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BY ELECTRONIC MAIL

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Dear Sirs and Mesdames:

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

National Bank Financial Inc. (NBF) welcomes this opportunity to comment on the potential impacts on Canadian capital markets of the December 2022 U.S. Securities and Exchange Commission (SEC) market structure proposals (the “SEC Proposals”). Given the interconnectedness of Canadian and U.S. capital markets, it is prudent for the CSA and CIRO to have undertaken this review. Our assessment is that several of the SEC Proposals will not have a material impact on Canadian markets and, therefore, not in need of a policy response in Canada. However, certain of the SEC Proposals could have the potential to materially harm secondary market activity in Canada unless compensatory policy changes are made by the CSA and/or CIRO.

Across each of the dimensions covered by the request for feedback, our guiding view is that **Canadian markets should seek to align with US rules** where practical to minimize complexity and achieve efficiencies.

Regulation National Market System (Regulation NMS)

We concur with the CSA's assessment that the contemplated changes to Regulation NMS would likely affect Canadian equity markets. These effects would arise from changes to the minimum pricing increment, access fee caps, and the standard trading unit, which we will address sequentially.

Minimum Pricing Increments

The SEC has proposed to adopt various minimum pricing increments, or "tick sizes", for the quoting and trading of National Market System securities. It is important to note that minimum price increments apply in Canada to all quotations, but in the US only to transactions occurring on marketplaces. This creates regulatory arbitrage whereby better prices can be attained off-exchange than on-exchange. The US rule changes are targeted particularly to address this discrepancy although changes to tick sizes may also impact liquidity.

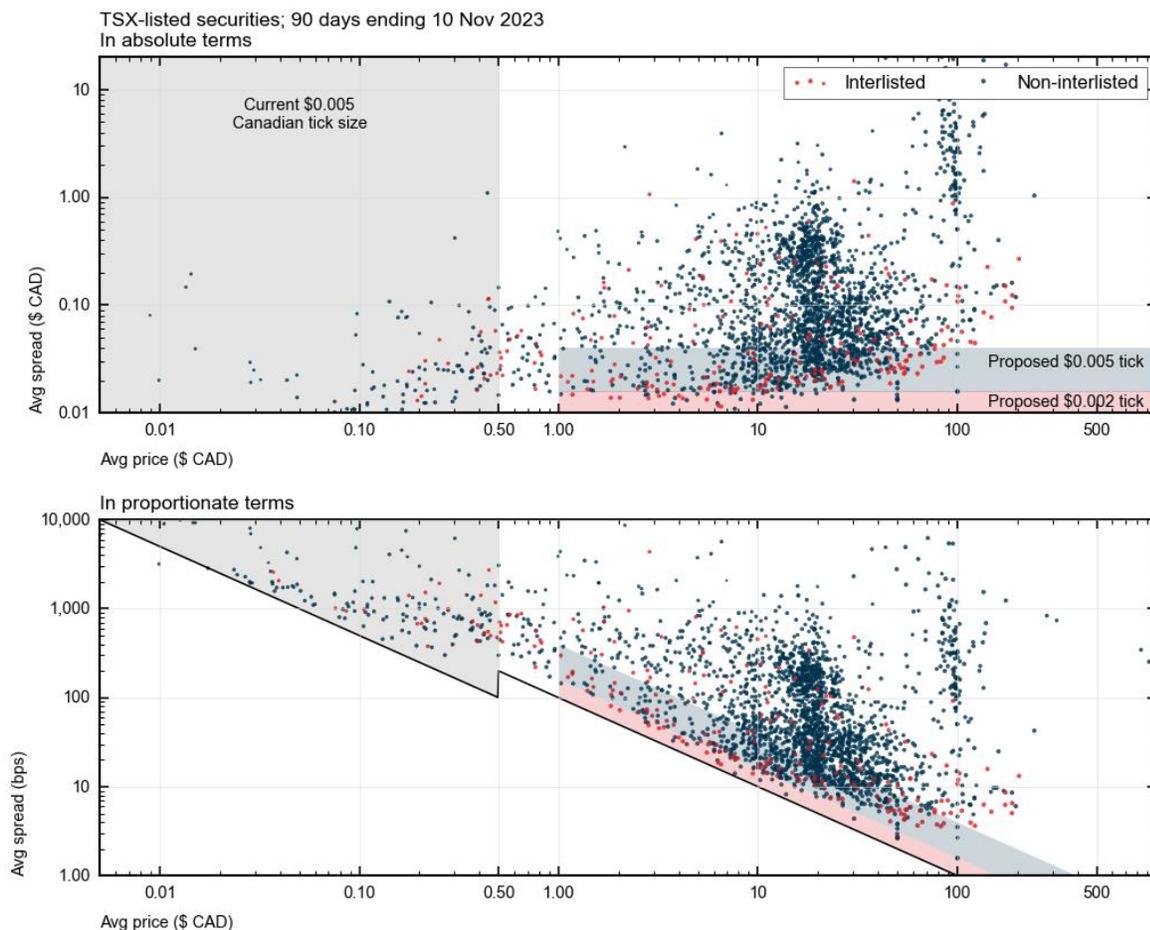
No such conflict exists in Canada, and so there exists less of a policy imperative to adjust tick sizes. Nevertheless, some changes may be necessitated in Canada should the US move to adopt the proposed rules as final.

