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Money & Investing

Stock Prices Switch to Decimals From Fractions, Raising Concerns

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When the long-awaited switch to decimal from fractional stock prices in the U.S. begins Monday, most investors expect to benefit from narrower bid/ask spreads.

But there is a potential dark side to the switch that many investors may be unaware of. With stocks quoted in dollars and cents, it will mean that for as little as one cent a share, Wall Street pros will be able to step in front of public orders -- in what some, including the president of the New York Stock Exchange, say amounts to "front-running."

Pros can step in front of the public even with stocks quoted in fractions such as 1/16 of dollar, and investors sometimes benefit from the practice. But some fear that reducing the minimum spread from 1/16, or 6.25 cents, to one cent, will make the practice so cheap that it will surge, at the public's expense.

Investors -- especially big investors -- could become more reluctant to use "limit orders," which are orders executable only within a defined price limit, resulting in more volatility. That is what happened with the switch from eighths to sixteenths in 1997, one study found.

"Certainly in a penny environment there's more of an opportunity for people stepping ahead," says Annette Nazareth, head of the division of market regulation at the Securities and Exchange Commission, which is overseeing the phase-in. "It's a concern. We're going to be watching it much more closely. We wouldn't want to see investors discouraged from placing limit orders."

Rob King, head of Nasdaq trading at Robinson-Humphrey, a unit of **Citigroup** Inc., says, "You narrow the spreads from a sixteenth to a penny, you save the customer five cents, but the reality is you'll make stocks much more volatile. You'll see stocks run up 20 cents, run down 20 cents -- the professional who knows what he's doing will easily be able to step in front of someone for a penny."

Here's how it works. Suppose an investor posts a limit order to buy 5,000 shares at no more than $20, which becomes the market's best bid. Suppose then a "market" order -- which can be executed at the best available price -- to sell 500 shares arrives. A professional -- a stock exchange specialist, a market maker on Nasdaq or the investor's own broker -- might decide that the presence of a big buyer at $20 suggests the stock is a good buy, and "steps in front" by bidding a little more for the 500 shares.

At present, the pro would generally have to pay $20.0625 to step in front of the $20 bid, for a total cost of $31.25. The 5,000-share buyer gets nothing, but the 500-share seller is "price improved" because $20.0625 is better than the best bid of $20. But with penny increments, the pro would only have to pay $20.01, for a total cost of $5. The buyer still gets nothing and the seller gets only a slightly improved price.

What if the pro bets wrong and he sees selling pressure build? He sells his 500 shares to the 5,000-share buyer at $20; his total loss is just $5, and the buyer now holds a stock that is about to drop.

Pros "are not stepping in front to price-improve out of the goodness of their heart," says Bill Burnham, a partner specializing in financial services at Softbank Capital Partners, but because "they know something you don’t."

Indeed, some such as Mr. Burnham say it amounts to front-running, which is when a broker uses knowledge of a customer’s intentions to trade ahead of that customer. Securities law prohibits it when the broker trades at the same price his customer would have traded at, but not necessarily when he trades at a better price.

Monday’s pilot program begins with seven stocks on the New York Stock Exchange and six on the American Stock Exchange. If all goes well, more will be added Sept. 25 on the Big Board, with decimals for all stocks by next April. (The Nasdaq Stock Market won’t start going decimal until March.) Spreads may not fall to one cent, which is simply the minimum. Actively traded stocks are expected to trade with spreads of a few pennies, while spreads on inactive stocks might actually widen.

The markets agreed to make the move in 1997 under pressure from Congress, which felt customers would save money on the spread. If a dealer was bidding $20 and offering $20.0625 for a stock, it would cost an investor $6.25 to buy then sell 100 shares. But if the stock was bid at $20.01 and offered at $20.03, the same trade would cost only $2. The difference, it was assumed, would come out of the pockets of dealers who quoted bid and ask prices.

However, those savings are more relevant to Nasdaq or a regional stock exchange, where buyers and sellers typically trade with a dealer. On the New York and American stock exchanges, a buyer usually trades directly with a seller, so a penny saved by one comes out of the other’s pocket. Sometimes the investor trades with a specialist, but normally on one, not both, sides of the market.

