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Via Email

Re: Request for Comments – Proposed Fee Model for TSX and TSXV Listed Securities Trading on the Canadian Securities Exchange

Scotiabank appreciates the opportunity to comment on the proposal by the Canadian Securities Exchange (the "CSE") to introduce a fee model which would vary the execution cost for resting orders based on the nature of the counterparty against which they execute, with daily disclosure of the mix of GMF-eligible (i.e. retail) and non-GMF-eligible (i.e. predominantly institutional) order flow.

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General Remarks

The proposal at question is a restatement of a previous initiative (CSE proposal dated July 7, 2016), which was subsequently withdrawn. We believe that the questions raised in relation to the 2016 proposal remain as relevant today as they were then. Generally speaking, five years' elapsed market evolution has not reduced the need to safeguard marketplace fair access, and has not diminished the importance of managing information leakage. On the contrary, we believe that the issues of information leakage in markets have become more acute; previously-expressed industry concerns over information leakage (in connection with the 2016 proposal) should be considered as relevant to the current proposal as they were when written.

In light of the above, and given the critical importance the institutional community places on information management, we are therefore adapting our stance on the issues being raised and deviating from the substance of comments previously submitted.

We acknowledge that the Proposal is, at its core, designed to allow the CSE to continue to provide benefits to the retail brokerage community by operating an inverted marketplace, while also attracting more passive flow. We acknowledge that benefits may accrue to the retail community from measures that protect the CSE's market makers from informed (institutional) flow – including altering the economics of active non-retail flow. The extent of those benefits is currently unknown, and not quantified in the Proposal.

Notwithstanding the above, we are concerned that any potential benefits ultimately accrue to market makers rather than being passed on to retail executing firms through tighter markets or larger quotes. This benefit – to a narrow constituency – would come at a significant cost of information leakage, added complexity, and a precedent being set on a marketplace model that currently does not exist. In other words, the Proposal introduces a “benefit to the few” vs. “cost to many” trade-off, including setting a precedent on that trade-off.

Given the unknown degree of benefits to the retail community directly, we analyze the Proposal and base our feedback and analysis on basic regulatory principles in Canada, including assessing whether the precedent set by the Proposal would be appropriate.

Fair access

The CSE proposal raises several fair access issues:

1. A combined “two markets in one order book” regime where orders are posting on both a traditional and an inverted marketplace at once.
2. A significant indirect economic cost (in the form of information leakage) incurred by institutional participants forced to access a protected market.

3. A regime whereby participants in a guaranteed-fill facility, which carry obligations, are required to pay for executions related to those obligations. We acknowledge that this fee structure for the GMF is in place today. However, this aspect of the GMF has not been subject to a public comment process, and we are therefore taking the opportunity to raise the associated issues.

On the first, notwithstanding the ability of participants to assume worst-case (inverted) economics, the proposal eliminates the ability of a participant to specifically choose which regime they participate in. Each resting order participant is exposed to either paying to trade (against retail), or being at greater risk of adverse selection from impactful orders (but receiving a traditional make-take rebate).

By offering these features in a combined marketplace, with no ability to opt out of one leg in favour of the other, the CSE would appear to be engaging in a form of tied selling. A resting order intending to operate on one regime is required to also be present in the other. We therefore believe that this combination robs participants of the ability of determining their expected outcome on the basis of their routing decisions, and therefore unreasonably discriminates against participants whose routing decisions require advance knowledge of trade economics.

Second, the substance of the proposal would create economic incentives for institutional flow to avoid a retail-friendly market, thus creating a form of segmentation not previously seen in Canada. While these incentives do not prohibit access for institutional investors, they are nonetheless a barrier to entry; institutions are forced to choose between receiving a fill (on a protected marketplace) and giving away information to their trading counterparty.

As the CSE is currently protected from trade-through, institutional investors are unable to simply refuse to access this market out of information leakage concerns. The institutional community would be faced with a Hobson's Choice: violate OPR, or give away their identity as a non-retail participant. We believe this unreasonably conditions access to the CSE's operations as a marketplace, by introducing information leakage as an explicit negative outcome to institutional investors.

