ANNEX D

Local Matters

Regulatory Impact Analysis

What is the problem or concern?

As indicated in the 2014 Notice, we believe that OPR affords marketplaces a degree of market power, as marketplace participants are constrained in choosing whether or not to consume and pay for certain marketplace services, in particular trading and market data. The finalization of amendments to NI 23-101 published concurrently with this notice will serve to address these concerns to some extent, through the introduction of a market share threshold, the finalization of a methodology for the regulatory oversight of market data fees and the implementation of a cap on active trading fees.

However, the trading fee cap that was proposed in the 2014 Notice and has now been finalized was intended to be an introductory or short-term step in a continued process to address concerns with active trading fees. At the time, we acknowledged that the cap of $0.0030 per share or unit of an exchange-traded fund (ETF) was higher than the fees already being charged by many Canadian marketplaces. We stated our intention to take further action on trading fees in the form of a pilot study prohibiting the payment of rebates by marketplaces. We continue to believe that a pilot examining the impact of a prohibition on the payment of rebates would be an informative study; however, given concerns about the potential loss or migration of liquidity that might occur for securities that are inter-listed in the U.S., we have deferred further consideration for now.

We acknowledge that the impact from the fee cap of $0.0030 will be somewhat limited, and reiterate that it was intended only as an introductory measure. Given that our intention to continue to address concerns related to trading fees through the introduction of a pilot study has been deferred, we are concerned that the issues raised regarding the high level of trading fees in Canada may not be addressed.

Who are the impacted stakeholders?

The fees associated with the trading of equities and ETFs impact the following stakeholders:

- Retail and institutional investors that trade Canadian equities and ETFs;
- Market Participants (Investment Dealers);
- Issuers; and
- Marketplaces.

How are stakeholders impacted?

Retail Investors	Retail investors do not typically pay the trading fees charged by marketplaces directly. However, the costs incurred by dealers executing retail order flow may be passed back to the retail investor either in the form of additional transaction costs or account / administrative fees, or indirectly through reduced investment in new products and services that may benefit the retail investor.
Institutional Investors	Similar to retail investors, many institutional investors do not pay the trading fees charged by marketplaces directly. However, where the executing dealer for an institutional investor absorbs the trading fees charged by marketplaces, investors may be paying additional costs that are passed along through increased commissions or other fees, or indirectly through reduced investment in products and services.
Marketplace Participants (Investment Dealers)	Marketplace participants must avoid trading through a better-priced protected order, regardless of the cost of trading on the marketplace displaying that order. Although the market share threshold for OPR protection will help to address the captive consumer issue, participants are still limited in their ability to control trading fees charged by those marketplaces displaying protected orders. While marketplaces charge fees on a per share traded basis, many marketplace participants charge their clients on a per trade basis. The differing basis for fees means that clients do not always pay the full cost of executing a liquidity demanding transaction (i.e. one that incurs an active

	trading fee). This cost pressure is particularly acute for firms that predominantly execute active orders on behalf of clients. There has been a recent downward trend in trading fees on certain marketplaces. Others have moved to a market model that pays rebates for active order flow (the “inverted maker-taker model”). While this has allowed some firms to better control the costs of executing active orders on behalf of clients, many marketplaces continue to employ the traditional maker-taker model where higher active fees are necessary to pay for the higher rebate paid to liquidity providers.
Issuers	Companies and ETF providers with securities listed on a Canadian exchange may be impacted to the extent that rebates and fees encourage or discourage liquidity in the secondary markets for their securities. For example, less liquidity in the secondary market for a company’s shares could increase the cost of capital for that company.
Marketplaces	In order to attract order flow, marketplaces often compete on the basis of the fee model offered and the particular level of these fees. Certain fee models are dependent on the ability to attract resting liquidity through the payment of a rebate offset by a fee associated to removing passive orders. Where the active fee must be reduced, a marketplace may be constrained in the amount of liquidity they are able to attract with a reduced rebate.

What alternative solutions were considered?

As noted above, when the $0.0030 per share or unit trading fee cap was proposed in 2014, it was intended to be an interim measure. The longer-term goal was to examine the impact of prohibiting the payment of rebates by marketplaces through the implementation of a pilot study. Where rebates are paid for passive liquidity and offset by active fees, the prohibition of the rebate would result in a decrease in the corresponding fee, and the pilot study would assess the impact on the Canadian market.

Given that the pilot study has been deferred, we considered the following options:

- Maintain the status quo;
- Impose a lower trading fee cap for all Canadian listed securities; and
- Impose a lower trading fee cap for Non-Inter-listed Securities.

Maintain the status quo

We considered taking no further action on trading fees at this time on the basis that measures already finalized (specifically the $0.0030 per share or unit trading fee cap and the market share threshold for OPR protection) could serve to address the issues highlighted in the 2014 Notice.

Although the implementation of a market share threshold for OPR should provide some relief with respect to the captive consumer issue, it will not address the trading fees charged by marketplaces that meet or exceed the threshold. Further, and as noted above, the $0.0030 cap per share or unit will have somewhat limited impact. As such, we are of the view that further steps should be taken to address the identified concerns regarding trading fees in Canada.

Lower the trading fee cap for all Canadian listed securities

An additional alternative is to impose a lower trading fee cap for all securities listed on a Canadian exchange. This would be reflective of the fact that the average share price for even Inter-listed Securities is lower than the U.S. average share price.

