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

Dear CSA Members:

CNSX Markets Inc. ("CSE") is responding to the CSA Staff Notice and Request for Comment 23-323 - *Trading Fee Rebate Pilot Study* ("Fee Pilot") published on December 18, 2018.

The CSE is not in favour of the Fee Pilot. With too many unknown unintended consequences, the likelihood of order flow arbitrage between Canada and the U.S., impacts on issuers that are involuntary and arbitrary, a stifling of competition (both among marketplaces and investment dealers), and the fact that the legality of the study is being challenged in the U.S. on various grounds, proceeding with the Fee Pilot at this time would not be prudent. If the CSA elects to proceed with the Fee Pilot, the CSE believes that it should be drastically reduced in scope – both in time duration (i.e. conduct only in parallel with the U.S.) as well as the number of securities included (if the number of matched pairs were reduced in half, there would still be sufficient data to be statistically significant).

The CSE also believes that it is ironic that at a time when the CSA has initiated several issuer regulatory burden reduction initiatives<sup>1</sup> and the Ontario Securities Commission is engaging with the

<sup>1</sup> See [https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_20180524\\_81-329\\_investment-fund-issuers.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20180524_81-329_investment-fund-issuers.pdf) and [https://www.osc.gov.on.ca/documents/en/Securities-Category5/csa\\_20180327\\_51-353\\_fund-reporting-issuers.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20180327_51-353_fund-reporting-issuers.pdf).



industry to identify and address unduly burdensome policies and rules generally,<sup>2</sup> the CSA, historically unwilling and unequipped to engage in price regulation in the industry, is proposing to introduce a costly and risky experiment upon the market. The burden of complying with the components of the Fee Pilot will be considerable and will be unevenly borne by the investment dealer community. Bank-owned investment dealers, with enormous compliance, technical and analytical resources will more easily be able to adjust routing tables and measure results for the different stocks included in the pilot than independent investment dealers who are already at a significant scale disadvantage in providing a competitive alternative.

The CSE is also concerned about the likelihood of unintended consequences. Several marketplaces already use incentives unrelated to execution fees to induce investment dealers to direct orders and trades to their venues. Some marketplaces, for example, pay for crosses. The only justification for this approach is these fees are more than made up for through higher market data fees that the venue can charge as a result of their higher market share. Will the terms and conditions of the pilot prohibit other incentives, such as volume discounts for investment dealers executing trades on a venue? We have also seen, in Canada and elsewhere, share ownership incentives provided by venues to investment dealers meeting certain trade volume thresholds. The simple fact is that if rebates are banned for the duration of the Fee Pilot, the marketplaces will find other means to compete for order flow and trade execution business. Unless every other term and condition of doing business with a marketplace is also “frozen”, the study is unlikely to achieve its goals.

### **Canadian versus American market structure – order flow payment**

As acknowledged in Appendix A to the CSA Staff Notice, there are important differences between Canada and the United States in market structure.<sup>3</sup> These differences are identified as the reason for conducting a separate Canadian study. On the face of it, it may be a reasonable approach. What is not acknowledged, however, is that there are many factors in the proposed Fee Pilot that give rise to significant risks to Canadian investors and the potential for unintended harm to Canadian equity market quality. We will focus on two significant considerations:

- As equity market structure has evolved in the U.S., most retail and institutional order flow is now executed away from the exchanges. Brokers receiving client orders will most often “sell” these orders to wholesale dealers (providing a fill to the client inside the publicly available bid/offer spread, while providing a payment to the dealer of 1/10<sup>th</sup> of cent per share), and then in turn work their open positions on a variety of non-exchange trading venues. The result of this model is that it is very rare for client orders to be executed on one of the exchanges in the U.S. In Canada, this “payment for order flow” practice contravenes the rules, which means that (in theory anyway) client orders will make their way to the exchanges and alternative trading systems (“ATS’s”) (collectively “marketplaces”) for execution. This difference is important, because if the result of the pilot project in the U.S. is significant harm to the exchange price discovery process, then the parties immediately affected are the proprietary trading firms supplying most of the order flow to the exchanges. They are more than capable of re-directing their trading operations to properly functioning market centres (which, because they aren’t exchanges, will be operating outside the constraints of the pilot). Canadian retail investors, and the investment dealers managing their orders, won’t have this luxury. All the venues providing execution services for these client orders will be caught within the scope of the Fee

<sup>2</sup> [https://www.osc.gov.on.ca/documents/en/Securities-Category1/sn\\_20190114\\_11-784\\_burden-reduction.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category1/sn_20190114_11-784_burden-reduction.pdf).

