

January 27, 2014

Chairman Joseph Dear
Investor Advisory Committee
United States Securities and Exchange Commission
100 F Street
Washington, DC 20549

Re: Recommendations to the Investor Advisory Committee by its Market Structure Subcommittee regarding Decimalization and Tick Size

Dear Chairman Dear:

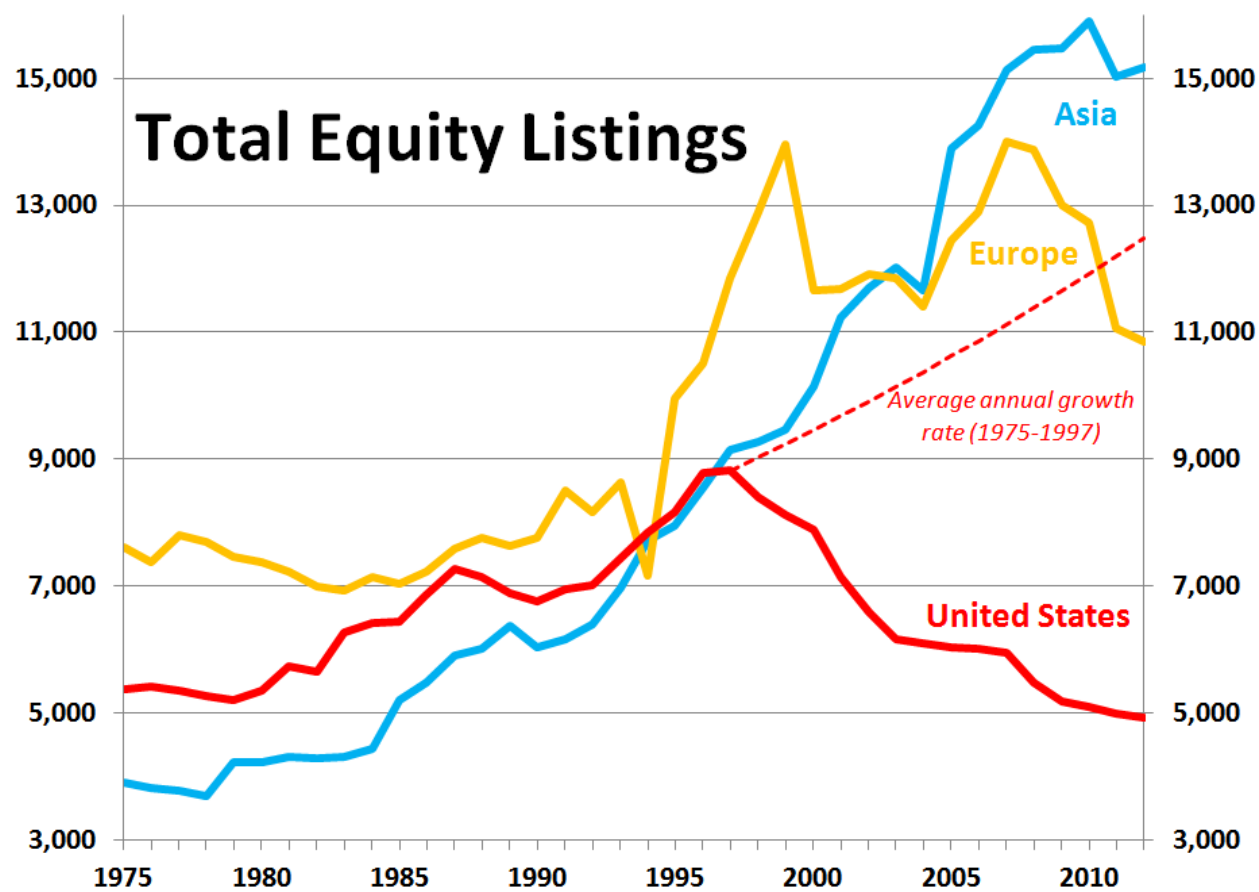
We are writing in response to the draft recommendations regarding Decimalization and Tick Size that were recently submitted by the Market Structure Subcommittee (the “Subcommittee”) of the SEC’s Investor Advisory Committee (the “Committee”) and posted to the SEC’s website. We are gratified to note that the Committee is engaged on these topics and on the larger issues of their impact on capital formation in this country. *Having followed the proceedings of the Subcommittee, however, we are troubled by apparent:*

