December 18, 2014

Mr. Brent J. Fields  
Secretary  
The Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: Comments to Plan to Implement a Tick Size Pilot Program

Dear Secretary Fields:

Thank you for providing us with the opportunity to comment on the proposed Tick Size Pilot Program. As co-chairs of the Equity Capital Formation (ECF) Task Force, we commend the SEC’s ongoing commitment to enhance the overall quality of the equity markets in general and for smaller companies more specifically. To date, the SEC’s actions have been thoughtful and decisive as it examines the challenges associated with a one-size-fits-all capital markets ecosystem, while maintaining investor protection. Constructive market structure reform, such as the data-driven pilot program plan (the “Plan”) submitted by the national securities exchanges and FINRA (the “Participants”) on August 26th, is a promising step in the right direction. If implemented effectively, the pilot program would appropriately assess the need for permanent change to the trading rules for small cap companies. Increasing liquidity for small-cap companies is important for them to thrive as independent, public companies and to create jobs in the U.S.

A well-designed pilot trading program that allows for a true empirical test of the effects of wider spreads and limited increments in small-cap stocks will encourage fundamental buyers and sellers to meaningfully engage with each other. Such a pilot program, as described in the Plan, would require all market participants to cluster their bids and offers at fewer discreet increments and limit the ability of certain market participants to "price improve" in sub-penny increments. This pilot program will enable the SEC and Participants to intelligently analyze the proposed changes’ effect on volume and depth and its impact on liquidity in the small cap market.

**Length of Pilot Program**

However, in order to achieve this objective, we strongly believe that a one year pilot program is too short to provide conclusive data regarding success or failure of the pilot program. A significantly longer time period is required to gather meaningful data around whether or not the changes to the market structure are having the desired effects.

We believe that the pilot program should operate for at least three years for two primary reasons:

a) Market participants, especially those that use algorithms and trade frequently, will need time to adjust their trading practices and/or business models to operate under the proposed small cap market structure changes. The behavior of market participants will evolve over time as the market adapts to the changes. Their trading practices will vary greatly under a one year pilot program versus a three year pilot program.

Under the pilot program, we anticipate a greater number of instances where traders "work the order" by mixing and matching tools and pools, and canceling and replacing orders by either the buy-side
trader (using low touch products) or sell-side trader (receiving a high touch order). Though price discovery is expected to be easier with fewer trading increments, traders will need to overcome a trust barrier when displaying size as they acclimate to the pilot program rules. From an algorithmic standpoint, for most electronic providers, the prudent implementation sequence will be to first develop functional logic (i.e. the ability for the algorithm to distinguish order handling rules for both pilot and non-pilot securities) followed by an optimization of the models. Optimization will be driven by historical data, empirical execution data and user feedback and, ultimately, will require a longer time period so that the sample size can be more meaningful than what would be gathered in one year.

b) By limiting the pilot program to a single year, we may fail to control for potentially confounding variables, such as an aberration in the performance of the equity markets due to other factors. For instance, had the pilot been conducted in 2008, the data gathered would have looked very different than in 2007 or 2009. By gathering three years’ worth of data, we will have a better picture on how these proposed changes will impact market structure in multiple market environments. We are very concerned that a one year program will provide insufficient and highly skewed empirical data, which may impact the SEC’s ability to assess the long term impact of the proposed market structure changes. We should not be hasty in our analysis. Rather we should be thoughtful and deliberate before making decisions that will impact our equity markets in the United States.

