March 1, 2019

VIA 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

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

Dear Sirs/Mesdames:

Nasdaq CXC Limited ("Nasdaq Canada" or "we") welcomes the opportunity to provide comments on the Canadian Securities Administrator's ("CSA") proposed Trading Fee Pilot that would apply temporary pricing restrictions on marketplace transaction fees applicable to trading in certain securities ("Pilot Study" and "2018 Notice").

Although we welcome meaningful reform in market structure, we believe that the Pilot Study violates the principle of proportionate regulation; violates the CSA's statutory mandate to foster a fair and efficient market; and fails to substantiate with data analysis a burdensome regulatory action. Restricting marketplace rebates will not address CSA concerns that marketplace fees create a conflict of interest for dealers when managing client orders, contribute to segmentation of retail orders or encouraging excessive intermediation on highly liquid securities. Instead, the Pilot Study will result in deteriorating market quality; harm participants and issuers; weaken competition between marketplaces; reduce Canada's ability to attract new entrants; and increase trading costs for investors.

Therefore we urge the CSA to consider less harmful alternative approaches to address its concerns including compliance reviews of dealer disclosure and best execution obligations, mandating that dealers pass-through rebates to clients, re-evaluate exchange guaranteed execution facilities that explicitly segment order flow and take a tiered approach to regulating trading fees. Using these approaches will help the CSA validate their concerns and better position it to evaluate whether any additional regulatory action is necessary. Finally, we believe the CSA should not move forward with the Pilot Study whether or not the SEC Access Fee Pilot is implemented. If there is an SEC Access Fee Pilot ("SEC Fee Pilot") it will provide a learning opportunity for the CSA without exposing the Canadian market, issuers, and investors to the risks and cost. We note however that the SEC Fee Pilot has recently been appealed on the grounds that the pilot program is unlawful under both the Securities Exchange Act of 1934 and the Administrative Procedure Act, does not promote competition and exceeds the agency's authority.

THE PILOT STUDY IS NOT JUSTIFIED BECAUSE IT IS INCONSISTENT WITH THE PRINCIPLE OF PROPORTIONATE REGULATION

We respectfully submit that the Pilot Study is inconsistent with the CSA's mandate to carry out proportionate regulation that requires the objectives of any regulatory action be proportionate to the costs and other restrictions that will be placed on the market participants. Recently in OSC Staff Notice 11-784 Burden Reduction ("OSC Burden Reduction Notice") staff acknowledged that one of the fundamental principles guiding the work of the OSC in meeting its statutory mandates under the Securities Act is that business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objective sought to be realized.[1] It follows that any regulatory action that introduces risks and imposes costs that are not proportionate to its regulatory objectives must therefore be interpreted as an unnecessary regulatory burden likely to introduce more harm than good.

The Pilot Study is predicated on unsubstantiated concerns lacking support from data driven analysis, uncertain benefits, and unclear objectives. The CSA's stated objective is "to study the effects of the prohibition of rebate payments by Canadian marketplaces and to provide an opportunity to understand any inherent conflicts for dealers and study both changes in order routing practices and impacts on market quality measures."[2] The reason for studying the effects of prohibiting marketplace rebates is that it may address concerns first raised by the CSA in the CSA Notice and Request for Comment Proposed Amendments to National Instrument 23-101 Trading Rules which included a review of the Order Protection Rule ("2014 OPR Review").

In the 2014 OPR Review, the CSA expressed concerns as to how the payment of rebates **may** be creating conflicts of interest for dealer routing decisions that **may** be difficult to manage, **may** be contributing to increased segmentation of order flow and **may** be contributing to increased intermediation on actively traded securities ("CSA Concerns"). Although a general description of these concerns is provided, no data is given to support the legitimacy of each concern and there is no explanation how each concern is measured. If there is a conflict of interest created for dealers when managing client orders, what data was

[1] Please see: http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20190114_11-784_burden-reduction.htm.
[2] Please see: http://osc.gov.on.ca/en/SecuritiesLaw_csa_20181218_23-323_trading-fee-rebate-pilot-study.htm.

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used to substantiate this concern? If the use of fee rebates provided to different sides of a trade may be contributing to the segmentation of orders by type of client, how is segmentation measured and what level of segmentation creates a market integrity concern? Finally, if the payments of rebates may have led to a situation where there is intermediation of investor orders where sufficient liquidity already exists, at what level does the otherwise necessary intermediation required to create sufficient liquidity for a security become excessive? Without data to substantiate the CSA Concerns, the regulatory objective of the Pilot Study must be understood to be based on speculation, and without a clear explanation how concerns will be measured, we do not understand how conclusions from the Pilot Study will be made.

