

**HOLMES' INTRODUCTORY COMMENTS TO THE IAC  
RE HIS DISSENT AND *ALTERNATIVE* RECOMMENDATION #1  
FOR DECIMALIZATION**

**1/31/14**

THE MAJORITY OF THE MEMBERS OF THE MARKET STRUCTURE SUBCOMMITTEE PROPOSE THAT THE INVESTOR ADVISORY COMMITTEE MAKE 3 FORMAL RECOMMENDATIONS REGARDING DECIMALIZATION TO THE SEC'S COMMISSIONERS.

I AM A MEMBER OF THE MARKET STRUCTURE SUBCOMMITTEE AND I CANNOT AGREE WITH ITS RECOMMENDATION #1, WHICH IS **TO NOT CONDUCT** PILOT PROGRAMS REGARDING DECIMALIZATION.

*INSTEAD*, I URGE THE INVESTOR ADVISORY COMMITTEE TO RECOMMEND MY "*ALTERNATIVE RECOMMENDATION #1*," WHICH IS **TO CONDUCT** PILOT PROGRAMS REGARDING DECIMALIZATION, WITH THE GOAL OF INCREASING THE LIQUIDITY OF SMALL-CAP STOCKS.

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I ASSUME THAT EVERYBODY HERE HAS ALREADY RECEIVED AND CONSIDERED THE DETAILED PERSPECTIVES CONTAINED IN THE:

- *SUBCOMMITTEE'S* DECIMALIZATION RECOMMENDATION #1
- *MY* DISSENT TO THAT RECOMMENDATION
- *MY* DECIMALIZATION *ALTERNATIVE* RECOMMENDATION #1, and
- THE COMMENTS THAT THE PUBLIC HAS SUBMITTED ON THIS TOPIC [AS SHOWN ON THE SEC'S WEB SITE]

THIS MORNING I WILL *BRIEFLY* COVER THE PRIMARY FACTS THAT I FOUND TO BE COMPELLING REASONS FOR THE *ALTERNATIVE* RECOMMENDATION #1.

**WE FACE AN IMPORTANT PROBLEM:**

THE VAST MAJORITY OF SMALL-CAP PUBLIC COMPANIES AND THEIR INVESTORS ARE BEING SERIOUSLY HARMED BY THE **ILLIQUIDITY** OF THEIR STOCKS. THE VAST MAJORITY OF THESE INVESTORS ARE INDIVIDUAL INVESTORS !

THE COST OF CAPITAL FOR THESE COMPANIES IS UNNECESSARILY HIGH, LIMITING THEIR ABILITY TO GROW. PLEASE REMEMBER THAT IT IS WELL DOCUMENTED THAT IT IS SMALL-CAP COMPANIES THAT ARE OUR COUNTRY'S PRIMARY ENGINES FOR JOB GROWTH AND INNOVATION.

MEANWHILE, **INVESTORS** IN THESE COMPANIES ARE BURDENED BY A SUBSTANTIAL 'ILLIQUIDITY DISCOUNT' ON THEIR INVESTMENTS.

I BELIEVE THAT A LARGE PORTION OF THIS PROBLEM IS **CAUSED BY** THE SEC'S CURRENT DECIMALIZATION MARKET RULES, WHICH CALL FOR A **TICK SIZE OF ONE PENNY** FOR ALL PUBLICLY-TRADED STOCKS.

THIS PENNY TICK *HAS BEEN SUCCESSFUL* WITH LARGER CAPITALIZATION STOCKS.

BUT THIS PENNY TICK SIZE HAS BEEN A FAILURE WITH SMALL-CAP COMPANIES. THESE COMPANIES AND THEIR INVESTORS ARE BEING SIGNIFICANTLY, **AND UNNECESSARILY**, HARMED BY THE CURRENT REGULATORY APPROACH REQUIRING THAT "**ONE SIZE FITS ALL**". THIS LINE OF THOUGHT DOES NOT HOLD FOR MUCH OF LIFE, AND IT DEFINITELY DOES NOT WORK FOR SMALL-CAP STOCKS.

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**THE PROPOSED PILOT PROGRAMS ADDRESS THIS PROBLEM**

I BELIEVE THAT THE COMMISSIONERS SHOULD CONDUCT MEANINGFUL PILOT PROGRAMS TO DETERMINE WHETHER THE SMALL CAPS' ILLIQUIDITY CAN BE SIGNIFICANTLY IMPROVED BY THESE **3 CORE RECOMMENDTIONS**:

1. > CHANGE THEIR TICK SIZE TO A NICKEL OR A DIME,
2. > LIMIT THEIR TRADING TO AT MOST ONE POINT WITHIN A TICK, AND
3. > APPLY THESE CHANGES TO ALL MARKET PARTICIPANTS AT ALL TRADING VENUES.

