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**Re: Notice of Proposed Amendments to Implement Changes to the TSX Market Making Program**

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 members nationwide, and is led by volunteer 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 (the "Committee", “CSTA TIC” or "we"), a group of 22 appointed members from amongst the CSTA. This committee has an equal proportion 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 Committee was assigned the responsibility of presenting the views of the CSTA as a whole. The views and statements provided below do not necessarily reflect those of all CSTA members or of all members of the Trading Issues Committee.

The Canadian Security Traders Association appreciates the opportunity to comment on the proposal by the TMX Group to amend the TSX rule book to enhance and modernize the operations of the TSX market making model in several meaningful ways (the “Proposal”). The CSTA wishes to discuss certain specific

elements of the proposal, particularly with respect to the Minimum Guaranteed Fill ("MGF") feature and by extension its implication on price discovery in the Canadian markets.

**MGF Fills at the NBBO**

In addition to the comments below, we wish to refer the reader to our comments in response to the recent proposal from the Canadian Securities Exchange ("CSE"), dated April 10, 2017. Similarly to the CSE proposal, the TMX Proposal contemplates allowing the TSX market maker ("registered trader" or "RT") to interact with active retail flow at the protected best bid or offer ("NBBO") regardless of whether the TSX displays a quote at that price.

The MGF facility was originally designed to be a source of last-resort liquidity for small "retail" orders. By placing the RT's MGF obligation as a last resort, the mechanism encouraged price discovery in the lit market by giving resting orders an opportunity for a first fill on the TSX, prior to the RT being able to interact with active flow. We continue to believe that one of the fundamental purposes of market making programs on exchanges should be to reinforce price discovery in the Canadian markets.

In our view, the TSX Proposal compromises the trade-off between last resort liquidity for retail orders and the value of price discovery by permitting TSX RTs to interact with retail flows without any requirement that the TSX be directly contributing to the NBBO or the requirement that any visible orders be filled first. The TSX RT would be "freeriding" on quotes established on other protected markets and taking away an opportunity for displayed orders elsewhere to receive a fill at their protected prices. This mechanism diminishes the incentive for other participants to display quotations on any visible market, compromises the integrity of displayed quotations by creating a means of bypassing and ignoring protected quotations, and in turn, generally undermines the concept of order protection.

Note that while the TSX attempts to downplay the Proposed MGF feature by quoting the relatively high percentage of the time the TSX is represented at the NBBO, we believe that the feature should be examined solely on its characteristics and not within the context of the elevated market share that the proposing marketplace currently enjoys.

For the above reasons (and those in our previous response to the similar CSE proposal), we believe the specific feature of allowing MGF fills at the NBBO on the TSX should be denied.

**Amendments to MGF Eligibility Quantity**

Currently, the TSX minimum guaranteed fill stipulates the maximum size of fill that a retail order will be offered on the TSX, regardless of displayed volume.

For example, if a particular stock's MGF size is set to 899 shares, retail orders at or below 899 shares in size would be given a complete fill, and orders above that size would be filled only to the extent that the TSX order book has offsetting orders. In this example, if the MGF size is 899 shares and the TSX order book displays 500 shares, an active retail order for 800 shares would be filled 500 shares from the TSX book, and the RT would fill the remaining 300. On the other hand, an active order for 900 shares or

more would only be filled for 500 shares from the displayed order and the RT would be under no obligation to fill the balance.

The TSX contemplates changing the MGF eligibility criterion from an absolute size on the active retail order, to a model where the MGF eligibility is an increase to the size of the displayed quotation on the TSX. In the above example, if the MGF size is 899 shares, and the TSX is quoting 500, then retail active orders up to 1399 shares would be filled at the TSX BBO.

We believe that this seemingly subtle change in behavior fundamentally alters the dynamics of the MGF facility. Currently, the MGF can be deemed as a "fill of last resort" for small retail orders. Under the Proposal, the MGF facility becomes a "top up" fill to increase the TSX effective quote size, with the TSX RT as a selective provider of liquidity at the TSX BBO. Additionally, given that the TSX will offer the ability for market makers to dynamically change MGF size, this "MGF top-up" effectively allows RTs to introduce undisplayed orders at the TSX BBO[1] on chosen securities under the guise of market making without any meaningful offsetting obligations (discussed in the next section).

The TSX MGF facility can be viewed as substantially unnecessary in the most liquid stocks, as the TSX order book naturally contains sufficient size to accommodate MGF-sized orders. Under the Proposal, the MGF would allow market makers to interact with larger retail flow without displaying orders and thus potentially dramatically increase the volume traded through the MGF facility. We believe that this proposed change would transform the TSX MGF facility into a significant vehicle that is designed primarily to allow market makers to receive preferential fills from retail sources.

While we recognize that this proposed change to the MGF functionality could potentially mean greater fill certainty for retail clients, the offsetting trade-offs include a reduction of the ability for the broader marketplace to interact with retail flow and a decrease in the value proposition for contributing to price discovery by posting quotes in the visible markets. Unlike other means of accessing retail active flow, such as by resting orders on inverted venues, fills from the MGF are given exclusively to assigned market makers, with no ability for multilateral interaction with the institutional community, natural retail limit orders, or firms engaged in market making but who are not "assigned" a given stock. Since the proposal creates order flow segmentation based on differentiated access, we would suggest that that may be a violation of the spirit of Canada's fair access rules.

