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

The Canadian Security Traders Association, Inc. (CSTA) is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 traders nationwide, and is led by Governors from each of three distinct regions (Toronto, Montreal and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee: a group of 20 appointed members from amongst the CSTA. This committee has an equal proportional number of buy-side and sell-side representatives with various areas of market structure expertise. It is important to note that there was no survey sent to our members to determine popular opinion; the Trading Issues Committee was assigned the responsibility of presenting the opinion of the CSTA as a whole. The opinions and statements provided below do not reflect the opinions of all CSTA members or the opinion of all members of the CSTA Trading Issues Committee (or their respective firms).

The CSTA appreciates the opportunity to provide feedback on the Notice of Initial Operations of CX2 Canada ATS.

## General Remarks

We promote the idea of competition in principle and understand the benefits derived from having a healthy competitive marketplace. With the Maple Group acquisition of TMX Group Inc. being very recent, we acknowledge the importance of the change in the Canadian marketplace landscape. The consolidation of two of the leading Canadian execution venues under one umbrella, with no immediate plans to shutter the operations of either due to overlap, creates a landscape of opportunity for other marketplaces. We recognize the precedent for allowing an existing marketplace to have a second Central Limit Order Book (CLOB) and understand the reasons why they would choose to do so (such as experimenting with pricing models and increasing market data revenues).

While the current CX2 Canada ATS application fits well within the current regulatory framework, our primary concerns surround the topic of market fragmentation in general. Canada currently has six visible CLOBs; Chi-X Canada is looking to add a seventh. The Maple transaction has brought us to a pivotal point and we believe that the following question should be answered before we move any further in the evolution of our market structure: where is the line drawn in terms of the number of marketplaces that are allowed to exist, or simply, how many marketplaces is too many?

The first area of concern in relation to market fragmentation is that the innovation and feature-enhancements we have seen to date cater primarily towards a very specific subset of participants, specifically those which drive marketplace volumes, rather than the traditional institutional community. This is evident in the vast majority of new order types and features introduced in the last few years in marketplaces across the world. Before Reg NMS went into effect in 2007, there were approximately a dozen order types in existence in the US. Although it is impossible for us to provide the exact number of order types in existence in the US today, BATS COO Chris Isaacson told attendees at the Security Traders Association's annual 2012 conference that BATS alone lists more than 2000 order types (Traders Magazine, "Too Many Order Types, Traders Fret", November 2012). Although the number that Mr. Isaacson stated includes order types and each of their possible permutations based on all available parameters, the number in itself is still very substantial and forces us to ask ourselves what percentage of the available order types are tailored specifically to a small minority of clients? The question also arises as to how exactly marketplaces should decide on the priority of resource allocation to developments catering to one subset of clients over another? There are certainly pending areas of development that the institutional community in Canada has requested that remains unanswered and queued behind requests made by higher volume clients (not an issue specifically related to Chi-X Canada).

The complexity of the current market structure is being exploited by a minority of market participants that have an advantage due to technological investments, but also because they do not necessarily have a directional bias in their trading strategies as some are driven almost purely by market structure related inputs. We question the need for some of the order types that exist, as seen in recent market structure coverage in the US (TABBforum articles dated October 11, 2012 and October 16, 2012) discussing the subtle ways in which some traders utilize sophisticated order types such as "Price to Comply" or "Display-Price Sliding" to achieve time priority by taking advantage of the nuances of rules. Even though these specific order types do not exist in Canada, there are still questionable practices that prevent a participant that is contributing to price discovery from gaining posting priority over order types that dynamically re-price (as we will discuss below). We strongly believe that disadvantaging participants that contribute to price discovery is contrary to the overriding purpose of markets.

Another important issue that is related to market fragmentation is the cost of market data. As a body representing predominantly institutional traders, we do not believe that it is feasible for any of our members to

consider a new marketplace only as it pertains to the Order Protection Rule (OPR). If an institutional trader uses a Smart Order Routing (SOR) (directly or via a DMA agreement) that did not consider the market data of certain marketplaces, their SOR would undoubtedly be inefficient compared to its peer group; this results in a situation where market data clientele is captive, simply to maintain a standard level of performance. We believe that a key component of any truly competitive marketplace is consumer choice. However, with a captive clientele as a side effect of the OPR, there is no choice available for consumers to turn elsewhere; as a result, marketplaces can survive without providing any tangible ‘net benefit’ to the community. What we are left with is a system where consumers are forced to consume a good at an un-regulated price point with no recourse.

