Chapter 13

SROs, Marketplaces and Clearing Agencies

13.2 Marketplaces

13.2.1 Alpha Exchange Inc. – Intraspread Trading Fee Model Amendment – Notice of Proposed Fee Change and Request for Comment

ALPHA EXCHANGE INC.

NOTICE OF PROPOSED FEE CHANGE AND REQUEST FOR COMMENT

Alpha is publishing this Notice of Proposed Changes ("Notice") relating to proposed IntraSpread fee changes ("Fee Proposal") as requested by OSC staff. Market participants are invited to provide the Commission with comments on the Fee Proposal.

Staff request for specific comment

On October 5, 2012, amendments to the Alpha Exchange Trading Policies were approved by the Commission to reflect changes proposed by Alpha Exchange Inc. (Alpha) to the functionality of IntraSpread, that included allowing Seek Dark Liquidity (SDL) orders to trade with eligible Dark orders as well as with visible (lit) orders booked in the Alpha central limit order book (CLOB), while not trading through better priced orders on other markets.

In conjunction with that functionality, Alpha is proposing changes to its IntraSpread fee model, which would extend the application of existing IntraSpread fees and rebates to trades between SDL orders and lit orders in the CLOB. Staff are seeking comment on two specific issues with respect to the Fee Proposal:

1) Fair Access – The Fee Proposal would provide for a reduction in trading fees for the active side of an execution within the CLOB, but only when the active side is an SDL order (which itself is limited to the category of Retail orders as defined in Alpha's Trading Policies) – the fee reduction is therefore not broadly available to any other participant when executing a similar active execution in the CLOB (e.g., an IOC market order or marketable limit order). OSC staff are considering whether the restricted application of the proposed reduced fees in an order book with otherwise unrestricted access, raises concerns with respect to fair access under National Instrument 21-101[1]. OSC staff are seeking specific comment on this, and on how, the Fee Proposal might impact those that cannot avail themselves of the reduced fees.

2) Leakage of information – OSC staff have concerns regarding the proposal that disclosure of the rebate associated with an SDL trade be made to the trade counterparty. Providing a specific fee/rebate applicable only to trades with a certain class of orders (i.e., SDL that represent retail interests), and subsequently disclosing that rebate in real or near-real time to the trade counterparty, may provide an unfair advantage over other marketplace participants – specifically, by providing information as to whether the counterparty to the trade was "Retail" or "non-Retail". Additionally, staff question whether the provision of trade-by-trade rebate disclosures even through an end of day report, provides relevant non-public information which could be used to the advantage of a participant for future trading decisions.

OSC staff request comments on Alpha's Fee Proposal, including specific feedback in relation to the issues noted above. This request is not intended to establish a precedent for publishing fees for comment at this time. However, OSC staff believe that the Fee Proposal could potentially have broader impacts on Canadian market structure, and that it is important to solicit stakeholder input.

Submission of comments

Comments on the Proposed Changes should be in writing and submitted by May 13, 2013 to:

[1] Section 5.1(3)(a) states that, "A marketplace must not permit unreasonable discrimination among clients, issuers and marketplace participants.

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Comments received will be made public on the OSC website. Upon completion of the review by OSC staff, and in the absence of any regulatory concerns, notice will be published to confirm the completion of Commission staff's review and to outline the intended implementation date of the changes.

ALPHA EXCHANGE INC.

INTRASPREAD TRADING FEE MODEL AMENDMENT

A. DESCRIPTION OF THE PROPOSED CHANGES

Alpha Exchange Inc. (Alpha) is proposing changes to its IntraSpread trading fee model, where existing Intraspread fees and rebates would apply to trades between SDL orders and lit orders in the CLOB (Proposed Fee Model). Under the proposal, the active fees and the passive rebates for trades between SDL orders and lit CLOB orders would be aligned with existing IntraSpread rates, and therefore be lower than the corresponding regular Continuous trade fees and rebates.

B. EXPECTED DATE OF IMPLEMENTATION

TBD - Subject to Regulatory Approval

C. RATIONALE AND RELEVANT SUPPORTING ANALYSIS

The IntraSpread model in place prior to October 15, 2012 demonstrated that liquidity providers are willing to accept reduced incentives[2] when transacting against retail flow. This in turn resulted in lower active fees for the Retail dealer community and better executions for Retail investors.

