January 24, 2022

VIA EMAIL

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Re: Canadian Securities Exchange (CSE) Notice of Proposed Change and Request for Comment – Proposed Fee Model For TSX and TSX-V Listed Securities on the CSE ("Notice")

Dear Mr. Faulkner:

Nasdaq CXC Limited ("Nasdaq Canada" or "we") welcomes the opportunity to provide comments on the CSE proposal to introduce a variable fee model where either a maker-taker fee schedule or taker-maker fee schedule will be applied to each side of a trade as determined by the type of counterparty responsible for the active side of the trade (the "Proposal"). While we are generally supportive of marketplace initiatives that introduce innovative products and services and differentiated fees and fee models for these services (in turn serving to promote a wider range of services being offered at lower cost) we believe that the merit of any new innovated design needs to be a secondary consideration when market integrity concerns are raised by a novel feature. With this in mind, we believe that the uncertainty and magnitude of different economic outcomes that will result for participants from the variable fee model being proposed represents a significant condition and limitation to access and therefore violates fair access principles. We also believe significant fairness issues are raised by the Proposal as an advantage will be provided to liquidity providers as a result of information becoming available to passive liquidity providers that is not accessible by other participants due to information leakage.

We begin our response by responding directly to staff's questions asked in the cover page of the Notice. We then discuss other market integrity concerns and other issues raised by the Proposal including:

- Uncertainty created for dealers when making routing decisions;
- The need for independent validation of the CSE billing process in the absence of dealers being able to reconcile invoices; and
- The introduction of a variable fee structure will do more harm than good.

QUESTIONS RAISED BY STAFF

I. Fair access - *how would the Fee Proposal, which entails the passive side of a trade paying trading fees depending on the nature of an incoming order, impact fair access to such passive participants*?

The fair access rules of National Instrument 21-101 *Marketplace Operation* (NI 21-101) require that a marketplace must not unreasonably prohibit, condition or limit access by a person or company to services offered by it.[1] The Companion Policy to NI 21-101 (21-101CP) provides that the level of a marketplace fee may constitute an unreasonable condition or limitation to access and that marketplaces are responsible for ensuring that the fees they set are in compliance with this requirement.[2] While the absolute fee levels in the Proposal are within the existing range of permitted fees charged by marketplaces, the uncertainty around whether a fee or rebate will be applied to a passive order by itself constitutes a condition and limitation to access. A passive order resting on the CSE will receive a rebate of ($0.0014) if it interacts with non-GMF order flow. However, if this same order interacts with a GMF active order it will be charged a fee ($0.0018). Comparing these two outcomes results in an economic difference of ($0.0032) which exceeds the ($0.0030) maximum fee a marketplace is permitted to charge for securities above one dollar in place today.[3]

While the magnitude of the economic difference between the two outcomes does not in itself constitute a violation of fair access, the difference between the two outcomes (i.e. the difference between receiving a rebate or paying a fee), and the uncertainty around being unable to predict the outcome does. The differential between receiving a rebate and paying a fee can meaningfully impact the viability of certain trading strategies for some participants and therefore creates a limitation from accessing the marketplace. For example, participants with capital constraints, the difference between receiving a rebate and paying a fee may be determinant to whether a strategy can be used.

II. Informational advantage - *would the passive participant on the CSE have an informational advantage over other market participants since they would have information about the nature of the incoming order flow and, specifically, about the nature of the counterparties to their trades, that is not available to other market participants?*

The short answer to this question is yes. There is informational asymmetry created by the Proposal whereby passive liquidity providers on the CSE are able to ascertain valuable information about the type of counterparties active on certain names while the same information is not made available to other

1 Subsection 5.1(1) of NI 21-101.
2 Subsection 7.1(5) of 21-101CP.
3 Subsection 6.6.1 of National Instrument 23-101 *Trading Rules*.

participants. Not only will this disadvantage participants that do not trade passively on the CSE (because these participants will not be able to know information such as the percentage of retail trading on a given name, the time of day when retail is most active etc.) but the Proposal will also negatively impacts non-retail active order flow by increasing trading costs. The Proposal prejudices non-retail participants by charging explicit trading fees when actively trading because of a marker-taker fee model being used (in comparison to providing a rebate being provided to retail accounts). Furthermore, the Proposal will result in information leakage, to the detriment of institutional investors, as market-makers can use fee information about their trades to identify orders from institutional accounts. This in turn may result in higher implicit trading fees as this information can be used to quote fade or to be traded against by liquidity providers, resulting in inferior execution performance.

The information asymmetry created by the Proposal violates two market integrity attributes of an ideal market – fairness and transparency.[4] Fairness refers to the perception, and the reality, that all participants are subject to the same rules and conditions and that no one participant or group of participants has an unfair advantage or disadvantage. The Proposal violates fairness because it affords an unfair advantage to liquidity providers who are able to acquire information about counterparties that is inaccessible to other participants. Transparency refers to the degree to which there is real-time dissemination of information about orders and trades to the public. Transparency is violated in that information about the type of accounts represented by active orders is made available to liquidity providers and not made available to the public.

