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GLOBAL BANKING AND MARKETS

February 27, 2019

The Secretary
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and

Me Anne-Marie Beaudoin
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Via Email

Re: CSA Staff Notice and Request for Comment 23-323 – Trading Fee Rebate Pilot Study

Scotia Capital Inc. appreciates the opportunity to comment on the proposal by the Canadian Securities Administrators to conduct a market-wide pilot study on the prohibition of marketplace rebates (the "Pilot").

General Remarks

We believe that the marketplace practice of paying rebates to some participants while charging fees to others introduces a range of side-effects, which we ultimately believe to be harmful. These include:

- Proliferation of trading venues with near-identical features, whose differentiation is primarily on fee structure.
- Fragmentation of natural order flow among these trading venues, leading to increased intermediation and greater market impact costs for participants seeking liquidity.
- Long queue lengths on high-rebate marketplaces, resulting in poor execution quality and information leakage for institutional clients.
- Greater indirect costs, such as the cost of connectivity and market data, directly stemming from marketplace fragmentation and excess intermediation.

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- A range of conflicts of interest, whether real or perceived, experienced by various participants whose economic incentives may be at odds with ideal client outcomes.

We note that a prior proposal to conduct a Canada-only marketplace rebate study, introduced as part of the 2014 review of the Order Protection Rule, was ultimately shelved on the basis that the risks to Canadian markets were too great at that time. The SEC's decision to conduct its Transaction Fee Pilot and include Canadian securities in the proposed manner presents a unique opportunity to study, identify and measure the magnitude of these effects on the market for the purpose of guiding future policy choices. **This is an opportunity that must not be passed up.**

We also wish to highlight that it is not enough to simply observe the U.S. study's results, and apply the conclusions to the Canadian market. Key differences in market mechanics and regulatory fabric will mean that the lessons observed from the U.S. experience do not necessarily translate in the manner anticipated.

Specifically:

- Any conclusions drawn from the Transaction Fee Pilot must be taken in light of the U.S. equity market being the largest and most liquid equity market in the world. As a result, conclusions to other, less liquid and less diverse markets may not apply – and the limitations of those conclusions will not be readily apparent simply from observing the U.S. experience.
- The widespread practice of direct dealer internalization in the U.S. market is substantially different from trends in Canada, owing to Canada's dark rules. This drives differences in order routing practices in the U.S. relative to those in Canada. As a result, the observations from the SEC Transaction Fee Pilot may not readily translate to Canada.
- The U.S. practice of payment for order flow also significantly alters the composition of order flow reaching the U.S. exchanges which are subject to the Transaction Fee Pilot. This practice does not exist in the same form in the Canadian market, instead relying on marketplace rebates to achieve similar economics.

This combination of factors leads us to strongly support the CSA's initiative to coordinate a pilot study on the prohibition of marketplace rebates, as proposed.

Pilot Study Design

We believe that the proposed study is well-structured overall, and wish to commend the academic team responsible for its design for the diligent and thoughtful proposal.

We broadly agree with the proposed structure of matched security pairs across both highly-liquid and medium-liquid securities. The breadth of the study must be balanced against the likelihood that the study will not result in enough data points for the least-liquid segment of the market to

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draw meaningful conclusions. We therefore agree with constraining the study to exclude securities deemed illiquid as a compromise between breadth and statistical integrity. We would expect that the study's results relating to medium liquid securities would allow for educated extrapolation of the effect of the study on less liquid segments of the Canadian market.

We agree with the proposed inclusion of activity on all marketplaces, both exchanges and ATSs, in the study. We believe that the regulatory distinction between exchange and ATS is not driving routing decisions or behavior, and as a result both categories of marketplace should be treated equally for the purpose of the Pilot. While we recognize that this approach diverges from the methodology of the Transaction Fee Pilot, we believe this difference is appropriate and necessary to achieve meaningful research results in Canada.

We also wish to affirm that in our view inclusion in either the test group or the control group should not require the consent of any issuer or third party. We believe any fears that the Pilot could impact corporate cost of equity capital are unfounded, as we believe that cost of capital is a function of business fundamentals rather than trading mechanics. On the other hand, the ability for issuers to opt-out of the study would seriously compromise the ability of the research team to construct appropriate matched pairs and draw meaningful conclusions from the study.

Finally, we would like to highlight that the Pilot will necessarily impact the commercial business models of marketplace operators. We expect the firms currently reliant on the payment of rebates may seek commercial means of achieving similar results without violating the terms of the Pilot. We therefore believe it is integral to the Pilot that marketplaces be prohibited from implementing any mechanism that ties overall cost reductions to trading activity in the treated group, including mechanisms such as volume discounts for overall activity (which could include trading in the treated group). For clarity, we believe this constraint should cover all sources of marketplace revenue, including market data and connectivity charges.

This restriction on fee transference should apply to formal guaranteed-fill market-making programs operated by some marketplaces. We believe that these facilities offer preferential fee treatment to some participants (typically sources of retail order flow) in exchange for trading against a narrow subset of counterparties (the designated market-makers). In our view, these features are a Canadian implementation of a wholesaling business model which operate in technical compliance of Canadian rules regarding internalization and payment for order flow. As a result, these programs (and their built-in rebate economics) should fall in the scope of the proposed Pilot. We recommend that for the purpose of the study, the fee structure for guaranteed-fill market-making facilities be harmonized with the fee structure for equivalent trading outside of the facility within each marketplace.

Answers to Specific Questions

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*

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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.

We are agree with the definition as proposed.

