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CANADIAN FORUM FOR FINANCIAL MARKETS
FORUM CANADIEN DES MARCHÉS FINANCIER
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Submitted via E-Mail

Attention:

Trading and Markets Division
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Matt Thompson
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Dear Sirs/Mesdames:

RE: NASDAQ CXC LIMITED – NOTICE AND REQUEST FOR COMMENT

The Canadian Forum for Financial Markets – formerly the Investment Industry Association of Canada – welcomes the opportunity to comment on Nasdaq CXC Limited's Notice of Proposed Changes and Request for Comments (the "**Request for Comments**") on proposed changes to the CXD Trading Book related to: (i) the removal of the Liquidity Seeking Order from PureStream's market model; (ii) the introduction of an independent CXD Conditional Order Book supporting CXD Conditional Orders; (iii) the introduction of an Extended Firm-Up Time Conditional Order; (iv) the introduction of PureStream Connect; and (v) the introduction of CXD Connect (the "**Proposed Changes**").

OVERVIEW

To achieve regulatory approval, the purpose of any proposed changes should be to render Canada's marketplace more competitive than other marketplaces globally.

With very limited disclosure, the Proposed Changes appear to risk increased cost without clear economic benefit to firms or consideration of alternatives.

As discussed below, further analysis and public disclosure is needed before proceeding with the Proposed Changes.

GENERAL POLICY CONSIDERATIONS

The Role of the Marketplace

The advantage of a regulated marketplace with members subject to best execution obligations is that the risk that members will not connect to or disregard the marketplace is nearer to zero relative to that of vendor and dealer alternatives to price discovery. Marketplaces generate an imprimatur of quality and safety which those who launch similar products as dealers and vendors do not enjoy. While they face some level of capacity utilization risk, marketplaces have an asymmetry of risk and reward as the lowest cost, and most subsidized system, bringing the highest of marketing benefits.

These advantages and benefits require particular attention and care be paid to matters such as the central limit order book ("**CLOB**"), managing market complexities and the impact of dark features.

Addressing Liquidity

Order Exposure Rules[1] have been designed in such a manner to concentrate liquidity in the central limit order book in Canada. Broker preferencing provides disincentives to the development of crossing "off-exchange" or "over the counter" networks by large Canadian dealers. Combined, these have maintained a measure of liquidity in a naturally illiquid Canadian market, while technology threatens to obscure differences, actions and purpose.

THE PROPOSED CHANGES

The proposal to remove the liquidity seeking order from the PureStream Order Book does not raise any concerns. However, overall, the Proposed Changes are an example of the proliferation of "me-too" order book proposals that fragment decision making and increase firm costs.

Generally, Canadian firms are already subject to multiple order books, excluding special terms, across a fragmented market. Fragmentation increases the fixed cost of technology and market data services to industry for both direct and indirect maintenance and further reduces transparency. Our concerns are outlined below.

Overemphasis on Alignment

Historically, Canada has punched above its weight. We have nurtured companies from venture senior listing to inter-listing. Converse to the United States, the majority of Canadian companies have natural spreads that are too wide and multiples of the minimum tick size. Canada in effect has three radically different equity market pools:

1. Highly liquid, deeply traded, mostly non-intermediated inter-listed equity securities markets. Canada is the only nation in the world that has a freely traded "Inter-listed' market with the largest capital market in the world. Our large cap companies benefit from exposure and liquidity in the United States. The global peer set of securities resembling the trading activity of these companies would be S&P small and mid-cap companies. The inter-listed capability is a unique and competitive advantage of Canadian markets on a global scale.

[1] Universal Market Integrity Rules, rule 6.3 - Exposure of Client Orders.

2. A liquid, intermediated, non-inter-listed senior equity securities market, consisting of the majority of the non-inter-listed names qualifying for listings on the senior Toronto Stock Exchange and trading as Tier A liquidity securities. The global peer set for these companies would be commonly held equities which are domestically traded in markets such as – Australia, Italy, and the Scandinavian countries. While not unique in and of itself, this tier of securities benefits from a highly competitive secondary trading mechanism, which itself is a unique asset to Canada compared to economies of a similar size.

3. An illiquid, Tier B security market, heavily intermediated secondary trading of junior and venture-oriented equity securities across a variety of junior exchanges including TSX Venture and the Canadian Securities Exchange (CSE). Market capitalizations range from $0.5MM to over $100MM. This capability is also a unique and competitive advantage of Canadian markets on a global scale, though admittedly challenged on a secondary trading basis.