Erik Sirri, a finance professor at Babson College and former chief economist for the SEC, says the cost of being stepped ahead of and the benefit of narrower spreads will probably balance out. He noted that pennies also make it cheaper for an investor to improve his price to ensure an execution.

Though the Big Board is anxious to make the move to decimals, it has been among the most vocal about its dangers. In April 1997, its president William Johnston testified to Congress that "professional front-running is another hazard that could result from decimal pricing ... . Decimalization could result in a significant shift of power from public customers [to] professional traders, undermining the very basis of our market."

In December, the association representing the Big Board’s specialists warned an internal exchange committee, "Professionals, including specialists, will be able to trade ahead of any public orders by paying a penny more or selling for a penny less," resulting in "fewer limit orders being entered, leading

to less depth and transparency, and fewer single price executions. Specialists witnessed this when the trading increment changed from eighths to sixteenths."

A study of the June 1997 switch to sixteenths by Michael Goldstein, now at Babson College, and Kenneth Kavajecz at the University of Pennsylvania's Wharton School, found that although quoted spreads declined 14%, the volume of limit orders within 50 cents of the best bid or offer shrank sharply -- by between 19% and 28%. They concluded small investors benefited on balance, though mostly on active stocks, while large investors, like mutual funds, suffered.

They also found the switch to sixteenths hadn't made specialists any more likely to quote better prices than, or add to, the best-priced limit orders. But it did appear to make them more likely to price-improve, i.e., step ahead. Indeed, New York Stock Exchange data show that specialists' trading jumped to 12.7% of total volume in 1998 from 9% in 1996. A Big Board spokesman notes that specialists' performance in keeping markets orderly has improved at the same time. He added that one reason for a pilot program is so that the exchange can "carefully monitor trading by all market participants in this new environment."

Andrew Cader, co-head of Spear, Leeds & Kellogg LP, whose Big Board specialists handle the stocks in this week's pilot, says he is less concerned about the impact of decimals than he was last year. "I don't think there are so many limit orders that it will be economic for anyone to jump them by a penny." Over time the limit order book, which displays orders to specialists, has gotten thinner and less useful for predicting the market's direction, and indeed, "I, for sure, and the specialist community in general are pushing the exchange to display the limit order book to the whole world."

The best protection for investors might be disclosure. If the New York Stock Exchange and Nasdaq market makers publish all their limit orders, as the SEC would like, professionals would no longer have an information advantage over the public. In addition, a recent SEC proposal would require brokers and exchanges to report how well they handle customers' orders, enabling an investor to see how often his limit orders are filled.

Trading Stocks a Cent at a Time

A new era begins Monday morning, when the New York and American stock exchanges begin trading some stocks in "decimals," meaning dollars and cents, rather than fractions. (The Wall Street Journal's stock tables have already been converted to a decimal format.)

Which stocks are going decimal?

The issues that will be traded in decimals in Phase One of a pilot program starting today:

On the NYSE: **Anadarko Petroleum**, **FedEx**, **Forest City Enterprises** (A shares and B), **Gateway**, **Hughes Supply**, **MSC.Software**

On the Amex: **Regal Beloit**, **Media General**, **ON2.com**, **eMagin**, **Psychemedics**, **Global Light Telecommunications**

What does it mean?

The stocks in the pilot program will be traded in one-cent increments. When using fractions, as Wall Street has done since the 1700s, stocks trade in wider increments, since 1/8, for example, means 12.5 cents and it takes another 12.5 cents to get to 2/8, or 1/4. Now, a stock won't move from 1/8 to 1/4, but rather can move a penny at a time from 12 cents to 25 cents.

When is the pilot expanded?

In Phase Two of the NYSE experiment, on Sept. 25, some 52 other companies will have their stocks traded in decimal format. They will include such heavily traded NYSE stocks as **America Online** and **Compaq Computer**. The Amex's second stage will involve 40-50 stocks.

Where are the Nasdaq stocks?

Nasdaq won't start its pilot until March. The market needed more time to get its act together. All the markets must go fully decimal by April, regulators say.

Source: New York Stock Exchange; Nasdaq; WSJ research

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