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May 31, 2019

VIA EMAIL

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

The Secretary
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Me Anne-Marie Beaudoin
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Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*

TMX Group Limited ("**TMX**" or "**we**") welcomes the opportunity to comment on behalf of its subsidiaries TSX Inc. ("**TSX**"), TSX Venture Exchange Inc. ("**TSXV**"), and Alpha Exchange Inc. ("**TSX Alpha**"), on the joint consultation paper published for comment by the Canadian Securities Administrators ("**CSA**") and Investment Industry Regulatory Organization of Canada ("**IIROC**") on March 12, 2019 titled "*Internalization within the Canadian Equity Market*" (the "**Consultation Paper**").

For purposes of this letter, all capitalized terms and terms otherwise defined in the Consultation Paper have the same meaning as set out in the Consultation Paper, unless otherwise defined in this letter.

Summary of TMX position

We commend the CSA on its ongoing efforts to examine potential issues regarding internalization, with the objective of protecting investors and fostering fair and efficient capital markets. We also express our appreciation for the thought and effort put into the Consultation Paper. The issues it covers are broad and complex, and the Consultation Paper outlined and framed them well.

We are supportive of the principles and rules underlying the Canadian regulatory framework that help to maximize the opportunities for orders to interact on Canada's public transparent markets, and would generally caution against mechanisms that prohibit or unduly restrict those opportunities to avoid adverse consequences for transparency, liquidity, price discovery, liquidity, and market integrity.

However, it is also necessary to maintain an appropriate balance in recognition of the fact that the markets are comprised of a diverse set of participants with varying needs, and that the market structure envisioned through the general principles and rules cannot accommodate all needs. This has led to market models, features and functionalities designed to service those varied needs, and may have also led participants to seek their balance through other means. While those being serviced under these models might benefit, the outcomes might not always contribute to 'the common good'.

In order to achieve and restore a better balance, we are therefore recommending that certain lines be drawn in the context of internalization and segmentation that will help to constrain the potential for harm, while continuing to recognize the need for flexibility in light of the varied needs and interests of those that participate in our markets. Our recommended actions are identified below and explained further in this letter.

a) Strengthen the existing framework to ensure that small orders are exposed to the market and cannot be easily internalized by addressing shortcomings in the UMIR 'large' size threshold.

b) Address concerns about systematic matching of orders by dealers through additional guidance in the context of the regulatory definition of a ‘marketplace’.
c) Revoke recent approvals for guaranteed fill facilities that have resulted in the creation of ‘one-to-many’ retail segmentation models, except where part of a formal market making program operated by the listing exchange for its listed securities.
d) Cap active rebates for inverted markets to address industry concerns about the effect of the recent escalation in rebate levels on segmentation of retail order flow.

Internalization and segmentation

In our view, internalization and segmentation are intertwined and should be considered together based on commonalities in terms of outcomes, and how those outcomes might affect certain key principles that frame our market structure.

This view and the positions reflected in the letter below are influenced by our definition of internalization and its relation to segmentation. In our eyes, internalization is the outcome of the intent and deliberate actions of a dealer to match two of its orders against each other, regardless of whether that outcome is achieved on- or off-market. It also involves the restricting or minimizing of the exposure of those two orders to the market (i.e., to any other dealer or their clients) so that the desired outcome is achieved. By that definition, internalization is also segmentation in that it results in the segmenting of the internalizing dealer’s orders away from the broader market.

While segmentation is broader than internalization, there are forms of segmentation that are similar to internalization in terms of outcomes. This is true where the mechanism or model that facilitates segmentation prevents other participants from accessing the segmented flow. For example - marketplace models or functionality that only allow access to certain participant types. It is these more prohibitive mechanisms that create potential issues in the context of the general principles that govern our market structure.

General principles

The rules and principles that define market structure in Canada have, for the most part, been designed to facilitate the accessibility and transparency of orders in order to promote the broadest degree of participation and thereby support liquidity and the efficiency of the price discovery process.

As the primary listing exchange in Canada and an operator of three trading venues that facilitate the secondary trading of our issuers’ securities, we consider liquidity and the efficiency of the price discovery process to be paramount. To that end, we are supportive of the principles and rules underlying the Canadian regulatory framework that help to maximize the opportunities for orders to interact on public, transparent markets, and would generally caution against mechanisms that prohibit or unduly restrict those opportunities on the basis of the general sentiment that Canada’s market is not large enough to support these types of mechanisms *en masse* without adverse consequences for transparency, price discovery, liquidity, and market integrity.

