May 8th, 2017

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RE: **TSX Inc. REQUEST FOR COMMENT on PROPOSED AMENDMENTS TO TSX'S MARKET MAKING PROGRAM** ("Proposal") published on April 6, 2017.

National Bank Financial Inc. ("NBF") appreciates the opportunity to comment on this Proposal. We support the OSC's statutory mandate to provide protection to investors from unfair, improper or fraudulent practices, and to foster fair and efficient capital markets and confidence in capital markets.

NBF is part of the diverse National Bank Financial Group ("NBFG") which: (i) manufactures mutual funds, owns proprietary distribution channels and supplies services to third party distributors; (ii) operates a discount brokerage firm; and (iii) is an IIROC-regulated investment dealer across Canada. We therefore take great interest in the regulatory initiatives contained in the Comment Paper and their potential impact on investors, the mutual fund industry, the investment industry and financial intermediaries.

NBF has long been a large and active participant in the TSX's market making program, acting as Registered Trader (RT) for some **425** listings, including **225 ETFs**.

Accordingly, our intention is to share our concerns regarding the initiatives contained in the Proposal and our experiences. Given our unique perspective, we trust that our comments will be taken into account during the review process and also provide a positive and productive contribution to the outcome of the initiatives proposed in the Proposal.

As background, let us acknowledge it is impossible to comment on the TSX's proposal without noting that it comes in the context of similar initiatives at their Canadian competitors. A host of programs have been proposed in variously differentiated structures but most of which mimic the TSX in structure broadly: that a designated market maker guarantee fills of a designated size to small order types of specific nature in return for the privilege of passive participation and odd-lots. These initiatives come as the retail brokerage community continue to seek ways to reduce costs and improve efficiencies while the market making community seek equally to provide liquidity to them.

The retail demand for such liquidity is significant and legitimate. As market makers, NBF is pleased to participate in such programs as to provide it. But, taking a broader view of Canadian capital markets as a whole, we remain concerned about the trend toward explicit retail segmentation and encourage the OSC to rule not just on the specific proposals as they arrive but also in their overall context. NBF believe that the healthiest capital market is one which has a high diversity of participants interacting within it.

Focusing more narrowly on the TSX proposal at hand, NBF recognizes that some reform to the market making program is in order. Minimum Guaranteed Fill (MGF) sizes are low, obligations are somewhat light, and over the last decade of vast change in our electronic markets the program has become less and less relevant.

For maximum clarity, let us address our comments directly toward the changes as they are proposed:

More than One Market Maker per Security

While it may seem logical that adding a Secondary Market Maker to each security would help tighten spreads and improve liquidity, NBF posit that the real value in the proposed changes is in the more specific performance obligations and performance criteria. As the TSX itself points out in the companion to the proposal, TSX BBO is on the NBBO some 90% of the time already. So the existing market makers have been doing the tightening. It's really size discovery and reliability that needs further encouragement.

Furthermore, the tangible benefits to the market maker are finite, most notably the odd-lot provision, while this proposal seeks, to double the obligations by foisting them on two different and *non-cooperative* parties. Put differently, the benefits for the existing market maker are halved while the obligations remain the same if not greater as a Secondary is added. Furthermore, since these obligations are outcome oriented (i.e. is the TSX at the NBBO as opposed to is the market maker at NBBO) there is little incentive for a secondary market maker to take risk if the primary is already posting risk. And yet the benefits are equally distributed.

NBF suggests that having two market makers with equal obligations and equal benefits will encourage free-riding. Maintaining a primary and secondary format would better recognize the relative contributions of the market makers and better incentivizes market makers to do their job properly. It would take some drawing to break out the separate schemes, and we would be happy to work with the TSX on this, but certainly the primary would retain the odd-lot responsibility.

The TSX clearly recognizes this in the ETF market as they have not proposed the Secondary Market Maker structure there. NBF applaud that sensitivity to the unique nature of ETF liquidity. Quality market makers are a cornerstone to keeping a largely intermediated market like the **ETF** market running smoothly. NBF submit that quality is not simply a function of the sheer quantity of available market makers or the degree of specialization and technological sophistication (though this is obviously key).

Stability and commitment are equally important for the long-term viability of quality market makers and for the issuers they support.

