



Securities Industry Association

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The Honorable Joel I. Klein
Assistant Attorney General
Antitrust Division
Room 3109
United States Department of Justice
950 Pennsylvania Avenue, N.W.
Washington, D.C. 20530-0001

Re: Request for Expedited Business Review Clearance: Securities Industry information exchange to help address conversion to decimal-based trading increments.

Dear Mr. Klein:

On behalf of the Securities Industry Association ("SIA"), we request a business review letter setting forth the Division's current antitrust enforcement intentions regarding what SIA believes are critically important information exchanges necessary to facilitate and expedite the conversion of the current fractional-based trading system for equity securities and options, to a decimal-based system. This request is made pursuant to the procedure for the issuance of business review letters set forth in 28 C.F.R. Sec. 50.6.

INTRODUCTION

The position of SIA with regard to the instant request is similar to the position of SIA with regard to its 1998 request (attached) concerning Year 2000 ("Y2K") issues. In general, we envision SIA's role with regard to the transition to a decimal-based trading system as comparable to the function it is playing in the efforts of the securities industry to prepare and test its systems to resolve Y2K computer concerns. Accordingly, this request seeks a response similar to that granted SIA in the business review letter dated July 1, 1998 from Assistant Attorney General Joel Klein concerning information exchanges designed to facilitate possible Y2K problems confronting the securities industry.

Due to the growing importance of decimalization conversion to both investors and the financial services industry, as described more fully below, there is an urgent need for the proposed information exchanges. SIA therefore requests that this business review determination be processed in accordance with the Department's procedure for expedited review of information exchanges. This procedure was announced by the Department on



December 1, 1992 and is reproduced at CCH Trade Regulation Reporter 8559.50. The information and documents called for by the expedited procedure, to the extent available and applicable, are furnished in this letter.

SIA is an association of nearly 800 securities firms. SIA members -- including investment banks, broker-dealers, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the U.S., SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans.

As detailed below, SIA has developed a comprehensive program to move the trading increments for equity securities and equity stock options from fractions of 1/8 and 1/16 (e.g., 8 or 16 price points within each dollar) to a decimal-based system based on either 5 cent or 1 cent increments (e.g., 20 or 100 price points within each dollar). The industry target date is June of 2000 for completing the conversion. SIA's effort has been strongly supported and encouraged by the Securities and Exchange Commission ("SEC"). To be successful, the project will require extensive sharing of information among securities market participants, including broker-dealers, exchanges, clearing entities, data processors, depositories and market data vendors.

Because of the pendency of an investigation by the Antitrust Division into the listing and pricing of options certain essential participants in the decimalization effort have been advised by counsel not to share any information concerning options pricing with any other party. In this regard, it would therefore be especially helpful if the Department could provide written assurance that generic discussions of pricing increments for securities and options on securities in the context of sharing information concerning the systems capacity and operational issues posed by "nickel-based" (\$0.05) increments and "penny-based" (\$0.01) increments would not be viewed as anti-competitive conduct. Consistent with the Division's regulations concerning its business review procedures, SIA provides the following information.

THE DECIMALIZATION CONVERSION ISSUE AND SIA'S DECIMALIZATION CONVERSION PROGRAM

The current pricing format used by all of the major U.S. securities and options exchanges (including NASDAQ) is in fractions (e.g., price increments of 1/8 s or 1/16s of a dollar). This pricing structure, which dates back over 200 years, has periodically been called into question, particularly in recent years as technology has made conversion to alternative pricing structures more feasible. Critics and proponents of fractional pricing have long debated whether a move to a decimal-based system would have a net beneficial impact on markets, by reducing the spreads (the price differential between offer and sale



price quotations of dealers), or a net detrimental impact by impairing market liquidity and depth. Another consideration in the debate is the fact that U.S. markets are the only major securities markets in the world that use fractional pricing. While this disparity has not significantly affected the preeminence of U.S. capital markets to date, it is possible that in the future this discrepancy could hinder cross-border transactions and attract new capital flows abroad. Technology has also gradually shifted the debate by making the prospect of a conversion from a fractional to a decimal system more realistic.

In light of these policy considerations, in 1997 legislation was introduced in Congress that would have directed the SEC to require that securities be traded in dollars and cents instead of the traditional fractions.¹ Securities exchanges and market participants opposed the legislation, and urged instead that the industry be permitted to move voluntarily toward a decimal-based system, in close consultation with the SEC.

Since that time, most of the securities industry's information technology resources have been devoted to readying trading systems for the impending date change in year 2000, as well as the introduction of a single currency in Europe in January 1999, and strengthening systems capacity to meet the unprecedented volume of trading activity on securities markets and investor demand for self-directed trading over the Internet. Although work on decimalization conversion has to some extent been deferred by these pressing concerns, particularly the Y2K conversion and testing efforts, the industry intends to move equity pricing from fractions to decimals by early in the second half of 2000.

