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Structural Differences Between Canadian and U.S. Equity Markets
Have Different Implications for Market Fairness

Over the last few years, the proliferation of High Frequency Trading ("HFT") in Canadian equity markets has generated considerable debate about the impact of this type of electronic trading activity on investors in secondary equity markets. HFT, which relies on sophisticated technology and considerable advantages in trading speed, has raised concerns about inherent fairness among investors in equity markets, and whether regulatory intervention is appropriate.

The recent publication of the latest Michael Lewis book "Flash Boys" and its allegations that HFT has led to investors' interests being compromised has ratcheted this debate to a much higher level. Balanced discussions about the costs and benefits of HFT have been displaced by emotional rhetoric, and repetition of Lewis's extreme allegation that "the markets are rigged".

As a starting point, let me state categorically that the Canadian equity markets are definitely not "rigged". The Canadian markets operate efficiently, and serve investors with a high degree of integrity. The issues and problems in the equity markets articulated in Lewis's book (albeit with its inaccuracies and exaggerations) relate primarily to U.S. markets. Canadian equity markets have gone through enormous structural change in terms of new marketplaces, new patterns of trading, new technology and new participants. These changes, however, have come to Canadian markets more slowly than in the United States, mainly because the successive waves of market change have been accompanied by carefully crafted rules and regulations to protect investors, and ensure fairness and integrity of markets. Canadian regulations have been developed to place priority on transparency, fair access, and the price discovery process.

The unique design of Canadian rules often reflect the lessons learned from U.S. market changes that presage change in our markets, and the experience with the U.S. rule framework. This has resulted in a vastly different market structure and correspondingly different investor behaviour in Canada. As a result, market observations and developments in the U.S. cannot simply be extrapolated to the Canadian context.

The structural differences between the respective markets are significant. For example, there are numerous "dark pools", or non-transparent markets, with some 40-plus dark trading venues operating south of the border. According to the SEC, as much as half of natural investor order flow is executed "in the dark". In contrast, trading through dark pools in Canada accounts for less than 10% of overall trading, reflecting stiffer rules for trades on dark pools such as required price improvement, fair access and order exposure. These rules ensure "lit" markets dominate secondary trading activity, promoting transparency, more efficient pricing though better price discovery, and result in more confident investors.

Payment for order flow is another characteristic of U.S. equity markets which is generally not permitted in Canada. U.S. brokers are permitted to sell their client order flow to other brokers that can utilize techniques such as internal electronic trade matching to generate the highest return for the firm, which may not necessarily lead to best execution for the client. Much of this trading occurs in dark pools or broker/wholesale dealer matching engines, without material price improvement over orders in the lit markets, without exposure to the order books in lit markets, and without interaction with other natural investor orders. The channeling of purchased order flow to dark pools compromises transparency and the price discovery process. In this regard, the SEC announced it will investigate this practice in more detail. With limited ability to facilitate payment for order flow, Canadian markets are permitted to internalize or match off internal broker orders under very strict conditions on marketplaces.

The Lewis book focuses on the abuses of HFT in secondary markets. It should be recognized that the business models of HFT firms are complex and differ considerably across the markets, ranging from predatory techniques to sniff out large transactions, to engaging in arbitrage strategies that are important to the price discovery process. HFT firms include entities such as specialized traders with a variety of strategies, as well as conventional brokers. While the debate about the benefits of HFT has been vigorous and sometimes caustic, the general consensus is that, on balance, certain HFT provides advantages to the markets and investors. This includes arbitraging various index products, as well as Canadian inter-listed shares across markets, and providing liquidity and tighter bid-offered spreads in small lot share transactions.

However, one must bear in mind that HFT has the potential to create unfairness in secondary markets. For example, HFT firms can take advantage of sophisticated technology to interpret trading patterns to detect large orders and then “front-run” these orders. In addition, they can use technology and other techniques to execute orders and trades at much faster speeds than typical investors, to get in front of posted orders, as well as receive and respond to data and news ahead of the general market. While market participants have made efforts to mask trading signals and information leakages to evade HFT interference, and regulators ensure public information is accessible to all investors at the same time, many market participants still call for further remedial action. The good news is that industry awareness has improved. As a result, when obvious abusive practices are identified, such as the use of Flash Orders in the U.S., marketplaces and participants are forced to discontinue these practices.

In addition, we are encouraged to see important stakeholders in the equity markets stepping ahead of expected pending regulatory reform. For instance, one bulge bracket U.S. broker announced its intentions to route more order flow to the investor friendly marketplace at the centre of the Lewis book, IEX. And, earlier this month, the NYSE announced that it plans to voluntarily eliminate certain order types in a first step "towards making our markets less complex".

Although the regulatory and structural differences between Canada and the U.S. result in a different trading environment with different vulnerabilities for abuse, there are some practices in the Canadian marketplace imported from U.S. market evolution that have raised concerns about their impact on market integrity. Like their peers to the south, Canadian regulators continue to examine the impact on market integrity and market quality of issues such as co-location, maker-taker fees, the proliferation of order types and faster access to market data to certain subscribers. While further investigation may be warranted, it is important that in order to avoid unintended consequences, suggested problems be well understood before remedial regulatory action is undertaken. In general, Canadian regulators have taken a more methodical and measured approach to regulation, avoiding interference from the political process that has characterized U.S. regulation.

For example, IIROC initiated an investigation of the dimension and impact of HFT on Canadian markets in 2012. The purpose of the study is to identify trading activity that is potentially harmful to the markets, and introduce appropriate remedial action, if required. The study, which is extremely rigorous in terms of its examination of vast amounts of data, is now in its final stage and will focus on the impact analysis. The conclusions are expected near year-end. In addition, in a recent publication, the regulators are seeking information and comment from industry participants and the public on the impact of proposed changes to the Order Protection Rule on protected markets, the maker-taker model and market data fees. This rigorous approach to regulation will largely mitigate the risk that existing abusive practices now under scrutiny in the U.S. will become widespread in Canada.

It is important for investment industry professionals in Canada to understand and convey to their clients that the Canadian markets are governed by an effective and evolving regulatory framework, prudently designed to minimize abuse and ensure investors are treated fairly. The Investment Industry Association of Canada and its member firms will continue to support and cooperate with regulators in identifying improper market behaviour and ensure that our markets remain efficient, competitive and fair.

Yours sincerely,

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