December 15, 2014

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

cc:
Market Regulation Branch
Ontario Securities Commission
20 Queen Street West
Toronto, Ontario M5H 3S8
Email: marketregulation@osc.gov.on.ca

BY EMAIL

RE: ALPHA EXCHANGE INC. - NOTICE OF PROPOSED RULE AMENDMENTS AND REQUEST FOR COMMENTS

Dear Mr. Yao,

Scotia Capital Inc. (SCI) appreciates the opportunity to comment on the proposed rule amendments for the TSX Alpha Exchange. We are generally supportive of the proposed amendments but have some concerns about some of the details of the proposed implementation. We also believe that if the changes are made, it not would be appropriate for Alpha to continue to be a protected market under UMIR.

We would begin by noting that though the proposal refers to “natural” orders and investors, in our analysis it is clear that the changes are designed to specifically target active retail order flow and connect it more effectively with HFT liquidity providers. In fact elements of the proposal are specifically designed to make the market unattractive to large institutional orders. This is not necessarily an issue but it is an important point in evaluating the likely impact of the changes on various market participants and our overall market structure.

Retail Trading Economics

Active retail order flow has value to the market-maker who executes against this order flow primarily due to the random nature of retail order flow as compared to institutional order flow. Retail orders are generated by thousands of different people, so there is a higher probability that any particular buy order will be followed by a sell order, whereas for an institutional order, an initial buy of 500 shares is more likely to be followed by the balance of a much larger buy order. For a market-maker whose aim is to buy at the bid and sell at the ask, the random nature of retail flow is highly attractive as it affords a continuous opportunity to achieve this objective on a regular and timely basis.

In the U.S. retail order flow is typically routed directly to U.S. wholesalers, also known as retail market-makers. These firms either take the other side of the order (trading within the U.S. NBBO and immediately reporting the executed trade to the tape in accordance with U.S. market structure regulations), or route the order to one or more marketplaces for booking or execution.

Retail brokers in the U.S. will typically route to several different U.S. market-makers who are chosen by the retail broker based on factors such as execution quality, price improvement, liquidity provision and order flow rebates. The result is that in the U.S. retail orders typically receive superior execution quality to non-retail orders, often receiving a larger fills than available in the visible market and price improvement over the visible U.S. market prices.

In Canada, due to market access rules and dark liquidity regulations, there is currently no mechanism for retail orders to capture any of these benefits effectively. Dealers typically route retail orders directly into the regular Canadian market for execution and pay significant active exchange fees to execute this valuable active retail order flow in the open market. The benefit from executing against this flow (including the explicit passive rebate paid by Canadian marketplaces) accrues to the party on the other side of the trade, often a U.S. HFT market-making firm.

Inter-listed Trading

With many securities being listed on both Canadian and U.S exchanges, the U.S. and Canadian equity markets are highly integrated, with a large percentage of trading in inter-listed names occurring in the U.S.. Institutional market participants on both sides of the border have been accessing liquidity in both markets seamlessly through inter-listed order routers and strategies for many years.

Given the continuing drive to provide best execution for clients, it is to be expected that Canadian retail brokers would explore providing similar features to their clients. This is a positive development for the retail investor who will benefit from participating in a deeper pool of liquidity and at superior economics than currently possible in Canada.

While we have some concerns with the specifics addressed below, we are pleased to see the TMX take steps to make their market more competitive for retail executions. We believe that a transparent, market-based solution that allows open competition for retail order flow is an ideal result, allowing investors to benefit from the superior fills available to retail orders while preserving transparency and fairness by having the trades take place on a marketplace with liquidity provision open to everyone.

Alpha Proposal

Speed Bump

The primary feature being proposed is the randomized speed bump to be applied to active orders.

The proposal mentions IEX as a precedent. It is important to note that the purpose of the proposed functionality is precisely opposite to that of the speed bump employed by IEX. In that case the stated goal was to help a large active order capture all quoted liquidity across multiple marketplaces before low-latency players were able to react by cancelling their offerings or trading ahead of the order. They attempted to accomplish this by delaying all incoming orders as well as the publication of trade and market data by a small and fixed amount of time.

The goal of the Alpha speed bump is to give liquidity providers *more* time to cancel their orders before a trade occurs. By providing this option, the goal is to make it profitable for them to post more size than they might otherwise be willing to display on existing inverted fee marketplaces. This has two components:

- Protecting posters from other HFT participants "picking off" resting orders. As long as the liquidity provider's system is capable of responding within the minimum speed bump time, they can kill their offerings in response to adverse market events before a faster competitor can interact with their order.

- Protecting posters from large (likely institutional) active orders which attempt to sweep all liquidity from multiple marketplaces simultaneously. There is no other reason to randomize the speed bump time. A fixed delay is sufficient to protect from getting "picked off" in response to market events; a random speed bump only adds protection from a large trader who might otherwise attempt to time orders to hit multiple marketplaces simultaneously.

Were this market to continue to enjoy protected status, this proposal creates very awkward results in a multiple marketplace context. Consider this sample set of offerings for a stock:

Ask	Market 1	Market 2	Market 3	Alpha
15.52	5000	5000	5000	5000
15.51	2000	2000	2000	4000
15.50	1000	1000	1000	2000

Suppose an institutional SOR receives a market or aggressive limit order to buy 25,000 shares. It might use a strategy meant to capture all visible liquidity as quickly as possible. In this case it would split the order and route portions to all markets simultaneously with a limit of 15.52. For the purposes of this example we will assume it preferences Market1 and Market2 in the case of equal prices being available.

