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SEC Has Approved A Two-Year Tick Size Pilot Program For Smaller Public Companies

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On May 6, 2015 the SEC approved a two-year pilot program with FINRA and the national securities exchanges that will widen the minimum quoting and trading increments, commonly referred to as tick sizes, for the stocks of smaller public companies. The goal of the program is to study whether wider tick sizes improve the market quality and trading of these stocks.

The basic premise is that if a tick size is wider, the spread will be bigger, and thus market makers and underwriters will have the ability to earn a larger profit on trading. If market makers and underwriters can earn larger profits on trading, they will have incentive to make markets, support liquidity and issue research on smaller public companies. The other side of the coin is that larger spreads and more profit for the traders equates to increased costs to the investors whose accounts are being traded.

The tick size program includes companies that meet the following $3 billion or less in market capitalization, an average trading volume of one million shares or less, and a volume weighted average price of at least $2.00 for every trading day. The pilot study group includes a control group of 1400 securities and three test groups with 400 securities in each. Notably, the tick size program will not include micro-cap securities with a weighted average price of less than $2.00 per day.

During the pilot the control group will be quoted at the current tick size increment of $.01 per share and will trade at the currently permitted increments. The first test group will be quoted in increments of $.05 but will continue to trade at any price increment that is currently permitted. The second test group will be quoted in increments of $.05 and will also trade at $.05 minimum increments subject to certain exceptions. The third test group will be quoted in increments of $.05 and will be subject to an additional “trade at” requirement to prevent price matching. The third test group will have the same exceptions as the second and an additional block size exception.

Background and Reasoning for the Program

Since the inception of decimalization in 2001 and minimum price variation of one penny for exchange-traded companies, there has been a significant change in the nature of trading and role of market participants. Many market participants believe that underwriters and market makers have lost their incentive to make markets and produce research for micro-, small- and mid-capitalization companies.

The JOBS Act directed the SEC to conduct a study and report to Congress on how decimalization affected the number of IPO's and the liquidity and trading of stock in smaller public companies. The JOBS Act also gives the SEC the authority to designate a minimum increment for the trading of emerging growth companies that is more than $.01 but less than $.10. In July 2012 the SEC submitted the "Decimalization Report" to Congress, failing to reach a firm conclusion and instead realizing further research was needed, including by pursuing a pilot program to study the impact of wider tick sizes. The SEC believes that the current approved tick size pilot program will provide the necessary information to determine whether to permanently change tick sizes for these smaller companies.

As mentioned, the goal of the program is to study whether wider tick sizes improve the market quality and trading of these stocks. The basic premise is that if a tick size is wider, the spread will be bigger, and thus market makers and underwriters will have the ability to earn a larger profit on trading. If market makers and underwriters can earn larger profits on trading, they will have incentive to make markets, support liquidity and issue research on smaller public companies. Moreover, additional market makers may enter the market as they see an opportunity to earn value. Additional market makers will equate to additional liquidity, which in turn attract more investors.

Issuers benefit from increased liquidity and market activity and quality in several ways. More trading activity and increased investor awareness could reduce the company's cost of capital and improve opportunities to attract capital. That is, more investors will be willing to invest directly into the company, through PIPE transactions, registered secondary offerings, equity lines and the like as they will see a strong exit strategy. Moreover, with higher liquidity and market value, the ultimate exit by these investors will have less of a downward impact on trading price. Where the investment instrument was convertible (such as convertible debt, warrants and options) using a market price formula, less downward pressure on trading price will mean fewer shares will need to be issued in the conversion and the existing shareholders will suffer less dilution.

In addition, one of the main purposes of going public is to use capital stock as currency in making acquisitions and attracting key executives. Where the company has an active trading market, market maker support and strong liquidity, the value of the capital stock is likewise higher. Not only will the capital cost of making stock-based acquisitions and attracting and retaining high-quality key executives be reduced but for some issuers, it will make the difference of being able to utilize this benefit of being public at all.

Although there is no doubt that improved liquidity, market activity and market maker and underwriter support is extremely beneficial to all public companies, and in serious need for improvement for smaller public companies, it is not known whether the increased tick size will have the desired outcome.

The other side of the coin is that larger spreads and more profit for the traders with the increased tick size equates to increased costs to the investors whose accounts are being traded. Moreover, the program itself will be complex and costly to implement for market participants. Market participants have stringent rules to follow for each test group to ensure a valid test result. Each participant must adopt written policies and procedures and monitor and report results.

Conclusion

It is important that the SEC and market participants actively seek to improve the market quality for smaller public companies, and this is just one measure in that wheelhouse. However, it is a two-year program. I'm anxious to see more timely efforts in this arena, such as through the launch of venture exchanges.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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