Requiring quantitative support to substantiate CSA Concerns is not only important from a policy making perspective but also because these concerns contradict the results of the Investment Industry Organization of Canada's ("IIROC") Best Execution Survey from 2014 ("Survey") for retail and institutional dealers. In the Survey only 6% of respondents engaging in full service retail or on-line retail trading business that used a Smart Order Router listed the cost/opportunity to capture rebates as a factor considered for routing decisions and this factor was the lowest ranked factor overall.[3] For participants engaging in institutional trading the result was the same. The cost/opportunity to capture rebates was also only considered by only 6% of respondents and also reported as the least important factor when considering making a routing decision.[4]

According to the OSC Burden Reduction Notice, proportionate regulation requires that the regulatory objectives sought to be achieved by any regulatory action must be proportionate to its risks and costs.[5] As we will expand on later in our response, the Pilot Study will introduce significant risks and will impose significant costs to investors and in particular retail investors. The restriction of marketplace rebates will negatively impact the market quality and efficiency of the securities where rebates will be restricted ("Pilot Securities"). The issuers of these securities will be placed at a disadvantage to their peers because of deteriorating liquidity profiles. Competition will be deterred as marketplaces will be limited in their ability to compete with one another (undermining the policy objectives of the ATS rules), and Canada will become less attractive to new entrants. Finally, the Pilot Study will result in higher costs to participants with a higher ratio of active orders to passive orders (active/passive ratio), a characteristic typical of retail dealers. Taken together, and in the absence of the clear benefits of regulatory objectives based on substantiated concerns, the Pilot Study cannot be considered consistent with the principle of proportionate regulation, the mandate of the Ontario Burden Reduction Task Force and therefore also unsupportive of the Government of Ontario's Open for Business Action Plan.

THE PILOT STUDY IS NOT JUSTIFIED BECAUSE IT IS INCONSISTENT WITH THE CSA'S MANDATE TO FOSTER A FAIR AND EFFICIENT MARKET

The Pilot Study is inconsistent with the CSA's mandate to foster a fair and efficient market. In the 2018 Notice the CSA explains that it "has been considering a pilot study on the payment of trading fee rebates

[3] See Criteria Influencing Retail Routing Strategy in section 3.3.2 of IIROC Notice 14-0082 Best Execution. Survey Results at http://www.iiroc.ca/Documents/2014/61ec2e27-7e15-4a42-9adc-5c7895d16c81_en.pdf.
4 See Criteria Influencing Institutional Rouging Strategy in section 3.3.3 of IIROC Notice 14-0082 Best Execution. Survey Results at http://www.iiroc.ca/Documents/2014/61ec2e27-7e15-4a42-9adc-5c7895d16c81_en.pdf.
[5] *Supra note* 1.

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for many years in relation to its continued work to foster fair and efficient capital markets and confidence in capital markets."[6] The CSA's 2014 OPR Review lists seven essential characteristics of an efficient market:[7] Liquidity, Immediacy, Transparency, Price Discovery, Fairness, Market Integrity and Transaction Costs ("Efficiency Characteristics"). The CSA notes that these characteristics have been vital throughout the ongoing development of the Marketplace Rules and, in its view, any regulatory change necessitates consideration of the above-noted characteristics of an efficient and effective market in the context of our collective mandates to protect investors, and to foster fair and efficient capital markets.[8]

We commend the CSA for defining characteristics it views essential for an efficient market so they can be considered when evaluating a regulatory change. We note however that the CSA has ignored all seven Efficiency Characteristics when proposing the Pilot Study. The Pilot Study is not supported when evaluating its merits based on these Efficiency Characteristics as it will result in negatively impacting the quality of four Efficiency Characteristics while leaving three unchanged. The restriction of marketplace rebates will deteriorate **liquidity** by widening spreads and decreasing market depth as a result of increasing the cost to liquidity providers. **Immediacy** of Pilot Securities will be impacted as this loss of liquidity will limit the capacity of Pilot Securities to absorb large orders resulting in trades at or near the last sale price of the security. **Price discovery** will suffer due to widening spreads, a lack of market depth and in turn increased volatility. Finally, **transaction costs** will rise for any participant with high active/passive ratios (typically retail dealers) forcing them to pay new fees for active trades instead of the rebates they currently receive. If, as the CSA proposes, any regulatory change necessitates consideration of the Efficiency Characteristics, then such consideration does not justify the Pilot Study. Furthermore if the Efficiency Characteristics reflect those of an efficient market then the Pilot Study represents a regulatory action that will result in a less efficient market and therefore is inconsistent with the CSA statutory mandate to foster fair and efficient markets.

