ITG Independent Trading Group

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Thank you for the opportunity to respond to the CSA Trading Fee Rebate Pilot Study.

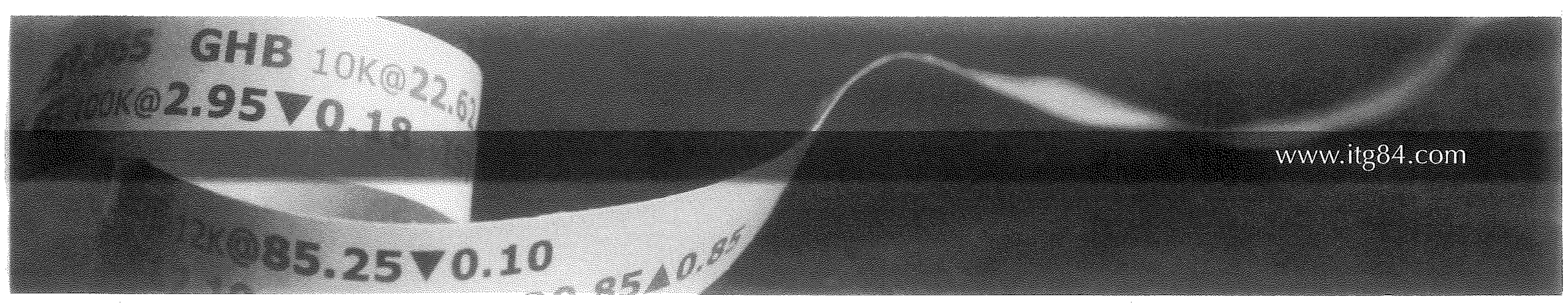
Independent Trading Group (ITG84) is Canada's only Investment Dealer solely focused on Market Making and Proprietary Trading. As such, we feel qualified to add our commentary to this Study. We will comment specifically to Question 3, as we feel other participants are more qualified to comment on other aspects of the Study.

When considering the effect of exchange rebates on market making, the committee must distinguish between liquidity providers of convenience and true Market Makers that have Marketplace Obligations, like TSX Specialists. Theoretically, both provide liquidity to markets, but only designated Market Makers are obligated to do so at all times.

Liquidity providers of convenience have the freedom to enter the market whenever they identify favourable odds. They are compensated implicitly by buying low and selling high, at prices and volumes chosen by them, and if the market action doesn't suit them, they can turn their focus to more favourable securities.

In stark contrast, designated Market Makers must routinely provide liquidity in their assigned stocks at the most unfavourable times. Consider, for example, the TSX MGF facility in which the primary and secondary Market Makers may be required to provide top of book liquidity up to 50 times what is available in the lit market. This is an obligation to accept a very adverse trade, one which is immediately a minimum one tick loser. Worse still, on any but the most liquid names the next best price is typically very far away from the top of book. Though the MGF facility is meant to provide liquidity to retail investors that cannot commit to the effort of working an order, experience shows that MGF fills often come the wrong way at short term tops and bottoms, especially when secondary liquidity is also poor, compounding the adverse selection. No "liquidity provider" of convenience would expose themselves to such trades.

Designated Market Makers are responsible for maintaining orderly markets, generally by quoting a maximum spread on their assigned stocks. Maintaining the spread is a minor risk for the few very liquid Canadian stocks, outside of times of market stress, but the great majority of names are very thinly traded, and the markets are not deep. It is common in such names to have the next level quote to be 1% or more away, on both sides, making the risk of quoting significant. No Market Maker can afford to routinely suffer such losses on a trade, and so are required to hold positions for some time until they find a reasonable exit. By facilitating trades, the Market Maker relieves the other side of the financial burden and risk of the position until the opposite side can be found. These trades are rarely exited profitably, and Market Makers must subsidize those losses by trading in their more liquid assignments. Liquidity providers of convenience have the freedom to focus only on the best trading names, with no obligation to provide liquidity where it is needed. Though these participants may tighten spreads, they will do so only by the minimum required to get ahead of liquidity that is already available in the market.



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Market Makers must also maintain orderly markets during periods of market stress. Unlike liquidity providers of convenience, Designated Market Makers cannot simply "shut off the machines" when markets get volatile. Exchanges automatically assign trades to the responsible Market Makers and we must continue trading to manage that assigned risk, and to help dampen the volatility. To prepare for that risk, Market Makers make significant investments in fault tolerant infrastructure. It's much easier to just shut down, but that is not what markets need us to do.

