CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

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

December 18, 2018

Executive Summary

The Canadian Securities Administrators (**CSA** or **we**) are publishing for comment a proposed Trading Fee Rebate Pilot Study that would apply temporary pricing restrictions on marketplace transaction fees applicable to trading in certain securities (**Proposed Pilot**). We are publishing the Proposed Pilot for a 45-day comment period to solicit views. We are seeking comment on all issues raised in this notice, including the design of the Proposed Pilot that is contained in the Design Report at Appendix A, as well as the specific questions raised within it.

The comment period will end on February 1, 2019.

I. Introduction

The CSA has been considering a pilot study on the payment of trading fee rebates for many years in relation to our continued work to foster fair and efficient capital markets and confidence in capital markets. On May 15, 2014, we published a Notice and Request for Comment (the **2014 Notice**) that proposed amendments to National Instrument 23-101 *Trading Rules* (**NI 23-101**) in relation to the order protection rule (**OPR**).[1] On April 7, 2016, as a result of our review of OPR, we published a Notice of Approval of Amendments to NI 23-101 and Companion Policy 23-101CP (the **2016 Notice**).[2] In the 2016 Notice, we acknowledged that we had been considering a pilot study for a number of years but, due to certain risks arising from the interconnected nature of North American markets and securities that are interlisted in the United States, we decided not to move forward with a pilot study unless a similar study was undertaken in the United States.[3]

On March 14, 2018, the United States Securities and Exchange Commission (**SEC**) proposed new Rule 610T of Regulation National Market System (**NMS**) that would conduct a transaction fee pilot for NMS securities (the **Proposed SEC Transaction Fee Pilot**),[4] and, as a result, an opportunity has emerged to move forward with a Canadian pilot study.

On March 16, 2018, we published CSA Staff Notice 23-322 *Trading Fee Rebate Pilot Study*[5] to provide an update on our plans to study the impacts of transaction fees and rebates on order routing behaviour, execution quality, and market quality, and noted that we have been engaged in dialogue with SEC staff on this issue.

We are publishing for comment the design and specifications of the Proposed Pilot to solicit feedback. We will continue discussions with SEC staff about coordinating the pilot studies,

[1] Published at: (2014) 37 OSCB 4873.
[2] Published at: (2016) 39 OSCB 3237.
[3] Please refer to section 7 *Pilot Study on Prohibition on Payment of Rebates by Marketplaces* in (2016) 39 OSCB 3237.
[4] Published at: https://www.sec.gov/rules/proposed/2018/34-82873.pdf.
[5] Published at: http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20180316_23-322_trading-fee-rebate-pilot-study.htm.

where possible and appropriate.

II. Background

Trading Fee Models

The "maker-taker" trading fee model originated in the United States as a method by which new marketplaces could attract orders and compete with established exchanges. The maker-taker model attracts orders through the payment of trading rebates. When a trade occurs, the participant that enters the liquidity providing order displayed in the order book (i.e. "makes" liquidity) is paid a rebate and the participant who removes that order from the order book (i.e. "takes" liquidity) is charged a fee. The fee is higher than the rebate and the difference between the two is the trading revenue earned by the marketplace.

In Canada, the maker-taker model was first introduced by the TSX in 2005 in order to compete with marketplaces in the U.S. trading interlisted securities. Since that time, and as marketplace competition emerged in Canada, the use of rebate payments to attract orders has become the standard fee model employed by Canadian marketplaces. The maker-taker model has also evolved to include an "inverted maker-taker" or "taker-maker" fee model, where the provider of liquidity pays a fee and the liquidity remover receives a rebate when a trade occurs.

Potential Issues Identified

In the 2014 Notice, we expressed our view that the payment of rebates by a marketplace is changing behaviours of marketplace participants. As elaborated below, the payment of rebates may be:

- creating conflicts of interest for dealer routing decisions that may be difficult to manage;
- contributing to increased segmentation of order flow; and
- contributing to increased intermediation on actively traded securities.

(a) Conflicts of Interest

Dealers that manage client orders make decisions regarding the marketplaces to which these orders will be routed. The payment of a rebate by a marketplace raises a potential conflict of interest when a dealer must choose between routing an order to a marketplace that pays them a rebate or to a marketplace that charges them a fee, neither of which are typically passed on to the end client. A decision to route orders based on costs may conflict with routing orders in a manner that results in the best outcome for clients. For example, the payment of a rebate may create a conflict of interest for dealers who must pursue the best execution for their clients' orders while facing potentially conflicting economic incentives to avoid fees or earn rebates. A dealer that routes to a marketplace that offers a rebate but does not offer high execution quality (i.e. orders are either less likely or take longer to execute) may ultimately provide suboptimal outcomes for clients.