**WE NEED ALL 3 OF THESE CORE RECOMMENDATIONS FOR THE PILOT PROGRAMS TO BE MEANINGFUL.**

I HOPE YOU KNOW THAT THE *ALTERNATIVE* RECOMMENDATION #1 CONTAINS A NUMBER OF ADDITIONAL, DETAILED SUGGESTIONS TO HELP ASSURE THAT WE HAVE *MEANINGFUL* PILOT PROGRAMS, BUT I WON'T COVER THOSE DETAILS NOW UNLESS YOU WANT ME TO.

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PLEASE KEEP THESE 3 FACTS IN MIND:

1. MY RECOMMENDED PILOT PROGRAMS WOULD APPLY TO ONLY TO **TWO PERCENT** OF ALL PUBLIC COMPANIES BASED ON TRADING VOLUME. IN OTHER WORDS, THIS IS NOT A BROAD-BASED TEST FOR THE WHOLE STOCK MARKET. THE PILOT PROGRAMS WOULD ONLY APPLY TO SMALL-CAP COMPANIES BECAUSE THEY HAVE BEEN HURT THE MOST BY THE PENNY TICK SIZE RULE.

2. **INDIVIDUAL INVESTORS** ARE THE PREDOMINANT OWNERS OF THESE SMALL-CAP COMPANIES, WITH AN OWNERSHIP OF NEARLY 70% OF THE SHARES. COMPARE THIS WITH LARGE CAP STOCKS, WHERE INDIVIDUAL INVESTORS OWN LESS THAN 20% OF THE SHARES.

> IF LIQUIDITY OF SMALL-CAP STOCKS IS ENHANCED BY THE 3 CORE RECOMMENDATIONS, THEN INDIVIDUAL INVESTORS SHOULD **BENEFIT FROM:**

[1] ENHANCED LIQUIDITY OF THEIR STOCK,

[2] A REDUCED "ILLIQUIDITY DISCOUNT" AND

[3] OVER TIME, AN ENHANCED VALUE OF THEIR INVESTMENT BASED ON INCREASING INSTITUTIONAL INVESTMENTS IN SMALL-CAP STOCKS.

> THE RECOMMENDED HIGHER TICK SIZE MAY COST THE LONG TERM, FUNDAMENTAL INDIVIDUAL INVESTOR **A FEW MORE PENNIES** PER SHARE WHEN THEY BUY OR SELL THEIR STOCK

- HOWEVER, STUDIES HAVE SHOWN THAT THIS SMALL COST SHOULD BE **FAR MORE THAN OFFSET** BY THE MARKET APPRECIATION THAT MAY COME FROM MORE INSTITUTIONAL INVESTMENT MONEY BEING FOCUSED ON SMALL-CAP STOCKS.

- THE COST TO THE INDIVIDUAL INVESTOR IS A FEW PENNIES PER SHARE; THE POTENTIAL BENEFITS COULD WELL BE MEASURED IN DOLLARS PER SHARE.

3. WHY IS THERE SUCH A DISPARITY TODAY BETWEEN WHO OWNS SMALL-CAP STOCKS VS. LARGE CAP STOCKS? THE ANSWER IS THAT **INSTITUTIONAL INVESTORS**, SUCH AS MUTUAL FUNDS (WHICH DOMINATE THE LARGE CAP OWNERSHIP), ARE NOT HEAVILY INVESTED IN SMALL-CAP STOCKS BECAUSE OF THEIR **LOW LIQUIDITY** AND **SINGLE-STOCK HIGHER VOLATILITY THAN THEIR LARGER-CAP BRETHREN**.

- INSTITUTIONAL INVESTORS REPRESENT A **VERY LARGE POOL OF CAPITAL**.
    - OVER THE COURSE OF THIS PROCESS, I HAVE REACHED OUT TO A NUMBER OF SENIOR PEOPLE IN THE MUTUAL FUND INDUSTRY AND ALL OF THEM TOLD ME THAT THEY WOULD *LIKE TO* BE ABLE TO INVEST IN MANY OF THE SMALL-CAP STOCKS.
    - HOWEVER, MOST INSTITUTIONAL INVESTORS *SHY AWAY* FROM INVESTING IN SMALL CAPS BECAUSE OF THE DIFFICULTY OF ENTERING AND EXITING POSITIONS.
    - WHY? THEY BELIEVE THAT THE CURRENT PENNY TICK SIZE AND SUBPENNY TRADING INCREMENTS MAKE IT *VERY DIFFICULT* FOR THEM TO TRANSACT IN VOLUMES THAT ARE SUFFICIENT TO ENABLE THEM TO BE ABLE TO ACCUMULATE OR SELL MATERIAL POSITIONS IN SMALL-CAP STOCKS WITHOUT SIGNIFICANTLY MOVING THE STOCK PRICE.
  - MY 3 CORE POLICY RECOMMENDATIONS ARE EXPECTED TO SIGNIFICANTLY IMPROVE THIS SITUATION, ALLOWING INSTITUTIONAL INVESTORS (WHICH CURRENTLY ARE ON THE SIDE LINE), TO INVEST IN SMALL-CAP STOCKS.
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THE ALTERNATIVE RECOMMENDATION #1 IS MEANT TO RESTORE SOME BALANCE TO THE SEC MARKET RULES SO THAT SMALL-CAP COMPANIES AND THEIR INVESTORS CAN EXPECT TO HAVE IMPROVED LIQUIDITY AND REDUCED PRICE VOLATILITY.

