Tick Size Pilot Program

OVERVIEW

The Tick Size Pilot Program was mandated by the Securities and Exchange Commission (SEC) in June 2014 to test the effects of wider quotes and trade increments in small cap stocks and to assess whether wider tick sizes enhance the market quality (liquidity, price discovery, and volatility) of these stocks for the benefit of issuers and investors. The premise behind the pilot is that wider spreads will increase profits for market makers and underwriters, and therefore increase trading liquidity. This will encourage market makers to support these stocks, fund more research coverage, and underwrite more IPOs, all of which, in theory, lead to more listings by issuers and improve capital formation.

The U.S. exchanges and FINRA submitted their collective proposal for the pilot study to the SEC, and on May 6, 2015 the SEC approved the final version. The pilot will begin on October 3, 2016 and continue for at least two years. While the change appears minor, given the multiple test groups, lines of exclusions, and reporting requirements, the pilot is an incredibly complex undertaking, and it may be among the more complex changes to U.S. equity markets.

THE PROGRAM

The structure of the program includes one control group with approximately 1,400 stocks and three test groups with 400 stocks each. The stocks impacted are those with a market cap of $3 B or less, an average daily trading volume of one million shares or less, and a share price of $2 or more.

Control Group

Stocks in the control group will continue to quote/trade in penny increments.

Test Group One

Stocks in Test Group One will be quoted in $0.05 minimum increments and traded at any price increment that is permitted today.

Test Group Two

Stocks in Test Group Two will be quoted in $0.05 minimum increments and traded in $0.05 minimum increments subject to three exceptions:

- Trading can occur at the midpoint between the National Best Bid and Offer (NBBO);
- Retail investor orders can be provided with price improvement that is at least $0.005 better than the NBBO (e.g. 10% of the $0.05 tick size); and
- Certain negotiated trades (e.g. trades with a performance target such as volume-weighted average price trades and time -weighted average price trades) could continue to occur at any price increment that is permitted today.

Test Group Three

Stocks in Test Group Three will be subject to the same minimum quoting and trading increments (and exceptions) as Test Group Two, but these stocks will also be subject to a "trade-at" rule. Under the trade-at rule, a trading center that is not displaying the NBBO at the time it receives an incoming marketable order can only:

- Execute the order with significant price improvement;
- Execute the order at the NBBO with significant size improvement, if the size of the order was of block size (5,000 shares/$100,000); and
- Allow trading centers to trade at the NBBO if they are a price matcher.

RIVER ROAD CONCERNS

The following are River Road's (and likely any small cap manager's) greatest concerns with regard to the Tick Size Pilot Program's potential impact on the firm's clients.

Increased execution costs for investors

Transaction costs for institutional investors like River Road are almost certain to increase, as River Road is often a liquidity taker that crosses the spread. The ability to trade volume in dark pools at the midpoint would mitigate some of the wider spread costs – as this already naturally occurs in stocks with wider spreads. However, the rules set out in groups two and three specifically counter this and could make the markets more aware of our intentions (lit signaling).

Decrease in liquidity

Investors, brokers, and market makers may decide to avoid these stocks altogether rather than invest to comply with the rules of the pilot brokers. Investors may opt to avoid those securities if they see increased cost and decreased liquidity in the early stages of the program. While large brokers will likely continue to participate, small to mid-sized brokers may choose to opt out of the program if the cost outweighs the realized increase in volume. Market makers may opt out if they determine the cost outweighs potential profits.

Block trading and information leakage

Proponents of the trade-at rule believe it will keep more volume on lit venues, thereby enhancing market quality and price discovery. River Road believes that alternative venues are necessary for hiding one's identity in order to avoid predatory players in the marketplace as well as having the ability to execute block trades while limiting information leakage.

Implementation costs, complexity, and related issue of operational risks

There are concerns there will be more time needed to implement the pilot. Implementation will require technology resources for brokers and exchanges to ensure that the stocks in each test group are trading according to the respective rules. Data collection and reporting will be a complex undertaking as infrastructure for collecting and reporting will need to be built by all trading centers and market makers that trade the pilot stocks. It is unclear who will bear the brunt of these costs and at what price.

Ability to properly assess the data

Assuming the program is able to accurately gather the data and, more importantly, measure the impact, it is unclear whether the SEC is equipped to properly assess the statistical and economic impact of (and not limited to): market quality, market makers, market participation, market transparency, liquidity, and transaction costs.

No direct correlation between trading profits and increased underwriting

River Road has concerns regarding the underlying premise that wider spreads would allow market makers to make a greater profit on small cap stocks, which they could then spend on new issuer research and underwriting. Brokers' trading departments and capital markets groups are often not interrelated.

Tick Size Pilot Program made permanent regardless of success due to sunk cost

There is a real dollar cost associated with implementing the required infrastructure to comply with the Tick Size Pilot Program. The cost to initiate pilot programs often results in permanent implementation.

The SEC does not believe in the plan

In 2013, the SEC's own Subcommittee on Market Structure of the Investor Advisory Committee on decimalization and tick sizes recommended that the SEC not reverse its decimal pricing policy. "That includes not engaging in 'tests' or 'pilot' programs," wrote the Subcommittee. "There is no evidence that if a larger tick size were adopted, any resulting increase in revenues for market makers would be used to support research or provide enhanced liquidity which would benefit capital formation."

CONCLUSION

What will be the final outcome of the Tick Size Pilot Program? Unfortunately, that answer is still at least two years away. In our view, the optimal scenario is that the program will achieve the desired goal of the SEC that wider tick sizes leads to a substantial increase in liquidity and a more robust market for investors. A more probable scenario is a minimal positive impact to liquidity, with the brokerage community bearing the sunken cost of implementation and continuing data collection and reporting. In the worst case scenario, we will see increased execution costs, a decrease in block liquidity, and a more complicated market structure. Ultimately, we believe the pilot program may have a negative effect on investors – execution costs and liquidity should be led by market participants and exchange competition, not through government-led market regulation.

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