Consumer Federation of America

December 22, 2014

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number 4-657
Proposed National Market System Plan to Implement a Tick Size Pilot Program On a One-Year Pilot Basis

Dear Secretary Fields,

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our views with regard to the proposed plan to implement a tick size pilot program. Before delving into the details of the proposal, we wish to express our skepticism with the premise on which the proposal is based. Despite its proponents' best intentions, increasing tick size will likely result in increased costs to investors but without any accompanying benefits to them or to market quality. That is because those increased costs will likely go directly to high frequency trading (HFT) market making firms whose business models do not include engaging in the type of research and capital commitment that promotes capital formation. Further, the profits that HFT market making firms generate will not be tied to any market making obligations that would promote dependable liquidity. Because a tick size pilot is likely to come with significant costs to investors, and is unlikely to serve the Commission's and Congress' ultimate goal of fostering an environment that is conducive for capital formation, we do not believe that the Commission should be dedicating valuable resources to move forward on a tick size pilot.

Proponents of a pilot project argue that it is justified in order to test these theories. But before undertaking a pilot, particularly one that comes at the expense of investors, we should have a reasonable basis for believing it is likely to be successful. That is not the case here. First, there is no persuasive evidence showing that increasing tick size is likely to result in any benefit to capital formation. The Commission staff's July 2012 Decimalization Report noted, for example, that there were no academic papers that directly examined the relationship between decimalization and the number of IPOs. Second, there is no persuasive evidence showing that

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

increasing tick size will result in enhanced market quality for smaller capitalization company stocks. Indeed, when Professors Maureen O'Hara, Gideon Saar, and Zhuo Zhong recently examined how relative tick size influences market quality, they found little evidence that a larger tick size is likely to increase liquidity, market maker participation by non-HFT firms, or research coverage in small cap stocks.[2]

If the Commission is interested in dedicating valuable resources to engage in various market structure pilot projects, we believe better alternatives would include eliminating maker-taker pricing or reducing the $0.30 per 100 share cap under the Access to Quotations Rule of Reg. NMS. Either would be significantly easier to implement than a tick size pilot, and could, if well-designed, provide useful information about ways to address market complexity and to better align brokers' routing decisions with their clients' best interests.

However, understanding that a tick size pilot is moving forward, it must be structured in a way so as to minimize potential harms to investors and market quality, and maximize potentially useful information that can inform the Commission's market structure reform efforts. Toward that end, the SROs implementing the plan, with the Commission's oversight, must engage in rigorous cost-benefit analysis, including:

- identifying what exactly they are testing;
- articulating how the various components of the plan fulfill the objectives of those tests;
- assessing the likely economic impacts stemming from each of the plan's components; and
- evaluating reasonable alternatives to the plan's individual components and overall design.

Yet, to date, no cost-benefit analysis of this sort has been undertaken. As a result, it's not entirely clear:

- why the securities to be included in the pilot were chosen, what the likely consequences are of including those securities, and whether those securities fit an appropriate testing criteria; or
- why the pilot's three test groups were chosen, what the likely effects are of each test group, and whether those test groups are designed appropriately.

If increasing tick size were being proposed through formal regulation instead of a pilot program, the Commission would need to engage in a rigorous economic analysis. While the Commission may not have a legal obligation to undertake an economic analysis here, doing so would improve the pilot's design and provide credibility for the plan and for its results. Therefore, we urge the Commission to engage in further economic analysis before moving forward.

Independent of the need for further economic analysis, there are concrete ways in which the plan design can be improved, discussed in further detail below.

[2] Maureen O'Hara, Gideon Saar, and Zhuo Zhong, Relative Tick Size and the Trading Environment, December 2013, http://1.usa.gov/1x32f5N.

The Universe of Securities Eligible for Inclusion in the Pilot Must be Narrowed

Among the requirements for securities to be included in the pilot are that they have a market capitalization of $5 billion or less, and an average daily trading volume of one million shares or less. In its order directing the exchanges and FINRA to submit a tick size pilot plan, the Commission stated that it “preliminarily believes that these criteria will capture the securities of smaller and middle capitalization companies with low liquidity and trading activity and should provide the Pilot with a broad sample on which to test the impact of wider tick sizes.” However, this sample will be significantly overbroad, resulting in the inclusion of many companies that do not suffer from low liquidity and trading activity. For example, several established companies that do not appear to suffer from low liquidity and trading activity, including some S&P 500 companies, would appear to be eligible for inclusion.[3] If the goal of the project is to determine the impact of increased tick size on small, thinly traded companies, these are not the types of companies the tick size pilot should be including.

In addition, according to the Commission’s order, some stocks that fall within the market capitalization and average daily trading volume thresholds currently trade in the $0.01 range. By requiring that the tick size of those securities increase from $0.01 to $0.05, the costs that investors pay to trade in those securities will increase fivefold. Those increased costs must be balanced against the expected benefit to liquidity of increasing tick size. Because securities with $0.01 spreads are already highly liquid and actively traded, any marginal increase in liquidity would be clearly outweighed by the significantly increased costs to investors of widening tick size.

