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The trouble with small tick sizes

Larger tick sizes will bring back capital formation, jobs and investor confidence

Capital Markets Series



The most important provision of the Jumpstart Our Business Startups (JOBS) Act, signed into law on April 5, 2012, is a little-known section (Title I, Section 106(b)) titled “Other Matters — Tick Size.” In it, Congress requires the SEC to conduct a study on the “transition to trading and quoting securities in one penny increments, also known as decimalization... [and] the impact that decimalization has had on the number of initial public offerings since its implementation relative to the period before its implementation.”

In our view, decimalization — a euphemism for the collapse in trading spreads, tick sizes and commissions — decimated the U.S. IPO market when it began in earnest with the 1998 implementation of Regulation ATS (alternative trading systems).

Adding back adequate economic incentives (through higher tick sizes, which may be the simplest way to accomplish this) to make the aftermarket support of small public companies once again profitable is likely the best way to achieve Congress’s intent to bring back the small IPO and associated job growth.

Executive summary

The Jumpstart Our Business Startups (JOBS) Act, signed into law on April 5, 2012, delivered two of the three legs of the stool required to revive the U.S. IPO market: 1) a framework to lower costs for small companies accessing the public markets, and 2) a framework to improve company communication with investors in the public and private markets. The authors argue that a framework to realign economic incentives in the public markets, primarily through a higher tick size (the minimum increment in which a stock or other security can trade) pricing regimen, is the essential third leg that is currently missing from the stool. The authors conclude that higher tick sizes will:

- lead to investment in the ecosystem (research, stock sales, investment banking and capital commitment to provide institutional liquidity) required to successfully take companies public and support them in the aftermarket;
- favor long-term investors and stock pickers over short-term traders; and
- increase investor confidence by reducing the number of price points at which stocks are traded and by limiting computer trading behaviors.

The authors contend that the current penny and sub-penny tick size regimen, especially as applied to less visible and liquid stocks — the natural state of most public companies and nearly all small public companies — is at the root of the systemic decline in the U.S. IPO market and that it contributes to trading behaviors that undermine investor confidence. They offer quantitative and qualitative evidence that the majority of harm to the U.S. IPO market was caused in 1997 and 1998 by the implementation of the Order Handling Rules and Regulation Alternative Trading Systems, which caused the bankable spread¹ available to small investment banks to drop from 25 cents per share to the minimum tick sizes of 6.25 (for NASDAQ stocks greater than \$10) and 3.125 cents (for NASDAQ stocks under \$10). This shift, from a quote-driven to an electronic-order-driven market, set the conditions under which decimalization would be implemented in 2001. However, decimalization, which further eroded the bankable spread from 6.25 and 3.125 cents to 1 cent, was a comparatively minor change — essentially *a coup de grâce* that removed any remaining economic incentives required to sustain a vibrant market and help support the U.S. economy.

¹ This is a notion that the authors use to describe how spreads are seen from the vantage point of market makers. It is the portion of a spread that market makers can reasonably rely upon to compensate them for their investment in capital, research and sales support. In a quote-driven market (pre-1998), bankable spreads were largely equivalent to quoted spreads, while in the electronic-order-driven market (post-1998), bankable spreads fell to the minimum tick size.

The authors recommend two alternative solutions — encompassed in what we call **The Jobs Act, Part 2** — to customize tick sizes² and create needed economic incentives to rebuild the ecosystem to support capital formation. Such solutions, which can be used individually or in combination, should be implemented via an SEC pilot program to provide valuable information before fully phasing in the solutions across the entire market.³ Both solutions rely on market forces to select tick sizes, as opposed to the current SEC-mandated system. The two recommended solutions are as follows.

1. Issuer choice of tick size, where issuers of all sizes, but small-cap companies in particular, are given the authority to choose their own tick size within a range that is capped at a maximum of some percentage — say, 5% — of their share price.

An issuer’s board of directors would choose its tick size by consulting with institutional investors, investment banks and stock exchanges in order to arrive at an optimal increment for its shares that would address both the needs of the ecosystem and the liquidity in its shares.

Pros	Cons
Empowers issuers.	
Enables mass customization of micromarkets. Eliminates the one-size-fits-all penny and sub-penny market structure that many believe is undermining capital formation and job creation.	Increases complexity, which is why some prefer to limit the tick size options to simple increments of 1 cent, 5 cents, 10 cents, 20 cents, 50 cents and even \$1 increments on high-priced stocks.
Educates management and boards by compelling them to engage in a discussion with investors, stock exchanges, investment banks and other advisers on how choice of tick size may impact equity research coverage, capital commitment, liquidity and investor interest.	Issuers will have to invest time in understanding market structure, but this understanding should pay dividends by making issuers better equipped to interact with investors and investment banks.
Creates a wide variety of data for analysis that will paint an unprecedented picture of how tick sizes impact market quality (e.g., volume, liquidity, volatility, research coverage).	
Will curtail speculative and high-frequency trading by adding “friction” (cost) to trading, thereby favoring fundamentally oriented, long-term investors. Will increase the incentive for stockbrokers to market shares to investors.	Anytime incentives are increased to market stocks to investors, there is potential for increases in sales practice abuses. This will require increased enforcement on the part of the SEC and FINRA.
Shifts “aftermarket support” back to Wall Street and may allow management to focus more time and energy on running the business.	