This is particularly true as it relates to retail order flow given that retail orders represent a significant proportion of traded volume in Canada - as much 20%-25% of the traded volume as suggested by previous IIROC studies.[1] Retail participation is important for our market in terms of their willingness to continue to contribute to price discovery and liquidity through their posted limit orders, particularly for the less-liquid and more speculative stock of our junior issuers. Retail participation is also important because retail volume is more often liquidity taking,[2] and there is value placed on interacting with this order flow on the basis of it being considered to most likely be non-directional (or 'uninformed'). Allowing for broad participation against this order flow also promotes price discovery and liquidity by those seeking to interact against that volume - whether institutional clients and their dealer agents seeking to minimize adverse selection costs, or proprietary market makers (dealer or non-dealer) seeking to capture the spread.

We should therefore be particularly cautious about mechanisms that prohibit or unduly restrict access to retail order flow. We believe the general market sentiment is that the level and nature of the internalization and segmentation being undertaken via US equity market structure is beyond the limits of what is acceptable for Canada. This is similarly a function of concerns about the ability for the smaller Canadian market to accommodate the impact of a mass siphoning of retail orders from the market.

The need for balance

At the same time, it is important to recognize that internalization and segmentation can be a mechanism to defray costs to dealer and client business models and avoid impacts to execution outcomes that arise from transacting in a market structure that has arisen from those same general principles.

Participant needs and the resulting competition amongst marketplaces to service those needs also play a role. Marketplace mechanisms that might contribute to the segmentation of order flow (whether retail or otherwise) arise because the market is diverse in terms of participant types and their needs. Marketplaces are incented to seek means to service the unique needs of its diverse client base in order to (a) provide options and choice, (b) provide value to clients and (c) compete with each other by attracting the business of those clients. The result is the level of differentiated offerings that we see today, which go beyond those that might contribute to the segmentation of retail - take for example marketplaces and marketplace functionality designed specifically for or limited to use by institutional client orders.

[1] See Table 12 of IIROC's 2014 paper on trader category classification (http://www.iiroc.ca/Documents/2014/169edd4f-15e6-4330-8cb5-2c31e8f2bf82_en.pdf#search=trading%20groups%20methodology) that estimates retail at about 25% of volume, and Table 2 of the joint IIROC / Bank of Canada study on the Alpha speedbump from 2018 (http://www.iiroc.ca/Documents/2018/25d5b306-3420-43cc-b260-a1527b82bfc3_en.pdf) that estimates it at about 23%.

[2] See Table 14 of IIROC's 2014 paper on trader classification (http://www.iiroc.ca/Documents/2014/169edd4f-15e6-4330-8cb5-2c31e8f2bf82_en.pdf#search=trading%20groups%20methodology).

When considering actions to restrict or limit internalization and segmentation, regulators need to recognize that the effect of any restrictions and limitations could be increased costs (or at least reduced ability to manage costs), reduced competition, and reduced flexibility for both dealers and marketplace to service their clients' needs. We believe these outcomes are also not desirable, nor are they consistent with regulators' general mandate to foster efficient markets (which also necessitates fostering competition).

Any actions should therefore seek to strike an appropriate balance between the desire to ensure accessibility and transparency of orders to promote the broadest degree of participation, and the objective of promoting efficient and competitive markets by allowing for continued differentiation of marketplace services to recognize that orders, the clients they belong to and the dealers that send them have different needs.

The need for a line (or lines) to be drawn

With that being said, it is our view that certain forms of internalization and segmentation run contrary to the general principles and if allowed to expand would most likely have negative effects for transparency, price discovery, liquidity and market integrity. There is therefore a need for a line (or lines) to be drawn. There are a number of more direct actions that regulators could take in order to draw these lines and reduce the extent of internalization and segmentation, or at least restrict the extent to which internalization and segmentation can expand. These are outlined below:

a) Strengthen the existing framework to ensure that small orders are exposed to the market and cannot be easily internalized

Rules are already generally in place to help facilitate this outcome, but would be bolstered by some needed updating of the current UMIR large size threshold applicable to rules governing order exposure and client-principal trading.[3]

As has already been acknowledged by IIROC in connection with recent proposed amendments to its dark rules,[4] the effectiveness of the existing 50 standard trading unit threshold as a proxy for large orders can vary significantly depending on a security's price level. As a result, it can allow for internalization of orders that should not otherwise qualify for exceptions from requirements for the internalized order to be provided with a better price.

We are supportive of IIROC continuing with its ongoing review of the various 'large-size' exceptions contained in UMIR. As part of this, we would also suggest that it may be worthwhile to consider adoption of a threshold based on value only, although additional research may be

[3] See UMIR 6.3 and 8.1 which establish the 'large' size threshold for the purposes of those rules as an order that is greater than either: (a) 50 standard trading units or (b) $100,000 in value.