SIA has agreed to oversee and manage the effort to implement decimal trading as it has done for the industry's Y2K effort. The decimalization project will involve coordinating the conversion efforts of numerous industry participants, including broker-dealers, stock and options markets, utilities, and clearing and settlement organizations among others. Such coordination will entail the development of a comprehensive plan to establish interim milestones for testing and implementation of the decimalization conversion, as well as delineating technical standards and specifications that will need to receive broad industry support for the markets to continue working efficiently. To develop and execute this plan, SIA and participating entities need to exchange information with each other on the potential effects of the conversion on all aspects of market operations, including information processing and communications capacity, as well as market and exchange rules.

SIA has taken three steps thus far to commence its work on conversion to a decimal-based equity trading system. First, we have appointed a Decimalization Committee to lead the initiative (a copy of the roster of the Committee is attached). That

¹ The Common Cents Stock Pricing Act of 1997, H.R. 1053 (introduced March 13, 1997) and S. 838 (introduced June 5, 1997).



Committee will work with other industry groups, as described below. Second, SIA has commissioned a recently completed study by an outside consultant assessing the impact of decimal trading on various message volume under both a nickle (\$0.05) and a penny (\$0.01) minimum price variation ("MPV"). (A summary of the report is available on the SIA web site at www.sia.com/decimalization.) Third, we have sent out a survey to broker-dealers, exchanges, financial utilities, and market data vendors, to try to determine from them their state of readiness for decimalization, and specific systems issues that they need to address to successfully convert to decimals. The results of the survey, together with the work of the SIA Decimalization Committee, and the Testing and Implementation Subcommittees, will be used to develop a detailed time table for the implementation of decimals trading.

SIA is also working closely with the SEC. This entails inviting SEC staff to participate in key meetings of the Committee, copying SEC staff on all material written communications, and regularly briefing the SEC staff on the status of the project and on all significant developments. We also expect that many or most of the recommendations resulting from our work will be published for public notice and comment by the SEC, either as rule proposals by one or more self-regulatory organizations subject to SEC approval, or as the SEC's own rule proposals.

THE PROPOSED INFORMATION EXCHANGE

The change to decimals is expected, at a minimum, to affect a vast array of systems. SIA proposes to exchange information in a manner similar to its effort on year 2000 conversion and testing. Unlike that effort, this project should not entail extensive gathering of information from manufacturers of computer hardware or chips, although it may require some information gathering from designers and vendors of software. However, it will entail extensive discussions and other information exchanges among all participating entities on topics such as:

- The feasibility and practicality of developing sufficient capacity to handle a particular MPV for each exchange, such that the MPV is compatible with the ability of the computer systems to handle increased message traffic;
- Managing increases in quotation message traffic on trading systems because of: (i) increases in potential price breakpoints and (ii) reduced bid-ask spreads.
- Implementation and testing scenarios, including whether a phase-in or a cut-over approach is the best way to implement decimalization. Other topics in this regard would include the development of a pilot program, as well as its duration and related testing schedule;



- Identifying functions to test in areas such as exchange interfaces, order routing and processing systems, buy-side interfaces, order submission, inventory systems, automatic executing systems, submission of information into trade comparison, portfolio systems, institutional delivery and affirmation, risk management, compliance, margin, and bookkeeping systems, correction processing, vendor interfaces and securities pricing systems;
- Considering new approaches to managing expected massive increases in message traffic, such as exploring new ways to process quotations, and
- Designing methods of stress-testing the infrastructure to ensure that the projected message volumes will not cause systems to queue up or fail due to heavy volume.

The development and testing of a program for the decimalization of options trading will be particularly important part of the overall decimalization effort. To a much greater extent than equity securities, the overwhelming amount of options message traffic consists of quote messages rather than trade and contract volumes. According to the Options Price Reporting Authority ("OPRA"), options daily message traffic composition is generally 94 per cent of all options message traffic. A reduction in quotation increments offers greater variation in quotes (e.g., the mechanical effect of changing the tick size from 1/16 to \$0.05 produces 25 per cent more potential price levels). Since quotation messages dominate options message traffic, there is expected to be a particularly significant increase in options message volume. A study commissioned for SIA projects that a nickel MPV would result in message traffic for options increasing by more than 50 per cent, while a penny MPV would boost message traffic volume by over 250 per cent. Surveying the impact of such dramatic volume increases and disseminating and discussing the results is part of what SIA is planning to do.²

As with the Y2K effort, survey results and proposals based upon those results would be shared among SIA members and others that are part of the decimalization conversion project, including regulators, broker-dealers, exchanges, depositories, utilities and clearance and settlement entities. To the extent possible, no company-specific information about prices, capacity, or future plans will be exchanged, although there will need to be some discussion of systems issues posed by trading in nickle or penny increments. Likewise, no discussion about specific prices of any security or option will take place. If any sensitive information is exchanged, it will be distributed in aggregate format by SIA, concealing the identity of specific providers. All competitively sensitive

² It should be noted that these projections do not take into account various other upcoming industry initiatives, such as extended trading hours, the development of an international securities exchange, multiple listing of options, and integration of Alternative Trading System quotations into the national market system pursuant to the SEC's Regulation ATS. These efforts will only exacerbate the message volume concerns for both equity and options markets.



information will go directly to SIA staff or our independent consultant, and will be further disseminated only in aggregated form. To further ensure that sensitive proprietary information is not exchanged, SIA has sent the attached letter to its outside consultant asking it not to disseminate any information that is identified to it, or that it believes to be proprietary or competitively sensitive.

