June 18, 2020

VIA E-MAIL

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
marketregulation@osc.gov.on.ca

Matt Thompson
Chief Compliance Officer
Nasdaq CXC Limited
25 York Street, Suite 900
Toronto, ON M5J 2V5
matthew.thompson@nasdaq.com

Dear Sirs and Mesdames,

Re: Notice of Proposed Changes (published April 23, 2020) (the "Proposed Changes" or the "Notice")

We at Select Vantage Canada Inc. thank the OSC and Nasdaq CXC Limited for this opportunity to comment on the Proposed Changes.

We have three principal concerns with them:

1) The Proposed Changes seem contrary to the core principle of "fair access" by creating new mid-point order types designed solely to allow a certain trading constituency to limit their interactions to other types of traders, all the while pricing off of the lit market that establishes that very same mid-point of dark market interactions.

2) The Proposed Changes introduce two new order types whose principal design feature is to facilitate internalization and, hence, increased market fragmentation.

3) Assuming the Proposed Changes are approved in whole or in part, the definition of a "certified retail Trader ID" should be more clearly articulated for implementation purposes.

Select Vantage
Canada

Preliminary Observation on Nasdaq's Assumption of Users of the Mid-Point Order Type

The overriding purpose of this Notice is to address particular constituencies of users of Nasdaq CXD's Mid-Point orders: "Nasdaq Canada is introducing the Proposed Changes to generate better execution outcomes for long term investors (retail and institutional) by providing price and size improvement opportunities otherwise not available to them today."[1] This is being done to address feedback from Members representing these constituencies: "This [sic] Proposed Changes are being made in response to feedback solicited by Members."[2] The Notice does not indicate how many Members provided this feedback, how many institutional or retail investors were solicited by Members, or even what percentage of users of Nasdaq mid-point orders (calculated either by value, volume, or number of executions) belong to these constituencies.

The Notice then makes this assumption about the type of user of mid-point orders: "Trading between the bid-ask spread is also the reason why market makers *would not use a Mid Peg order*. Where the objective of a market making strategy is to capture the bid-ask spread, giving up half of the bid-ask spread is not economically attractive [emphasis added]."[3]

This assumption is not accurate.

Select Vantage's traders are "marker makers" as opposed to "long term investors" in that they make two-sided markets or employ other market-making strategies that contribute significant liquidity and price discovery to Canadian equity markets. Although our numbers vary month to month, we typically trade just under 10% of all traded volume on Canadian equity marketplaces.

The statement that our traders "would not use a Mid Peg order" and that they would not "give up" half of the bid-ask spread to execute a trade in the dark seemed odd to us at first read, given that our traders are willing to buy and sell stocks on any marketplace, lit or dark. So we looked at our trading volumes on Nasdaq CXD as compared to the IIROC-reported trade volume on Nasdaq CXD for the most recently available month.[4] We discovered that our recent trading on CXD comprises a total of 4.0% of all of its executed volume (10.4 million shares out of 262.1 million shares executed in April, 2020), and at least 83% of such volume [5] is passive (*i.e.*, posted to the book for subsequent execution against incoming orders). Specifically, in that month we traded 5.2 million shares (2.0% of all CXD traded volume) at the mid-point (at least 70% from passive orders[6]) and several hundred thousand additional shares closer to the *far side* of the bid-ask spread. This constitutes a significant amount of intermediation between lit and dark markets.

[1] First paragraph under "Rationale for the Proposal".
[2] Under "Consultation and Review" on the last page.
[3] Third paragraph under "Rationale of the Proposal".
[4] As of date of compilation for this comment letter, the IIROC Marketplace Report for April, 2020.
[5] We say "at least" 83% because we cannot readily ascertain those instances where a trader intended to post a passive order in the CXD dark book, but immediately executed against a resting contra order, and so appear in our databases as "active" order executions.
[6] Same comment as in footnote 5.

We cannot be the only market-making firm posting orders to CXD and, specifically, at (or better than) the mid-point, but no statistics are offered in the Notice as to types of users of this order type.