Imposing a lower fee cap on all Canadian listed securities would mean that Inter-listed Securities would have a lower trading fee cap (and therefore lower rebate) in Canada than in the U.S. As noted above, we are concerned that creating such a disparity between Canadian and U.S. marketplaces could lead to unintended consequences, including the migration of significant amounts of market liquidity. As a result, we decided to not pursue this option.

Lower the trading fee cap for Non-Inter-listed Securities

To further our commitment to additional action on trading fees and to achieve our intended goals, it is our view that while recognizing issues and risks associated with Inter-listed Securities, we should consider measures to address identified concerns where possible. In our opinion, the appropriate course of action is to implement a lower trading fee cap on those stocks that are not also listed on a U.S. exchange.

Policy Proposal

As discussed in this notice, CSA staff are proposing to reduce the cap on active trading fees for Non-Inter-listed Securities from $0.0030 to $0.0017 per security traded or per unit traded for an ETF, if the execution price of the security or unit traded is greater than or equal to $1.00. If approved, the proposal would not change the application of the $0.0030 per share or unit cap applied to Inter-listed Securities priced at or above $1.00.

At this time we are not proposing any further changes to the trading fee cap for securities prices below $1. In our view, the finalized $0.0004 cap from the 2014 Notice sufficiently addresses any concerns for those securities.

Anticipated Impact of Proposals

Retail Investors

The proposed changes will have a limited direct impact on retail investors as they do not typically pay the fees associated with the execution of their active order flow. However, if the proposed changes result in cost savings for executing dealers, retail investors may benefit through reduced trading or administrative costs, or potentially through investment in new products and services. This assumes that any cost savings to dealers are passed on to clients in some form.

A reduction in active trading fees on Non-Inter-Listed Securities will lower the passive rebates they finance. To offset this loss of rebate revenue, market makers could widen bid-ask spreads. As a result, costs of trading for retail investors may be impacted.

Institutional Investors

Institutional investors may also see some reduction in trading costs if the proposals serve to reduce dealer costs associated with the execution of their orders. However, as with retail investors, any benefits to institutional investors are dependent on any dealer cost savings being passed on to clients.

A reduction in active trading fees on Non-Interlisted Securities will lower the passive rebates they finance. To offset this loss of rebate revenue, market makers could widen bid-ask spreads. As a result, costs of trading for institutional investors may be impacted.

Marketplace Participants

Marketplace participants will see a reduction in trading fee costs due to the lowering of the $0.0030 trading fee cap for Non-Inter-listed Securities. The extent of the cost savings will be dependent on the trading activity of each marketplace participant in these securities, and how they choose to route orders to each marketplace. In particular, firms that tend to route more active flow will see more cost savings than others.

As the proposed new cap will only apply to trading in Non-Inter-listed Securities, cost savings will only apply to trading in those securities. We estimate that approximately 60% of traded volume for stocks priced above $1 occurs in securities which are not inter-listed.

The proposed trading fee cap will also have an impact on those participants that engage in market making activity. Liquidity providers, including market participants and high-frequency traders, make money from buying and selling securities, and their margin is the net-of-fee (and rebate) bid-offer spread. A reduction in trading fees lowers passive rebates and, as a corollary, net-of-fee spreads and market maker income, all else remaining unchanged. In other words, lower rebates resulting from lower active trading fees change the economics of market making by reducing the potential return on capital.

In response to lower rebates, market makers may require wider bid-ask spreads. In addition, the market makers might decrease market depth – the size of the quotes posted at the best prices. Alternatively, some market makers may no longer find it economically viable to offer liquidity for some securities at the lower rebate levels and may withdraw from the market.

Issuers

We anticipate that imposing a lower trading fee cap on Non-Inter-listed Securities would lead to lower liquidity provider rebates being provided for those securities. The impact of this on issuers will be immaterial as long as the reduced rebates do not impact the available liquidity for the issuer’s securities. Lower rebates may lead to lower levels of secondary market liquidity for some securities and this could result in lower market activity and higher costs of capital for those issuers. This risk could be more acute for issuers (e.g. some ETFs) that are reliant on liquidity provision from a small number of marketplace participants.

Marketplaces

The most significant impact would be for those marketplaces currently charging trading fees in excess of the proposed cap for Non-Inter-listed Securities. At the time of publication of this notice, 10 Canadian marketplaces or facilities of Canadian marketplaces are subject to the pre-trade information transparency requirements in section 7.1 of National Instrument 21-101 *Marketplace Operation*, and would therefore be subject to the proposed cap. Of these 10 marketplaces, six have elements of their fee model that charge active trading fees higher than the $0.0017 per share or unit proposed.

However, marketplaces that are forced to lower their active fees would likely also lower the liquidity provider rebate they offer so as to maintain the net revenue they receive from each share traded. If trading activity remains at current levels, the impact of the proposal on marketplace revenue will be limited. At this time, we are not able to estimate any potential impact on the number of shares traded and therefore the revenue of affected marketplaces.

The maker-taker (and taker-maker) pricing model permits a marketplace to differentiate its fees and rebates from its competitors. The proposed lower fee caps may limit the ability of a marketplace to differentiate its net-of-fee pricing from other marketplaces subject to the cap.

As such, marketplaces trading securities under this non-inter-listed fee cap may face greater competitive pressure as the services they offer become more similar, particularly marketplaces that were only competing on price. This increased competition among the marketplaces could make the trading of some of these securities uneconomical on certain marketplaces.