



May 25, 2020

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and

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Re: 13.2.3 Lynx ATS – Notice of Proposed Changes and Request for Comment

XTX Markets LLC appreciates the opportunity to provide comment to the Ontario Securities Commission (OSC) on Omega Securities Inc.'s (OSI) proposal to adopt new market microstructure rules governing trading on its Lynx ATS (Lynx). In relevant part, OSI is seeking approval to (i) introduce broker preferencing, (ii) amend hidden trading functionality, and (iii) create a latency sensitive trader (LST) trader ID definition and limit LST trader IDs to Post Only orders. The intended effect of the latter proposal is to prevent HFT firms from removing liquidity on Lynx.

By way of background, XTX Markets LLC is a U.S. broker-dealer and an affiliate of XTX Markets Ltd. (collectively "XTX Markets"), a London-based proprietary trading firm. XTX Markets is a quantitative-driven and regulated electronic market maker with global trading operations. We provide liquidity in equities, FX, Futures, Commodities, Options, and U.S.



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Treasuries. XTX Markets executes daily volume of approximately \$200 billion across all asset classes and geographies. XTX Markets is a strong advocate globally for fair and transparent markets and is committed to making markets more efficient and competitive, in part by advocating for policies that reduce barriers to entry. Based on our experience globally, and for the reasons that follow, XTX Markets believes OSI's proposal with respect to Lynx will have the effect of enabling liquidity providers to narrow spreads and display larger size for the benefit of end investors whilst simultaneously reducing the barriers to entry for new liquidity providers who may have risk absorption appetite and unique pricing and time horizons. We therefore strongly support these proposed rule changes.

XTX Markets believes that the race for speed in trading has reached an inflection point where the marginal cost of gaining an edge over other market participants, now measured in microseconds and nanoseconds, has exceeded the marginal benefit to investors. This can best be illustrated by the evolution of latency arbitrage, which in today's market generally means using dedicated microwave towers to transmit order information from one location to another to trade the same or correlated financial instrument based on information that is a few milliseconds away from becoming available to all market participants. The extent to which latency sensitive firms will go to gain incremental microseconds of an edge over competitors has been well documented globally, including an HFT firm building a microwave tower between an exchange and a competitor's microwave tower¹, wire-tapping an exchange's internal network in order to receive market data faster², bribing an exchange's officials for preferential access to the exchange's matching engine³, and HFT firms being advantaged by exchange systems that provide private information about a fill on a futures trade before that market data is publicly disseminated.⁴

As noted by Professor Donald Mackenzie of the University of Edinburgh, the exchange groups' considerable and successful focus on reducing "jitter" (quasi-random fluctuations in processing times) on their exchanges means "even tiny speed advantages" have become incredibly important, such that "*in a particular market ... one HFT firm – or a small number of firms – may achieve an advantage in speed that's very hard and very costly for their rivals to overcome.*"⁵ These efforts result in a tax on liquidity providers that is passed on directly to

¹ <https://www.bloomberg.com/news/features/2019-03-08/the-gazillion-dollar-standoff-over-two-high-frequency-trading-towers>

² <https://meanderful.blogspot.com/2018/01/the-accidental-hft-firm.html>

³ <https://www.bloomberg.com/opinion/articles/2019-05-02/india-s-nse-pays-158-million-for-algo-trading-scandal>

⁴ <https://www.wsj.com/articles/glitch-exploited-by-high-speed-traders-is-back-at-cme-1518431401>. See also

⁵ <https://tabbforum.com/opinions/how-fragile-is-competition-in-high-frequency-trading/> (March 26, 2019) (emphasis added).

investors. Liquidity providers need to price to the average toxicity of the order flow they interact with, and to the extent they are being adversely selected by latency arbitrage strategies they must widen their spreads to account for that possibility. This in turn increases the costs of trading for all investors accessing that market.⁶

XTX Markets believes the following market benefits will accrue from limiting LST traders to Post Only Orders only:

- ***The indirect operational tax on market end users will be reduced.*** If raw speed is the determining factor of successful trading, any liquidity provider that is systematically outpaced will consistently trade at stale prices, as the fastest market participants observe quotes moving on one venue and race to trade with quotes on another venue a few milliseconds before the liquidity provider receives the same market data and can react. In fact, even if the liquidity provider and the LST trader are *equally* fast, due to exchange jitter one can expect that in 50% of attempts the LST trader will successfully trade against the liquidity providers stale price. The result is that liquidity providers are forced into an expensive arms race or to stop providing liquidity all together.

This is a classic example of the tragedy of the commons wherein multiple participants are commercially obliged to participate in a negative-sum activity due to the participation of others. Liquidity providers are for-profit entities and the significant operational expenditure incurred in becoming or remaining low latency – always relative to other participants and therefore relevant even at increasingly diminishing timescales – is ultimately passed on to long-term investors.

- ***Lynx can expect tighter pricing and deeper books for end users.*** End users are hedging genuine exposures or making long-term investments and not reacting to millisecond-level external events, unlike LST traders. Any market maker on an all-to-all exchange has no idea with whom it will trade; it gets a mix of LST trader flow and regular end-user flow.

