# Re: TMX Request for Industry Feedback – Use and Impact of Sliding Scale Model

February 7, 2025

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## A. Executive Summary

We welcome the opportunity to respond to the TMX Request for Industry Feedback (the "**Request for Feedback**") on the use and impact of the sliding scale model.

Our ability to provide feedback has been hampered by the lack of information included in the Request for Feedback. Additional context would contribute to a more meaningful dialogue on this issue.

The sliding scale model is generally geared towards the proper allocation of costs within firms and across desks. However, it has the potential to negatively impact market integrity by reducing transparency, uniformity, and predictability. These risks may be addressed through the measures referenced in this letter.

## B. The Context Surrounding Sliding Scales

The Request for Feedback is devoid of context and does not provide any information on the impetus behind this request or the TMX's position on this issue. In the absence of further context, it is difficult to provide complete and comprehensive comments on this topic.

It is our understanding that NASDAQ, CBOE, and TradeLogiq utilize what the TMX refers to as a "sliding scale" model, and that the net fee on these markets is zero. It is unclear whether the TMX has concerns related to this fee structure and believes that such fees should be restricted or, alternatively, whether the TMX is supportive of this fee structure and is considering adopting a similar structure.

As a fundamental proposition, marketplace participation is based on the premise that marketplaces do not unreasonably prohibit, condition, or limit access to trading, and do not permit unreasonable discrimination among market participants. On a practical level this is achieved by affording all participants with a level of transparency and uniformity which generates predictability.

Generally speaking, the sliding scale model is geared towards the proper allocation of costs within firms and across desks. In other words, fees are a method whereby firms may allocate costs and cross-subsidize. For example, a retail desk may get "no costs or free use of the trading desk" in return for its flow being managed by an institutional desk. It is not within the role of the exchanges to regulate business preferences or cost allocations within an organization.

In most cases where a sliding scale is used simply to allocate accounting costs, it does not impact market fairness or transparency. In such cases, sliding scale fees do not condition trading. This is because, practically speaking, investors are charged the same price for retail trades and most institutional trades regardless of whether the order is a market order, a marketable limit order, or a limit order. The dealer bears the cost as an input to their service. In these cases, if the costs of exchange fees are on the sliding scale, exchange fees are an almost irrelevant contribution to overall trade costs and are unlikely to drive behavior.

## C. The Risks of Sliding Scales

Sliding scales fee models have the potential to negatively impact market integrity. The following risks arise:

i) **Complexity reduces transparency:** Rebates and discounts applying post trade or allocations changing post-trade may impact market competition for those who participate in this segment of the market. In this scenario, a participant's *a priori* incentives are entirely hidden from public view, making it harder to compete and making participants less willing to contribute to price discovery.

ii) **Uniformity is eliminated:** An inversion of the fee norm on the central limited order book (CLOB) would harm the market by removing uniformity on the treatment of orders. The concern is a scenario where it is possible to invert incentives such that an active trade is charged on the CLOB and generates a rebate in the sliding scale.

iii) **Predictability is eliminated:** A pass-through participant could direct their order to generate a rebate on a sliding scale by being active on an order at a specific broker (where they would otherwise be charged) and can cross the spread on that specific broker.

Not all clients trading costs are borne by a dealer prior to charging commissions. DEA clients and others who avail themselves of pass-through billing may be presented with unique incentives from sliding scales which impact market integrity. Many DEA clients have multiple brokers and routing mechanisms, knowing it is subsidized to do so *a priori*, where it would otherwise be charged. This subsidy would be the absolute value of the active charge and the rebate.

Dealers offering sliding scales would then be offering free options to their pass-through clients that are not offered to other participants, thereby obfuscating the difference between active and passive orders to other participants and further consolidating flows to those benefiting from broker-priority.

Generally, re-allocating costs *ex poste* may harm the price discovery process, when the net fee or the trading friction itself would be re-allocated, or when removing the predictability of incentives and behavior necessary for an orderly market from both the client of the dealer and other participants who interact with that dealer. Also, where net fees are zero and the broker is on both sides of a trade (and clients or internal desks pay an unassociated gross commission), marketplaces are providing support for dealer internal billing models across business units which introduces agency costs and has been subject to criticism.

