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RESEARCH SUMMARY

# Small Stocks Experiment: How Increased Tick Sizes Impact Trading Activity and Volatility

In October 2016, the Securities and Exchange Commission (SEC) launched a pilot program designed to increase trade in small stocks. The program raised the minimum trading increments, or "tick sizes," for 1,400 small-capitalization stocks. Its objective was to determine whether increasing tick sizes from $0.01 to $0.05 would improve the liquidity and overall market quality of stocks that were part of the program.

In short, would the increase in tick sizes from $0.01 to $0.05 improve trading in these stocks? Would it entice more market makers to participate and, thus, improve capital access for smaller companies?

Benjamin M. Blau and Ryan J. Whitby set out to answer those questions in "Rethinking Decimalization: The Impact of Increased Tick Sizes on Trading Activity and Volatility." After examining a preliminary report of the SEC's pilot program, they conclude that the answer is "no." If anything, the program seems to harm the market quality of the affected stocks.

The SEC pilot program marked the first change in tick sizes since 2001. That year, stock exchanges began to price shares in one-penny increments rather than in fractions of dollars. This move was generally welcomed by investors. Blau and Whitby examine the effects of the most recent experiment in tick sizes and conclude the following:

- *Trading activity*. Trading volume and turnover are two traditional measures of trading activity. Neither of these measures improved for pilot stocks relative to control stocks as a result of the increase in tick sizes.
- *Volatility*. The wider minimum tick sizes were responsible for an increase in volatility for the pilot stocks vis-à-vis other stocks. This harms market quality because volatility can undermine the overall confidence of participants in the market.

## KEY TAKEAWAYS

- The change in tick size was not effective in its underlying objective of improving market quality.
- When the SEC's two-year pilot program expires, it should not be extended to other nonpilot, eligible stocks.
- A regulatory policy change is not warranted.