Wide adoption of IntraSpread by the liquidity providers was based on the economic incentives that liquidity providers could derive from providing liquidity to natural investors, while being able to trade exclusively with retail order flow and not with other informed participants.

The same low-incentive approach does not work in marketplaces where access is open to all participants and under the same conditions. The limited success of lit marketplaces with low rebates[3] provides evidence that rebates are a necessary incentive and risk protection mechanism for liquidity providers when trading against a mix of informed and uninformed flow.

The Proposed Fee Model incorporates benefits originally obtained in IntraSpread by extending the low-incentive approach to trades between lit passive orders and active Retail orders. Under the proposal, a lit liquidity provider trading with an SDL (Retail) order will receive a reduced rebate, but will receive a full rebate when trading with a non-SDL order. With this model, the rebate is a compensation for the risk, awarded only to trades where the risk is assumed.

D. EXPECTED IMPACT ON MARKET STRUCTURE, MEMBERS, INVESTORS, ISSUERS AND THE CAPITAL MARKETS

It is expected that proposed changes will strengthen the visible liquidity, as natural investors will be able to trade with liquidity providers in the transparent book, under economic conditions acceptable to all parties. This will reduce the pressure to execute retail flow in the dark pools and improve price and liquidity discovery in the consolidated book.

With the proposed fee model, the average active fees for Retail dealers will drop, as will the average passive rebates on Alpha, contributing to the overall reduction in maker/taker fee levels in Canada.

With the Proposed Fee Model, a participant posting a lit order in the Alpha CLOB can receive different rebates, depending on whether the order traded with an SDL or a non-SDL contra-order. Alpha believes it is important to provide transparency of fees given the uncertainty and variability of the resting order rebate in the CLOB. Increased transparency related to the varying costs associated with resting orders in the lit book will allow participants with resting orders to determine accurate net positions inclusive of trading fees and rebates, better manage their risk, and optimize liquidity provision. There are various means by which Alpha can provide this transparency:

1. Real-Time – immediate disclosure of the rebate associated with an SDL trade to the participant on a trade by trade basis on the participant's trade execution message

2. Delayed – post-trade disclosure of the rebate associated with an SDL trade to the participant on a trade by trade basis, through an additional delayed (eg. minutes) execution message or report to the participant.

3. End of Day – post-trade disclosure of the rebate associated with an SDL trade to the participant through an end of day trade by trade report

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2 Zero rebates and mandatory price improvement of 10% of the NBBO spread.

3 Omega, TMX Select

Some may be concerned that such transparency provides the liquidity provider in the CLOB with information related to the nature of the counterparty. This view assumes that the ability to distinguish a trade counterparty as SDL vs. non-SDL constitutes a leakage of information, even though this information is limited given there are many classes of participant that fall into the non-SDL category, including Institutional, Proprietary, and Retail.

While any concerns over possible counter-party information leakage are increasingly mitigated as the disclosure of the rebate is increasingly delayed, the value of the fee transparency is increasingly diminished as well.

Alpha would like to seek specific comments on the impact of disclosing real-time, near-time, and end of day information in regard to the rebate provided to the liquidity provider on any trade in the CLOB.

E. IMPACT ON SYSTEMIC RISK AND MITIGATION

This change does not increase systemic risk.

F. IMPACT ON EXCHANGE'S COMPLIANCE WITH THE SECURITIES LAW, ESPECIALLY FAIR ACCESS AND MAINTENANCE OF FAIR AND ORDERLY MARKETS

Alpha believes that the proposed changes are in compliance with the Ontario securities laws, and more specifically, not contrary to the Fair Access provision.

- Any Alpha Member managing orders for Retail customers is eligible to send orders to IntraSpread and benefit from execution against price improving Dark orders as well as low-priced lit CLOB liquidity.

- All retail Members are provided fair and equal access to choose how their orders are to be handled by Alpha, and whether to seek dark liquidity through IntraSpread, or to access the visible book directly. Retail Members are therefore able to make that choice with consideration to the fully transparent differing execution and cost implications these options provide.

- We do not believe that all flows managed by a dealer need to have access to same services under the same conditions. Different flows represent unique business objectives within a dealer, require unique products and services, and often attract unique regulatory obligations. In support of this view, we note that today's market environment supports products accessible only to a class of participant (fees for market makers, up-stairs market/crosses, Liquidnet for buy-side, IntraSpread and MGF for retail). Also, in the US SEC recently approved a number of pilot programs with products and fees tailored specifically for retail flow (see Section J).

