BMO Financial Group

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority (Saskatchewan)
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

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Re: PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 23-101 TRADING RULES

BMO Nesbitt Burns Inc. (BMO) welcomes the opportunity to provide comments on the Canadian Securities Administrators (CSA) Notice and Request for Comments on the proposed amendments to National Instrument 23-101 Trading Rules (NI 23-101) and related Companion Policy 23-101CP (23-101CP), together with a proposed data fee review methodology (the Proposed Amendments).

BMO is appreciative of the CSA's work on this important topic and generally agrees in principle with CSA's stance on the captive consumer issues created by the Order Protection Rules (OPR). On a number of occasions, marketplaces have opened up with very little competitive differentiation other than permutations on pricing models. This results in additional market fragmentation with little added value for the investment community.

However, we would like to add that while the issues created by captive consumerism are very real, and a drag on the Canadian Capital Markets in general, OPR itself is fundamentally sound in principle. With that in mind, we believe that focusing on solving pain points caused by captive consumerism rather than introducing an OPR threshold would better serve the investment community.

Captive consumer issues:

In our experience, the key issues that result from captive consumerism relating to Canadian marketplaces are:

- **Excessive market data costs** – Canadian markets continue to have some of the highest market data fees in aggregate of any developed market. In a number of instances, marketplaces that provide little value have turned market data fees into an annuity and rely on that as a business model to stay afloat creating an artificial tax on participants.
- **Marketplace connectivity costs** – Each new marketplace (or iteration of existing ones) creates new connectivity costs for the entire dealer community. While the connectivity costs are borne by all participants, the benefits are enjoyed by a handful of operators that the new marketplaces cater to.
- **Lack of marketplace liability** – Canadian marketplaces assume no liability for any losses resulting from direct marketplace negligence. The market on close failure on Aug 14th 2014 is an example of this. This contrasts with the US where marketplaces are responsible for losses resulting from their operations (e.g. Nasdaq's settlement relating to the Facebook IPO).
- **Marketplace externalities** – A hidden cost to the industry is the tie up of participants' development resources required to keep pace with marketplaces pursuing their business plans. Given the environment we operate in, any marketplace changes require the industry to commit resources to maintain compatibility.
- **Excessive fragmentation and complexity** – As more marketplaces open up, we are further fragmenting the Canadian market, making it harder for natural investors to interact with other natural investors. Often times fragmentation is rendering 'time priority' meaningless as it is easier to jump ahead of orders at the same price by placing orders in inverted markets. In addition, this increasing complexity can be exploited by a small minority of market participants, to the detriment of other participants.

Potential solutions:

We appreciate the extensive framework that the regulators have proposed and acknowledge that it tackles most of the issues we have highlighted. However, we believe that the problems the proposed changes are intended to solve could potentially be addressed in a more direct manner without altering OPR itself. We offer the following suggestions to gradually build on some direct approaches to address these problems:

- **Excessive market data costs** – We propose implementing an absolute cap on total market data fees for the industry, based on fees as they were in the pre-multimarket environment (adjusting for inflation) or other metrics discussed in the proposal. Markets should be compensated based on value provided as discussed in the proposal. Smaller markets (<5% marketshare) should not be permitted to charge for data. In addition, marketplaces should not be permitted to charge based on each instance of data consumption or fees per user.

- **Marketplace connectivity costs** – We suggest an equitable form of redistributing marketplace connectivity costs. Perhaps marketplaces should be required to offer initial trades for free (or at a discount) to cover the connectivity costs of participants.
- **Lack of marketplace liability** – Liability clauses should be standard language in any marketplace contract to cover participants from losses directly resulting from a marketplace's negligence or marketplace failure.
- **Marketplace externalities** – There should be consideration of the costs participants incur when marketplaces make changes to their businesses. Large undertakings should require regulatory pre-approval to assess the benefit to the broader investment community relative to the undertaking required.
- **Excessive fragmentation and complexity** – We firmly believe that fragmentation and complexity can fundamentally be tackled by addressing their root cause: the maker/taker pricing model. While we do not advocate banning the practice of maker/taker outright (at least not without coordination with the US regulators), implementing caps and gradually ratcheting down the practice would be beneficial. Caps could also be adjusted based on liquidity of the stock with more liquid stocks getting tighter caps.

