STATE STREET GLOBAL ADVISORS.

April 12, 2018

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via email: chairmanoffice@sec.gov

State Street Global Advisors
One Lincoln Street
Boston, MA 02111

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Re: Market Structure for Thinly-Traded Securities

Dear Chairman Clayton:

State Street Global Advisors (State Street) strongly supports the principles and priorities you have outlined for the Securities and Exchange Commission (SEC)[1], particularly your focus on capital formation and market structure, which we agree are interrelated. We believe the agenda you have outlined will provide significant benefits to investors. As one of the largest asset managers in the world,[2] we at State Street are committed to ensuring that US capital markets continue to serve the needs of investors. In keeping with your recent remarks at the Equity Market Structure Symposium in Chicago[3], we are eager to share our perspective on one of the near-term initiatives you mentioned: ensuring the US equity market structure is optimal for thinly-traded securities.

We believe the SEC can take steps to enhance the capital markets by revisiting an old debate: revoking Unlisted Trading Privileges (UTP) for thinly-traded securities. UTP allows a security listed on one national exchange to be traded on other exchanges, thereby allowing markets to compete for order flow. We acknowledge that competition for order flow has benefited investors by incentivizing trading venues to reduce costs and provide high quality products and services.[4] That standard approach to liquidity fragmentation, however, may not achieve the desired results for thinly-traded securities. For these securities, we believe that concentrating quoted liquidity on the primary listing exchange could enhance market quality, reduce trading costs, and reduce unnecessary complexity in the markets. As an added benefit, suspending UTP could also provide an opportunity for the listing exchange to seek innovative ways to improve market quality in these securities, benefitting investors and improving the attractiveness of the public markets for issuers.

While we believe revoking UTP for thinly-traded securities could enhance the capital markets, we anticipate that concentrating quoted liquidity on one exchange could also have undesired drawbacks that may need to be addressed. We suggest that the SEC initiate a targeted pilot program to test the effects of eliminating UTP for thinly-traded securities. A pilot program would illuminate whether revoking UTP improves market quality in thinly-traded securities, while minimizing potential negative side effects.

1 SEC Chairman Jay Clayton. "Remarks at the Economic Club of New York." July 12, 2017. Available at: https://www.sec.gov/news/speech/remarks-economic-club-new-york.

2 State Street manages nearly $2.8T and is the third largest asset manager in the world, as of 12/31/17.

3 SEC Chairman Jay Clayton. "Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation." April 10, 2018. Available at: https://www.sec.gov/news/speech/speech-clayton-2018-04-10.

4 Securities and Exchange Commission. Concept Release on Equity Market Structure. January 21, 2010. Available at: https://www.sec.gov/rules/concept/2010/34-61358fr.pdf.

Recent recommendations for concentrated liquidity for thinly-traded securities

Competition among US equity exchanges is beneficial for several reasons, but the "one size fits all" approach we've created over the years may not be optimal for thinly-traded securities. In the US, where there are 13 national securities exchanges, having UTP in place fosters continuity and competition across exchanges, benefitting investors through wider choices, resilience, innovation, and exchange fee competition. The resulting fragmentation of liquidity, however, may not necessarily work for all stocks and all companies, especially those traded infrequently or at consistently lower volumes. Such securities generally have higher transaction costs for investors.

Concentrating quoted liquidity on the listing exchange could benefit market quality for thinly-traded securities, as observed by the following stakeholders:

- The US Treasury Department, in its recent report on Capital Markets, noted that "consolidating trading to fewer venues would simplify the process of making markets in those stocks and thereby encourage more market makers to provide more liquidity in those issues."[5]
- Nasdaq, in its recent report on "Reigniting America's Economic Engine," suggested that eliminating UTP for small and medium growth companies "would allow liquidity to develop, and for supply and demand to find one another." Nasdaq added that "Without the rigidity of Regulation NMS which was enacted to cater to a UTP market model, the new markets would also create natural opportunities for other market structures to develop and thrive – for example, intraday auctions to bring together supply and demand."[6]
- Bats Global Markets, in a rule filing in 2015, stated, "By concentrating quoted liquidity on the listing exchange, [...] the Exchange believes liquidity providers will quote more competitively, resulting in more efficient price formation and a narrower national best bid and offer ('NBBO'), as well as the display of more quoted size at price levels outside the NBBO ('depth of book')." Bats added that "these enhancements to market quality could ultimately increase investor and member interest in such securities resulting in greater average daily trading volume."[7]

In the rule filing from Bats, the exchange identified several reasons why concentrating the quoted liquidity in thinly-traded securities on the primary listing exchange could incentivize

5 US Department of the Treasury. "A Financial System that Creates Economic Opportunities: Capital Markets Report to President Donald J. Trump." October 2017. Available at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf. (The Treasury Department recommended that the SEC should consider allowing issuers of less-liquid stocks to choose to have their stock trade on a smaller number of venues until liquidity in the stock reaches a minimum threshold. Broker internalization should remain as a trading option to maintain a basic level of competition for execution.)