OTHER MARKET INTEGRITY CONCERNS

Uncertainty Created for Routing Decisions

In order for participants to effectively manage their trading costs they need to have certainty with regard to the trading fee schedules that will apply when trading on different marketplaces. In the absence of fee information being provided on a trade-by-trade basis via a FIX message or drop copy feed, participants must rely on consistent and predictable fee schedules. The importance of participants having full knowledge of a marketplace's fee schedule is the basis for the requirement under part 10 of NI 21-101 for marketplaces to make all their fees publicly available.[5] With the Proposal there is no way for a participant to know what rebate/fee may be applied before entering a passive order on the CSE for a TSX/TSX-V listed security and also no way for a participant to know what rebate/fee has been applied in real-time to an executed order during the trading day. This creates economic uncertainty for dealers and in turn challenges for making routing decisions. Of particular concern is when a dealer handles a client order. How is the dealer supposed to make best execution decisions if there is no way to properly assess what rebate/fee will be applied to a passive client order entered on the market? And how is a participant supposed to perform meaningful trade cost analysis to assess the quality of the CSE as a trading venue if trading costs and execution performance in the past do not translate to those in the future, largely because market metrics are most impacted by the type of counterparty a passive order interacts with, and the corresponding rebate/fee.

[4] These attributes were first proposed as attributes of an ideal market in the TSE Report of the Special Committee on Market Fragmentation and which has been used by the CSA as reference to evaluate policy initiatives.
[5] Part 10 of NI 21-101.

We note that marketplaces wanting to offer differentiated fee structures, amongst other differentiating features, have launched additional independent markets to support these differences. CX2 was the first market to support an inverted fee model with CXC continuing to offer a maker-take pricing model. If the CSE wants to offer an inverted fee model we suggest that it considers following industry practice and launch a second market. This will provide participants the choice to trade on a CSE market with a different fee structure while also providing economic certainty so that they are able to make efficient and informed routing decisions. We note however that with any regulatory evaluation of a new market or a new marketplace feature that the benefits from its introduction should outweigh any costs imposed on the industry.

What has changed in Canadian Market Structure since 2016 to Lead to a Different Decision?

The Notice mentions that the CSE published the same proposal for comment on July 7, 2016. At that time the original proposal did not receive regulatory approval primarily because of concerns around information leakage and fair access. While we recognized that markets could evolve over time and in turn support a regulatory re-examination of a previous decision, in the absence of significant change precedents generally become more constrained rather than relaxed. We do not believe the Canadian equity market has undergone changes that would address staff's previous concerns with the Proposal and justify a different decision.

OTHER ISSUES RAISED BY THE PROPOSAL

- **Audit trail and billing reconciliation**

Participants receive trade details at the end of the month which are used to reconcile billing information. Should the Proposal be approved, participants will not be able to reconcile their invoices and will need to rely solely on the CSE for its calculation of which rebate/fee applies to which trade as there is no transparency into who the counter party is for each trade. In order to ensure invoices are calculated accurately an independent third party should be required to audit the CSE's billing process so that participants are provided assurance that the trading fees are correct.

- **Unnecessary complexity**

The Canadian secondary market for equity trading represents only 10% of the size of the market in the United States. However, despite its smaller size, Canada supports a highly complex market structure consisting of many unique trading rules, marketplace features and requires a number of order markers (for both regulatory and public purposes) to name just a few of its unique features. Looking past the market integrity concerns that are raised by the Proposal we think the added complexity created by the introduction of a variable fee structure will do more harm than good. As the Notice fails to identify a similar pricing model being used either within or outside of Canada, the model will be unfamiliar to both existing and new participants. The Proposal will result in costs to existing participants as it will require development work by existing participants to incorporate the fee model into trading strategies and trading tools and will serve as a disincentive for new participants to enter the market that are unfamiliar with the model.

- **The Proposal Fails to meet the CSE's own test to justify a significant change**

In the CSE's comment letter in response to Nasdaq Canada's proposal to introduce size priority for securities below one dollar on CX2 the position was taken that "significant changes" should carry a very high burden of proof before being allowed to proceed: the benefits must be clearly stated and supported, and the analysis of potential harm, and possible harm reduction measures be included in the supporting submission. In the CSE's view Nasdaq Canada did not identify the problem that the proposal was trying to address and instead that the rationale was to improve the liquidity profile for lower priced securities. We note that if this standard is used, the Proposal also fails to meet the aforementioned burden of proof for a significant change. In fact, the CSE provides the same rationale – that the Proposal will improve liquidity provision – to support the Proposal. For the sake of consistency, we believe that if the CSE is going to impose such a test, that they should be subject to a similar standard.

- **Why is the Proposal limited to TSX and TSX-V listed securities?**

While we are not supportive of the Proposal because of the issues and concerns discussed above, we are curious why, if the CSE is truly confident in the value of the Proposal, its application is being limited to only TSX and TSX-V listed securities and not also CSE-listed securities?

We thank the OSC for the opportunity to provide comments and would welcome the opportunity to discuss our views further with the CSE or with Commission staff.

Sincerely,

Nasdaq Canada