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via e-mail

December 7, 2012

Re: CX2 Canada ATS - Notice of Initial Operations Report and Request for Feedback

Dear Sirs:

TD Securities welcomes the opportunity to comment on the Notice of Initial Operations Report and Request for Feedback relating to the proposed CX2 Canada ATS.

TD Securities is a leading securities dealer in Canada and the number one block trader in Canadian equities based on dollar value and shares traded. TD Securities also acts as the executing dealer for TD Waterhouse which is the largest discount brokerage firm in Canada.

Introduction

The evolution of Canadian market over the past five years has expanded the number of competing visible marketplaces from one (in early 2007) to six presently. In this time the market has also seen structural evolution based on make-take subpenny pricing, the proliferation of high frequency trading, the introduction of order protection rules and the growth (and recent curtailment) of dark liquidity.

While the expansion of multiple marketplaces has added a degree of innovation and improved the efficiency of the Canadian market, we have also seen unintended negative consequences of subpenny price increments, fragmentation and the abuse of protected status. We recommend these issues be addressed before additional marketplaces are approved in Canada.

Subpenny Price Increments

The UMIR Order Entry and Exposure Rule (6.1) defines the minimum trading increment as one cent for orders priced at or above $0.50 and a half cent for orders priced below $0.50. While we believe trading increments could be improved by aligning the increment with the price and liquidity of the security, we recognise that moving to subpenny trading increments can be harmful to the marketplace. Negative impacts of subpenny pricing include increased quote traffic and flickering, reduced depth on the inside market, and the disadvantaging of investors' limit orders by allowing other participants to gain execution priority for a nominal amount.

An unintended consequence of the make/take fee model combined with multiple marketplaces is that it undermines the intent of UMIR 6.1 and creates subpenny trading increments for a select group of market participants. By crediting the liquidity provider and charging the liquidity taker, the make/take model is equivalent to shifting the price of a trade by a subpenny increment.

For example, an offer priced at $5.01 is equivalent to the following subpenny price levels at each of these marketplaces, when accounting for take fees:

Marketplace	Liquidity Taker Price Level	Increment to Next Price Level
Omega	$5.0100	2 mils
TMX Select	$5.0102	23 mils
Pure	$5.0125	3 mils
Alpha	$5.0128	1 mil
Chi-X	$5.0129	5 mils
TSX	$5.0134	66 mils

Marketplace operators have an incentive to create multiple venues to cover a range of subpenny price increments, each at a different make/take level. An analysis of the impact of CX2 on the Canadian marketplace is not complete without considering the make/take level to be applied to orders on CX2 and how this subpenny price increment fits in with the existing subpenny increments at other marketplaces.

These subpenny price increments are at odds with the spirit of fair access since the price points are only available to a select group of High Frequency Trading firms. Historically marketplace fees were absorbed by dealers and clients paid a flat commission on trades. More recently, some dealers have begun offering a cost-plus commission model (passing through marketplace fees and rebates) to attract high frequency clients. The net result is a two-tier market where traditional clients continue to trade in standard price increments while HFTs trade in subpennies.

Subpenny price increments are used by HFTs to disadvantage the limit orders of natural participants through the use of order scalping strategies. For example, if a natural participant posts a limit order on the TSX, an HFT may post a shadow order on Chi-X to gain priority over the natural order for a nominal 5 mil price improvement. This enables the HFT to intercept active orders which would have otherwise traded with the natural limit order. Once filled, the HFT may post an order on the opposite side of the market to collect a one cent spread (plus rebates) while using the natural order as "insurance" to limit any potential losses.

Subpenny scalping destabilizes order books since the shadow orders are contingent on natural orders and are immediately withdrawn if the natural orders are cancelled or filled. The strategy is dependent on low latency access and subpenny trading increments, enabled by a combination of

the make/take model, multiple marketplaces and cost-plus commission schedules. The more subpenny price increments (ie. marketplaces) that exist in the market, the easier it becomes to gain execution priority over natural orders for a nominal amount.

Subpenny price scalping is prevalent in today's market and denies opportunities for natural limit orders to be filled. Scalping behaviour crowds out natural passive orders and forces them to cross the bid-ask spread more frequently, increasing total transaction costs. Proponents of the make/take model claim it adds liquidity and tightens bid-ask spreads, but in our view the model enables subpenny scalping, which harms market quality by adding "liquidity" when it's least needed and aggressively removing liquidity when it's needed most.

Regulators should be aware that by approving a new marketplace they are also approving a new subpenny price increment in the Canadian market, an increment that is only available to a select group of High Frequency Trading firms and which may be used by those HFTs to disadvantage the orders of natural participants.

While we acknowledge that a precedent for subpenny pricing has already been set with the creation of six visible marketplaces operating at different make/take levels, we recommend a moratorium on new marketplaces to prevent further price fragmentation in the Canadian market. We request that Regulators evaluate the impact of the make/take model on market structure before continuing further down the path of subpenny trading increments.

Protected Status of Marketplaces

An unintended consequence of the Order Protection Rule (OPR) is that each marketplace has equal standing in the market regardless of its contribution to price discovery, liquidity or the costs of accessing this venue. By protecting orders on each visible marketplace the OPR also grants these marketplaces with protected monopolies with respect to their own connectivity fees, market data fees and subscriber terms. This monopoly status incents rent-seeking behaviour without benefiting the public interest.