<sup>3</sup> “Although the U.S. and the Canadian equity markets are similar, there are several key differences that may affect dealer routing decisions. Examples include the practice of retail order internalization in the U.S. and broker-preferencing in Canada.”



Pilot. If things go wrong, Canadians will have nowhere to go.

- The other consideration not acknowledged by the authors of Appendix A is that many of the fee models introduced by Canadian marketplace are designed to address the advantages that payment for order flow gives to U.S. broker/dealers over their Canadian counterparts. Prior to the implementation of these models, there was considerable suspicion in Canada that many investment dealers were routing client orders to the U.S. to take advantage of order payments. Canadian trading volumes and the price discovery process was harmed as a result. If, to take advantage of the payments offered by U.S. wholesalers, Canadian investment dealers route client orders to the U.S. for execution in the large number of liquid stocks covered by the Fee Pilot, then we are likely to see considerable harm to the price discovery process on the marketplaces.

## **Stifling of Competition**

The time period for the proposed study is unduly long. If the SEC extends its pilot for the full 2 years (1 year plus an option year), the regulators are effectively proposing a 2½ year freeze on pricing for a significant number of liquid securities. The industry is, to be blunt, fed up with marketplaces introducing new order types and market venues employing new and unique execution modalities. Latency is no longer a competitive factor. Pricing, as a result, is the only practical means of differentiation and competition amongst marketplaces. Thus, there is an effective long-term freeze on competition for the trading of stocks included in the Fee Pilot.

The competitive landscape on the investment dealer side is also going to be skewed by the Fee Pilot. One of the fastest growing broker/dealers in the United States is Robinhood.<sup>4</sup> It operates exclusively on-line and offers trade execution services at a commission rate of 0%. The company earns revenues on, according to recent SEC filings, payments for orders and interest earned on client cash balances. A Canadian investment dealer, WealthSimple, recently announced the launch of a client service also offering trading commissions of 0%. With payment for order flow banned in Canada, the only way this competitive offering works is with the rebates currently paid by many marketplaces in Canada for “active” orders. The Fee Pilot would eliminate these payments for the stocks included in the study, seriously compromising the potential success of this initiative. We are very concerned that an unintended consequence of the Fee Pilot would be to limit competition in the provision of services to retail investors in Canada.

## **Legality of the U.S. study**

As noted in the section on stifling of business strategy, removing price mechanisms restricts marketplaces in terms of competition. This is one of the key arguments being advanced in against the SEC regarding its fee pilot. More problematic, the U.S. legal challenges are squarely premised on the principle that the SEC has not articulated the problem it seeks to solve.<sup>5</sup> There is a parallel to Canada – insufficient justification in terms of the costs and benefits of the Fee Pilot is provided, when one considers the level of intervention the CSA is proposing to visit on the industry.

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<sup>4</sup> <https://investing.robinhood.com/>.

<sup>5</sup> The fee pilot has been called a “data gathering” exercise that is insufficient to justify the program’s disruptiveness and expense. <https://www.wsj.com/articles/were-suing-the-sec-to-protect-the-stock-market-11550188636>



## **Solution looking for a Problem**

The Fee Pilot's rationale is premised on the notion that there are potential issues in Canadian market structure relating to conflicts of interest, increased segmentation, and "unnecessary" intermediation. However, none of these issues have been conclusively proven to exist or impact the market to an extent that warrants an intrusive and expensive study. There is no consensus among the academics or practitioners as to what constitutes an appropriate level of intermediation. In a time of looking to reduce regulatory burden, there should be a clear public interest rationale before instituting as far ranging and potentially disruptive market intervention as the Fee Pilot.

In terms of the potential issues raised in the CSA Staff Notice, there appears to be conflicting explanations. It is postulated that there could be potential conflicts of interest because investment dealers may route an order to a marketplace that pays a rebate rather than charging them a fee. Routing to such marketplaces, it is suggested, may result in lower likelihood of fills or longer time to fill (although if an order is not filled, no rebate would be earned, and the client may not be pleased with their order not being filled, both negatives for the investment dealer and presumably a situation that would be avoided by the investment dealer). On the other hand, in the segmentation of orders section, it is suggested that retail investment dealers would be more sensitive to immediacy of trade execution and that such investment dealers would route to inverted maker-taker marketplaces (to receive a rebate). In the conflict of interest section, a delayed fill while receiving a rebate is considered undesirable. Yet in the segmentations of orders section, immediacy of a fill with a rebate is considered undesirable.