NASDAQ's marketplace expertise as a global provider of solutions in many jurisdictions is recognized. Overall, Canadian operations are not material to NASDAQ whose economic drivers in North America are guided by the United States.

Product introductions, such as the CXD, are generally targeted toward the first pool. But over-engineering products, focus and regulation to suit these companies, risks damage. While low costs of intermediation are a driver of continued competition in the most liquid companies, sufficient incentives for intermediaries must remain.

The Request for Comments ought to have included discourse on: (a) the materiality of the Proposed Change to Groups 2 and 3 above; and (b) the volume, trade activity and improvement in economics CXD is expected to offer to Groups 2 and 3.

No Cost-Benefit Analysis

The operation of marketplaces in Canada is a "public good". The introduction of new features must have economic benefits that outweigh their costs to the market.

The Proposed Changes bring economic benefits to NASDAQ of a potentially increased market share. NASDAQ has the benefit of integrating its existing data feeds as a protected marketplace without dealer or vendor costs and risks.

For NASDAQ, the development of these features is an option-like "call" investment, with a very low exercise price, but a potentially profitable payoff in product uptake. Industry will pay an ongoing "premium" of fixed costs of support, and opportunity costs with unknown benefits.

Net industry benefits should be analyzed and disclosed in economic, operational terms rather than solely qualitative statements. They should include financial and operational data on the benefits of the additional order book and resulting fragmentation. This should include data on:

1. **Volume:** Data on how the Proposed Change will impact trade volume, liquidity, and execution including data on:
    a. the existing volume in the Pure Stream book and the volume being removed;
    b. the projected uptake in volume based on relevant, comparable market data (i.e. MatchNow, etc.) and any assumptions regarding new volume; and
    c. demand for the Proposed Changes.

2. **Latency:** Data on latency including:
    a. Latency measures of outbound systems – including architectural drawings – to support 100ms and 20s implied firm-up time. Depending on the latency of outbound confirmations and open-end sessions, there may be considerably less practicable time to respond depending on the systems utilized. Coupled with inbound latencies and differential latencies in dealer systems, there may be opportunities for flash trading, automated front-running or on exchange internalization bypassing the order exposure rules.
    b. Expected intra-order book latency between Pure Stream, CXD and CXC CLOB.
    c. Any latency drags between the open-end session and the trading engine (risk filters, ports etc.) which may cause differential latency between the conditional orders and non-conditional orders in the CLOB or Pure Stream.
    d. The expected latency of client order entry systems for smaller, retail-sized orders and for institutional or other blocks.
    e. The expected latency of high frequency order entry systems and whether: (i) There is a mechanism present such that while HFT order entry systems are measurably faster < 100ms, and the non HFT systems are well over 100ms; (ii) The reaction time difference to the hold-up (firm up) between the two system types can be maintained at 100ms; and (iii) It is possible for a conditional order, to act like a continuous quote, appearing to be firmed up, but ahead of the intent of the order.
    f. The cross connect latency between books.

3. **Additional Mechanisms** including data on**:** (i) the architectural differences of the order book; (ii) the equidistance, if any, of all co-located servers at NASDAQ to the order books and to the OE gateway; (iii) the mechanism in dealers' inbound or outbound gateways to see orders prior to submission to NASDAQ; and (vi) the mechanism to prevent any form of communication between orders *a priori* to entry at NASDAQ with systems control to prevent "pre-arranged" trades / matching automated fills with systematically "firmed-up" or held up orders on the NASDAQ platform.

4. **Economic Benefits:** The aforementioned data will also enable the disclosure of informed assumptions on the economic benefits (for example, tightened spreads, reduced market impact) to NASDAQ and dealers on volume net of displaced volume.

5. **Alternatives:** The Request for Comments does not include any consideration or supporting data on available policy alternatives.

Marketplace Concerns

i. The CLOB

The Proposed Changes continue the constant attack on the CLOB by non-dealer trading modalities. These modalities blur the lines between dealers and marketplaces function to marketplaces' advantage by offering highly differentiated pricing on dark order types. The profit incentive is then created, and reinforced, to continue to expand their vertical integration rather than protect the CLOB.

ii. Managing Market Complexities

We have concerns with respect to the following statement made in the Request for Comments: "We believe that introducing the CXD Conditional Order Book and clearly separating the three Order Books from one another will make it easier for Members to understand, and in turn encourage, the use of the Order Book that is most suitable to achieve a Member's trading objectives."

