Examining the SEC's Plan to Improve Liquidity by Suspending UTP

February 10, 2020

On October 17, 2019, the SEC published its Statement on Market Structure Innovation for Thinly Traded Securities (the "Statement"). The SEC's Statement recognizes that markets in liquid securities function well, but believes that the "one-size-fits-all"[1] equity market structure may be suboptimal for thinly traded securities. A major concern of this dynamic is that new and emerging companies may find the inhospitable trading environment a roadblock to going public. Moreover, volume begets volume, and without some change in dynamics, these securities may never reach critical mass. To be fair, they may not reach it *even with* changes to the market, but without making some attempt, we will never know.

Reactions to Proposed UTP Suspension

In an effort to address these concerns, the SEC requested proposals from the market for the possible suspension of Unlisted Trading Privileges ("UTP") for these stocks. In response, the commenters on the Statement fall into three main camps:

- **Markets are Broken:** The markets are broken for new IPOs because modernization and electronification of trading has been bad for the incentives for companies to go public, for banks and brokers to help them go public, and there are few (to no) incentives for making a market in newly public, thinly traded securities. Basically, the intent seems to be that we should tear it all down, and go back to a kinder, gentler era of trading.[2] - *In our view, the genie is out of the bottle, and wishing for a return to a prior era of market structure is, at best, wishful thinking.*
- **Things aren't Perfect, but Regulators Should Tread Lightly:** The market for thinly traded securities may not work perfectly, and there are changes which could help, but suspension of UTP is a broad over-reach which will hamper competition and stifle innovation.[3] - *In our view, there are legitimate concerns regarding competition and innovation. However, for this limited sub-set of the equity markets, the trade-off may be enough to justify the effort.*
- **UTP Should go Away Now, but Don't Stop There:** The market for thinly traded securities would benefit not only from the suspension of UTP, but a host of other potential changes.[4] - *In our view, the SEC is looking to make changes in this arena, and therefore is likely to view such proposals favorably.*

Some of those commenters proposed changes aimed at improving trading in these thinly traded securities. CBOE's comment letter, for instance, suggests incentivized pricing, on-demand auctions, as well as possibly allowing exceptions to the firm quote rule, allowing block trading exemptions, and even allowing exchanges to offer conditional orders. MIAX reproposed a former BATS rule that would allow exchange groups to only trade thinly traded securities on one of their exchanges (forcing some amount of concentration, given the number of exchanges owned and operated by the largest exchange groups today). They also vigorously opposed an outright suspension of UTP, in particular if dark pools and internalizers are allowed to continue trading these securities.

As of February 5, 2020, Nasdaq has filed with the SEC a proposal in response to the SEC's request.[5] In this proposal, Nasdaq has suggested[6]:

- The suspension of UTP for currently listed Nasdaq stocks that are operating companies (and all classes of such securities, including common shares, preferred shares and warrants) that trade 100,000 shares of less in Average Daily Volume.
- The decision to suspend UTP (or not) is made by the company. Nasdaq will allow changes in this status once every six months, based on their applicable metrics.
- The maintenance at current levels of market data costs for these stocks and highlighting that the Reg NMS access fee cap will remain in place.

It is interesting that Nasdaq is also looking at this as a test bed for a series of other possible market changes. Such changes may include exemptive relief from the OPR, batch auctions (including on demand closing auctions[7]), a request for quote system, intelligent ticks[8] and others. Nasdaq's view is that suspension of UTP itself will not be sufficient to make a marked improvement in the thinly trade security market. In fact, Nasdaq notes that it will not implement UTP suspension in isolation without (1) a critical mass of issuers opting-in and (2) sufficient relief along the lines proposed.

Conclusion

By allowing issuers choice, the Nasdaq proposal certainly increases complexity. But with appropriate time to market notice, this should not be an overwhelming burden on the industry. We also like that Nasdaq lists the relevant metrics for success - e.g. narrowing spreads, increasing depth of liquidity, increasing limit order submission, increasing trading activity, and increasing number of SMEs that go public (although that last metric is remarkable tricky to deterministically attribute to any single regulatory action). This should in theory allow market participants and regulators to determine whether or not the changes have achieved the desired effect.

We believe that an exploration of suspension of UTP is certainly an appealing concept. If the proposal also prohibited OTC transactions, we would be much more skeptical, and much more concerned about the proper alignment of incentives. That said, Nasdaq stated it was not seeking such a restriction in "this Application", but also asked the SEC to request comment on the limitation or prohibition of OTC trading of thinly traded securities (with possible exceptions for block trading or significant price improvement opportunities). As usual, the devil is in the details – which makes this public discussion all the more important and relevant.

References:

[1]https://www.greenwich.com/blog/one-size-does-not-fit-all

[2]https://www.sec.gov/comments/s7-18-19/s71819-6508078-199866.htm; https://www.sec.gov/comments/s7-18-19/s71819-6555835-200936.pdf; https://www.sec.gov/comments/s7-18-19/s71819-6671698-204008.pdf

[3]https://www.sec.gov/comments/s7-18-19/s71819-6437015-198647.pdf; https://www.sec.gov/comments/s7-18-19/s71819-6574727-201085.pdf; https://www.sec.gov/comments/s7-18-19/s71819-6386387-197861.pdf

[4]https://www.sec.gov/comments/s7-18-19/s71819-6686826-205907.pdf; https://www.nasdaq.com/docs/2020/02/05/2020%20UTP%20Termination%20Application.pdf

[5]https://www.nasdaq.com/docs/2020/02/05/2020%20UTP%20Termination%20Application.pdf

[6]Nasdaq is also somewhat reproposing its April 2018 request for suspension of UTP – the significant differences are the other market structure changes Nasdaq suggests are required to make full use of such a suspension. See https://www.sec.gov/comments/265-31/26531-3515735-162293.pdf

[7]We presume that Nasdaq will still provide an official closing price, but this will need to be verified.

[8]https://www.nasdaq.com/docs/2019/12/16/Intelligent-Ticks.pdf

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