We do recognize that the CSA is currently reviewing the regulatory structure underlying Real-Time Market Data Fees in Canada, but we still would like to highlight the fact that the application for a new marketplace should not be considered without also reviewing the potential market data costs involved. An example of this phenomenon is Chi-X Canada ATS’s recent announcement that they will begin charging for TSX Venture market data. In our understanding, the Venture market is heavily dominated by retail trading and that there are very few retail-originated orders on Venture stocks resting on Chi-X Canada ATS. This means that while price discovery for Venture stocks – in the form of resting orders – occurs elsewhere, Chi-X Canada can support quoting in parallel on their ATS, and charge for market data. This essentially resells the value of the price discovery occurring elsewhere to a captive community. We see no reason why CX2 Canada ATS would be unable or unwilling to similarly charge for market data.

The ‘true cost’ of allowing additional marketplaces goes far beyond explicit costs such as market data. We also cannot ignore that each new marketplace involves an added level of complexity, technologically and in terms of the education that is necessary to be able to completely digest the real and implied nuances that it creates. Market fragmentation also introduces unnecessary layers of intermediation, often times for fractions of seconds. It is not difficult to see why a marketplace would encourage fragmentation as it adds to overall volumes, which results in an increase in the marketplaces’ revenue. The Maple Group acquisition of TMX Group Inc. is a good example of this point: Maple has decided to keep the Alpha Exchange operational (without listing rules) even though it offers very little competitive differentiation from TMX and promotes market fragmentation. Under the same umbrella, Alpha will also not be able to exert competitive pressure on the incumbent marketplace, which begs the question: what purpose does Alpha Exchange serve other than fragmentation?

There are currently no barriers preventing additional CLOBs or new marketplaces from being founded, thus theoretically there is no limit to market fragmentation and potential additional costs. We believe that there has to be a limit to the number of marketplaces that the Canadian trading community can feasibly support. For this reason, we would strongly support a ‘net benefit’ approach to determine whether or not to permit an additional marketplace to launch. Such a standard should require that any new entrant clearly articulate their value proposition to the Street, without relying on the notions of ‘choice’ and ‘competition’ as a basis for imposing costs – both direct and implicit – for the trading community. The only potential benefit mentioned in the CX2 Canada ATS application is that given the Maple transaction, they are “a viable competitor in the market offering unique market structure and pricing schedule”. How can any market participant be expected to ascertain the possible value of CX2 Canada ATS without more detailed information?

### **Specific Concerns with CX2 Canada ATS**

The CSTA has several specific concerns with the details of the proposed market model for CX2 Canada ATS, which we will discuss in turn:

- The existence of the Dynamic Order Re-pricing feature, which also exists on Chi-X Canada ATS, creates a situation that disallows a participant that is actively contributing to price discovery from gaining posting priority;
- The broker preferencing model presented allows anonymous orders to receive the benefits of preferencing, resulting in information leakage and fairness concerns;
- The ability to opt-out of broker preferencing on an order-by-order basis opens the possibility for subtle abusive practices and difficult to detect best execution violations;
- Certain definitions for order types in the Notice of Initial Operations are misleading and must be clarified.

### Dynamic Re-pricing

Both Chi-X Canada ATS and the proposed CX2 Canada ATS offer dynamic order re-pricing to prevent a violation of National Instrument 21-101 *Marketplace Operations*, and more specifically the ban on “locked markets” in place as part of the Order Protection Rule (OPR). This feature, which would re-price a potential locking order to the next inferior trading increment rather than lock an away market, appears good, in theory. However, in practice, this feature can lead to situations where a participant enters orders on both sides of the market priced to lock, and relies on the ATS function to peg to a one-increment wide NBBO. When the NBBO changes, the automatic re-pricing feature ensures that the participant establishes time priority on the ATS in the direction of the move, disallowing a participant that is actively contributing to price discovery establishing from the said priority.