CSA CONCERNS NEED TO BE SUBSTANTIATED WITH ANALYSIS OF EXISTING DATA BEFORE REGULATORY ACTION IS TAKEN

Canadian regulators have access to a comprehensive data set dating back to 2011 that can and should be used for policy development and reform. The requirement that all marketplaces provide data to IIROC through individual marketplace Market Regulation Feeds ("MRF Feed") has resulted in a complete data warehouse of public and private order and trade information. Throughout that data warehouse, the trader responsible for entering each order is identified by a unique Trader identifier ("Trader ID") captured in the MRF Feed. The Electronic Trading Rule requires that all Direct Electronic Access clients ("DEA Clients") be assigned unique Trader ID and that information about each DEA Client and its Trader ID must be provided to IIROC.[9] This means that the order and trade information warehoused by IIROC can be attributed to specific traders and DEA clients that in turn can be used to analyze the behaviour of these participants.

[6] *Supra note* 2 at p. 1.
[7] Published at: (2014), 37 OSCB 4877.
[8] Published at: (2014), 37 OSCB 4878.
[9] See Section 4.6 at http://osc.gov.on.ca/documents/en/Securities-Category2/ni_20140301_23-103_unofficial-consolidated.pdf.

The CSA should use the most recent data from IIROC's data repository to perform analysis to substantiate its concerns. When the CSA first considered conducting a pilot study in 2014, reference was made to some data analysis done as part of the 2014 OPR Review. However, changes in markets conditions, market structure and other developments since 2014 have resulted in changes in behaviour that would not be reflected in data used in 2014. Developments include the introduction of new markets including dark pools and venues that apply systematic delays to active orders in addition to new industry sectors attracting significant retail participation. The 2018 Notice does not mention any further analysis performed using more recent data that supports the Pilot Study. Without supporting analysis performed using data that reflects current market structure, the legitimacy of the CSA's concerns cannot be verified.

The CSA should also use the opportunity to study the impact of an existing precedent mandating lower marketplace rebates. In 2017 the trading fee cap for non-inter-listed securities was decreased from $0.0030 to $0.0017 resulting in several marketplaces lowering their fees. As a result, marketplace rebates also decreased. Given there is an existing precedent mandating lower rebates, it should be used to study whether the lower rebate resulted in changes to dealer routing behaviour and the level of intermediation for more liquid non-inter-listed securities.

We believe the CSA should utilize IIROC's data repository to perform analysis resulting in support for CSA's Concerns before considering the introduction of the Pilot Study. Only after CSA's Concerns can be substantiated with data analysis can the regulatory objectives of the Pilot Study begin to be considered proportionate to its risk and costs.

CSA CONCERNS WILL NOT BE ADRESSED BY RESTRICTING MARKETPLACE REBATES

Concerns about Conflicts of Interest

In the 2018 Notice, the CSA reiterates its concern that the payment of a rebate by a marketplace raises a potential conflict of interest when a dealer must choose to route orders based on costs while routing orders in a manner that results in the best outcome for clients."[10]

The CSA's concern that there may be a potential conflict of interest created for dealers when making routing decisions in handling client orders is not created by marketplace rebates but instead by the economic impact of different marketplace pricing schedules. In a competitive environment marketplaces will compete with one another by using different fees to attract market flow from participants with differing trading objectives. The result of competition is that there will always be a marketplace offering a better economic incentive through either providing a higher rebate or charging a lower fee.

All other best execution factors considered, a dealer will always be incentivized economically to send client orders to the market with the most attractive economics. However the creation of this conflict does not differ from other potential conflicts of interest faced by dealers when handling client orders. Examples include the incentive to route orders to a marketplace where the dealer has an ownership interest and when routing decisions are made on the basis of a higher likelihood to internalize flow (often against

[10] *Supra note* at p. 2.

proprietary flow) rather than achieving best execution. In some cases these conflicts are compounded when dealers consider internalizing order flow on illiquid marketplaces where they have an ownership interest. Realizing that marketplace pricing is only one factor contributing to potential conflicts and that the conflict it creates will exist whether or not rebates are permitted, the question becomes not how to eliminate this conflict but instead how to manage it. We submit that the onus should be on the dealer to address this conflict and not the marketplace and if the CSA is concerned about execution quality for client orders that an action is taken to evaluate dealer compliance with their best execution obligations instead of restricting marketplace competition.

