Risks of Using Stop Orders

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The U.S. equity markets occasionally experience periods of extraordinary volatility and price dislocation. These market swings may be temporary, lasting only hours—or they may be more protracted, going on for days at a time.

The Financial Industry Regulatory Authority (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. One contributing factor receiving a high level of attention is the role stop orders and market orders may play in contributing to downward price pressure and market volatility.

What are stop orders?

Investment professionals often recommend—and investors often use—stop orders as a tool to help manage market risk.[4] Stop sell orders may be used to protect a profit position if the price of a stock declines. Stop buy orders may be used to limit an investor's losses to a short position if the price of a stock increases.

Risks to consider

Stop prices are not guaranteed execution prices. A "stop order" becomes a "market order" when the "stop price" is reached. And as a market order, market centers are required to execute the order fully and promptly at the current market price. During volatile market conditions, these orders may be executed at prices significantly below the investor's price expectations (above for buy stops), especially if the market is moving rapidly. Another risk to consider is the fact that stop orders may be triggered by a short-lived, dramatic price change. 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 and resume trading at its previous level during the same trading day.

Alternatives to stop orders

Placing a "limit price" on a stop order may help investors 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, investors will receive additional certainty with respect to the price received for the stock.

Important caveat

Since brokerage firms cannot sell a stock for a price that is lower than the limit price selected (or buy a stock for a price that is higher than the limit price selected), there is the possibility that the "stop limit" order will not be executed at all. Therefore, FINRA recommends investors use limit orders only in cases where achieving a desired target price is more important to investors than getting an immediate execution irrespective of price.

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Summary

Stop orders present risks that should be carefully considered, if not avoided all together, by investors. For more information about stop orders and alternatives to stop orders, contact your financial professional.

Additional information

Hard copies of this disclosure document can be obtained upon contacting your financial professional. See "Risks of Using Stop Orders" on our public websites at: www.rbcwm.com/disclosures, or www.rbcclearingandcustody.com/disclosures.

Information courtesy of FINRA regulatory notice 16-19. To learn more, visit

www.finra.org/sites/default/files/notice_other_file_ref/Regulatory-Notice-16-19.pdf.

[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.