For example, consider the market in a hypothetical stock ABC, which has a Consolidated National Best Bid at 10.10 and National Best Offer at 10.11. The same Participant (A) can enter a Post-Only order on CX2 Canada ATS as follows:

- Buy with a limit of 10.11 (A1)
- Sell with a limit of 10.10 (A2)

In this circumstance the CX2 Canada ATS re-pricing feature would price the Bid (A1) at 10.10 and the Offer (A2) at 10.11, avoiding a lock of away markets and preventing a wash. Suppose a Natural Buyer (N) wishes to establish a new 10.11 bid. To do this, the common practice for Smart Order Routers (SORs) is to send Immediate or Cancel (IOC) Directed Action Orders (DAOs) for the amount of shares that are currently visible on the Consolidated CLOB to ensure that all available liquidity is taken on all marketplaces. If there was a dark fill received on any marketplace after sending the initial DAOs, meaning that there would still be liquidity available at 10.11, the SOR would resend another DAO to the marketplace with the remaining liquidity. After all liquidity is taken from the Consolidated CLOB, the Consolidated NBBO would then temporarily move to a 10.10 National Best Bid and a 10.12 National Best Offer, at which time the CX2 Canada ATS engine would re-price the Participant’s Post-Only Buy order (A1) to 10.11 – precisely the level at which the same Participant just made a sale (A2). The next step for the Natural Buyer (N) is to send a Buy Limit order at 10.11. In this example, the Natural Buyer (N) would be behind the Post-Only Buy order (A1), thus Participant (A) gained priority over the Natural buyer (N) that decided to actively contribute to the price discovery process.

Now it is easy to say that the Natural Buyer (N) should simply oversize their limit order if they wish to have priority on a given marketplace when taking liquidity at a given price level. Let’s go back to the example of a Consolidated NBBO of 10.10 – 10.11. The only way for the Natural Buyer (N) to gain priority over the Post-Only Buy order (X) is for their SOR to: 1) send Limit DAO orders to all marketplaces with visible liquidity on the

Consolidated CLOB, 2) size the limit DAO orders to be at least as large as the contra-side orders that are currently visible in the Consolidated CLOB and size them larger where they wish to post. However, note that the failure to mark SOR “take waves” with the Bypass Marker can (and frequently does) give rise to locked markets.

The aforementioned example addresses the frequent creation of so-called “unintentional” locked markets. However, given that Canada offers full book price protection (as opposed to only top of book protection in the US), the failure to mark aggressive “take waves” with the Bypass Marker can in fact give rise to a violation of UMIR 5.2. Assume the same Natural Buyer (N) wants to clear not only all the top of book liquidity at the National Best Offer of 10.11, but also wants to take all liquidity for sale at the 10.12 and the 10.13 price levels, and finally post a passive Bid at 10.13 on CX2. In this case, a failure to mark all SOR “take waves” with the Bypass Marker could result in the active orders encountering undisplayed liquidity on one or more marketplaces, followed by a visible Sell Order at 10.12 being denied a fill and traded through at 10.13. Thus, the Natural Buyer (N) would be in direct violation of UMIR 5.2 since a “reasonable effort” to prevent a trade-through requires the use of the Bypass Marker to all markets which potentially have undisplayed liquidity.

We have now established that in order to ensure a top of book position on a given marketplace which offers Dynamic Repricing order types, we must absolutely use the Directed Action Order and the Bypass Marker concurrently. Currently on Chi-X ATS Canada, the only order type that accepts the use of the Bypass Marker is the Immediate or Cancel (IOC); this has also been confirmed as the format for CX2. Therefore, it is impossible for the Natural Buyer (N) to gain priority on CX2, since the Bypass Marker is not available for a Limit DAO Buy order that is not an IOC. (We have confirmed that for the time being, the Bypass marker will only be available via IOC on CX2, which is the same format as Chi-X ATS Canada).

