

MEMO# 19043

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GAO REPORT ON DECIMALIZATION

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Government Accountability Office has released a report on the impact of decimal pricing in the U.S. securities markets on retail and institutional investors, market intermediaries, and options market investors and intermediaries.¹ The report notes that since the move from the use of fractions to decimal pricing, concerns have been raised that the smaller tick size has made trading more challenging and costly for large institutional investors, including mutual funds and pension plans, that trade large blocks of shares. The report analyzes these issues and, as summarized below, concludes that decimal pricing has resulted in lowered trading costs and reduced market transparency.² The report found that since the move to decimal pricing, trading costs, a key measure of market quality, have declined significantly for retail and institutional investors. For institutional investors in particular, the report suggests that additional factors may have contributed to reduced trading costs, including for example, the multiyear downturn in stock prices that began in 2000. The report also found, however, that while decimalization has lowered trading costs, it also has reduced market transparency, as the number of shares that are generally displayed as available for purchase or sale on U.S. stock markets declined significantly. The report explains that institutional investors became less willing to display large orders in the markets following the switch to decimalization for fear that competing traders would improve the best quoted prices by as little as one penny, thereby driving up prices to execute large orders.³ In response, 1 GAO Report: Securities Markets – Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment, GAO Report to Congressional Requesters (May 2005). The report can be found at <http://www.gao.gov/new.items/d05535.pdf>. 2 The GAO's conclusion was based on an analysis of trades conducted and related trading costs, a review of academic, industry and regulatory studies, and interviews of numerous market participants, including pension and mutual fund investment managers. In support of the GAO Report, the staff from the Securities and Exchange Commission's Division of Market Regulation and Office of Economic Analysis said that, overall, the GAO Report accurately depicted conditions in the markets after the implementation of decimal pricing. 3 This trading strategy, called "penny jumping" or "stepping ahead," harms institutional investors that display large orders and can increase their trading costs. The report adds that the potential for stepping ahead has increased in a 2 the report found that institutional investors have adopted new trading strategies and technologies, such as breaking up large orders into smaller lots and using electronic trading technologies to submit a larger volume of smaller orders, and making greater use of alternative trading venues, such as ECNs and crossing networks that

anonymously match large institutional investor orders. The report adds that through these adaptations, institutional investors have been able to continue executing large orders at reduced costs. Barry E. Simmons Associate Counsel decimal environment as the financial risk to traders stepping ahead of larger displayed orders has been greatly reduced.

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