



CANADIAN SECURITY TRADERS ASSOCIATION, INC.

P.O. Box 3, 31 Adelaide Street East
Toronto, Ontario M5C 2H8

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

and

M^e Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22^e étage
C.P. 246, tour de la Bourse
Montréal, QC, H4Z 1G3
consultation-en-cours@lautorite.qc.ca

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

The Canadian Security Traders Association, Inc. is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 members nationwide, and is led by Governors from each of three distinct regions (Toronto, Montreal and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee (the "Committee", "CSTA TIC" or "we"), a group of 21 appointed members from amongst the CSTA. This committee has an approximately equal proportion of buy-side and sell-side representatives with various areas of market structure expertise, in addition to one independent member. It is important to note that there was no survey sent to our members to determine popular opinion; the Committee was assigned the responsibility of presenting the views of the CSTA as a whole. The views and statements provided below do not necessarily reflect those of all CSTA members or of all members of the Trading Issues Committee.

The Canadian Security Traders Association appreciates the opportunity to comment on the Canadian Securities Administrators (the CSA) proposed trading fee rebate pilot study (the “proposal” or “proposed pilot”).

General Remarks

We wish to applaud the CSA for its ongoing effort to understand the impact of trading fee rebates on the policy objective of fair and efficient capital markets and public confidence in those markets. We appreciate the need for unbiased data to support sound policy making and the complexities involved in establishing the best conditions for an objective, thoughtful and informative study.

In 2016, the CSA decided not to proceed with a study of Canadian trading fee rebates unless a similar study was undertaken in the U.S. As noted in the decision, the risk that divergence between Canadian and U.S. trading economics would cause undesirable consequences for Canada’s equity markets limited the CSA’s ability to conduct a unilateral pilot.

The CSTA TIC had previously opinion that the CSA and SEC should jointly conduct a comprehensive cross-border study of the effect of trading fee rebates¹. With the recent SEC announcement of the proposed implementation of a transaction fee pilot, this represents a unique opportunity to coordinate a study on the impact of trading fee rebates in Canada and in the U.S., decreasing the risk of regulatory arbitrage that would detract from the quality of the results of a study.

With the opportunity for a coordinated study within reach, there are certain considerations that should inform the approach of the proposed pilot. In general, we believe that the CSA and the academic team with whom they have engaged have established a core study framework that is appropriate for Canada, including coordination with the proposed U.S. study. The transparency and flexibility which has been shown to all participants through the process of developing the said framework has been commendable.

Industry Focus Areas

Since their introduction in 2005, there has been a debate in Canada as to the consequences of marketplace trading fee rebates. The following are some of the key questions that frame the debate::

- Are rebates the optimal mechanism to incentivize liquidity formation when considering behavioral and economic impacts?
- Do trading fee rebates enhance liquidity and decrease costs for investors?
- Should trading fee rebates be applied equally across all exchange traded securities?
- Is the principal-agency conflict at play and does it undermine the motivation of brokers to seek best execution for client orders?
- Are exchanges and ATSS capitalizing on the impact of rebates at the cost of industry participants, specifically in the context of an order-protected regulatory regime?
- Do the competitive dynamics caused by trading fee rebates result in unnecessary complexity and an additional cost to investors and participants?

¹ <https://www.sec.gov/comments/s7-02-10/s70210-424.pdf>

Institutional investors (whom members of our Committee either represent or furnish services to) are particularly interested in how trading fee rebates affect the following factors:

- Market impact and opportunity cost for large orders;
- Conflicts of interest in the routing of institutional orders (principal-agency);
- Cost of monitoring agency relationships for best execution;
- Long queue times for resting orders incented by rebates vs. the ability to access shorter queues by posting on markets with inversed trading rebates;
- Intraday volatility, potentially impacting confidence to trade in size for institutional asset managers and for institutional sell-side brokers to offer risk capital;
- Liquidity incentivization and the search cost to find liquidity;
- Cost of general management of complexity.

These issues are intertwined with the difficulties that institutional investors face in assessing order routing practices by dealers. Canada currently lacks a standardized framework for order handling disclosures, such as the SEC amendments to Rule 606 enacted in 2018. Some of our Committee members believe that standardized and mandated broker order handling disclosures should be required before undertaking a trading fee rebate study. Others believe that the additional data would be useful, but that the lack thereof should not delay the pilot.

