

Flash Orders

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With all the headlines out of the U.S. regarding Flash Orders over the past two days we wanted to share a few thoughts on what is going on, and what we would expect to happen next. As always we are more than happy to answer any client questions around this matter.

What is a Flash Order?

In the U.S. market the marketplaces are responsible for protecting against trade through. So if you send a buy order to trading venue X and there is a better offer on venue Y then Venue X is supposed to re-route your order to venue Y to trade against the better offering. The rule allows the trading venue to take up to 1 second to re-route your order. The reason for this is that when the rule was written – 2002 – 1 second was considered to be fast. Nowadays marketplaces can re-route orders in less than a millisecond ($1/1000^{\text{th}}$ of a second) meaning they can hold onto the order for most of the 1 second allotment. As a result Direct Edge started sending out an IOI to various liquidity providers for $\frac{1}{2}$ a second informing them of the existence of an order that would be routed away. They called this their Enhanced Liquidity Program. Their goal was to have the liquidity provider sell them the stock, preventing them from having to route trades to a competing venue. The problem is that the liquidity providers have no fiduciary duty to the end client and may use the IOI as a signal to lift the other venues offer in front of the original client. This has lead to some U.S market structure analysts referring to this order type as front running.

As Direct Edge's market share grew other marketplaces felt the need to create their own Flash order types.

What trading venues have flash order types?

Four different marketplaces have had flash order types – with both BATS and NASDAQ voluntarily removing their Flash style orders yesterday. Direct Edge has the ELP order, CBSX (the little known CBOE Stock Exchange) has HAL, Nasdaq had Flash and BATS had BOLT.

Why would you allow someone to do this to your order?

Each of the trading venues that have a flash style order allows you to mark orders in such a way as to ensure they don't flash your order. Most institutional firms do this. (Both Goldman and Credit Suisse have publically stated in recent days that none of their institutional flow is allowed to be flashed). The advantage to allowing your orders to be flashed is a lower fee charged by the trading venue. As a result the firms that allow their orders to be flashed are typically firms that have purchased retail flow and have limited best execution obligations to the end client. (This purchasing of retail flow has not been allowed in Canada for many years, and may come under scrutiny in the U.S. as the SEC investigates Flash orders).

NASDAQ and BATS ended their flash programs yesterday. Does this mean the end of Flash orders?

No. Direct Edge is fighting hard to keep their ELP order alive. It is important to realize that while an exchange like NASDAQ is sensitive to political pressures and reputational risks, an ATS like Direct Edge is less sensitive and more likely to fight on. NASDAQ has to ensure it doesn't upset its corporate issuers and institutional owners - this is not the case for Direct Edge. (An important consideration for Canadians – TSX and Alpha have greater sensitivity to reputational risk than do the other trading venues – Alpha due to the sensitivities of its ownership group).

In the event that the SEC bans Flash orders, Direct Edge is already working on a 'FLARE' order type. The FLARE order type is much like a Flash order but instead of sending the IOI to a select group of liquidity providers they make the IOI available to the full marketplace. This seems to address the stated concern that some participants are getting an advanced look at orders. In reality, because the IOI is only good for a subsecond before Direct Edge must re-route to the better market, the vast majority of industry participants will not be able to react quickly enough to trade against the Flared order. As a result it will be the same proprietary firms that were already getting the Flash IOIs that will be trading with, or against, the Flared Orders.

Direct Edge will be hard pressed to explain how a Flare IOI sent to the whole market is not a quote. If it is a quote then Direct Edge will be locking the market - a practice that has wisely been banned in the U.S. via REG NMS. The argument put forth is that the Flare IOI is not a quote as you may not be able to trade against because another liquidity provider may beat you to it. This argument fails as the same can be said of any quote. If Direct Edge fails to convince the regulators that their IOI is not a quote they will likely be forced to stop the program.

Will Flash or Flare orders come to Canada?

Section 7 of REG ATS states

A marketplace that displays orders of exchange-traded securities or foreign exchange-traded securities to a person or company shall provide to an information processor accurate and timely information regarding orders for the exchange-traded securities and orders for the foreign exchange-traded securities displayed on the marketplace as required by the information processor.

This prevents a marketplace from sending IOIs to a subset of clients without informing everyone at the same time. As a result Flash order types will most likely not be allowed in Canada. The Flare order type could potentially be allowed in Canada – even after the CSA finally bans locked markets later this year – if marketplaces are successful in convincing regulators that the IOI somehow differs from a quote. We consider the argument to be weak, and thus think it unlikely that Canadian regulators will allow Flare orders.

If you have any questions regarding these changes please contact the BMO Quantitative Execution Desk at 416-359-5743

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