



VIA ELECTRONIC MAIL

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Re: CSA/CIRO Staff Notice 23-331 Request for Feedback on December 2022 SEC Market Structure Proposals and Potential Impact on Canadian Capital Markets

Dear Sirs/Mesdames:

Nasdaq CXC Limited ("Nasdaq Canada")¹ appreciates the opportunity to comment on the joint Canadian Securities Administrators (CSA) and Canadian Investment Regulatory Organization (CIRO)

¹ Nasdaq Canada operates three trading books for trading TSX, TSX-Venture, and CSE listed securities. Nasdaq CXC is a lit book providing clients with a reliable platform for trading Canadian equities, offering the benefits of anonymous or attributed trading and price/broker/time priority. Nasdaq CX2 is designed to provide additional cost savings and trading efficiencies. Through unique pricing model and broker preferencing functionality, this lit book helps to improve investment performance and to drive positive market structure change. Nasdaq CXD provides an alternative source of non-displayed liquidity, which facilitates robust size discovery and price improvement opportunities.

(together, “Canadian Regulators”) request for feedback on the 2022 SEC Market Structure Proposals² (“SEC Proposals”) and Potential Impact on Canadian Capital Markets (“RFF”). Given the close relationship between the US and Canadian equity markets and the number of securities interlisted on exchanges in these two countries³ we commend the Canadian Regulators for recognizing the potential significant impact that certain SEC Proposals could have on the Canadian market and for proactively consulting with industry about what action, if any, should be taken in anticipation of these changes.

Canadian Regulators are positioned to respond to the SEC Proposals with changes that can protect or improve Canada’s competitive position. To protect against a competitive disadvantage being created we believe that any reductions made to the minimum trading increment in the US need to be harmonized for interlisted securities in Canada. However, we recommend that Canadian Regulators wait for at least a twelve-month period after implementation of each new tick size that the SEC adopts to study the impact of these changes before deciding if conforming changes should be made for other securities. If analysis at that time demonstrates that trading quality has improved because of sub-penny increments, then harmonizing changes allowing sub-penny increments can be extended to all other Canadian-listed securities. Taking a “wait and see” approach for non-interlisted securities will prevent the risk of possible unintended outcomes such as flickering quotes and lower available volumes and save industry the costs of increased message traffic and system changes.

Whereas harmonizing tick sizes is necessary to ensure fair competition between jurisdictions, we believe that Canadian Regulators are uniquely positioned to take action that will strengthen Canada’s competitive position if the SEC reduces its access fee cap. By differentiating the trading fee limitation in the two countries and supporting a higher fee cap in Canada, marketplaces may be able to potentially attract a higher share of order flow on interlisted names where almost 60% of all volume is traded in the US today. We also believe complexity can be reduced by harmonizing fee caps within Canada for all securities whether or not the SEC moves forward with its access fee cap proposal.

VARIABLE MINIMUM PRICING INCREMENTS AND REDUCING ACCESS FEES

Policy Reform Needs to be Advanced Incrementally and with Caution

Nasdaq Canada is supportive of market structure changes that can improve liquidity, efficiency, and the overall quality of markets however it is important that changes are made based on data, where available, and should be incremental in nature because of the risk of unintended consequences due to the interconnection and complexity of the market. Radical policy changes however well-intentioned may result

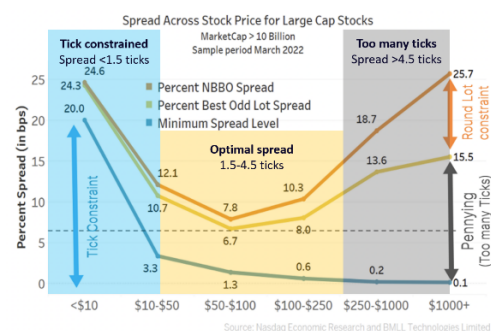
² The SEC Market Structure Proposals relate to 1) Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders; 2) Regulation Best Execution; 3) Disclosure of Order Execution Information and 4) Order Competition Rule.

