PROS AND CONS OF CIRCUIT BREAKERS

Since 1987, whenever the Financial Markets pass by a period of high volatility, we witness a heated debate about the pros and cons of the Circuit Breakers systems. Usually short term speculators are against; their argument is that markets can take care of finding their equilibrium. Regulators and long term investors think that something needs to be done as the markets are not always efficient. Both sides have a point. In this period where the Oil prices are affecting considerably the volatility of the Arab markets, some members of the Arab Federation of Exchanges applied the Circuit Breakers system or are considering applying it in the future. Several international studies were conducted trying to answer the following two questions: Do Circuit Breakers reduce Volatility? Do Circuit Breakers enhance price discovery? The debate is conducted in a permanent way and any study about these two topics needs to carefully weight the pros and cons of the Circuit Breakers for the Exchange as well as for the investment community. I tried in this overview to summarize, as follows, the pros and cons mentioned by a long list of international analysts and researchers.

The Pros of the Circuit Breakers:

- Provides investors with time for price reassessment in time of market turbulence.
- Reduce large price swings due to overreactions driven by panic.
- Protects the Market Makers in times of market stress, as they are mainly able to stimulate liquidity supply in times of normal conditions.
- Should normally allow investors to change or cancel standing limit orders during trading halt.
- Decreases information asymmetries and promote the price discovery by improving the information available to market participants.
- Prevents shares prices from plunging or spiking too wildly within a short time for the markets where most of trades are being done by software programs instead of humans (Flash crash May 6, 2010).

The Cons of the Circuit Breakers:

- The inability to trade may force investors to alter their trading behavior. Impatient traders may be forced to anticipate their trading plans which might worsen order imbalances.
- Portfolio managers may be unable to rebalance their portfolios.
- Postpones price discovery which can affect the price efficiency. It might spread the volatility over long periods of time and prevents the immediate correction.
- Might only postpone the inevitable trading, which might intensify price changes in the following periods after resuming the normal trading conditions.

Each one of the proponents and opponents of the Circuit Breakers has a point. From the above, we might conclude that the Pros prevail on the Cons. However, the most important to know is, who should apply it and under which limitations?

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