CLIENT MEMORANDUM

SEC Announces Proposed Tick Pilot Program

September 2, 2014

AUTHORS

Howard L. Kramer | **Erin A. Galipeau**

On August 26, 2014, the Securities and Exchange Commission (the "SEC") announced that the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA") have filed a proposal to establish a national market system ("NMS") plan to implement a tick pilot program. The pilot program will allow the SEC to assess over a one-year period the market impact of changing the minimum tick sizes, *i.e.*, quoting and trading increments, for certain NMS common stocks[1] with a market capitalization of $5 billion or less, a consolidated average daily trading volume of one million shares or less and a closing price of at least $2 per share.[2] If adopted, the tick pilot program would be the biggest change, albeit a temporary one, to tick sizes since the decimalization of the U.S. equity markets. The SEC previously ordered the national securities exchanges and FINRA to create the pilot program in June 2014.[3]

[1] NMS common stock is generally exchange-listed common stock.

[2] Plan to Implement a Tick Size Pilot Program Submitted to the Securities and Exchange Commission Pursuant to Rule 608 of Regulation NMS Under the Securities Exchange Act of 1934 (Aug. 25, 2014), *available at* http://www.sec.gov/divisions/marketreg/tick-size-pilot-plan-final.pdf.

[3] Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a Tick Size Pilot Plan, Exchange Act Release No. 72460 (June 24, 2014), *available at* http://www.sec.gov/rules/other/2014/34-72460.pdf.

The tick pilot program, as proposed, would consist of three groups of 400 stocks and a control group, which would be quoted and traded in the following manner:

- ***Pilot Control Group:*** Quoted at the current minimum increment ($0.01 per share) and traded at the price increments currently permitted.
- ***Pilot Group One:*** Quoted in $0.05 minimum increments and traded at the price increments currently permitted. Orders priced to execute at the midpoint or those entered in a retail liquidity program, however, may be ranked and accepted in price increments under $0.05.
- ***Pilot Group Two:*** Quoted and traded in $0.05 minimum increments, subject to the same quoting exceptions as group one. In addition, the following trading exceptions may apply, allowing the securities to trade in increments of less than $0.05: (1) a trade at the midpoint of the consolidated National Best Bid and National Best Offer (the "NBBO") or of the "best protected bid and the best protected offer";[4] (2) a retail investor's order that is provided $0.005 or better price improvement over the best protected bid or best protected offer; and (3) negotiated trades (*i.e.*, benchmark trades, such as volume-weighted average price or time-weighted average price trades).
- ***Pilot Group Three:*** The group will have the same quoting and trading requirements, and exceptions, as group two. Group three will also be subject to a trade-at prohibition, which generally prevents price matching by a trading center, such as a dark pool, that is not displaying a protected bid or protected offer.[5] There are several exceptions to the trade-at prohibition, including block size orders, retail orders executed with price improvement of $0.005 or more, negotiated trades and intermarket sweep orders.

---

[4] A "protected bid" or "protected offer" is an automated quotation that is the best bid or offer of a national securities exchange or FINRA that is displayed by an automated trading center and disseminated pursuant to an NMS plan. *See* Rule 600(b)(57) of Regulation NMS of the Securities and Exchange Act of 1934. The proposal defines "best protected bid" and "best protected offer" as the "highest priced protected bid" and "lowest priced protected offer."

[5] *See supra* note 4 (defining "protected bid" and "protected offer"). Although the SEC's tick pilot program order indicated that the trade-at prohibition was "intended to prevent price matching by a trading center not displaying the NBBO," the national securities exchanges and FINRA chose to propose protected quotations as reference points for the trade-at prohibition. *See* Letter from Brendon J. Weiss, Vice President, Intercontinental Exchange, NYSE, to Secretary, SEC at 6-7 (Aug. 25, 2014), *available at* http://www.sec.gov/divisions/marketreg/tick-size-pilot-plan-transmittal-letter.pdf.

The proposal is an initiative by the SEC to address fragmentation in the equity markets and the decline of liquidity providers for less liquid stocks. It is also a back door way for the SEC to test a trade-at rule irrespective of the tick pilot program. It will be interesting to see what the studies discover about the impact of wider minimum spreads on liquidity and best execution in the pilot stocks, as well as who benefits economically from the larger tick size. There is a 21-day public comment period for the proposed tick pilot program.

If you have any questions regarding this memorandum, please contact Howard L. Kramer (202-303-1208, hkramer@willkie.com), Erin A. Galipeau (202-303-1259, egalipeau@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Paris, London, Milan, Rome, Frankfurt and Brussels. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

September 2, 2014