³ There were 206 interlisted securities as of October 31, 2023.

in costs and burdens in addition to the degradation in market quality that result in the opposite outcome of a reform’s regulatory objective.

The SEC Proposal to introduce new minimum trading increments risks hurting market quality and the strength of the NBBO for affected securities. Data suggests that the proposed tick size buckets are too granular and will provide for too many ticks, which will lead to flickering quotations, increased price instability, less aggregated liquidity, wider spread, greater market fragmentation and ultimately will weaken the NBBO. Study on Canadian names suggest that setting sub-penny tick sizes would very rarely result in narrower quoted spreads and that reducing the tick size would likely also reduce the quoted volume available.⁴

Research demonstrates that an optimal tick size exists.⁵ Analysis shows that spreads form a U-shape, with optimal spreads at the bottom of the U, as shown in the following chart:



The U shape is repeated across all market cap spectrums.⁶ Trading is optimal at the center of the U, and impaired at both arms: transactions are more expensive both for securities with prices that are too low (tick-constrained) and for those with prices that are too high (excessively-wide spreads).

While it is unclear what methodology was used by the SEC in creating the four new categories of tick sizes proposed, it is clear this approach is complex and that there is a risk of introducing tick sizes that are too low. In its comment letter to the SEC in response to the SEC Proposals Nasdaq Inc. suggests a simpler

⁴ See National Bank of Canada Market Structure Update Vol 5, Issue 11 – November 2023.

⁵ Many researchers agree that securities with a 2-3 tick spread trade efficiently. Some researchers have argued that securities with spreads as wide as 4.5 ticks can trade efficiently as well, but we believe that there is not a consensus on this point. See Phil Mackintosh, Research on What Ticks Make Spreads Trade Best, (Mar. 2, 2023), <https://www.nasdaq.com/articles/the-tick-spreads-that-help-stocks-trade-best>.

⁶ Phil Mackintosh, Why Intelligent Ticks Make Sense, (Jan. 9, 2020), <https://www.nasdaq.com/articles/why-intelligent-ticks-make-sense-2020-01-09>. See also Phil Mackintosh, The Data is Already Out There to Design Better Markets, (Feb. 15, 2019), <https://www.nasdaq.com/articles/the-data-is-already-out-there-to-design-better-markets-2019-02-15>

approach be taken where only one additional tick size is added below one penny at \$0.005 to help constrained securities trade more naturally.⁷

Recognizing these risks of introducing sub-penny trading increments that are too small we believe that a cautious approach should be taken by Canadian Regulators. While it is necessary to harmonize tick sizes on interlisted names for competitive reasons irrespective of whether or not smaller tick sizes result in improved market quality for these names, we believe that Canadian Regulators should wait for at least a twelve-month period after implementation of each new tick size that the SEC adopts to study the impact of these changes before deciding if similar changes should be made for other securities. If empirical evidence demonstrates improvement in market quality for interlisted securities from the change, action can then be taken to harmonize the changes across other Canadian-listed securities.

Canada's Regulatory Regime needs to Consider its Impact on Competition

Because of its small size relative to the US and the ability for participants to seamlessly direct order flow across either border, it is important for Canadian Regulators to consider the impact of any new reform on Canada's ability to attract capital and order flow. When considering changes, Canadian Regulators should not only evaluate what rules and market structure features will preserve Canada's existing competitive position but should also consider what rules could strengthen its competitive positioning without impacting investor protection or fair and efficient markets. Such considerations fall directly under the responsibility of provincial regulators to foster competitive capital markets and capital formation.⁸

Canadian Regulators need to harmonize any changes made to the minimum trading increment by the SEC for interlisted securities to prevent a competitive disadvantage from being introduced. A smaller trading increment allows participants to make more competitive markets and to quote at more aggressive prices. If no action is taken by Canadian Regulators in response to this change regulatory arbitrage will be created where participants are restricted from making equivalent markets in Canada on interlisted names. It is necessary then for this reason to harmonize tick sizes on interlisted names whether or not smaller tick sizes demonstrate over time better trading quality on these names.