This potential conflict has been the subject of academic literature including Angel, Harris, and

Spatt 2010[6] and Battalio, Corwin, and Jennings 2016,[7] and was also highlighted by the International Organization of Securities Commissions (**IOSCO**) in a December 2013 publication, *"Trading Fee Models and their Impact on Trading Behaviour: Final Report"* (the **IOSCO Report**).[8] The IOSCO Report notes that

> …various jurisdictions raised concerns about the potential conflicts of interest [trading fees or trading fee models] may create – for example, by providing incentives to enter into transactions for improper purposes (such as increasing trading volumes solely for the purposes of achieving volume-based incentives) or by impacting routing decisions based on earning a rebate or discount for the participant at the expense of the quality of best execution for its client.[9]

In prohibiting the payment of marketplace rebates for a test group of securities, we believe the Proposed Pilot will provide an opportunity to understand any inherent conflicts for dealers and study both changes in order routing practices and impacts on market quality measures.

(b) Segmentation of Orders

In the context of the execution of orders, segmentation refers to the separation of orders from one class or type of market participant to other classes or types of market participants, and in the Canadian context, is often associated with the orders of retail investors. For instance, it is our understanding that a key driver for the introduction of the inverted maker-taker model was to attract orders from dealers that are more cost-sensitive to "take" fees, such as retail dealers. Retail investors may tend to demand immediacy of trade execution (i.e. use marketable orders) more frequently than other types of clients. As a result, retail dealers often "take" liquidity from order books and may choose to route orders to marketplaces with an inverted maker-taker model, where they receive a rebate rather than pay a fee.

The use of different fee models that pay rebates to different sides of a trade may be contributing to the segmentation of orders by type of client. The Proposed Pilot will study any changes in dealer routing practices based on type of client in an environment where for certain securities rebates do not play a role in influencing decisions.

(c) Increased Intermediation on Actively Traded Securities

It was argued that marketplace rebate payments have contributed to increased market participation by intermediaries that provide liquidity to Canadian marketplaces. In the 2014 Notice, we highlighted the concern 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. The Proposed Pilot will study the level of intermediation on Canadian marketplaces

---

[6] "*Equity Trading in the 21st Century,"* May 2010, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584026.
[7] *"Can Brokers Have It All? On the Relation between Make-Take Fees and Limit Order Execution Quality,"* available at https://onlinelibrary.wiley.com/doi/abs/10.1111/jofi.12422.
[8] "*Trading Fee Models and their Impact on Trading Behaviour: Final Report*," available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD430.pdf.
[9] *Id.*

where the payment of rebates to providers of liquidity is prohibited for certain securities.

III. Summary of the Proposed Pilot

The objective of the Proposed Pilot is to study the effects of the prohibition of rebate payments by Canadian marketplaces. In July 2018, we selected and retained three Canadian academics (the **Academics**)[10] to design the Proposed Pilot and measure the results. While greater detail can be found in the Design Report at Appendix A, a summary of the Proposed Pilot is set out below.

(a) Timing and Duration

The Proposed Pilot will run concurrently with the Proposed SEC Transaction Fee Pilot, and thus timing is dependent both on SEC approval of their proposed rules and the date of implementation. Should timing of the Proposed SEC Transaction Fee Pilot permit, the intention is to implement the Proposed Pilot on a staggered basis consisting of two stages:

1. non-interlisted stocks three to six months prior to the implementation of the Proposed SEC Transaction Fee Pilot; and
2. interlisted stocks in tandem with the implementation of the Proposed SEC Transaction Fee Pilot.

(b) Applicable Marketplaces

The Proposed Pilot will be applicable to trading rebates paid by Canadian marketplaces, both exchanges and alternative trading systems (**ATSs**), for the execution of an order with respect to certain equity securities outlined in more detail below.

(c) Proposed Pilot Securities

The Proposed Pilot will include a sample of securities selected from a list of highly liquid securities that is prepared and published by the Investment Industry Regulatory Organization of Canada (**IIROC**) [11] and a sample of actively traded, medium liquidity securities that will be constructed by the Academics. These sample securities will include both interlisted and non-interlisted common stocks.

A matched pairs design will be used to find securities that closely match on a set of characteristics such as firm size, share price, and/or trading volume, and then a treated security and a control security will be randomly selected from each pair.

We do not believe that the Proposed Pilot will harm issuers even though it may result in the elimination of trading fee rebate incentives that would otherwise be used to attract posted liquidity in certain securities. While the Proposed Pilot will eliminate trading rebates in certain

[10] http://www.osc.gov.on.ca/en/NewsEvents_nr_20180801_csa-trading-fees-rebates-pilot-study.htm. The CSA has selected the following group of researchers with expertise in Canadian equity market structure to design and conduct the pilot study: Katya Malinova, Andriy Shkilko and Andreas Park.

[11] Please see: http://www.iiroc.ca/industry/rulebook/Pages/Highly-Liquid-Stocks.aspx.

securities, it will not impact the application of OPR. Marketplaces that display protected orders will continue to receive trade-through protection under OPR,[12] which may continue to serve as an incentive to attract liquidity.

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. The cost of capital for issuers is determined by a number of factors, most of which are not impacted by secondary market trading activity.

While the Proposed Pilot is limited in scope (for instance, it does not include illiquid securities or exchange traded products), this is because a study is, by nature, limited. The exclusion of certain securities from the Proposed Pilot is in no way intended to signal that these securities will not be subject to whatever policy actions are taken as a result of the findings of the Proposed Pilot.

