RBC Capital Markets®

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Via email to: tsxrequestforcomments@tsx.com

**Re: Alpha Exchange Inc. Notice of Proposed Rule Amendments and Request for Comments**

Dear Mesdames and Sirs,

We write today on behalf of the institutional division of RBC Dominion Securities Inc. ("RBCDS") in response to the above noted request for comment. RBCDS welcomes the opportunity to provide comment on these proposed rule amendments.

As we respond, we do so at a critical time for Canada's capital markets – with many concerned about the impact that predatory high frequency trading has on our markets. Today, we believe the Commission has heard these concerns and is walking a more delicate line than ever to try to foster an environment of fair and productive competition going forward. With this in mind, we are encouraged that the impact of this proposal on the Canadian equity market and participants will be carefully considered – in particular as it relates to the Commission's mandate to foster fairness, price discovery, transparency, liquidity, market integrity and competition.

The rationale TMX offers for the proposed amendments to Alpha aims to capitalize on fear of increased southbound migration of order flow out of Canadian retail networks. To be sure, shifts in the dynamics for Canadian retail order routing, associated costs and

the risk of regulatory arbitrage between Canada and the U.S. should be taken seriously. However, the broad context of concern and scrutiny around routing practices in the U.S. are equally important considerations. These factors should make us wary of sanctioning an unproven commercial model to replicate the economics of U.S.-style payment for order flow – something Canada has long deemed unacceptable in the context of our markets.

The most critical part of the Alpha proposal attempts to leverage the precedent of a "speed bump" approved as part of the Aequitas NEO Exchange.[1] In its position paper published on October 23rd, the TMX claimed that with this functionality "*providers of passive liquidity will have an increased likelihood of interacting with active orders of natural investors, while being protected against opportunistic, latency sensitive active strategies*." Headlines from major news outlets over the ensuing hours included:

- TMX Group to install 'speed bump' to slow HFT traffic ahead of Aequitas launch – *Financial Post*
- TMX to Change Equity Exchange Rules to Slow Speed Traders – *Bloomberg*
- Canada's TMX plans anti-HFT model ahead of Aequitas launch – *Reuters*
- Canada's TMX acts on predatory HFTs – *Financial Times*
- TMX says biggest threat is losing trades to U.S. – *Globe and Mail*

Most focused on TMX's implied claim – that it is curbing predatory HFT. We feel the real implications of the proposed model are very different and quite clear:

1. **The proposal would facilitate the strategies it claims to curb** – The proposed implementation of the speed bump applies to all liquidity takers – who remain (for the most part) natural investors.[2] The TMX implies this proposed implementation would be more "equitable" – something that from a practical perspective we emphatically disagree with. What is clear is that it would create entirely new challenges for natural investors with far broader implications than the Aequitas implementation, and quite likely negative outcomes for investors and, we believe, our markets.

   Within the context of a protected marketplace, the proposal places new burdens and costs on all natural investors and their agents to develop logic to cope with this market complexity. But not just complexity, the functionality will actually subject all liquidity takers to material routing delays – as much as 25 milliseconds in addition to processing and transmission time. Yet, under regulatory obligation Alpha cannot be ignored. Introducing these new, unpredictable and unavoidable delays broadly to all routed orders will create opportunity cost problems and unquestionably lead to more information leakage for natural investors. These impacts will be exponential for all investor seeking to access liquidity at multiple price levels or across Canadian and U.S. marketplaces in a coordinated fashion.

   On the passive side, Alpha would reward speed – with post only orders, no speed bump and employing the common "first past the post" time priority model. The implication here is that co-located participants will again have first look at natural investor order flow and discretion to cancel, re-price or compete for liquidity on other venues – notably, among the chief behaviors that raise concerns about the impact of HFT. In fact, approval of this model would enable, enshrine and legitimize these behaviors through regulatory sanction.

[1] For full disclosure, RBC is a minority shareholder in the parent company of Aequitas NEO Exchange.
[2] IIROC, "Identifying Trading Groups: Methodology and Results", September 9, 2014 – Table 9.

2. **It is an anti-competitive "all or nothing" solution** – Applying a randomized speed bump to all liquidity takers renders Alpha an anti-competitive "all or nothing" proposition – a significant and unprecedented development within the context of OPR. The randomized delay will force investors looking to access liquidity greater than that displayed on Alpha to choose – either access Alpha only or access other markets and forgo Alpha. Spray smart order routing approaches designed to access liquidity across marketplaces would cease to be effective – in effect forcing the serialization of routing.