We believe that Canadian Regulators do not have to harmonize changes if the SEC reduces its access fee cap. Canadian Regulators can help improve the competitive position of Canadian marketplaces (in aggregate) on inter-listed names by differentiating its approach and supporting a higher fee cap in Canada than in the US.

When considering pricing strategy, marketplaces must weigh the value of offering a higher incentive to providers to attract liquidity against losing position on routing tables for liquidity removers by charging a

⁷ See <https://www.sec.gov/comments/s7-31-22/s73122-20162299-331153.pdf>.

⁸ The OSC mandate was amended in 2021 to include competitive considerations.

higher fee. Pricing decisions are constrained by the maximum trading fee permitted. Using a typical maker-taker fee model a higher fee cap provides room for a higher corresponding rebate to be offered. Allowing a higher fee in Canada not only will foster competition between Canadian marketplaces but will also provide more ability for Canadian marketplaces to compete in aggregate for order flow on interlisted names. A second benefit of supporting differentiated fee models between the US and Canada is the valuable insight this will provide regarding how rebates contribute to liquidity and efficient markets.

The importance of rebates in attracting order flow was acknowledged by the CSA when it proposed a lower fee cap for non-interlisted securities in 2016; “if the difference in rebates between Canada and the U.S. for Interlisted Securities was too large, a shift of liquidity to U.S. marketplaces and widening spreads on Canadian marketplaces could result.”⁹ By allowing Canadian marketplaces to provide higher rebates they can offer a higher incentive for liquidity provision which may help attract order flow and balance volumes on interlisted names where the majority trades in the US today.

We believe an unnecessary complexity exists today because of National Instrument 23-101 prescribing two different trading fee limitations for interlisted and non-interlisted securities. A simpler model can be used by harmonizing fee caps across all Canadian securities and the direction for the harmonizing change can be determined by SEC action. If the SEC lowers the access fee cap to \$0.005 or \$0.0010 as proposed, then the fee cap for interlisted securities (\$0.0030) should be harmonized with the fee cap for non-interlisted securities (\$0.0017). This will remove any differences for Canadian securities while also allowing a higher range for Canadian marketplaces to compete.

If the SEC does not lower the access fee than we propose the fee limitation for non-interlisted securities should be increased to be harmonized with interlisted securities. This change will bring the benefits of simplifying market structure while allowing a wider range in which markets can compete.

Looking at the tick size and access fee proposals together we suggest the following actions be taken in each of the four scenarios that may result given SEC action or non-action:

Scenario 1 – Lowering the minimum tick size and lowering the access fee:

Trading increments should be harmonized with the US for interlisted securities but no changes should be made to the current trading increment for non-interlisted securities until a one-year period after implementation of each new tick size that the SEC adopts so the impact of the change can be studied and a similar approach can be made for non-interlisted securities if there is evidence that benefits have come from the change.

⁹ Published at: (2016), 39 OSCB 3344.

The fee limitation for interlisted securities should be harmonized with the same level as non-interlisted securities today but should be kept higher than the access fee cap in US securities. If the SEC lowers the cap to a level at or above \$0.0017 then the fee cap across all securities should be moved to a higher level allowing a wider range to compete.

Scenario 2 – Lowering the minimum tick size but maintaining the current access fee:

Trading increments should be harmonized with the US for interlisted securities but the current trading increment for non-interlisted securities should be maintained as described above.

If the SEC does not move forward with its proposal to lower the access fee cap, Canadian Regulators should harmonize the trading fee cap for non-interlisted securities (\$0.0017) with that for interlisted securities today (\$0.0030). Increasing the fee cap for non-interlisted securities will allow a wider range for marketplaces to compete on these securities while also providing a simpler model for participants to consider as there will be only one fee cap for all securities.

