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and

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Re: Nasdaq CX2 – Introduction of New Dark Trading Book CXD – Notice of Proposed Changes and Request for Comment

The Canadian Security Traders Association, Inc. ("CSTA") is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 members nationwide, and is led by volunteer Governors from each of three distinct regions (Toronto, Montreal and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee (the "Committee", "CSTA TIC" or "we"), a group of 21 appointed members from amongst the CSTA. This committee has an approximately equal proportion of buy-side and sell-side representatives with various areas of market structure expertise, in addition to one independent member. It is important to note that there was no survey sent to our members to determine popular opinion; the Committee was assigned the responsibility of presenting the views of the CSTA as a whole. The views and statements provided below do not necessarily reflect those of all CSTA members or of all members of the Trading Issues Committee.

The Canadian Security Traders Association appreciates the opportunity to comment on the proposal by Nasdaq CX2 to introduce a separate dark trading book, Nasdaq CXD. We are generally supportive of competitive marketplace solutions and innovation in the trading landscape. However, we believe that there are some notable areas of concern within CXD's proposed feature set that may have unintended consequences and should therefore be addressed.

NCX2 Sweep Order (NCSO)

The CXD proposal contemplates the creation of the NCSO order marker, wherein the user indicates to the matching engine that they (the user) have "already checked the quotes of all other markets before routing the order to CXD" and that the NCSO order "will [therefore] trade with the best priced contra-side order(s) without consideration of prices on other marketplaces." We believe this feature is inappropriate.

As an undisplayed ("dark") market, CXD is expected to comply to Canada's regulatory framework for dark liquidity (the "dark rules"), including: 1) every trade executed within the CXD matching engine must be in the context of the National Best Bid and Offer (either Protected "PNBBO" or Universal "UNBBO") to avoid a trade-through, and 2) trades must be priced in accordance to the price improvement rules based on the size of the active order. (Note: Since the CXD proposal outlines the use of the PNBBO, we will base our discussion solely on the use of the PNBBO).

The requirement for trades to occur in the context of the PNBBO not only protects resting orders on visible (protected) markets from being traded through, but it also protects resting orders in dark order books from adverse selection to the extent that the dark markets' matching engine has an accurate view of the PNBBO. Trades within a dark market currently only take place at prices that reflect an updated PNBBO, based on the market data that is available to the matching engine.

By permitting a CXD user to enter active orders with the NCSO order marker, CXD has delegated its obligation for compliance with the dark rules, effectively enabling users with information on the immediate direction of stock prices to adversely select resting orders in CXD (since the active user is the triggering participant of the price change of the PNBBO). Active NCSO orders would interact with resting CXD orders whose limits (which may be pegging orders subject to repricing) were tradeable by the NCSO sweep order but would not be in the context of the PNBBO after the sweep is complete. This behavior fundamentally increases adverse selection risk for orders resting on CXD, with no ability for those orders to contain or manage that risk (other than to avoid resting in CXD altogether).

For example, a midpoint peg sell order with a 10.12 limit would ordinarily not be eligible to trade if the PNBBO was $10.10-$10.11. However, CXD's NSCO order marker would permit the trade to execute at $10.12, as CXD would assume that the active participant (NSCO buy order) would also be simultaneously displacing the offers up to $10.12 on protected markets. With a new PNBBO of $10.12-$10.13 after the trade, the midpoint peg sell order which was filled at 10.12 was (in retrospect) adversely selected, since it would have normally been repriced to $10.125 had the active participant lifted the offers on protected markets up to $10.12, bidding at $10.12, established a new PNBBO, and then accessed the CXD midpoint facility. In this case, a pre-emptive sweep of CXD with a $10.11 limit would not have resulted in a fill.