The end-user flow is thus subsidizing the LST trader flow because the spreads charged on a venue are determined by the average quality of flow on the venue. By limiting LST traders to Post Only orders, Lynx will stop LST traders from engaging in latency arbitrage strategies and thus market makers will be encouraged to quote

⁶ See also Aquilina, Budish, and O’Neill, *Quantifying the High-Frequency Trading ‘Arms Race’: A simple New Methodology and Estimates*, January 2020, <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-50.pdf> (evidencing, among other things, that liquidity provision is useful and latency arbitrage is harmful).

tighter and in larger size to compete for and attract more flow from end users whose orders stem from genuine economic exposures rather than intermarket races.

The OSC needn't take our word for it. While the OSI proposal for Lynx may in some respects be innovative to the Canadian marketplace, a similar market has been operating with a near identical rule set in Europe for several years. Specifically, the Aquis Exchange (Aquis) is a pan-European equity exchange that bans HFT traders from removing liquidity from its book. Since adopting these rules in 2016, Aquis' market share of pan-European securities trading has grown from less than 1% in 2015 to nearly 5% today. Significantly, on average, Aquis has more displayed liquidity and tighter spreads than any other pan-European exchange.⁷

- ***Barriers to entry will be reduced and competition encouraged.*** If raw speed is a prerequisite for success in liquidity provision, any participants – including new entrants that cannot afford such expensive infrastructure – cannot compete and will logically withdraw. This is detrimental, as such liquidity providers may well have risk absorption appetite, as well as unique pricing and time horizons. Removing these resting limit orders from the market entirely (because they systematically trade at stale prices each time a related market moves) reduces valuable liquidity.
- ***The diversity of resting orders will increase, and systemic risk will be reduced.*** Latency-sensitive markets tend to have heavily concentrated market share among a small group of extremely fast participants. This leads to systemic risk, as a small number of HFT firms have limited risk absorption capabilities in relation to their outsized market share, and the failure or operational interruption, even if brief, of such an entity would have a disproportionate adverse impact on the market and liquidity relative to its size.

Reducing the focus on minor speed advantages encourages more competition and a wider group of participants which will deepen the risk absorption capacity of the overall market.

LST trader opponents of OSI's proposed Lynx rule changes may argue (i) that they will be denied fair access to the Lynx market, and (ii) that their LST trader taking orders provide valuable liquidity provision to resting orders and, therefore, should be allowed. With respect to the first point, XTX Markets believes fair access should be considered in the context of whether the proposal at issue is unreasonably discriminatory. In this instance, while the proposal does

⁷ <https://www.aquis.eu/data/2020-data/>

discriminate against all LST traders by denying them the ability to remove resting liquidity, for all the reasons stated above, XTX Markets submits that proposal is not *unreasonably* discriminatory. The proposal is narrowly-tailored to target a specific type of predatory trading behavior that harms liquidity provision, increases market spreads, reduces competition, and creates systemic risk.

With respect to the second point, the liquidity LST traders provide to resting orders is precisely the liquidity those resting orders do not want because those trades instantly move adversely against them. One can imagine a resting bid in a 10 x 12 market being filled in response to a related market crumbling to 6 x 8. Immediately post-fill, the end user's order looks to be off-market, having bought at 10 while the prevailing price is now 6 x 8. Had this end user 'missed out' on this fill because LST traders could not access the order, the end user would be better off, now able to buy immediately at 8. Incidentally, this form of "liquidity provision" is very common: multiple LST traders will compete to trade against these stale orders at the same time. XTX Markets submits that if end users want to be provided this kind of liquidity from LST traders, they will simply place their resting orders on other markets and not on Lynx.

Finally, XTX Markets notes that Lynx is currently an unprotected order book, meaning in practice that absent a best execution obligation, traders, including LST traders, may ignore the Lynx quote and trade at worse prices on other markets without violating the Order Protection Rule. Retaining that status is a critical component to operation of a market that does not allow LST traders to remove liquidity. In its proposal, OSI represented to the OSC that if Lynx's market share reaches the level that would require its quote to be protected (generally, ~2.5%), OSI will seek to change the market microstructure on Lynx by implementing a de minimis speed bump, which would ensure continuous unprotected status for orders entered on Lynx. OSI's proposed manner of retaining unprotected status at scale may well be the only option available to do so under the existing market structure scheme in Canada; however, we would simply request that the OSC remain open in the future to re-evaluating that market structure in the face of successful innovation, as we expect OSI's proposed changes to Lynx will be.

Thank you for the opportunity for XTX Markets to provide its comments. As noted above, XTX Markets supports OSI's Lynx proposal. XTX Markets believes the proposal, when implemented, will enable liquidity providers to narrow spreads and display larger size for the benefit of end investors. If you have any questions about our views, please don't hesitate to contact me.

Sincerely,

A handwritten signature in blue ink, appearing to read "ES", followed by a long horizontal flourish.

Eric Swanson
CEO, XTX Markets LLC (Americas)