## **Negative Impact on Issuers Included in the Pilot**

The goal of the provision of fair and orderly markets is to reduce the cost of capital for companies from the public markets. We are very concerned that, at least for the securities of the issuers included in the framework of the Fee Pilot, the issuers themselves will be put at a disadvantage vis-à-vis their peers outside the pilot. Has any consideration been given to permitting the companies to opt out of the pilot?

## **Responses to specific matters raised in Appendix II: Questions for Market Participants**

Question 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."*

CSE Response:

The CSE has concerns regarding the inclusion of non-interlisted securities in the Fee Pilot. There is no acknowledgement of the fact that non-interlisted securities trade over-the-counter in the U.S., and in considerable quantities. It is a fact that Canada's marketplaces are competing with U.S. markets for trade execution services for all publicly listed securities. With payment for order flow permissible in the U.S., these non-interlisted securities are subject to the very same competitive pressures as for the interlisted securities. The potential for negative unintended consequences regarding these non-interlisted securities is possible during the Fee Pilot. The CSE submits that if the Fee Pilot is to proceed, that it should parallel the U.S. study in the scope of its time period. This is especially true



when, given the litigation initiated by the U.S. exchanges against the SEC, there is uncertainty as to when the U.S. study will commence.

Question 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. On 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?”*

CSE Response:

Market maker rebates have been ingrained in Canadian market structure for some time. Although still a matter of some controversy, the notion is generally accepted by the industry that in return for providing an orderly two-sided market, the Designated Market Maker should receive certain advantages in the form of increased participation opportunities and lower fees or rebates from the marketplace. Limiting these incentives may cause negative unintended consequences in Canada during the Fee Pilot, as the services provided by the market maker are primarily aimed at improving trading outcomes for retail clients. It is reasonable to expect that agency order execution quality will suffer with the removal of market maker rebates.

Question 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.”*

CSE Response:

The CSE suggests that, should the Fee Pilot proceed, the CSA track trades for both interlisted and non-interlisted securities to determine any change on leakage of order flow to the U.S. This would include volumes on not just the national securities exchanges, but also volume reported to the OTC Markets Group, the OTCBB and the alternative display facilities that capture trades occurring on proprietary dark pools and other broker operated systems in the U.S. To our knowledge, these venues have not been considered in any academic study of Canada-U.S. trade execution patterns.

Question 7: *“...[g]iven 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?”*

CSE Response:

The CSE sees no reason to exclude ETPs from the Fee Pilot. We believe that it is the intent of the U.S. pilot project to include ETP's in their study.

## **Other Factors to Consider**

### ***Payment for Crosses***

Will payment for crosses be prohibited during the pilot? The CSE believes this should be the case in order to gain an understanding of the impact of such payment on trading.

## ***Market Data Pricing***

It is possible that the market data model that is in place in Canada has a significant impact on the fees and rebates applied on trading (e.g. marketplaces seeking to increase volumes to become “protected” and hence be able to charge corresponding market data fees). Payment for crosses (noted above) is a perfect illustration of this approach by some marketplaces. Understanding the impact of strategies designed to support market data feed needs to be taken into consideration in the study.

## ***Client Fees***

What will be the impact on client fees if the Fee Pilot proceeds? Will the ability of investment dealers to lower commissions for their clients will be compromised? Is there potential harm to investors in the form of higher commissions in addition to concerns over the price discovery process.

## **Conclusion**

The CSE believes that while the Fee Pilot may be based on good intentions, its potential for significant (albeit unintended) harm undermines its *raison d'être* (which is, in its essence, to collect and study data to see if there is a problem that needs solving). Unfortunately, there are too many questions about its design. Duplicating U.S. efforts at a time when the CSA members are undertaking regulatory burden reduction strategies is not only ironic but irresponsible. A study as proposed, at least in the U.S., may not even be legal.

It is guaranteed that unnecessary costs will be introduced into the Canadian capital markets. Correspondingly, the potential economic impact has not been assessed. It is not known whether clients will be better off, leaving aside the impacts on the marketplaces, investment dealers, issuers and other entities.

With the significant number of unknowns and unanswered questions, the CSA should proceed very cautiously. While the CSE is not in favour of the Fee Pilot, if the CSA elects to move forward, the CSE believes that the study should be drastically reduced in scope – both in time duration (i.e. conduct only in parallel with the U.S.) as well as the number of securities included (if the number of matched pairs were reduced in half, there would still be sufficient data to be statistically significant).

Respectfully submitted,



Richard Carleton  
Chief Executive Officer

cc. Jamie Anderson – General Counsel & Corporate Secretary