



November 6, 2003

Mr. Jonathan G. Katz  
Secretary  
Ms. Annette L. Nazareth  
Director, Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549

Re: Standard & Poor's proposal to change pricing procedures for the S&P 500 index, and SR-Amex-2003-81 relating to Amex closing prices

Dear Mr. Katz and Ms. Nazareth:

As a follow-up to our discussions with the staff of the Division of Market Regulation,<sup>1</sup> members of the Trading Committee and Options Committee ("Committees") of the Securities Industry Association<sup>2</sup> wish to reiterate our concerns with Standard and Poor's ("S&P") proposal to change its pricing procedures for its major equity indices. In addition, we note that the American Stock Exchange ("Amex") recently submitted a proposed rule change that is relevant to S&P's proposal, which was effective immediately upon filing.<sup>3</sup> Because this rule change is integrally related to the issues discussed herein, we believe that it should have been filed for notice and comment and fully addressed by the Securities and Exchange Commission ("SEC" or "Commission") and the industry.

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<sup>1</sup> Telephone conversation with David Shillman, Heather Seidel and Stephen Williams, Division of Market Regulation, Securities and Exchange Commission, and representatives from the Trading and Options Committees, Securities Industry Association ("SIA"), on October 10, 2003.

<sup>2</sup> The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues. (More information about SIA is available on its home page: [www.sia.com](http://www.sia.com).)

<sup>3</sup> See Securities Exchange Act Release No. 34-48652 (October 17, 2003), 68 FR 60729 changing the manner in which transactions are reported to the consolidated tape for Nasdaq securities. The filing was designated as non-controversial, eligible for immediate effectiveness under Securities Exchange Act Rule 19b-4(f)(6).

As you know, S&P recently announced, as an initial step, a pilot program in which the S&P 500 will be calculated using closing prices as determined on the Amex for 12 stocks listed on The Nasdaq Stock Market (“Nasdaq”).<sup>4</sup> S&P will begin the pilot on December 1, 2003 and continue it through the first part of 2004.

As S&P explained in its announcement of the pilot, the “...objective is to improve the reliability of closing prices on the S&P 500 for investors who use the index.... We have been monitoring efforts by Nasdaq to provide for a single-price closing for Nasdaq-listed stocks and we believe that at least for the time being, it is in the interest of the investment community to consider alternative approaches for closing index values.” Before the announcement of this pilot, S&P had sought comment from the industry on its plans to reconsider the basis for determining opening and closing values for all of its major equity indices. Therefore, if S&P deems the pilot successful, it is our understanding that S&P will consider expanding this program to use Amex opening and closing prices for all of the Nasdaq-listed stocks in the S&P 500. It is also our understanding from communications with S&P that any such change in pricing procedures will impact the index prices used for futures and options settlement and the index levels and divisor calculations used when stocks are added to or deleted from the index.

Member firms on the Committees have both individually and, as part of an SIA Working Group on this issue, raised a number of questions and concerns regarding S&P’s proposal with Amex, Nasdaq, S&P and the SEC. In conference calls with Amex and Nasdaq,<sup>5</sup> the Group discussed firms’ concerns, which are detailed below, and learned of planned improvements to Amex’s operational and regulatory systems and to Nasdaq’s opening and closing processes and pricing.

In the Group’s discussions with S&P,<sup>6</sup> firms again raised their concerns and emphasized that they support competition among market centers but with a level playing field. The Group also offered S&P a consensus position: that the S&P should delay any action for 12 months in order to allow time for Amex and Nasdaq to implement their planned improvements, as this could change how S&P may want to proceed. Unfortunately, S&P announced shortly after this call the implementation of their pilot program starting December 1, 2003.

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<sup>4</sup> See S&P News Release dated October 8, 2003 at [www.standardandpoors/indices.com](http://www.standardandpoors/indices.com). See also S&P News Release dated November 3, 2003, which explains the phase-in of the 12 stocks (six stocks initially and then another six to be phased-in at a later date).

<sup>5</sup> Telephone conversation with Brett Redfearn, Amex, and representatives of the Trading and Options Committees, SIA, on October 2, 2003, and telephone conversation with Adena Friedman, Nasdaq, and representatives of the Trading and Options Committees, SIA, on October 3, 2003.