- **Conflicts of Interest:** The Subcommittee Chairman Steven Wallman, in our view, should have recused himself from participation in the Subcommittee for reasons detailed below. The fact that he instead chaired this Subcommittee taints every recommendation in which he is involved.
- **Misconceptions:** The subject of “tick sizes” in a post Reg. NMS world requires highly specific knowledge of market structure for what is a highly technical evaluation. We viewed the transmission of the November proceedings, and it was clear, based on their own statements, that members of the Subcommittee had *fundamental misconceptions* on the subject. There was in evidence a clear and erroneous belief that tick sizes – the smallest increment in which a security may be quoted, are set by market forces. In fact, tick sizes are set by the SEC.
- **Shortage of Expertise:** There are no investors in microcap stocks with direct experience in the valuation, selection, trading and investing in these stocks on the Subcommittee (and in fact, they are in very short supply on the Committee overall). Large- and mid-cap trading is fundamentally different from small-, micro- and nano-cap trading. Large-cap stocks are innately liquid. Small company stocks are innately **illiquid**. Any review of the academic literature studying tick sizes, and tick sizes as a percent of share price, on stock exchanges the world over will show that smaller tick sizes increase liquidity in innately liquid stocks (large-cap), while undermining liquidity in innately illiquid stocks (smaller companies). The lack of fundamental micro-cap investors with a core-competency in micro-cap trading making up this committee strikes us as the moral equivalent of “taxation without representation.”

This is why, we believe, that the mutual fund industry through the ICI has been receptive to a pilot program to increase tick sizes: Institutional liquidity has been compromised by the penny tick size model applied to small company stocks.

For the record, IssuWorks does not have a trading business. We are both qualified (see "Thought Leadership" at www.IssuWorks.com) and without conflict. This letter is not written on behalf of any other entity. We are simply interested in reversing the damage that was done to our stock markets and contributed so mightily to unemployment. The integrity of our markets was compromised through one-size-fits-all penny tick sizes. The interests of investors, consumers and issuers alike have been undermined. Voting against a pilot to test higher tick sizes would be a total abdication of the Committee's responsibility in our view. As can be seen in Figure 1 below, the United States listed stock markets have been in secular decline since 1997 in stark contrast to Europe (which is starting to experience similar problems – We have been invited to address the European Federation of Securities Exchanges and European Issuers in Zurich in June) and Asia. We now have fewer listed companies than at any time all the way back to 1975. This flawed market structure may have cost the American people over 10 million jobs.

Figure 1. United States stock exchange listings suffered 15 consecutive years of declines in the wake of new Order Handling Rules and Reg. ATS



Source: Jason Voss, CFA Institute, and IssuWorks

Supreme Court Justice Louis Brandeis once famously said, “Sunlight is said to be the greatest of disinfectants.” A carefully designed pilot program to test the effect of higher tick sizes is the “sunlight” needed to “disinfect” this debate. For the Committee to adopt the Subcommittee’s Recommendation 1 to forego a pilot would deprive the American people of the knowledge and answers that could lead to a better future. Union members need jobs. Poor people need jobs. The lack of IPO activity that was caused by this market model and the concomitant loss in liquidity has likely exacerbated the disparity between the “haves” and “have nots” in our economy. It has been said that there is a “multiplier effect” in job formation and that as many as five service sector jobs may be created by every technology job (see “The New Geography of Jobs” by Prof. Enrico Moretti at Berkeley).