Trades will occur immediately on all markets except Alpha, so right after the order is sent the market will look like this:

Ask	Market 1	Market 2	Market 3	Alpha
15.52	0	0	5000	5000
15.51	0	0	0	3000
15.50	0	0	0	2000

The result is confusion for market participants:

- The automated strategy offering shares on Alpha will see the other trading activity and likely decide to cancel its sell orders in response to the surge of buying. Knowing the minimum length of the speed bump, they could potentially use this as a brief option, waiting to see how the other markets react to this trade before cancelling. They may also have an advantage in establishing the new bid price as they know when they will cancel their orders and move the NBBO.
- The offering on Market 3 now looks very attractive and will likely be filled or cancelled immediately.
- The original buyer will need to wait for a response from Alpha on that part of their order. Most likely these shares will go unfilled and the SOR will need to trade them at inferior prices than would have been achieved had it ignored Alpha entirely. Had the speed bump been a fixed interval they could have attempted to hit all markets simultaneously, but due to the randomization they had to choose between the Alpha offerings and those of the rest of the market.
- For other strategies viewing this market data, at this point it is very likely that the Alpha quotes are fleeting. The purchaser of the rest of the shares has likely already put in orders to buy on Alpha, and/or the seller will cancel their offerings. However it would still appear as a protected offering at 15.50. To place buy orders, the strategy would need to decide whether to wait for this offering to disappear and risk being at the back of the queue at the new prices, send an unlikely-to-fill buy order to Alpha to officially try to take out the shares while simultaneously bidding on other markets, or ignore the Alpha offering entirely and hope that nobody notices as the locked or crossed market is likely to be brief.
- Depending on how the speed bump is implemented, other participants could also attempt to send an order to buy the Alpha shares immediately and hope for a lesser random delay than that of the original buyer, and thus get the fill in spite of their order arriving at the marketplace later. They could also try sending multiple IOC orders to increase their odds. For this reason it might make sense to implement the delay in a way that guarantees the first active order to arrive will be the first processed.
- Programs used by regulators and compliance departments are likely to see locked or crossed markets as all of this plays out.

While the timeframe for this is very small in normal terms, it is a meaningful amount of time in today's markets. Note that the IEX speed bump referred to is for 350 *microseconds*, so the proposed range of 5-25 *milliseconds* is 15 to 70 times longer.

For this reason we do not believe it to be appropriate for Alpha to remain a protected order book if this plan is implemented. If Alpha were to retain its protected status it will almost certainly result in worse fills for institutional and larger retail orders and confusion of the real NBBO. It will also significantly increase the complexity of effective order routing behaviours and present significant opportunities for latency based arbitrage by higher frequency market participants.

In general, we are comfortable with more experimental trading models in unprotected markets where participants can determine the value of the market for themselves. This does not seem like an appropriate model for a protected marketplace which sets the NBBO and participants are required to access.

Fees

As we have noted above, there is an inherent value to market-makers in executing against retail order flow, particularly when it is separated from institutional and HFT orders. We have also highlighted how this Alpha proposal is clearly designed to largely isolate active retail orders while allowing liquidity providers maximum flexibility in executing against those orders.

It is our view that if approved, these changes would deliver clear benefits to HFT market-makers providing liquidity on the marketplace. This is important in order to incent them to post larger sized orders and more meaningful liquidity on the market. It is however equally important to the success of this initiative that the retail order flow being routed to the marketplace be appropriately incented as well.

We believe that a meaningful inverted fee structure, with rebates for active flow, would be necessary for this marketplace in order to justify the complexity and expense that will be incurred by market participants in implementing and adapting to these changes.

Conclusion

This is a unique approach, and it will be interesting to see how effective this is in encouraging greater liquidity provision. Aside from the order protection issues, our main comment is that this is a fairly convoluted way to attempt to segment retail flow from the rest of the market, creating complications for all other traders. We believe that it would likely be simpler and more effective to simply restrict active orders to being from Retail accounts in the same way that this was done for the IntraSpread marketplace.

Overall we are supportive of these changes and see them as a reasonable market response to the significant execution cost issues caused by our fully protected market structure and high maker-taker fee structures. We strongly believe however that Alpha cannot continue to be a protected market if these changes are allowed since it will negatively impact execution quality for larger orders and would cause a significant increase in locked and crossed markets. We also believe that the approved fee structure must fairly incent all parties involved in order to increase

the chance of success for this initiative and offset the implementation costs and increased market complexity that it will bring.

As always, we appreciate the opportunity to comment on this issue and would be pleased to provide any more details if desired.

Sincerely,

Evan Young
Managing Director
Head of Electronic Execution Services
Global Equity, Scotia Capital Inc.
Global Banking and Markets
Scotiabank
(416) 863-7281
evan.young@scotiabank.com

Sean Kersey
Director
Global Equity, Scotia Capital Inc.
Global Banking and Markets
Scotiabank
(416) 863-7295
sean.kersey@scotiabank.com