² Liquidity rebates and other mechanisms that effectively enable trading within established tick sizes should be eliminated to create tick size “integrity.”

³ The SEC has traditionally used pilot programs as a test and phase-in implementation strategy.

2. Algorithmic customization of tick size, where the SEC could automate the “mass customization” of tick sizes via a simple algorithm that establishes increments at one-half of the average quoted spread of a stock over some defined period of time, e.g., trailing 12 months.⁴

Stock exchanges increasingly acknowledge that today’s market structure is effective only for a small minority of innately liquid, mostly large-cap stocks, and that higher priced and less liquid stocks could benefit from higher tick sizes, while lower priced and extremely liquid stocks could benefit from smaller tick sizes. The NYSE, NASDAQ and BATS have jointly petitioned the SEC to request smaller tick sizes in very liquid, low-priced companies.⁵ Market participants have expressed that the logical extension of this request would be allowing larger tick sizes for illiquid and/or high-priced stocks.

Pros	Cons
Simple, in that it requires no input from issuers.	Requires an optimal algorithm. ⁶
Enables mass customization of micromarkets. Eliminates one-size-fits-all penny and sub-penny market structure that many believe is undermining capital formation and job creation.	Increases complexity, which is why some prefer to limit the tick size options to simple increments of 1 cent, 5 cents, 10 cents, 20 cents, 50 cents and even \$1 increments on high-priced stocks.
Requires no investment of time by management or management boards of directors in determining tick size.	No opportunity to educate management and boards by requiring them to engage in a discussion with investors, stock exchanges, investment banks and other advisers on how choice of tick size may impact equity research coverage, capital commitment, liquidity and investor interest.
Creates a variety of data for analysis that will paint an unprecedented picture of how tick sizes impact market quality (e.g., volume, liquidity, volatility, research coverage).	
Will curtail speculative and high-frequency trading by adding “friction” (cost) to trading of small-cap stocks, thereby favoring fundamentally oriented, long-term investors.	May exacerbate high-frequency trading in already liquid stocks (mostly S&P 500-type stocks) where the algorithm dictates sub-penny quotes (i.e., even smaller tick sizes than currently occur).
Shifts “aftermarket support” back to Wall Street and may allow management to focus more time and energy on running the business.	

⁴ For example, a stock that trades with a quoted spread of 20 cents might have a tick size of 10 cents (two increments within the natural spread). For a stock whose quoted spread is 1 cent per share, the tick size might be one-half of 1 cent (two sub-penny increments).

⁵ See www.sec.gov/spotlight/reg/nms/jointnmsexemptionrequest043010.pdf.

⁶ Most 25 cent spread stocks traded in 12.5 cent tick sizes before 1998. The sub-\$50 million IPO eroded with the move to 6.25 cent tick sizes. As a result, we believe that limiting the number of ticks per quoted spread increment (e.g., to no more than two), may be required to create an adequate economic incentive to materially improve capital commitment, research, and sales coverage for many issuers. Therefore, the algorithm used might be as simple as this: [(average quoted spread over trailing 12 months) divided by 2 = tick size].

Pilot program: Regarding trial and implementation, the authors suggest a pilot program, which the SEC should establish to examine larger tick sizes in a significant (hundreds) and representative (share price, volume, market value, etc.) sample of stocks. It must be acknowledged that while a pilot program would generate valuable data on the impact on short-term liquidity in these stocks, it will not enable the SEC to gauge the magnitude of commitments that Wall Street might make if it were certain that the size and scope of tick size increases would be made permanent. For example, Wall Street cannot be expected to hire permanent equity research analysts, institutional salespeople or sales traders (capital committers) in response to a pilot program.

Finally, the authors also recommend that there be an associated “Issuer Bill of Rights”:

An Issuer (Job Creators) Bill of Rights would call for public companies to have:

1. equal standing to the trade execution community at the SEC on market structure matters;
2. representation in the form of a standing issuer advisory council to the SEC that comprises issuers and issuer advocates;
3. transparency, timeliness and completeness of ownership data,⁷ because issuers deserve real-time trading and ownership data of all long and short activity;
4. choice in market structure that is not a “one-size-fits-all”; and
5. market structures that encourage fundamental investment strategies over trading strategies.

The recommended solutions, which the authors call **The JOBS Act, Part 2**, would build upon the JOBS Act. They would give issuers and their advocates a voice in this debate and provide the essential fuel through economic incentives that our capital markets and economy need. They would favor long-term, fundamentally oriented investors — the foundation without which the stock markets would cease to function — over short-term traders and would help to restore confidence in our stock markets.

⁷ Large investor positions are currently disclosed to the market on a delayed basis. These data do not disclose short positions and do not help issuers understand in near real-time (days) which investors have been transacting in their stock. The SEC should require the timely release of all issuer ownership data to the issuer, subject to insider trading restrictions, so that issuer managements can make more effective use of their time.

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