OTC Markets

VIA Electronic Submission

February 24, 2015

Brent Fields

Secretary

Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549-1090

Re: **Proposed National Market System Plan to Implement a Tick Size Pilot Program on a One-Year Pilot Basis; Exchange Act Release No. 73511; File No. 4-657**

Dear Mr. Fields:

OTC Markets Group Inc. [1] ("OTC Markets Group") respectfully submits to the Securities and Exchange Commission (the "SEC") the following comments on the above-referenced proposed National Market System Plan to implement a tick size pilot program (the "Tick Proposal"), as jointly proposed by a group consisting of the registered national securities exchanges[2] and the Financial Industry Regulatory Authority, Inc. ("FINRA").

Our comments include four primary points:

1. Focus on Smaller Companies with Naturally Wider Spreads - The Tick Proposal should focus on companies with market capitalizations under $250 million that currently have average execution weighted spreads of greater than $0.05. That

[1] OTC Markets Group Inc. (OTCQX: OTCM) operates Open, Transparent and Connected financial marketplaces for 10,000 U.S. and global securities. Through our OTC Link® ATS, we directly link a diverse network of broker-dealers that provide liquidity and execution services for a wide spectrum of securities. We organize these securities into marketplaces to better inform investors of opportunities and risks – OTCQX®, The Best Marketplace; OTCQB®, The Venture Stage Marketplace; and OTC Pink®, The Open. Our data-driven platform enables investors to easily trade through the broker of their choice at the best possible price and empowers a broad range of companies to improve the quality and availability of information for their investors.

[2] The national securities exchanges filing the Tick Proposal include NYSE Group, Inc., BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., NASDAQ OMX BX, Inc., NASDAQ OMS PHLX LLC, the Nasdaq Stock Market LLC, New York Stock Exchange LLC, NYSE MKT LLC and NYSE Arca, Inc. (collectively, the "Exchanges" and in combination with FINRA the "Participants").

group of companies is most in need of support for more liquidity in individual investor trades.

2. <u>Support the Broker-Dealer Ecosystem</u> – Tick size reform should be part of a broader group of initiatives aimed at supporting the entire broker-dealer ecosystem, including the shrinking number of firms that support public smaller company investment banking and secondary trading.

3. <u>Incentivize Broker-Dealer Liquidity</u> - Smaller companies do not have deep order books, which means liquidity must come from broker-dealers acting as market makers and proprietary traders.

4. <u>Remove the Anticompetitive Trade-At Provision</u> -The tick size study should not be used to support the stock exchange business model. The anticompetitive Trade-At provision restricts fair competition between stock exchanges and broker-dealers in the trading of smaller company securities.

Discussion

We applaud the Tick Proposal's initiative to review and perform a data-driven study of market structure issues impacting small company trading. We believe the goal of any market structure reform should be to incentivize choice and competition among trading venues, which provides investors with more efficient trading. Trading venues can compete on price, available size and execution quality, each of which will suit the needs of different investors. Market structure reform should promote a better trading experience for all, but when choices are made, the trading needs of retail investors should continue to be the leading concern in regulating our equity markets.

The Tick Proposal is a valuable opportunity to study the impact of setting larger pricing increments for certain small capitalization stocks to increase secondary trading liquidity for investors. We support the SEC's effort to compile data and study whether wider tick sizes would be beneficial to the market as a whole. Small companies could greatly benefit from adjustments to market structure that result from the SEC's study.

We also support the Tick Proposal as an initiative to support the diverse ecosystem of broker-dealers that serve smaller public companies. In their 2012 paper supporting higher tick sizes in certain securities,[3] David Weild, Edward Kim and Lisa Newport make the argument that higher tick sizes will "lead to an investment in the ecosystem

[3] *Weild, David, Edward Kim, and Lisa Newport. "The Trouble with Small Tick Sizes." (September 2012). Grant Thornton's Capital Market Series.*
Available at:
http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Trouble_Small_Ticks.pdf.

(research, stock sales, investment banking and capital commitment to provide institutional liquidity) required to successfully take companies public and support them in the aftermarket." We agree strongly, as a thriving and diverse ecosystem of broker-dealers that provide investment banking services to small companies and offer efficient trading to investors is a cornerstone to fostering the success of the equity market in small capitalization stocks.