We realize that some of these items are in the proposal and that the regulator's plan to provide order protection for marketplaces with >5% marketshare will address certain items. However, we foresee a number of issues with the proposal:

- **Three tier markets** – The proposal provides order protection to markets that have >5% market share or is the primary exchange listing. This creates a 3 tiered market place: 1) protected markets, 2) non-protected markets, and 3) Marketplaces that have primary listings. This will lend to confusion on which stocks are protected on which marketplaces.
- **Incumbents' advantage** – There would be an advantage to incumbent marketplaces that currently meet the 5% threshold. Conversely, new marketplaces would be at a disadvantage until they attain 5% market share, even if such a marketplace provides real value to investors.
- **Increased fragmentation** – We believe that having a tiered marketplace structure will incent non-protected marketplaces to aggressively pursue market makers. This in turn will lead to further fragmentation as certain segments of the market will pursue the cheapest available liquidity regardless of other considerations (such as toxicity of flow or size of quote) and result in unnecessary trading with intermediaries. We do not expect non-intermediaries to be present in any significant capacity on unprotected marketplaces which further exacerbates the intermediation issue.
- **Best execution** – The proposal indicates that best execution will take care of the non-protected markets. In our experience, best execution is a nebulous concept and we believe tightening up the rules will start to make best execution very similar to today's OPR. The UK Financial Conduct Authority report from July 31st 2014 indicates that most dealers in the UK do not adequately understand or follow best execution principles, in a market that relies on best execution as the guiding principle for routing in lieu of OPR.
- **Quirky market structure and complexity** – the proposed 5% threshold would create a quirky market structure that would increase the complexity of the Canadian markets as different participants will have different definitions of basic items such as NBBO, volume etc. In addition, there will be further confusion for consumers of market data for analytic purposes (calculation of VWAP, index inclusion metrics, and reference benchmarks, for example).

Below are responses to the specific questions in the Request for Comments.

Question 1: **Please provide your views on the proposed market share threshold metrics, including the types of trades to be included in and excluded from the market share calculations, and the weighting based on volume and value traded. Please describe any alternative approach.**

In principle, we do not favor a threshold approach to OPR. We actually believe this introduces unnecessary complexity despite the fact this is intended to address various other issues.

However, we believe the threshold metrics are valid for determining when a marketplace should be permitted to charge for data. Alternatively, the market data pie could be divided up based on time/size weighting of contribution to the national best bid/offer.

Question 2: **Is a 5% percent market share threshold appropriate? If not, please indicate why.**

See response to Q1.

Question 3: **Will the market share threshold as proposed help to ensure an appropriate degree of continued protection for displayed orders? In that regard, will the target of capturing at least 85-90% of volume and value of adjusted trades contribute to that objective?**

See response to Q1.

Question 4: **Will the market share threshold as proposed affect competition amongst marketplaces, both in relation to the current environment or for potential new entrants? Please explain your view.**

We believe the proposed OPR approach creates a tiered marketplace that provides an unfair advantage to incumbents while making it difficult for new entrants to gain traction. We would suggest that new entrants be given a certain amount of time to satisfy the proposed thresholds

Question 5: **Is it appropriate for a listing exchange that does not meet the market share threshold to be considered to be a protected market for the securities it lists? If not, why not?**

In principle, we believe trading rules should be kept independent of listing exchange status. Therefore we do not believe that a listing exchange should automatically be deemed a protected market

Question 6: **If the Proposed Amendments are approved, should an exchange be required to provide unbundled access to trading and market data for securities it lists and securities that it does not list? Please provide details.**

We believe it will be unnecessarily confusing if protected market status does not apply uniformly to all securities traded/listed on an exchange, therefore we continue to believe this status should be granted irrespective of whether it is a listing exchange.

Question 7: **What are your views on the time frames under consideration for the market share calculation and identification of 'protected market' status?**

12 months seems like an appropriate timeframe.

Question 8: **What allowances should be made for a new dealer that begins operations during the transitional notice period with respect to accessing a marketplace for OPR purposes that no longer meets the threshold?**

No special allowances should be granted. Any dealer looking to operate in Canadian markets should be on level footing with all other participants during the transitional phase.

Question 9: **Are there any implementation issues associated with the 'protected market' approach?**

Please see our general comments above.

Question 10: **What should the transition period be for the initial implementation of the threshold approach, if and when the Proposed Amendments are adopted, and why?**

We believe that 6-9 months is an appropriate transition period.

Question 11: **Please provide your views on the proposed approach to locked and crossed markets. If you disagree, please describe an alternative approach.**

We believe rules applying to locked and crossed markets should only apply to protected quotes.

Question 12: **Is the guidance provided sufficient to provide clarity yet maintain flexibility for dealers? If not, what changes should be considered?**

We believe the guidance related to best execution obligations and disclosure are reasonable in principle. However, we believe the interpretation of best execution continues to vary significantly among participants. We would be supportive of standardized reporting requirements to ensure the interpretation is consistent.