Simplicity

A key tenet in the Equity Capital Formation Task Force’s report, *From the On-ramp to the Freeway: Refueling Job Creation and Growth by Reconnecting Investors with Small-Cap Companies*, is a clarion call for simplifying the markets as it relates to small cap stocks. As such, we encourage the SEC to consider implementing only Test Group One and Two and limiting the market capitalization of those stocks participating in the pilot to $750 million and under. Under this scenario, the pilot program will be basic enough for market adoption while assessing the impact of wider spreads and limited increments on small cap stocks.

a) We believe Test Group Three introduces an unnecessary layer of complexity. The 13 exceptions outlined in the Trade-at Prohibition are diverse, ranging from 1) type of market participant, 2) size of the trade, 3) type of venue (displayed or hidden), 4) timestamps, 5) order types, 6) trading halts, 7) special trades and 8) clearing and settlement, which makes for complex implementation and data analysis. Eliminating or modifying some of these exceptions is unlikely to ease the burden of implementation or simplify the data analysis. The complexity of the current trade-at proposal and the extensive programming adjustments required are unlikely to provide a fair picture of the effects of trade-at on a security. In fact, it may result in negative unintended consequences, ranging from the creation of loopholes to non-participation from certain market makers and brokers who choose to “wait it out” rather than participate.

b) The pilot plan should focus on that segment of the small cap market that stands to benefit the most from a change in market structure, i.e. those stocks with a market capitalization of $750 million and under. The Equity Capital Formation Task Force’s report discusses the challenges faced by public companies with market valuations under $750 million and how a simpler, more orderly market structure could more adequately serve their needs. By definition, a $5 billion market cap threshold will include a greater number of companies in the pilot program and a greater number of data points to analyze. However, we do not believe a larger data set is necessary as it is clear that the challenges faced by companies under $750 million are different from larger companies, even those in the $1 billion to $5 billion range. Subjecting these additional companies to the pilot adds a layer of complexity that is not critical to the outcome of the program.
Data Analysis

We believe that the pilot program should include a clear methodology for collecting and analyzing data regarding the effects on small cap trading. This methodology should measure of the effects through an analysis of the following key metrics:

a) Relative level of trading liquidity. Relative level of trading liquidity should be measured by any changes in the number of blocks traded (more than 5,000 shares), number of trades (absolute), displayed liquidity (quote) size, Average Daily Trading Volume, and single-name stock volatility.

b) Changes in institutional ownership. Increases in institutional ownership would be desirable, both in number of institutions and as a percentage of ownership, because institutions generally provide higher trading volume.

c) Rate of equity capital issuance. Higher rates of equity capital issuance would be a marker for lower costs of capital because issuers would resist issuing equity capital at depressed prices.

At the conclusion of the pilot program, the SEC should use the data to evaluate whether the pilot program's trading rules should be applied to small cap companies on a permanent basis. However, as we stated earlier in this letter, we believe that a one year pilot program will not generate sufficient meaningful data for the SEC to make a determination. An analysis of the metrics listed above, as well as any other metrics deemed necessary, will require a significantly longer time period for meaningful data capture.

Additional Comments

In addition, the pilot program plan’s definition for “Retail Investor Order” should be expanded and clarified. This is to ensure that the definition does not inadvertently include a mechanism for non-retail orders to be considered retail or, conversely, exclude orders that are retail.

Finally, as this is a data driven program, timely and accurate collection of data will be extremely important. It is realistic to expect data collection to be challenging at the outset, either from untimely submissions or incorrect data collection procedures. To ensure timely reporting, the SEC should consider establishing a fine for non-compliance with the pilot program.

Conclusion

Equity markets are dynamic and complex and changes to market practices should be considered carefully. By implementing a pilot program – which we acknowledge is not a small undertaking – the SEC should ensure that the program is constructed with the appropriate duration that accurately reflects the market’s behavior and in a manner that simplifies the market’s ability to implement the pilot program.

If this pilot can demonstrate that we can enhance the small company capital formation process through improved market function, we will have found a path to creating critical private sector jobs by driving innovation as a global market leader as well as providing a more positive investment experience for both individual and institutional investors. Conversely, should this pilot fail to provide meaningful improvement in market function for small stocks, we encourage the Commission to continue to innovate market structure in order to achieve that end.
In conclusion, we hope that you will take these comments under advisement. Please do not hesitate to contact us with any questions or comments.

Respectfully submitted,

Scott Kupor
Managing Partner, Andreessen Horowitz
Co-Chair, ECF Task Force

Jeffrey M. Solomon
Chief Executive Officer, Cowen and Company
Co-Chair, ECF Task Force