The SEC's study of wider tick sizes will very likely lead to practical benefits for smaller companies, however the Tick Proposal will be more effective if its focus is narrowed to (i) establishing quote increments in certain small capitalization securities, as is proposed under Test Groups One and Two, taking care not to artificially widen spreads for those securities that currently trade with less than a $0.05 spread at the inside, and (ii) adding a provision to incentivize broker-dealer proprietary liquidity. This more targeted tick size program would provide specific, measurable data, promote increased liquidity for small capitalization securities to meet investor needs in trading these securities, and limit the potential for increased costs that could further damage the fragile broker-dealer ecosystem.

While the Tick Proposal may lead to valuable solutions for smaller companies, we have serious concerns regarding the Trade-At provision. As proposed, the Trade-At provision is anticompetitive in that it serves only to protect the exchange business model from competitive alternative venues, and the Trade-At rulemaking proposal by the Exchanges is unconstitutional. Trade-At harms investors, and needlessly shifts the focus of the Tick Proposal away from the broker-dealer ecosystem and the services that can be provided to small and emerging companies.

Each of our four primary points is discussed in further detail below.

A. <u>Limit The Study To Smaller Companies with Naturally Wider Spreads</u>

The Tick Proposal is a worthwhile experiment, but like any well-designed experiment it must be careful to strike a cost/benefit balance, particularly when it comes to artificially widening spreads. While many smaller capitalization stocks have wide spreads at the inside, the larger tick sizes outlined in the Tick Proposal may still lead to artificially wider spreads in some securities. Investors, including retail, would be left to bear the corresponding increase in transactional costs. Those costs would rise for exchange executions as well as market makers and agency brokers that are often able to provide investors with price improvement.

As investors react to higher trading costs, companies may see a corresponding decrease in liquidity and overall investor interest. To protect against this unintended collateral damage, the Tick Proposal should be revised to indicate that tick size in an applicable security should never be greater than the average spread of the security, and when securities reach a one tick average spread for a certain period of time they should be quoted in smaller increments. This would allow for data gathering based on larger tick sizes without the corresponding cost increases brought on by artificially widening spreads.

Specifically, the Tick Proposal should be limited to smaller companies with market capitalizations of $250 million or less and average execution weighted spreads of greater than $0.05. The commission should also review larger increments of $0.10 and $0.25 for securities with average spreads greater than those amounts. These companies are less likely to have their spreads artificially widened by the tick study, and also stand to reap the greatest benefit in the form of additional liquidity. The SEC should also closely monitor the costs associated with the Tick Proposal to ensure that any undue costs are uncovered and mitigated as the study goes forward.

B. Supporting the Broker-Dealer Ecosystem

The broker-dealer "ecosystem" refers to the wide range of broker-dealer business models, ranging from large, automated firms making markets in many thousands of securities to industry specialists, regional firms and small broker-dealers that compete on price and customer service. The efficient functioning of secondary markets, particularly the markets for small capitalization companies, depends on the participation of broker-dealers across this spectrum. Broker-dealers on the smaller, more specialized end of the ecosystem regularly fall victim to increased costs of operation brought on by regulatory burdens and risk allocation, and the entire industry suffers as a result. Regional broker-dealers have been merging and being acquired, which has reduced the services available to smaller companies in their regions. When a big bank purchases a broker-dealer that services smaller companies, many of the specialized small company investment banking and trading services are discontinued.

The traditional model, exemplified by Hambrecht and Quist, in which an investment bank broker-dealer brings a smaller company public through an initial public offering, distributes research on the company and trades more than 50% of the company's liquidity has become extremely rare, giving way to decoupled specialization. For example, certain broker-dealers act only as execution and liquidity providers that match and internalize trades in the secondary markets, some distribute research, others efficiently serve self-directed retail clients with online brokering, and still others perform an institutional sales role. While some broker-dealer firms offer all of these services under one umbrella, in the small and emerging company space it is far more common to see unbundling and decoupling as firms focus on specific service offerings.

