The Canadian Advocacy Council for Canadian CFA Institute Societies
ADVOCATING THE CFA INSTITUTE'S CODE OF ETHICS AND STANDARDS

February 12, 2019

BY EMAIL

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

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Email: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, Square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Staff Notice and Request for Comment 23-323 Trading Fee Rebate Pilot Study (the "Pilot Study")

The Canadian Advocacy Council[1] for Canadian CFA Institute[2] Societies (the CAC) appreciates the opportunity to provide general comments on the Pilot Study that would apply temporary pricing restrictions on marketplace transaction fees applicable to trading in certain securities, as well as respond to specific questions posed in the CSA Staff Notice.

[1] The CAC is an advocacy council for CFA Societies Canada, representing over 17,000 Canadian charterholders, of the 12 Member Societies across Canada. The council includes investment professionals across Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. Visit www.cfacanada.org to access the advocacy work of the CAC.

[2] CFA Institute is a global, not-for-profit professional association of over 166,000 investment analysts, advisers, portfolio managers, and other investment professionals in 163 markets, of whom more than 159,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 152 member societies in 74 markets. For more information, visit www.cfainstitute.org.

We are supportive of the collaborative, data driven approach proposed by the Canadian Securities Administrators (CSA) to study the impact of trading fee rebates on order routing behavior, market quality and execution quality measures. In our view, the Pilot Study has been reasonably designed and is well thought out. Capping or eliminating rebates could potentially reduce marketplace incentives to structure order types and pricing tiers in ways that encourage excessive complexity, fragmentation and exacerbate agency concerns between investors and their brokers. Below are comments on what we believe to be the key aspects of the Pilot Study.

Scope, timing and Duration

We generally agree with regulators regarding the timing, duration, and scope of the Pilot Study. Given the interconnected and porous nature of Canadian capital markets, we believe that it is reasonable to align the timing and duration of the Canadian pilot with the US pilot for interlisted securities to prevent any unintended consequences disproportionately harming Canadian liquidity.

We see no issue with a proposed staggered start date for non-interlisted securities and we concur with regulators that such an approach may help to mitigate the potential for market-wide confounding events. However, because the second phase of the Pilot Study is going to be co-ordinated with the SEC study, we would suggest starting as soon as possible to allow for a sufficient time for the non-interlisted securities study.

As stated in the CSA Staff Notice, highly liquid securities account for more than 90 percent of the TSX market capitalization and thus the universe of "highly liquid" and "medium liquid" securities is sufficiently broad in our view, without any contrary evidence being presented. Such a scope should create a representative sample of securities. By leveraging IIROC's Surveillance Technology Enhancement Platform (STEP), we believe that regulators and researchers ought to be able to capture a consistent, cross sectional view of all trading, occurring on all exchanges and ATS marketplaces.

Pilot Design and Prohibition of Rebates

We would suggest adding a volatility criteria (specifically, intraday volatility) when applying the matched pairs study design to group securities. Market capitalization, trading volume and volatility are all meaningful drivers of transaction cost estimates in widely used and acceptable models, and taken together, such drivers should provide a reasonable representation of securities trading behaviour.

As proposed, the Pilot Study's intent to prohibit the payment of trading fee rebates by marketplaces with respect to trading in selected securities is an essential feature of the study. It is only by having a test group where no rebates are permitted and where the impact of prohibiting rebates can be isolated that the Pilot Study can gather useful data about the impact of rebates on order routing behavior, execution quality and market quality.

Empirical Measures

As proposed, the purpose of the Pilot Study is to better understand how the prohibition of rebates may affect dealers' routing practices, and standard measures of market quality and execution quality. We also suggest observing how the overall degree of intermediation, particularly across liquid securities, impacts investors.

We believe that understanding the impact of rebates on opportunity cost measures such as the delay cost of unfilled trades should also be considered with equal emphasis. More specifically, from an institutional investors' perspective, often the costliest order is the order that is delayed, or never completed at all. We encourage regulators to examine passive order placement and to measure the delay cost of marketable, passive orders that are canceled or subsequently repriced.

You will find below our response to each question set forth in *Appendix II: Questions for Market Participants* to the CSA Staff Notice. For ease of reference, we have reproduced each question in italics preceding the applicable comment.

1. We propose to define a security as medium-liquid if it trades at least 50 times a day on average and more than $50,000 on average per trading day over the past month. Do you believe that this definition is appropriate? If not, please provide an alternative definition and supporting data, if available, to illustrate which securities your definition captures.

After reviewing the recent trading statistics of securities listed on major Canadian stock exchanges, and without opposing evidence, we agree with the proposed definition of a security as medium-liquid if it trades at least 50 times a day on average and more than $50,000 on average per trading day over the past month.

2. We propose to introduce the Pilot in two stages, with non-interlisted securities first, followed by interlisted securities. Do you believe that such staggered introduction will cause material problems for the statistical analysis and the results of the Pilot? If so, please describe your concerns in detail.

No. We support the staggered start date between Canadian listed and interlisted securities. As stated above, the Pilot Study should begin as soon as possible to allow sufficient time to study non-interlisted securities prior to the start of the SEC study.

