

Stop Orders

FINRA Issues Guidance Regarding the Use of Stop Orders During Volatile Market Conditions

Summary

FINRA encourages firms to review their practices regarding stop (or stop-loss) orders, with an emphasis on educating investors regarding the risks and benefits of stop orders and special considerations around the use of stop orders during volatile market conditions. To accomplish this, firms should consider, among other things, providing targeted training to registered representatives regarding the risks associated with stop orders and, where appropriate, making alternative recommendations to meet customer objectives. Firms that allow customers to enter stop orders directly online should ensure that they prominently provide clear and comprehensive disclosures to customers at the time of order entry. Firms should also consider implementing systemic safeguards around the use of stop orders.

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Discussion

On occasion U.S. equity markets experience periods of extraordinary volatility and price dislocation; sometimes these occurrences are prolonged and at other times they are of limited duration. FINRA and other self-regulatory organizations have instituted regulatory safeguards to help address potentially destabilizing market volatility, including recalibrating the market-wide circuit breakers,¹ revising clearly erroneous transactions rules,² and implementing limit up/limit down price bands and trading pauses.³ Nonetheless, significant price volatility may still occur and regulators and market participants have been exploring possible causes and contributing factors, including the role that stop orders and market orders may play in contributing to downward price pressure and market volatility.

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Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Internal Audit
- ▶ Legal
- ▶ Operations
- ▶ Risk
- ▶ Senior Management
- ▶ Systems
- ▶ Trading
- ▶ Training

Key Topics

- ▶ Customer Protection
- ▶ Extraordinary Market Volatility
- ▶ Order Types
- ▶ Stop Orders

Referenced Rules

- ▶ FINRA Rule 5350
- ▶ FINRA Rule 6121
- ▶ FINRA Rule 6190
- ▶ FINRA Rule 11892

Registered representatives often recommend, and investors use, stop orders as a tool for managing market risk.⁴ Investors generally use stop sell orders to protect a profit position in the event the stock's price declines. Investors with a short position generally use stop buy orders to limit losses in the event the stock's price increases. However, because stop orders, once triggered, become market orders, investors immediately face the same risks inherent with market orders—particularly, that during volatile market conditions, their orders may be executed at prices materially above or below their price expectations.

FINRA is issuing this *Notice* to encourage firms to (1) educate registered representatives on advising their customers regarding the use of stop orders; (2) disclose risks prominently where investors are able to enter stop orders directly online; (3) review their customer base to determine whether any safeguards should be put into effect around the availability and use of stop orders; and (4) consider whether systemic safeguards around the use of specific order types is appropriate.⁵

Disclosure to Customers

While stop orders may be a useful tool for investors who are unable to regularly monitor the price of their positions, stop orders are not without potential risks. Therefore, firms that encourage stop orders should educate their customers about the risks inherent in the use of stop orders. Firms that allow customers to enter stop orders directly online should ensure that they prominently provide clear and comprehensive disclosures to customers at the time of order entry, and registered representatives should do the same when advising their customers. For example, firms and registered representatives should inform customers that:

- ▶ **Stop prices are not guaranteed execution prices.** A “stop order” becomes a “market order” when the “stop price” is reached and firms are required to execute a market order fully and promptly at the current market price. Therefore, the price at which a stop order ultimately is executed may be very different from the investor’s “stop price.” Accordingly, while a customer may receive a prompt execution of a stop order that becomes a market order, during volatile market conditions, the execution may be at a significantly different price from the stop price if the market is moving rapidly.
- ▶ **Stop orders may be triggered by a short-lived, dramatic price change.** Customers should be informed that, during periods of volatile market conditions, the price of a stock can move significantly in a short period of time and trigger an execution of a stop order (and the stock may later resume trading at its prior price level). Investors should understand that if their stop order is triggered under these circumstances, they may sell at an undesirable price even though the price of the stock may stabilize during the same trading day.

- ▶ **Sell stop orders may exacerbate price declines during times of extreme volatility.** The activation of sell stop orders may add downward price pressure on a security. If triggered during a precipitous price decline, a sell stop order also is more likely to result in an execution well below the stop price.
- ▶ **Placing a “limit price” on a stop order may help manage some of these risks.** A stop order with a “limit price” (a “stop limit” order) becomes a “limit order” when the stock reaches the “stop price.” A “limit order” is an order to buy or sell a security for an amount no worse than a specific price (i.e., the “limit price”). By using a stop limit order instead of a regular stop order, a customer will receive additional certainty with respect to the price the customer receives for the stock. However, investors also should be aware that, because brokers cannot sell for a price that is lower (or buy for a price that is higher) than the limit price selected, there is the possibility that the order will not be executed at all. Customers should be encouraged to use limit orders in cases where they prioritize achieving a desired target price more than getting an immediate execution irrespective of price.
- ▶ **Improving communication with customers regarding market conditions.** Customers may not regularly monitor overall market conditions. Registered representatives should include information regarding volatile market conditions when advising customers in selecting a stop order type and the stop price (or the stop and limit prices for a stop limit order). In addition, firms that allow customers to enter stop orders directly online should include information regarding volatile market conditions at the time of order entry if markets are abnormal.