In general, the CSTA TIC recognizes that enacting broker transparency requirements (similar to Rule 606) prior to the trading fee rebates' start may not be realistic and could unnecessarily delay the study. However, we would ask the CSA to make institutional order handling disclosure a priority as this topic is key to investors' decision-making on order execution.

Conducting a Canadian Rebate Pilot

The proposed structure of the Canadian trading fee rebate study has inherent advantages, including:

- The CSA and academic group are positioned to identify design considerations reflecting the unique characteristics of Canadian equities, inclusive of highly fragmented Canadian interlisted securities, as well as the questions of Canadian investors, participants and marketplaces;
- Through staggered introduction of non-interlisted names, the Canadian study offers the opportunity to diversify against confounding exogenous factors related to implementation on a single event date;
- Dialogue between Canadian and U.S. regulators and the teams charged with conducting these studies offers an opportunity for exchange of ideas and approaches which should improve the likelihood for robust study design, analytics and interpretation across both jurisdictions;
- Unlike the U.S. study, which applies only to exchanges but not ATSS, the study of non-interlisted names will be the only opportunity to examine the pure impact on the prohibition of trading fee rebates across all marketplaces;
- Access to the IIROC STEP database will provide the Canadian academic team with a comparatively robust dataset, which will afford greater ability to study the impact on the prohibition of rebates on various constituencies;

- The results of a Canadian study will not only better inform Canadian policy making but arguably U.S. and Global policy making and academic discourse on matters of market structure. This is an opportunity for Canadian leadership.

Our Committee believes it is unlikely that the study will answer all questions definitively. There will remain questions related to causality, lack of information, temporary changes in behavior vs. permanent, etc. We believe the results will, nonetheless, serve to inform policy making and support the maintenance of confidence in the secondary markets.

Pilot Sample Selection and Control Matching Procedure

Broadly speaking, we agree with the methodology that the academic team has outlined for the selection of the universe of possible corporate pilot securities. Importantly, this includes the exclusion of stocks priced at less than \$1. While some have voiced concern over the inclusion of only TSX listed securities, we believe that for the purposes of a robust study, that this is a reasonable limitation which does not significantly impact the general applicability of the study's results.

Inclusion and segmentation of "highly liquid" securities as defined by IIROC vs. "medium liquid" securities is a reasonable approach that balances the risk of less liquid securities introducing difficult to manage noise into the study vs. the need to include less liquid securities to best inform policy making.

The outlined control matching procedure described and expanded upon in Appendix I of the request for comment appears reasonable and contemplates appropriate factors of price, volume and market capitalization.

For the robustness of the study, it will be important to validate that results of this approach do not unduly introduce industry sector biases in the final treated/untreated groups – this could introduce contamination to the study. To address this, we would propose generating several random treatment assignment groups and selecting the one that achieves the highest level of sectoral balance (as measured by GICS sector or other similar classification) across the treatment and control groups.

Finally, we would underscore that sample selection and treated/untreated assignment should be geared to maximize the opportunity for a robust and meaningful study. Accordingly, there should be no ability for issuers to opt-in/opt-out of treatment/non-treatment. Sample selection and treated assignment should remain at the discretion of the CSA based on the work of the academic group leading the study.

Inclusion of Exchange Traded Products

Perhaps one of the most complex considerations in the formation of both the proposed U.S. and Canadian studies is Exchange Trade Products (ETPs). At present the U.S. study contemplates inclusion of ETPs. Participants in the U.S. articulated various complexities, confounding factors and competition considerations related to the inclusion of ETPs. Chief among these is the problem of "picking winners and losers" as it relates to the treatment/non-treatment of like (and presumed competing) products.

Generally speaking, our Committee believes that the impact of rebates on market quality in ETPs can reasonably be expected to differ materially from corporate securities. As instruments whose precise value can be derived by observing underlying securities, the difference with corporate securities lacking any such inputs to determine fair value is self-evident. Yet, while the aforementioned is sufficient to argue for a separate study of ETPs, it is not sufficient to generally argue for their exclusion from the study. The fact remains that ETPs are an important part of the trading landscape.

The request for comment correctly identifies the challenges to render the identification of matched pairs. The reasonable approach grounded in sound academic practices proposed for selecting corporates does not translate to ETPs. We are unable to offer a proven methodology for matching ETPs for the purposes of an academic study. We also do not have a solution for the controversy of “picking winners and losers”.