[4] See IIROC Rules Notice 18-0231 *Proposed Amendments Respecting Provision of Price Improvement by a Dark Order* at http://www.iiroc.ca/Documents/2018/b6fb9bd9-c7fd-4251-97e8-9dacddee45e8_en.pdf.

needed to determine whether the long-standing $100,000 threshold continues to be a relevant proxy for a ‘large’ order.

b) Address concerns about systematic matching of orders by dealers through additional guidance

We believe that a dealer that is internalizing orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules. We also believe that if a dealer has, as is suggested in the Consultation Paper, implemented technology or processes to pre-match orders that can then be ‘internalized’ on-market with a high-degree of certainty, then the dealer should also likely be considered to be operating a marketplace. What is important here is the deliberate attempt to achieve the outcome (i.e., the internalized trade), regardless of whether that outcome is achieved on- or off-market.

We believe the general sentiment of many in the industry is that if (a) these practices are in fact currently being undertaken and (b) adoption was allowed to continue, then there will likely be negative impacts for transparency, price discovery, liquidity and for perceptions of market integrity (i.e., confidence). There will also be negative impacts in terms of competition between those that have the technological capabilities and the breadth and depth of order flow to make such endeavours profitable to undertake (i.e., large brokers) vs. those that don’t (i.e., small brokers).

We believe that guidance of this sort is needed not only to avoid the above impacts, but also to ensure that rules like fair access that govern how marketplaces must operate will similarly apply to what should otherwise be considered a marketplace operated within a dealer’s internal systems.

It is also our view that without such guidance being provided, systematic pre-matching of orders could still be undertaken by dealers where the provision of price improvement is not a material factor for the liquidity providing side of the trade - for example, where the to-be-internalized order is retail and the liquidity providing side of the trade is dealer inventory or a held client’s position.

c) Revoke recent approvals for guaranteed fill facilities, except where part of a formal market making program operated by the listing exchange for its listed securities

We believe that recent approvals of guaranteed fill facilities that are similar to the TSX’s Minimum Guaranteed Fill (MGF) facility should not have been granted. These types of facilities should only be permitted where part of a formal market making program operated by a listing exchange, and where the eligible securities for the facility are limited to the listings of that exchange.

Allowing other exchanges to operate these facilities under the guise of a market making program on securities the exchange does not list represents explicit segmentation via a one-to-many trading model where the ‘one’ represents proprietary trading interests and the ‘many’ is primarily retail order flow. While the argument could be made that the TSX’s MGF facility is no different, it is important to consider the intent of these facilities when operated by the listing exchange and the differences in terms of practical outcomes.

TSX has a responsibility to its issuers to promote a vibrant and healthy secondary trading environment. The TSX market making program and the obligations of TSX Market Makers under that program to provide investors with guaranteed fills via the MGF, when there is insufficient liquidity in the CLOB, is meant to help TSX fulfill that responsibility. Other exchanges that operate these facilities for TSX-listeds have no such responsibilities, which begs the question - what objective do these other guaranteed facilities fulfil?

In addition, considering that liquidity in Canada has tended to concentrate on the primary exchange (whether for TSX-listed securities, CSE-listed securities or Aequitas-listed securities), it makes it more likely that the lack of depth at the quote on a non-primary exchange will help to ensure that its guaranteed fill facility will be accessed. The result is then the conferring of benefit upon the liquidity provider that is supporting the facility at the expense of displayed orders on other markets (including the many 'natural' orders displayed on the primary exchange) that were denied the opportunity to interact with what was likely to have been a small-sized non-directional retail order.

We therefore believe that revoking, or amending approvals for these other facilities to limit their applicability to the listed securities of the offering exchange, is appropriate as it would eliminate a form of explicit segmentation that is not otherwise justified in the context of fair and efficient markets, and would remove the potential for harm to transparency, price discovery, liquidity and market integrity if volumes within these facilities were to grow.

d) Cap active rebates for inverted markets

It is our belief that a certain amount of industry concern around segmentation arises from the potential for inverted fee models to segment cost-sensitive retail active order flow (which receives a rebate) away from 'natural' resting orders that might also be sensitive to paying fees to post (despite best execution obligations of the dealers managing these orders).

The recent escalation in rebate levels amongst inverted markets has brought these concerns to the forefront. We appreciate these concerns and acknowledge that TSX Alpha Exchange has also played a role in the recent escalation.

As marketplace operators, we compete and will continue to compete for order flow. So will our competitors. As a result, we expect that a further escalation of inverted active rebates is possible considering that it is not clear that the maximum level for the contra-side posting fees has yet been found beyond which passive liquidity provision would be negatively affected. Regardless, we acknowledge that various participants are concerned with the continued escalation and the associated costs that many perceive as creating a barrier for 'natural' orders to access the segmented active order flow.

We therefore believe that it may now be time to consider the application of a cap on active rebates to help address these concerns.