BUT IS IT LIKELY THAT THE RECOMMENDED PILOT PROGRAMS WILL BE SUCCESSFUL?

YES, THERE ARE VERY GOOD REASONS TO BELIEVE WE CAN OBTAIN THIS OBJECTIVE.

IT DIDN'T USED TO BE THIS WAY AND THE CURRENT CONDITIONS DO NOT NEED TO CONTINUE.

AND IT'S NOT JUST ME WHO BELIEVES THAT THE PILOT PROGRAMS NEED TO BE TESTED.

THIS VIEW IS SHARED BY MANY VERY EXPERIENCED, EXPERT MEMBERS OF THE SMALL-CAP COMPANY ECOSYSTEM.

I HOPE YOU'VE HAD TIME TO READ THE *MANY* **COMMENT LETTERS** SUBMITTED TO THE SEC.

FOR EXAMPLE:

1. A PROMINENT HARVARD LAW PROFESSOR RECOMMENDS CONDUCTING THE PILOT PROGRAMS
2. THE NATIONAL VENTURE CAPITAL ASSOCIATION RECOMMENDS CONDUCTING THE PILOT PROGRAMS
3. THE EQUITY CAPITAL FORMATION TASK FORCE RECOMMENDS CONDUCTING THE PILOT PROGRAMS. THIS TASK FORCE CONSISTS OF PROMINENT REPRESENTATIVES OF *SMALL-CAP COMPANIES, MUTUAL FUNDS, PROFESSIONAL VENTURE CAPITALISTS, ACADEMICS, INVESTMENT BANKERS, SECURITIES ATTORNEYS, STOCK TRADERS AND THE SECURITIES EXCHANGES.*
4. THE NATION'S LARGEST EARLY-STAGE VENTURE CAPITAL FIRM RECOMMENDS CONDUCTING THE PILOT PROGRAMS
5. A PROMINENT MUTUAL FUND THAT FOCUSES ON PRE-IPO EMERGING GROWTH COMPANIES RECOMMENDS CONDUCTING THE PILOT PROGRAMS
6. A FORMER SEC COMMISSIONER AND ACADEMIC BELIEVES THAT TO NOT CONDUCT A PILOT PROGRAM IS NOT AN APPROPRIATE RECOMMENDATION.
7. A VERY EXPERIENCED TRADING FIRM AND MARKET STRUCTURE EXPERT RECOMMENDS CONDUCTING THE PILOT PROGRAMS, **A N D**
8. A HIGHLY RESPECTED INVESTMENT BANK REPRESENTING THE INTERESTS OF INDIVIDUAL INVESTORS AND EMERGING GROWTH COMPANIES RECOMMENDS CONDUCTING THE PILOT PROGRAMS, **A N D**
9. A TRADE ASSOCIATION REPRESENTING OVER 1,100 ENTITITES IN THE U.S. BIOTECH ECOSYSTEM RECOMMENDS CONDUCTING THE PILOT PROGRAMS.

*After the fact addendum: as of 2/1/14 an additional FOUR comment letters have been posted and they all recommend conducting the pilot programs.*

**IN CONCLUSION...**

I THINK THAT CAREFULLY DESIGNED AND IMPLEMENTED PILOT PROGRAMS WILL VERY LIKELY MAKE A SIGNIFICANT IMPROVEMENT TO THE CURRENT DIRE SITUATION FACED BY INDIVIDUAL INVESTORS AND SMALL-CAP COMPANIES.

THERE ARE NUMEROUS CONFLICTING POINTS OF VIEW ON THIS SUBJECT. SOME PEOPLE BENEFIT FROM THE CURRENT SYSTEM AND MAY NOT BENEFIT FROM AN ALTERNATIVE SYSTEM. ON THE OTHER HAND, SOME PEOPLE DO NOT BENEFIT FROM THE CURRENT SYSTEM AND MAY BENEFIT FROM AN ALTERNATIVE SYSTEM. AND SOME PEOPLE HAVE MAY NOT HAVE A DIRECT BENEFIT FROM EITHER THE CURRENT OR AN ALTERNATIVE SYSTEM.