Question 13: **Please provide your views on the proposed dealer disclosure to clients.**

Conceptually we are supportive of increasing disclosure to clients and believe if implemented, this should apply consistently to all dealers, including non-investment dealers. As noted in our response to Q12, we believe disclosure should be standardized to eliminate different interpretations of the requirements

Question 14: **What should the transition period be for the proposed disclosure requirements, if and when the Proposed Amendments are adopted, and why?**

We believe that 6-9 months is a reasonable time frame for dealers to adopt these proposed disclosure requirements.

Question 15: **Are changes to the consolidated data products provided by the IP needed if the amendments to OPR are implemented? If so, what changes are needed and how should they be implemented?**

Dealers should have the ability to pick and choose, a la carte, on what markets the subscriber wants to see in the quotes on the IP. This is in addition to the protected NBBO provided. We would also suggest that non-IP vendors be required to unbundle the consolidated data products to prevent market data fees for non-protected markets being bundled with market data from protected one.

Question 16: **Please provide your views on the proposed trading fee caps as an interim measure. Please describe any proposed alternative.**

We believe this is a good start to the maker/taker issue plaguing modern markets and would encourage regulators to continue to tighten the cap. One additional consideration would be to align maker/taker caps with liquidity characteristics on a stock by stock basis such that more liquid stocks would have lower caps.

Question 17: **What should the transition period be for the proposed trading fee caps, if and when the Proposed Amendments are adopted, and why?**

The caps should be implemented immediately as the proposed levels are not drastically different than the highest levels that exist today.

Question 18: **Is action with respect to the payment of rebates necessary? Why or why not?**

Yes, payment of rebates (or maker/taker pricing models) needs to be addressed in general. The industry experiences an outsized cost relative to benefit received from such models (i.e. it results in more liquidity in already liquid names while providing little impact on illiquid securities).

Question 19: **What are your views on a pilot study for the prohibition of the payment of rebates? What issues might arise with the implementation of a pilot study and what steps could be taken to minimize these issues?**

We would be supportive of a pilot study for the prohibition of payment of rebates. Clearly we cannot include interlisted securities in such a study (other than coordinating this in lock-step with US regulators) as flow on interlisted securities would otherwise migrate to the US if this is not coordinated.

Question 20: **Should all types or categories of securities be included in the pilot study (including interlisted securities)? Why or why not?**

See response to Q19.

Question 21: **When should the pilot study begin? Is it appropriate to wait a period of time after the implementation of any change to OPR or could the pilot start before or concurrent with the implementation of the OPR amendments (with a possible overlap between**

the implementation period for the OPR amendments and the pilot study period)? Why or why not?

We would prefer to see such a study done <u>in advance</u> of any proposed OPR changes. We firmly believe that addressing the maker/taker model (which we believe to be a root cause of many issues plaguing our markets) will address some of the issues that OPR rule changes hope to fix. The pilot might even demonstrate that the OPR rule changes are unnecessary.

Question 22: What is an appropriate duration for the pilot study and why?

The pilot study should run for at least a year to take into account annual trading cycles.

Question 23: If rebates were to be prohibited, would it be appropriate to continue to allow rebates to be paid to market makers and, if so, under what circumstances?

Marketplaces should only be permitted to pay rebates to market makers out of profits generated outside the realm of trading.

Question 24: Will the implementation of a methodology for reviewing data fees adequately address the issues associated with data fees, or should other alternatives be considered? Please provide details regarding any alternative approach.

Please see our general comments above.

Question 25: Do you have concerns with respect to market data fees charged to non-professional data subscribers that securities regulatory authorities need to address? If so, how should the concerns be addressed?

Yes. We believe that dealers providing services to non-professional data subscribers are paying excessively high market data costs and especially relative to the declining commissions associated with these clients. Therefore there should be limits on the fees charged for data that will ultimately be used by retail investors. We believe that market data costs should be assessed in terms of their impact on the entire subscriber community.

Question 26: Is modifying OPR by introducing a threshold, and at the same time dealing with trading fees and data fees, an appropriate approach to address the issues raised? If not, please describe your alternative approach in detail.

Introducing an OPR threshold should be the last resort. Rather, a better approach would be to address the problematic side-effects of the current OPR directly (such as trading and data fees as well as other items we described earlier in this letter). In particular, we have identified 5 key areas that need to be addressed: Market data, connectivity costs, marketplace liability, marketplace externalities, and excessive fragmentation/complexity. We believe that addressing these items directly will solve the issues caused as a byproduct of captive consumerism without the complexity that an OPR threshold may cause.

