

**MEMO# 13760**

July 24, 2001

## **SEC ISSUES CONCEPT RELEASE ON EFFECTS OF DECIMAL TRADING IN SUBPENNIES**

[13760] July 24, 2001 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 26-01 SEC RULES COMMITTEE No. 61-01 RE: SEC ISSUES CONCEPT RELEASE ON EFFECTS OF DECIMAL TRADING IN SUBPENNIES The Securities and Exchange Commission has issued a concept release requesting comment on the impact of trading and potentially quoting securities in increments of less than a penny.<sup>1</sup> The Release states that with the conversion to decimal pricing complete, the SEC believes it is an appropriate time to request comment on the effect of subpenny trading on SEC and SRO rules that are dependent on trading or quoting price differentials. In particular, the Release requests comment on the effect of subpenny trading on market transparency, customer limit orders, various price dependent rules, and automated systems. The most significant aspects of the Release are summarized below and a copy of the Release is attached. Comments on the Release are due to the SEC no later than September 24, 2001. If you have any comments you would like the Institute to include in its comment letter, please contact the undersigned by phone at 202-371-5408, by fax at 202-326-5839, or by e-mail at [aburstein@ici.org](mailto:aburstein@ici.org) no later than August 8.

**A. Impact of Subpenny Trading on Transparency** The Release discusses several aspects of market transparency that have been affected by the conversion to decimals. In particular, the Release states that the ability of investors to understand the consolidated quotations of competing market centers may be adversely affected, and the accuracy of the quotations could be compromised, if the consolidated quotations used by investors do not fully reflect the subpenny orders available for execution at various price levels. Therefore, quotes may need to be displayed in subpennies. However, the Release notes that if quotes were to be displayed in subpennies, investors and market participants might have to deal with confusing and rapidly changing quote montages which could result in "flickering" quotes in very small price increments. In addition, quoting in subpennies could have implications for market rules pertaining to locked and crossed markets and the ITS Plan's "trade-through" provisions.

<sup>1</sup> Securities Exchange Act Release No. 44568 (July 18, 2001), 66 FR 38390 (July 24, 2001) ("Release"). <sup>2</sup> The Release also discusses the effect of the conversion to decimals on quotation depth. In particular, the Release notes that as the minimum quoting increment has narrowed to a penny, the market depth at any particular price level has decreased as well. The Release states that some firms and institutional investors have expressed concerns that the reduction in quoted market depth may be adversely affecting their ability to execute large orders and that smaller trading and quoting increments have increased the risk of displaying limit orders, particularly larger limit orders, leading to a reduction in the amount of liquidity provided by such orders. In order to address these issues, the Release requests comment on two mutually independent scenarios under which subpenny

trading might be accommodated. 1. Rounding Scenario. Under this scenario, if the exchanges and Nasdaq accept orders in subpenny increments, quotations would be rounded in whole penny increments. The Release requests comment on, among other things: the effect this practice would have on price discovery, price competition, liquidity, transparency, trading costs, and execution quality; how investors would monitor executions and execution quality; whether this practice would promote or hinder institutional participation; and whether this practice would encourage or impede competition among multiple markets. 2. Inclusion Scenario. Under this scenario, if the exchanges and Nasdaq accept orders in subpenny increments, consolidated quotes would be displayed in subpenny increments. The Release requests comment on, among other things: how small the allowable quotation increment should be; at what point the quoting increment would be so small as to be economically insignificant for order entry decisions; the impact this practice would have on the displayed quote size and the overall depth of the markets; whether increased display of the limit order book would help to alleviate concerns about transparency; what effect this practice would have on price discovery, price competition, liquidity, transparency, trading costs, and execution quality; how this practice would affect institutional participation in the markets; and how this practice would affect competition among multiple markets. B. Order Priority The Release discusses the effect of decimalization on the priority of orders in the securities markets. The Release notes that, historically, traders were required to make an economically significant contribution to the price of a security to gain priority over other traders. However, with subpenny orders, a trader may step ahead of an order with priority for an increment below a penny, which, in turn, may significantly affect priority rules and order submission strategies. For example, the Release states that investors may use floor brokers to shield their orders from being publicly displayed or they may increasingly use market orders or may seek to trade more in automated systems that offer greater confidentiality by not displaying their orders. The Release therefore requests comment on whether there should be a minimum trading increment that requires a trader to make an economically significant change to the quoted price of a security in order to obtain priority over another order and, if so, what that increment should be. In addition, the Release requests comment on whether all market participants should be subject to the same trading increment and whether the minimum increment used to establish priority over other orders should be dependent upon the security price or quotation spread. C. Effects of Subpenny Trading on Other Price Dependent Rules The Release requests comment on the effect of trading in subpennies on, among other things, customer limit order protection rules. In particular, the Release states that subpenny trading may have an adverse effect on the operation of these rules and the use of limit orders. The Release therefore requests comment on whether price improvement by less than a penny is an economically sufficient amount for specialists or market makers to be able to "step-ahead" of customer limit orders and, if not, what amount of price improvement would be considered economically sufficient. The Release also requests comment on who the "stepping-ahead" minimum increment should apply to, e.g., specialists, market makers, floor brokers, or other market participants, and whether imposing a minimum "stepping-ahead" increment on these individuals would benefit non-professional customers. Finally, the Release requests comment on whether customers will seek alternative means of displaying their orders to avoid "stepping-ahead" activity or if they will use automated systems which do not display orders if limit order protection provisions continue to incorporate the minimum pricing increment in each market. D. Automated Systems Issues The Release states that, notwithstanding that at each stage of the decimal phase-in of stocks and options no significant problems were reported with regard to systems operations or capacity, the SEC is concerned that a widespread transition to quoting, trading, or reporting of stocks in increments of less than a penny could result in

systems issues that could compromise essential market and broker-dealer operations or disrupt the successful transition to decimals. The Release therefore requests comment on, among other things, the readiness of the industry's automated systems to handle potential quoting, trading, and reporting of stocks and options on those stocks in increments of less than a penny. E. General Issues for Comment The Release requests comment on several general questions regarding subpenny trading behavior. In particular, the Release requests comment on, among other things, whether there are any other market issues associated with subpenny trading that have not been addressed in the Release; if the minimum trading increment is less than a penny, whether there should be a limit on this increment and whether there is a practical or logical limit to the number of decimal places in our trading market; and would allowing trading and possibly quoting in very fine increments increase investor confusion. Ari Burstein Associate Counsel Attachment 4Attachment (in .pdf format)

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