THIS DEBATE WILL CONTINUE UNTIL THE SEC ACTUALLY RUNS PILOT PROGRAMS SO THAT WE CAN DETERMINE WHO IS CORRECT. THIS IS WHY I STRONGLY URGE THE COMMITTEE MEMBERS TO RECOMMEND THAT THESE PILOT PROGRAMS BE RUN.

THE FACT THAT THE ALTERNATIVE RECOMMENDATION #1 WOULD BE LIMITED TO A MERE 2% OF THE MARKET SHOULD GREATLY REDUCE THE CONCERNS OF SOME MEMBERS THAT IT WOULD BE IMPLEMENTING A WHOLESALE CHANGE.

THIS IS A COMPLEX SITUATION AND NOBODY CAN GUARANTEE THE SUCCESS OR FAILURE OF THESE PILOT PROGRAMS.

BUT IF WE DO NOTHING, YOU CAN PRETTY MUCH BE SURE THE CURRENT BAD SITUATION WILL CONTINUE.

IT IS LOGICAL TO EXPECT POSITIVE RESULTS FROM WELL-DESIGNED PILOT PROGRAMS.

MANY EXPERTS SUPPORT THIS.

IT IS A COSTLY MISTAKE TO DO NOTHING.

IT IS A PRO-INDIVIDUAL-INVESTOR AND A PRO-SMALL-CAP-COMPANY INITIATIVE.

THIS CAN BE A WIN-WIN SITUATION FOR INVESTORS, FOR CORPORATE GROWTH AND FOR PRIVATE SECTOR JOB CREATION FOR AMERICA.

THIS CAN BE AN IMPORTANT CATALYST IN REVIVING AMERICA'S ECONOMIC VITALITY.

THIS IS WHY I RECOMMEND THE ALTERNATIVE RECOMMENDATION #1 TO THE INVESTOR ADVISORY COMMITTEE FOR ITS ENDORSEMENT.

THANK YOU FOR CONSIDERING THIS POINT OF VIEW.

**[ END OF OPENING COMMENTS ]**

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**THIS IS AN EXPLANATION OF TICK SIZE THAT I WILL USE ONLY IF NEEDED:**

JUST TO BE CLEAR:

A 'BID PRICE' IS WHAT THE MARKET WILL PAY IF I SELL MY STOCK, FOR EXAMPLE \$10.00.

AN 'ASK PRICE' IS WHAT THE MARKET WILL CHARGE ME IF I BUY THE STOCK, FOR EXAMPLE, \$10.01.

THE TERM 'TICK SIZE' MEANS THE SMALLEST INCREMENT, OR DIFFERENCE, THAT IS ALLOWED BY THE SEC'S MARKET RULES BETWEEN THE QUOTED BID AND QUOTED ASK PRICES.

THE TICK SIZE DOESN'T MEAN THE MANDATORY OR MAXIMUM DIFFERENCE BETWEEN THE BID AND THE ASK – ONLY THE MINIMUM SPREAD.

FOR EXAMPLE, A *PENNY* TICK SIZE WOULD ALLOW FOR A BID PRICE OF \$10.00 AND A MINIMUM ASK PRICE OF \$10.01.

A *NICKEL* TICK SIZE WOULD ALLOW FOR THE SAME BID PRICE OF \$10.00 BUT THE MINIMUM ASK PRICE WOULD BE \$10.05.

HOWEVER, THE QUOTED SPREAD BETWEEN THE BID AND ASK PRICE CAN BE MUCH HIGHER THAN THE MANDATED PENNY OR NICKEL TICK SIZE. THAT SPREAD IS BASED ON WHAT MARKET PARTICIPANTS WANT TO QUOTE AS LONG AS THE SPREAD IS NOT LESS THAN THE MANDATED TICK SIZE. THEREFORE, A STOCK MAY HAVE A BID OF \$10.00 AND AN ASK OF \$10.15. THE DIFFERENCE HERE IS 15 CENTS AND THAT IS THE SPREAD. THE TICK SIZE MAY BE 1 CENT, BUT THE QUOTED SPREAD IS 15 CENTS AND THAT IS DRIVEN BY THE MARKET PARTICIPANTS.

NOTE: THESE QUOTES ARE OFTEN ILLUSORY BECAUSE THEY MAY REPRESENT AN OFFER FOR 100 SHARES. IF YOU WANT TO BUY 1,000 SHARES YOU CAN EASILY SEE YOUR PURCHASE PRICE GO UP SIGNIFICANTLY. AND IF YOU WANT TO SELL 1,000 SHARES YOU CAN EASILY SEE YOUR SALE PRICE GO DOWN SIGNIFICANTLY. **THAT'S THE HALLMARK OF A SHALLOW, ILLIQUID AND VOLATILE MARKET!**

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