Thus, in reviewing the Subcommittee’s recommendations, we support Recommendation 2 – considering alternate approaches to promote capital formation and/or enhanced liquidity for smaller capitalization companies – and Recommendation 3 – ensuring that any pilot program of increasing tick sizes should be designed to limit the potential harm and maximize any benefits to investors – though we would prefer to see Recommendation 3 cast more positively as “ensuring that any pilot program of increasing tick sizes should be designed to maximize the benefit to fundamental investors.”

We have grave concerns, however, about the Subcommittee’s lynchpin Recommendation 1 – to leave the current one-cent tick regime unchanged and to not engage in any pilot programs. We call this “The Ostrich Recommendation” as it is tantamount to voting to put your heads in the sand. We urge the Committee to summarily reject this recommendation and, instead, to recommend that the SEC adopt the Subcommittee’s *Alternative Recommendation #1*, as presented in the dissenting opinion of Mr. Stephen Holmes, and immediately initiate a pilot program to study the impact of expanded tick sizes on the quality and viability of our stock markets.

Finally, we would offer a 4th Recommendation for your consideration: “That the Committee be tasked to come up with viable means to reverse the secular decline in the population of listed companies while balancing and protecting the interests of investors.” Only then will the best interests of Americans be upheld.

Fulfilling the promise of the JOBS Act

We believe that The JOBS Act of 2012 represented the most significant change to securities laws for small and emerging growth companies in modern history. The Act has specific provisions to ease the burden on companies raising private capital as well as those desiring to be publicly traded. The Act mandated that the SEC must study the impact of decimalization on the number of initial public offerings (IPOs) and issue a report to Congress. That report to Congress, issued in July 2012, concluded that further study was needed. To this end, the SEC subsequently held a Roundtable on Decimalization, in which we participated, to solicit a wide range of views and consider how a pilot program to increase tick sizes, might be constructed. One year has

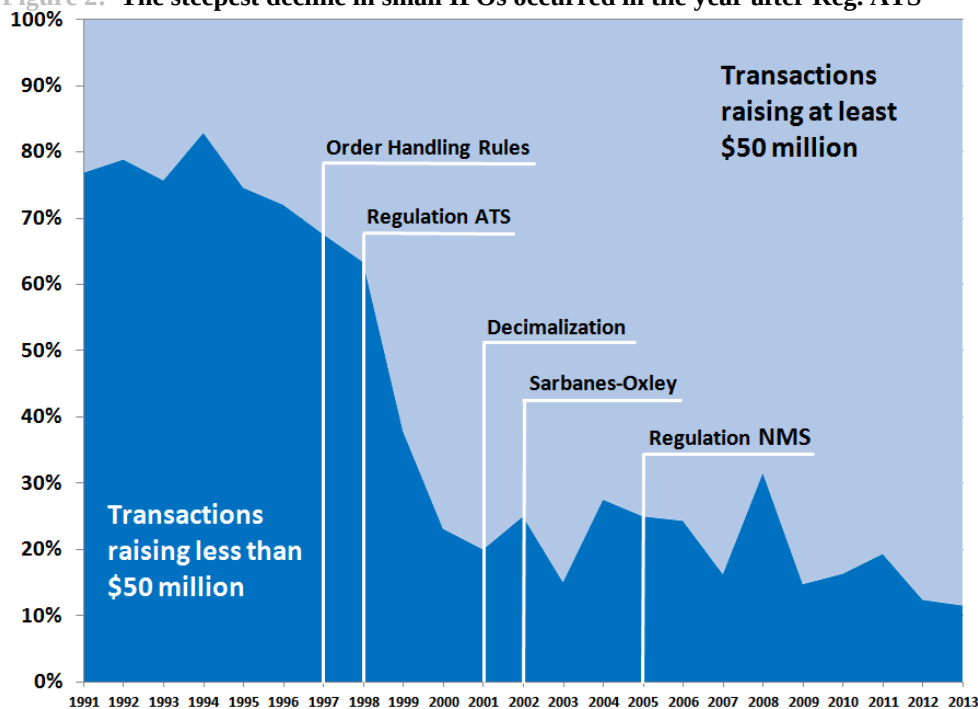
elapsed since that Roundtable without any resolution. Establishing a pilot program to study the impact of larger tick sizes would help fulfill the promise of the JOBS Act.