As regional and full service firms have consolidated into larger entities, and moving toward specialization to unbundle services in response to increased costs of operation over the past decade, there has been a decline in the number of broker-dealers serving smaller companies. In fact, the number of broker-dealers making markets in non-exchange listed securities over the past ten years has decreased by more than 30%, from approximately 190 firms in 2005 to 130 at the end of 2014.[4] The trend continues to accelerate, as while trading volumes grew strongly in 2014, the number of broker-dealer subscribers to OTC Link ATS decreased approximately 8%. Broker-dealer attrition impacts small and emerging companies directly, as many of the firms forced out due to increased costs were market makers for smaller companies in their regions and industry specializations.

Given the pressures on small and emerging company liquidity, the Tick Proposal should also experiment with ways to incentivize broker-dealer proprietary liquidity, particularly at the inside. For example, the SEC and FINRA should require increased displayed size for smaller company stocks so that with the widened spreads, the average retail order can be regularly and substantially filled at the bid or offer. These securities typically have limited order books, making broker-dealer proprietary quotes and market makers internalization a primary source of liquidity. More displayed liquidity fosters more non-displayed liquidity for retail investors as market makers compete with prices displayed on exchanges by offering retail order flow executions at a multiple size of displayed liquidity. By incentivizing more broker-dealer proprietary liquidity in these securities, the Tick Size Proposal would be a valuable tool for developing efficient secondary markets for investors in these securities, which would foster more IPOs, research and other services within the ecosystem.

C. <u>The Value of Broker-Dealer Proprietary Liquidity</u>

According to the SEC's recent study of small capitalization liquidity[5] , stocks with market capitalizations under $250 million suffer from the greatest lack of liquidity. Many of these smaller capitalization stocks have average spreads at the inside much greater than $0.05. Simply increasing the tick size for these stocks is a good start, but the Tick Proposal can do more to support a better trading experience for companies, broker-dealers and, most importantly, retail investors.

The SEC study of small capitalization liquidity provides clear data supporting the proposition that small capitalization companies suffer from a lack of limit order books, particularly at the inside. According to the study, the smaller a security's market capitalization, the less depth of order book exists. The Tick Proposal should include an additional experiment, requiring increased displayed size of broker-dealer proprietary

---

[4] Including the predecessor system to our OTC Link ATS, as well as the OTC Bulletin Board operated by FINRA (f/k/a the National Association of Securities Dealers)

[5] *Collver, Charles. "A Characterization of Market Quality for Small Capitalization US Equities." (September 2014).* Available at: *http://www.sec.gov/marketstructure/research/small_cap_liquidity.pdf*

quotations in stocks with larger tick sizes. This can be done initially on a trial basis, to allow for appropriate data gathering. Greater displayed liquidity has the benefit of increasing the amount of non-displayed liquidity available to compete with displayed liquidity for investor executions. The overall increase in liquidity available for trade executions will increase investor's willingness to trade smaller company securities with marketable orders.

According to the SEC's study, small capitalization stocks priced at $10.00 have less than $5,000 of displayed liquidity within $0.05 of the midpoint on more than 90% of trading days.[6] In other words, it would be difficult to overstate the liquidity problem experienced by these small cap securities. With limited order books, the best opportunity for systematically creating increased liquidity for smaller companies is broker-dealer market making and proprietary trading.

In practice, a pilot program could be implemented in OTC Equity Securities to generate meaningful data regarding the effect on liquidity of larger minimum quote sizes. The SEC could work with FINRA to implement tick sizes and increase the minimum quotation, or "tier," sizes under FINRA Rule 6433[7] as it applies to market makers in OTC Equity Securities in the small market capitalization category with a price of less than $25.00[8]. For example, under FINRA Rule 6433, in order to be displayed in an interdealer quotation system, a quote in a security priced at $5.00 must have a minimum quote size of 100 shares. The $5.00 price and 100 share minimum size results in a minimum displayed liquidity of $500.00. Contrast that with a typical order size of approximately $5,000[9] and it is clear that limit order display alone is not effectively increasing liquidity at the inside in small capitalization securities.

Increasing the tier size requirements for broker-dealer proprietary liquidity to two to five times the current limits should lead to immediate increases in liquidity at the inside in

[6] *See* Id at page 20, noting that "Nearly 95.0% of ticker-days for $100 Million to $250 Million capitalization stocks within the [$10.00 - $19.99 price range] have displayed of less than $5,000."

