



May | 2024

Market Regulation

## A better way to ‘pilot’ financial regulation

*Pilot programs allow regulators to test – in a real-world, yet controlled environment – whether a particular market structure reform is likely to have its intended effect. In this paper, we urge regulators to make greater use of pilot programs and propose a framework for designing these programs.*

The SEC’s soon to be finalized equity market structure [proposals](#) offer up the most significant re-shaping of the US stock market in nearly two decades. Given the magnitude of the proposed reforms – and unpredictability around how they may interact with each other – Optiver believes pilot programs are best suited to implement these changes. However, before the proposals even come up for a vote, they present an opportunity to consider a broader question: How should regulators adopt rules-based market structure changes in the first place?

When it comes to market structure changes driven by regulation, Optiver believes that authorities should follow, where possible, an empirical or data-based approach. Pilot programs allow regulators to test – in a real-world, yet controlled environment – whether a particular market structure reform is likely to have its intended effect. In instances where the findings of a pilot prove compelling, the programs create a path for introducing the measures to the broader market – or, if warranted, terminating the program.

Some critics point to the perceived failures of previous pilot programs as a reason to be wary of them. However, pilot programs with well-communicated and clearly-defined objectives and scopes can provide regulators with the information and data necessary to analyze the impact of new rules on existing market structures. Such programs could help address SEC critics who argue the agency fails to follow an empirical or data-based approach in its rulemaking.

We urge the SEC to use pilot programs to test a number of key market structure proposals currently under consideration, including proposals impacting cash and options markets such as tick sizes, volume-based pricing and daily options. In this paper, we propose a framework that can be used to design pilot programs of all shapes and sizes. We believe that implementing changes via limited pilot programs is an effective way of judging the impact rules will have on existing market structures ahead of their market-wide adoption.

### Notable pilot programs

Previous pilot programs undertaken by the SEC can provide important lessons for how to design such programs in the future.

In 2007, six options exchanges proposed a “penny pilot” program in order to evaluate reduced tick increments in select Equity and ETF options. The SEC used the program to collect empirical data to highlight the impact that smaller tick sizes have on spread, liquidity, message traffic and volume. While the initial program was intended to last only six months, the SEC approved a number of additional rules that expanded its scope to include over 360 options classes. As a result, a permanent program was finally instituted in 2020.<sup>1</sup>

While the pilot lasted longer than intended, empirical evidence demonstrated that a reduced tick provided measurable value to investors. The “penny pilot” program is widely regarded as a success because the rule when finally enacted functioned largely as intended.

The SEC’s Rule 610T of Reg. NMS,<sup>2</sup> which established a Transaction Fee Pilot in NMS stocks, provides a counterpoint to the success of the “penny pilot” program. The SEC enacted Rule 610T to gather data from securities exchanges to determine the impact that access fees could have on volumes and liquidity. The exchanges promptly sued, alleging the SEC exceeded its authority under the Exchange Act by changing existing regulatory standards as a way to determine the impact of those new standards. Rather than identifying a problem, adopting a rule and then testing potential solutions, the exchanges argued that the SEC created a regulation to look for a problem to regulate. In June 2020, the US Court of Appeals agreed with the exchanges and Rule 610T was terminated.

Industry participants often cite the failure of SEC Rule 610T as evidence that these programs pose an increased potential of litigation, thereby unnecessarily disrupting the broader market structure. Rule 610T demonstrates that pilot programs must be sufficiently well thought out to ensure they are able to achieve what they set out to do. Below we propose a framework for a successful pilot program.

## What should a pilot program look like?

### Objectives

The pilot should clearly articulate the objectives of the program, its timeline and the metrics that will be used to judge its success. This should include:

- What issue the adopted rule is designed to address and evaluate
- The criteria by which the program’s effectiveness will be judged
  - These criteria should be sufficiently flexible to allow for an increase in the number and types of metrics, if desirable
- The baseline against which data will be measured
- Timeline of the pilot program and the timing of the decision to extend or end the program

### Environment

A pilot by definition should not encompass the entire market. Rather, the scope of the program must be carefully defined to be both manageable but also reflective of the broader market. This means identifying an appropriate set of products, as well as a sufficient length of time, to gauge its impact.

<sup>1</sup> <https://www.sec.gov/files/rules/sro/nms/2020/34-88532.pdf>

<sup>2</sup> <https://www.sec.gov/rules/2018/12/transaction-fee-pilot-nms-stocks#34-84875>

## Analysis

How will data from the program be collected? How will it be reported? An administrator, appointed from within the SEC, should be responsible for answering these and other material questions. The administrator should have responsibility for establishing or using a preexisting database to collect relevant data both before and during the pilot. This data must then be validated and translated into metrics. The administrator should be in a position to document any significant market events or issues that could affect the analysis. Finally, where appropriate, the administrator should be able to produce periodic reports for the broader industry.

## Transparency

It is critical for both the pilot program framework and its results to be communicated transparently. The administrator of the pilot should periodically provide updates to participants, exchanges and regulators, as well as ensure that all data and reporting is publicly accessible.

## Implementation

Should the findings of the pilot program support permanent implementation, a clear plan and timeline must be in place for rolling out the changes to the broader market.

Conversely, if the findings do not support a permanent implementation, a plan and timeline should be designed for reverting to the previous regulatory standard.

## Conclusion

Pilot programs reflect the importance of continual experimentation and adaptability when it comes to regulating financial markets. These programs have supplied crucial insights to policymakers by providing a controlled framework for testing proposed market structure changes. As markets continue to evolve, we should not allow past failures to rule out the use of pilot programs – rather we should learn from them and apply those lessons moving forward. Optiver encourages regulators to make greater use of pilot programs in the future and to engage market participants in the design and execution of these programs.

## About Optiver

Optiver is a global market maker founded in Amsterdam, with offices in London, Chicago, Austin, New York, Sydney, Shanghai, Hong Kong, Singapore, Taipei and Mumbai. Established in 1986, today we are a leading liquidity provider, with close to 2,000 employees in offices around the world, united in our commitment to improve the market through competitive pricing, execution and risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets. We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.