With respect to all information to be exchanged, it is important to note that neither the participants nor SIA intend to recommend in favor of, or against, the products or systems of particular vendors. In short, the information will be stated in non-judgmental terms so that there can be no legitimate inference that the sharing of information will result in any anticompetitive consequences (i.e., group boycott activity). It will be for SIA members to decide as individual entities how, or even whether, each will use the information disseminated.

As noted above, SIA has appointed a Decimalization Committee to lead our effort. That Committee in turn will appoint subcommittees as issues arise. Legal counsel will participate in all meetings, and SEC staff are expected to attend frequently. We anticipate that the makeup of the Committee may change over time. The current roster of the Committee is attached, and SIA will update the roster as changes occur on its web site. (http://www.sia.com/about_sia/html/decimalization.html).

In addition to the Decimalization Committee, at the SEC's specific request the Securities Industry Automation Corporation ("SIAC")³ has organized a related effort to focus on the capacity issues related to the decimalization of options. SIA is a participant, and expects to cooperate in that effort.

THE NEED FOR THE PROPOSED INFORMATION EXCHANGE

Dissemination of information regarding decimalization through SIA would be highly beneficial. As with its Y2K effort, such SIA involvement will foster the dissemination of accurate information and, will also avoid industry-wide confusion. Clearly it will be vastly more efficient for SIA to obtain and disseminate information among market participants than for scores of broker-dealers, exchanges, utilities, information processors and other entities to request information individually from each other and receive nonstandard responses that may be difficult to interpret. Additionally, immense duplication of effort may be avoided.

³ SIAC is not part of SIA, but is a subsidiary of the New York and American Stock Exchanges. SIAC provides automated information and communications systems to support the activity of those exchanges, as well as the activities of the National Securities Clearing Corporation and the securities industry nationwide. More information on SIAC is available at its web site, www.siac.com.



Moreover, without the umbrella of an information exchange sanctioned by the Department, many entities may receive legal advice not to participate in any exchange of information with any other entity, and simply decide whether and how to convert their own systems to decimals unilaterally. Such action could easily result in a very chaotic and disruptive conversion process, or more likely, could unnecessarily forestall the conversion process itself to the detriment of the entire market.

PRO-COMPETITIVE CHARACTER OF THE INFORMATION EXCHANGE

The benefits of a decimal trading system over a fractional system include the likely narrowing of spreads on equity securities and options, resulting in savings to investors. Securities and options prices in a decimalized system should be easier for small investors to follow and understand, strengthening public trust in the securities markets. Moreover, a move to decimalization is likely to strengthen the competitiveness of U.S. capital markets with its competitors around the globe.

THE DEPARTMENT'S EXPEDITED PROCEDURE

Given the content of the information exchange discussed in the instant request, we believe the foregoing provides sufficient information to comply with the requirements of the Division's expedited review procedure. That procedure appears to have been drafted to apply most particularly to price related exchanges. The exchange proposed by SIA is not of that type, and as such, SIA has not attempted to include information concerning customers and annual purchases which would be relevant to an exchange of price related information. If further information is needed by the Division to respond to this request, we are prepared to provide it promptly.

CONCLUSION

The conversion from a fractional-based trading system to one that is decimal based has long been discussed, and advocated as a means of making the markets more efficient. The implementation of such a system is a substantial undertaking that could, if not handled properly, disrupt financial markets in this country and throughout the world. The information exchange proposed by SIA herein is a modest attempt to facilitate the conversion of this nation's securities markets to a decimal based system without negatively effecting the liquidity or efficiency of these markets. Towards that end, SIA



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intends to work diligently towards implementation of a decimal-based trading system as described above.

Sincerely,

Stuart J. Kaswell /s/ Kromer

Stuart J. Kaswell
Senior Vice President and
General Counsel

Attachments

Roster of SIA Decimalization Committee
Letter to SRI from SIA dated August 25, 1999

Cc (w. attachments):

Barry Grossman, Regulatory Counsel, Antitrust Division, Department of Justice
John D. Worland, Jr., Computers and Finance Section, Department of Justice
Arthur Levitt Jr., Chairman, Securities and Exchange Commission
Harvey J. Goldschmid, General Counsel, Securities and Exchange Commission
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