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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,
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Virtu ITG Canada response to the Trading Fee Rebate Pilot Study

Virtu ITG Canada Corp. would like to thank the Ontario Securities Commission ("OSC") for this opportunity to comment on proposed Trading Fee Rebate Pilot Study.

Our thoughts on these proposals, and all market structure matters, are largely influenced by the over-arching desire to foster a fair, competitive and healthy market, underpinned by a high level of transparency provided by Liquidity Providers. We applaud the approach of a data-driven pilot, with clearly defined goals, and metrics.

Answers to questions for the market participants

1. We propose to define a security as medium-liquid if it trades at least 50 times a day on average and more than $50,000 on average per trading day over the past month. Do you believe that this definition

is appropriate? If not, please provide an alternative definition and supporting data, if available, to illustrate which securities your definition captures.
The definition of medium liquidity, as stated, seems very low. Stocks that trade less than $50,000 CAD a day would typically be defined as illiquid in most developed markets. Having said that, our analyses using 2019 data suggests that this standard will remove ~ 62% of TSX listed names from the pilot. In the interest of ensuring a reasonable subset of stocks to study, we believe the definition should stand.

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.

To the extent that the CSA can get the pilot approved and finalized, and give industry participants reasonable time to code and test changes for the pilot, we are in favour of the proposed timing. Should the staggered start require the regulators to reduce the lead time offered up to the street, we would be opposed to such move.

3. Several Canadian marketplaces offer formal programs that reward Liquidity Providers with enhanced rebates in return for liquidity provision obligations. On the one hand, such programs may benefit liquidity. One the other hand, one of the primary objectives of the Pilot is to understand if rebates cause excessive intermediation. In your opinion, should exchanges be allowed to continue using rebates or similar arrangements for market making programs during the Pilot? Do you believe any constraints on such programs during the Pilot to be appropriate?

We believe that this is the most interesting and difficult question put forth. The Canadian regulators have long desired to study maker taker pricing, but have held off out of concern that such a study, done alone, would harm the competitiveness of the Canadian market relative to the U.S. We applaud this stance, and believe that similar concerns should inform our answer on this issue.

The US Transaction Fee Pilot clearly contemplates exchanges being able to offer “non-rebate linked pricing to its registered market makers in consideration for meeting market quality metrics” for the no rebate bucket (bucket 2)[1]. We believe that the Canadian markets need to be afforded the ability to compete on an even footing with their US competitors. Marketplace participants benefit from marketplaces globally, and seek various sources of liquidity. The liquidity ecosystem is composed of: (1) retail and agency orders, (2) market makers; and (3) principal liquidity, all of whom enjoy symbiotic relationships that stitch together the marketplace fabric; one participant cannot survive alone without the other.
Consequently, we are of the view that Canadian marketplaces should be allowed to offer similar incentives for liquidity provision, which would support a healthy ecosystem. Such incentives should be allowed at all Canadian marketplaces, to ensure that primary listing venues don’t derive an unwarranted monopoly on Liquidity Provider liquidity. The incentives offered to principal Liquidity Providers should be clearly linked to their quoting, and trading obligations, like the market making programs that NYSE offers to DMMs[2] and SLPs[3]. Regulators are wise to calculate and weigh the benefits to, and risks taken by, Liquidity Providers to ensure they are proportionally rewarded for their efforts. To mitigate any cross-border arbitrage, and to foster healthy competition, regulators would also want to ensure that Canadian marketplaces can compete with US marketplaces for liquidity.

[1] https://www.sec.gov/rules/final/2018/34-84875.pdf page 370, section (2)
[2] https://www.nyse.com/publicdocs/nyse/listing/fact_sheet_dmm.pdf
[3] https://www.nyse.com/publicdocs/nyse/listing/fact_sheet_slps.pdf

4. We propose to compute price impacts at the one- and five-second horizons. Do you believe that we should consider other horizons? If so, which ones?

While we agree there would be a benefit to compute price impact based on different time horizon segments, there might be greater utility computing the price impacts based on different order intent. For example, the price impact analysis should vary between orders that (1) exhaust the entire visible quote; (2) only consume a portion of the visible quote and don't change the quote; or (3) consume quotes in some variant, such as orders that target dark orders and don't move the quote. Such analysis could better inform the market about both the quality of liquidity offered by various venues, as well as the shifting nature of liquidity resulting from the pilot. We might then be able to answer questions such as whether the removal of rebates impact: (1) the liquidity profile of dark and lit marketplaces; (2) the refresh rates of quotes in lit marketplaces; (3) the overall liquidity profile of certain stocks; (4) spreads; (5) Best Execution for clients.

5. We propose to compute time-to-execution for limit orders posted at the CBBO prices or improving these prices. Do you believe that we should consider different price levels? If so, which ones? Please provide supporting data and analysis, if available, to demonstrate the empirical importance of order postings at other levels.

