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Re: CSA Notice and Request for Comment Proposed Amendments to National Instrument 23-101 *Trading Rules*

The Canadian Securities Exchange ("CSE") is pleased to provide its comments in response to the CSA's "Proposed Amendments to National Instrument 23-101 *Trading Rules*".

As the potential for unintended consequences is great, the CSE is ordinarily reluctant to support the adoption of hard price caps for any regulated service in Canadian securities law and policy. With the number of marketplace operators competing to provide execution services, it would be expected that market forces would ensure a steady decrease in costs for consumers of these services. Experience in Canada, unfortunately, suggests otherwise. Due to the incentives underpinning the maker/taker (and more recently, the taker/maker) fee model, the high cost provider of execution services has bizarrely retained the lion's share of the market in Canada, while innovative newcomers offering these services at materially lower prices have struggled to attract customers and market share. The CSA's decision, under recent amendments to the OPR regime, to "protect" markets with more than 2.5% market share of trading (calculated in equal measures of volume and value) makes it even more unlikely that a marketplace would sacrifice short term business volume in hopes of winning a higher level of market share at some future date by offering services to the industry at lower prices.

With this background in mind, although the CSE supports the policy direction set out in the proposed amendments to National Instrument 23-101 *Trading Rules*, the CSE has three major concerns with the approach set out in the proposal.

"1.2 Basis Points" is Not an Appropriate Benchmark

For the same reason that inter-market competition in Canada perversely favours higher take and make fees, "legislating" the cap below the U.S. standard of $0.0030 per share for the Inter-listed Securities could lead to a migration of order flow in these stocks to U.S. market centres. As such, it appears likely that our hands are collectively tied when it comes to these Inter-listed Securities. For the Non-Inter-listed Securities, however, the CSE does not accept that applying the 1.2 basis points of value measure to determine the trading fee cap is appropriate.

In arriving at the $0.0030 per share cap, the U.S. Securities Exchange Commission ("SEC") was looking at a universe of stocks with a significantly higher average share price than their Canadian counterparts. As many Canadian commentators have noted, at $0.0030, liquidity providers in the maker/taker venues are vastly overcompensated vis-à-vis their U.S. counterparts. The value at risk in Canada is lower (probably by two-thirds) for a market maker pursuing a rebate capture or other liquidity provision-based strategy as demonstrated in the differential between Canada's volume-weighted average price of $25.26 and the U.S. estimated price of $75. The CSE does not have access to the average share price for U.S. National Market Stocks for the period cited by the CSA. On the assumption, however, that the average price is $75.00 per share, a cap of $0.0030 generates a value of 0.4 basis points. If 0.4 basis points represents the "appropriate" compensation for the liquidity provider in a maker/taker environment, then the 1.2 basis point level proposed by the CSA would hard code the overcompensation of Canadian liquidity providers into law. The CSE does not believe that this approach is in the interest of marketplace customers or the broader public interest.

If the assumption that 0.4 basis points is the appropriate compensation level for the liquidity provider, then a quick calculation suggests that the appropriate cap on the "take" fee for Non-Inter-listed Securities should be closer to $0.0006 per share. Moving to a lower cap would go some ways to addressing concerns from the many liquidity consumers who have complained over the years about the high cost of accessing public liquidity in Canada. While the industry would still have to find ways of addressing the costs of liquidity for Inter-listed Securities, a strong step in the right direction would be made if the cap was implemented at a much lower level than $0.0017.

The CSE recommends that the CSA confirm, through research, that the appropriate fee cap is significantly lower than the 17 mils proposed.

Regulating Maker/Taker is Fine, But What About Taker/Maker?

In an effort to reduce the costs of accessing liquidity, a number of Canadian marketplaces have introduced "inverted" fee models.[1] Also known as "taker/maker", under these fee models, the liquidity consumer is provided with a rebate from the marketplace upon execution, while the liquidity provider pays a fee. Interestingly, the same mechanics that inhibit price competition on the maker/taker side are present in the inverted model. Liquidity consumers are naturally incented to direct marketable orders to the marketplace offering the highest rebate. To compensate for the provision of higher rebates, marketplaces will necessarily need to charge higher fees to the liquidity provider, to maintain the marketplace's net fees per trade. Thus, marketplaces looking to encourage liquidity providers to quote tighter spreads and to commit to larger volume with lower "make" fees, will be penalized. The lower "make" fees will not cover the provision of the higher rebates. The existence of the OPR thresholds further discourages marketplaces from experimenting with lower rebates and fees, for fear of market share losses.

Given that the same market dynamics are in place, it is curious that the CSA did not propose to regulate the "maker" side fees for marketplaces offering an inverted fee model. The CSE submits that the "maker" side for inverted markets should be capped at the same level as the "taker" side in conventional maker/taker markets. Taking this approach will have a number of benefits to market participants:

- Reducing the cost of liquidity provision in the inverted markets will enable and encourage the market maker, for existing stocks of responsibility, to tighten spreads and commit greater size to the visible market.
- Reducing liquidity provision costs could increase the number of stocks for which market makers would be willing to assume formal responsibilities: spread goals, visible size, participation, and guaranteed fills.
- Liquidity consumers looking for trade execution in Non-Inter-listed Securities would be likely to see more formal market makers participating and better quality markets available.

If the CSE analysis is correct, and the appropriate cap for Non-Inter-listed Securities is approximately $0.0006, then it is expected that the benefits noted will be increased. The CSE sees no logical reason why the "maker" fee should not be capped for inverted marketplaces.

Why not move to the obvious conclusion and ban maker/taker and taker/maker fee models for Non-Inter-Listed Securities?

If the point of this exercise is to reduce the cost of trade execution for liquidity consumers trading Non-Inter-Listed Securities, the CSA should take a harder look at banning fee structures

[1] CSE, Omega, Alpha, Aequitas, and Chi-X Canada ATS.

that provide rebates to one side of the trade. If maker/taker and taker/maker fee models were prohibited, there would be a reversion to fee models that charge both parties; likely $0.0002 a side for stocks trading at $1.00 per share and above. Such a fee structure would reduce costs for liquidity consumers used to the maker/taker model and would reduce costs for market making firms providing liquidity under a taker/maker model. These reduced costs could contribute to an improvement in market quality by improving the economics for the parties to the trade. Without competition from U.S. venues for these stocks, what is the risk to Canadian market quality if this approach were taken? One area of concern would be Exchange Traded Funds. If a significant number of the stocks in an ETF were Inter-Listed Securities, restricting maker/taker and taker/maker pricing for these instruments could create an unfavourable arbitrage between the Canadian and U.S. markets.

Recommendation: The CSA should formally investigate and propose for comment the prohibition of the maker/taker and taker/maker fee models.

Conclusion

To summarize, while the CSE reluctantly agrees that capping the fees paid by liquidity consumers is an appropriate step in our current market structure, the CSE questions two components of the CSA's proposals and adds a recommendation for further investigation:

- Capping the Non-Inter-listed fee at $0.0017 enshrines into law a significant overcompensation for liquidity providers on maker/taker venues;
- Common sense and fairness dictate that if it is appropriate to regulate the take fee on maker/taker venues, then it is also appropriate to apply similar limits on fees to provide liquidity on inverted venues; and
- In addition, the CSE proposes that the CSA formally investigate the prohibition of maker/taker and taker/maker fee models for Non-Inter-Listed Securities.

The CSE again thanks the CSA for the opportunity to comment on these important market structure concerns. The CSE is more than willing to answer any questions from the CSA and to support any further research required to achieve a fair and balanced result.

Yours truly,

Richard Carleton
Chief Executive Officer