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Comment Letter on Effects of Decimal Trading in Subpennies, November 2001

November 20, 2001

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Request for Comment on the Effects of Decimal Trading in Subpennies (File No. S7-14-01)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's concept release[2] regarding the impact of trading and potentially quoting securities in an increment of less than a penny. 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. Our specific comments follow below.

I. Entry of Orders and Quoting of Securities in Subpennies Would Adversely Impact the Securities Markets

Decimalization was implemented in the U.S. securities markets in order, among other things, to simplify the pricing of securities for investors and to reduce spreads. While the full impact of decimalization has yet to be determined, it appears that significant progress has been made in achieving these goals. Nevertheless, the Institute believes 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.[3]

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. This, in turn, would make it more difficult to trade securities. In a fast moving market environment, this situation may be exacerbated due to increased instances of "flickering" quotes.

The Institute also is concerned about the effect of quoting securities in subpennies on market transparency and depth. As we have previously noted, the reduction in quoted market depth as the minimum quoting increment has narrowed to a penny has adversely affected institutional investors' ability to execute large orders.[4] Preliminary data has shown that the implementation of decimalization has already had an adverse impact on transparency and depth of book.[5] The Institute believes that displaying consolidated quotes in subpenny increments would further reduce the displayed quote size and overall depth of the markets.

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. Preliminary data has shown that, post-decimalization, it has become more difficult for large institutional orders to be filled entirely at the inside.[6] As a result, mutual funds and other institutional investors now face increased transaction costs. Quotations in subpennies will surely exacerbate these effects.

Finally, much of the difficulties that institutional investors have faced trading large orders since the implementation of decimalization has been caused by increased instances of stepping-ahead of limit orders. 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 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. We have already seen the reduction of the use of limit orders by institutional investors on the exchanges and Nasdaq under decimalization with trading in whole penny increments.[7] We believe the entry of orders and the quoting of securities in subpennies would only further this reduction.

II. There Remain Unresolved Market Structure Issues

As noted above, while decimalization has produced significant benefits to our markets, it also has exacerbated the detrimental effects of certain flaws in our securities market structure. For this reason, it would be especially inappropriate to permit the entry of orders and the quotation of securities in subpennies before addressing these problems. In particular, 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.

Increasing transparency would provide investors with a greater indication of the interest in a particular security and would allow investors to better gauge the market in general. For this reason, market centers should make available for public viewing a meaningful portion of their limit order book, if not the entire book.[8] In addition, in the absence of sound priority rules for orders entered into the market, investors are deterred from entering large orders for display, as these orders are not protected against other orders that are entered at the same price but at a later time.

The full benefits of decimalization will only be realized when these issues are addressed. 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.

III. One Penny Should be Established as the Minimum Price Variation in the Securities Markets

For the reasons noted above, the Institute 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. Permitting the entry of orders in increments less than the minimum price increment permitted for quotations would have a serious adverse impact on price discovery and would misrepresent the true orders entered into the market. For these reasons, we also believe that quoting should not be permitted in subpennies either directly or through a “rounding scenario” as discussed in the Concept Release under which the exchanges and Nasdaq would round the quotations to display orders in whole penny increments.[9]

The one penny minimum price variation also should apply in the case of any trading rules or practices under which a market participant obtains priority over another order. Any minimum trading increment less than one penny would lead to increased instances of stepping-ahead and the associated adverse consequences discussed above.[10]

The Institute recognizes that there is no a priori justification for selecting one penny (rather than, say, two pennies or one-half penny) as the minimum price variation for the entry of orders, quotations, and trading. Clearly, smaller increments can have both positive and negative effects. Nevertheless, we believe one penny is the most logical choice, as it is the generally accepted minimum increment used in commerce. We also note that mutual funds historically have priced their shares in penny increments. For these reasons, we believe our equity markets would be well served with the establishment of one penny as the minimum price variation, along the lines described above.[11]

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The Institute appreciates the opportunity to comment on the Concept Release. Any questions regarding our comments may be directed to the undersigned at 202-326-5815 or to Ari Burstein at 202-371-5408.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable Harvey L. Pitt, Chairman
The Honorable Isaac C. Hunt, Commissioner
The Honorable Laura S. Unger, Commissioner
Annette L. Nazareth, Director
Robert L. D. Colby, Deputy Director
Division of Market Regulation
Paul F. Roye, Director
Division of Investment Management
Securities and Exchange Commission

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes9,108 open-end investment companies ("mutual funds"), 487 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.396trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] Securities Exchange Act Release No. 44568 (July 18, 2001), 66 FR 38390 (July 24, 2001) ("Concept Release").

