## 13.2 Marketplaces

### 13.2.1 Nasdaq CXC Limited – Notice of Proposed Changes and Request for Comment

**NASDAQ CXC LIMITED**

**NOTICE OF PROPOSED CHANGES AND REQUEST FOR COMMENT**

Nasdaq CXC Limited (Nasdaq Canada) has announced plans to implement the changes described below in Q4, 2020 subject to regulatory approval. Nasdaq Canada is publishing this Notice of Proposed Changes in accordance with the requirements set out in the Process for the Review and Approval of Rules and the Information Contained in Form 21-101F1 and the Exhibits Thereto (Exchange Protocol). Pursuant to the Exchange Protocol, market participants are invited to provide the Commission with comment on the proposed changes.

Comment on the proposed changes should be in writing and submitted by June 22, 2020 to:

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
Fax 416 595 8940
Email: marketregulation@osc.gov.on.ca

And to:

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

Comments received will be made public on the OSC website. Upon completion of the review by OSC staff, and in the absence of any regulatory concerns, notice will be published to confirm the completion of Commission staff's review and to outline the intended implementation date of the changes.

## NASDAQ CXC LIMITED

## NOTICE OF PROPOSED CHANGES

Nasdaq Canada has announced plans to introduce the following change in Q4, 2020 subject to regulatory approval. Nasdaq Canada is publishing this Notice of Proposed Changes in accordance with the requirements set out in the Exchange Protocol.

Summary of Proposed Changes

Nasdaq Canada is proposing to introduce three new options on the CXD Trading Book for Members that use Minimum Acceptable Quantity and Minimum Quantity order types (together, Minimum Size Orders) with Mid Peg orders to execute trading strategies. Each option will allow certain contra-side orders that do not meet the minimum size parameter of a Minimum Size Order to be eligible to trade. The three options are as follows (Proposed Changes):

- Option 1 – Retail Orders: permits orders entered by all certified retail Trader IDs to trade regardless of the minimum size parameter;
- Option 2 – Member Retail: permits orders entered by certified retail Trader IDs of the Member to trade regardless of the minimum size parameter;
- Option 3 – Trusted Flow: permits all orders from the Member to trade regardless of the minimum size parameter.

Rationale for the Proposal

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. The Proposed Changes will also decrease the current level of market segmentation, and in turn address a current concern of the Canadian Securities Administrators (CSA).

Nasdaq Canada currently supports two order types that enable Members to specify a minimum size parameter that must be met by one or more contra-side order(s) to be eligible to trade. With the Minimum Acceptable Quantity Order (MAQ), a Member specifies the minimum size that must be met by a single contra-side order for it to be eligible to trade. With the Minimum Quantity Order (MQ) a Member specifies the minimum size that must be met by the aggregate of all contra-side orders.

Mid Peg Minimum Size Orders are primarily used by institutional investors to lower trading costs and prevent information leakage. By floating at the midpoint of the NBBO, Mid Peg orders lower implicit trading costs by trading between the bid-ask spread. 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.

Institutional investors often include a minimum size parameter when using Mid Peg orders to prevent other participants from detecting these orders with small size contra-side orders. This mitigates the risk of adverse selection which leads to increased trading costs. In the absence of this concern, a minimum size parameter would not be needed and Mid Peg orders would otherwise be able to interact with all available liquidity.

The use of a Minimum Size Order with Mid Peg orders not only limits execution opportunities for institutional investors but also limits price and size improvement opportunities for other long term investors. A contra-side order from a long term investor that does not meet the minimum size parameter of a Minimum Size Order will currently forgo what would otherwise be an opportunity to trade and receive price improvement. For example, retail orders that do not meet a minimum size parameter (typically entered as market orders that cross the spread), will bypass a Minimum Size Order resting at the midpoint and execute at an inferior price at the NBBO.

The Proposed Changes are being introduced to provide additional liquidity and price improvement opportunities than would otherwise be unavailable for eligible orders. The first option will permit all retail orders that do not meet the minimum size parameter to trade against a Minimum Size Order regardless of size. This option will provide institutional investors more opportunities to trade without the same level of concern of being adversely selected while providing price improvement and a new opportunities for active Retail Orders. The second option will permit retail orders from the same Member that do not meet the minimum size parameter to trade. This option is being introduced to provide Members another choice, particularly to address any expressed concerns by an institutional customer about the quality of retail order flow handled by other Members. Option 3 will permit all orders from the same Member to be eligible to trade. Because Members are aware of the type of order flow they handle, they are positioned to assess the risk of adverse selection of their non-retail order flow.