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.*

We defer to the academic research team on whether a staggered introduction will confound statistical analysis of the results of the Pilot.

The primary consideration for whether the start of the Pilot is staggered or otherwise should be to maximize the opportunity to study market effects. If, for any reason, the Canadian Pilot is delayed to a point past the beginning of the U.S. Transaction Fee Pilot, we believe an immediate start to researching both non-interlisted and interlisted securities may be warranted.

Additionally, in lieu of a staggered beginning, it may also be appropriate to conclude the non-interlisted study subsequent to the end of the U.S. Transaction Fee Pilot, as the non-interlisted equities are not subject to the same cross-border trading dynamics as interlisted ones. As a result, Canada-specific observations for this security set may be obtainable after the end of the Transaction Fee Pilot and without additional implementation disruption.

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 believe that exchanges should not be permitted to continue to use rebates for market making programs or other related mechanisms for securities in the test group.

The integrity of the Pilot, and the applicability of its conclusions, depend greatly on whether there are any "loopholes" in the study structure which indirectly allow otherwise-prohibited practices. A key example of this loophole is the use of "market making" programs to permit indirect bilateral trading of retail order flow, with a payment of rebates to active parties. This activity is precisely of the type that should be examined under the proposed Pilot. By permitting the continuation of such programs for stocks in the test group, the Pilot is significantly compromised.

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For further clarity, we believe the restriction on the payment of rebates should apply to any facility, feature, order type or mechanism which would result in either a payment or a reduction of overall fees to any participant (whether a dealer or a client of a dealer) where the economic value of the payment (or fee reduction) is a direct function of traded volume.

We are not concerned with participation incentives offered by marketplaces where those incentives are expressed as improved queue priority or flat fees for service offered in exchange for meeting performance obligations.

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 believe that these time horizons are too long to capture the effect of rebates at the order execution level (i.e. order router performance degradation), and would instead bias study results towards capturing longer-dated information leakage effects.

To capture the effect at a more precise level, we recommend also computing price impact at the 1ms, 5ms, 50ms and 100ms levels.

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 computing time-to-execution for limits posted at the CBBO is appropriate, subject to ensuring that the study captures the effect of CBBO changes which may be the direct result of the entry of the orders being studied. In other words, if an order is entered and the CBBO subsequently changes (at a short time interval), the study should consider whether such CBBO changes are systematic and may be related to marketplace rebates.

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 agree with the metrics contemplated in the proposal.

In addition to the metrics presented, we would like to include some metrics of the breadth of participation in securities with or without marketplace rebates. We believe that a key tenet of the practice of paying rebates (in certain circumstances) is to "incentivize liquidity." We believe that liquidity in the market is closely related to the breadth of participation by risk-taking parties.

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Empirical measures of participation breadth would allow the research team to test the hypothesis rebates incentivize liquidity-provision.

7. 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 agree with Staff and with the research team that the Canadian ETP market presents unique challenges which may confound the research goals of the Pilot. However, we also believe the goals of the Pilot can be achieved without the inclusion of ETPs directly.

The inclusion of ETPs would introduce unique difficulties in constructing matched pairs, particularly as it relates to the confounding effect on activity levels of ETP issuer sales practices, brand and product differentiation. We believe that in most cases, rebate economics do not significantly alter investor interest in specific products, but instead impact order routing decisions. In turn, we believe order routing for client orders in ETPs to be largely handled in a manner that is consistent with order routing for corporate securities.

We believe that ETPs can be included in the study without introducing the difficulty of constructing a matched-pair allocation method by comparing order routing practices of ETPs with order routing practices of corporate securities within the control group. This would allow the research team to test the hypothesis that ETP order routing is substantially similar to, or differs from, routing for corporate securities. Any differences identified in this manner can be used to guide policy decisions in the future, without directly involving ETPs or their issuers in the Pilot. In other words, if ETP routing is the same as corporate securities routing on average, then the effect of rebates on the routing in the ETP market can be expected to similar to the effect of rebates on the corporate market. If routing practices are different, further study may be warranted.

We also wish to stress that measures of ETP liquidity need to be considered in light of the heavily intermediated nature of the ETP market, and its links to the underlying assets of each product. We believe that the key determinants of liquidity in the ETP market is the willingness of firms to intermediate ETP flows and arbitrage the ETP market through the creation & redemption process. The drivers of this decision are typically outside the scope of rebate economics, and are instead influenced by factors such as the liquidity of the underlying market and the business relationship between the issuer and market-making firms. We therefore believe that the inclusion of ETPs in the Pilot will not significantly improve the understanding of ETP liquidity. Any results from the Pilot which suggest a causal relationship between rebates and ETP liquidity must be taken with a further analysis of the nature of participation by both intermediaries and investors.

We wish to stress that any policy conclusions from the Pilot should be applicable to the market at large without loss of generality from the specific choice of securities included in the study. If policy implications of the pilot would be constrained by the exclusion of ETPs, then we believe ETPs should be included in some fashion. We would rather face study difficulties now than increased complexity and costs in the future if that complexity is a result of study limitations.

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Conclusions

Scotiabank appreciates the opportunity to comment on this important matter. We wish to affirm our support for the proposed rebate pilot, its coordination with the SEC's Transaction Fee Pilot, and our confidence in the academic team involved in this work.

We believe this pilot is the most important market structure initiative undertaken by our regulators since the introduction of multiple marketplaces over a decade ago. We commend the CSA and Staff for the efforts to date and look forward to the Pilot's successful conclusion.

Respectfully,

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