May 2005

SECURITIES MARKETS

Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment

GAO
Accountability·Integrity·Reliability
Highlights

Highlights of GAO-05-535, a report to congressional requesters

Why GAO Did This Study

In early 2001, U.S. stock and option markets began quoting prices in decimal increments rather than fractions of a dollar. At the same time, the minimum price increment, or tick size, was reduced to a penny on the stock markets and to 10 cents and 5 cents on the option markets. Although many believe that decimal pricing has benefited small individual (retail) investors, concerns have been raised that the smaller tick sizes have made trading more challenging and costly for large institutional investors, including mutual funds and pension plans. In addition, there is concern that the financial livelihood of market intermediaries, such as the broker-dealers that trade on floor-based and electronic markets, has been negatively affected by the lower ticks, potentially altering the roles these firms play in the U.S. capital market. GAO assessed the effect of decimal pricing on retail and institutional investors and on market intermediaries.

What GAO Recommends

GAO observes that the goals for implementing decimal pricing have been met and that investors have adapted to the new environment and continue to trade large numbers of shares at lower cost.

www.gao.gov/cgi-bin/getrpt?GAO-05-535.

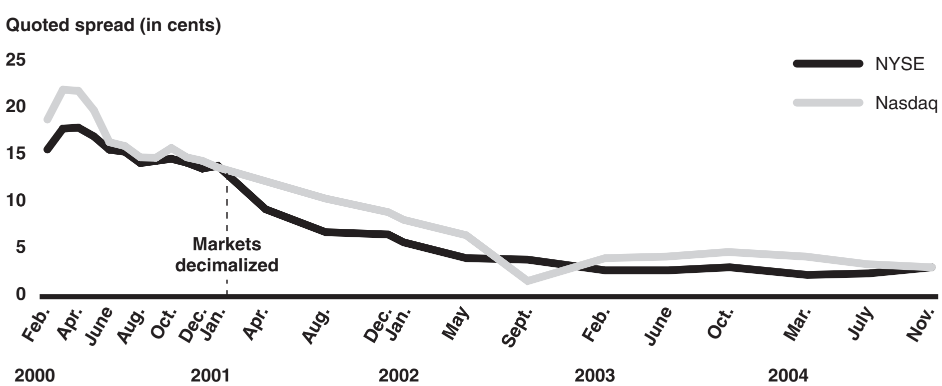
To view the full product, including the scope and methodology, click on the link above.
For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

Trading costs, a key measure of market quality, have declined significantly for retail and institutional investors since the implementation of decimal pricing in 2001. Retail investors now pay less when they buy and receive more when they sell stock because of the substantially reduced spreads—the difference between the best quoted prices to buy or sell. GAO's analysis of data from firms that analyze institutional investor trades indicated that trading costs for large investors have also declined, falling between 30 to 53 percent. Further, 87 percent of the 23 institutional investor firms we contacted reported that their trading costs had either declined or remained the same since decimal pricing began. Although trading is less costly, the move to the 1-cent tick has reduced market transparency. Fewer shares are now generally displayed as available for purchase or sale in U.S. markets. However, large investors have adapted by breaking up large orders into smaller lots and increasing their use of electronic trading technologies and alternative trading venues.

Although conditions in the securities industry overall have improved recently, market intermediaries, particularly exchange specialists and NASDAQ market makers, have faced more challenging operating conditions since 2001. From 2000 to 2004, the revenues of the broker-dealers acting as New York Stock Exchange specialists declined over 50 percent, revenues for firms making markets on NASDAQ fell over 70 percent, and the number of firms conducting such activities shrank from almost 500 to about 260. However, factors other than decimal pricing have also contributed to these conditions, including the sharp decline in overall stock prices since 2000, increased electronic trading, and heightened competition from trading venues.

Average Quoted Spreads Before and After Decimal Pricing Implemented in Cents per Share, February 2000 through November 2004



Source: GAO.