[7] FINRA Rule 6433 currently mandates minimum tier sizes at various price levels as follows:

Price (Bid or Offer)	Minimum Quote Size
0.0001–0.0999	10,000
0.10-0.1999	5,000
0.20–0.5099	2,500
0.51–0.9999	1,000
1.00–174.99	100
175.00+	1

[8] $25.00 x100 shares being half the average trade value for a retail order

[9] Based on discussions with market makers that process retail order flow

small capitalization stocks. Incorporating this requirement on a trial basis into the Tick Proposal should provide clear data as to whether it is an effective method of increasing overall small company displayed and un-displayed liquidity and providing a better retail investor trading experience.

D. <u>The Trade-At Requirement is Anticompetitive</u>

We are disappointed that Trade-At has made it into the Pilot Proposal. Simply put, Trade-At is anticompetitive, violates the principles of Section 11(a)(1)(C)(ii) of the Securities Exchange Act of 1934 (the "Exchange Act"), under which Congress finds that "it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . .fair competition . . . between exchange markets and markets other than exchange markets." The Trade-At provision is harmful to the proper functioning of markets, removing the ability of competitive venues to provide more economically efficient execution of securities transactions. Further, the inclusion of Trade-At in the Tick Proposal, as a rulemaking proposal by the exchanges, is an unconstitutional violation of the principles of non-delegation.

It is no surprise that Exchanges, as middle tier intermediaries between consumers and producers of liquidity, have aggressively lobbied for and proposed a Trade-At requirement to force trading onto exchanges and eliminate competition from Alternative Trading Systems ("ATSs") and market makers that can offer more diverse choices and lower-cost trade execution services. In every other industry, consumers and producers of goods and services are taking advantage of the "network effect" to directly connect without the need for an intermediary exchange. Networks give consumers and producers the choice to directly connect with counterparties, and let them remove a middleman that does not add value. With more diverse choices of trading venues and liquidity providers, the market can often meet consumers' desires without an anonymous matching engine in the middle of each transaction charging fees. As a result, markets can operate in a more efficient, cost-effective manner.

Despite the inclusion of the Trade-At requirement, the SEC pays little attention to the Tick Proposal's impact on competition. The SEC's entire statement on competition in the Tick Proposal consists of an unsupported statement that "the [Tick Proposal] does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act," and that the "[Exchanges] do not believe that the [Tick Proposal] introduces terms that are unreasonably discriminatory …." With the Exchanges standing to benefit greatly from the inclusion of the Trade-At requirement, it is no surprise that they view it as perfectly acceptable. The SEC's lack of analysis of the anti-competitive aspects of Trade-At directly contravenes the principles expressed in the Exchange Act.

The Trade-At requirement benefits only one type of market center, the national stock exchanges, at the expense of competing market centers such as ATSs and market makers. Market centers should compete for trade executions on price and service level (such as the quality of executions and order types each market center accepts), offering investors a choice of execution and liquidity providers to suit their trading needs.

In the secondary markets the consumer of liquidity agrees to take or pay a quoted price, making the consumer the price-setter. The price setting function is essential to the operation of trading markets. It follows that price-takers should have the choice of competitive venues, with those venues offering various price and service levels. With Trade-At restricting and removing competitive venues from the market, consumers of liquidity will be forced to go only to the Exchanges, paying higher access and connectivity fees for less liquidity and more risk. The Exchanges would have little incentive to offer better pricing or more service to consumers of liquidity because they would have effectively regulated away their more dynamic competition.

Investors and broker-dealers benefit today by having market makers and ATSs providing substantial competition for the trade execution services offered by exchanges. These institutions compete for executions by providing larger size -- which can equal multiples of displayed liquidity -- greater execution quality and better risk control. These competitive advantages, in combination with cost considerations, can provide more economically efficient executions for investor orders than what is offered by the Exchanges.

In a circumstance such as the Facebook IPO, where broker-dealers suffered massive losses due to erroneous trades, the listing exchange instead took advantage of its limited liability as a registered national securities exchange. The broker-dealers, on the other hand, took on the bulk of the losses on behalf of investors. Now, with the Trade-At requirement, the Exchanges would have an effective monopoly, retain their limited liability, and force trading away from the risk-bearing broker-dealers. The resulting risk allocation would work to the detriment of investors.