The problem of disappearing economic incentives

Over the past 6 years, we have studied in great detail the structure of our stock markets and the causes of the decline in IPO activity and exchange listings. In 2008, in *Why are IPOs in the ICU?*, we uncovered two previously unrecognized and highly disturbing facts: first, that the small IPO market in the United States, defined as IPOs raising less than \$50 million, declined abruptly in 1998 and never recovered; second, that this decline in the small IPO market took place a full two years before the introduction of one-cent trading increments and three years before the much-criticized Sarbanes-Oxley Act of 2002. In 2009, in *A wake-up call for America*, we documented the percent change in the number of listed companies for seven major global stock markets. We showed that the U.S. listed stock markets (excluding OTC) were losing companies every single year from its peak in 1997, while the other major markets all enjoyed increased listings. By year end 2012, the United States stock market had experienced 15 consecutive years of declines in listed companies: a 44% reduction in the population of listed companies from 1997 to year end 2012, to levels not seen before 1975. While the bleeding may have temporarily stopped in 2013 due to a Fed-liquidity fueled bull market, the long-term secular decline should be disturbing to the SEC, Congress and all market practitioners. In the absence of proactive regulatory measures such as increased tick sizes, we would fully expect the long-term decline in listings to resume with the next bear market.

In 2012, we focused our research on the period leading up to decimalization in 2001 in *The trouble with small tick sizes: Larger tick sizes will bring back capital formation, jobs and investor confidence*. We discovered that the steepest drop off in the small IPO market, one from which we have never recovered, occurred in 1998, when primarily quote-based markets were converted to electronic order book markets under Regulation Alternative Trading Systems (Regulation ATS). This rule, and its 1997 precursor (the Order Handling Rules), caused a collapse in dealer incentives from as much as 25 cents per share to 3.125 cents per share – or as much as an 87.5% decline. (See Figure 2 below.) Notably, these major changes in U.S. stock market structure were implemented *without* any kind of pilot study.

Figure 2: The steepest decline in small IPOs occurred in the year after Reg. ATS



Source: Dealogic and IssuWorks

Fulfilling the Committee's Charter

The Committee, as established by Section 911 of the Dodd Frank Act, was formed to, among other mandates, to advise the SEC on initiatives to protect investor interest, and to promote investor confidence and the integrity of the securities marketplace. Can a marketplace that has been in secular decline since the late 1990s be considered to have integrity? Is the Committee truly fulfilling its mandate if it does not examine the problem and propose viable solutions? We submit that the Subcommittee's Recommendation 1 ("The Ostrich Recommendation") – which is, in fact, the complete absence of a substantive recommendation – calls for the Committee to abdicate its charter, and, therefore, that it should be rejected on its face.

Furthermore, we believe that the Committee, as currently constituted, may not fulfill the membership requirements as established by Section 911 of Dodd Frank, which states that the members of the Committee shall represent the interests of individual and institutional investors and be knowledgeable about investment issues and decisions. We believe that it is fair to interpret this broad mandate as requiring that a critical mass of the membership must have experience, knowledge and expertise specific to small or microcap stock markets and investing. It is abundantly clear to us that the Committee and, in particular, the Subcommittee, is lacking representation from experienced and active fundamental investors and traders in small and microcap stocks.

Finally, as we highlighted in the opening of this letter, we have concerns about the Subcommittee and the conflicts of its chairman, Mr. Wallman, who fought for one-cent tick sizes while he was an SEC Commissioner and refers to himself as the “Father of Decimalization.” He was responsible for driving the changes – the new Order Handling Rules in 1997 and Regulation ATS in 1998 – that destroyed the economic model required to support small and microcap stocks. We would reiterate here that these changes were all instituted *without* any kind of pilot program.