The Proposed Changes are also being introduced to provide a solution to address the CSA's concern about an increase in segmentation of order flow. Segmentation of order flow created by pricing models was one of the main reasons for the CSA Trading Fee Rebate Pilot Study that was recently approved to proceed on the condition that a similar study is implemented by the Securities and Exchange Commission.[1] In CSA Staff Notice and Request for Comment 23-323 – *Trading Fee Rebate Pilot Study* the CSA explains that the segmentation of orders from retail investors occurs because "retail dealers often take liquidity and choose to route orders to marketplaces with an inverted maker taker model where they receive a rebate instead of paying a fee." The Proposed Changes will provide a solution that will help address this concern. By providing additional liquidity and price improvement opportunities to retail orders that do not meet the minimum size requirement, these orders will be filled before they are routed to an inverted venue (discussed further below).

To prevent potential unintended consequences, the Minimum Size will be limited to a maximum value to be determined by the Exchange.

<u>How it Works</u>

Example 1: Without the new options – Incoming retail order

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | 098 | 10.11 (MAQ ) | | |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

Action: A retail order is entered by Member 094 to sell 900 shares at the midpoint on the CXD Trading Book (CXD) before it is sent as a limit order with a price of 10.10 to the CX2 Trading Book (CX2).

Result: The 900 share order is below the 1,000 share MAQ minimum size parameter and therefore is not eligible to trade against the Mid Peg MAQ order on CXD. Instead, the order is routed to CX2 where it executes at 10.10 (NBB).

Example 2: With new option (Option 1) – Incoming retail order

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | 098 | 10.11 ( MAQ) | | |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

Action: A retail order is entered by Member 009 to sell 900 shares at the midpoint on CXD before it is sent as a limit order with a price of 10.10 to CX2.

Result: Although the 900 share order is below the 1,000 share MAQ minimum size parameter, the new option allows the order to trade against the Mid Peg MAQ order at the midpoint (10.11) on CXD. The order receives better execution because of the immediacy of execution at an improved price level ($0.01).

Example 3: With new option (Option 2) – Incoming retail order from a different Member

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | 098 | 10.11 ( MAQ) | | |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

[1] https://www.securities-administrators.ca/aboutcsa.aspx?id=1868

Action: A retail order is entered by Member 009 to sell 900 shares at the midpoint on CXD before it is sent as a limit order with a price of 10.10 to CX2.

Result: Although the incoming order is a retail order, the order was entered by a Member other than Member 098. The 900 share order is below the 1,000 share MAQ minimum size parameter and therefore is not eligible to trade against the Mid Peg MAQ order on CXD. Instead, the order is routed to CX2 where it executes at 10.10 (NBB).

Example 4: With new option (Option 2) – Incoming retail order from the same Member

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | 098 | 10.11 ( MAQ) | | |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

Action: A retail order is entered by Member 098 to sell 900 shares at the midpoint on CXD before it is sent as a limit order with a price of 10.10 to CX2.

Result: Although the 900 share order is below the 1,000 share MAQ minimum size parameter, the order is a retail order entered by the same Member. Therefore, the new option allows the order to trade against the Mid Peg MAQ order at the midpoint (10.11) on CXD. The order receives better execution because of the immediacy of execution at an improved price level ($0.01).

Example 5: Without the new options – Trusted Flow

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | | | 10.11 (MAQ) | 076 |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

Action: An order is entered by Member 009 to buy 900 at the midpoint of CXD before it is sent as a limit order with a price of 10.12 (NBO) to CX2.

Result: The 900 share order entered by a Member other than Member 076 is below the 1,000 share MAQ minimum size parameter. Therefore is not eligible to trade against the Mid Peg MAQ order on CXD. Instead, the order is routed to CX2 where it executes at 10.12 (NBO).