It is clear that Trade-At will force broker-dealer trading activity to exchanges that charge higher fees. Even when a market-maker or ATS owns the quote publicly displayed on an exchange and has orders on both sides of the trade, they would not be able to cross the trade on their own systems, instead being forced by Trade-At to pay an exchange to match the transaction. With Trade-At, the Exchanges would have a built-in protection of their business model and would not be incentivized to offer competitive services. In fact, it will be a perfect opportunity for the Exchanges to increase profits by charging their captive clients extra fees for connectivity, membership and other services. This violates the most basic principles of competition and capitalism, under which a variety of venues, including broker-dealers, ATSs and other market centers, should be able to compete to offer the best package of price and services to investors. Exchange businesses should not be able to use regulations to force current clients or competitors to use their services.

Trade-At will also prevent competition on the size of non-displayed liquidity, which is often a multiple of the displayed liquidity. Trade-At will effectively remove choice in the handling of marketable orders, leading to increased trading costs for investors that are forced to pay the Exchange's access fees. Market makers and ATSs will no longer be able to compete against displayed prices with larger execution sizes, lower fees or better execution quality and risk controls. Eliminating valuable choice and competition among market centers, as well as between displayed and non-displayed liquidity, will reduce innovation, raise costs and place investors at greater risk (such as in the case of erroneous trades) without introducing any corresponding benefits. The Exchanges would win a monopoly, and there would be no fair competition between exchange markets and markets that are not exchanges, which directly contravenes the Exchange Act. Investors and other market participants would suffer the consequences. This is the very scenario U.S. antitrust laws were created to prevent.

Nothing in the Exchange Act allows the SEC to delegate rulemaking authority to a group of private, for-profit companies, such as the Exchanges, such that those private companies can regulate their own industry to their benefit and the detriment of their competitors. Exchange Act Section 4A gives the SEC the ability to delegate certain of its regulatory functions, and Exchange Act Section 19 discusses the SEC's oversight of self-regulatory organizations. Neither section, however, trumps the basic, fundamental principal expressed in Exchange Act Section 3(f), which requires that whenever the SEC is considering rulemaking, it must consider whether the rule will promote efficiency, competition and capital formation.

In addition to violating Exchange Act principles, the Trade-At requirement also violates the non-delegation doctrine of Article I of the U.S. Constitution. Non-delegation is a function of the Constitution's separation of powers, under which legislative authority, such as the SEC's rulemaking authority, cannot be delegated to private entities. This is particularly true where those private entities stand to gain at the expense of the industry being regulated.[10] Despite the Exchange Act provisions allowing the SEC to delegate certain powers to the Exchanges, nothing in the Exchange Act overrides this general Constitutional principle. The SEC has chosen to present the Tick Proposal exactly as proposed by the Exchanges and FINRA. This amounts to giving rulemaking authority to private, for-profit organizations that have the ability to achieve gains and harm their competitors. Thus, the Trade-At requirement as promulgated by the Exchanges violates the non-delegation doctrine and should not be allowed to stand.

[10] *See* Carter v. Carter Coal Co., 298 U.S. 238 (1936) (holding that it is an unconstitutional delegation of legislative power to permit certain coal companies to set wage and hour standards for the entire coal industry).

Conclusion

The Tick Proposal can positively impact the market for small company securities as long as improving the retail investor experience in trading these securities is the top priority of the Tick Proposal and of market structure reform generally. Secondarily, supporting the broker-dealer ecosystem is the best way to ensure that small companies and their retail investors receive the services necessary to maintain a liquid secondary market. Rather than protect the national securities exchange business model with the Trade-At provision, the SEC should focus on fostering the broker-dealer ecosystem by reducing regulatory cost and complexity, particularly for the smaller firms that provide the trading, research, investment banking and capital commitments required to facilitate small company secondary trading markets.

* * *

We appreciate the opportunity to comment on the Tick Proposal. Please contact me at [redacted] or [redacted] with any questions.

Very truly yours,

Daniel Zinn

General Counsel

OTC Markets Group Inc.