INVESTMENT COMPANY INSTITUTE

MEMO# 14111

November 6, 2001

DRAFT INSTITUTE COMMENT LETTER ON SEC SUBPENNY CONCEPT RELEASE

[14111] November 6, 2001 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 40-01 SEC RULES COMMITTEE No. 87-01 RE: DRAFT INSTITUTE COMMENT LETTER ON SEC SUBPENNY CONCEPT RELEASE As we previously informed you,1 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. The Institute has prepared a draft comment letter (attached) on the concept release. The draft letter states that while the Institute supported the move from fractional pricing to decimal pricing in the U.S. securities markets, we strongly oppose the entry of orders and the quoting of securities in subpennies. In particular, the draft letter states that permitting the entry of orders and the quoting of securities in subpennies would eliminate much of the benefits brought by decimalization and would exacerbate many of the unintended consequences that have arisen in the securities markets since its implementation, which have proven harmful to mutual funds and their shareholders. For example, while the move to pricing in whole pennies has enhanced the ability of investors to more fully understand the prices at which securities are quoted, quoting securities in subpennies would make it more difficult for investors (as well as market participants executing orders for investors) to understand these prices which, in turn, would make it more difficult to trade securities. The draft letter also states that the Institute is concerned about the effect of quoting securities in subpennies on market transparency and depth. The letter notes that preliminary data has shown that the implementation of decimalization has already had an adverse impact on transparency and depth of book and that displaying consolidated quotes in subpenny increments would further reduce the displayed quote size and overall depth of the markets. The letter also notes that the reduction in market transparency and depth that would occur in a subpenny environment would adversely affect liquidity, especially for mutual funds and other institutional investors that need to execute relatively large-sized orders. In addition, the draft letter states that much of the difficulties that institutional investors have experienced trading large orders since the implementation of decimalization has been caused by increased instances of stepping-ahead of limit orders. The letter notes that permitting 1 See Memorandum to Equity Markets Advisory Committee No. 26-01 and SEC Rules Committee No. 61-01, dated July 24, 2001. 2 the entry of orders and the quoting of securities in subpennies would allow a trader to gain priority over another trader by bidding as little as $.001 more for the same security with almost no risk of loss and that this potential for the increased stepping-ahead of limit orders would create a significant disincentive for market participants to enter any sizeable volume into the markets. Finally, the draft letter states that it would be especially inappropriate to permit the entry of orders and the quotation of securities in subpennies before addressing several unresolved market

structure issues. In particular, the letter notes that it has become more important than ever to ensure that all markets display a meaningful depth of book and establish appropriate priority rules for orders entered into the market and that it would be nothing more than folly to permit the entry of orders and the quoting of securities in subpennies before we have established an appropriate regime for trading in pennies. For these reasons, the draft letter recommends that one penny be established as the minimum price variation in the securities markets. This minimum price variation should apply to both the entry of orders and the quoting of securities as well as in the case of any trading rules or practices under which a market participant obtains priority over another order. Comments on the concept release are due to the SEC no later than November 23, 2001. If you have any comments on the draft Institute letter, please provide them to the undersigned by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at aburstein@ici.org no later than November 15. Ari Burstein Associate Counsel Attachment Attachment (in .pdf format)