It can be argued that participants that chose to rest orders in CXD should be aware of the pricing mechanism and the inherent adverse selection risk associated with resting orders therein. While we agree that participants are responsible for being educated on the operations of marketplaces that they chose to access, the NSCO order type represents a disproportionate advantage to takers of liquidity without a commensurate benefit to participants with resting orders. Additionally, we believe that marketplaces should be responsible to demonstrate the net benefit of new proposed features/order types/order markers and consider the effects of additional incremental complexity, regardless of whether participants can chose to abstain from use or not. In this case, we do not believe the CXD proposal has demonstrated a net benefit from providing the potentially-harmful NCSO order type, beyond the convenience of order type consistency between CXD and CX2.

Additionally, in the context of NCSO orders, it is unclear how CXD can enforce price improvement requirements for dark orders without independently verifying the state of the PNBBO. For example, if the PNBBO is $10.10-$10.11, an active buy order for 1000 shares (and under $100,000 in value) priced at $10.11 would ordinarily not be eligible to trade at any price worse than $10.105. However, CXD's NSCO order marker would permit the trade to execute at $10.11, notwithstanding the fact that there is no way to verify that the same user displaced the $10.11 offers on protected markets, thus changing the PNBBO to $10.10-$10.12 (or wider).

We fundamentally believe that it is inappropriate for a dark marketplace to relinquish its responsibility of independently verifying the PNBBO or UNBBO at the time of a trade and do not believe that it should be permitted. We also believe that if the NCSO order type were approved, there would be a net increase to the complexity of Canadian market structure without a demonstrated commensurate benefit.

Priority of Lit Orders over Dark Orders on a Marketplace

We note that the CXD market is proposed as a separate book of Nasdaq CX2 (an existing ATS). Historically, there have been other implementations of dark facilities on existing ATSs or Exchange licenses, most notably the implementation of IntraSpread as a separate book of the Alpha ATS (later Alpha Exchange).

In October 2012, as part of the implementation of Canada's regulatory framework for dark liquidity, Alpha Exchange was required to amend its market model for IntraSpread to ensure that trades on IntraSpread which satisfied the size requirements for "at the touch" trading only executed at times when Alpha did not display a quote at the prevailing NBBO price. This requirement was introduced to comply with the requirement that lit orders take matching precedence over dark orders on a given marketplace.

We note that as proposed, CX2 and CXD are seemingly a single marketplace, with CXD as a "facility" or "separate book" of the broader Nasdaq CX2 ATS. We therefore believe that the same priority model introduced for Alpha IntraSpread should apply: lit orders on CX2 should be filled in priority to dark orders on CXD.

We acknowledge that the priority rule above would be more complex in this case since CXD is contemplated as a completely separate matching engine in a separate data center. However, we do not believe that technical limitations or architecture decisions for a newly proposed marketplace should drive an exception to regulatory considerations, such as prioritizing displayed orders on CX2 over undisplayed orders on CXD.

Size Requirements for At-The-Touch Trading

Finally, while we believe that the proposed market model for CXD is in compliance with the size requirements for dark trading in Canada, we reiterate our historical stance that the definition of "large" orders (either greater than 50 board lots or greater than $100,000 in value) does not reflect what is generally meant by "large" orders entered on a marketplace. For further discussion, we specifically refer to our response to a proposal by TriAct Canada Marketplace LP, dated October 1, 2014, to introduce "large" trading at the protected NBBO. We would encourage industry debate of what constitutes size discovery for the purpose of dark trading, with the goal of updating Canada's dark liquidity regulatory framework to reflect a more appropriate definition of "large order".

Thank you for your attention in this matter.

Respectfully,

“Signed by the CSTA Trading Issues Committee”

c.c. to:

Ontario Securities Commission:
Ms. Maureen Jensen, Chair & CEO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

Alberta Securities Commission:
Ms. Lynn Tsutsumi, Director, Market Regulation

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M[e] Élaine Lanouette, Directrice des bourses et des OAR

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Mr. Mark Wang, Director, Capital Markets Regulation

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Mr. Andrew Kriegler, President and CEO
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