Concerns about Segmentation of Orders

The CSA has expressed concerns that different fee models that pay rebates to different sides of a trade may be contributing to the segmentation of orders by types of client and in particular retail dealers may tend to be cost sensitive to active fees.[11]

It is rational that a dealer handling an order where immediacy of trade execution is prioritized should, all things being equal, direct that order to the marketplace with the lowest cost. Similarly, dealers with higher active/passive ratios will tend to send more orders to marketplaces with better economics for active sides of their trades. We note that different participant's trading strategies and different composition of clients will result in different active/passive ratios for different dealers. Retail dealers tend to prioritize both immediacy and size discovery to lower back office ticketing costs. If an inverted venue offering better economics does not offer the opportunity for an order to be fully executed, these dealers will consider the potential benefit of lower explicit trading costs with higher ticketing costs resulting from the order trading on multiple venues.

In our opinion, concerns about segmentation of retail orders because of marketplace rebates will not be addressed by the Pilot Study because, all things being equal, dealers with a higher active/passive order ratios will continue to seek the least expensive venue to send marketable orders to in order to lower their explicit trading costs. Realizing this, the result from restricting rebates will be that trading costs for these firms will increase substantially. A second outcome (potentially unintentional) that should be considered by the CSA is that if the prohibition of rebates results in more than one marketplace offering the best economics for marketable orders (such as applying a zero fee), routing decisions will be made between venues based on the likelihood of internalization flow – adding to the increase in internalization rates which is a market integrity concern currently being reviewed by the CSA.

Concerns about Increased Intermediation on Actively Traded Securities

In the 2014 OPR Review the CSA highlighted "that while the payment of rebates has successfully increased the level of liquidity primarily in the most liquid securities, it may have led to a situation where there is intermediation of investor orders where sufficient liquidity already exists and is least needed."[12]

[11] *Supra note* at p. 3.
[12] *Ibid* at p. 14.

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Some Securities require more liquidity support than others. Securities with characteristics such as high volume, high turnover rates and low volatility will always attract greater liquidity provision because these characteristics facilitate the objective of liquidity providers which is to capture the spread, manage risk and avoid adverse selection. Consequently, although the proposed restriction on rebates will impact to economics for liquidity provision on Pilot Securities it will not materially impact the level of intermediation on highly liquid names. Furthermore restricting rebates will not address a larger issue in the market of how to attract liquidity to less liquid securities. The issue of illiquidity for small cap and medium cap securities is now being faced in different global jurisdictions but is of particularly importance in Canada given that the majority of listed securities are not liquid, especially TSX-V listed securities. Restricting any marketplace feature that can encourage liquidity for even some of these illiquid names should be considered with extreme caution.

RISKS AND COSTS THAT WILL RESULT FROM THE PILOT STUDY

1) Negative Impact to Market Quality

The Pilot Study will negatively impact the market quality of Pilot Securities by deteriorating the liquidity profiles of these securities and in turn increasing implicit trading costs for all investors.

Marketplace rebates act as an economic incentive for market makers to take on greater risk by displaying trading interest and to make markets more aggressively; restriction on the use of marketplace rebates will harm market quality and increase implicit trading costs. The nature of liquidity provision is a function of the economics of the bid-ask spread and making a spread tight enough to compete with other market makers. The strategy of a traditional liquidity provider is to place orders on both sides of the market with the objective of capturing the bid-ask spread. Given short term imbalances in demand and supply, the result of the majority of these trades will be to break even. In order to be profitable, many small profits are required to be made in order to compensate for a few large loses. Also at risk is the fact that all quotes are susceptible to adverse selection where there is an informational advantage. Without marketplace incentives to subsidize the market maker for more instances of adverse selection, the liquidity provider will need to make wider and in turn inferior markets to compensate for being exposed to additional risk.

