

GLOBAL BANKING AND MARKETS



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Via Email

Re: TSX Inc. Notice of Proposed Amendments and Request for Comments – Enhancement of ‘Seek Dark Liquidity’ Functionality

Scotia Capital Inc. appreciates the opportunity to comment on the proposal TMX Group to alter the functionality of the Seek Dark Liquidity Order type to introduce cross-seeking functions (the “Proposal”) which are otherwise described as “SDL Plus.”

We believe that the SDL Plus functionality is intended exclusively to limit executions from active flow against same-dealer resting orders. The concurrent feature of interacting with “price-improving dark liquidity” is not different from the behavior of regular attributed active orders, which already interact with price-improving dark orders, and is not material to the SDL Plus proposal. We therefore limit our remarks in scope to the restriction that contra-side executions must come from the same dealer as the active order.

We believe the purpose of this order is to allow dealers with active flow (particularly retail flow) to limit their exposure to high take fees on the TSX order book by ensuring that the same firm also receives a rebate. In turn, this may incent those firms to place the TSX destination higher in routing priority in the knowledge that with this order type the overall cost of execution is limited to the TSX’s net fee capture.

If permitted, this order type can be expected to have a number of consequences which must be considered:

- Orders resting on the TSX would typically be executed either against same-firm active flow, or as the liquidity source of last resort. This would increase the toxicity experienced by



resting orders on the TSX for any firm that is not routing a significant amount of aggressive flow using SDL Plus.

- Competitors to the TSX would be expected to implement similar features as a commercial matter.
- The degree of inter-to-dealer activity in the market would generally decline in our view.

We believe that while this may be an economically advantageous outcome for some firms, the overall outcome of this type of functionality must be considered holistically and take into account the expected impact of this type of functionality on the overall market.

We disagree with the Proposal's assertion that the SDL Plus would be used primarily "by those already using cross-seeking active routing strategies." Our expectation is that firms sophisticated enough to use cross-seeking active-routing strategies on multiple markets with high precision do not currently require SDL Plus functionality. Therefore, the likely users will be those firms whose "cross-seeking active routing strategies" performance is inferior to what SDL Plus could provide. Therefore, market-wide unintentional-cross and 'internalization' rates cannot be expected to decline on the basis of the introduction of a feature specifically designed to accomplish higher unintentional-cross rates.

Fair Access

Canada's regulatory framework for equity markets relies on the fundamental principle of "fair access" under which a marketplace cannot unreasonably condition or limit access to marketplace features to certain participants¹. We acknowledge that any dealer may equally use "SDL Plus." However, the consequence of various dealers' choice to use this functionality would be that smaller dealers and those with relatively less active flow would find it more challenging to receive executions simply because "bigger" dealers choose to avoid them. We do not believe that an environment where order types allow counterparty selection, or favour big dealers over small, is consistent with the principles of fair access.

We acknowledge that similar functionality may be achieved by technically-sophisticated dealer systems, and that some of this technology exists today. The Canadian regulatory framework does not prohibit dealers from operating systems which optimize the economic outcome of their routing. However, dealer systems are an area of competition and innovation which are not required to be governed by the principles of fair access. Furthermore, dealer routing intended to achieve same-dealer executions will not be as reliable as the enforcement of this limitation at the marketplace level. We therefore dismiss the argument that the same functionality "could" be achieved independently and therefore this is an order type of convenience.

We note that there are two precedents that merit consideration in this matter:

¹ <https://www.osc.gov.on.ca/documents/en/responsive-market-regulation.pdf>



1. The initial IntraSpread proposal² (July 16, 2010) contemplated an internalize-only model wherein dealer flow would only interact with contra orders from the same dealer. This model was denied on the basis of fair access concerns. In the OSC's Notice of Completion of Staff Review of the Original IntraSpread Proposal³, Staff comment:

It is our view that a marketplace that offers order types that allow for an order to be systematically restricted from interacting with the orders of other participants is operating in a manner that is inconsistent with the fair access requirements set out in NI 21-101.

We believe the considerations that gave rise to Staff's decision above remain valid today. The proposed SDL Plus order is restricted from interacting with the orders of other participants, by construction. Therefore the IntraSpread precedent should stand as a basis for denying the SDL Plus proposal.

2. CNSX Markets Inc. proposed⁴ to alter its allocation to consider jitney trades as part of the broker preferencing mechanism. In the OSC's Notice of Completion of Staff Review⁵ of the CNSX Markets proposal, this approach was denied. We cite Staff reasons including:

In particular, Staff are concerned that, by permitting two dealers to bypass committed orders in the book, jitney preferencing could lead to the formation of "liquidity consortiums", where dealers can make their order flow available to a select group of market participants through jitneying.

While the SDL Plus Proposal does not specifically address jitneying, the principles of bypassing committed flow in the book, and concerns around the formation of "liquidity consortiums" remain appropriate.

We support the OSC's past views on this matter, and believe that the precedents previously set should not be overturned through the Proposal.

We therefore believe the Proposal to expand Seek Dark Liquidity functionality to limit execution to same-dealer counterparties should be denied as presented.

² https://www.osc.gov.on.ca/documents/en/Marketplaces/ats_20100716_proposed-changes.pdf

³ https://www.osc.gov.on.ca/en/Marketplaces_ats_20101214_review-intraspread.htm

⁴ https://www.osc.gov.on.ca/en/Marketplaces_cnsx_20111125_rfc-jitney-trades.htm

⁵ https://www.osc.gov.on.ca/en/Marketplaces_cnsx_20120517_nc-jitney-trades.htm

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