3. Several Canadian marketplaces offer formal programs that reward market makers with enhanced rebates in return for liquidity provision obligations. On the one hand, such programs may benefit liquidity. One the other hand, one of the primary objectives of the Pilot is to understand if rebates cause excessive intermediation. In your opinion, should exchanges be allowed to continue using rebates or similar arrangements for *market making programs during the Pilot? Do you believe any constraints on such programs during the Pilot to be appropriate?*

We expect that studying the effect of no-rebates on the test group will produce data and analysis that serve the core purpose of the Pilot Study: to assess the potential conflicts of interest and impact on market quality which comes from transaction-based fees and rebates.

We believe that any liquidity or market making incentive programs that are effectively similar to rebates should be constrained during the duration of the Pilot Study. In particular, we remain concerned that firms qualifying for market maker incentives benefit in ways that materially impact the economies of their agency-facing businesses and overall order routing behaviours. While we understand the goals of promoting market making by market makers, in practice, the implementation may be difficult and may undermine the utility of the Pilot Study.[3]

4. We propose to compute price impacts at the one- and five-second horizons. Do you believe that we should consider other horizons? If so, which ones?

We would recommend 15 second and 30 second horizons as well as those proposed, and would welcome the examination of longer horizons for inclusion in the event that such addition yields meaningful insight or observations of specific behaviours, especially with respect to those securities that trade less frequently, such as those deemed medium-liquid in the study design.

5. We propose to compute time-to-execution for limit orders posted at the CBBO prices or improving these prices. Do you believe that we should consider different price levels? If so, which ones? Please provide supporting data and analysis, if available, to demonstrate the empirical importance of order postings at other levels.

We believe that computing time-to-execution for limit orders posted at the CBBO is sufficient. It would also be interesting to examine time-to-execution for CBBO +/- 1 and 2 price levels either absolutely or relatively in order to determine any informational impact of limit orders off of CBBO.

6. We propose a number of market quality metrics. Do you believe that we should consider additional metrics? If so, please outline these metrics and provide supporting data and analysis, if available, to demonstrate their empirical importance.

We encourage regulators to measure the delay cost of marketable, passive orders that are canceled or subsequently repriced.

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[3] Letter from Ty Gellasch, Healthy Markets Association, to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission, May 24, 2018, available https://www.sec.gov/comments/s7-05-18/s70518-3704495-162465.pdf

7. We have had extensive discussions with a number of market participants on whether to include exchange-traded products (ETPs) in the Pilot, and some participants suggest that such an inclusion is warranted. Nevertheless, others point out that trading characteristics of ETPs are substantially different from those of corporate equities and including ETPs will present significant challenges in the matching stage and will likely confound the results in the analysis stage. These participants and our own research identify the following concerns:

• most liquidity in ETPs is determined and provided by contracted market makers, and the ETP creation/redemption process represents its own source of liquidity;
• matching characteristics that we propose to use for corporate equities do not have the same meaning for ETPs. For instance, ETP fund size is not a relevant metric, and ETP trading volume is usually not correlated with quoting activity or liquidity;
• spillover effects of two types may confound the results. First, liquidity in ETPs relates to liquidity of the underlying basket of securities, and if the basket is significantly affected by the Pilot, the ETP will be affected too. Second, ETPs that follow the same baskets may be viewed not only as good matches, but also as substitutes for investment, hedging, and trading purposes. If one of them is selected to be treated, and the other is not, market participants may move between products, potentially confounding the results of the Pilot.

The above-mentioned concerns make finding matched ETP pairs a uniquely challenging task. To the best of our knowledge, there is no established procedure for matching ETPs to study their trading costs. As such, in relation to ETP inclusion, we ask that market participants consider the following questions: Given the challenges that ETP matching presents, can the goals of the Pilot be achieved without including ETPs in the sample? If ETP inclusion is important, can you propose a way to construct a matched sample that addresses the concerns identified above?

We believe that ETPs should be included, and that the exclusion of ETPs from the Pilot Study would be problematic. If the empirical evidence gathered from the Pilot Study suggests that regulators should take a policy action on trading fee rebates, regulators will need to extrapolate the results observed from equities and apply them to ETPs. The trading behavior of ETPs is similar, but also distinct from equities and notwithstanding the concerns raised above, it would be better to avoid any extrapolation and observe the impact of trading fee rebates directly on ETPs.

We acknowledge that market capitalization and trading volume are not meaningful characteristics driving the trading behavior of ETPs. We suggest that regulators look through the ETP structure and instead focus on the market capitalization and trading behavior of the underlying securities. An examination of the underlying securities held within the ETP structure should permit the application and extension of the matched pairs approach to ETP securities.

Regarding the concern that ETPs tracking similar holdings may be viewed as substitutes for investment, hedging and trading purposes, we argue that the impact of trading fee rebates on such perfect substitutes is precisely what regulators should be studying.

Concluding Remarks

The CAC believes, and the CFA Institute Code of Ethics and Standards of Professional Conduct provides, that economic agents should place the interests of their clients before their own.[4] Similarly, if brokers are truly adhering to their best execution obligations, brokers should be prioritizing the best interests of their clients. While we are generally supportive of the proposed Pilot Study, we also query if a broader best execution review may be appropriate following this study and with its results available for examination of broker behaviours.

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council for*
Canadian CFA Institute Societies

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[4] CFA Code of Ethics and Standards of Professional Conduct, Section III A. Loyalty, Prudence, and Care, available online at https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/code-of-ethics-standards-professional-conduct.ashx