<u>Propriety of Designing Dark Order Types that Encourage Sub-sets of Trade Interaction</u>

We briefly raise the larger issue of dark marketplaces introducing new order types that price off interactions from the lit markets (*i.e.*, the NBBO), and yet are designed to *minimize* interactions between institutional investors and traders who will notice and react to the presence of large mid-point orders (see further discussion on this point below). We do not wish to repeat here the larger debate of the relative place for dark markets in the lit marketplace ecosystem, which debate has gone on for years, but we note that anyone proposing dark order types that are expressly designed to benefit one constituency over other trading constituencies should bear a higher onus of establishing that "fair access" is being maintained. Respectfully, all three Options inherently seem contrary to this principle, although our greater concern is with Options 2 and 3.

<u>Internalization (or "We have order flow you can really trust")</u>

The Proposed Changes are additionally concerning because, under the guise of increasing interactions between hidden block orders and "retail orders", they create two additional types of segmented pools of order interactions based on a very different attribute - broker preferencing:

- Option 1 (participating hidden block orders entered through a Member interacting with all "retail orders")
- Option 2 (participating hidden block orders entered through a Member interacting with *only* that Member's "retail orders"), and
- Option 3 (participating hidden block orders entered through a Member interacting with *all types* of that Member's other client orders, whether "retail" or not).

Option 2 is a more restrictive subset than Option 1, so why would any institutional investor, ostensibly wanting greater interaction with "retail orders", restrict execution possibilities to only their *own* broker's "retail orders" as opposed to all of the market's "retail orders"? Following "feedback solicited by Members"[7], the explanation is that a Member may need to "address any expressed concerns by an institutional customer about the *quality* of retail order flow handled by other Members [emphasis added]"[8]. "Quality" in this context seems to mean nothing more than the likelihood a Member's retail clients will *notice and subsequently react to* the presence of a

[7] Under "Consultation and Review" on last page.
[8] Sixth paragraph under sub-heading "Rationale for the Proposal"

large, hidden mid-point order[9], with *lower quality* orders coming from retail clients who *will notice and react to* the presence of hidden orders, and *higher quality* orders coming from retail clients who *will not* notice and react to the presence of hidden orders.

Option 3 is an extension of Option 2: "Members are aware of the type of order flow they handle, [and so] they are positioned to assess the risk of adverse selection of their non-retail order flow"[10] – in other words, this order type is for those Members who know *all* of their order flow is "Trusted Flow" seen from the perspective of institutional investors (with *low trust* flow coming from clients who *will notice and react to* the presence of hidden orders, and *high trust* flow coming from clients who *will not* notice and react to the presence of hidden orders).

The use of such rhetoric regarding "quality" flow and "trusted" flow is unhelpful in this context and in any policy debate involving new order types. If there is any suggestion Members or their clients are not transacting on CXD in accordance with UMIR, then that should be investigated. That does not at all seem to be the suggestion here. So then on what basis can a marketplace create order types designed to allow sub-sets of users to pick and choose the "quality" and "trusted" flow they wish to interact with? This seems the direct antithesis of "fair access", and the use of such rhetoric here appears to be nothing more than an attempt to legitimize such cherry-picking.

Moreover, logic dictates implementation of Options 2 and 3 will result in Nasdaq Members internalizing a greater number of executions vis-a-vis the CXD. The Notice soothingly predicts only "a marginal increase in internalization rates [on CXD]"[11] with no estimates provided. How will we measure the success or failure of the Proposed Changes in this regard? What is an "acceptable" rate of increase - a fraction of a per cent from a prior reference period? Is there no risk that the increase will quickly become material? If that happens, will the OSC require a rollback of these two order types, or will it permit material new rates of internalization to stand as the acceptable new benchmark?