Trading costs for investors consist of explicit costs (marketplace fees and commissions) and implicit costs represented by crossing the bid-ask spread. Marketplace rebates coupled with competitive pressure among market makers, result in tighter spreads and larger sized posted orders which are available to marketable active orders. Economically, the higher the rebate provided – the greater risk that can be taken by a market maker to make better markets and in turn tighten the spread. Tighter spreads benefit all investors as they lower implicit trading costs. When considering the net impact of tighter spreads and a marketplace fee, a tighter spread will always provide a superior benefit as there is no decrease in the level of a marketplace trading fee that will ever compensate for the loss of a wider spread.

Concern about the negative impact on market quality that will result from the restriction of marketplace rebates is not theoretical. A recent study by Nasdaq's Chief Economist, Phil MacKintosh demonstrated that for NMS stocks, liquidity incentives (rebates) are important to creating two-sided markets across all stocks, especially thinly traded stocks. The data and analysis showed that liquidity incentives contribute significantly to market quality, liquidity and spreads and that the best spreads were found on markets that reward liquidity providers.[13]

The importance of rebates for liquidity provision is also highlighted by examples when marketplaces have lowered their fees and related rebates. In 2015 Nasdaq Canada lowered its fees (and related rebates) for ETF securities to levels significantly below those of the TSX ($0.0017 vs. $0.0023). Instead of resulting in increased market share because of the lower cost to actively trade, Nasdaq Canada lost market share for these securities. This provides evidence that liquidity provision encouraged by a rebate compensating providers for the risk to make better markets is more important in resulting in trades than applying lower fees to active orders. A similar outcome was observed in the United States when Nasdaq Stock Market lowered its access fees and rebates in fourteen stocks during the first four months of 2015. The Nasdaq market also lost liquidity and market share as fee sensitive market makers shifted their market making activity to other U.S. markets which continued to offer rebates and access fees similar to those offered by Nasdaq before the experiment.

If the Pilot Study is implemented and restrictions on rebates are introduced for Pilot Securities, we believe that they should apply equally to market making programs. The impact to liquidity provision from the removal of rebates should be studied for both exchange market makers and liquidity providers. If market makers do not provide the same level of liquidity, or do not fulfil their market making obligations, it will evidence the importance of the economic incentive that is required to compensate for the risk of making markets.

2) Impact to Issuers

The Pilot Study will negatively impact the liquidity profiles of issuers creating a disadvantage with peers without being afforded the right to opt-out of participation.

The CSA expresses its belief in the 2018 Notice that the Pilot Study will not harm issuers included in the Pilot Study because OPR will continue to apply to marketplaces that display protected orders. Furthermore the temporary elimination of trading rebates for certain securities may make it less expensive, and consequently more attractive, to transact in those securities, which also may offset the reduced rebate incentive and attract liquidity.[14] We respectfully disagree. OPR only focuses on the active side of the trade and not on liquidity provision. Whereas active orders are mandated by OPR to be directed to the marketplace with the best protected lit order, a passive order is free to post on any marketplace. Referring back to the earlier discussion on the economics of liquidity provision, it is not the assurance of receiving an execution by being the best priced lit limit order that motivates liquidity provision, it is the economic incentive weighed against the possibility of adverse selection that determines at what price a quote will be made. Without the support of the rebate, liquidity providers for Pilot Securities will be forced to quote at inferior prices which will result in wider spreads.

Issuers that are included in the Test Group will be unfairly disadvantaged by deteriorating liquidity when compared to their matched pair equivalent securities outside the Pilot Study. Recognizing this impact, at a

[13] See Risks and Incentives for Market Makers in US Equities https://www.sec.gov/comments/s7-05-18/s70518-4814879-176987.pdf

[14] *Supra note* at p.5

minimum we strongly encourage the CSA to reconsider the recommendation we made in response to the 2014 OPR Review to consult with issuers when considering having their listed security be included in the program and to provide issuers the right to elect to opt-out of participation.

3) Impact on Competition

The Pilot Study will negatively impact competition by limiting the ability for marketplaces to compete with one another and weaken Canada's competitive position to attracting new entrants.

Restricting marketplace rebates will undermine the policy objectives of the Marketplace Rules. The regulatory objectives of the Marketplace Rules when they were first introduced were "to provide investor choice, improve price discovery and decrease execution costs."[15] Since their introduction in 2001 the CSA has acknowledged the benefits of a competitive environment for equity marketplaces as marketplaces have introduced different fee models, faster innovative technology, and new order types."[16] In other words competition has resulted in its intended design in encouraging innovation and lower costs for participants.

