A Tick too Far:
How Decimalization Changed the Industry (and Why it's a Hot Topic Again)

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To commemorate the 20th anniversary of Fidessa's presence in the US, we are proud to present the latest in a series of articles looking at some of the key industry and regulatory events that have helped shape the trading landscape since the opening of Fidessa's first US office in New York some two decades ago.

A lot has changed in financial markets over the past two decades. Without a doubt, one of the most significant events was the shift from fractional share prices to a decimalized quote system, a change mandated by the SEC in the late nineties. Jess Haberman, Fidessa's Compliance Officer, explains how the move to decimalization in the US affected not just share prices, but permanently changed how equities were traded.

In the mid-1990s, financial markets still had a long way to go in terms of achieving today's levels of electronic sophistication and interconnectedness. Still, increased automation was helping drive a certain degree of uniformity and standardization in many of the world's markets. For example, most of the world's marketplaces had adopted a decimalized trading system in which share prices were quoted in penny (or local currency) increments.

The US, however, was a holdout, with prices still quoted in fractions – a throwback to an 18th century system of trading based on the Spanish dollar in which prices were divided into sixteenths. In 1998, a bill was introduced in Congress that would have directed the SEC to adopt a rule requiring quotations for equities to be in dollars and cents, and after the NYSE announced that it would implement decimal pricing by January 2000, the SEC directed the exchanges and FINRA to develop a Decimals Implementation Plan.

The primary case for decimalization was that it would result in tighter spreads, increased competition among market makers, and quotes that were easier to understand – all things that would benefit investors and, by extension, the markets themselves. Plus, it would bring the US into closer alignment with global standards. (Former SEC Chairman Arthur Levitt reiterated at the time that US securities markets needed to "adopt the international convention of decimal pricing in order to remain competitive.")

Full decimalization went into effect on April 9, 2001, after which all US stock quotes were required to be priced in penny increments.

Reception

Like any major industry shift, the changeover from fractions to decimals was not without some resistance. Specialists and others traders were concerned that narrower spreads would erode the profitability of their businesses. Nevertheless, the industry was marching steadily towards uniformity, transparency and operational simplicity – and decimalization of the US quote system was a critical step in that direction.

Consequences

There were a number of consequences that resulted from decimalization. Whether these were good or bad depended largely on who one spoke to. As one would expect, the narrowing of spreads did affect profitability of trades in the immediate aftermath. There is no doubt that this change also reduced costs for investors.

One of the most enduring consequences of decimalization was the effect that it had on electronic trading. Markets were already seeing a rise in market access and execution technologies, but tighter spreads caused firms to transact more of their order flow electronically in order to preserve now slimmer margins. This migration helped fuel an electronic trading boom in the years that followed, which brought about some of the markets' most revolutionary advances from algorithms to high frequency and ultra-low latency trading.

Decimalization also led to unanticipated consequences and changes on the regulatory front as well. Most significantly, the sub-penny trading rule of RegNMS, for instance, aimed to address the issue of traders jumping to the front of the queue by inputting the smallest price increment possible. Under the fractional system this was a sixteenth of a dollar – about six cents. With decimals, however, it became easier to receive priority over orders already displayed by placing orders at better prices for an amount less than one cent. To address what seemed to some as an unfair practice, RegNMS Rule 612 required, among other changes, minimum pricing increments of one cent for all stocks over $1.00.

Reopening the Spread Debate – Tick Size Pilot

Now, 15 years after decimalization went into full effect, the industry is revisiting the issue. The Tick Size Pilot program, mandated by the SEC and implemented as a NMS plan by US equity exchanges and FINRA, is set to fully launch in early October and will implement nickel increments on a basket of about 1200 stocks to gauge the impact of wider spreads on the industry's fundamental business model. The thinking behind this study is to see whether increasing the profit potential on certain trades will lead to more research coverage of the underlying stocks – and subsequently more buy-side interest in them. In other words, if wider spreads help market makers facilitate more demand in a stock, then it could lead to more listing activity overall – a vital component to economic growth, many affirm.

From a technology perspective, the move to decimalization in the US occurred in the relatively early stages of the global electronic trading boom. That is not to say the conversion process was without headaches – it wasn't. Firms were tasked with adapting their architectures across all areas of the front, middle and back office. As an international firm, Fidessa had experience guiding companies through decimalization in other parts of the world, where the system had already been implemented. When Fidessa's New York office opened in 1996, US financial markets were in the beginning stages of moving from fractions to decimals, and Fidessa was in a unique position to deliver its expertise to customers operating in the changing US marketplace.

As a pioneer in trading technology, Fidessa's experience with the shift to decimalization was just one example of many, over the last 20 years, in which we've provided solutions to our clients to help them navigate and benefit from the ever-changing trading landscape. We look forward to continuing this journey with them in true partnership for the next 20 years and beyond.