The pilot must only include securities that stand to benefit significantly from increased intermediation. Otherwise, investors would be forced to pay unjustifiable costs without any accompanying benefits to the capital formation process. And, the only beneficiaries would be the intermediaries making markets in those securities, and being enriched as a result of the increased costs borne by investors. To ensure that the most appropriate securities—truly small cap stocks that exhibit characteristics of illiquidity—are included in the pilot, the market capitalization and daily average trading volume must be lowered. Accordingly, the market capitalization threshold should be lowered from $5 billion to $2 billion, and the daily average trading volume threshold from 1 million shares to anywhere between 300,000 and 500,000. These are generally accepted market capitalization[4] and trading volume thresholds[5] for small cap companies, and are therefore likely to yield meaningful results. In addition, the Commission and the plan participants should ensure that the pilot only include securities that have wide enough average effective spreads such that increasing tick size does not automatically multiply by several times the costs investors are paying. Accordingly, the pilot should include an additional threshold so that only securities with average effective spreads of $0.05 or greater are included.

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[3] A few examples include: FLIR Systems (market cap of $4.55 billion; three month average daily volume of approximately 855,000); Ryder System (market cap of $4.72 billion; three month average daily volume of approximately 632,000); Assurant (market cap of $4.65 billion; three month average daily volume of approximately 553,000); and Sally Beauty Holdings (market cap of $4.80 billion; three month average daily volume of approximately 997,000).

[4] Rick Wayman, Understanding Small- and Big- Cap Stocks, Investopedia, http://bit.ly/1CdFd0x.

[5] Matthew Ciccone and Judd Schwab, Small Cap Liquidity in 2013, Weeden and Co., January 2014, http://bit.ly/1JzcaGR.

It is critical that the universe of securities eligible for inclusion in the pilot be narrowed. Otherwise, the pilot would result in a biased and unrepresentative sample set that yields irrelevant and unreliable data, at best. At worst, it would expose investors to increased costs without any material benefits to capital formation or market quality.

The Pilot Design Must be Better Justified, Minimize Harm to Investors and the Market, and be Simplified

The pilot consists of a control group and three test groups. In its order, the Commission stated that it preliminarily believes that three test groups should generate sufficient data to test a variety of potential changes. Indeed, the pilot will foist a variety of changes on market participants, and in turn, have considerable effects on their trading practices as well as on the market overall. However, the order does not go into great detail to explain:

- the need for each test group;
- what can be expected in each test group;
- what are the expected costs and benefits of each test group;
- how the expected costs are being minimized and benefits are being maximized;
- what are the specific benchmarks by which the data will be analyzed;
- what are the purposes of those benchmarks; and
- what the Commission will consider a success or failure in each test group.

Our impression is that the Commission hasn't sufficiently answered these questions. As a result, the Commission appears to be taking an approach that is akin to throwing different options at a wall and seeing what sticks, and only then trying to figure out what exactly happened and why. With the pilot's three test groups, the Commission is effectively testing three unique market structures to try to learn about how liquidity forms and migrates based on various stimuli. This is not how the plan should be structured. The pilot plan should be based on a clear and precise framework of what each test group is seeking to evaluate. The plan should also be narrow in scope, with every individual component of the plan being necessary to the overall plan. Finally, it should seek to impose the minimal amount of harm to investors and to the market as practicable.

Based on these criteria:

- **Test group one should be eliminated.** Pilot securities in test group one would be quoted in \$0.05 increments but would continue to trade in \$0.01 increments. As a result, a substantial amount of trading would migrate to dark venues that reference quoted prices but do not display quotes. Specifically, test group one is likely to foster a growth in midpoint matching within dark pools and internalization by broker-dealers. Chair White acknowledged earlier this year that, "the consensus of the research is that the current extent of dark trading can sometimes detract from market quality, including the informational efficiency of pricing."[6] Given the consensus that current levels of undisplayed liquidity can be harmful to market quality and the heightened risks that are likely to result from further eroding price discovery, we should not be engaging in experiments that actively increase undisplayed liquidity.

[6] Chair Mary Jo White, "Enhancing Our Equity Market Structure," Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, New York, N.Y., June 5, 2014, http://1.usa.gov/1mfkOvW.

- **Retail investor orders should be required to provide significantly more price improvement than at least $0.005 better than a best protected bid or offer.** We recognize that retail investor orders are most likely to be internalized by broker-dealers, and that they therefore increase undisplayed liquidity. To counterbalance the harms to market quality that occur from increasing undisplayed liquidity, and to ensure that retail investors receive tangible benefits from internalization, they should receive significant price improvement on their orders. We are pleased that the Commission's order recognizes this principle. However, the required amount of price improvement must be considered in relation to tick size. Otherwise, the costs that retail investors are paying as a result of increased tick size won't be sufficiently offset by the amount of price improvement that they receive. While $0.005 would be significant in an environment that quotes and trades in $0.01 (50 percent of the tick size), $0.005 would not be significant in an environment that quotes and trades in $0.05 (only 10 percent of the tick size).