<sup>6</sup> Telephone conversation with David Blitzer, S&P, and representatives of the Trading and Options Committees, SIA, on October 3, 2003.

Subsequent to its call with S&P, the Working Group discussed this issue with the SEC staff.<sup>7</sup> We very much appreciated the opportunity to talk with the staff on this important issue; however, because firms' concerns with S&P's proposal remain, we thought it important to reiterate these concerns at this time and to ask that the Commission study the proposal and the many market integrity and regulatory issues involved. We recognize that S&P is a private entity that can choose how they wish to price their indices and, therefore, the SEC's authority may be limited. We believe, however, that S&P's proposal raises several serious market integrity and regulatory issues over which the SEC does have authority. S&P's pricing changes, particularly when coupled with Amex's recent rule filing, could have a significant impact on both retail investors and market integrity, and indeed on many of the market structure issues the SEC currently is considering.

Consequently, we believe that Amex should withdraw and resubmit SR-Amex-2003-81 for notice and comment, as the rule change is integrally related to the issues discussed below.

## **SIA Member Firm Concerns**

Member firms in the Working Group raised the following concerns:

### **1. Operational and Technological Concerns**

Firms expressed concern with the fact that Amex does not have fully automated linkages with most broker-dealers or market centers. For example, firms note that Amex still must receive most orders manually or by phone. If S&P's proposed changes go into effect, firms believe that their operations will be burdened by the potential need to convert electronic tickets back to paper. This could result in greatly increased breaks and exceptions, and therefore costs to broker-dealers and investors. Firms are also concerned with Amex's lack of fully automated execution capabilities.

Because of these operational and technological inefficiencies, firms maintain that it is most likely that Amex's systems will not be able to handle efficiently the increase in volume brought on by a great number of orders to be priced at the open and close delivered to the exchange. Firms believe that the poor execution turnaround times they see now at Amex will only become worse after S&P's proposal is implemented and trading volume increases.<sup>8</sup> Overall, firms believe that pricing an index on Amex's opening and close will produce inefficient trading around the times of the open and close,

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<sup>7</sup> See *supra*, note 1.

<sup>8</sup> Firms note that the liquidity providers/takers in Nasdaq's SuperMontage and the National Association of Securities Dealers, Inc. ("NASD") Alternative Display Facility experience turnaround times in sub-seconds, while access to Amex liquidity averages more than six seconds and often entails even lengthier delays in actively traded securities. Firms are not only concerned with the delay in returning the execution to the market participant that is entitled to the execution (as required under the SEC Firm Quote Rule), but also with the delays in the Amex updating their market to reflect a market that is no longer stale.

cause enormous burdens for firms and investors, and raise market integrity concerns that impact investors, broker-dealers and market centers.<sup>9</sup>

## **2. Liquidity Dislocation Concerns**

Under S&P's proposal, some firms believe that a significant amount of liquidity may be shifted at the opening and close to Amex, an exchange that does not currently offer automated executions, and then shifted back to the fully automated exchanges. Firms believe that this could result in significant price dislocation caused by trade-throughs and locked/crossed markets.

In addition, the goal of attracting a critical mass of order flow to one market on Friday expirations to provide a national single-price opening is jeopardized by the fact that the Amex may only attract orders from hedgers and arbitrageurs with underlying positions in S&P index derivatives. Generally, S&P index-related positions constitute approximately 50% of the shares bought and sold to unwind at expiration. Consequently, the notion of bringing buyers and sellers together for one price would probably instead result in large buyers in one market missing large sellers in another market. This could create settlement prices for indexes that would be less reflective of fair values than what is achievable currently.

The aforementioned practice of shifting order flow from one market to another, and the potential price dislocations that could occur during those shifts, could greatly impact the smaller retail investors who would not experience on Amex the fast turnaround times that are commonplace in other market centers. Also impacted would be broker-dealers sending the orders to an unlinked market and attempting to comply with their best execution obligations (*i.e.*, slower speed of execution, missed execution opportunities and potential price disimprovement).

Notably, while there is support for a single market for opening and closing prices, others emphasize that there should be multiple, yet equally accessible, markets contributing to the open/close. Although open/close trading may gravitate to a market with a superior open/close mechanism, whichever market it is must be easily accessible to all participants.