Example 6: With the new option (Option 3) – Trusted Flow

| | PO # | BID | ASK | PO # |
|---|---|---|---|---|
| NBBO | | 10.10 | 10.12 | |
| | | | | |
| CXD Book | | | 10.11 (MAQ) | 076 |
| MAQ Minimum Size Constraint: (1000 shares) | | | | |

Action: An order is entered by Member 076 to buy 900 shares at the midpoint on CXD before it is sent as a limit order with a price of 10.12 (NBO) to CX2.

Result: Although the 900 share order is below the 1,000 share MAQ minimum size parameter, because the order was entered by the same Member (076) the order is eligible to trade against the Mid Peg MAQ order at 10.11 on CXD. The order receives better execution because of immediacy of execution at an improved price level ($0.01)

**Fairness Considerations**

There are no restrictions for participants to use a Minimum Size Order or to interact with it. Orders from all account types are able to enter Minimum Size Orders and orders from all account types are able to access and trade against Minimum Size Orders as long as the minimum size parameter is met. As discussed earlier, the reason why Mid Peg orders are primarily used by institutional investors is not because they have an exclusive right to use this order type but instead because the features of this order type (lowering implicit trading costs by capturing half the bid-ask spread) align with their trading objectives. Whereas capturing half the bid-ask spread is a desired outcome for institutional investors, giving up half the bid-ask spread a market maker is intending to capture makes this order type less attractive for those using these strategies.

While we recognize the exceptions for retail orders (Retail Order and Member Retail exceptions, together "Retail Options") are only made available to one account type, we believe the benefits brought to both sides of the trade outweigh any fairness concerns. Furthermore, the Minimum Size Order remains available to all account types as long as the minimum size constraint is met. In order to maximize liquidity opportunities for the resting order, a member will decide to use the Trusted Flow option where order flow from all types of accounts are eligible to trade. The only reason a Member would not elect to use this option is because of concerns about potential adverse selection from its own non-retail order flow. Given that the Retail Options are only being proposed to specifically address the risk of adverse selection, we believe that the proposal is fair. By using the Retail Options, not only do institutional users of Minimum Size Orders benefit but retail investors receive superior execution by being provided meaningful price improvement. Understanding the benefits offered to both sides of the trade made possible by the Proposed Changes, and recognizing that without the exceptions that retail orders will continue to execute at inferior prices at the NBBO, we believe the more appropriate question to ask with regard to the impact on fairness of the Proposed Changes is why would the introduction of these exceptions not be permitted?

**Impact on Internalization**

Although it could appear at first glance that the Proposed Changes may increase internalization rates (because two of the exceptions being introduced are only made available to orders from the same firm), we believe that given today's market structure and dealer order routing behavior that the Proposed Changes will not result in a significant increase in internalization rates. Because order routers are now able to prioritize internalization opportunities by sending orders to venues where they can be matched with an order from the same firm irrespective of the time priority of the order (made possible by broker preferencing as dealers attempt to "seek the cross"); orders that are currently ineligible to trade against a Minimum Size Order are being directed to another marketplace where they are internalized today. In the case where the economics of the passive side is prioritized, orders will be sent to a traditional maker-taker venue (and often trade against inventory). Where the economics of the active order is prioritized, orders will be sent to an inverted venue where they will also most often be internalized because of broker preferencing. It is because of the opportunity to internalize made possible by broker preferencing that we do not anticipate internalization rates to increase significantly because of the Proposed Changes.

If there is a marginal increase in internalization rates resulting from the Proposed Changes, we believe that this should not preclude the Proposed Changes from being approved. Currently, the CSA and the Investment Industry Regulatory Organization of Canada (IIROC) are reviewing the internalization rates in the Canadian equity market (Regulatory Review) and are considering whether any additional regulatory action needs to be taken given existing rules and market structure. The Regulatory Review involves looking at many policy considerations including the need to weigh the trade off between the individual benefits of internalization for the firm (and in particular its clients) with any negative impact to the common good of the market. In that context, we believe that it is clear that the opportunity for better execution made possible for investors by the Proposed Changes far outweigh any incremental cost to the market, should one exist.

Finally, we note that marketplace features contributing to increased rates in internalization have been approved during the Regulatory Review. Recently two marketplaces have been approved to introduce broker preferencing for anonymous orders on dark markets; a feature that by definition is designed to facilitate internalization. We continue to hold our position expressed previously that we will comply with any future direction taken by the CSA and IIROC to address internalization. However, we believe that until the Regulatory Review is completed that the approval of marketplace features that may result in only a small increase in internalization should not be delayed.