Finally, a primary function of Market Makers is "price discovery", to facilitate the market's ability to identify the price at which the most trades will clear, the fair price. Finance text books refer to price discovery in the abstract, implying that it is a process that happens organically. Not so. Price discovery happens by people trading at the wrong price. You only know you are paying too much when everyone tries to sell to you, or are offering too cheap when everyone is a buyer. Market Maker obligations force us to provide liquidity at those worst prices, as it is the promise of liquidity that attracts the opening trades, leaving us managing incremental losses until the market settles at the true clearing price. Only when fair value has been established can a Market Maker begin to earn back those initial losses, buying and selling around the price that they helped discover, until a new imbalance requires the clearing price to move again. Liquidity providers of convenience will wait until markets have settled, avoiding the cost of price discovery while capturing the opportunities available when it's found.

For accepting all these risks, providing all these services, a Market Maker is compensated in two ways: the opportunity to participate in trades at attractive prices, and market fee incentives.

Historically the primary source of Market Maker revenue was from the capture of the bid-ask spread, buying below and selling above the mid-point. Once those spreads were measured in 1/8ths, when market making required nothing more than a couple of phones and a seat on the exchange. Now decimalization and fractional penny trading have collapsed the bid-ask spread while required technology costs have exploded. They have at the same time dramatically increased the cost of price discovery as there are so many more levels at which the price can be wrong, and because the true clearing price can move incrementally outside of the spread all the time.

To recover price discovery losses and start earning a profit, Market Makers must execute to capture the bid-ask spread as many times as possible before the clearing price moves again. To do so we must compete with the liquidity providers of convenience that also try to capture the bid-ask spread when the market settles, but typically become significant liquidity takers when the clearing price begins to move.

Some exchanges offer some structural advantages to Designated Market Makers to improve their odds of trading at more favourable prices, such as the Participation facility of the TSX. But these advantages are easily trumped by the advantage derived from Broker Priority. Liquidity providers of convenience,

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especially the trading desks of large brokerages, can use Broker Priority to capture a large fraction of trades and starve out orders booked long before. And with multiple venues to which they can direct order flow, dealers can also segregate and capture the majority of low risk retail flow, leaving Market Makers to interact primarily with high adverse selection institutional flow.

Trying to capture the bid-ask spread in modern Canadian markets is a low probability trade for which profits rarely exceed the cost of price discovery, even with the slight structural advantage offered to Designated Market Makers. On the other hand, it is a great trade for liquidity providers of convenience that can leverage the structural advantage of Broker Priority while minimizing the overhead costs of price discovery.

Exchange rebates are the only guaranteed income that Designated Market Makers have. The trading that generates them is accepted as a loss leader. Without the guaranteed income, Market Makers cannot offer the services they provide to the Canadian market place, especially in the very thinly traded names, the majority, that need Market Makers the most. In contrast, for liquidity providers of convenience exchange rebates are simply found money, paying them for a service that they do not provide.

IIROC, in its wisdom, has determined that exchanges that exceed 2.5% market share should be designated as protected marketplaces for the purposes of OPR, guaranteeing them significant revenue streams for the services of processing messages and matching trades. Designated Market Makers routinely trade 3 – 10% of the daily volume in their assigned securities, with even greater fractions occurring in the least liquid names, committing their capital to ensure that trades can get done. To provide that service, we need some protection too. The lack of meaningful distinction between liquidity providers of convenience and true Market Makers is the equivalent of granting Firefighter status to anyone with a hose.

We feel very strongly that marketplaces be given the freedom to incentivise Market Makers to contribute meaningful liquidity to their respective marketplaces. As we have described, not all liquidity provision is equal. It is imperative that fee models reflect this distinction. Currently they don't. And the result is excessive intermediation in areas where it is not needed and at times when it is unnecessary.

It is critical to Canadian Capital Markets that there is a backbone of committed liquidity provision. For all listed Issues.

It is our opinion that any constraints on existing liquidity provision mechanisms during the Pilot Program would be inappropriate and detrimental to Canada's share of trading volumes.

If Marketplaces are constrained in their ability to provide meaningful, measurable, results-based incentives for liquidity provision, it becomes an issue of the strength and relevance of our Capital Markets, not just trading venues fighting over market share.

We would be happy to discuss further any questions you may have