Although this example is highly technical in nature, it could certainly not be avoided since the more our market structure evolves, the more it becomes harder to see the unintended consequences that are created by the overlay of various marketplaces, order types and data feeds. We were honestly surprised to find this “loophole” while doing research for this letter. If we, the practitioners, do not fully digest the nuances of the current market structure, can we expect anyone else to?

Now, would all be resolved and the previously mentioned “loophole” closed simply by asking Chi-X/CX2 to turn on the Bypass market availability for all Order Types? Absolutely not, since the more important problem then becomes the fact that the Bypass Market is a publicly visible field of data. If the Natural Buyer (N) in our example were to start using a SOR that systematically used the Bypass Marker, there would be a significant amount of information leakage caused by this. He would also be foregoing the price improvement potential of any dark execution, simply because there was no other way he could ensure that he would have time priority at a given price level. Could he then first “sweep” the dark before sending the oversized Bypass Marked DAOs? No, because then he would take the chance that the latency created would allow a participants currently posted on the top of book to disappear after seeing a dark fill.

We can describe other circumstances where dynamic re-pricing causes problematic and paradoxical outcomes as the orders interact with participants who are on either side of the market at any given time. We believe that notwithstanding the precedent of this function being available on Chi-X Canada ATS, the proliferation of this dynamic re-pricing order type, under the guise of “beneficial” lock-prevention, should be studied carefully before more marketplaces (in this case CX2 Canada ATS) are permitted to offer the feature.

## Anonymous Broker Preferencing

The CX2 Canada ATS Notice of Initial Operations proposes offering broker preferencing on anonymous orders, using the underlying broker number. Historically, broker preferencing for anonymous orders was not offered by any of the marketplaces offering preferencing, for the following two reasons:

- The effect of an anonymous order “jumping the queue” when interacting with an attributed order (or vice-versa), would immediately disclose the identity of the anonymous order and result in information leakage;
- If a trader wishes to give up the transparency of attribution, then it is entirely reasonable to also take away some of the benefits of that transparency to the trader at question. Specifically, if one wishes to no longer attribute their orders, then it is fair and reasonable to no longer allow that order to jump the queue. This would also implicitly address the unpredictable queue-jumping that would result in a market where all orders are marked anonymous, but nonetheless offer broker preferencing using the underlying order.

While we do not necessarily believe that it is appropriate for anonymous orders to benefit from both anonymity and preferencing at the same time, the fact that you must explicitly “opt-out” is our main concern. The leakage resulting from anonymous orders visibly jumping the queue would de-facto sway mostly all anonymous orders to explicitly “opt out” of preferencing to continue to ensure their anonymity. To enable this opt-out, upstream systems would require additional infrastructure work to support the new tag, enhancements to routing systems, and other technological costs. This begs the question: why offer both anonymity and preferencing at the same time? What is the ‘net benefit’ to the community?

## Opt-Out Broker Preferencing

In conjunction with broker preferencing for anonymous orders, the CX2 Canada ATS Notice of Initial Operations contemplates the ability for users to selectively opt-out, on an order-by-order basis, from broker preferencing. Other than in regards to the aforementioned anonymous preferencing – which is problematic in its own right (as we discuss above) - we find it very difficult to rationalize a bona-fide reason to do this within the CX2 ATS framework since:

- Market-bound liquidity-seeking orders are indifferent to which specific orders they interact with from the perspective of their execution price; it does not matter whether the contra-side liquidity originates at the same firm or not;
- Resting orders on CX2 Canada ATS can only benefit from the option to jump the queue at times. By opting out of broker preferencing, a resting order on CX2 can only degrade its execution options.

In our view, the main motivation for Opt-Out Broker Preferencing is for the stratification of flow within the CX2 Canada ATS. For example, opt-out preferencing can be used to selectively deprioritize trading within the same firm. This would be most advantageous if CX2 Canada ATS also adopts a pay-to-post fee structure, in which case active orders would wish to not interact with the same firm, thus forcing a different firm to pay the “make fee”. This creates a best execution conflict: if a firm with orders resting on CX2 Canada ATS sends a marketable contra-side order to CX2, opting out of broker preferencing potentially deprives a client passive order of a fill, for the purpose of saving the executing firm an execution cost. We do not believe this a reasonable trade-off for any executing firm to be forced into making, and more worryingly this would be a very difficult best execution violation to detect.

