

SPECIAL NASD NOTICE TO MEMBERS 97-41

**NASD Requests
Comment On Use Of
Decimal Pricing In The
Nasdaq Stock Market;
Comment Period
Expires July 15, 1997**

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☒ Corporate Finance
- ☐ Government Securities
- ☒ Institutional
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☒ Mutual Fund
- ☒ Operations
- ☒ Options
- ☐ Registration
- ☒ Research
- ☐ Syndicate
- ☒ Systems
- ☒ Trading
- ☐ Training

Executive Summary

In the following document, NASD® requests comment on the positive and negative effects of decimalization on investors and the securities industry.

Questions concerning this *Request For Comment*, in particular the format for any data that may be provided, should be directed to Jeffrey Smith, Office of Economic Research, NASD, at (202) 728-8032.

Request For Comment

The NASD encourages all members and other interested parties to comment to ensure that its review of this issue evaluates and analyzes the costs, benefits, and other implications of decimalization as fully as possible. All comments received will be available to the public unless the commenters request confidentiality in their submissions.

Comments can be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD
1735 K Street, NW,
Washington, DC 20006

or e-mailed to:
pubcom@nasd.com.

To be able to conclude the NASD's review within a reasonable period of time, comments must be received **by July 15, 1997**.

NASD REQUEST FOR COMMENT 97-41

Executive Summary

As a part of its continuing review of the appropriate quote and trade increments for stocks that are traded in The Nasdaq Stock Market, Inc. (Nasdaq[®]), the NASD[®] has determined that the issue of decimalization in Nasdaq should be thoroughly evaluated to analyze the potential gains for investors that may be achieved. As a part of its review of the issue, the NASD believes it is important to obtain information about the positive and negative effects of decimalization on investors and the securities industry from as wide a range of constituents as possible. The NASD also preliminarily believes that the costs entailed in decimalization may be alleviated by setting a firm, future date for the transition.

Accordingly, through this *Request For Comment* and other means, the NASD encourages investors, NASD members, Nasdaq issuers, information vendors, and any other interested parties to provide the NASD with comments, views, and studies regarding the effects that a move to the use of decimals for quoting and trading purposes may have on Nasdaq-listed stocks. Comments should be received **by July 15, 1997**, for such views and analyses to be incorporated into the NASD's evaluation of the issue.

Background

During recent years, the NASD and Nasdaq have carefully reviewed the benefits and the costs of trade reports and quotations priced in narrower increments. For example, in 1994, the Nasdaq system was revised to accept trade reports in increments as small as 1/256ths. Further, earlier this year Nasdaq proposed to reduce quotation increments to sixteenths for all Nasdaq stocks.¹ Nasdaq's purpose in doing so was to improve the transparency of the market, provide investors with an opportunity to receive better execution prices, facili-

tate greater quote competition and narrower spreads, and promote the price discovery process.

In addition, the U.S. Congress recently held hearings related to the issue of the use of decimals in the U.S. stock markets. In particular, the hearing focused on proposed legislation called the Common Cents Stock Pricing Act of 1997 (H.R. 1053).² This bill would require the Securities and Exchange Commission (SEC) to promulgate, within one year of the bill's enactment into law, a new rule that would require the quotation of equity securities traded on U.S. exchanges in dollars and cents. Under the proposed law, the SEC would be permitted to set an implementation schedule regarding the period in which the securities industry would ready itself to trade in stocks priced at decimals instead of fractions, the current general practice in U.S. equity markets.

Along with other U.S. stock markets, the NASD testified at this hearing and promised to conduct a study that would allow the NASD to evaluate the costs and the benefits that may be associated with a shift to decimalization. The NASD agreed to provide the results of this analysis to the congressional committee that is considering the bill.

The NASD's plan for this study includes: a review and interpretation of the relevant literature, in particular any academic research that has evaluated decimalization or related issues; a study of other markets with experience with decimalization; and an analysis of the technology impact that a change to decimals would have on Nasdaq trading and regulatory systems, based on current experience in the Nasdaq market. This study will play an important part in the NASD's consideration of the decimalization issue.

If the NASD's review of this issue demonstrates that a shift to decimal pricing aids investors in the purchase and sale of Nasdaq stocks, the NASD is committed to undertake the necessary technological changes to provide this benefit for investors. A critical component of a conversion to decimalization is the technology that supports Nasdaq systems, and those operated by member firms and information vendors. The NASD currently has scheduled changes to its systems that would permit the use of decimals, if appropriate, before the end of 1998. This technical preparation should not be interpreted as a predisposition by the NASD to move forward with decimalization.