Empirical market structure research has shown that tick sizes have a material impact on market liquidity. In our February 2020 market structure letter, we showed that many securities trade at a spread close to the minimum price increment, indicating that these securities could potentially trade at spreads tighter than a single penny if given the opportunity. We revisited this study in October 2021, finding similar results. Allowing highly liquid securities to trade at narrower price increments would reduce quoted spreads. However, this would also have the likely effect of reducing the volume available at the NBBO. This trade-off between quoted spread and market depth must be carefully considered. **Independent of US rule changes, there does not exist a compelling argument to independently adjust Canadian tick sizes.**

However, if Canadian price increments are not amended in response to an amended SEC rule, it is likely that there will be cases where the American NBBO becomes tighter than the Canadian NBBO. In such cases, an interlisted router would likely send a greater share of its volume on a Canadian-originated order to the US. This would have an adverse effect on the overall liquidity of Canadian markets. The difference in value between USD and CAD does not significantly affect our analysis.

The CSA is correct in noting that there will likely be scenarios in which an aligned method results in different trading increments between Canada and the US. In these cases, the trading increment chosen for Canada should be the narrower of (1) the US increment and (2) the increment calculated through the Canadian method. In our analysis, we find that many securities (those in the blue region in the chart below) may move to a half-penny tick, and a small number may move to a \$0.002 tick (red region), if US proposed rule changes are adopted in Canada.

Minimum price increment applied to Canadian securities



Source: National Bank Financial Markets

When considering potential changes to tick sizes in Canada it is also important to note differences in the types of Canadian listed securities as they can be impacted differently. For example, Exchange Traded Funds (ETFs) warrant special consideration as quoted prices of ETFs are derived from other instruments, so no price discovery occurs in ETF markets, and prices in ETF markets fluctuate rapidly to reflect changes in the fair value derived from the underlying instruments. As a result, reducing tick sizes on ETFs would likely massively increase message traffic without commensurate improvements in liquidity. We also see little policy rationale for amending pricing increments on preferred shares or listed debentures.

Generally, we view additional pricing increments as potentially having the effect of reducing price discovery and transparency for many retail investors as they would typically only have access to 'top of book' information. Changes to tick sizes in Canada could also disrupt order flow within Canada, for example, would orders move away from dark pools towards lit markets?

The CSA is right to be mindful of the operational resiliency and systems readiness concerns that may arise from an increase in the number of pricing increments and the periodic adjustment of tick sizes. However, trading systems already consume security master files, and can already handle differential tick sizes (e.g.,

on securities less than \$0.50). Moreover, many dealers' systems should generally already be able to handle changes (increases) in tick sizes, because of the SEC tick size pilot. However, there would be work and time required to ensure all industry trading systems, particularly those used for retail orders, to accommodate sub-penny trading.