**Participation**

The Proposal contemplates certain technical changes which would permit an additional expansion of the circumstances where the TSX's Participation feature would grant a market maker a fill. TSX Participation is currently limited to 40% of the active order size, with a limitation that a market maker is only filled on their full allocated participation volume if they do not have a booked order at a given price level.

In the "Details and Rationale" section of the Proposal, the original 40% Participation cap seems intact: "*If only one Market Maker turns on Participation at a given time, then that Market Maker will be allocated the full Participation eligible fill (up to 40% of the incoming order, rounded to the nearest board lot).*"

[1] UMIR 6.6 was introduced to address concerns that hidden orders (in the normal course) should be ranked below all equally priced lit and protected orders and to ensure a hidden order only ranks higher when the hidden order provides meaningful price improvement beyond all lit and protected orders.

However, in the blackline amendments to the TSX Rule Book, Policy 4-802 Allocation of Trades eliminates the 40% Participation cap by changing the wording to "*a Market Marker may participate up to a percentage, specified by the Exchange, of the eligible order*".

Assuming the blackline amendments are correct, the Proposal would eliminate the historical 40% cap, and therefore allow the TSX to change participation levels at its discretion. In addition, the Proposal would also allow market makers to be "topped up" to their theoretical participation size regardless of the size of their displayed orders.

We believe that these steps move in the direction of expanding the Participation feature to permit additional circumstances wherein the TSX market maker would be given preferential fills. We highlight that any additional means for market makers to be given fill priority necessarily come at the trade-off of missed opportunity for passive fills among other market participants. We would suggest that the Proposal pushes the envelope of benefits to market makers without creating direct offsetting obligations which are measured on the performance of the market maker (discussed in the next section), and consequently any expansion of these benefits should be curtailed or denied.

**Obligations of TSX Market Makers**

The TSX Proposal contemplates evaluating secondary market makers (and eventually all TSX market makers) on the basis of whether a particular stock has met or failed to meet a specified spread goal and NBBO presence. The TSX further contemplates making the selection of market makers a competitive process on the basis of these metrics.

We wish to highlight that it is our understanding that the measurement of performance of TSX market makers will be disconnected from the measurement of whether the assigned market maker(s), specifically contributed to the final outcome. For example, we believe that many liquid stocks generally do not require any RT intervention in order to maintain either a bid-ask spread that is within the TSX's target spread goals, or a TSX NBBO presence surpassing the TSX's desired threshold.

The Proposal would offer TSX market makers significant benefits in the form of fill priority versus retail flow under the theoretical guise of "obligations." However, these obligations are not being measured on the performance of the market maker that is receiving benefits. Instead, performance may be met on the TSX without any market maker intervention, while the market maker maintains its clear benefits. In effect, for many liquid stocks (which are also the most lucrative to market makers), the effect of the Proposal would be to confer benefit with NO tangible obligation whatsoever, as the stocks maintain their performance naturally.

We believe it is inappropriate to offer market makers benefits in exchange for obligations unless those obligations specifically measure the performance of the RT themselves. We believe it is not appropriate to maintain or offer additional benefits until such a time as the TSX creates and implements market maker specific obligations which 1) specifically measure the contribution of each individual market maker's action, and 2) creates an enforcement process for these obligations.

We would like to highlight that a competing market maker model at Aequitas Neo Exchange does confer benefits in exchange for specific obligations, with measurement taking place based on the activities of

each market maker. While we are not necessarily in agreement with the Aequitas market making model as a whole, we do approve of connecting market making benefits to market making performance.

**Conclusions**

While the Proposal makes certain amendments that enhance the fundamental nature of the TSX market making program (such as introducing competition for market making assignments), we believe that the benefits that are being conferred to market makers are clearly greater than the obligations being required. Furthermore, certain aspects of the proposal, particularly the ability to fill retail orders at the NBBO, are generally contrary to the spirit of exchange market making programs.

For the above reasons, we believe the TSX proposal should be significantly amended, as follows:

- TSX MGF fills should only be applicable in situation where a TSX quotation exists on the contra NBBO side of the retail order that is being filled;
- TSX MGF fills should be constrained to an absolute size, not as a top-up to the TSX BBO;
- Obligations of market makers must be measured based on each market maker's unique performance and contribution to price discovery, rather than on the basis of whether a particular stock has maintained its target metrics with or without market maker involvement.

Finally, we believe that this proposal (among other market making-related proposals from various exchanges), raise questions on the appropriateness of market making facilities in the market today. The intense focus on decreasing the costs associated with executing retail client trades and the interest of firms wishing to interact with retail order flow may be overtaking the fundamental premise of market making facilities as a means of bolstering displayed price discovery. Market making facilities are being positioned as a simple means for retail-to-market maker interaction by specific firms. We believe that it would be appropriate to initiate an industry-wide discussion and debate the overall appropriateness of the use of market making programs for this specific purpose, which could result in the need for changes to the overall regulatory framework. Until such a holistic debate takes place, we believe it is inappropriate to expand the use of market making facilities in the manner being contemplated here, and by other exchanges.

Based on the above, we strongly believe that the Proposal should be denied.

Thank you for your attention in this matter.

Respectfully,

"Signed by the CSTA Trading Issues Committee"

c.c. to:

**Ontario Securities Commission:**
Ms. Maureen Jensen, Chair & CEO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

**Alberta Securities Commission:**
Ms. Lynn Tsutsumi, Director, Market Regulation

**Autorité des marchés financiers:**
M$^{e}$ Élaine Lanouette, Directrice des bourses et des OAR

**British Columbia Securities Commission:**
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**IIROC:**
Mr. Andrew Kriegler, President and CEO
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