Decimalization Under Attack on Wall St.


Abstract (Summary)
"I suspect the liquidity that used to exist has been severely dampened," William H. Donaldson, the chairman of the Securities and Exchange Commission, told CNBC this week. Yesterday, Mr. Donaldson told me that he believed "we have sufficient experience now with decimal trading to begin to analyze the effect of penny pricing on fair and orderly markets."

There is no question that individual investors who trade in lots of 100 or 200 shares have benefited from the narrower spreads. But there is evidence that institutional investors have suffered. Big trades of thousands of shares are more likely to exceed the number of shares offered at the best bid or ask price, forcing the buyer to pay more. "What you have done," Mr. [Richard A. Grasso] said, "is collapsed spreads but made the depth of the market far more shallow."

A new study shows how that is working. Two scholars, Nicolas P. B. Bollen of Vanderbilt and Jeffrey A. Busse of Emory, estimated trading costs for mutual funds before and after decimalization. Their conclusion is that actively managed mutual funds are incurring greater transaction costs, and that those costs could be reducing annual returns by one percentage point. Index funds, which do not do a lot of trading, appear to be unaffected.

Full Text (636 words)

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RARELY has a change on Wall Street been more important in making life better for retail investors than the change to decimal pricing in stocks. Now it is under attack.

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Many on Wall Street would love to see the commission act. Richard A. Grasso, the chairman of the New York Stock Exchange, suggested yesterday that the S.E.C should order an experiment in which some stocks be required to trade with prices moving in nickel increments, rather than the current penny.

Broadly speaking, the bigger the spread, the happier Wall Street is. In the old days, brokers prospered from minimum spreads of 12.5 cents, or an eighth of a dollar. In 1997, that was cut in half, and in 2000 and 2001 decimalization came in.

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That study did not try to differentiate among different types of actively managed mutual funds, but Mr. Bollen said yesterday he thought that the effect was greater on momentum funds and less on value funds that may be more patient in their trading.

But it may be that decimalization will turn out to be like other major market changes of the past, ranging from the introduction of block trading in the 1960's to program trading in the 1980's. At first those not accustomed to the new rules screamed that markets had been severely damaged. But in time traders learned to deal with the new conditions.

Indeed, the study by Mr. Bollen and Mr. Busse indicates that the negative effect of decimals declined a bit as traders adjusted.

Next week, the Big Board will introduce its "liquidity quote" in a test involving the 28 Dow Jones industrial average stocks.
traded on the exchange. The published quotes for those stocks will show not only the narrow spread for small orders but how much wider the spread is for large block trades. That additional information could help institutions lower their transaction costs.

If Mr. Donaldson wants to study the effect of decimals, he certainly can do so. But action should be delayed until it is clear the market has been unable to adapt, and that may take years.

He should remember that his predecessors at the S.E.C. spent years trying to figure out how to regulate the odious practice of payment for order flow, in which market makers paid brokers for the right to execute a customer's trade. Then decimalization, and the competition in spreads it brought, largely ended the practice.

Price competition is usually good for the customers. Proving that that is not the case in stocks will be difficult, at best.

[Photograph]
William H. Donaldson

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