Despite these challenges, some members of our Committee make a compelling argument that ETPs should nevertheless be included. This is because (a) they have been included in the U.S. study; (b) failure to include them would introduce a blind spot for future policy making; and (c) there could be important findings which, forgoing the chance to study them, could jeopardize the prospect for policy action.

As such, despite the challenges, our Committee requests inclusion of ETPs with matched pair identification conducted on a best effort basis. If no established methodology can be identified, we suggest taking the U.S. lead on the chosen approach. Consultation with Canadian ETP providers may help identify a method for treatment-control pairs. Consultation to address concerns of commercial bias across providers should be part of these discussions. Exclusion of ETPs should be considered an option only once all such efforts are exhausted. In the end, given the nature of ETPs, we believe they should be included if at all possible, but impact analysis should be examined discretely from corporate securities.

Regardless of whether ETPs are included in the study, we believe that the results that are observed should lead to policy-making that is applicable to all securities including ETPs. Any policy-making resulting from the rebate pilot should apply to the market as a whole, and not only to the securities that may have been covered in the study universe. This does not preclude differentiated treatment of securities on the basis of factors such as relative liquidity or breadth of participation. Rather, we believe that market structure decisions should not discriminate between asset classes on the basis of whether certain securities were included in a pilot study whose construction is necessarily limited by practical issues (such as the difficulty of constructing matched pairs in the ETP space).

Constraints on exchanges and ATs for in-sample securities

One of the core questions related to the proposed pilot is how and to what extent exchanges and ATs should be restricted in implementing fee reduction programs, incentives, etc. for in-sample securities that might seek to simulate the economics of rebates through alternative mechanisms. Likewise, there is likewise the question of whether the existing market maker, fee or volume incentive programs may undermine the goals of the study. Our Committee believes these are important considerations.

In general, for the pilot study to be robust, we believe that transactions in treated securities must not generate any fee reductions (i.e. rebates) based on volume or any other type of activity. This restriction should extend to non-trading costs, such as connectivity and market data fees. For clarity, this would include scaled fee reductions, discounts or other such transfer economics between treated security transactions or across treated or untreated securities. Any mechanism that has such effects would be likely to undermine the purpose of the study and should be prohibited over the study period.

In our view, market maker programs should conform to the aforementioned restrictions. We understand that some market makers in the U.S. have argued that as agency conflict is not a concern for their business that the pilot restrictions should not apply to them. We disagree as we believe that the core objectives of the proposed pilot extend beyond simply studying the impact of rebates on agency conflicts. In our view, the goal should be to understand how trading inducements in the form of trading fee rebates impact all market participants – this should cover both agency and principal players.

It is important to underscore that the proposed pilot should not be likened to government price control at odds with natural competitive dynamics. Price controls are typically implemented as ceilings/floors on costs of goods or services where that cost is some positive number. The proposed pilot does not aim to regulate such fees in this way and should not be seen as such.

To summarize, it is our view that exchanges and ATs should be prohibited from offering any form of rebate or mechanisms which would have an economic effect similar to that of trading fee rebates. If exchanges wish to offer discounted fees to market makers, they should be explicit and not scale based on transactions in treated securities.

The remaining special case to be considered is the common exchange practice of tiered discounting. It is our view that the practice of broad-based tiered discounts in fees may be acceptable for the duration of the pilot provided that: (a) they are not scaled but are broad-based and stepwise tiered; (b) they are measured without regard to, or differentiated based upon treated/untreated status; (c) they do not in any way generate transfer economics within treated securities transactions (in particular active or passive trades) or between treated securities and other fee liable services that the marketplace may offer. Tiered discounting that meets these criteria would, in our view, be appropriate to offer over the duration of the proposed pilot.

We are pleased to see that Staff has contemplated the risk that marketplaces are likely to test boundaries with fee or market structure changes over the study period. Any proposed fee or major market structure change proposed by a marketplace during the duration of the pilot should demonstrate that they do not serve to frustrate the objective of the proposed pilot.

It should finally be noted that, some of our members believe that the only way to entirely eliminate conflicts in marketplace fee models would be through symmetrical pricing, suggesting that asymmetrical pricing increases the risk of complexity and conflict in trading fee models. Others believe that such a prohibition would be overly prescriptive in the context of the proposed study. However, given that the SEC pilot has introduced no such prohibition, we ultimately conclude that general alignment with the U.S. zero-rebate bucket in this regard should be sufficient to gain insight on the impact that rebates have on market structure.