With Chi-X Canada having previously indicated that CX2 Canada ATS will have a “retail friendly” fee model, we believe that a pay-to-post mechanism is likely. In this case opt-out broker preferencing would be a means for a systematic exclusion of one’s own firm as a trading counterparty. This is also contrary to the stated goal of broker preferencing – the ability to have one’s firm’s orders interact with each other as frequently as possible, thus maximizing fills for clients. Indeed, the ability to de-emphasize trading with one’s own firm is not substantially different from a hypothetical ability de-emphasize any other firm. We do not believe it would be appropriate for Firm A to instruct an ATS to minimize specific fills with Firm B; why, then, should firm A be able to instruct the same ATS to minimize fills with itself?

There are other opportunities for abuse. For example, a firm could systematically establish settings on CX2 such that client orders are not eligible for preferencing (minimizing a hypothetical make fee), while turning on preferencing for proprietary orders aiming to interact with retail flow targeting CX2 from within the same firm. This would create a difficult-to-detect situation where client priority is not being maintained within the firm.

Note that while the above analysis is limited to a pay-to-post scenario, it is not limited thereto. We can point to similar opportunities for difficult to justify outcomes involving the stratification of retail and institutional flows (which have varying degrees of information content), entirely as a result of the ability to opt-out of preferencing on CX2 Canada ATS.

### **Good ‘Till Orders**

Finally, we believe the definition provided by CX2 Canada ATS for “Good ‘Till Date” and “Good ‘Till Cancelled” orders – being orders that are nonetheless cancelled at the end of each trading day – is perplexing, to say the least. While this may appear to be splitting hairs, the concept of “GTD” and “GTC” orders is well understood by the Street and we see no reason why CX2 Canada ATS should vary from the accepted definition. Instead, by accepting “Good ‘Till” orders that are nonetheless cancelled, the marketplace opens the possibility for firms entering orders on behalf of clients to find that a portion of their “Good ‘Till” order is not represented in the market on the next trading day. This could result in missed fills, the requirement to guarantee client execution, and widespread confusion.

We see no benefit to CX2 Canada ATS’s approach and ask that either the marketplace fully support GTD and GTC orders as they are commonly defined, or reject them outright.

### **Conclusion**

In conclusion, although the CX2 application is very timely due to the recent Maple transactions, we believe that there are fundamental questions in relation to market fragmentation that need to be answered before approving the creation of any new marketplaces. How many marketplaces is too many marketplaces? Does OPR create a captive market data clientele that is the primary enabler of new entrants? Is it acceptable to create market structure complexities that are not demonstrably of ‘net benefit’ to a majority of participants transacting within the Canadian equities market?

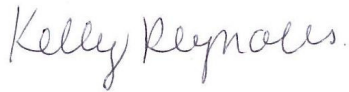
The specific aspects that we believe should be reviewed in regards to the CX2 Canada ATS Application are the Dynamic Order Re-pricing functionality, the enabling of broker preferencing for anonymous orders, the ability to opt-out of broker preferencing and certain definitions of standard order types that deviate from the norm. We consider that the combination of anonymous broker preferencing and opt-out broker preferencing on the proposed CX2 Canada ATS would lead to substantially more possibility for abuse than the benefits that could possibly be provided to the Street. Our concerns with this combination of features is consistent with the views

expressed in the CSTA response to *IIROC Proposed Guidance on Certain Manipulative and Deceptive Trading Practices*, dated October 30, 2012, where the CSTA discusses the role of marketplaces in inadvertently enabling potentially abusive practices of participants in the market.

Finally, we hope that future applications for new marketplaces will include practical examples of all new features and of any order type that is considered non-standard. We believe that this would greatly help with the 'net benefit' analysis and to enable more participants to be able to contribute to the feedback process.

We appreciate the opportunity to comment on this very important topic, and look forward to a continued dialogue.

Respectfully,



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