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and

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Re: Nasdaq CXC Limited – Proposed GEF Facility for an Exchange – OSC Staff Notice and Request for Comment

The Canadian Security Traders Association, Inc. ("CSTA") is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 members nationwide, and is led by volunteer Governors from each of four distinct regions (Toronto, Montreal, Vancouver and the Prairies). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee (the "Committee", “CSTA TIC” or "we"), a group of appointed members from amongst the CSTA. This committee seeks an equal proportion of buy-side and sell-side representatives with various areas of market structure expertise. It is important to note that there was no survey sent to our members to determine popular opinion; the Committee was assigned the responsibility of presenting the views of the CSTA as a whole. The views and statements provided below do not necessarily reflect those of all CSTA members or of all members of the Trading Issues Committee.

The Canadian Security Traders Association appreciates the opportunity to comment on the proposal by Nasdaq CXC Limited (“Nasdaq CXC”) to introduce a “Guaranteed Execution Facility” or “GEF” on the Nasdaq CX2 market (the “Proposal”). Our letter will discuss certain specific elements of the proposal, including the overall implications to the Canadian market with the existence of such facilities when they have an inverted trading fee structure (take-make). We believe that the Nasdaq CX2 GEF facility should not be approved as it is currently proposed and that all existing retail-oriented execution facilities should be comprehensively reviewed before any additional facilities are considered for approval.

General Comments

The proposed Nasdaq CX2 GEF will, by design, increase the segmentation of retail flow away from multilateral markets. We reiterate the CSTA's historic and prevailing position that such segmentation of flows increases trading costs for all participants not qualified as "retail" and in particular the institutional investment community. We believe that attempts by marketplaces to service the needs "retail investors" have resulted in benefits to economics of retail executing brokers, with institutional investors bearing the additional costs. Institutional investors manage the majority of the Canadian publics' wealth and the impact to this group should be of primary concern when considering marketplace proposals.

Over the past several years, Canada has seen a proliferation of retail-centric guaranteed fill facilities in the trading ecosystem. Existing approved facilities include the TSX MGF (including recent revisions which dramatically enhance the MGF effectiveness), the CSE GMF and the Aequitas AEF[1]. The common element among all of the facilities (including the proposed Nasdaq CX2 GEF) is the ability to grant a specific party (a market maker) the ability to interact preferentially or exclusively with retail order flow.

The origins of retail-centric guaranteed fill facilities in Canada rest with the TSX MGF facility, which was introduced to provide small orders with an ability to be filled when the prevailing TSX quote at the time was insufficient to fill the complete order. This feature rested on the presumption that the TSX quote was the entire quote in the market, and therefore the MGF would provide fills at a price where they would otherwise not be possible. Since the MGF facility had a make-take fee structure, market makers were incented by receiving a rebate for providing liquidity and active retail orders were charged accordingly for the service. This dynamic meant that the TSX MGF was a generally a liquidity source of "last resort".

Today, the nature of trading on multiple markets means that in many cases, guaranteed fill facilities such as those above (including the proposed facility) will instead provide active retail flow with fills which may otherwise be available on other displayed markets. It also means that guaranteed fill facilities can also be seen as "first resort" liquidity since some are attached to take-make models (including the CSE GMF and the proposed Nasdaq CX2 GMF), where market makers must pay for the right to have access to incoming active retail orders, while the active orders are paid a rebate for executing within the facility.

[1] Note that while the Aequitas AEF was approved in January 2017, Aequitas decided not to launch the facility "based on the concerns raised by the institutional trading community." (Excerpt from an email sent from Aequitas to clients on May 9, 2017, Subject: "Segmentation of order flow and an update on the Auto-Execution Facility (AEF) implementation),

We agree with Aequitas' decision and would point to it as a relevant precedent to consider in the evaluation of the cost benefit analysis for the segmentation of retail flow.

Additionally, recently approved changes to the TSX MGF facility, as well as the proposed mechanics of the Nasdaq CX2 GEF facility, act not as a “minimum size” order that can be filled at the prevailing bid or offer, but rather as a top-up to the liquidity available at the facility. In effect, the only thing being accomplished is a reduction in the probability of an order being executed on other displayed trading venues. While some may argue that it is less costly to settle trades when they are executed on a single market vs multiple markets, we do not believe that net additional marginal cost to executing brokers should trump the potential impact on market quality of participants generally being incented to post passive orders away from displayed markets and instead on facilities that allow them to interact with retail orders only.

We believe that allowing guaranteed fill facilities to multiply is a move towards an ecosystem where retail flow primarily trades with professional market-making firms on venues with inverted fee structures, disallowing any access to active retail flow by institutional investors or retail investors that place limit orders on displayed markets. This will raise transaction costs for institutional investor and by extension negatively impact investment returns for individuals whose assets are managed by institutions.

We believe that prior to the approval of any additional facilities for enhanced execution of retail flow, including the Nasdaq CX2 GEF, a holistic regulatory review and industry-wide discussion must take place to debate the merits of client order flow segmentation. Until such a debate takes place, we believe that the expansion of the use of market making facilities for retail execution is inappropriate.

