waters

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Decimalization. No, it's not the killing of every 10th Roman soldier for a legion's cowardice in battle, but it is clearly of European origin and an unexpected consequence of Napoleon's 19th-century rout of Europe. The work of world-class mathematician Condorcet, the 10-base system made sense of all the "leagues, hectares, pounds, florins" and other incongruous measures. Condorcet introduced the metric system to France, and Napoleon introduced it where he conquered. Throughout Europe from 1815, measures of length, liquid volume and mass were base 10, measured in meters, liters and grams, respectively.

The exceptions were in the UK, with its shillings, pence and guineas, which ultimately beat Napoleon at Waterloo, and of course the UK's former colony, the US, which had beaten the UK with a little help from the French. The UK adopted a 10-base monetary system in February 1971. President Jimmy Carter tried to get the US to adopt the metric system from 1976 to 1980. Although US currency was based from inception in 1792 on the decimal system, the first and dominant securities exchange, the NYSE, founded by the Buttonwood Agreement in 1792 to facilitate the trading of US treasury obligations and other stocks, established pricing in 1/32. Below 1/4 , fractions split by half to 1/8, 1/16, 1/32, 1/64 and so on. Compared to a spread of a few basis points, you can drive an American Hummer through a 1/32 and a British Challenger II through 1/8.

The US bond market continues to price in 1/32s, but under Securties and Exchange Commision guidance in July 2000 the US equity markets were required to move to the decimal system to make our markets more competitive with European exchanges, to make pricing more transparent to the retail customer and to narrow spreads. The NYSE inaugurated trading decimal pricing with seven stocks in September 2000. By April 2001, all US equity markets traded in decimals.

"Decimalization had a profound impact on the way the market is traded and how some people's roles changed; some profits and losses were squashed," says Jim Leman, now principal and head of capital markets at Westwater Corp. "Market-making became a completely different animal as the spreads tightened up dramatically. Market participants had incentive to trade much more frequently. It impacted everyone's profitability-some big pluses, some big minuses. It changed everything."

Every broker-dealer and specialist lost a big payday when buy-sell spreads all but disappeared. Those with size that modified their business model are still with us, but firms with smaller balance sheets and less access to the efficiencies of technology went out of business. Technology innovators like ECNs who built for speed and volume prospered and every business user who adopted these technologies, whether for trading, risk management, clearing or settlement, prospered. And those who had not invented the new way forward merely needed the capital and the wit to buy it: Witness NYSE's acquisition of Archipelago and later Euronext, and Instinet's acquisition of Island, later acquired by Nasdaq.

Millions of cash equities investors save over $1 billion a year in transaction costs as a result. Trading volumes have grown enormously, which places even more reliance on technology to handle the actual trading and clearing. Investors have clearly benefited.

Nearly six years after cash equities started trading in pennies instead of eighths, listed options followed suit in early 2007 in another SEC-mandated pilot program that reduced quote brackets from five cents to one penny. With sometimes more than 12 strike prices for both puts and calls and 10 active settlement months listed on options for the underlying stock, concerns have been raised about liquidity and technology challenges.

The year 2008 will sort out the winners and the losers. Stay tuned.

-Maureen Callahan

Source: