



August 8, 2016

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario
M5H 3S8
marketregulation@osc.gov.on.ca

and

Carina Kwan
Legal Counsel, Regulatory Affairs (Equity Trading)
TMX Group
The Exchange Tower,
130 King Street West
Toronto, Ontario
M5X 1J2
tsxrequestforcomments@tsx.com

Re: TSX INC. NOTICE OF PROPOSED CHANGE AND REQUEST FOR COMMENT

Dear Sirs/Mesdames:

Nasdaq CXC Limited (“Nasdaq CXC” or “we”), formerly Chi-X Canada, welcomes the opportunity to provide comments on the TSX Inc. (“TSX”) Notice of Proposed Change and Request for Comment (“Notice”) which proposes to introduce the use of a Post Only feature with dark orders (“Proposal”). We support the introduction of this feature by the TSX as it represents functionality that has already existed in the market since 2010 when it was first introduced by Chi-X Canada. We therefore have no concerns about the Proposal and instead want to address comments to Staff around their concern regarding the fairness of the sequence in which orders are repriced in the Proposal and on Nasdaq CXC today. Specifically, Staff question the fairness of matching engine logic when, after the Protected National Best Bid and Offer (“NBBO”) is repriced more aggressively, a non-Post Only midpoint order entered first becomes active and takes liquidity from a Post Only midpoint order entered second (the “Functionality”).

We submit that, because all market participants have equal opportunity to use the Post Only feature when entering a midpoint order (or any other order for that matter), the Functionality supported today is fair. In fact, we contend that if Staff’s views lead to changing existing Functionality that this will unfairly limit trading choices for participants. By removing the option for participants to choose to potentially trade against available liquidity (and incur a trading fee) certain trading strategies will be unable to manage the execution risk of missing a trade and the possibility of price slippage if the market moves away.

NASDAQ CXC LIMITED FUNCTIONALITY

In the Notice the TSX comments that it understands that Nasdaq CXC supports similar functionality today. We would like to confirm this is the case and provide two examples outlining how matching engine logic operates on both Nasdaq CXC trading books today.

For each of the examples below, the following series of events has occurred:

1. The midpoint of the NBBO is 10.025
2. A midpoint buy order is entered as non-Post Only
3. A midpoint sell Post-Only order is entered following the entry of the midpoint buy order locking the market at the midpoint price

Example 1 – Changes in the NBBO resulting in a more passively priced midpoint

Original Order Book and Midpoint

	BID	ASK	MidPoint Price
NBBO	10.00	10.05	10.025
	Midpoint Buy 10.025	10.025 Midpoint sell Post Only	

Action: Protected Best Bid moves to a lower price of 9.99 resulting in a new midpoint price of 10.02

New Order Book and Midpoint

	BID	ASK	MidPoint Price
NBBO	9.99	10.05	10.02

Actions

- The Midpoint buy order is repriced first at the new midpoint price of 10.02
- The Midpoint sell Post Only order is repriced second at the new midpoint price of 10.02

Result

- **No trade (and resulting locked market) as the Midpoint sell Post Only order will not become active after being repriced at the new midpoint after the Midpoint buy order**

Example 2 – Changes in the NBBO resulting in a more aggressively priced midpoint

Original Order Book and Midpoint

	BID	ASK	MidPoint Price
NBBO	10.00	10.05	10.025
	Midpoint Buy 10.025	10.025 Midpoint sell Post Only	

Action: Protected Best Offer moves to a higher price of 10.06 resulting in a new midpoint price of 10.03

New Order Book and Midpoint

	BID	ASK	MidPoint Price
NBBO	10.00	10.06	10.03

Actions

- The Midpoint sell Post Only order is repriced first at the new midpoint of 10.03
- The Midpoint buy order is repriced second at the new midpoint of 10.03

Result

- **An execution occurs as the Midpoint buy Post Only order becomes active after being repriced at the new midpoint after the Midpoint sell Post Only.**

FAIRNESS CONSIDERATIONS

A fundamental characteristic of fairness in the Canadian equity market is that all participants have equal opportunity to use a marketplace's features, including the order types supported by a marketplace. To ensure this is the case, all new order types must be first approved by the Ontario Securities Commission ("OSC") prior to their introduction. The Post Only feature which guarantees that an order will not actively trade was approved by the OSC and made available to Chi-X Canada subscribers in 2010. As part of the approval review process at that time, consideration was made around the use of the Post Only feature with lit and dark orders including midpoint dark orders.

Staff is now raising concern that the existing Functionality may be unfair as it appears to favor midpoint Post Only orders over previously entered non-Post Only midpoint orders as certain matching logic allows non-Post Only orders to trade and incur a trading fee when the NBBO is repriced more aggressively. We submit that in fact the opposite is true and that a fairness issue will be created if the Functionality is required to be changed as a result of Staff's views.

The fact that all participants have the choice whether or not to use the Post Only feature when entering an order ensures that the Functionality supported today is fair. This equalization of opportunity ultimately empowers participants with the choice to use this feature if it will assist them in achieving their trading objectives. Understanding that a non-Post Only midpoint order may become active and trade, a trader will choose either to not enter an order as Post Only if they prefer to maximize execution and are willing to pay a trading fee, or choose to enter an order as Post Only in order to avoid paying a fee at the cost of accepting the risk of missing a trade. In other words, using a non-Post Only order may result in paying an active fee, while using a Post Only order may result in missing an opportunity to trade.

The decision to use the Post Only feature needs to be understood in the context of different trading strategies. For a market maker whose strategy is to capture the bid ask spread using small orders with positions held for only a short time in the day, it may be more important to the success of this strategy to ensure that a trading fee is not incurred when using a midpoint order. However, for a participant such as an investment fund manager whose trading objective is to accumulate a large position in a security over the trading day, the opportunity for an execution to take place at a more aggressive midpoint price may be more important than the trading fee that will be incurred on the trade. In fact, given that all participants have equal opportunity to decide whether or not to use the Post Only feature with a midpoint order, it can be inferred from its use whether or not the trading fee or a potential execution is more important to the participant.

Staff questions the fairness of this Functionality because they say it appears to ultimately benefit Post Only midpoint orders over non-Post Only midpoint orders in the form of the rebate. We respectfully disagree. In fact, the Functionality today offers the non-Post Only order two benefits: the potential to capture the rebate with price improvement when the NBBO is repriced more passively, and the mitigation of execution risk when the NBBO is repriced more aggressively. In Example 1 above, the midpoint buy non-Post Only order is given the opportunity to execute at a better price than its original resting price while also being provided the opportunity to capture a rebate when the midpoint price is recalculated to 9.99. In Example 2 when the NBBO is repriced more aggressively, the order is provided the benefit of executing against available liquidity (the Post Only order) at 10.03 when the market is moving away thus mitigating the chance of further price slippage. If this trade was prevented as Staff propose, participants will lose the freedom to decide to enter midpoint orders as non-Post Only and take advantage of potential liquidity. We submit that given that all participants have equal opportunity today to decide how they want

to trade in Example 2, that if this functionality is changed it will be unfair. Participants will have fewer choices and those participants who use non-Post Only midpoint orders today will be forced to absorb increased execution risk.

TIME PRIORITY AND REBATE ELIGIBILITY

Staff's position appears to be based on the beliefs that counter-side time priority should apply and that the midpoint non-Post Only order should not become active when the NBBO is repriced more aggressively. We believe existing precedents undermine both of these beliefs. The principle of time priority in market structure is intended to apply to orders on the same side of the market. From a buyer's perspective, it does not matter if shares are purchased from the first order in the order queue or the last. However for a seller, in order to encourage participation in the market, it is a general rule that the first participant to post an order at a price should be compensated with the opportunity to trade first at that price in order to compensate the participant for the risk taken. We note however that in the Canadian market structure precedents exists, approved by the OSC, where time priority is not maintained on the same side of the market. These include: broker preferencing where orders are matched between the same broker ahead of orders that are entered first at the same price, the matching allocation priority model used by the Aequitas NEO lit trading book where, after broker preferencing has taken place, NEO Traders orders are given priority over orders that have time priority, and the TSX Long Life Order. Given that time priority is not maintained in all situations, we fail to see Staff's concern and desire to apply contra-side time priority in this situation particularly as participants knowingly choose how their orders will interact today.

Regarding the view that the midpoint non-Post Only order that is passive at the original NBBO midpoint should not become active when the NBBO is repriced more aggressively, we note that this order will become active in other scenarios where the NBBO is repriced more aggressively. This is clear in Example 3 below where the midpoint buy order trades against a contra-side limit hidden order that is posted at the price of the repriced NBBO.

Example 3 – Midpoint buy order executes against a resting hidden limit order and pays active trading fee

Original Order Book and Midpoint

	BID	ASK	MidPoint Price
PNBBO	10.00	10.05	10.025
	Midpoint Buy 10.025	10.03 Hidden Limit Order	

Action: Protected Best Offer moves to a higher price of 10.06 resulting in a new midpoint price of 10.03

New Order Book and Midpoint

	BID	ASK	MidPoint Price
PNBBO	10.00	10.06	10.03

Actions

- The Midpoint buy order is repriced at the new midpoint of 10.03

Result

The midpoint buy order trades against the 10.03 hidden limit order and incurs an active trading fee.

Understanding this potential outcome, a trader is given the same decision whether or not to use a Post Only attribute when entering a midpoint order. If they want to interact with hidden liquidity when the

NBBO is repriced more aggressively they will decide not use a Post Only feature. However, if they want to avoid paying trading fees they will decide to enter their order as Post Only.

CONCLUSION

Today, all participants have equal opportunity in deciding whether or not to use the Post Only feature when entering a midpoint order and will make this decision based on whether or not the Post Only feature will help achieve their trading objectives. Given that different participants use different trading strategies, a participant that places a higher priority on the value of a potential execution at a more aggressive midpoint price when the market moves away will decide not to use the Post Only feature with their midpoint orders. If however, a participant places a higher value on not incurring a trading fee, they will forfeit the opportunity to trade and decide to use the Post Only feature. The value of this choice appears to be shared by our subscriber community who, in the six years that this functionality has been supported, has never made a complaint. Given that today all participants are empowered to decide how they want to use the Post Only feature, not only do we believe that there are no fairness issues raised by the Functionality but we also believe that if the Functionality is required to be changed it will be unfair. Participants will lose a valuable trading option and participants that use non-Post Only order today will be forced to absorb increased execution risk. We strongly encourage the OSC therefore not to make any changes to this Functionality so that participants will continue to enjoy the freedom to choose how they want to use Post Only feature.

We thank the OSC for its consideration of these comments and would welcome the opportunity to discuss further our views with staff.

Sincerely,

Nasdaq CXC