Scenario 3 – Maintaining the current minimum tick size but lowering the access fee:

No changes should be made to the minimum trading increment for interlisted and non-interlisted securities. Similar to what has been suggested above, the fee limitation for interlisted securities should be harmonized with that for non-interlisted securities today (0.0017) but should be kept higher than the access fee cap for US securities. If the SEC lowers the cap to a level at or above \$0.0017 then the fee cap for non-interlisted securities should be moved to a higher level allowing a wider range in which to compete.

Scenario 4 – Maintaining the current minimum tick size and maintaining the current access fee:

No changes should be made to the minimum trading increment for interlisted and non-interlisted securities. Canadian Regulators should harmonize the trading fee cap for non-interlisted securities (\$0.0017) with that for interlisted securities today (\$0.0030) to foster more competition between marketplaces in Canada for these securities.

Variable Minimum Pricing Increments – Additional Considerations

Methodology used to determine pricing increments: It is imperative that there is never a situation where an interlisted security has a higher trading increment in Canada than it has in the US. To remove any possibility of misalignment we strongly suggest reliance is made on US determinations (calculation based on US trading days and US trading data) for which interlisted securities fall into which pricing bucket if the SEC introduces variable pricing increments.

While the SEC has not identified which entity will be responsible for assessing minimum price increments, we understand this responsibility will likely fall to the listing exchange. This raises a question as to which entity should be responsible in Canada if changes are made for Canadian listed securities. We suggest that CIRO be responsible for performing the calculation and determining the minimum tick size for non-interlisted securities if the minimum trading increment for non-interlisted securities is revised in the future because of its access to a comprehensive and complete set of Canadian market data, and its role as an independent third party. We also recommend that the frequency of changes should be no more than two times per year. Limiting changes to two times per year will minimize added complexity for dealers and marketplaces created by having to make adjustments to their systems and trading models.

Impact to Marketplace Systems: Although decreasing the minimum tick size for securities will likely result in increased message traffic that in turn will add stress to marketplace system capacity and resilience, we believe it is a fundamental obligation of a marketplace to be able to support and operate systems that are capable of meeting the demands of whatever level of trading activity a market produces.

Impact to Dealer Order Handling: Similar to the fundamental obligation that a marketplace has to operate a fair and efficient market, we believe dealers have an obligation to their customers to be able to understand, consider and adapt to all characteristics of a market's structure and a market's trading features when managing client orders and seeking best execution not matter how challenging this may be. While we recognize changes in tick sizes may increase complexity and that operational procedures will be required to ensure that changes to tick sizes are updated into trading models in a timely manner, we believe these additional challenges fall under a dealer's responsibility and fiduciary duty to provide quality services to their customers. We note a comparable example exists today where different trading fee limitations exist for interlisted securities and non-interlisted securities that can apply to different securities that can change over time. A list of interlisted securities is required to be published by the listing exchange on a quarterly basis which require dealers to have processes in place to monitor and incorporate these changes. We would expect similar procedures and processes to be adapted to monitor and adjust when tick sizes for securities change.

Investor Education: We do not see any unique issues regarding investor education if an amended approach is taken to minimum pricing increments. There is only a small percentage of retail investors today that have a comprehensive understanding of trading rules and market structure. Instead, they rely on dealers for their knowledge in seeking best execution which will not change irrespective of whether a change is made to the minimum pricing increments.

Definition of better price: We do not see the need to modify the definition of "better price" under UMIR if smaller tick sizes were introduced. The dark rules are intended to provide the benefit of size discovery for dark orders that can trade without contributing to pre-trade price discovery if they meet a minimum size threshold and that price improvement is required to be provided otherwise. Price improvement defined by a full tick increment (or half tick increment if the spread is at a minimum) is meaningful in the context of

the price of a security's spread. Therefore, a full tick increment (or half tick increment) will continue to be meaningful if a smaller notional spread is created by a smaller tick size.