The NASD recognizes, however, that member firm and vendor systems would also have to be converted to permit trading in decimals and that other technology-intensive projects, such as preparations of systems for the Year 2000 project and for complying with the recently adopted SEC Order Handling Rules, are consuming significant resources in the industry. Because of these concerns, the NASD believes that if conversion to decimals is appropriate, implementation of decimalization should occur on a date when the NASD is certain that all participants can be technologically ready, with full consideration given to the other significant technology projects that members are currently dealing with, such as Year 2000. Accordingly, as discussed below, the NASD believes it is appropriate to obtain additional information on the effects that decimalization may have on the securities industry as a whole, including the feasibility, appropriateness, and timing of implementing any change.

To make its review of the decimalization issue more complete, the NASD believes that it is very important that it obtain views from others that may be affected by any change to deci-

imals in the U.S. equity markets. Consequently, the NASD is seeking to obtain the views of all interested parties, supported by as much empirical evidence as possible, on the costs and the benefits that could result from any shift to decimal pricing. The NASD plans to reach as wide a range of constituents as possible through this *Notice* and other means. That is, the NASD wishes to receive comments on decimalization from investors, NASD member firms, Nasdaq issuers, information vendors that distribute Nasdaq price information, and other interested parties that may have views on the benefits and the costs related to conversion to decimals.

To sharpen the focus of commenters on the issues, the NASD requests that commenters provide information on the following questions. The questions set forth below are not intended, however, to limit the information that commenters should provide. If commenters believe other issues related to decimals should be addressed in the NASD's review and they have information related to such issues, the NASD welcomes such input.

1. Identify and Assess the Positive and/or Negative Effects

- A. What are the general or specific positive and/or negative effects that would arise if the U.S. equity markets, including Nasdaq, used decimals instead of fractions in pricing stocks?
- B. What are the best means to measure these effects, *i.e.*, is there an appropriate methodology to quantify the effects to the overall market or a particular segment of market participants?
- C. What is the likelihood that investors would trade in increments of one cent?

- D. Would the effects described above occur if all U.S. markets had a minimum quotation increment of five cents?

2. Identify and Assess the Technology Costs to Broker/Dealers and Vendors

- A. What are the general or specific costs that a broker/dealer or an information vendor would likely incur to convert its technology support systems to be able to handle decimals?
- B. How quickly could such conversion occur? Commentators, where possible, should quantify any additional costs entailed in a conversion to decimalization by 1999. Conversely, commentators should indicate whether any technology costs would be substantially reduced by scheduling the transition in 2001.
- C. Would broker/dealers or information vendors rely on internal data processing resources to convert systems or would it be necessary to rely on external vendors and/or consultants? If external resources were to be used, is this a scarce resource that may not be readily available to all?
- D. What is the effect on technology resources of issues related to system development work required for Year 2000 projects and projects related to upgrading systems for the purpose of meeting the SEC's Order Handling Rules? What would be the general effect on the capacity of the systems used in the industry?

3. Regulatory Effects

- A. If the U.S. equity markets convert to decimals, are there any regulatory benefits or costs associated with such a move? For example,

if stocks can be traded in one cent minimum increments, does such an increment pose risks related to professional traders being able to trade ahead of less sophisticated traders at a minimal cost to the professional trader? If commenters view this ability as a negative effect, should there be a minimum increment rule or some other rules that effectively prohibit such activity. If such a rule should be adopted, what are the likely costs associated with monitoring and enforcing any such rule.

- B. Would any existing marketplace rules be affected by decimalization? If so, what are they and what would the effect be?

4. Market Quality Effects

- A. What effect, if any, would decimalization have on dealer participation in the U.S. equity markets? Can the effect be quantified? If so, what are the estimates and on what basis were such estimates derived?
- B. To the extent that decimalization reduces dealer-spread profits, can or should such reductions be recaptured through increased commissions?

5. Phased Implementation

- A. Would phased implementation over a period of time have a positive or negative effect on conversion to decimals?
- B. Can implementation be phased in over time or classes of stock, or

should all systems and operations in a market be converted at the same time?

6. Universal or Segmented Implementation

Is there any effect if one equity market converted to decimals in advance of other equity markets? Would any such effect be viewed as positive or negative? Is there a means to measure such effect?

7. Minimum Decimal Increments

- A. Assuming that the markets use decimals, should stocks be traded in minimum decimal increments, such as five cents?
- B. What is the value if no minimum increments are allowed?
- C. To the extent that quotation spreads already occur in increments of one sixteenths, is there any added economic value to investors to use decimals with a minimum increment of five cents?

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Endnotes

¹ On May 27, 1997, the Securities and Exchange Commission approved the NASD rule filing on this issue. Accordingly, on June 2, 1997, all Nasdaq-traded stocks are eligible to be quoted in increments of a sixteenth.

² On May 21, 1997, the House Commerce Committee's Subcommittee on Finance and Hazardous Materials approved the bill and voted to send the bill to the full Committee for consideration.

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