NBF has made the point before that this kind of stability is best found in long-time diversified members of the Canadian financial community. Diversified, local firms are necessarily more exposed to the entire financial eco-system in which they operate. With this more holistic viewpoint, they are able to focus on the long-term health of the markets in which they operate; and that level of commitment is good for all stakeholders. To put a sharper point on it: when the going gets tough they cannot simply pack it in and leave.

Changes to the MGF facility

NBF does not support the first MGF change proposed **(2.i)** regarding the execution of MGF trades being at the protected NBBO instead of the TSX BBO. We understand it would make the facility more attractive to routers who need trade-through price protection. It is problematic, in our view, because if the TSX is not at the NBBO then clearly the Market Makers are not at the NBBO. They would be participating *at the touch* against small order types while not actually posting liquidity at that price level. *This is in neither the spirit nor the letter of the prevailing Dark rules.*

The proposed & renewed obligations of the market makers should serve to alleviate this concern to some degree. But it still seems inequitable that a market maker be able to participate at levels they are not willing to support on the board. NBF propose that MGF participation only be available to the market maker if the TSX is at the NBBO.

NBF supports the proposal to introduce pre-qualified MGF-eligible trader ID's. We have, over the years, experienced much misuse of the MGF facility and this will serve to provide a more consistent experience for both sides. We remain a little skeptical of the eligibility determination process as we've seen that this can be more difficult to implement in practice than it sounds. NBF looks forward to learning more about the policies and procedures the TSX intends to implement in this regard.

NBFs largest issue with the proposed changes to the MGF facility lie in the methods for calculating the minimum size of the MGF. Growing the MGF size to either of the newly proposed calculation methods: (**2.iii.b**) MGF-eligible order size is TSX BBO size <u>plus</u> MGF or (**2.iii.c**) MGF-eligible order size is the protected NBBO size <u>plus</u> MGF. We feel either of these would result in significantly oversized obligations from the market makers.

Case c) would result in significant risk of gaming as the Market Maker could be forced to provide sizable liquidity at prices they may not have set – consider the case where the TSX offer is very small but elsewhere the offer is very large: a large TSX-bound incoming order would have to be nearly entirely filled by the market maker. An enterprising gamer could even set the sizeable offer size elsewhere while picking off the market maker on TSX and then cancelling their offer. Again, this could happen at a price the Primary Market Maker is not even posting at. In its capacity as a market maker, NBF is willing to supply smaller sized liquidity at these levels, but needs to retain full control over the sizing of this risk.

The inherent risk of oversized MGF would be especially egregious in the case of **ETFs.** In addition to having to commit to rather large sizes at orders the market maker may not be setting, as described above, even in the normal course of trading the NBBO for an ETF includes sizable orders from many non-TSX-designated market makers. Each of these market makers will have posted bids and offers to multiple trading venues in accordance with what each could hedge if they were lifted. Adding further size obligations to the market maker on these names will result in consistently being forced to provide liquidity in size that cannot be hedged.

The results will be significantly smaller MGF size posted by primary market makers, which is the opposite of the intention to the proposals.

NBF strongly advocate that the TSX retain the current requirement (**2.iii.a**) the MGF size be the MGF size.

Reorganizing the rule and policy framework outside of the TSX Rule Book

From the perspective of both our institutional brokerage and our market making operations, NBF have long supported increased transparency in market functionality. Market maker obligations and rights are as fundamental to trading in a market as any other rules and should be treated as such – fully disclosed and disseminated to all trading members.

It is our understanding from the TMX itself that the purpose of moving the market making obligations out of the exchange rules and into a publically available document available on their website is to make it easier to make changes in the future. The current structure requires board approval for even small changes and that's clearly inefficient in a fast changing industry.

NBF agrees with this in principle. The Market Making Guide published as companion to this proposal is easy to read and understand. NBF asks for some further clarity on what would be involved in making changes to the Market Making program in the future, should it be moved out of the rule book. We certainly hope that broad public consultation and regulatory approval would still be required.

NBF appreciates the opportunity to comment on this significant development in the Canadian trading landscape.

We look forward to our continued participation in any further public consultation on these topics and our objective is to find solutions that are relevant for, and serve the needs of the Canadian market. NBF and its employees are willing to take a leadership role in this issue participating in consultations with investors, industry participants and the CSA.

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