MEMO# 14171

November 21, 2001

INSTITUTE COMMENT LETTER ON SEC SUBPENNY CONCEPT RELEASE

[14171] November 21, 2001 TO: SEC RULES COMMITTEE No. 93-01 EQUITY MARKETS ADVISORY COMMITTEE No. 48-01 RE: INSTITUTE COMMENT LETTER ON SEC SUBPENNY CONCEPT RELEASE The Institute has filed a comment letter (a copy of which is attached) with the Securities and Exchange Commission on the SEC's concept release requesting comment on the impact of trading and potentially quoting securities in increments of less than a penny. The comment letter is substantially similar to the draft letter previously sent to members.1 The comment 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 letter states that permitting the entry of orders and the quoting of securities in subpennies would eliminate many 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, the letter states that 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 to understand these prices which, in turn, would make it more difficult to trade securities. The comment 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 also would adversely affect liquidity, especially for mutual funds and other institutional investors that need to execute relatively large-sized orders. In addition, the comment letter states that many of the difficulties that institutional investors have faced trading large orders since the implementation of decimalization have been 1 Memorandum to SEC Rules Committee No. 87-01 and Equity Markets Advisory Committee No. 40-01, dated November 6, 2001. 2 caused by increased instances of stepping-ahead of limit orders. The letter notes that permitting 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. This potential for the increased stepping-ahead of limit orders would therefore create a significant disincentive for market participants to enter any sizeable volume into the markets and would result in the reduction in the value of displaying limit orders. Finally, the comment 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 letter recommends that one penny be established as the minimum price variation in the securities markets and that this minimum price variation 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. Ari Burstein Associate Counsel Attachment Attachment (in .pdf format)
