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SEC report sheds light on the August flash crash

By Jonnelle Marte
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A trader is reflected in his computer screen on the floor of the New York Stock Exchange at the market open in New York. (REUTERS/Carlo Allegri)

When fears of a slowdown in China sent U.S. stocks plummeting in late August, some of the market mechanisms meant to protect investors during times of volatility may have triggered even greater losses among exchange-traded funds, market regulators said in a report released this week.

Some investors were surprised during the early minutes of stock trading on August 24 when they noticed that many ETFs became worth much less than their underlying investments. The study issued by the Securities and Exchange Commission looked at the factors that may have contributed to the unusually wide market moves that morning. About 19 percent of exchange-traded products fell by 20 percent or more that day, the report found.

ETFs work similar to a mutual fund by investing in a basket of stocks and bonds, but unlike mutual funds they trade all day on an exchange the way stocks do. It is not unusual for the price of an ETF to go slightly above or below the net asset value of the stocks and bonds it invests in, but usually such differences are minor.

Their performance on that day showed that markets can act in unexpected ways when volatility hits, the report found.

One factor that may have contributed to the significant price drops among ETFs is related to the technical methods some brokers and advisers use to limit losses when stocks are falling. One tool, known as a sell order, leads investments to be sold after they fall below a certain price. But when stocks are falling rapidly, those investments can be sold for prices far below what investors intended, which could contribute to losses.

The report also found that because of the volatility, many stocks started trading late on the New York Stock Exchange that morning, even though they were already trading on other exchanges. With the delay, the S&P 500 index only registered a 5.2 percent drop in those early minutes, falling short of the 7 percent drop needed to freeze trading.

It’s possible that trading would’ve been frozen, limiting some of the volatility in stocks and ETFs, if the exchange had registered those market moves differently, said **Joe Saluzzi**, a partner at **Themis Trading**, a brokerage firm.

The types of funds studied in the report were traditional ETFs that invest directly in stocks and other securities, not the more complicated and riskier ETFs that use leverage or complex derivatives to track a market.

The Investment Company Institute, which represents mutual fund firms and ETF providers, said that the flash crash should draw attention to how exchanges cope with bouts of volatility. “As ICI has stated previously, those events are largely related to market structure and trading issues, not to the characteristics of ETFs,” ICI spokesman Mike McNamee said in a statement.

Jonnelle Marte is a reporter covering personal finance. She was previously a writer for MarketWatch and the Wall Street Journal.