We believe that time to execution should only be computed against orders that are at, or improve, the CBBO on entry, or after the quote moves such that an order is now at the CBBO. To understand why, let's consider the recent SEC rules for institutional 606 reports. These rules require dealers to report the "average time between order entry and execution or cancellation for orders providing liquidity"[4], regardless of whether the order is at the CBBO at time of sending. We believe this metric is flawed, as non-CBBO orders will muddy the results, and dealers could be incented to send fewer off market orders, in the pursuit of better results versus an imperfect metric. Such a behavioral change from the dealer community would likely result in less liquidity beyond the NBBO, greater quote volatility, and more fragile markets.

Orders are placed away from the CBBO for a variety of reasons: (1) price-limited orders; (2) opportunistic orders looking to capture the benefits of contra short term aggressive orders; (3) orders informed by some micro-term alpha signal. Regardless of the reason, orders that are placed away from the CBBO can have very different intentions than those at, or improving, the CBBO on entry. Thus, it would distort results to include orders placed away from the CBBO. The goal of the study should be to determine the impact of rebates on liquidity, and broker conflicts for marketable, or near marketable orders. Thus, it would be logical to flag orders as marketable or non-marketable at the time when the order is submitted, and then measure how long it takes for non-marketable orders to become marketable.

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.

As highlighted in our answer to Question 4, we believe that understanding the impact of the pilot on different types of orders would be most useful. While understanding the aggregate impact of the study is important, it will be equally important to appreciate how different types of participants and orders are impacted. For example, if the study were to appear slightly beneficial in aggregate, but somehow negatively impact the quality of the opening or closing auctions, it would be important to know this.

[4] https://www.sec.gov/rules/final/2018/34-84528.pdf page 108

Ideally, we would have greater clarity on how the study impacts liquidity taking, liquidity supplying, lit, dark and auction trades.

While not specifically mentioned in the proposal, or related questions, we do think the study provides an excellent opportunity for Canada to consider the adoption of US style 606 reports.

Traditionally the US market has mandated retail brokers to provide 606 reports, to demonstrate the execution quality of "held" orders. These reports have historically been used by US retail dealers to demonstrate fill quality, and allow retail clients to better compare the various dealers. Such reports have been deemed less necessary in Canada, due to the lack of bilateral off-exchange trading of retail flow. However, in recent years some Canadian dealers have managed to replicate US style "wholesaling" using on exchange tools. As such, we believe the evolving nature of retail execution warrants a fresh look at providing execution metrics for non-discretionary order flow.

Recently, the SEC has issued new rules for 606 reports of "not held" orders, more commonly used by institutional clients. These reports are designed to highlight any broker routing conflicts. As such conflicts are the single biggest driver of the Transaction Fee Pilots, on both sides of the border, it makes sense to improve broker routing transparency in line with the pilot. As most dealers will be building out reporting for US flow, the cost of building similar reports for Canadian order routing should be minimal.

7. We have had extensive discussions with a number of market participants on whether to include exchange-traded products (ETPs) in the Pilot, and some participants suggest that such an inclusion is warranted. Nevertheless, others point out that trading characteristics of ETPs are substantially different from those of corporate equities and including ETPs will present significant challenges in the matching stage and will likely confound the results in the analysis stage.
These participants and our own research identify the following concerns:

• most liquidity in ETPs is determined and provided by contracted Liquidity Providers, and the ETP creation/redemption process represents its own source of liquidity;

• matching characteristics that we propose to use for corporate equities do not have the same meaning for ETPs. For instance, ETP fund size is not a relevant metric, and ETP trading volume is usually not correlated with quoting activity or liquidity;

• spillover effects of two types may confound the results. First, liquidity in ETPs relates to liquidity of the underlying basket of securities, and if the basket is significantly affected by the Pilot, the ETP will be affected too. Second, ETPs that follow the same baskets may be viewed not only as good matches, but also as substitutes for investment, hedging, and trading purposes. If one of them is selected to be treated, and the other is not, market participants may move between products, potentially confounding the results of the Pilot.

The above-mentioned concerns make finding matched ETP pairs a uniquely challenging task. To the best of our knowledge, there is no established procedure for matching ETPs to study their trading costs.

As such, in relation to ETP inclusion, we ask that market participants consider the following questions: Given the challenges that ETP matching presents, can the goals of the Pilot be achieved without

including ETPs in the sample? If ETP inclusion is important, can you propose a way to construct a matched sample that addresses the concerns identified above?

ETPs trade very differently from corporate issues. As a derivative, the pricing of each ETP is closely related to the pricing of the underlying, as determined by an active market making community. We believe it is more likely that Liquidity Providers are using the rebates to inform their net pricing. This would explain why we often see multiple participants bidding for an ETP at a price slightly greater than NAV, or offering slightly below NAV. Given this difference in trading behaviour, and sensitivity to Liquidity Provider pricing, we would suggest that ETPs either be removed from the pilot, or considered separately when computing the results.

Aggregating metrics for corporate issues alongside ETPs, may give a result that is suboptimal for both asset types.

In conclusion, we thank the CSA for allowing us to comment on the proposed pilot. We would be happy to address any questions you may have.

Sincerely,

Doug Clark
Virtu ITG Canada Corp.