At an extreme, a sliding scale model, coupled with differentiated caps could allow a dealer to treat its end of the month billing as an *a la carte* pricing model to allocate costs to customer segments at will after trades occur and utilize the exchange as the rationale for doing so. Negative commissions are not permitted in Canada. However, a sliding scale model could allow for synthetic negative commissions in reaction to pass-through clients if not subject to caps or limitations to inversion.

If an organization uses extreme measures to cross-subsidize business lines (institutional over retail, or proprietary trading over institutional for example), distortions may arise across the marketplace, such as locked and crossed markets.

Finally, while generally a broker should allocate costs as it sees fit, utilizing an exchange as the rationale to charge for queue jumping reduces transparency and/or avoids the order exposure rule and the benefits it provides to price-discovery. Where a marketable order has some optionality of generating a rebate by executing through a specific broker, helping that broker "queue jump" has serious implications on the competitiveness of all other market orders that might face a charge for lifting liquidity. This may incentivize the further consolidation of order flow within the largest traders of specific securities.

## D. Mitigating The Risks of Sliding Scales

Application of the following general principles mitigates the risks of sliding scales:

i) **Transparent Pricing Models:** As stated, complexity and obfuscation of fees may reduce the willingness of participants to contribute to price discovery, and more troublingly, could harm marketplace integrity by encouraging the deliberate use of fee differentiation to alter net spreads for different participants in an unfair manner.

Pricing models should be transparent and applied *a priori* to provide predictability and clarity on the incentives for trading behaviors. All participants should not only know their own costs *a priori*, but also the costs and incentives of other participants.

ii) **Proportionate Regulation:** Setting caps and/or regulating internal allocation would not serve the market. It is within each dealer's purview to generate a trading cost structure with commissions. Dealers also allocate costs for internal accounting purposes which are not bound by exchange billing models. The internal allocation of trading costs after a trade has cleared are the subject of commercial decisions made by dealers. While regulation should play no role in internal accounting systems of organizations, it should also not facilitate or support cross-subsidization by obfuscating fee structures.

These general principles may be applied as follows:

i) Sliding scales should only be applied where net zero markets exist.

ii) Sliding scales should be subject to uniformity across sides and in fee caps. A passive trade that gets a rebate on a central limit order book should only be allocated a rebate on the sliding scale.

iii) Sliding scales should be subject to additional review. A firm, business unit, or trading desk availing itself of sliding scales should also be subject to elevated trade desk reviews/audits of the trades benefitting from sliding scales, with an emphasis on the interaction of pass-through billing clients and retail clients, the order exposure rule, and any unnecessary hold-up of orders.

iv) Should trades be found to be structured to benefit from sliding scales, they should be treated like intentional crosses, and subject to the same rules.

v) Any differentiation *a priori* on the queue-jumping side of an order should only apply to that side of the order. There are arguments that queue jumping has value. This value could be charged *via* lower rebates relative to normal passive rebates, or higher active fees. Differentiating, by reversing the charge to a rebate or *vice versa* does not have economic basis and provides a means to consolidate orders amongst the larger firms. Any fee differentiation for the benefit of broker-priority on an unintentional cross should only apply to the side which benefitted from the queue jumping.

vi) The marketable order which unintentionally crossed within the same broker, generates economic savings for the broker itself, and those savings could be shared between the broker and their client.

vii) Unintentional cross fees should be reduced to net zero.

viii) Any possibility of price inversion on sliding scales should be explicitly banned.

## E. Answers to Questions

**Question No. 1: Are you in favor of the sliding scale model in Canada - why or why not?**

Please see above.

We suggest that the TMX's inquiries focus on how orders and trades would be treated as a result of a sliding scale model.

An "unintentional cross" is not a pre-arranged trade like an order with a cross – marker. The order exposure rule is a critical element in the price discovery process of generally illiquid Canadian marketplaces.

If the sliding scale model treats charges on the unintentional active side like the intentional active side and treats rebates on the unintentional passive side like the intentional passive side, such that the model does not provide optionality for inversion, then the question of cost is mostly between the organization's business units. Likewise, where the client is a pass-through client, the fee structure is a commercial negotiation where the economics of volume and scale, speak in any event on the "plus" side of the cost-plus equation to the extent any rebates respect the caps on the CLOB. That is, sliding scales should not offer ½ penny rebates or even more where normal passive orders are capped, as this could be construed as a negative commission.