FOLIOfn, the business that Mr. Wallman founded and runs, benefits from low-cost markets that favor his basket-trading model while undermining the ability of investors and markets to engage in single-stock selection through fundamental research and sales. We understand that FOLIOfn also engages in the practice of selling its order flow, which may run contrary to the interests of investors who are using FOLIOfn’s platform.

To our knowledge, there have been only three outside speakers who have presented to the Subcommittee: Professor James Angel, micromarkets economist at Georgetown University; Kevin Cronin, head of equity trading at Invesco, a global investment management firm with nearly \$800 billion in assets under management and whose stock is an S&P 500 constituent; and David Weild, the co-writer of this letter.

*All three of the outside speakers endorsed the need to have a pilot program to increase tick sizes in order to save capital formation and bring back liquidity and investment from large investors in small cap issues. Increased investment interest in these stocks would improve returns to investors and drive down issuers’ cost of capital resulting in higher rates of job growth. The hearings were not available to the public under the Government in the Sunshine Act, and Mr. Wallman was completely dismissive of our views, refusing to acknowledge even the remote possibility that the loss of economic incentives has in any way impacted capital formation. We know from our most recent study that was commissioned by the Organization for Economic Co-Operation and Development (OECD) in 2013, *Making stock markets work to support economic growth: Implications for governments, regulators, stock exchanges, corporate issuers and their investors*, that lower economic incentives (defined as the “tick size as a percent of share price”) are highly correlated to lower IPO rates (normalized for GDP size). We also know that as practitioners in the 1990s at a major Wall Street firm, that the loss of economic incentives driven by rule changes (OHRs – 1997, Reg. ATS – 1998, culminating with Decimalization in 2001) caused practitioners to (1) cut support to small public companies and (2) increase minimum required IPO sizes in order to stem losses from the underwriting business. Thus, the changes driven by the SEC in the 1990s directly caused the implosion in listed markets.*

Pilot programs are intended to examine issues, raise questions and find solutions. Why is Mr. Wallman fighting so hard against a pilot program? Does he fear the impact that higher tick sizes will have on FOLIOfn? Does he fear his legacy as the “father” of decimalization? Mr. Wallman may be the proverbial fox guarding the henhouse in his interest and ability to offer an objective view on the impact of a pilot program to expand tick sizes.

Alternative Recommendation #1 is the Logical Next Step

To do nothing, as the Subcommittee's Recommendation 1 states, will only exacerbate the crisis that we face in our markets. We must move forward, rather than stand still, to find a solution to improve liquidity in our small and microcap markets. We must move forward, rather than stand still, to restore the vibrancy to our markets and to restore confidence up and down the capital formation chain. The pilot program is the logical next step, and is consistent with our proposal in *The trouble with small tick sizes*.

We would also urge Congress and the SEC to create a separate committee that assembles the necessary small and microcap specialized expertise that is required to address the peculiarities of these markets – and is absent from the Committee as structured. Experience in large cap markets – where stocks are innately liquid – is simply not applicable to small and microcap markets. We believe that a distinct committee or task force comprised exclusively of small and microcap long-term focused, fundamental institutional and individual investors – no hedge funds, no short-term traders – tasked to address this crisis, is in the very best interests of the American people.

We applaud Mr. Stephen Holmes for presenting the dissenting opinion of the Subcommittee, and we urge the Committee to recommend that the SEC move immediately to adopt *Alternative Recommendation #1* and establish a pilot program to examine the impact of larger tick sizes.

Respectfully submitted,



David Weild IV
Chairman & CEO



Edward H. Kim
Managing Director

cc: Honorable Mary Jo White, Chair
Honorable Luis A. Aguilar, Commissioner
Honorable Daniel M. Gallagher, Commissioner
Honorable Kara M. Stein, Commissioner
Honorable Michael S. Piwowar, Commissioner
Lona Nallengara, Chief of Staff
John Ramsay, Acting Director, Division of Trading and Markets
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