   Competition through well designed and innovative spray routing techniques has been a key means for investors to cope with today's market structure. Routing in a manner that aims to hold intermediaries to orders they place on all markets has been a critical tool for investors to protect their orders against information leakage. Proliferated across most or all lit markets, the proposed model would render this coping mechanism obsolete – in the process eroding the concept of market linkage through order protection and fair competition between marketplaces. As such, by functionally demanding a first and exclusive look at investor orders, the Alpha proposal is inherently anti-competitive.

3. **It would introduce de facto investor segmentation** – By forcing investors into the aforementioned choice (Alpha <u>or</u> other OPR protected venues but not both) they will be constrained by the size displayed on Alpha. This will discourage active institutional orders and predominantly attract small-sized retail order flow – serving that flow up first to co-located top of queue HFTs attracted by shelter from investors desiring to access liquidity greater than what Alpha has to offer. In this sense, the proposed changes aim to drive a wedge between types of natural investors rather than encouraging them to interact.

4. **It would bait and switch investors** – Inclusion of liquidity displayed on Alpha will lead investors to a false sense of the liquidity available at the prevailing NBBO. The problem of phantom liquidity is not new – rather, as we have said, it is one of the chief concerns about the impact of HFT. What is different here is the inclusion of material liquidity at the NBBO that is *by definition* conditional. Introducing such liquidity to the consolidated quote <u>and</u> institutionalizing its ability to "fade" will lead to an uncertain but very likely negative impact on price discovery and certainly decreased transparency for natural investors.

5. **It will push Canada down the slippery slope** – Approval of this model would crystallize a dangerous message – that innovations, once approved, can be leveraged for any purpose with little further justification as to their application or implications. The 'why' behind applications will matter less – precisely at a time that many believe such deeper justification and understanding should be pursued.

   These developments would open the field of play for broad applications of randomized latency delay for near any purpose. At the extreme, this could lead Canada to a scenario where a decision to take liquidity across any more than one marketplace would be virtually impossible. Rather this would create a network of marketplaces legally linked through OPR but for all practical purposes conditional markets that are collectively inaccessible to investors.

Given the above it's clear the implications of this application are vastly different than how they have been marketed by TMX. How can we possibly hope for a robust comment process with such disconnect?

It is well known that innovation can stretch the limits of existing rules. The Aequitas application was such a case, where regulators needed to make a judgment call. We think it is fair to say they did so based on a careful evaluation of the professed investor-centric philosophy and purpose underpinning that model. If the proposed Alpha model is approved it will run near precisely counter to that philosophy and purpose.

To allow innovation permitted through a long and costly regulatory process to be used as precedent by the incumbent to a near diametrically opposed purpose without similarly fulsome scrutiny, dialogue and justification would be a mistake. Not only is the functionality that TMX seeks being used contrary to the permitted application – its implications would be *significantly* broader. We cannot allow exploitation of innovation for any means that yield a profit. This is even truer at a time when the regulatory framework itself is under review. In this environment we need to be guided as much by the spirit of the rules and a focus on the community of investors and issuers these markets are meant to serve.

Consider for a moment that Aequitas has a valuable commercial solution with the potential to restore equilibrium, curb excess intermediation and level the playing field for natural investors. To permit the incumbent marketplace operator to leverage the precedent of that model in an opposite fashion (turning it on investors to the benefit of intermediaries) would not only undermine its effectiveness but pull the market in opposite directions. Any notion that this would represent productive competition would be misguided – in particular consideration of the consequences we have outlined. We implore the commission to carefully consider the long-term implications of such an action.

**Retail Cost and Regulatory Arbitrage**

We acknowledge the risk posed by regulatory arbitrage relating to the practice of payment for order flow in the U.S. The relevance of this is magnified by both the comparatively small nature of our equity markets and the fact Canada remains in competition with the U.S. for equity market share in our household names. That said, we are of the view that the commercial solution proposed by TMX does not offer a holistic solution to these challenges.

Through the lens of a marketplace operator it's easy to see how retaining volume in their ecosystem is important. The plan to offer rebates for active flow will accomplish this by propagating a practice – inverted taker-maker pricing – that we believe contributes to perverse asymmetrical incentives and inefficiencies in equity markets by putting broker interests in <u>direct conflict</u> with the interests of their clients.

Such marketplaces generally attract niche liquidity in ETFs and low price names where spread compensates for the lack of a rebate. Liquidity on these venues in high price names is less meaningful – consisting largely of single board lot orders. These orders contribute to venue and trade fragmentation, latency arbitrage and information leakage.

We are not in a position to specifically scrutinize the merits of the proposal to enforce minimum posting size by name – as no details on this have been offered. At the end of the day this, the economics and risk appetite of liquidity providers will introduce

constraints to bring liquidity to Alpha. Again, this means the ability of this model to truly address the issues it purports to will be similarly constrained and far from comprehensive. Outside of this volume, the remainder will continue to be free to ship to U.S. wholesalers.

