Lessons We Can Learn from the Failure of the Tick Size Pilot Program

September 27, 2018

The SEC recently announced that the Tick Size Pilot Program will expire[1] on September 28th. After two years, various studies have estimated that the cost to investors of this experiment range from $350mm[2] to $900mm[3]. And these estimates do not include the implementation costs to the industry in terms of rewriting the computer code at exchanges, brokers, technology vendors, market data providers, and other market participants. These costs also likely ran into the hundreds of millions of dollars.

For many in the industry, the unceremonious demise of the tick size pilot did not come as a surprise. As I wrote in FT Alphaville in 2016: "The Tick Size Pilot Program… will likely end up as a costly failure[4]."

Nevertheless, it is important that the time, money and effort spent on this endeavor are not completely wasted. Let us look to this as a case study in bad decision-making and learn from it, so that similar mistakes are not made again in the future.

A Flawed Project from the Start

Problem #1 is that the rule was conceived in Congress, not the SEC. Originally inserted into the JOBS Act as an idea to test, it was initially rejected as a bad idea by the SEC in a thoughtful 27-page analysis[5] of the academic literature. Unsatisfied with this expert opinion, the House of Representatives passed the Duffy-Carney Bill in 2014, advancing the tick size pilot forward from an idea to near decree. This led then-Commissioner Michael Piwowar to say, "Even if we don't [launch the pilot program], Congress is going to mandate that we do it."

Problem #2 was that the idea didn't even pass the most basic of smell tests. The rationale was that wider tick sizes would increase the profit of market makers, which would, in turn, spur brokerage houses to produce more research on these companies, which would thereby attract more investor interest, which would lead to increased capital formation, which would create jobs. Like a magical chain reaction, one action is supposed to trigger a sequence of downstream events, until we get the desired outcome. Not even Hollywood movies have plots that tortuous. Industry practitioners recognized this, of course, but proceeded anyway, tweaking the new rules and hoping that some trading or liquidity benefits might accrue. This was **Problem #3**—there was not a clear objective of the pilot.

Problem #4 was that no cost benefit analysis of any kind was performed. For a regulation that was supposed to be business friendly, one might expect some basic "Business School 101" analysis would be included as part of the planning process. And while I recognize that (because of problem #1) the pilot program was effectively a mandate, a thorough analysis of the expected costs may have been enough to change the minds of our elected representatives.

Soliciting Industry Feedback

In addition, there are some other facts to consider. As with many SEC initiatives, the agency sought public comment. I analyzed the 63 comment letters[6] submitted to the SEC prior to the launch of the pilot and noted that only 11 were opposed. Most were either supportive or supportive with some specific modification.

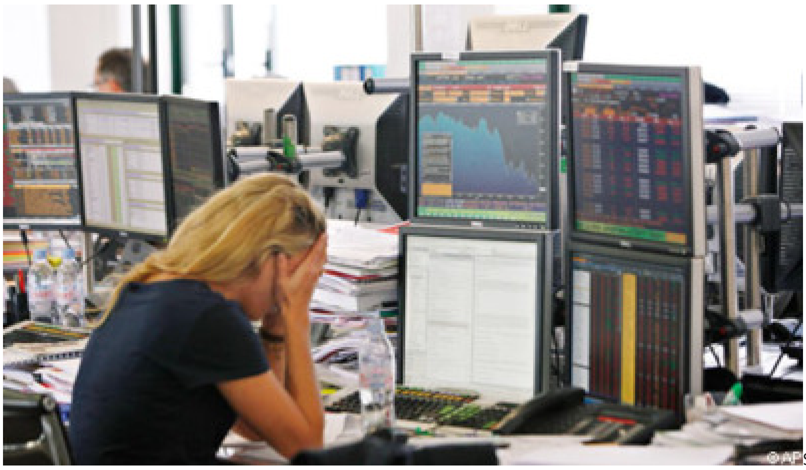
Did our industry experts really get it so wrong? Or was supporting the pilot simply the safe thing to do (because of problem #1)? Or perhaps, the comment letter process is not a reliable way to assemble opinion on these important topics. For an industry with tens of thousands of brokers and asset managers and other organizations employing hundreds of thousands of people, 63 comment letters represent a tiny fraction of the market.

Indeed, as I read the comment letters for the proposed Transaction Fee Pilot[7] (a new proposed rule change almost as large in scope as the tick size pilot), I notice that there are over 30 from issuers using similar or identical language in opposition to the pilot. These issuers have likely been encouraged by a market participant to write these letters, in the hope that opinion can be swayed in the favor of this participant's position. This should again cause us to question the efficacy of the comment letter process in deciding important market structure issues.

Final Thought

The tick size pilot has indeed ended up as a costly failure. To avoid bad decision-making in the future, it is important that we learn from the mistakes that were made. The most important takeaway is that Congress should set the policy, and the SEC should make the rules.

Let the tick size pilot be the poster child for the separation of policy and rulemaking. In addition, when considering future market structure changes, we should ensure that the mission and objectives are well-defined, a thorough cost-benefit analysis is performed, and that industry opinion is solicited and evaluated in the most effective manner.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[1]https://www.sec.gov/news/public-statement/tm-dera-expiration-tick-size-pilot

[2]https://www.pragmatrading.com/resource/tick-size-pilot/

[3]https://www.barrons.com/articles/sec-tick-size-pilot-program-1536961160

[4]https://ftalphaville.ft.com/2016/09/20/2175469/guest-post-small-cap-trading-revamp-is-no-more-than-a-costly-distraction/

[5]https://www.sec.gov/news/studies/2012/decimalization-072012.pdf

[6]https://www.sec.gov/comments/4-657/4-657.shtml

[7]https://www.sec.gov/comments/s7-05-18/s70518.htm

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