

Time to Lock-up Locked Markets For Good

There was a time when we at Omega ATS were neutral about locked markets – which occurs when a dealer sees a bid/ask on a marketplace and, instead of hitting that bid/ask with a matching order, books the matching order at the same price on another marketplace, thereby reducing the bid-ask spread to zero.

We initially said this was a best execution issue for each dealer to decide, but not a market integrity issue (if you really enjoy reading about this topic, see page 7 of our October 2008 comment letter: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/Comments/21-101/com_20090116_21-101_josipovicm_kingg.pdf).

Well, based on the recent upsurge in locked markets, we agree it is time to end this practice. Omega ATS is willing to ban locked markets if the other visible (protected) marketplaces would agree to do the same. In other words, each of us would agree that if an order is booked to our marketplace at a price level equal to the far side anywhere else, we would automatically adjust the booking price to one UMIR pricing increment away from the far side. We would all do this before the CSA bans the practice anyway sometime in 2010.

Why are we volunteering this now? Some of our clients have become very exercised about posting an order and then seeing a contra order get booked at the same price on another marketplace. The dealer's irate client calls to say "Why haven't I been filled? I see the other side at the price I want", which forces the dealer to go to the other marketplace, incur a higher "take" fee than it wanted to pay and also reward the contra party with the corresponding rebate.

Some people see "fee arbitrage" being the driver behind the recent upsurge in locked markets. This was starting to happen on Omega too, but our recent pricing change ended that. Since we no longer pay liquidity providers when their penny stock orders (whether TSX-listed or TSX V-listed) get hit on Omega, they don't have much incentive to lock a market from Omega. And if they do, we are sure our other dealer clients don't mind coming over to Omega to get charged \$0.50 flat for filling their active order. (Price improvement for their clients and a low transaction fee.) So our first challenge to our clients and prospects was to increase your routing to Omega in order to inject real competition between marketplaces on the issue of high "take" fees.

But we realize that increased competition will not end "fee arbitrage" overnight.

More importantly, others are pointing out a larger principle of duty to the market – rewarding those who first contribute to price discovery. As an industry, we need to decide which value trumps: whether (A) the person who first posts the best bid/best ask should be rewarded with a fill when a contra party has a matching order (duty to the market), or (B) the contra party with the matching order should be free to post to another marketplace and lock the market (freedom to choose execution venue).

From everything we have seen, the industry strongly prefers (A) over (B).

One last point: the industry should know that if we all want to get serious about banning locked markets, we cannot limit trade-through protection to only the top-of-book, top two levels or even top five price levels. Here is why.

Under the current trade-through regime, an active (take) order will smart order route through all price levels until the order is exhausted against all available posted volume. However, if we go with only top-of-book or only the first few price levels, the posted volume that is swept will not always be enough to exhaust the active order – so the balance has to be booked somewhere, typically on the default marketplace specified by the dealer. The problem is that the default marketplace’s best price at that moment in time may be inferior to what is still remaining elsewhere, and so the booked order locks or even crosses other marketplaces.

Don’t just take our word for it - check with your smart order router vendor. They’ll agree this is a very real danger that cannot be easily solved unless we stay with full depth-of-book trade-through protection.

Sincerely,

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