2/4/2013

James R. Burns
Deputy Director
Division of Trading and Markets
Securities and Exchange Commission
100 F Street NE
Washington DC 20549-1090

RE: SEC Release 34-68510, File No. 4-657; Decimalization Round Table

Dear Mr. Burns:

ModernIR appreciates the opportunity to offer remarks on the impact of decimalization and tick-size on markets. We are the No. 1 Market Structure Analytics firm providing mathematical market intelligence on trading behaviors to publicly traded companies. Small-to-mid-cap companies comprise 40% of our clientele.

One preamble: There are no public-company executives on any of the planned panels. We're delighted to see Patrick Healy and David Weild on hand, both outstanding issuer advocates. But more effort must be made to include issuers. Omitting them is like leaving the patient out of discussions on treatment options.

In 1792, when 24 brokers met under a New York buttonwood tree and agreed to give each other preference in transactions and to charge a minimum commission, the idea behind capital-formation was simple. There is investment capital. There are investment opportunities. Intermediaries match them for a profit.

When this process is working, risk-takers on both sides of that equation use markets. The metrics for success are as unassuming as the process. Are small companies raising capital publicly and becoming large companies? Is there a thriving community of market-makers?

David Weild has already offered into record comments and data showing the precipitous denouement in small-company IPOs since circa 2000. IPO researcher Renaissance Capital ranked lead underwriters for 2012 US IPOs by proceeds, and seven firms – the same dominating prime-brokerage, primary-dealership, program-trading and derivatives markets – accounted for 92% of proceeds.

The tale is best told by the tape. The share of small-cap volume traded by proprietary high-frequency trading firms like Sun Trading, Hudson River Trading, Two Sigma, TradeBot and others is substantially greater than in mega-caps, according to the data we track. We assign a statistical metric for "high-frequency trading" to volumes for every client. It's a measure of intermediation – moving shares from one marketplace to another for profit – and we include both proprietary traders and large two-sided market-makers who furnish significant liquidity to exchanges. Where large caps (over $5 billion) and mega caps ($100 billion and higher to us) average about 60% HFT daily, small-caps average roughly 69% HFT, 15% more.

But aren't we told that liquid names attract high-frequency traders? In some instances, yes. But more companies exit capital markets through consolidation and go-private initiatives than come public through

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IPOs. With the number of national market system stocks falling steadily – now about 3,700, down from 7,500 in 1997, and comparable to levels in 1975 – as derivatives like ETFs increase (totaling about 1,500 now), a greater proportion of daily liquidity from a declining number of securities must be consumed to satisfy benchmark inflows and outflows, and to create and redeem ETF and ETN units.

The largest broker-dealers (Morgan Stanley, Goldman Sachs, etc.) are the principal drivers behind this trading activity. Proprietary traders find less profit and more risk in competing with them and so shift their algorithms to capitalize on order-fill variances that arise when trading liquid and thin names simultaneously in different markets or in trading equities and derivatives together. This arbitrage replaces second-tier market-making that supports companies with research. These firms fail or consolidate. Offering an illustration, small-cap Exelixis Inc. in April 2009 had 131 different brokers, dealers or market participants. In January 2013 there were 87, a 34% decline. This 30% decline in market participants is consistent across our client base.

Tick-size is a material contributor. With spreads in pennies – and now through retail orders, tenths of pennies – the opportunity to profit on wholesale-to-retail market-making fostered by valuable information is effectively gone (worsened certainly by a raft of other rules ranging from the Global Settlement and Reg NMS to order-routing and best-execution standards). Conventional market-making isn't dissimilar to underwriting. In IPOs, underwriters assess demand for shares, commit capital to buy the offering, and then place shares with buyers, earning returns from fees (and perhaps through the overallotment). They have "skin in the game" as intermediaries. Now imagine if underwriting were intermediated by parties trading in tenths of pennies who could profit without running a book, performing due diligence, or committing capital.

In after-market brokerage, dealers commit their own capital to accumulate supply, and then support the market for that product (company shares) with information. Under mandatory penny spreads, intermediaries who risk little or nothing to profit from arbitrage (statistical, intermarket, time-priority and more) and rebates have an advantage. Bulge-bracket firms providing riskless-principal execution that incorporates alpha and price-improvement also benefit disproportionately. Both types of participants can trade hundreds of equities and derivatives simultaneously against a model that ensures minimal capital commitment and exposure, and maximum alpha (better returns with the same risk). With the right mix, this dispassionate intermediation is exceedingly profitable for intermediaries and institutions trading around positions (average monthly volatility in stocks is 40%). But it's not capital-formation.

Suppose companies could set and change spreads for their shares. Probability-based intermediaries would suddenly face steeper price uncertainty. That opens doors for committed market-makers willing to buy inventory and market it. And, mathematically, an intermediary model with more risk attracts investors with longer horizons.

Encouraging change may require education for issuers on the difference between volume and liquidity. But the opportunity to improve capital-formation and fuel committed aftermarket support is real and can be facilitated by removing the advantage that penny spreads give to automated market-makers. Small brokerages might make markets again, provide research coverage again. And small IPOs could again come public. As it is, the IPO process is more an exit strategy than a capital-raising endeavor.

On the Oregon cattle ranch of my youth, we used auction markets to move product from the producer level to wholesale buyers, who then distributed to retail outlets (grocery stores, fast-food chains, etc.). If we didn't like wholesale prices, we took our cattle home.

Applying this analogy to equity markets, public companies are the producers. They have zero control over wholesale prices, they have no say in rule-making, and they frankly don't know who intermediates more than 50% of trades. They are disengaged from their own supply chain, so to speak.

This is inherently wrong and inequitable – and contrary to the Securities and Exchange Act, which requires fair treatment for all constituents. The data are unequivocal. Intermediation for arbitrage ends has replaced intermediation for capital-formation means. At minimum, issuers are owed a remedy. Let them (all of them – why different standards?) voluntarily choose tick-size ranges, or waive that right.

This alone will not fix what's wrong with capital markets, but it's a firm step in a better direction. Certainly, some participants will resist. Everyone wants a healthy return at low risk. But the parties receiving that opportunity through tick sizes are the least committed ones. Reward is supposed to accrue to risk-takers.

Yours sincerely,

Timothy Quast

President & Founder