BMO Capital Markets

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Dear Sirs/Mesdames:

Re: PROPOSED FEE MODEL FOR TSX AND TSXV LISTED SECURITIES TRADING ON THE CANADIAN SECURITIES EXCHANGE

BMO Capital Markets[1] welcomes the opportunity to provide comments to the British Columbia Securities Commission, the Ontario Securities Commission (the Commissions) and the Canadian

[1] BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. (member FDIC), Bank of Montreal Europe p.l.c, and Bank of Montreal (China) Co. Ltd,

Securities Exchange (CSE), with respect to the above-referenced proposal for a change in trading fees for TSX and TSXV listed securities trading on the CSE (the 2021 Fee Proposal) on issues relating to fair access to markets.

Our Canadian equity market structure is strong and does well to balance the needs, and sometimes competing interests, of the retail investor, the market maker and the institutional investor. The market maker plays a critical role in maintaining fair and efficient markets, standing ready to buy or sell and efficiently bridging the gap in time between natural buyers and sellers who wish to transact. The market maker is especially vital to the retail investor who are generally more likely to use market orders and trade for their full size without the benefit of sophisticated algorithms to manage the execution process.

The Canadian market is novel in that the retail investor participates on exchange and we believe market centers should be allowed to compete for this flow in ways that recognize the unique value of retail order flow. Canadian regulators continue to show thought leadership in carefully allowing speed bump markets, innovative fee structures and dark rules to improve choice and competition for order flow, however the recent CSE fee proposal has the potential to disrupt the current harmony and balance of incentive structures in our market

Our primary concern with the proposal is not the variable fees, nor is it the long standing GMF facilities, but the combination of two.

Background

Providing guaranteed minimum fills and meeting quoting requirements are obligations of the market maker, and in return they receive optional and customizable participation rights on all incoming marketable orders that are less than the agreed upon GMF size. Specifically, a market maker can choose in real time, by side, and in what magnitude to invoke their participation rights[2]. It is common practice for exchanges to compensate and incentivize a market making firm and we are supportive of such arrangements when the fee model of the exchange is roughly similar for all participants[3].

In an extreme example, if the limit order book were 10,000 shares on the bid and 100 shares on the offer, a market maker could set their bid side participation rate to 40% and the ask side to 0%, allowing them to queue jump the deep book on the bid while avoiding participating on the offer, except for orders that are designated as GMF[4]. The variable economics provide further incentive on the bid side participation, should an GMF order to sell arrive the market maker can step in front of orders that had

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2 See section 5.1 https://webfiles.thecse.com/CSE_Order_Types_and_Functionality_Effective_December_4_2020_Final_0.pdf?r7ZBXiYZYGKMr.GWL5a8EoyL2RPMKdCK

3 While pricing tiers create differentiated fees, exchanges generally either charge the liquidity adder or rebate them, but not both within the same venue and dependent on the nature of a counterparty.

4 A simple technique for estimating the fair value of a stock is calculating book skew. In the example above there is 100 times more buy interest than there is to sell, a clear signal that the price is likely to move up, making a buy on the bid considerably more valuable than a sale on the offer.

time priority to trade 40% of the GMF order, but should a proprietary trader or institutional order to sell for less than the GMF size the market maker is compensated for the higher risk of adverse selection with a rebate. Furthermore, if a sell order *larger* than the GMF size is sent the market maker does not have to provide any liquidity on the bid. The liquidity removing rebate will attract the desirable GMF contras, the liquidity providing rebate will compensate for the increased adverse selection risk of smaller non GMF orders, and anything over the GMF size can be avoided entirely.

Objections

CSE fee proposal coupled with the participation rights raise fair access concerns as the institutional investor will have a reduced ability to interact with retail contra parties, the primary sender of GMF orders. The proposed model disincentivizes institutional investors from posting larger size and or setting the best bid or offer as the market maker can jump the queue specifically for the most valuable class of order flow while also not subjecting themselves to the same adverse selection risk as the posted institutional order. Matching facilities that actively enable disintermediation between natural counterparties disincentivize posted liquidity. Additionally, if approved the CSE filing presents a risk of contagion as other markets seek to emulate and compete, which could further weaken the public quote. Simply put, institutions will be subject to more adverse selection risk, suffer a reduced interaction rate with retail investors, and these negative effects will compound as other markets are incentivized to copy the CSE.

An additional concern with the proposal is a new dimension of information leakage created at the end of each trading day. Specifically, the CSE disseminates at the end of each trading day a file containing the days trades and the fees associated with each transaction. Using the fees to identify the GMF orders also identifies those trades which are non GMF, essentially reducing noise and making it easier to identify institutional buying or selling imbalances. The information leakage risk is not the same in all securities, for less liquid securities it is common for an institutional investor to take days, and sometimes weeks to move into or out of a position, and its generally less likely that multiple institutions are trading the same name. The signal will be stronger and last longer in the securities where liquidity and trading frictions already create a deterrent to investors. Issuers should be particularly concerned as their names could become incrementally more difficult to invest in.

Solutions

We believe that the 2021 Fee Proposal will benefit retail market participants as they will be able to secure additional liquidity and better pricing with orders flagged as GMF. However, it is possible to avoid the fair access and information leakage concerns identified above while preserving the benefits to the retail investor and market maker.

We suggest that the above issues could be remedied by amending the 2021 Fee Proposal as follows:

1. Limiting the participation benefit of the market maker to trade only after the displayed liquidity has been exhausted. In this manner the market maker enjoys their participation benefit to supplement the liquidity at the NBBO for GMF and small sized orders without having to display liquidity or face adverse selection from large orders. This change eliminates the fair access concerns for orders resting in the limit order book, maintains the GMF economics that will benefit the exchange and retail investor, and preserves benefits to the market maker.

2. In the end of day trading file, remove fees for every execution and instead provide a single blended rate for the days adding volume to the market maker, while preserving the rest of the trade by trade detail. Any other proxies that could be reasonably used to estimate GMF trades

should also be removed. At the end of each month or billing cycle provide a single file with trade by trade fees.

BMO Capital Markets continues to offer its assistance to the Commissions and the CSE as they examine the 2021 Fee Proposal. If you have any questions on our comment letter, please feel free to contact the undersigned.

Sincerely,

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