G. CONSULTATION AND INTERNAL GOVERNANCE PROCESS

The proposed fee changes were discussed with TMX Management and users of IntraSpread.

The proposed fee changes are generally supported by retail participants and SDL providers to IntraSpread. These participants have experienced negative impacts, namely higher average take fees, resulting from the dark rules which removed the economic benefits for LPs transacting in the dark and consequently reduced IntraSpread fill rates. These participants are therefore seeking a new integrated dark/lit approach.

Through consultation around incorporating the IntraSpread benefits into the lit market, feedback was provided suggesting that allowing retail and LPs to trade at low fees/incentives in both the lit and the dark markets under the proposed fee model would help to retain some of the original benefits offered by the IntraSpread model:

- Liquidity providers could compete for marketable retail order flow by giving up incentives.

- The liquidity providers risk of trading with other non-SDL order flow is not eliminated, but is compensated via rebates when trading against non-SDL flow.

- Ability for retail dealers to reduce their average active fees by increasing fill rates within IntraSpread and the Alpha CLOB at a reduced active fee.

Under the proposed fee model, retail dealers can continue to seek dark liquidity in IntraSpread to achieve the benefits of price improvement, reduced adverse selection, and reduced take fees. However, when dark liquidity is not available in IntraSpread, SDL participants are supportive of the opportunity to receive a fill through Alpha's CLOB at the same low take fee without the information leakage and opportunity costs that would otherwise be associated with re-routing an order.

Liquidity providers to IntraSpread were also consulted and provided support for the proposed model. Provided there continues to be a material probability of interaction with a retail order in Alpha's CLOB, liquidity providers will continue to be incented to participate in Alpha's CLOB irrespective of the unpredictability of the rebate. However, concerns were raised as the model requires liquidity providers to adjust to the unpredictable rebate. These concerns can be somewhat mitigated by providing increased transparency of the rebate, which Alpha is seeking specific feedback on as indicated in Section D.

H. TECHNOLOGY IMPLEMENTATION IMPACT ON MEMBERS AND SERVICE VENDORS

Members posting passive orders on Alpha will receive different passive rebates, depending on whether the active order is SDL or not. Many Members may want to reconcile their positions and P&L at the end of the day based to determine their actual cost of trading during the day, to allocate fees to varying internal desks, and to assess the ongoing risk profile associated with their liquidity provision.

I. ALTERNATIVES CONSIDERED

The proposed fee model is believed to be the best option under the current regulatory framework to retain and achieve many of the benefits and value that IntraSpread provided to the retail community prior to the implementation of the Dark Rules.

Other models were considered but deemed unsuitable. One option included raising the Continuous fees and rebates for the non-SDL orders trading with the CLOB, to increase the risk compensation when trading with other informed flow. This proposal was abandoned as raising the overall maker/taker fees in the visible book would be contradictory to some of the feedback provided by market participants.

J. EXISTENCE OF COMPARABLE RULES IN OTHER MARKETS OR JURISDICTIONS

Numerous examples exist in the US market supporting differentiated fees for trades involving Retail orders.

- Direct Edge launched a program on December 17, 2012, where unique fees and rebates apply to Retail Orders when transacting with other lit orders in the EDGX book.
  https://www.directedge.com/About/Announcements/ViewNewsletterDetail.aspx?NewsletterID=856

- On December 17, 2012 BATS launched a one year Retail Price Improvement Program on the BATS Y-Exchange, where unique fees and rebates apply to Retail Orders when transaction with Retail Price Improving Orders or other non-displayed liquidity. Note that in this program, for Group 1 Securities, the other non-displayed liquidity can receive different rebates, depending on whether it interacts with Retail orders or other orders (comparable to different passive rebates under Alpha's Proposed Fee Model).
  http://cdn.batstrading.com/resources/regulation/rule_book/BATS-Exchanges_Fee_Schedules.pdf

- On February 13, 2013 the SEC approved NASDAQ's Retail Price Improvement pilot program (http://www.sec.gov/rules/sro/nasdaq/2012/34-68336.pdf)

- NYSE also launched a Retail Liquidity Program on August 1, 2012, a program very similar to the original IntraSpread model, as there is no interaction of Retail Orders with liquidity other than Retail price improving orders introduced as part of this program (comparable to IntraSpread SDL and Dark orders only interaction only with each other).