



BULLETIN *from* PENSERRA

September 2016

Uncertainties with the 'Tick Size Pilot' Program

Wall Street is gearing up for the SEC's latest test program which is designed to assess whether wider minimum quotes can improve the market quality (more specifically, the liquidity, price discovery and volatility) of small-cap stocks for the benefit of both issuers and asset owners. While many in the industry support the continual review of market structures by policymakers, and efforts to seek market efficiencies, the program scheduled to launch in October seems to raise as many questions as answers with respect to its outcome.

Pilot Program Summary

The Tick Size Pilot Program, as it's known, is a 2-year plan that involves evaluating a control group of some 1200 securities and three test groups with 400 securities in each (selected through a stratified sampling approach). The groups are defined in the following manner:

- **Control Group** - Securities are to be quoted and traded at their current tick size (penny) increments.
- **Test Group 1** - Securities are to be quoted in \$0.05 increments, but will be permitted to trade at their current price increments.
- **Test Group 2** - Securities are to be quoted and traded in \$0.05 minimum increments only, but allow certain exceptions for midpoint executions, retail investor executions, and negotiated trades.
- **Test Group 3** - Securities will apply the same constraints/exceptions as those in *Test Group 2* but also be subject to a "trade-at" requirement in order to prevent price matching by a trading center/market maker not displaying the best bid/offer.

Over the next 18 months, data is to be collected monthly by the SEC from those participants of the program for analysis.

Example

To illustrate how a quote and execution will work, take the following example. Stocks in *Test Group 2* are to be quoted in nickel (.05) increments and could be executed at a mid-point of the quote assuming liquidity exists at that level. They can also be executed at any nickel increment within the inside market which can be accessed through various liquidity sources (dark pools, hidden order types, etc.) A stock that is quoted at 1.05-1.10 can be executed at 1.075. A stock that is quoted at 1.05-1.40 can be executed at 1.10, 1.15, 1.20, 1.225, 1.25, 1.30, or 1.35 within the spread assuming (again) liquidity is provided at those levels. These are the only price improvements available on execution under this scenario.

Impact

Proponents believe the premise of the program is valid in that it will not only spur on more trading from existing and new participants with market makers incentivized by higher profits from wider bid-ask spreads, but also stimulate the investment banking activities (through increased underwriting and research coverage) targeting small capitalization companies. In theory, this should lead to opportunities for more company listings, create jobs and benefit capital formation in the small-cap equity space.

Uncertainties with the 'Tick Size Pilot' Program

Opponents, on the other hand, argue that the adoption of the program will have some major unintended consequences. For one, asset owners can expect securities to be more expensive to trade as they will likely experience higher transactions costs from the mandated wider spreads (*Test Group 2*) and possibly be subject to increased information leakage in an effort to enhance price discovery (*Test Group 3*). Note that this is in addition to any costs incurred by trading centers/market makers for initial technology upgrades and ongoing data collection and reporting requirements to permanently implement the program. These explicit costs will likely be passed along to their customers. Also, there is a question whether profits made from trading will benefit the capital markets side of the business leading to an increased investment in smaller companies. Lastly, results of the program data capture may be difficult to interpret as participant behavior may be driven by ease of use issues as much as any increased perception of the 'quality' of the markets. Some may even consider to avoid trading the chosen securities, all else being equal, rather than comply with the program rules.

With such varying views, it shall be interesting to see what the results are and interpret their implications --- in two years time.

For more information, including the lists of eligible securities, please refer to the FINRA website: <http://www.finra.org/industry/tick-size-pilot-program>

*For more information, please
contact us at*

800.456.8850

globalequity@penserra.com

REGULATORY DISCLOSURE

All materials are provided for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security. Penserra Securities LLC is not responsible for gains/losses that may result in the trading of these securities. All information is believed to be obtained from reliable sources, but there is no guarantee that the information supplied is accurate, complete or timely. There is no guarantee or warranty with regard to the results obtained from its use. There is no guarantee of suitability or potential value of any particular investment or information source. You acknowledge that your requests for this information are unsolicited and shall neither constitute nor be considered investment advice. Past performance is not an indication of future performance. Investors are encouraged to consult a registered broker or investment adviser before making any investment decisions. This material is not intended to provide investment advice. All strategies referred to herein are among various investment strategies that are managed by Penserra Capital Management LLC and Penserra Transition Management LLC as part of their investment management fiduciary services. Penserra Capital Management, LLC is an investment advisor registered with the Securities and Exchange Commission and Penserra Transition Management LLC is an investment advisor registered in the State of California and New York. Execution services are offered through Penserra Securities LLC. The interpretations and opinions expressed herein are solely those of the author and not of any other individual or organization. Penserra Securities LLC, Member SIPC and FINRA.