The SEC is also proposing periodic adjustments to tick sizes. While we believe a periodic review of tick sizes makes sense, the frequency of those adjustments should not bring confusion to investors or impose unnecessary systems changes on to dealers, marketplaces, or service providers. We believe the SEC's proposed quarterly re-calibration should be manageable in Canada provided the list of impacted securities, and their recalibrated price increment, was provided to industry within a reasonable time before implementation of the new tick sizes.

Lastly, should Canada amend its tick sizes to mirror the SEC proposals it would require us to reexamine all our current trading rules and practices to reevaluate the usefulness of terms such as "mid-points" and "top of book" or whether "meaningful price improvements" are still necessary.

Considering the many considerations above, we believe the CSA and CIRO should take a measured approach in revising tick sizes in Canada. Specifically, should the SEC price increment proposals be adopted the rationale for amending tick sizes in Canada is strongest for interlisted securities. Amending tick sizes across all (non-interlisted) Canadian equities could have unintended consequences and would require further study.

Access Fee Caps

The access fee caps proposed in the Reg NMS update are unlikely to harm trading in Canadian interlisted securities. As such, should this rule be adopted as final, no policy response would be immediately required from Canadian regulators.

Notwithstanding US rule changes, the CSA should independently consider whether the fee caps in NI 23-101 are still adequate in light of fee expansion in inverted markets. High inverted (make) fees may give rise to a principal-agent conflict, which in equilibrium may result in distortive pricing and order routing practices. However, negative order routing responses to recent fee changes (i.e., the increase in active rebates on sub-dollar securities on NEO) show that market forces may be sufficient to limit distortive fee schedules. In either case, this question deserves independent study by the CSA.