Systemic Safeguards

In addition to reviewing the order types made available to customers to determine whether current disclosures are sufficient, firms also should consider whether any systemic safeguards around the use of specific order types is appropriate. For example, with regard to stop orders, firms may consider:

- ▶ **Prominent disclosures at the time of order entry.** For example, firms should consider steps to educate and alert investors before permitting them to confirm entry of a stop order. This may include the use of an affirmative pop-up when an investor attempts to enter a stop order, which explains the operation of the order type as well as discloses other relevant factors, such as special considerations applicable during volatile markets.
- ▶ **Controls on the use of stop orders that do not carry a limit price.** Firms should consider making stop limit orders the default type of stop order. Requiring customers to acknowledge disclosures regarding the risks of unpriced stop orders and affirmatively choose the stop market order type should help make customers aware of their options and help ensure that they are informed and deliberate in making their decision.

- ▶ **Special terms on stop orders.** Firms should consider restricting the time of day during which a stop order may be triggered to preclude the activation of stop orders around the open and close when markets may be more volatile. These measures may be of increased importance for illiquid stocks, which may become even harder to sell and experience added price dislocation during times of extraordinary market volatility.
- ▶ **Expiration of good-til-cancelled stop orders.** Firms should consider adopting and disclosing to customers a policy around the expiration of good-til-cancelled stop and stop limit orders. For example, firms may limit the life of good-til-cancelled stop and stop limit orders to 90 days, notifying customers of impending expirations and advising them that they must re-price and re-enter the order, if desired. Firms also should consider accompanying good-til-cancelled stop orders with additional disclosures.

Endnotes

1. Rule 6121.02 (Market-wide Circuit Breakers in NMS Stocks) generally provides that FINRA will halt all over-the-counter trading in all NMS stocks when a circuit breaker has been triggered on the primary listing market.
2. Rule 11892 (Clearly Erroneous Transactions in Exchange-Listed Securities) generally provides for uniform treatment across self-regulatory organizations of clearly erroneous reviews for executions in NMS stocks, including in the case of multi-stock events involving 20 or more securities.
3. FINRA Rule 6190 (Compliance with Regulation NMS Plan to Address Extraordinary Market Volatility) requires firms to comply with the NMS Plan to Address Extraordinary Market Volatility (the Plan), which provides for a market-wide limit up and limit down mechanism to prevent trades in NMS stocks from occurring outside of specified price bands, coupled with trading pauses in the event of more significant and prolonged price moves. The Plan generally prohibits the display of offers at prices below the lower price band and bids above the upper price band and the execution of trades outside the price bands.
4. FINRA Rule 5350 (Stop Orders) defines “stop order” and provides that a stop order must be triggered by a transaction at the stop price, rather than another trigger—*e.g.*, a quotation at the stop price. Supplementary Material .01 further provides, among other things, that a firm may offer an order type that activates as a market or limit order using a triggering event other than a transaction at the stop price, however, such order cannot be labeled a “stop order” or a “stop limit order” and must be clearly distinguishable from a “stop order” or a “stop limit order.” In addition, the firm must disclose to the customer, in paper or electronic form, prior to the time the customer places the order, a description of the order type including the triggering event. A firm that permits customers to engage in securities transactions online also must post the required disclosures on the firm’s website in a clear and conspicuous manner.

A “stop” order is an order to buy (or sell) that becomes a market order to buy (or sell) when a transaction occurs at or above (below) the stop price. The “stop price” is the price, selected in advance by the investor, at which the order becomes a market order to buy (or sell). For a buy stop order, investors choose a stop price that is above the current market price for the security, whereas, for a sell stop order, investors would choose stop price that is below the current market price.

5. On April 19, 2016, the Equity Market Structure Advisory Committee (EMSAC) Customer Issues Subcommittee issued a status report recommending, among other things, that the SEC and FINRA consider issuing additional guidance to further emphasize the importance of effective practices relating to stop orders. See [EMSAC Customer Issues Subcommittee Status Report](#).