Timing, Duration and Staggered Introduction of Non-Interlisted

Our Committee is of the view that for the proposed study to be meaningful, it should comprise a long enough time horizon to be impactful to all participants. In other words, the economic cost of ignoring the study should be high enough to encourage changes in behavior for all participants. We believe the proposed one- to two-year horizon for the study should be sufficient to achieve this objective.

For the purposes of the timing of the proposed Canadian study, Canadian interlisted securities should precisely mirror that of the U.S. study. This will provide the purest possible environment for which to measure the impact of a no-rebate environment on this universe of securities. Likewise, the cessation of the pilot (when determined) should be coordinated.

We believe the staggered introduction of non-interlisted names is also reasonable. This will provide a basis for which to diversify against the risk of exogenous factors to contaminate the study. It will also provide an opportunity for Canadian participants to ready their systems for any challenges that might be experienced were the entire study to be implemented on one discrete date.

Market Quality Metrics and Analysis

Our Committee expects that a breadth of market quality metrics must be examined in order to maximize the likelihood of extracting meaningful results from the proposed study. Since participants weigh the importance of metrics differently depending on their economic interests, we expect subjectivity in the interpretation of the results. We also expect that an absence of metrics covering dimensions of market quality which are typically considered important by various constituencies would risk criticism of the proposed study as lacking legitimacy.

We would suggest consideration of the following additional metrics:

- A measurement of diversity of passive liquidity across securities. If the diversity of available liquidity across Canadian markets or for particular classes of securities changes, this could impact market quality.
- Diversity of order type usage as a possible gauge for market “complexity” level.
- The opportunity cost of near-side limit orders, posted at the NBBO, which go unfilled. We believe that these opportunity costs represent a significant portion of institutional trading costs, especially in the context of scheduled trading strategies (eg. TWAP, VWAP, POV). The effect of marketplace rebates on placement strategies in such algorithms, and in turn their overall performance, is of significant interest. We would welcome any research that may quantify the effect of a prohibition on rebates on aggregate performance as measured through the lens of unfilled resting orders.

Aside from these suggestions, our Committee believes the appointed academic team has selected appropriate metrics that span the dimensions of market quality typically cited by various participants. Our review of the calculation methodology suggests the team has aptly sourced academically accepted and rigorous means to calculate the various measures and adjust for exogenous factors such as market-wide macro-volatility.

We are also pleased to see that the CSA and academic team are taking steps to provide transparency into the code that will be used to calculate the metrics. We would however caution that technical suggestions submitted via the online code repository should be carefully vetted and, where the team deems necessary, subjected to industry and/or third-party verification.

Conclusions

We are supportive of the proposed study and the efforts on the part of the CSA to improve the trading landscape. While we generally believe that the Canadian trading fee rebate study should seek to coordinate with the proposed U.S. pilot, it is our view that differing our approach to that of the U.S. in the inclusion of ATSS is warranted and will generate results that will more informative.

We also believe that it is important to prohibit marketplaces from offering transaction-linked inducements or discounts on non-transaction fees. This is admittedly more aggressive than the U.S. approach. We believe this type of restriction limits room for behavior that may undermine the opportunity to obtain a clear view of what a rebate inducement-free market structure would look like. As such, along with the inclusion of ATSS, we feel this is an important way that the Canadian pilot would be correct to differ from the U.S. approach.

In closing, we would like to reiterate our confidence in the transparency and thoughtfulness of approach that the CSA and the academic team are taking to this important initiative. Our Committee stands ready to address further or more specific questions as the process unfolds.

Thank you for your attention in this matter.

Respectfully,

“Signed by the CSTA Trading Issues Committee”

c.c. to:

Ontario Securities Commission:

Ms. Maureen Jensen, Chair and CEO
Ms. Leslie Byberg, Executive Director & CAO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

Alberta Securities Commission:

Ms. Lynn Tsutsumi, Director, Market Regulation

Autorité des marchés financiers:

M Dominique Martin, Director, Exchanges and SROs

British Columbia Securities Commission:

Mr. Mark Wang, Director, Capital Markets Regulation

IIROC:

Mr. Andrew Kriegler, President and CEO
Ms. Victoria Pinnington, Senior Vice President, Market Regulation
Mr. Kevin McCoy, Vice President, Market Regulation Policy