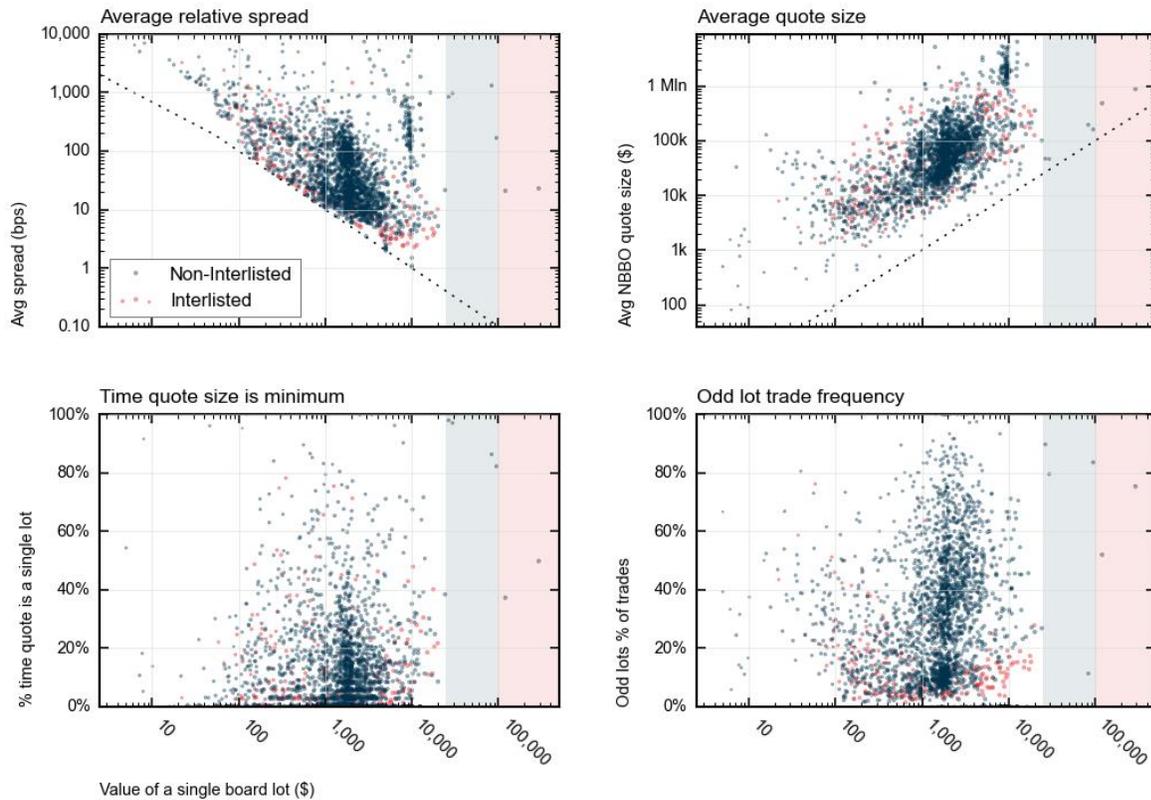
Transparency of Better Priced Orders

To enhance transparency surrounding better priced orders, the SEC is proposing to introduce a standardized definition of round lots and require odd-lot orders to be made available on market data feeds. As all odd lot orders in Canada, like other orders, are required to be executed on marketplaces, Canadian market structure does not give rise to the same issues that demand an American policy response. The odd lot book is consumed by most trading systems and orders in the odd lot book may be passively executed. Changes to US rules do not demand a policy response from the CSA or CIRO.

Should the US rules be adopted in Canada, few securities are likely to be affected as evidenced in the following charts which show all TSX-listed securities and their prices relative to the volume available at the unprotected NBBO. Securities falling within the blue region would adopt a 40-share lot size if we were

to follow the US rules; securities in the red region would adopt a 10-share lot size. Furthermore, the additional complexity and confusion brought on by new lot sizes is unlikely to outweigh any changes to liquidity. Simpler solutions already exist: a high-dollar security may always choose to split their stock to a more practical level.

Cost of a single board lot, versus liquidity characteristics



Source: National Bank Financial Markets

Order Competition Rule

In the U.S. a large portion of retail orders are traded off-exchange by OTC market makers who then execute these orders internally or route them to an exchange thereby not providing market participants the opportunity to interact with these orders. The SEC is proposing to promote order competition by requiring retail orders to first be routed to a qualified auction operated by an open competition trading center prior to being routed back to the OTC market maker.

We concur with the CSA’s assessment in that present Canadian market structure does not give rise to the same issues that the SEC seeks to address with the *Order Competition Rule* (“OCR”). While Canadian brokers who route retail orders may be affected by the SEC rule changes, we do not see a need for Canadian policy interventions in this area.

Disclosure of Order Execution Information

The SEC has proposed to expand the disclosure of order execution information by market centers to better enable investors to compare execution quality among different trading venues and dealers. It continues to be NBF's view that mandating formal, quarterly reports on routing of orders when acting as agent would impose an undue regulatory burden on broker-dealers, especially smaller brokers, and are unlikely to materially inform broker selection. Canadian market structure, especially the requirement that all trades occur on a marketplace, does not give rise to the same issues that the SEC seeks to address with disclosure rules.

Although the changes contemplated by the *Disclosure of Order Execution Information* proposal do not directly affect Canada, more could be done to improve transparency of how US brokers execute orders in Canadian securities. Because Rule 606 covers only NMS securities, execution quality reporting does not cover "F-shares," including Canadian-listed securities which may trade on OTC Markets in the US. Were the SEC to also include non-NMS stocks in Rule 606 it would introduce transparency to the routing of orders in non-interlisted Canadian securities and could lead to US brokers routing such orders to Canadian markets where they would receive better prices.

Regulation Best Execution

The SEC has proposed introducing a Best-Ex framework which would apply to all securities and co-exist with FINRA's Best-Ex obligations. The SEC proposal aims to address potentially conflicted transactions with retail customers, including payment for order flow to retail brokers. We concur with the CSA's assessment in that the SEC's proposed Best-Ex rules are not dissimilar to the existing requirements in Canada. As such, the SEC proposal should not have material impact on Canadian capital markets.

Conclusion

Much like Canada's decision to shorten its settlement cycle to T+1 to remain aligned with the U.S., there is a rationale for Canadian trading practices to stay aligned to the U.S. where sensible. However, our review of the SEC's proposed market structure changes reveals that many of the SEC's proposals will not have a material impact on Canadian markets and, therefore, do not necessarily require any changes in Canada. While the SEC's planned changes to price increments could negatively impact market functioning in Canada, we caution the CSA and CIRO against moving too aggressively in this area as it could have unintended consequences.

As always, we would be happy to make ourselves available to discuss any part of our letter.

Sincerely,

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