The concern, without further context, is a scenario whereby an organization consistently takes advantage of a sliding scale model where effectively an unintentional cross is treated with an inverted rebate structure on a passive rebate market or *vice versa*. The organization would either:

i) a priori: implement technology to route and allocate orders across markets, holding them up, shaping them and directing them to take advantage of the sliding scale to generate those; or

ii) ex-poste: have a consistent routing model and assume certain orders would be treated a certain way and deliberately seek to allocate fees charged by the exchange on a differentiated basis.

Our suggested inquiries include the following:

i) Should all passive – price displaying orders be treated exactly the same way in a marketplace – for example all rebate for passive orders or all charged for passive regardless of whether they benefit from broker priority?

   In the extreme inversion model, perversely the passive order is being charged for offering the broker the benefit of price-broker priority if the sliding scale allowed the broker to provide rebates to the active side where normally the CLOB would charge it for being active. We believe this would be very damaging to the market and every effort by the regulators should be made to avoid this.

ii) Should some passive orders which may benefit from queue jumping be charged for this benefit?

iii) Should active order which interact with a queue-jumping order – not benefiting from any price improvement from price-broker-time and interacting within the broker, now have the treatment of its order "flip" pricing in a different manner on exchange than if it interacted with a different broker?

   Any costs-benefits from broker-priority to the active order are the brokers' and should be allocated downstream by the broker not exchanges.

**Question No. 2: Does the sliding scale model introduce any risks to the Canadian market?**

Yes, for the reasons set out above. Any desk/marketplace should have answers to the following fundamental questions:

i) Why does an order that offers price discovery deserve a rebate (or charge) on a venue, but is then charged (or rebated) when it is willing to expose itself, but gets treated differently solely because the other side of the trade is within the broker? They have no control of the other side of the trade.

   For further illustration: Two crosses occurring on the order book – one which is at the top of the book from the same broker, and one which is behind the time queue. Will the top of book order matching with the same broker be distinguished from truly unintentional crosses? Our current understanding is these are not readily distinguished by data feeds.

ii) Is the argument that orders benefit from queue jumping? If so, how did the active order benefit from queue jumping and why should it be differentiated from regular CLOB active trades?

   Where queue jumping orders interact collectively to meet a size requirement of the active order – should further differentiation occur?

   If a retail trade is going to be charged for queue jumping, then this should be done by the broker to the retail trade, which benefits from broker - priority in a transparent manner and that trade desk review for meeting the requirements of the order exposure rule should be elevated in such case.

**Question No. 3: Similar to the access fee cap placed on marketplaces by National Instrument 23-101, should the sliding scale model be subject to a maximum fee/rebate limit?**

Our main concern is uniformity:

i) Any caps on active or passive trades should be uniform across all order types and across all markets.

ii) Any application of any rebates or fees should be uniform within markets.

iii) Any application of fees or rebates on a sliding scale should be uniform across business or clients and not trade by trade.

**Question No. 4: If trades are being structured under the sliding scale model, should those trades be reported or categorized as "unintentional" crosses?**

No. If it is structured on a singular trade basis:

i) A trade is by definition intentional if it is structured.

ii) Unintentional crosses are not reported, a *bona fide* match occurs within the trading engine algorithm and a risk at all times during the order entry of the marketable order exists that a limit order with a better price may reach the venues engine prior to that marketable order.

iii) They are not categorized *per se* by the trading engine, this is an ex-poste categorization where queue jumping occurs.

iv) If there must be fee differentiation for queue jumping, then a transparent fee (or rebate for jumping the queue should apply), but a rebate (or opposite) should not apply to the active side which does not derive any price benefit from the passive orders queue jumping. Alternatively, if there is to be any structuring, they should be treated as crosses and subject to walking the book and the order exposure rule and should be audited accordingly.

**Question No. 5: What impact, if any, does the sliding scale model have on fragmenting liquidity or price discovery?**

Any added complexity or uneven treatment of orders which, at the margin, reduces the incentive to expose orders, risks damaging the price discovery process.

Allowing for sliding scales *ex poste* within the same parameters of CLOB fee structures and as net zero fee attracting trades, removes complexity and uneven treatment as the marketplace would know the general economic incentive behind these orders.


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