Draft Statement of Professor Joseph A. Grundfest

I concur with much of the analysis presented in the Recommendation of the Market Subcommittee regarding Decimalization and Tick Size (the "Recommendation"). The weight of the evidence is that decimalization has not had a significant impact on IPO activity and that history offers a rich set of alternative explanations for the evolution of IPO activity over the last decade or so. Practices currently governing order flow raise further questions as to whether the revenues that might be generated by wider spreads would in fact be invested in a manner that would promote additional IPO activity. Evidence also suggests that IPO activity and other forms of capital formation might be more effectively promoted through alternative policy recommendations.

That said, the Recommendation, as currently drafted, relies on a potentially overstated central assumption. Its position against experimentation is also overly harsh and is unsubstantiated by the evidence on record. I therefore cannot join the Recommendation in its current form, and respectfully suggest that consideration of matter be tabled until the Committee has before it a precisely defined experimental protocol that can be subject to appropriate expert review by this Committee and by the Commission.

I. Harm to Retail Investors

The Recommendation asserts that wider spreads will harm retail investors. "The harm of moving away from decimalization is borne primarily by retail investors diffusely." (Recommendation at 5) "Finally, and perhaps most importantly, there is ample evidence that increasing tick size would harm retail investors." (Id.) "In essence, a government-mandated increase the tick size would subsidize profits for the most sophisticated financial participants at the expense of retail investors." (Id. at 6) "Moreover, we are concerned that any increase in minimum tick size would disproportionately harm retail investors, who would see their trading costs artificially inflated above the rate set in competitive markets." (Id. at 6) "As noted, above, the ample evidence that increasing tick size would harm retail investors in particular argues against the pilot." (Id. at 7)

The proposition that retail investors will bear the costs of a wider spread warrants closer analysis and is, in any event, substantially more nuanced than theses broad assertions suggest. This proposition depends critically on the assumption that non-retail investors will be able to transact in a manner that avoids the wider spread, regardless of how the wider spread requirement is implemented. If, however, this proposition is incorrect, and if it is possible to introduce a wider spread in a form that is also borne by non-retail investors, then the proposition fails as stated. So too do all of implications.

Under those circumstances, the costs of the wider spread could be borne substantially by non-retail investors. Indeed, because the aggregate costs of a wider spread depend on the frequency with which investors trade (*i.e.*, the wider spread will be borne by high frequency traders more than by low frequency traders, *ceteris paribus*), and because high frequency trading is dominated by non-retail investors, it is entirely plausible that a large portion of the additional burden of the wider spread would be absorbed by non-retail investors. Additional data are necessary to resolve this question of fact.

Whether this alternative hypothesis is correct evidently depends on the implementation details of an experiment that, to the best of my knowledge, has yet to be fully specified. Absent a detailed specification of the experiment, it is impossible to draw a categorical conclusion as to the likely incidence of the "transactions tax" that would be imposed by a wider spread. Further, absent a detailed specification of the experiment, it is impossible to draw categorical conclusions regarding many other of the experiment's likely consequences. The burden is properly placed on the experiment's proponents to specify a regime that has a plausible likelihood of generating a socially beneficial outcome. But until that experimental design is fully articulated it is difficult to draw firm conclusions regarding the experiment's likely consequences or the experiment's value for regulators.

It is also constructive to observe that, even if the cost of the spread is in fact borne exclusively by retail investors, it will not be borne equally by all retail investors because high frequency retail traders will bear more of the cost than low frequency retail traders. A large literature suggests that buy-and-hold investors outperform frequent traders. The wider spread would then act as a tax on frequent trading that could be viewed as a form of a "sin tax" designed to deter behavior that is inimical to retail investors' own best interests. Proponents of a wider spread, relying in part on arguments that can be drawn from libertarian paternalism and optimal taxation, could then contend that the wider spread is socially beneficial even if its costs are borne entirely by retail investors.

II. The Opposition to Experimentation

As already observed, it is difficult to take a position regarding the merits of an experiment that has yet to be fully specified. For that reason alone, the Recommendation's opposition to an experiment seems both overstated and premature.

It does not follow that it makes sense to support any experiment that might be proposed simply because it is an experiment. An emerging literature suggests that experimentation can and should play a more significant role in the rulemaking process, and I agree with that perspective. The burden is, however, rationally placed on an experiment's proponents to define the experiment with sufficient specificity so that its potential effectiveness can be judged by objective third party observers. Included in that burden is an obligation to explain how and why the experiment has a reasonable probability of generating information that would lead to the adoption of a socially beneficial rule.

Viewed from this perspective, the Recommendation's highly negative approach to any experiment testing the implications of a wider spread is unwarranted. The Recommendation's critique is perhaps better interpreted as an explanation of the hurdles to be overcome by the experiment's proponents if they are to persuade this Committee and the Commission to engage in the experiment. The experiment's proponents should, at a minimum, be given an opportunity to address the concerns articulated by the Recommendation, and then be afforded a fair hearing as to the potential merits of their detailed proposed experimental design.