The restriction of marketplace rebates will compress the range of permitted fees that a marketplace can apply and in turn will constrain one area where marketplaces are able to compete for limit orders. Typically customers respond to differences in fees by optimizing the most favourable economics for routing orders. As the largest competitor to the incumbent we can attest that this is not the case in Canada yet as many dealers continue to preference the incumbent irrespective of opportunities for shorter queue times, better fill rates, lower trading costs and better execution on other marketplaces. This is evidenced by the incumbent continuing to capture over 50% market share compared to its closest competitor with around 20% market share. Whether this is because of slower adoption or a competitive landscape where order flow is concentrated in the hands of a few participants, differences between marketplaces fees continue to provide opportunities for marketplaces to compete with the incumbent and provide opportunity to lower costs for participants.

The Pilot Study will also damage competition by adding further complexity to Canada's already complex market structure, making Canada less attractive for new entrants. Canadian market structure today is highly complex relative to its size. Robust regulations such as a full depth order protection rule, IIROC's dark rules, ETR requirements, order handling rules etc. although contributing to market integrity and investor protection also place demands on new entrants from both an educational perspective and technological perspective. In addition to these demands, a new entrant will need to consider additional pricing categories for Pilot Securities when making trading decisions. We are concerned this will result in making Canada less attractive to investors considering entering the market. At a time when overall volume levels are decreasing, anything that discourages new entrants who represent an opportunity to grow Canada's equity market needs to be clearly justified.

[15] Published at (2001), 24 OSCB (Supp).
[16] Published at (2014), 37 OSCB 4879.

4) Increasing Trading Costs for Participants including Retail Dealers

Restricting marketplace rebates will result in significantly higher trading costs for retail trading desks.

Marketplace fees were cited as one of the direct costs connected to the captive consumer issue created by the Order Protection Rule and leading to the 2014 OPR Review; "Regarding trading fees, participants raised specific concerns about the implications of OPR on their costs to execute marketable order flow, given that OPR necessitates that participants trade with the best-priced displayed orders, regardless of the level of fees charged by marketplaces displaying those orders."[17] Participants most affected at that time were those with high active/passive order ratios resulting in increased explicit trading costs (although all investors benefited with lower implicit trading costs). The inverted maker-taker fee model, introduced by CX2 in 2013 was designed as a marketplace solution to address this unintentional outcome created by OPR. By providing a rebate to active orders, CX2 provided a similar economic incentive for active orders that was only available to passive orders. The Pilot Study will restrict rebates on inverted venues. The result will be that trading costs for dealers' with high active/passive ratios will significantly increase.

ALTERNATIVE APPROACHES ARE AVAILABLE TO THE CSA TO ADDRESS CONCERNS

We encourage the CSA to consider the use of the following alternative approaches to address its concerns,

1) Potential Conflicts of Interest Created by Marketplace Rebates.

   a) *Use of Compliance Reviews for Disclosure and Best Execution Obligations*

A fundamental tool used by regulators to address conflicts of interest is the use of disclosure which requires that information be provided to clients about dealer conflicts so that they can make their own decisions. Both the CSA and IIROC have established general frameworks in place today for dealers to address conflicts of interest. National Instrument 31-103 ("NI 31-103") and IIROC Dealer Member Rule 42 ("IIROC Rule 42") require dealers to identify and manage conflicts of interest through avoidance, disclosure and other tools. Recently the CSA Client Focused Reform proposed amendments to NI 31-103 includes a best interest standard where all conflicts of interests must be resolved in the best interest of their clients, and where this is not possible the conflict should be avoided. Similarly IIROC Rule 42 today requires that "any existing or potential material conflicts of interest between an Approved Person and a client must be addressed by the Approved Person in a fair, equitable and transparent manner, and consistent with the best interests of the client or clients" and, that "a conflict of interest between an Approved Person and a client must be addressed by avoiding the conflict, or must be addressed at least in part by disclosing the conflict of interest to the client."[18] Given that robust disclosure frameworks are in place for dealers today, we suggest a similar approach using disclosure if the CSA is concerned that marketplace rebates may create a potential conflict of interest for dealers when handling client orders.

[17] Published at (2014), 37 OSCB 4881.
[18] See Rule 42.2 at http://www.iiroc.ca/Rulebook/MemberRules/Rule00042_en.pdf.

