NIRI Virtual Chapter

Program Wrap-Up

Program Title: Demystifying Market Structure

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There's a number of us in the IR community that have viewed quotes from major exchanges on our Bridge terminals in increments of 1/16ths, with specialists and sell-side traders having a near-perfect view of the actual market for our shares. There are also those in the IR community who have only known a world governed by Reg NMS (2006), with liquidity displayed across dozens of markets and dark pools on Bloomberg / Factset / Eikon, and orders lasting for just milliseconds with spreads of $0.01 or less.

How did we get from there to here? And, more importantly, what are the next changes to market structure that we'll face? *NIRI Virtual Chapter*'s November session included an in-depth discussion from experts that have seen this evolution play out over time and have an informed view of its future. Tim Quast, President & Founder of *ModernIR*, moderated a panel featuring:

- Mehmet (Mett) Kinak, VP, Global Head of Equity Market Structure, *T. Rowe Price*

- Joe Saluzzi, Partner, Co-Founder, Co-Head of Equity Trading, *Themis Trading*

The decision to trade (or not trade) doesn't reside with the IRO, but the impact associated with whether investors choose to trade (or not trade) *does* affect the IRO – here are some of our takeaways from the session:

For investors, the market for a stock can be just as important an input into an investment decision as fundamental analysis. The world's strongest fundamental case for investment can be easily derailed by a lack of liquidity. An investor in a smaller-cap company that's looking to build, say, a 0.1% S/O stake in a company may need to represent greater than 10% of overall volume over a short period to complete this position, and if it's likely to move the price against itself too much during execution it may not be able to make the investment at all until more liquidity is available.

"Round lots" may be a thing of the past for institutional traders. Average trade sizes for many stocks have dipped below the 100-share limit as algorithms are able to split larger orders down to smaller amounts to execute them more quickly and effectively. This may, however, lead to weaker market transparency, as non-round-lot quotes aren't always spread out into the retail community. Companies with high nominal share prices (>$100) are traded much more in less-than-round-lot increments by institutions, meaning "reading the tape" requires a much broader view than it used to.

Investors trade using different strategies during the open, mid-day, and at the close. The open trade for the day often includes a larger percentage of retail orders that were entered outside market hours, and often these retail orders are traded at price that aren't necessarily beneficial for their traders and at wider spreads. Therefore, institutions tend to avoid the first 15-30 minutes of trading. Intraday volumes are typically lower and there's a greater "signal" seen from an aggressive trader – investors are able to trade here but do need to act with caution. About 30% of all volume for a day is traded in the last 30 minutes, with tighter spreads and more overall interest – the larger institutional orders are typically filled during this period.

Liquidity begets liquidity, illiquidity begets illiquidity... ETFs seeking to keep their trading costs low have constructed themselves to avoid already illiquid shares and own more of the most-liquid companies. Combined with the ability of HFT to spot and trade against investors filling larger orders, over time this leads to the more-liquid companies gaining even more liquidity at the expense of smaller-caps.

…and hence, regulators are looking at different options to improve liquidity for small-caps. The tick size pilot conducted in 2017 and 2018 doesn't appear to have generated conclusive evidence that putting a higher minimum spread (i.e. $0.05) on trading would benefit companies or investors. Transaction fee pilots that adjust how trading rebate pricing would work are currently held up in the courts. However, the SEC has stated it's looking for other ways to improve market structure in the small-cap range, including potentially removing "unlisted trading privileges" and pushing liquidity back to the listing exchanges, setting up intraday auctions, or even moving small-caps to "negotiated" instead of electronic markets. The SEC's statement on trading in small-caps covers some of these concepts, but issuers may want to make their voices heard with the SEC and other regulators with any other ideas that help improve their investors' experience.

More information on who owns what in the market does *not* necessarily make it easier or cheaper to trade. NIRI has previously proposed shortening the lag on 13F ownership disclosures from 45 days to a much shorter timeframe (as little as 2 days). That said, panelists suggested that with smaller companies where it may take a long time to open or close a position, shorter lags in ownership reporting may be counterproductive and make it more *difficult* or *costly* for investors to enter or exit late in a reporting period.

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