



August 25, 2015

BY EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority (Saskatchewan)
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Re: Proposed Amendments to the Companion Policy to National Instrument 23-101 Trading Rules: Application of the Order Protection Rule ("OPR") to Marketplaces Imposing Systematic Order Processing Delays (the "Proposed Amendments")

Dear Mesdames and Sirs:

As Chief Technology Officer of KOR Group¹, I appreciate the opportunity to submit comments on the above proposed amendments seeking to revoke Order Protection for marketplaces that impose systematic order processing delays.

The focus on the Order Protection Rule ("OPR") and systematic trading delays is particularly timely, given the recent recognition of the Aequitas NEO Exchange, the approval of changes to the TMX Alpha Exchange, the Securities and Exchange Commission's first Equity Market Structure Advisory Committee ("SEC MSAC") meeting which focused on Rule 611 (Order Protection) and the IEX exchange application in the United States². I would urge caution on making significant changes to the current order protection mechanism without proper analysis. The current hybrid model of protected / unprotected venues is awkward and complex, and it is important that any further changes have the following objectives:

- (a) Promote fair and efficient markets;

¹ KOR Group LLC is a SaaS (Software as a Service) based analytics and trading compliance firm specializing in venue and algorithmic-level trading performance and in-depth market structure analysis. Our clients include buy-side firms, sell-side firms, exchanges and alternative trading firms. Dave Lauer is the co-founder and CTO of KOR Group, Co-founder and Chairman of the Healthy Markets Association and an Independent Director for the Aequitas NEO Exchange (and chair of the Regulatory Oversight Committee). These comments are only meant to reflect the views of KOR Group.

² As a co-author of the IEX systematic delay patent, one of the presenters at the SEC Market Structure Advisory Committee meeting on Order Protection (Rule 611), an Independent Director for Aequitas and Chair of Aequitas's Regulatory Oversight Committee, I have spent considerable time thinking through the issues that the CSA has raised.

- (b) Simplify market structure; and
- (c) Clarify and enhance best execution responsibilities.

The current US model allows for a hybrid of protected exchanges, unprotected ATSs, and mandatory displayed (protected) quotes from ATSs if a 5% threshold is reached on a symbol-by-symbol basis. And while this complex system may be helpful in evaluating proposals, we should not forget that the US model has never really been dominant. The US regime promotes numerous types of trading venues, with different obligations and expectations as a way to promote competition and reduce concerns of monopolistic practices by exchanges. As we begin the discussion below, we also want to note that no market center in the US has remained a displayed ATS – both BATS and Direct Edge went on to become exchanges. They only breached the 5% display threshold in the framework of Rule 605, a disclosure mandate that ensured the ability to evaluate execution quality on those venues, and with their displayed orders being protected.

While I urged in my written presentation to the SEC MSAC to make significant changes to order protection in the US, I did so in a holistic way – in that order protection does not live in isolation. As such, there will be unintended consequences from pulling on one thread without ensuring the sweater remains intact. There are many parallels between US and Canadian order protection rules, and my suggestions are similar to those that were presented to the SEC MSAC: transform best execution and disclosure requirements; push OPR responsibility to the dealers as part of enhanced best execution requirements; and reduce market data costs and address monopolistic practices.

Responses to the specific questions in the Notice

Question 1: What are your views on whether OPR should apply to marketplaces that impose an order processing delay? If OPR should apply to marketplaces that impose an order processing delay, should it apply to some or all of them? What factors should be considered in processing delay?

As we have seen with recent market developments, not all order processing delays are created equal. Further, market centers have disparate technology systems, and not all focus on performance at any cost. We would urge the CSA to take into consideration the nuances of the differences between the current 2 Canadian markets that impose order processing delays, and to also consider the IEX order processing delay:

1. The Aequis NEO book imposes a randomized multi-millisecond delay on aggressive orders from Latency Sensitive Traders (LSTs) in order to account for order routing system differences between those traders and the dealer platforms that most investors are beholden to. This delay takes place on a take-take market, which does not create order routing conflicts. **This systematic delay is designed to protect investors.**
2. The TMX Alpha book imposes a randomized multi-millisecond delay on all orders, EXCEPT those using the Post-Only Order Type, typically the same LSTs that Aequis targets with its order processing delay. The TMX Alpha delay takes place on a take-make market, which creates the same perverse order routing incentives as the Payment For Order Flow wholesaling model in the

United States. **This systematic delay is designed to protect high-speed liquidity providers who are willing to pay to trade against uninformed order flow.**

3. IEX imposes a systematic 350 microsecond delay on all orders in and out of the IEX platform, in order to ensure that the IEX view of the market is as accurate as possible, to ensure that IEX remains faster than its fastest participants, and to therefore eliminate latency arbitrage opportunities. This delay takes place on a take-take market, which does not create order routing conflicts. **This systematic delay is designed to protect investors.**

Given such fundamental differences between the order processing delays, we find it difficult to understand how the CSA can apply a carve-out from OPR uniformly. We firmly believe that a hybrid OPR environment would introduce additional market structure complexity and have a significant, detrimental impact on best execution adherence.