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The use of the Pilot Study to address the conflict created by marketplace rebates represents an exception to the current regulatory approach taken to address other conflicts by attempting to eliminate its potential cause instead of managing it. We do not understand the basis for making this exception especially as regulatory intervention is not being proposed to address other conflicts that impact routing decisions such as when dealers could route orders to a marketplace based on ownership interest. It would appear that it is a lack of confidence by the CSA in dealers' ability to manage the conflict that explains the need for regulatory intervention. Given current disclosure and best execution requirements we believe that reviews of current requirements may be a more appropriate approach.

New amendments to IIROC Best Execution of Client Order Rules ("Best Execution Rule") introduced on January 2, 2018 include requirements for disclosure and best execution policies and procedures. Under the Best Execution Rule dealers must describe any material conflict when sending orders and how these conflicts are managed.[19] Firms are also required to provide written disclosure to their clients including a description of the firm's best execution policies, the factors considered for achieve best execution and a description of the dealers order handling and routing practices.[20] Included in client order handling disclosure is information about whether routing decisions are based on fees paid or payments received.[21]

The Best Execution Rule introduced an explicit requirement for dealers to establish maintain and ensure compliance with best execution policies and procedures and ensure traders know and understand firm policies. Dealers must identify the specific factors that are considered in their best execution policies and procedures for the purpose of achieving best execution. These factors now include how changes to routing tables are determined and the circumstances under which a Dealer Member will move an order entered on one marketplace to another marketplace.

Given the disclosure and best execution requirements in place today we suggest that a more appropriate alternative for the CSA to address its concerns with routing conflicts is to conduct comprehensive compliance reviews of dealer disclosure and best execution obligations at least as a first step. The results of these reviews will determine if this conflict is being properly managed or will identify compliance deficiencies that can be remedied. Either outcome should alleviate the concern while avoiding the unnecessary risks and costs that will be introduced by the Pilot Study.

The need for compliance reviews of dealer best execution obligations is highlighted by the continued practice by dealers to post nearly all retail orders on the TSX, calling into question how this practice is consistent with their best execution obligations. This practice was confirmed by both the 2014 OPR Review and IIROC's Best Execution Survey[22]. More recently, problems with this practice extend beyond best execution concerns as evidenced on July 2018 when the TSX experienced a system issue resulting in trading being closed for the last 3 hours of the day. During the outage many retail dealers did not accept orders from retail accounts directed to the Canadian market despite there being alternative marketplaces open for trading. Augmenting this weakness in Canadian market structure is the fact that retail orders directed to US markets including those for inter-listed securities were accepted.

[19] See Rule 3300.4 at http://www.iiroc.ca/Rulebook/MemberRules/Rule03300_en.pdf.
[20] See Rule 3300.11 at http://www.iiroc.ca/Rulebook/MemberRules/Rule03300_en.pdf.
[21] Ibid.
[22] Published at (2014), 37 OSCB 4880.

We believe that this practice is troubling from a best execution perspective that posting an overflow of orders on any one marketplace will decrease the likelihood of execution and strongly urge IIROC and the CSA to more closely examine this practice in the context of current dealer best execution obligations. In response to explanations we have heard that the reason for this practice is because only TSX data is provided to retail customers and posting orders on alternative marketplaces results in client confusion. We fail to see how the conflict between saving costs and providing retail investors' access to other marketplaces is being managed in the best interest of their clients. Is the cost of consuming at least one secondary source of market data enough to deny retail investors a better view of the Canadian consolidated market and be able to trade?

b) Requiring marketplace rebates to be passed onto clients

CSA should consider requiring dealers to pass-through rebates (and fees) to customers. Although mandating this practice will introduce further complexity and may be potentially unpopular with the institutional community, it will eliminate the conflict and the need for it to be managed which is consistent with the proposed approach by the CSA taken in the Pilot Study. However unlike the Pilot Study, taking this approach will not result in any new costs to investors or negatively impact market quality. Passing through rebates to customers not only will increase the level of dealer accountability but will also lead to opportunities to educate clients on the reason for existing practices.