**Segmentation Considerations**

We believe that the Proposed Changes will result in decreasing segmentation of retail orders on inverted venues[2] and, while the Retail Options may only be available for retail orders, the Proposed Changes will actually result in these orders interacting with more diverse types of participants than they do today. By offering the opportunity for meaningful price improvement at the

[2] The CSA expressed its view in 2014 when it published a Notice and Request for Comment on proposed amendments to National Instrument 21-101 (NI 21-101) and National Instrument 23-101 in relations to the order protection rule that the payments of rebates by a marketplace is changing behavior of marketplace participants and that they may be contributing to increased segmentation of orders. This concern was cited as one of the reasons for proposing the Trading Fee Pilot Study which has now been approved to proceed subject to the SEC also proceeding with its own Trading Fee Pilot Study.

midpoint, dealers that handle retail orders will send orders to CXD prior to routing them to an inverted venue to trade at the NBBO. This in turn will increase retail trading volumes on CXD and in turn address a CSA concern by decreasing the aggregated amount of retail orders trading on inverted venues. In addition, whereas retail orders today actively trade against participants using market making strategies posting orders at the NBBO on inverted venues (those willing to pay a fee to gain queue priority) these orders will trade on CXD with more a more diverse set of counterparties than they do today. We want to highlight that the only features in the Proposed Changes where eligibility for an exception is limited to a class of participant are the Retail Options which a member will only choose in order to mitigate against adverse selection. There are no eligibility restrictions on orders eligible to trade against a Minimum Size Order with the Trusted Flow exception.

Expected Date of Implementation

Subject to regulatory approval, we are expecting to introduce the new options in Q4, 2020.

Expected Impact on Market Structure

The Proposed Changes will provide opportunities for long term investors to improve execution outcomes and will result in decreasing the current level of segmentation of order flow.

Expected Impact on the Exchange's Compliance with Ontario Securities Law

The Proposed Changes will not impact Nasdaq Canada's compliance with Ontario securities law as it does not represent an “unreasonable” limitation or condition and therefore is consistent with the fair access requirements of NI 21-101. We reference the Alpha IntraSpread Facility (Revised), approved in 2011 which supported an active order type (SDL order) made only available to retail investors. In the Alpha ATS LP Notice of Completion of Staff Review of Proposed Changes – Intraspread Facility[3] Staff expressed the view that “although the IntraSpread facility limits access in some respects in that "Seek Dark Liquidity" orders will be limited to the orders of a "Retail Customer", OSC staff are of the view that this does not constitute an "unreasonable" limit or condition on access under the fair access provisions in NI 21-101.” Unlike the Alpha InstraSpread model, Nasdaq Canada's Minimum Size Orders are available to interact with all orders from all types of accounts that meet the minimum size parameter. The limited exception being introduced in the Proposed Changes are being made to increase execution opportunities for institutional accounts that use Minimum Size Orders while continuing to mitigate the risk of adverse selection in addition to providing superior execution outcomes for contra-side orders entered by long-term investors.

Consultation and Review

This Proposed Changes are being made in response to feedback solicited by Members.

Estimated Time Required by Subscribers and Vendors (or why a reasonable estimate is not provided)

Some optional development work will be required by Members and vendors that choose to incorporate the proposed options into their trading systems. Based on the intended implementation date we anticipate that a 90 days period after regulatory approval has been granted will provide ample time for any development work to be completed in advance of the change.

Will Proposed Fee Change or Significant Change introduce a Fee Model or Feature that Currently Exists in other Markets or Jurisdictions

No. Although many other marketplaces including MatchNow in Canada and the NYSE and Nasdaq in the United States support Minimum Quantity Order types, these marketplaces do not currently support the option for contra-side orders that do not meet the minimum size parameter to trade.

Any questions regarding these changes should be addressed to Matt Thompson, Nasdaq CXC Limited: matthew.thompson@nasdaq.com, T: 647-243-6242

[3] https://www.osc.gov.on.ca/en/Marketplaces_ats_20110408_review-intraspread.htm