Finally, we are concerned with the implications of requiring a fill guarantee to be also subject to an inverted fee structure. Guaranteed fill facilities have their origins in enhancing the retail clients' experience by ensuring that smaller orders from individual retail participants can be filled immediately. These facilities are viewed (in the regulatory sense) as an obligation, though we acknowledge that in certain situations retail order flow may be profitable despite the obligations involved.

In the CSE's trading rules, market makers in a particular security are required to maintain two-sided markets at an acceptable spread goal, and provide guaranteed fills. The two-sided market and spread goal may in practice be wider than the prevailing BBO for the security, and market makers ultimately remain in control over the markets they post. However, market makers are required to provide guaranteed fills at prices set by other participants on the CSE. Under the Proposal, this would expose

market makers to the possibility of having to pay marketplace fees for fills occurring at prices better than their own quotes.

In short, under the Proposal (and, indeed, today), a CSE market maker is required to pay a fee to discharge their obligation, with no ability to manage the price risk – and no economic reward (at the fill level). We believe this unreasonably conditions access to the CSE market making program by significantly raising the economic obligation of market making firms, and the risks those firms must take.

In conclusion, we find the Proposal raises subtle but important fair access concerns. If allowed to proceed, we believe the precedent-setting nature of the Proposal would erode fair access industry-wide, as other marketplaces would be in a position to similarly offer features targeting a narrow constituency of market making firms, to the effective exclusion of others.

Information Leakage

The Proposal would unequivocally expose the nature (retail vs institutional¹) of liquidity-taking participants to market making firms. The CSE offers two mitigants:

1. Delayed dissemination (end-of-day)
2. Exposure only to the counterparty, as the information would be provided through disclosure applicable to the participant whose fees are being assessed

Neither mitigating factor eliminates the fact that sufficiently-active market making firms on the CSE would be able to develop an accurate view of the mix of retail & institutional activity in a particular security over the course of that day. Since institutional activity can (and frequently does) persist over multiple days, particularly in illiquid stocks, the information thus gathered can be used by the beneficiaries to position in anticipation of broad institutional flows and otherwise erode the performance of institutional clients.

It is important to note that the institutional community does not have a recourse against this activity, as the CSE is a protected marketplace². Trades on the CSE done by or on behalf of institutional clients will necessarily expose information related to overall trends & patterns of institutional activity to market making firms active on the CSE, with a delay that we believe is short enough to maintain the relevance of this information to subsequent trading days.

Further, we believe that while the CSE is proposing to provide information on a delayed basis, the firm will undoubtedly face pressure from market making firms to provide information with a shorter and

¹ Subject to appropriate and compliant identification of GMF-eligibility, which we assume will occur.

² https://www.osc.ca/sites/default/files/2021-02/csa_20210225_23-328_order-protection-rule.pdf

shorter delay. Such firms may (appropriately) point out that without an accurate view of trade economics, it is impossible for them to accurately measure trading P&L or otherwise manage risk – potentially in furtherance of their obligations to the CSE as designated market makers.

The information leakage dimensions of the Proposal have been previously explored in the response³ by the Canadian Security Traders Association to the original publication of this Proposal in 2016. We agree with the concerns expressed in that response and believe them to remain as relevant today as they were when written.

Conclusion

The Proposal raises numerous issues related to the overall health of the Canadian trading ecosystem. If approved, the Proposal would set a dangerous precedent related to fair access encroachment and tolerance of information leakage. We fundamentally believe that the concerns originally raised remain valid today. In the specific matter of information leakage, institutional concern over this topic has never been greater, and this issue remains at the forefront of market integrity considerations. Marketplace features which clearly introduce information leakage not only damage institutional outcomes, but also risk damaging the international reputation of Canada's capital markets.

Given the above, we believe that the Proposal should not be approved.

We appreciate the opportunity to comment on this matter.

Respectfully,

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³ https://www.osc.ca/sites/default/files/2021-01/com_20160802_csta.pdf