Reductions in Access Fee Caps – Additional Considerations

Inverted Venues: We believe there should be no regulatory restriction on the level of rebates that can be provided by a marketplace for removing liquidity because a natural limit already exists that is determined by market forces. For a marketplace to be economically viable when setting fees on an inverted venue, a higher fee needs to be charged than the rebate that is offered. At some point the liquidity providing fee becomes too expensive for participants to make markets and liquidity providers will stop quoting. A regulatory restriction on rebates is not necessary because of this self-correcting mechanism and if it was introduced would unnecessarily limit competition, interrupt competitive forces and deprive active traders of the benefit of higher rebates.

We would like to note that the access cap in Section 610 of Regulation NMS only applies to the fees for accessing (“removing”) liquidity. The cap does not apply to the level of the rebate to remove liquidity or the fee to provide liquidity.

Requiring full cost of transaction at time of execution: In Nasdaq Canada's response to the CSA Staff Notice and Request for Comment 23-323 *Trading Fee Rebate Pilot Study* we suggested a solution for addressing the potential conflict created by marketplace rebates when dealers make routing decisions – that dealers should be required to pass-through rebates and fees to their end customers.¹⁰ While this approach would address the conflict, it has not been adopted, either because of new regulation or industry practice because of the resulting complexities for institutional investors allocating costs across multiple funds.

Without there being a benefit provided to clients from knowing the full cost of a transaction, introducing this new requirement does not justify the cost of developing new functionality needed to make available the full cost of a transaction at the time of execution. There also does not appear to be any benefit for dealers and their clients as there are only a few volume tier pricing programs in Canada and those that target qualifying for monthly discounts are already able to monitor their trading levels and standing in trading incentive programs during the month.

ENHANCE TRANSPARENCY ABOUT BETTER PRICED ORDERS IN THE MARKET:

The rule amendment process that would need to be followed to make changes to UMIR and the cost of updating trading system code to change the size of a board lot is not warranted in Canada. There are only a

¹⁰ See https://www.osc.ca/sites/default/files/pdfs/irps/comments/com_20190301_23-323_nasdaq-canada.pdf.

few high-priced securities that would benefit from a smaller board lot size. Furthermore, we believe the level of transparency for odd lots in Canada is sufficient because information about all trades (board lot and odd lot transactions) is provided to, and disseminated by, the Information Processor unlike in the US.

REGULATION BEST EXECUTION

We believe that since amendments were made to CIRO's Investment Dealer and Partially Consolidated Rule 3100 Part C – Best Execution of Client Orders in 2018 that Canada's best execution regime is robust and that no further changes are needed at this time. We believe however that tools to monitor dealers' best execution practices by their clients is an important step to fill a gap in Canada's best execution regime today and that the introduction of best execution reporting requirements similar to Rule 606 in the US will assist in this regard.

DISCLOSURE OF ORDER EXECUTION INFORMATION

In general we are supportive of the CSA introducing new requirements for best execution reporting in Canada that will assist clients monitoring the order handling practices of their dealers. Recognizing that the SEC is proposing changes to an existing requirement where no requirement exists today in Canada, we suggest that Canadian Regulators begin by convening a working group comprised of industry representatives to propose a set of introductory reporting requirements that are relevant, made easily available electronically, with data that is easy to understand and can be easily interpreted.

Best execution reports will provide information for clients and an accountability measure for best execution that will buttress Canada's existing best execution regime. It will also help to address the CSA's concern that the payment of a rebate by a marketplace raises a potential conflict of interest when a dealer must choose to rout orders based on costs while routing orders in a manner that result in the best outcome for clients.¹¹

SEC ORDER COMPETITION RULE

We agree with the Canadian Regulator's preliminary view that there is no need to consider a new matching mechanism as payment for order flow is not permitted in Canada and retail orders sent to and interact with orders from all participants on approved marketplaces are required to provide fair and equal access.

¹¹ Please see: http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20190114_11-784_burden-reduction.htm at page 2.

Nasdaq Canada appreciates the opportunity to share its views on the Request for Feedback and would welcome the opportunity to discuss them in more detail.

Sincerely,

Nasdaq Canada