Overall, it is our view that the proposed model will have limited ability to advance the policy objective of retaining retail order flow in Canada. Rather, the solution will be far from complete – yet will introduce many negative consequences. Among these, it would undermine the ability of natural investors to effectively access liquidity across marketplaces, enable behavior that many investors have voiced concern with and again tilt the tables towards excess intermediation.

Ultimately, the appropriate policy response to the regulatory arbitrage problem may lie in the previously proposed but never implemented dark anti-avoidance rules. The key to success here will be to fashion a policy response that does not unreasonably hinder the seeking of best execution across North American equity markets (in particular for institutional investors) but prevents default bulk shipment out of retail networks without meaningful price improvement relative to the Canadian quote. While the previously proposed rules had some gaps, we believe it is possible to address them.

**Fair Access**

Section 5.1 of NI 21-101 states that a marketplace must not "*permit unreasonable discrimination among clients, issuers and marketplace participants*" or "*impose any burden on competition that is not reasonably necessary and appropriate.*" Section 5.8 continues that a marketplace must not "*impose terms that have the effect of discriminating between orders that are routed to the marketplace and orders that are entered on the marketplace for execution.*" Furthermore, the Maple Recognition Order states that a recognized exchange "*must not provide discounts or rebates that are accessible only to, by design or implication, a class of market participants, except with the prior approval of the Commission.*"

*Unreasonable discrimination by design or implication*

What is clear from the above is that the approval of any functionality designed to segment between classes of participants is at the discretionary power of the Commission. How and in what cases this discretion is used is understandably vague. We believe this power constitutes a safety valve that contemplates innovation outside the context of existing rules.

It is our view that this discretion calls for more than confirmation that a tool has precedent and does not expressly violate existing rules. Rather it requires an understanding of its unique application and implications for different classes of participants and consistency with the spirit of existing rules and evolving policy goals of the Commission.

*Discrimination against routed orders*

In fact, it is our view that the proposed speed bump functionality is in violation of Section 5.8 of National Instrument 21-101. As we have said, the practical application of the proposed implementation of a randomized speed bump will be to render impractical and ineffective the use of any smart order router designed

to consume liquidity across multiple displayed marketplaces in compliance with OPR. It is our belief that this randomized speed bump would by design discriminate against liquidity taking orders *routed* across multiple marketplaces (either by an exchange smart order router or that of a participant) in favor of directed liquidity taking orders targeted to consume liquidity on Alpha only.

By comparison, the precedent set by the Aequitas NEO Exchange implementation is focused only on latency sensitive traders ("LSTs"). Prominent among the driving factors for this implementation was to prevent co-located LSTs (latency sensitive, and as such, typically not passing through a smart order router) from competing with natural investors for liquidity across marketplaces in the process known as latency arbitrage. The approved Aequitas implementation provides shelter to liquidity providers from this and other problematic behavior.

By applying to all, the proposed Alpha implementation turns the entire concept of a speed bump on its head by subjecting all liquidity takers (including all liquidity consuming investors) to non-deterministic behavior that cannot be reasonably managed. It is our view this represents a clear discrimination against routed orders and as such would represent a violation of Section 5.8.

**In Summary**

Seen through any reasonable lens the application of the precedent established by the approval of the Aequitas NEO Exchange speed bump has drastically different implications in scope and functionality within the context of the Alpha proposal. Failure to sufficiently explore these implications would validate every warning offered during the Aequitas comment process of floodgates through precedent.

In our view the implications of this proposal are clear. They will come in the form of:

- Increased intermediation;
- advantages to fast, passive, co-located participants who will compete to exploit them across all other marketplaces;
- de facto segmentation of classes of natural investors;
- institutionalization and new regulatory sanction for latency arbitrage and conditional "all or nothing" marketplaces within the NBBO;
- decreased marketplace transparency and increased complexity for natural investors and their agents;
- proliferation of a precedent without proper exploration as to anticipated consequences contemplating its specific application;
- proliferation of perverse inverted taker-maker pricing that pays brokers to remove liquidity, placing broker interests in direct conflict with those of their clients.

Aside from these concerns, there is every reason to believe that the ability of the proposed changes to further the policy objective of retaining retail order flow in Canada will be limited at best. The question also remains open as to whether a rules-based regulatory response will be the most appropriate way to achieve this objective. While these remain the case we fail to see how retention of order flow in Canada can then be held in support of this proposal – in particular given the concerns we have outlined.

In order for the comment process to function effectively it needs to be founded on well-informed and transparent debate. As framed, the proposal leads to neither. On this basis, and due to the aforementioned concerns, we are of the view that this application should be rejected as proposed.

Please do not hesitate to contact the undersigned should you require any further details.

Regards,

Stephen A. Bain
Managing Director – Global Equities
RBC Capital Markets