  Moreover, while the vast majority of retail order flow is internalized, this exception risks increasing internalization further. That's because it may be more economical for retail brokers to direct customer orders to internalizers, which match at the tick, and then provide $0.005 in price improvement, rather than send their customer orders elsewhere. This is the same problem that exists when internalizers step ahead of, and thereby gain an execution advantage over, displayed orders.

  There also seems to be a troubling inconsistency between the order and the plan as it relates to the minimum required amount of price improvement for retail investor orders. The order states in its discussion of test group two that retail orders could be provided with price improvement that is at least $0.005 better than the NBBO. In its discussion of test group three, the order states that, pursuant to a trade-at requirement, orders could be executed with significant price improvement (such as the minimum allowable $0.05 increment or the midpoint between the NBBO). However, in the proposal, retail investor orders in both test groups only require $0.005 price improvement. As stated above, $0.005 is not sufficient to counterbalance the harms to market quality that occur from increasing undisplayed liquidity and the increased costs to retail investors of increasing tick size. In test group three, the problem is even more pronounced given that the purpose of the test group is to preference displayed liquidity. By providing an exception to the trade-at rule that requires only $0.005 of price improvement, retail brokers will have a stronger incentive to internalize retail orders. Thus, in the context of broker-dealer internalization, the exception will effectively swallow the rule.

  To ensure that undisplayed liquidity does not gain an advantage over displayed liquidity, and that the purpose of the trade-at test group is fulfilled, all retail investor orders, regardless of which test group they apply to, should receive a minimum price improvement of $0.025, equal to 50 percent of the tick size.

- **Test group three's many exceptions should be better justified and the overall trade-at rule should be simplified to the maximum extent possible.** We strongly support a trade-at rule as a mechanism to preference displayed liquidity over undisplayed liquidity and to encourage aggressive quoting over passive price matching. Aggressive quoting on displayed venues fosters transparent price competition, which ultimately benefits investors by lowering their costs. However, we are concerned that the plan to implement a trade-at rule may be too complex to yield meaningful and potentially beneficial results. The Commission's order had three exceptions to the rule, whereas the plan has thirteen. The plan justifies nine of the exceptions by saying that it is applying the trade-through exceptions in Reg. NMS to the trade-at prohibition, and that the rationales underlying the trade-through exceptions apply to the trade-at prohibition as well. Yet, Reg. NMS has been the subject of legitimate criticisms. If we are going to have a serious conversation about our current market structure, we must reassess whether Reg. NMS, including its trade-through rules and exceptions, is still appropriate given how our market has transformed over the last decade. Importing those controversial rules to the trade-at context without providing any further justification about their necessity or appropriateness appears to favor the status quo and foreclose the possibility of a fresh look at how our market structure can work better. Such an approach is contrary to what a trade-at rule is intended to accomplish.

If these exceptions are indeed vital to the trade-at rule's implementation, then they should be better justified. If, however, the only justification is that this is how the market currently works, the Commission and the plan participants should rethink how this test group and its exceptions are designed.

Issues on Which the Commission and Plan Participants are to be Commended

While we have been critical of the premise and the proposal to increase tick size, there are several areas where we think the Commission's order and the plan participants' proposal got it right.

First, on duration. We agree with the Commission that, given the inherent limitations of a pilot project, a one-year time period would generate sufficient data to reliably analyze the effects and impact on a wider tick size. We urge the Commission to maintain this time period.

Second, on data collection and assessment. We are pleased that the data will be made publicly available for free. This will allow academics, third party analysts, and other capital market participants to better understand the pilot's results. We urge the Commission and the plan participants to present the data in "tagged" format, such as XML or XBRL. Tagging the data will allow all of the information to be fully searchable and sortable, which will, in turn, foster the ability of those who wish to analyze the data to do so.

The order called for the participants to assess the effect of the quoting and trading increment requirements on market maker profitability. However, the proposal states that the exchanges believe that market makers will be in a better position than the participants to analyze the effects of the pilot on market maker profitability, and therefore, the participants removed this assessment from the pilot. While we understand exchanges may not be in a good position to assess market maker profitability, it is still critical to collect data on market maker profitability. It is important to understand which types of market makers are changing their business practices, how they are doing so, and to what extent they are being successful. Profits are an essential gauge of their success. Market makers cannot be relied on to assess these issues impartially. A better approach would be to have FINRA collect and assess data on market maker profitability. We urge FINRA to do so and to make that information public.

<u>Conclusion</u>

A tick size pilot has the potential to raise costs on investors and cast unnecessary harm into the market. However, if it is structured appropriately, many of those costs and harms can be mitigated. The current proposal fails this test. Our recommendations are designed to achieve those objectives, and we therefore urge the Commission and the plan participants to adopt them.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
Financial Services Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner
Stephen Luparello, Director, Division of Trading & Markets