When Securities and Exchange Commission chairman William Donaldson said last week that he wants to reexamine decimalization because hedge fund managers and market makers were complaining of how the pricing process was cutting their profits, I practically snorted with laughter.

Here was another case of regulators bowing to pressure from rich, influential insiders at the expense of the little guy. And then I read an academic study saying decimalization is pulling big money from the pockets of ordinary investors in everyday mutual funds.

That's not nearly so funny.

But it does thrust this obscure issue back into the news, where it could become the next hot button.

To see why, let's delve into the confusing world of decimalization, which is a 10-cent word for "pricing by the penny." For two centuries, stock prices were quoted in fractions, with trading increments based on a system descended from Spanish pieces of eight. Each dollar was cut into eight equal "bits" worth 12.5 cents. It was narrowed in the late 1990s as the financial markets moved to sixteenths - nicknamed "teenies" - and some trades were made in 256ths. Without decimals, the markets were prepared to split hairs down to 8,192ds (just over one one-hundredth of a penny).

Having just eight or 16 ticks within each dollar kept the "spread" on stocks - the difference between the price at which a broker buys stock from one investor and sells it to another - artificially high. If a stock wasn't available at, say, $10 per share, the next bid would be $10 1/16th ($10.0625); there might have been people willing to sell at $10.03, but the market couldn't handle that kind of trade.

That changed just over two years ago, when the markets moved to decimal pricing, reducing spreads to a penny.

The idea was sold as being good for small shareholders, who not only got better deals on their own trades but whose mutual funds would profit from reduced "slippage," the amount of investor money that slips away due to "less than optimal" execution of a fund manager's trades.

Slippage, like all transaction cost data, doesn't show up in expense ratios, but it does come right off the top. In 2001, several big managers said that funds with $40 billion in assets could lose 2 percent per year in slippage, trading costs, and spreads; that's $800 million a year.

Decimalization was supposed to help reduce that slippage by at least 10 percent, a saving that would go directly into investors' pockets.
Now market makers and hedge fund managers say that decimal pricing has made trades more costly. Pricing, they say, has become "too competitive," with "penny jumpers" buying or selling just ahead of fund managers by beating a price by a penny. The "decimalization hurts" crowd also says liquidity has decreased, making shares more expensive.

Fund equity traders aren't buying this argument. They say decimalization - and the evolution of certain trading technologies - has made trades cheaper and more efficient.

"All of our data shows that trading costs are going down and have been for 15 years," says Harold Bradley, senior vice president for American Century Capital Management, which runs the American Century funds. "Someone is losing money as a result of this change - look at the people who are complaining if you want to know who - but it's not mutual fund investors."

It's worth noting that the Investment Company Institute, which logically would complain if fund companies were feeling the pinch, hasn't said a word about decimalization recently; officials there still seem to think the system benefits shareholders.

That brings us to the recent study from Nicolas Bollen of Vanderbilt University and Jeffrey Busse of Emory University, contending that changes in tick sizes are costing investors in actively managed funds 1.37 percentage points of return per year.

That's huge, as it is nearly the same amount as the average fund's expense ratio. Having undisclosed transaction costs that large would devastate long-term returns.

That's also why I doubt the data. The study defines "transaction costs" as including dollars lost when large trades are made at lesser prices when the manager got "pennied" and paid lost money to a market that was anticipating a buy or sell move.

I'd consider those "market costs," rather than transaction expenses. The price impact may be real, but its exact size is nearly impossible for even the specialists to gauge.

Academics say there's a problem, guys on the trading floor say there isn't.

"The transaction costs for actively managed funds have increased, and we think it's by a lot," says Busse. "The SEC chairman is talking about revisiting the issue, but he hasn't mentioned what decimalization does to fund investors. . . . Before any action is taken to change things or leave them the same, that impact needs to be looked at more closely."

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