Our proposal is to set the cap for active rebates at a level that is reasonably reflective of active rebate levels prior to the most recent competitive escalation - i.e., within a range of $0.0010 to $0.0017 per share. Setting it at this level would help to better balance between the cost reduction benefits of active rebates for ‘natural’ liquidity taking order flow against the costs for ‘natural’ liquidity providing orders to participate against that flow. It would also continue to allow marketplaces a reasonable degree of room to compete and continue to provide differentiated offerings to its diverse client base.

If the implementation of a cap via regulation cannot be achieved within a reasonable timeframe, we plan to take the lead by calling together all marketplaces to discuss voluntary approaches to address the concerns.

Where caution is needed

In our view, the four specific recommended areas of action that we have outlined above would help to address industry concerns while in some cases placing limits on the extent to which internalization and segmentation can further expand. They also all generally relate to more recent phenomena that have contributed to the current levels of industry concern, and to a certain extent would help to reset market structure to its state prior to the recent events that had led to the Consultation Paper. As a result, we suggest that our recommended actions present a viable means to help towards addressing the concerns while minimizing overall risk.

We would generally caution against changes that would materially affect long-standing practices or mechanics within the market structure if such changes can be avoided. Included in this are changes that some are suggesting be made to broker preferencing – ranging from the imposition of limitations on when broker preferencing can apply to an outright prohibition. Either will impose unnecessary costs and the related complexity that would accompany such change, while removing or neutralizing a mechanism that has historically acted as a trade-off to the costs and inefficiencies that results from a market structure in Canada that forces retail orders to execute on-market (as opposed to off-market as is more typically the case in the US). If broker preferencing was removed, it would also create incentives for dealers to find other means to internalize their orders, or other means by which to achieve similar outcomes which could include executing their orders away from the Canadian public markets.

In our view, the need for changes to broker preferencing would be unnecessary if regulators were to implement our recommendations to provide additional guidance on systematic pre-matching of orders by dealers, and make needed changes to UMIR to update what is meant by ‘large’ size for rules governing order exposure and client-principal trading. The result would be that dealers’ ability to leverage broker preferencing to effectively and deliberately internalize orders would be greatly diminished, while allowing dealers to continue to obtain some of the benefits of internalization but subject to the controls of a mechanism that should under normal circumstances impose a structural limit on the total amount of on-market internalization that can actually take place.

Before considering any change to broker preferencing, it should also be recognized that the current levels of broker preferencing are likely not sufficient to lead to issues affecting price discovery, liquidity and market integrity that would necessitate and justify a change. As reflected in the Consultation Paper, broker preferencing is currently only 7% of volume, 5% of value and 5.5% of trades.[5] Further, the published rates may be overstated if measured on a trade-by-trade basis (as was the case for the stats provided to the regulators by TSX, TSXV and TSX Alpha which were based on trade flags applied at each individual trade). When reviewing executions on our three venues and excluding trades flagged as having been broker preferenced that would have traded against the incoming order regardless,[6] we found that flagged broker preferencing rates across the three venues might be considered by some to be inflated by about 10% - 15%.[7]

Taking action on broker preferencing would also do nothing to address industry concerns if dealers are allowed to systematically pre-match orders, including those that are small despite being considered 'large' under UMIR, and then effect the internalized trades with a high degree of certainty on low-volume marketplaces or marketplaces that the dealer has set up or sponsored to help it achieve that result.

We therefore suggest regulators' efforts would be better focused on imposing a framework to address concerns regarding internalization further up the order life cycle, as would be achieved through our recommendations to more clearly restrict the systematic pre-matching of orders by dealers and to clarify what is 'large' for the purposes of order exposure and client-principal trading requirements. We also urge the regulators to take the additional steps we have recommended to prevent further internalization and segmentation by limiting certain types of guaranteed fill facilities and implementing a cap on active rebate levels for inverted markets.

Thank you for the opportunity to comment. We would be pleased to discuss any aspect of these matters at your convenience.

Yours truly,

"Kevin Sampson"

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TMX Group Limited

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[5] Based on Figures 4-6 in Part 2 of Appendix A to the Consultation Paper.

[6] For example, consider a scenario where there are two resting buy orders in the book at $10.00, each 100 shares in size, with the first in time priority belonging to Broker A and the second belonging to Broker B. If a 200 share sell order from Broker B comes in priced at $10.00, the result will be that the resting order from Broker B will be broker preferenced and jump over the Broker A order to trade first, followed by the trade against the Broker A order. When measured on a trade-by-trade basis, the preferencing of the Broker B resting order is considered to be an instance of broker preferencing. However, given that both orders would have traded regardless, its inclusion may overstate the extent of the volume identified as having benefited from broker preferencing.

[7] Based on Q1 2019.