[3] See The Impact of Decimalization, American Stock Exchange, dated September 10, 2001 ("Amex Report") ("Benefits to small, active retail investors appear to have come at the expense of professional investors, large institutions and the public investors they represent"); Philadelphia Stock Exchange Decimal Pricing Impact Study for Equities and Options, dated September 7, 2001 ("PHLX Report") ("[P]erhaps the greatest negative impact [of decimalization] has been on mutual funds, pension funds and similar institutional investment vehicles that collectively represent millions of investors"); and The Impact of Decimalization at the Boston Stock Exchange, dated September 26, 2001 ("BSE Report") ("Individual and small investors may seem to be benefiting [from decimalization] as the result of the reduced spreads, but the overwhelming majority of investors, as represented by the institutional investors who manage their clients' pension, 401(k), trust and related funds, are paying the price").

[4] See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Richard A. Grasso, Chairman, New York Stock Exchange, dated March 1, 2001; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Catherine R. Kinney, Group Executive Vice President, New York Stock Exchange, dated June 26, 2001; and Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 7, 2001.

[5] See Decimalization of Trading on the New York Stock Exchange: A Report to the Securities and Exchange Commission, dated September 7, 2001 ("NYSE Report") (quoted amounts of buying or selling interest displayed at the quoted prices fell by an average of two-thirds); The Impact of Decimalization on the Nasdaq Stock Market: Final Report to the SEC, dated June 11, 2001 ("Nasdaq Report") (displayed depth has decreased by two-thirds under decimals); Amex Report (size at the inside quote has decreased by almost two-thirds under decimals): BSE Report (quote size decreased substantially and liquidity declined precipitously since the implementation of decimalization); PHLX Report (quote sizes have decreased which has led to reduced transparency and liquidity in the national markets); Letter from Jeffrey T. Brown, Vice President, Regulation and General Counsel, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 10, 2001 (market transparency has suffered as a result of decimal pricing); Decimalization Impact Report, Chicago Stock Exchange, dated September 10, 2001 ("CHX Report") (visible liquidity at each NBBO price point has diminished and liquidity is more difficult to access via existing intermarket exchange linkages); and Changes in Order Characteristics, Displayed Liquidity, and Execution Quality on the New York Stock Exchange around the Switch to Decimal Pricing, New York Stock Exchange Working Paper 2001-02, July 2001.

[6] See Nasdaq Report (many market makers have indicated that working large institutional orders requires more trades); BSE Report (larger institutional investors are now being forced to split large orders into numerous smaller transactions at various price points); and PHLX Report (penny increments have resulted in multiple executions for larger orders and orders to be broken into smaller orders).

[7] See Nasdaq Report (the number of limit orders being submitted has decreased after decimals); Amex Report (risk of getting pennied appears to be discouraging entry of limit orders); CHX Report (decrease in the number of limit orders routed to the CHX and in the ratio of limit orders to market orders since decimalization); BSE Report (institutional investors have curtailed the use of limit orders since the implementation of decimalization); and "Getting Pennied": The Effect of Decimalization on Traders' Willingness to Lean On the Limit Order Book at the New York Stock Exchange, NYSE Working Paper 2001-01, June 2001.

[8] The Institute recognizes that several market centers have been moving towards increased transparency in their respective markets. For example, Nasdaq's Super Montage proposal will display the best bid and offer for a particular security and two levels away from the NBBO. In addition, the NYSE is now disseminating "depth indications" and "depth conditions" to display market interest in a security beyond the best bid and offer and has indicated that it will open its entire limit order book in the near future. We commend

these efforts on the part of Nasdaq and the NYSE, which are extremely important in a decimalized environment. Nevertheless, if securities are quoted in subpennies, being able to view the top of the book and a few price levels away in Nasdaq or allowing market participants to see the entire book at a time where investors are utilizing limit orders to a much lesser extent in the NYSE will be insufficient to provide investors with the transparency they require to provide them with information as to the trading interest in a particular security.

[9] The Institute recognizes that several ECNs and market makers currently allow their customers to submit limit orders in subpenny increments (which are then rounded to the penny when displayed on the Nasdaq montage). Nevertheless, to date, subpenny trades have represented an extremely small proportion of trades in Nasdaq securities and almost none of the orders on the New York Stock Exchange. Thus, a prohibition on the entry of orders in subpennies should not cause any significant disruptions in current trading practices.

[10] As a practical matter, this would mean that most trades would have to be executed at prices in full penny increments. The Institute, however, believes that it is not problematic if executions take place in subpenny increments where the prices for these executions are determined through the application of a passive algorithm, as is the case where a trade is executed on a crossing network at the mid-point of a bid and offer.

[11] Consequently, we do not support a minimum increment that varies depending on the security price or quotation spread.