One order book, with less obscuring order types, is a natural control to market complexity. Managing complicated orders at the dealer level requires dealers to continue to justify their decisions at their desk, rather than through market structure or technology. Trader, order and LEI identifiers further put the onus and responsibility for decision-making on dealers. In the case of a singular book with conditional orders managed at the dealer level, a dealer could not point to a venue for executing in a certain manner to mask what would otherwise be viewed as unacceptable.

A complicated structure which deliberately automates the holding up of orders, with the possibility of "shaped" order flow in a non-transparent manner, could be used contrary to fair markets. The following principles should apply:

1. Any order type which is conditional and influenced by time delays, is a mechanism for automating the holding up of orders.

   The term "firm–up" order confuses the nature of the order from the client perspective. If the order meets a certain size parameter, the trading desk can "hold it up", by leaving it in a conditional book, and in this case through an automated and deliberately timed process. A "retail block" trader can send all their blocks as conditional orders, expecting that the firm up period avails them of the opportunity to hold up the orders with latency programmatically embedded in the order type to determine if contra orders meet their execution needs.

2. Any activity in an order book, which is not clearly visible to the majority of participants of protected markets is not transparent. Dark pools are in effect "optional" and are not necessarily analyzed by all participants.

3. Conditional orders can be utilized in combination with other orders and latency differences for ulterior purposes.

   The generally understood purpose for conditional orders is to allow traders to be in multiple trading venues at the same time. When a real trading opportunity presents itself in one, the market sends a conditional request to the dealer system. The dealer system cancels the other orders, and, when it receives those acknowledgements, it makes executable, the tradable order. This prevents overfills.

   The Proposed Changes contemplate that matching priority for the CXD Conditional Order Book will be determined by dealer/size/time. A dealer can choose which orders (possibly based uniformly by stamp ID) are directed to the CXD book or Pure Stream, as conditional orders or as orders to execute against the CXD book. Dealers could shape the order flow directed to these order books, such that not all of their clients have access to the contra side of the held-up orders.
   Scenarios could be developed whereby the combination of automating the holdup of client orders, the shape the order flow and the lack of transparency could conceivably create a mechanism for the synthesis of "flash trading" or automated front running or bypassing order-exposure rules.

iii. Free-Riding

Dark features effectively free ride off the marketing of existing order books and historical participation of upstairs markets. The cumulative free – riding over the years in the industry has caused great market harm to the price discovery of larger sized interest and can now be seen in the lack of liquidity in underlying corporate securities, disincentives to market participation and the dearth of new issuance and supply of risk capital.

EXEMPTIVE RELIEF

The Proposed Changes include reference to a pending application to the Ontario Securities Commission pursuant to s. 15.1 of National Instrument 21-101, *Marketplace Operation*, for exemptive relief for the new CXD Conditional, CXD Connect order opt in feature, and the XFT Order along with a variation of and re-statement of the decision issued by the OSC on August 18, 2022, for a similar opt-in for Pure Stream Orders.

The Exemptive Relief application should have been reproduced in full as a schedule to the Proposed Changes to better inform public comment. A comparison should also be included to similar exemptive relief granted to other marketplaces or a clear statement of the lack thereof, as applicable.[2]

CONCLUSION

Marketplace venues continue to spend much time developing dark venues and order type functionality which mimics that of a trading desk because vertically integrating upstream allows them to capture more profit from the price discovery mechanism.

The continued fragmentation of the price discovery process and vertical integration should not continue unabated, without proper cost benefit analysis on the impact of this fragmentation on Canada's competitiveness and a meaningful look at alternatives.

A deliberate market wide approach to reduce conditionality of orders and the creation of "free riding optionality" may enhance liquidity in subsets of the Canadian market and constitute a new uniquely competitive advantage.

In the absence of complete information around latencies, connectivity between books, dealers, clients, and information flows, it is unknown whether fair, orderly, and competitive markets may be maintained.

Respectfully submitted,

Canadian Forum for Financial Markets

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[2] On November 21, 2021, the TSX was granted exemptive relief from section 7.1(1) of NI 21-101 to implement a new functionality that allows for interaction between conditional orders and firm dark orders: https://www.osc.ca/en/securities-law/orders-rulings-decisions/tsx-inc-s-151-ni-21-101-marketplace-operation-2?utm; https://www.tsx.com/en/resource/2748/approval-of-amendments-to-introduce-conditional-orders-on-tsx-2021-11-11-en.pdf?utm