2) Segmentation Concerns

Re-evaluation of Guaranteed Execution Facilities that Explicitly Segment Order Flow

If the CSA is concerned about the trend of increasing segmentation of order flow, it should re-evaluate marketplace facilities that explicitly restrict the interaction of orders from certain types of account with all other orders. The tendency for certain participants to select marketplaces based on differences between marketplace fees is a natural outcome of a competitive market. Differences in pricing, including different economics offered to different classes of participants do not restrict the interaction of orders from certain accounts with other orders. Recently there has been a trend for exchanges to offer or enhance guaranteed fill facilities where retail orders are interacting with market makers. The ability to restrict the interaction of retail order flow was first proposed by Aequitas Neo Exchange ("Neo"). After Neo established an approval precedent the CSE introduced a similar facility, followed by the TSX that amended its market maker program and minimum guaranteed fill facility to provide more than the minimum size guarantee for retail orders. Nasdaq Canada has recently announced that it will introduce its own in Guaranteed Execution Facility on April 1st in order to compete with other exchanges. If the CSA is concerned about the impact of segmentation of order flow, we suggest that a re-evaluation of the benefits and costs of these facilities be performed first as an alternative to the introduction of the Pilot Study. When re-evaluating the impact of segmentation, consideration should be made of the benefits that these facilities offer retail dealers in providing greater certainty of execution and size discovery. Only when the concern that segmentation results in an inferior quality market is substantiated by data analysis should any regulatory action be considered.

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3) Excessive Intermediation

Taking a Tiered Approach

Recognizing that certain securities will always attract more liquidity providers than others, there will always be the need for more liquidity on some names and sufficient liquidity provided for others. This outcome is the result of a one-size fits all model that treats all securities the same. Although concerns about excessive intermediation may exist for highly liquid large capitalization securities, the use of marketplace rebates serves to incentivize higher quality markets for less liquid securities. If the CSA wants to address its concerns that rebates result in excessive intermediation on certain names, we suggest it evaluates the use of different pricing models with restrictions on the level of rebates and fees for securities grouped together based on their liquidity or volatility profiles. Liquidity and volatility levels defining each group of securities should be clearly identified using IIROC data. Like other regulatory initiatives the benefits of taking this approach must be weighed against its costs. The introduction of new pricing categories for securities grouping will add further complexity to an already complex market. The period of time used to re-evaluate the securities in each group will lead to inefficiencies when the liquidity profiles of securities change in between the periods of categorization. And, understanding that the liquidity and volatility profiles of certain securities will always be more attractive to market makers, there will still be excessive and insufficient liquidity within a pricing category for certain names.

LEARNING FROM THE SEC TRANSACTION PILOT

We believe the CSA should not move forward with the Pilot Study whether or not the SEC Fee Pilot is implemented. However, if the SEC Fee Pilot proceeds, we recommend that the CSA let the SEC Fee Pilot be conducted independently of the Pilot Study. This approach will provide an opportunity for learning without exposing the Canadian market, issuers, and investors to the risks and cost discussed previously. Specifically, the CSA will be able to observe the impact of restricting rebates on liquidity and market quality in US traded inter-listed securities compared to these same securities traded in Canada where rebates will continue to be permitted. If rebates do in fact facilitate higher quality and more liquid markets, then the CSA will be able to confirm this belief while also positioning the Canadian market and participants to enjoy the benefits of higher liquidity on inter-listed securities traded in Canada. We acknowledge that differences in the design and scope of the SEC Fee Pilot and in the market structure of the Canadian and US markets will not allow findings from the SEC Fee Pilot to be directly applied to Canada. However general lessons will be made available for future consideration without incurring any costs.

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CONCLUSION

We commend the CSA's continued consideration in assessing the need for regulatory action that may result in enhancing market efficiency. However at this time, without data driven analysis substantiating CSA Concerns and the real risks and costs that will be introduced by the Pilot Study negatively impacting the market, issuers and investors; we do not believe the Pilot Study is justified as it violates the principle of proportionate regulation and the CSA's mandate to foster a fair and efficient market. Instead we encourage the CSA to evaluate the use of less harmful alternative approaches to address its concerns including compliance reviews of dealer disclosure and best execution obligations, mandating dealers to pass-through rebates to clients, re-evaluating exchange guaranteed execution facilities that explicitly segment order flow and taking a tiered approach to regulating trading fees. Using these approaches will help the CSA validate concerns and better position it to evaluate whether any additional regulatory action is necessary. Finally, we believe the CSA should not move forward with the Pilot Study whether or not the SEC Access Fee Pilot is implemented. If there is an SEC Fee Pilot it will provide a learning opportunity for the CSA without exposing the Canadian market, issuers, and investors to the risks.

We thank the CSA for its consideration of these comments and would welcome the opportunity to discuss further our views with staff.

Sincerely,

Nasdaq Canada

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