As best as we can tell, the internalization design features of Options 2 and 3 find no precedent in the Alpha ATS example cited on the last page of the Notice. The Notice does refer to "two marketplaces hav[ing been] approved to introduce broker preferencing for anonymous orders on dark markets"[12] as a direct precedent for Options 2 and 3. Once Nasdaq is permitted these new order types, what is preventing the remaining marketplaces from following suit? There you have it – the floodgates begin to open to mind-numbing permutations of bespoke internalization order types. The danger here is of an industry landscape where marketplaces vie to create products whose principal effect is to increase internalization rates (particularly for the larger dealers with

[9] *Noticing*, by placing a small bid or ask in the dark and immediately interacting with a contra, resting mid-point order, thereby revealing both the presence and side of the latter; and *reacting to*, by modifying their subsequent bid or ask prices with such new market knowledge.
[10] Sixth paragraph under "Rationale".
[11] See first and second paragraphs under "Impact on Internalization".
[12] See third paragraph under "Impact on Internalization".

Select Vantage
Canada

significant retail flow). These large fragmented pools will price off of the very contra orders that miss out on execution opportunities because they aren't posted through the right "internalization" dealer.

We respectfully recommend the OSC not allow, and/or that Nasdaq withdraw, the Option 2 - Member Retail and Option 3 - Trusted Flow order types, in the very least until the CSA and IIROC complete their larger review of broker preferencing.

Imprecise Definition of "Retail Order" and UMIR ID Mapping Difficulties

As much as we disagree with all three Options and, particularly, Options 2 and 3, we note that the Proposed Changes do not provide enough guidance to determine what constitutes a "certified retail Trader ID". The published Notice refers to the "precedent"[13] definition within the Alpha IntraSpread Facility of an order of a "Retail Customer" and under the sub-heading "Fairness Considerations" the Notice refers to retail "account types", so it is safe to assume this concept derives from the basic IIROC Rule 1 classification of client account types:

> "**Institutional Customer**" means: (1) An Acceptable Counterparty (as defined in Form 1); (2) An Acceptable Institution (as defined in Form 1); (3) A Regulated Entity (as defined in Form 1); (4) A Registrant (other than an individual registrant) under securities legislation; or (5) A non-individual with total securities under administration or management exceeding $10 million;…
>
> "**Retail Customer**" means a customer of a Dealer Member that is not an institutional customer;….

If that is the intention here, then a "certified retail Trader ID" should be rephrased as "a UMIR ID conveying order instructions given on behalf of one or more *Retail Customer* accounts". So, for example, the UMIR IDs assigned to self-directed brokerage accounts of Retail Customers would be readily identifiable as "certified retail Trader IDs".

Our first implementation questions in this regard are: Can all Retail Customer orders be readily mapped to exclusively "retail" UMIR IDs without commingling of order flow streams from non-retail accounts? And will each Member firm "certify" to Nasdaq such mapping is accurate and doesn't inadvertently include non-retail order flow?

Our second implementation question in this regard is: Will discretionary orders submitted by a broker's Registered Representative on behalf of one or more Retail Customer accounts be considered "retail orders" under the Proposed Changes? If so, in the process of interacting with and gaining knowledge of a large, hidden order while trading on behalf of a Retail Customer, the

[13] Again, precedential only as to the concept of increased interactions with "retail orders", not with respect to the internalization aspects of Options 2 and 3.

Select Vantage Canada

Registered Representative's best execution obligations would obligate him or her to subsequently trade *all* Retail Customers' orders in light of such market information.[14] If that is the case, that broker's clients would receive the benefit of the very same "information leakage" which the Proposed Changes are trying to limit. On the other hand, if such orders are *not* "retail orders" due to such risk of "information leakage" by the savvy observations of a Retail Customer's Registered Representative, then the definition should perhaps be further refined as "a UMIR ID representing *non-discretionary* orders entered *directly* by a Retail Customer".

If the OSC permits Option 1, there should be absolute category certainty as to the nature of the order flow in question.

Sincerely,

Mario Josipovic VP, Regulatory Affairs and General Counsel	Daniel Schlaepfer President

[14] This should also be the case if a Registered Representative discovers the presence of a large, hidden order placed by an institutional customer of his or her *own* firm, on the basis that Registered Representatives ought to always trade retail customers' orders based on as much publicly available, market information as possible.