for all securities subject to circuit breakers.

That includes all S&P 500 index shares, Russell 2000 index shares, and many exchange-traded funds. For times of the trading day when circuit breakers do not apply, at the market open and close, quotes must be within 20 per cent of the best price.

All other shares, which are significantly less liquid than shares in primary indices, will require quotes within 30 per cent of their market price.

Extreme quotes will also be allowed to “drift” a further 1.5 per cent from the market price before they must be adjusted.

Bernard Donefer, a lecturer on market structure at Baruch College in New York, said the 8 per cent band was still possibly too wide to maintain constant market pricing, and likely represented a compromise.
“At 8 per cent, people still won’t be able to trade against those quotes. It’s not clear to me it will meet the SEC’s objective of providing liquidity in volatile markets,” he said. “It is, however, a great improvement over the stub quote, which was useless.”

Mr Donefer, along with high-frequency trading shops, have supported circuit breakers that halt market trading when firms see problems with market data, which can cause them to pull back from the market.

However, the industry is also concerned that too-narrow bands might force market makers to take on too much risk by having quotes that could be executed at prices that threatened firms’ limited capital.

“The last thing we need is to bankrupt market makers. Rules [should be] broad enough not to put anyone under,” said Gus Sauter, chief investment officer at Vanguard, at a Securities Industry and Financial Markets Association meeting in New York.

John Neary, global head of portfolio products at Morgan Stanley, however, emphasised that the new rules gave specific, enforceable obligations to market makers.

“From a legal standpoint, they will have to behave in a certain way,” said Mr Neary.

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