Select Vantage

April 20, 2018

Via email: chairmanoffice@sec.gov

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

Dear Chairman Clayton,

Re: Market Structure for Thinly-Traded Securities

Select Vantage Inc. is a privately owned proprietary trading firm that has participated on US equity markets since 2012. We have broad experience trading both liquid and less-liquid names on various lit markets and in dark pools around the world. Our business model scales the judgment of individual human traders globally across shared market-access, data, execution, compliance and surveillance infrastructure.

We applaud the recent attention given to the problem of thinly traded stocks in the October 2017 Treasury Department Report, including the proposal to allow issuers of less-liquid shares the right to concentrate trading of their stock to a smaller set of venues.

But venue fragmentation is just one of several reasons why many stocks have wide spreads and low turnover. We believe it is important to look at this problem holistically. Accordingly, we invite the Commission to consider a host of other factors affecting liquidity in thinly traded issues.

The quoted liquidity in a security (its bid-ask spread and displayed size) is in large part a function of the reward available to a liquidity provider. The bid-ask spread reflects the equilibrium point where a liquidity provider can earn a positive rate of return by trading that stock. That, in turn, depends on the costs and risks associated with making a two-sided market, as determined by the following variables:

- Risks
  - Regulatory risk (mistakes, lack of clear guidance, changing rules)
  - Risk of adverse sanctions (*ex post* fines where employees violate a trading rule)
  - Capital risk (potential losses from trading)
  - Execution risk (complicated market structure)
- Costs
  - Regulatory (licenses, training, fines)
  - Capital (cost of capital, opportunity cost)

- Execution costs (commissions, clearing, net exchange fees)
- Compliance (software, staff, surveillance)
- Technology (to compete against fastest traders in multiple markets)
- Connectivity (to multiple exchanges, dark pools)
- Labor and overhead (skilled personnel, usually in a major U.S. city)
- Market data (costs increase proportionate to venue fragmentation)

Another very important consideration is that using automated systems, rather than human judgment, to make markets in the least-liquid securities is virtually impossible. Less-liquid stocks rarely trade with a parallel hedging strategy because they typically are not correlated with any other securities or assets. Most also are not part of a liquid index. Many have only been listed for a short time, meaning there little to no historical data on which automated-trading models can be developed. Most of these names, either for their entire trading lives or until they develop into bigger companies and join a tradable index, require active human intermediation.

In the past, when liquidity was primarily provided by humans as registered market makers, these traders generally were assigned a range of stocks. Some were profitable for those market makers; others were not. To keep their assignments, market makers typically would subsidize money-losing names with the extra profit made on their "best" issues.

Market structure has transformed over the past 20 or so years, effectively replacing human market-making with automated systems, which are subject to fewer obligations. Firms deploying these systems have done a great job of reducing spreads and increasing liquidity in the stocks they trade. But, for the reasons cited above, they are rarely making markets in thinly traded issues. Their per-share profits are less than the manual market-makers they replaced, but they are trading more frequently. As a result, they tend to concentrate their efforts in higher-volume securities. They are not obliged to support illiquid issues. And unlike the previous generation of human traders, they are not applying excess profits from liquid stocks to subsidize money-losing trading of illiquid ones. And unlike for higher-volume names, the per-share rebates provided by exchanges as part of their fee schedules generally are not sufficient to compensate for the greater risk in less-liquid securities.

We welcome SEC and industry consideration of these additional variables affecting liquidity in thinly traded securities. Understanding the risks and costs associated with providing liquidity in less liquid names may help policy makers craft intelligent solutions to address these risks, costs and unique challenges. Importantly, the SEC must understand that liquidity in this stock market segment requires human traders. Only when these factors are addressed effectively will liquidity in thinly traded stocks increase and bid-ask spreads narrow.

SelectVantage

Sincerely,

Daniel Schlaepfer
President