GEF Eligibility

While the Proposal does not specifically contemplate “retail-only” flow in its design, the stated definition of GEF Eligible Orders closely matches other definitions for retail activity used in similar facilities. We believe that any discussion that attempts to indicate that institutional investors are indeed eligible for the proposed GEF should be tempered with the following counterpoints:

- Institutional orders handled via DEA are specifically excluded, as DEA flow is not eligible unless it is specifically executing retail client order flow.
- Institutional orders handled by trading desks would be substantially excluded, as high-touch order flow is typically resulting multiple child orders for the same client, on the same day.

In the interest of market transparency, Nasdaq’s GEF system description and eligibility criteria should be amended to clarify that the facility’s design substantially excludes all sources of non-retail flow.

Additionally, we ask that the Nasdaq CX2 GEF proposal clarify and confirm that GEF members must be IIROC Dealer Members and that the individuals involved in use of the GEF facility must be approved persons. This treatment would be consistent with the requirements of other market making facilities in Canada.

Obligations and Benefits of Market Makers

a) Benefits

The most notable benefit of the Nasdaq CX2 GEF to market markers is clearly the ability to access segmented active retail flow. Less notably, market makers would also receive an allocation priority over other undisplayed orders.

The Proposal states that GEF Orders will first execute against all visible orders on the Nasdaq CX2 Book, including the visible portions of icebergs. By extension, this means that any undisplayed portion of icebergs and any dark orders posted at the BBO will not have priority of the GEF market maker orders. The fact that Nasdaq GEF market makers have a higher allocation priority than other market participants that are willing to provide liquidity to all participants (not just retail) via undisplayed order types is not directly mentioned in the Proposal. We fundamentally disagree with this treatment and believe that orders which are constrained to only trade with a subset of counterparties should always receive lower priority than those which may trade with anyone.

b) Obligations

We do not believe the benefits granted to GEF members are commensurate with the obligations imposed on those firms. Additionally, we do not believe the obligations act to promote price or size discovery within the Canadian market.

Specifically:

- The obligations imposed on GEF members do not provide for the traditional balance between benefits on certain active securities in exchange for market making services in other, less liquid securities. We believe that, notwithstanding our concerns around exchange market making facilities generally, such trade-offs are appropriate for the health of the trading ecosystem in Canada and should be mandatory in any attempt to balance benefits with obligations for market making programs.
- The GEF members commit to trading the size of the Guaranteed Minimum Volume on both sides of the market. We note that the Guaranteed Minimum Volume is determined by the market maker and is no more than 50 standard trading units. Given that the facility will provide fills up to the GMV, we do not believe this obligation amounts to anything more than the ability to simply participate in the GMV and therefore there is no true "commitment" to trading the GMV amount.
- We do not believe that the obligation to maintain a one-sided quote for 25% of the trading day of one Board Lot is sufficiently stringent to be deemed an obligation since the securities selected by the market makers may be only those that are the most actively traded securities.
- The requirement to trade a minimum percentage of total volume for each security across all markets (expected to be 1% for TSX-listed securities, and 0.25% for TSX Venture listed securities) appears to broadly allow for inclusion of flow that is not related to the market makers own flow in the calculation. We do not believe that any other non-market making related flow (client flow, institutional facilitation, etc.) of a member firm should be counted in market making volume. Not only does this allow a market maker to undeservedly use investor participants flow as a benefit to themselves, it also advantages member firms that have more client flow even though this does not speak to the quality of the market making.

- We do not believe it is appropriate for Nasdaq to include an obligation based on a minimum percentage of Total Consolidated Trading Volume on other markets as there is no means for Nasdaq to independently verify the activity of any participant on other markets. Such obligations would amount to an honor system. Additionally, we believe the inclusion of trading metrics on other venues is inconsistent with past treatment of similar systems. For instance, it is our understanding that Aequitas NEO Exchange was prohibited from granting benefits in the Lit book based on activity in the Neo book. We believe that consistent application of precedent would lead to limiting obligations to only the book where benefits are being offered.

Conclusions

Based on the arguments presented in this letter, the CSTA TIC believes that the Nasdaq CX2 GEF proposal should be denied primarily on the grounds that the obligations and benefits of the facility are not appropriately balanced. In addition, we would suggest that any further proposals for retail-oriented market making facilities such as the GEF should be halted pending regulatory review of the broader issues arising from such facilities, including those currently in operation. The proliferation of models of this nature, combined with their inclusion on inverted-fee trading venues (such as the previously approved CSE GMF and the proposed Nasdaq CX2 GEF) is a consequence of efforts on the part of marketplace operators to introduce on-exchange implementation of U.S.-style wholesale execution facilities.

Currently, wholesale execution of flow is prohibited in Canada, yet marketplaces continue to provide features which offer the same effect, such as allowing market makers to pay fees for certainty over the nature of the active flow in return for little to no relevant obligations. The systematic provision of guaranteed fill executions to small retail orders is a direct arbitrage to the spirit of Canadian market regulation. If market participants are prohibited from performing an activity directly (wholesale execution), we do not believe it is appropriate for marketplace facilities to exist which perform the same activity indirectly.

Thank you for your attention in this matter.

Respectfully,

"Signed by the CSTA Trading Issues Committee"

c.c. to:

Ontario Securities Commission:
Ms. Maureen Jensen, Chair & CEO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

Alberta Securities Commission:
Ms. Lynn Tsutsumi, Director, Market Regulation

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