Question 2: In an environment where not all displayed orders on visible marketplaces are protected under OPR because marketplaces impose an order processing delay, what are your views with respect to the outcomes for protected and unprotected visible marketplaces and for trading on those marketplaces? (For purposes of this Notice, a “protected” marketplace is considered to be a marketplace which displays protected orders as defined in OPR, while an “unprotected” marketplace is one which does not display protected orders.) In responding, please consider the impacts on:

- a) various market participants including retail and institutional investors, and liquidity providers;
- b) liquidity on both protected and unprotected visible marketplaces;
- c) price discovery;
- d) complexities and changes you anticipate from participating in both protected and unprotected visible marketplaces, including costs and effort; and
- e) the provision and use of consolidated data.

The only way to impose a selective OPR environment would be to have clear, robust guidance for Best Execution and enhanced disclosure requirements. Order routing systems would presumably still need to connect to non-protected market centers for those situations in which execution quality will be maximized by routing to them (unless the CSA is prepared to allow dealers to ignore non-protected venues entirely). It is unclear how they should make such a determination in the absence of public execution quality disclosure, and even what benefits there are from OPR in such an environment. As we stated before the SEC’s MSAC meeting, in the US, Rule 611 (order protection) is “one of the only explicit protections that investors have to force their brokers to achieve best execution,”³ but we believe that “Rule 611 is a terrible proxy for best execution.”⁴

In a highly fragmented, fast-moving, complex electronic market, order protection does not guarantee best execution. There are many more factors that must be taken into account outside of price, especially for

³ See Written Statement of Dave Lauer before May 13, 2015 SEC Equity Market Structure Advisory Committee. <https://www.sec.gov/comments/265-29/26529-15.pdf>, Page 3

⁴ Ibid, Page 4

larger institutional orders, but certainly also for smaller retail orders. Both Aequitas and the TMX are putting forth a theory – that a systematic order processing delay will lead to better outcomes for some or all participants. **What if either, or both, are correct?** If dealers are not required to route orders to try to attain optimal execution quality, will clients be disadvantaged in a selective protection environment? If dealers are required to route orders to attain optimal execution quality, how can they evaluate non-protected venues, or ensure that they have the capability to route to those venues when their routers tell them to send order flow there? In this context, order protection has far less meaning than Best Execution, but what is certain is that the ambiguity of current Best Execution guidance and disclosures will disadvantage investors.

Further, as we have stated repeatedly in other contexts, we believe strongly that the segmentation of retail order flow harms the price discovery process, and the conflicts introduced via Payment For Order Flow on the TMX Alpha inverted venue will lead to brokers routing to capture rebates rather than to maximize execution quality and certainty. Even in the absence of order protection on TMX Alpha, the lack of public disclosure is of tremendous concern in ensuring that those brokers who are routing to any venue, let alone routing marketable retail orders and receiving payment for doing so, are focused first and foremost on execution quality rather than payments and fees.

To summarize, we are concerned that the introduction of unprotected status on any market center will lead to deterioration in Canadian market quality due to:

- Increased market structure complexity;
- Order routing conflicts-of-interest trumping execution quality and Best Ex;
- Non-existent public routing and execution quality disclosures; and
- Loss of faith in the NBBO in the presence of locked/crossed markets when unprotected venues are taken into account.

We would urge the CSA to be more deliberative on the implications of this decision, and would further emphasize the difficulties involved in any order protection mechanism.

We firmly believe that a robust Best Execution regime with principles-based guidance, in which the onus for “order protection” is rather to ensure Best Execution by the dealer on an order-by-order basis, robust public disclosures for dealers and market centers, and extensive quantitative analysis of execution quality is the most forward-looking and investor-centric approach.

Question 3: A key objective of OPR is to recognize and support the role of retail participation in the market. If the Proposed Amendments are finalized, what changes if any, do you expect will be required for dealers handling retail order flow? What changes if any, do you expect in terms of outcomes for retail clients?

The adoption of these Amendments would result in two unprotected marketplaces, one of which presents a significant conflict-of-interest for routing marketable retail orders (generally considered to be the best orders to trade against as a market maker). Would retail brokers hold themselves to the highest execution



quality standards, and ensure that orders are routed based on execution quality rather than payments and rebates? Unfortunately, there will be no publicly disclosed way of confirming this.

Recommendations

As stated above, we believe that a more deliberative, analytical approach should be taken with respect to any changes to the Order Protection Rule, with a view towards phasing out Order Protection. These recommendations are similar to those made to the SEC's MSAC:

1. Create robust public disclosures for market center execution quality and broker/dealer order routing⁵;
2. Push order protection responsibility to broker/dealers as part of a more robust Best Execution obligation; and
3. Modernize Best Execution rules and mandate firms to have audit trails quantitatively analyzed. Elevate the conflicts check in determining Best Execution and force brokers to transparently demonstrate execution quality on a quantitative basis.

If the CSA continues down the path of selective / partial Order Protection, we believe strongly that very specific guidance will need to be issued regarding dealer responsibilities to route to unprotected venues, when / whether dealers need to look at unprotected quotes and why, and how dealers should handle the obvious conflicts that arise from an inverted venue that systematically delays orders from investors that are already slow relative to high-speed participants. We would further urge the CSA (as we have several times in this comment letter) to institute a robust public disclosure regime on market centers and dealers.

Please do not hesitate to contact the undersigned with any questions.

Sincerely,

A handwritten signature in blue ink, appearing to read "Dave Lauer", is positioned above the printed name.

Dave Lauer
CTO, KOR Group LLC

⁵ These disclosures should be modeled on the Healthy Markets proposals for US Rules 605 and 606 which can be found at www.healthymarkets.org.