Our analysis of stocks to be included in the TSP shows they already trade at a median spread of just over $0.05. So what will the Pilot Program actually accomplish? Likely not its original purpose: to boost capitalization and research coverage (and therefore investor interest) in small cap stocks and their Initial Public Offerings through increased market making support. The Program should, however, make useful contributions to a broader assessment of U.S. equity market structure, especially as it relates to clustering reliable, stable and tradable liquidity.
On October 3, U.S. equity markets will change more in one day than they have in 10+ years.

On that day, as well as other proposed dates throughout the month of October, test groups of U.S. listed equities will go from quote spreads of $0.01 to $0.05 in a novel program called the “Tick Size Pilot” (TSP) Program. With 3,556 stocks currently in the Wilshire 5000 Index, representing essentially the entire “tradeable” U.S. stock market, the TSP will therefore touch 34% of all domestic listed equities.

The scale of the TSP is broad and as with all large scale experiments, the details matter a lot. There will be a control group of stocks and three test groups, with each test group bucketed equally in terms of total number of securities in the following manner:

- The securities in the control group will be quoted and trade at current tick size increments.
- The first test group of approximately 400 stocks will be quoted in $0.05 increments, but will continue to trade at current price increments (including subpennies).
- The second test group of approximately 400 stocks will be quoted and trade in $0.05 minimum increments, but will allow exemptions for midpoint executions, retail investor executions and negotiated trades including block trades of 5000 or more.
- The third test group of approximately 400 stocks will adhere to the requirements of the second test group, but will also be subject to a “trade at” requirement, meaning one cannot trade in the dark at the NBBO without first attempting to do so at the lit venues displaying that price and size. There will be a “trade-at” exemption for block size orders.

Make no mistake: this is a complex and important change to U.S. market structure and the Convergex team is ready to help clients navigate through these new rules.

Recent industry commentary about the Tick Size Pilot has highlighted the numerous challenges, both to the buy-side and sell-side, implicit in its execution.

All of our business lines, from the Millennium ATS to PerformEx trade analytics package, high touch trading to our algorithmic suite, are ready for this change.

As industry leaders we are also focused on the ultimate goals of the Tick Size Pilot, and once it is up and running these will be topics of considerable discussion. After all, such a fundamental rewiring of something as basic as tick size needs to have clear goalposts so the data the TSP generates can help improve the functioning of capital markets. To use this lens correctly, however, we must first look back in time to understand the origins of the TSP.

While we suspect there will be some Industry Day One “hiccups” on October 3, we believe that, in general, the transition to the TSP should go smoothly if individual market participants have devoted the appropriate resources to its adoption.
The starting point for this journey is the 2012 Jumpstart Our Business Startups (JOBS) Act, which required the SEC to conduct a study and report to Congress on “How decimalization affected the number of initial public offerings (IPOs) and the liquidity of trading of smaller capitalization securities.” The central concern at the time was that penny quotes had so reduced the profitability of market making that broker-dealers could no longer afford to maintain analyst coverage on small capitalization companies. As a result, the number of IPOs had declined from the 1990’s tech-boom, pre-penny spread highs to a much lower level in the 2000s. Less research meant less investor interest in small cap stocks, which in turn led to fewer IPOs.

With the benefit of further analysis and time, we can now see that global investment trends explain much more about the decline in IPOs than the size of the bid-ask spread ever could. Venture capital and private equity have matured in the last 20 years and are now the go-to source of capital for many high growth businesses. Fast growing private companies have access to a deep well of venture capital that focuses on long term growth, visionary management, and a “change the world” business model. To their credit, these investors have proven to be very patient capital, and companies like Uber and Airbnb are changing the world as a result. The upshot here is that going public is no longer the only path a fast growing company can take to raise more capital. In some cases, it is not even the “best” choice.

Another driver of lower levels of IPO issuance is the slow pace of business investment outside of the narrow confines of Silicon Valley. This has been a primary cause of below-average GDP growth and labor productivity in the U.S. since the Great Recession, of course, but also a headwind for other developed economies around the world. The current negative interest rate environments in Europe and Asia tell you all you need to know about global business investment growth: there isn’t enough. Without faster economic growth, the chance for an IPO renaissance seems slim indeed.

Changing the tick size on small cap U.S. stocks isn’t going to alter any of these challenges, but what about the notion that wider spreads will improve market maker profitability and encourage more research coverage of these underfollowed names? That could certainly help smaller public companies and their investors. More research – “buy,” “sell,” or “hold;” it doesn’t matter – should make for a more vibrant and informed investor base and generate more interest in small cap securities.

The trouble with this argument, at least as it relates to the stocks to be included in the Tick Size Pilot, is that they already trade at spreads much wider than a penny.

- There are, by our count, just over 2,400 U.S. listed small capitalization stocks whose characteristics make them eligible for the TSP.

- Looking at this universe of securities, we find that the median bid-ask spread is currently 6.2 cents, or even wider than the “new” 5 cent spread envisioned by the Tick Size Pilot.

We also found that the 61% of all equities eligible for inclusion in the TSP trade for average spreads of $0.05 to $1.00.

- Moreover, these wider spreads are not due to high stock prices; the average price here is $27/share. We have included a link to FINRA’s test file of eligible symbols in case you would like to see examples of this phenomenon.

This data casts a new light on the Tick Size Pilot, since moving to nickel spreads for the securities chosen to participate in those buckets will not necessarily increase their actual bid-ask spread.

It may, in the case of the median names with a 6 cent spread, actually decrease it if market makers round down rather than up to a dime. The same, of course, holds true for stocks with a current average spread of 11 cents, 16 cents, and so forth.
In the end, the Tick Size Pilot may not see spreads widen at all, but there is still a wealth of information that market participants and regulators can gain during its two year life. Chief among these is the clustering of liquidity at nickel increments for stocks in the buckets where trading must generally occur at those points. Instead of 100 shares offered at every penny, there might be 500 shares or more at the nickel level. Moreover, this may result in more “persistent” bid-ask levels and less unnecessary shifting of prices for a given security.

To sum up, we believe considerable useful information will come out of the Tick Size Pilot even though it is unlikely to lead to a rejuvenation of the U.S. IPO market or more research on small cap companies. We’d be happy to be proven wrong on those points but we simply believe alternative answers are required. The TSP will, however, provide useful data on how limiting tick size can serve to maximize liquidity in stocks that would most benefit from that improvement. Lessons learned here may even inform whether such an initiative would benefit larger, more liquid names.

Will “getting pennied” become a thing of the past?

Hard to say, but we believe the Tick Size Pilot is a productive effort at outlining a potential solution to this and other problems endemic to efficiently trading small cap stocks. U.S. market structure has developed along a one-size-fits-all structure since the adoption of Reg NMS. Now, the TSP sees shades of gray where previously there was only black and white.

As the renowned architect Frank Gehry once said “I work from the inside out.” The TSP does exactly that, focusing on smaller cap stocks that may not get the attention they merit. Whatever we learn from the “inside” will also be useful on the “outside” as well.

Sources and Additional Reading


FINRA Information on the Tick Size Pilot: http://www.finra.org/industry/tick-size-pilot-program

FINRA Implementation Timeline: http://www.finra.org/industry/tick-size-pilot-implementation-timeline

FINRA Trial List of TSP Eligible Equities: http://www.finra.org/sites/default/files/TSP_Sample_File.txt


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