## **3. Regulatory Concerns**

SIA member firms are concerned that Amex may lack appropriate regulatory and surveillance systems, which will become even more problematic if S&P's pilot program should go into effect. Adequate regulatory systems to protect against fraud, manipulation and other trading violations are vital for protecting all investors and the quality of our markets. Some firms are particularly concerned that, because Amex lacks efficient

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<sup>9</sup> Some firms also maintain that it will cause pegging or crossing the market. Nasdaq by design prevents both pegging and crossing and has an efficient trading engine that allows all market participants equal, immediate electronic access to the quoted market.

execution systems and sufficient connectivity to relevant market participants and market centers, there will be uncertainty for all investors/traders at the opening and close except for one group – the Amex specialists. Some firms believe that this creates a window of opportunity for specialists that, without proper regulatory and surveillance systems, could be used to their advantage.

Firms are also concerned that additional regulatory issues could be presented by the different regulatory regime at Amex (as compared with Nasdaq's),<sup>10</sup> and by Amex's pending sale and the potential transfer of Amex's regulatory responsibilities to an outside regulator such as the NASD. Firms believe that a 12-month delay by S&P in implementing its pilot program would provide the necessary time for these regulatory concerns to be addressed.

#### **4. Options Concerns**

Automated exercise<sup>11</sup> on Nasdaq S&P underlying securities could pose significant confusion to the individual investor who may have witnessed a closing price on one exchange only to find that a different closing price was utilized for the exercise of the investor's option contracts. Member firms may also suffer operational risk on options expiration due to exercise prices being incorrectly administered because of confusion created by multiple closing prices. In addition to the issues created by two separate standards, the specifications administered by the Amex Official Closing Price allow for final pricing to occur at 4:25 p.m. EST. In contrast, the Nasdaq Official Closing Price is fully administered by 4:00:02 p.m. EST. The timing of the final pricing value adds an additional note of concern and could lead to further confusion on how affected underlying equity expirations are administered. As a result, the final pricing may well allow for an arbitrage opportunity to exist for the sophisticated investor and/or specialist at the expense of the individual investor.

#### **SIA Member Firms' Recommendations**

As a general principle, SIA member firms are in favor of competition in the trading of equity securities, but believe that there should be a level playing field. Firms believe that the commencement of S&P's pilot program at this time could seriously impact all investors, particularly retail investors, and broker-dealers, and could affect market quality. For the reasons discussed above, we recommend that the SEC take steps to delay the implementation of the S&P's pilot program until it has had a chance to

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<sup>10</sup> For example, Nasdaq closing prices are currently determined by the last transaction reported to the tape by 4:00:02 p.m. EST. In an exchange market-on-close ("MOC") environment, the specialist has the leeway to price his/her closing transaction subjectively based on order imbalances at the close, whereas Nasdaq MOC is based on the last print and is usually done away from the market maker. This difference could present an environment for potential manipulation that the Amex is not presently prepared to regulate.

<sup>11</sup> Automated exercise "Exercise Thresholds" stipulate that expiring options subject to exercise thresholds shall be  $\frac{3}{4}$  point per share in-the-money for equity options (the difference between the exercise price and the "closing price" of the underlying security). According to the exercise thresholds, an investor need not communicate with his/her clearing firm the intention to exercise as long as the exercise threshold is met.

review (1) S&P's proposal with member firms' concerns in mind and in conjunction with Amex's existing regulatory and surveillance systems, and (2) the relative performance of the Amex in Nasdaq stocks, including responsiveness to the marketplace, timeliness of customer transaction reports, and market-on-close procedures. In addition, we recommend that the SEC take steps to provide the industry with an opportunity to fully consider and comment on SR-Amex -2003-81. This will afford the industry and the SEC an opportunity to thoroughly explore the important issues here, and also will give Amex and Nasdaq an opportunity to implement their planned improvements before S&P initiates its pilot program or otherwise makes a final decision as to its pricing procedures.

SIA appreciates this opportunity to express our concerns with the S&P and Amex proposals. If you would like to discuss our concerns and recommendations further, please contact me at 202-216-2000.

Sincerely,

Ann L. Vlcek  
Vice President and Associate  
General Counsel

cc: Robert L.D. Colby  
David Shillman  
Stephen Williams  
Heather Seidel