We are encouraged that Regulators are considering the impact of OPR on market data fees in the recently published Consultation Paper on Real-Time Market Data Fees, but we have already seen a rapid and unreasonable inflation of market data costs with the introduction of multiple marketplaces and we are concerned this rent-seeking trend will continue as more marketplaces are introduced.

By requiring participants to access every visible marketplace as a regulatory obligation the OPR not only suppresses competition in marketplace fees but also restricts the negotiating position which participants have with marketplaces. This was demonstrated during the launch of TMX Select when the TMX invoked its protected status to force participants to sign a Subscriber Agreement despite including indemnification terms which were broadly rejected by the Street.

We are not opposed to the Order Protection Rule itself, we consider the trade-through obligations as supporting efficient price discovery in our public markets. However, we believe that if marketplaces are to be granted protected status then a regulatory framework must be in place to manage access fees and market data fees to prevent rent-seeking behaviour. We recommend a moratorium on the creation of new marketplaces until this regulatory framework can be evaluated and implemented.

Broker Preferencing

We are fully supportive of Chi-X's goal to add broker preferencing to their marketplace. In our view broker preferencing strikes an appropriate balance between the ability of dealers to match their clients' orders and the need for public display of liquidity for efficient price discovery. Public broker preferencing avoids the extreme fragmentation created by private internalization pools as seen in the US market and is preferable to pure price-time priority which encourages a race to zero latency in an "winner take all" competition for queue priority.

However we question why a new marketplace is necessary to add optional broker preferencing for Chi-X. Besides this option we see no significant differences between CX2 and the current Chi-X marketplace. An additional marketplace imposes costs to the industry in terms of market fragmentation, operational complexity, connectivity costs and market data. We prefer to see market operators add features to their existing venues rather than create new marketplaces for each optional feature.

We also question the need for broker preferencing on anonymous orders since the two are mutually exclusive. The broker identifier for an anonymous order on CX2 could immediately be discovered by observing the contra-side identifier on broker preferenced executions. This disclosure could happen unintentionally whenever orders from the same dealer are matched with the anonymous order, which breaks the intent of anonymity. We don't see the benefit of allowing broker preferencing and anonymity in combination. If the intention is to be anonymous then the broker preferencing option must be disabled for that order to remain anonymous.

Resource Contention

The industry is facing significant infrastructure changes over the next twelve months which will strain the resources of participants and vendors alike.

On March 1 2013, the Electronic Trading Rule of National Instrument 23-103 will come into effect. This framework for pre-trade controls and post-trade monitoring will reduce the risk associated with electronic trading, but also carries substantial implementation costs and resource commitments for dealers and vendors. These efforts will continue as the Direct Electronic Access rules are implemented later in 2013.

In the same timeframe as the ETR implementation, the TSX is planning to migrate Alpha to the Quantum platform. This will also be a major project for the Street to re-configure all order entry gateways, market data feeds and smart order routers.

Beyond the Alpha migration the TSX is planning to upgrade to Quantum XA, an upgrade that will impose significant costs to the Street while providing questionable benefits. At a time when global regulators are considering slowing the speed of trading, we are disappointed the TSX is moving in the other direction by shaving a few microseconds for the benefit of a select group of HFTs while disadvantaging natural participants and imposing the cost of the upgrade on the Street.

The launch of CX2 will compete with these mandatory projects and will consume resources to add custom tags to trading workstations, establish order entry gateways and market data feeds, and configure smart order routers. The 2011 launch of TMX Select is a cautionary experience. Approval for TMX Select was granted on June 3 2011, and the marketplace became operational

(and protected) a short five weeks later, insufficient time for the Street to complete development and testing of order routing and gateway connectivity.

Changes to market infrastructure bear high risk, require adequate lead time and resources for development and testing, and should not be undertaken lightly. In the case of CX2 we do not see this risk and cost to the industry as being justified compared to the marginal benefit of adding an option for broker preferencing.

Recommendations

We recommend the application by Chi-X to begin operating a second trading facility (CX2) not be approved for the following reasons:

- The new marketplace will establish a subpenny trading increment which is only available to a select group of HFTs, contrary to the principle of fair access and UMIR 6.1.
- The subpenny trading increment will facilitate scalping strategies which disadvantage limit orders from natural participants.
- Approval of a protected marketplace will enable monopolistic rent-seeking behaviour in the form of excessive market data fees, connectivity fees and trading fees.
- The cost and risk of this change to market infrastructure is not commensurate with the marginal benefit of optional broker preferencing.

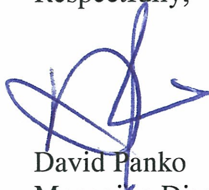
In our view the approval of CX2 is not in the public interest.

We also recommend that Regulators place a moratorium on the launch of new marketplaces until the following are complete:

- Evaluation and implementation of a framework to manage market data costs,
- Analysis of the impact of the make/take model on market structure including the implications of subpenny trading increments arising from rebate differentials between multiple marketplaces, and
- Implementation of all infrastructure changes required for the Electronic Trading Rule and Direct Electronic Access Rule.

We appreciate the opportunity to comment on the Notice Of Initial Operations for CX2 and we would welcome a meeting with CSA Staff to further discuss our views.

Respectfully,



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