6 Nasdaq. "The Promise of Market Reform: Reigniting America's Economic Engine." May 4, 2017. Available at: http://ir.nasdaq.com/releasedetail.cfm?releaseid=1024751. (Nasdaq recommended permitting issuers to choose to trade in an environment with consolidated liquidity.)

7 Bats Global Markets. "Notice of Filing of a Proposed Rule Change to State that the Bats Exchange, Inc. Will Not Designate for Trading Any Security Admitted to Unlisted Trading Privileges on the Exchange Unless that Security Satisfies Certain Liquidity Requirements." May 18, 2015. Available at: https://www.sec.gov/rules/sro/bats/2015/34-74987.pdf.

liquidity providers to quote more competitively, resulting in narrower bid-ask spreads and greater quoted depth of book. Bats noted that concentrating liquidity has potential to: "(i) reduce liquidity providers' risk of adverse selection inherent in quoting in a fragmented market, (ii) provide greater certainty of execution on the one exchange at which liquidity providers are quoting, and (iii) enhance competition for order book priority at the NBBO and throughout the depth of book."[8] To the extent that concentrating quoted liquidity improves market quality for thinly-traded securities, such enhancements would not only benefit investors in individual securities, but would also benefit funds that hold such securities, improving the end results for issuers and investors on multiple levels.

Benefits of concentrated liquidity for common stocks and exchange-traded products

We suspect that concentrating quoted liquidity on the primary listing exchange could improve market quality for a subset of common stocks as well as exchange-traded products (ETPs). There are roughly 4,000 common stocks listed on the major US exchanges (excluding ETPs, Pink Sheet, and Bulletin Board names), which represent approximately $33 trillion in market capitalization and an average traded volume of 4.1 billion shares or $200 billion per day. While the vast majority of these stocks trade daily without issue, there is a subset with relatively low average daily volumes and relatively wide bid-ask spreads. In 2017, approximately 20% of publicly traded companies (824 stocks) had an average daily traded volume of 50,000 shares or less, representing 35 basis points of dollar turnover. These stocks had a median bid-ask spread of 234 basis points, compared to a median of 36 basis points for the total universe. Among ETPs, more than 60% of the 2,147 US-listed products traded below 50,000 shares per day, representing only 1% of total dollar turnover. The less-actively traded ETPs also had wider bid-ask spreads, at an average 33 basis points, compared to 8 basis points for the more-actively traded ETPs. It is worth noting that while a 50,000-share threshold is helpful for illustrative purposes, there may be other ways to determine which securities may benefit from revoking UTP. Additionally, average daily trading volume of ETPs is only one measure of their liquidity profiles. Because of the structure of ETPs vis-à-vis single stocks, one must also consider the liquidity characteristics of an ETP's underlying constituents.

Revoking UTP for thinly-traded securities would mean consolidating the on-exchange portion of trading at the primary listing exchange, while still permitting trading via alternative trading systems (ATSs) or broker-dealer internalization. While promoting market quality on exchanges is paramount, the availability of off-exchange liquidity in US equities is significant. Thinly-traded securities – especially in the case of ETPs – can see a greater percentage of average daily volume traded off-exchange as compared to more actively-traded securities. Permitting off-exchange trading in thinly-traded securities would preserve the ability for investors to minimize information leakage and obtain price improvement in some cases.

Benefits of concentrated liquidity for smaller issuers

Although the US equity market is known for its depth and breadth, a large portion of the dollar turnover is concentrated in a relatively small number of listings which change hands easily with minimal transaction costs. For the 2,100+ securities that trade below 50,000 shares a day, however, an effort should be made to promote liquidity and decrease transaction costs. If, after a pilot period, there is value identified in revoking UTP, then

[8] See Supra note 7.

issuers of thinly-traded securities, including issuers of ETPs, should be permitted to choose to have their securities traded in an environment with consolidated quoted liquidity. Given that this universe represents less than 50 basis points of dollar turnover per day on average, there would appear no better opportunity than now to revisit the idea of revoking UTP, which could simplify and improve the marketplace for these securities. In addition to the possibility of reducing transaction costs which would benefit asset owners, the possibility of enhancing market quality could increase investor interest in trading these securities. In the case of stocks, capital formation could grow for the benefit of smaller-cap companies.

Potential side effects

Since concentrating quoted liquidity on one exchange could also have drawbacks associated with restricting competition in the marketplace, a program to revoke UTP for thinly-traded securities would need to consider and address the possibility of undesired results. Potential adverse effects may include: creating single points of failure that would degrade market resilience and reducing fee competition among exchanges that would increase costs for investors.

Conclusion

State Street strongly supports the SEC's interest in improving US capital formation and equity market structure. We believe improving market quality for thinly-traded securities could be an important element of the SEC's work in these areas, and that revoking UTP for such securities should be further assessed for its potential to benefit US markets, issuers, and investors. As a result, we suggest the SEC initiate a pilot program for thinly-traded securities to help assess the effects of revoking UTP on market quality and the experience of investors.

We would be happy to have the opportunity to discuss this issue in more detail with you or SEC staff, at your convenience.

Sincerely,

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Head of Trading, Americas
State Street Global Advisors

David LaValle
Managing Director
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cc: Brett Redfearn, Director, Division of Trading and Markets