Question 27: What is the expected impact of the Proposed Approach on you, your organization or your clients? If applicable to you, how would the Proposed Approach impact your costs?

The proposed approach will eventually bring down trading and market data costs for participants including BMO, however we believe it will take time for the industry to see the benefits of the proposed approach. As far as connectivity is concerned, BMO will likely continue to connect to all marketplaces given the breadth of our operations. However, we will closely assess this and look to selectively disable market data for those markets that fail to maintain meaningful market share.

Question 28: Is the Proposed Approach an effective way, relative to the other approaches described, to support a competitive market environment that encourages innovation by marketplaces? Please explain your view.

We believe that the pain points should be addressed directly rather than loosening OPR. We believe that addressing the specific issues we've identified in this letter would have a positive impact on marketplace structure and likely eliminate the need to change OPR itself.

Question 29: Considering the Proposed Approach, is it necessary to take additional steps to regulate membership and connectivity fees charged by marketplaces? If so, why, and if not, why not?

Yes, please see our comments above addressing connectivity fees. We believe marketplaces should be responsible for membership and connectivity fees until such time they are deemed viable by the investor community. We are open to creative solutions on how to make this practically feasible.

Question 30: Considering the Proposed Approach, is it necessary to take additional steps at this time to address issues relating to marketplace liability? If so, why, and if not, why not?

Yes we believe this is a critical issue that needs to be addressed. See our general comments above.

Question 31: Taking into consideration how these pre-trade metrics will be used within the various ranking models, are these reasonable proxies for assessing a marketplace's contribution to price and size discovery? Are there other metrics we should consider? Please provide details.

The metrics are a reasonable start as they fairly allocate contribution to the quote by marketplaces. In certain instances (such as 5 level $Time), the metrics are not easy to evaluate by the wider industry and would have to rely on the regulators to set the rates.

Question 32: Are the pre-trade metrics described appropriate for a marketplace that predominantly trades less liquid securities? Please indicate and describe what pre-trade metrics would be appropriate to use for such a marketplace.

We believe the metrics are appropriate, we prefer the $Time (value) method as it factors in trading as well as liquidity quoted, allowing less potential for gaming.

Question 33: **Taking into consideration how these post-trade metrics will be used within the various ranking models, are these reasonable proxies for marketplace liquidity? Are there other metrics we should consider? Please provide details.**

Yes, the metrics are reasonable proxies. However we would like the value calculations to exclude blocks as they can easily skew a marketplace's true value add.

Question 34: **Are the post-trade metrics appropriate for a marketplace that predominantly trades less liquid securities? Please indicate and describe any additional post-trade metrics would be appropriate to use for such a marketplace.**

Most of the metrics are geared towards volume as a component so markets that trade less liquid securities would be at a disadvantage. However, marketplaces in general typically don't segment their approach based on liquidity of a stock so this should not be a concern.

Question 35: **Are the ranking models described appropriate for ranking a marketplaces' contribution to price discovery and liquidity? Are there other ranking methods we should consider? Please provide details.**

Yes, the rankings seem appropriate but we do not favor including $Time (equal) in the calculations as it is easy to manipulate on illiquid securities.

Question 36: **If you had to choose one of the three ranking methods described, which method would you chose and why?**

We prefer the first model (US SIP model) over the other two. We do not like models that provide equal weighting of time without any concept of volume and value traded as these can easily be manipulated with respect to illiquid wide spread securities.

Question 37: **Please provide your views on the reasonableness of the two approaches for establishing an appropriate reference amount for data fees to be used in applying the data fee review methodology?**

The domestic approach has no reference point to fairly size up the value of the data and we would prefer the international reference in order to evaluate usefulness of market data.

Question 38: **What other options should we consider for identifying an appropriate reference amount? Please provide details.**

One other possible approach would be to look at historic TSX market data fees before the advent of multiple marketplaces and use that as a basis (inflation adjusted) to form the basis of the overall size of the market data pie.

Question 39: How frequently should any selected reference amount for data fees be reviewed for their continued usefulness?

Market data fees should be reviewed and allocated on a monthly basis and fluctuate with the market's 'usefulness metrics'. This should keep market data fees somewhat aligned with trading and quote activity on the marketplace.

We are extremely appreciative of the thoughtful in-depth work and analysis that the regulators have undertaken on this important topic. We look forward to seeing actionable items come out of this process and look forward to a better, more equitable market structure.

Sincerely,

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