(d) Proposed Pilot Design

The Proposed Pilot will prohibit the payment of trading fee rebates by marketplaces with respect to trading in treated securities.[13] The Academics will conduct an empirical analysis based on market quality metrics and compare the treated securities with the control securities. This statistical analysis will investigate the effects of the prohibition of rebates both pre- and post-implementation of the Proposed Pilot.

As the purpose of the Proposed Pilot is to study the effects of prohibiting rebates, the design relies on only this prohibition. In relation to studying conflicts of interest in order routing, we recognize that prohibiting rebates alone will not eliminate all conflicts and, in consultation with the Academics, we considered alternative approaches such as mandating symmetrical marketplace fee models.[14] Although symmetrical fee models may better control for conflicts of interest, we ultimately decided that this approach would be overly prescriptive and limit the ability of marketplaces to compete to attract orders. For this reason, we have proposed only a rebate prohibition for the treated securities.

In order to ensure that the Proposed Pilot meets the objective of providing a better understanding of the effects of the prohibition of rebate payments on Canadian marketplaces, marketplaces seeking to implement either a fee or major market structure change throughout the implementation period of the Proposed Pilot will be required to demonstrate to the CSA that such a change does not interfere with this objective. The regulators may seek public comment on these changes to aid in making such determinations.

Please refer to the attached Design Report for more details. Please also refer to GitHub for ongoing code and data analysis from the Academics as the Proposed Pilot moves forward.

---

[12] See https://www.osc.gov.on.ca/documents/en/Securities-Category2/sn_20160620_23-316_order-protection-rule.pdf.

[13] This will include the prohibition of rebate payments for intentional crosses.

[14] Symmetrical marketplace fee models charge the same fee to both sides of a trade.

(e) Local Matters - Implementation

In Ontario, the Proposed Pilot will be implemented by orders of the Ontario Securities Commission (the **Commission**) under s. 21(5) and s. 21.0.1 of the *Securities Act* (Ontario), as applicable for each exchange and ATS carrying on business in Ontario. Where a marketplace pays a trading fee rebate with respect to trading in a security that is included in a treatment group in the Proposed Pilot, the Commission will order that marketplace to file a fee amendment that would eliminate the rebate payment for the duration of the Proposed Pilot. The Commission will also order that for the duration of the Proposed Pilot, where a marketplace seeks any amendment to its Form 21-101 F1/F2, including the exhibits thereto, that marketplace will file submissions that satisfy the Commission that any such proposed amendments do not negatively impact the objective of the Proposed Pilot. A draft model order for both an exchange and an ATS is attached at Appendix B. Note that should we have any concerns about the Proposed Pilot following its implementation, we will immediately apply to the Commission for orders under s. 144 of the *Securities Act* (Ontario) revoking or varying the orders issued under ss. 21(5) and 21.0.1, as applicable.

In other jurisdictions, the Proposed Pilot will be implemented by orders of such jurisdictions, as applicable.

IV. Next Steps

The CSA will seek public comment on the Proposed Pilot for 45 days following the publication of this proposal, and if implemented, will monitor the Proposed Pilot on an ongoing basis and evaluate the results. Prior to implementation, the CSA will also be requesting that marketplace participants advise the CSA what actions they are taking or will take to comply with the Proposed Pilot.

We invite participants to provide input on the issues outlined in this public Consultation Paper. You may provide written comments in hard copy or electronic form. The consultation period expires **February 1, 2019.**

Please submit your comments in writing on or before **February 1, 2019**. If you are not sending your comments by email, please send a CD containing the submissions (in Microsoft Word format).

Address your submission to all of the CSA as follows:

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

Deliver your comments **only** to the addresses below. Your comments will be distributed to the other participating CSA regulators.

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

M[e] Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square Victoria, 22[e] étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax : 514-864-6381
Consultation-en-cours@lautorite.qc.ca

V. Questions

Questions and comments may be referred to:

Kent Bailey Trading Specialist, Market Regulation Ontario Securities Commission kbailey@osc.gov.on.ca	Alex Petro Trading Specialist, Market Regulation Ontario Securities Commission apetro@osc.gov.on.ca
Heather Cohen Legal Counsel, Market Regulation Ontario Securities Commission hcohen@osc.gov.on.ca	Serge Boisvert Analyste en réglementation Direction des bourses et des OAR Autorité des marchés financiers serge.boisvert@lautorite.qc.ca
Roland Geiling Derivatives Product Analyst Direction des bourses et des OAR Autorité des marchés financiers roland.geiling@lautorite.qc.ca	Maxime Lévesque Analyste aux OAR, Direction des bourses et des OAR Autorité des marchés financiers Maxime.levesque@lautorite.qc.ca

Sasha Cekerevac Regulatory Analyst, Market Regulation Alberta Securities Commission sasha.cekerevac@asc.ca	Bruce Sinclair Securities Market Specialist British Columbia Securities Commission bsinclair@bcsc.bc.ca