January 27, 2014

Chairman Joseph Dear
Investor Advisory Committee
United States Securities and Exchange Commission
100 F Street
Washington, DC 20549

Re: Recommendations to the Investor Advisory Committee by its Market Structure Subcommittee regarding Decimalization and Tick Size

Chairman Dear:

Introduction

Themis Trading appreciates the opportunity to comment on the critical issue of decimalization and tick size. As institutional agency traders and experts in US equity market structure, we believe Themis Trading is uniquely qualified to comment on this proposal. We strongly support the Subcommittee's Alternative Recommendation #1, which calls for a pilot program for small-cap public companies to trade at wider spreads and limited increments. However, there should be no exemption for internalizing market makers. We believe such an exemption would undermine the entire program.

The Small-Cap Problem

With all due respect, we believe that the discussion of small-cap wide tick sizes has not been fully understood by all committee members. Only a small proportion of retail investors are represented by 100-share online-brokerage firm orders. The majority of retail investors are represented by institutional managers (mainly the $8 trillion equity mutual fund industry). These managers pool retail money in order to make long term investments. The challenge these managers have in finding liquidity in the small-cap space has never been more difficult than it is in our current modern market structure. Thus, attempts to address the liquidity issues that small cap stocks face must take into consideration the issues these managers face.

How the Problem Manifests Itself

As institutional traders who trade small cap stocks for our clients, we observe this lack of liquidity on a daily basis. The high volumes and penny-wide spreads, which have been touted as benefits of our modern market structure, rarely manifest themselves in small cap stocks. Routinely, we encounter wide bid ask spreads (a nickel or greater), but with little size and depth (100 shares). As a result, small-cap liquidity is more of an illusion, inhibiting the opportunity for institutional investors to make meaningful small-cap investments for retail clients.

Why There Is a Lack of Small-Cap Liquidity

We believe that one of the main reasons for the dearth of liquidity in these small cap stocks is the lack of incentive for investors and real market makers to display visible liquidity. Visible quotes are often traded in front of by so called "internalizing" market makers. These market makers pay online retail brokerage firms for the right to trade against orders from the firms' clients. These trades take place off exchange in "dark markets" with at best minute sub-penny price improvement. In fact, it is routine to observe half of the trade volume in the small cap space to occur off-exchange and in the dark. Thus, the internalizer-payment-for-order-flow-system that fuels this off-exchange trading disadvantages displayed liquidity providers.

The Solution

We strongly believe a mandated wide tick program can help alleviate this problem, particularly if it includes a minimum price improvement feature for any trade that occurs off-exchange. Therefore, we recommend that all trades executed in stocks that are in the wide tick pilot program only be allowed to trade at the bid and offer of such minimum wide tick increment, with an exception allowed for all participants at the mid-point between the two.

Example of the Problem

To better understand the problem that internalizing market makers have caused in the equity market, we think it's necessary to dig into some of the details of order routing. For example, the 2013 Third Quarter 606 Report for TD Ameritrade proclaims that it was paid "less than $0.002 per share" for market orders that were directed to market makers. During the quarter, TD Ameritrade sent approximately two-thirds of its equity market orders to Citadel Execution Service and the balance to Citigroup. If these market orders had been sent to an exchange, TD Ameritrade would have paid a "take fee" (for example, TD Ameritrade's take fee with the Direct Edge exchange was $0.0015 per share).

Make no mistake, the online brokerage community enjoys the business model of internalizers; it is a revenue center. If internalizing market makers were not allowed to step ahead of the displayed quote with sub-penny price improvement, online brokers, instead of receiving rebate revenue, would have to incur "take" execution costs. However, we believe that if the order routing and execution process were not distorted by payment-for-order-flow, then the price discovery process would be cleaner, and displayed limit orders would be encouraged, and not disadvantaged.

Summary

The goal of a wide-tick pilot program is to encourage and attract displayed liquidity. In addition to the enhanced economics of a wider spread, a successful wide tick pilot needs to reward the display of liquidity by rewarding the investor who displayed a quote with a fill. Allowing internalizers to jump ahead of this displayed liquidity for de minimis price improvement will discourage such displayed liquidity, and harm the price discovery process**. It will negate the very attempt to encourage real market makers to re-enter the small cap arena, and neuter the intent of the pilot program.**

Of course, it would be presumptuous for us to suggest that the wide tick program will automatically fix all of the liquidity problems that currently exist in the small cap arena. We do recognize that there are other factors at work. However, we can only know whether a wide tick pilot will work if we actually implement it in a pure fashion, and study the results. It would be a shame if we neuter such a program from the start by not accounting for the potential negative effect of internalization, and allowing exemptions for internalizing market makers.

We agree with the Equity Capital Formation Task Force "that policy-makers now have a critical opportunity to seize the momentum generated by the JOBS Act's success and apply its principles more broadly to benefit even more promising small companies – now and in the future." We strongly recommend that the Committee and SEC adopt the Subcommittee's Alternative Recommendation #1 and approve the pilot program for small-cap public companies to trade at wider spreads and limited increments for all participants without exemption.

Respectfully Submitted,

Joseph Saluzzi and Sal Arnuk
Partners and Co-Founders,
Themis Trading LLC