IIAC ACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Dear M^e Jannelle and M^e Beaudoin,

Re: Bourse de Montréal Inc. – Requests for Comments:
Amendments to the Rules and Procedures of Bourse de Montreal Inc. to accommodate the extension of its trading hours (Circular 165-17);
Amendments to the Rules and Procedures of Bourse de Montreal Inc. to expand the definition of approved persons (Circular 166-17).

The Investment Industry Association of Canada (the "IIAC") and its members would like to take this opportunity to express their views on the proposed amendments to the Rules and Procedures of Bourse de Montreal Inc. to accommodate the extension of its trading hours as per Circular 165-17 published on November 14, 2017 and on the proposed amendments to the Rules and Procedures of Bourse de Montreal Inc. to expand the definition of approved persons as per Circular 166-17 published on November 14, 2017.

The IIAC is the national association representing the position of 129 IIROC-regulated Dealer Member firms on securities regulation, public policy and industry issues. We work to foster a vibrant, prosperous investment industry driven by strong and efficient capital markets.

We remind Bourse de Montreal that this comment letter, in its entirety, can be published on the Bourse's website.

<u>Industry Position – Low Support for Extended Trading Hours</u>

With respect to the Bourse's project to extend its trading hours, it should be noted that our members have had extensive conversations with the Bourse regarding this topic over the years.

The industry's view remains: The IIAC and its members are not in favor of this initiative. Our industry, to this day, has major concerns regarding market liquidity, market integrity and market reputation.

Furthermore, the initiative implies additional cost and potential regulatory burden for our members with what we expect to be minimal offset from incremental revenue. We also believe that the liquidity issues, mentioned above, will greatly impact risk levels as well as market integrity. Our industry concerns are summarized below.

<u>Market Liquidity - Risk to Aid Liquidity</u>

Our Canadian members have been the largest supporters of the Canadian futures market, both from a sales perspective and from a market making perspective. Liquidity on the futures market in Montreal is a direct result of the capital and support that those members have devoted to each product.

Despite the Bourse's confidence in the eventual development of liquidity during the extended hours, the basis for this level of confidence is unclear to the industry members. While support for these products is currently supported by Canadian-based and/or foreign-based market makers during regular hours, there is no basis to believe these same participants will be willing to provide liquidity in non-traditional hours when liquidity in the underlying instruments is not available.

After surveying our members active in the Canadian futures market, we feel that support would not extend to an overnight session in which the largest of those end-user clients – the UK and European hedge fund community – would want to have access to liquidity in that early session (liquidity that they would normally have in the regular session).

The financial, operational, and reputational risks involved to aid liquidity in that early session are not risks that our members are currently willing to take.

Furthermore, we note that despite the Bourse's support, material market liquidity has failed to develop for other products introduced by the Bourse including carbon futures, 2 year, 5 year and 30 year Interest rate futures. The failure to have supportive liquidity materialize in the extended hours session could have knock-on impacts to the overall integrity and reputation of the market for products which are currently successful.

If the Bourse wishes to implement the extended hours despite low industry support, the industry advocates that the Bourse have concrete plans in place to ensure liquidity support for products trading in the extended hours session prior to operationalizing this approach. As articulated below, failure to ensure appropriate liquidity may have material impacts on market integrity and participants' risk.

<u>Market Integrity - Market Quality and Manipulation:</u>

Members doubt there will be sufficient market depth and liquidity in derivatives markets without:

i) the support of the Canadian dealers, and
ii) the availability of the underlying securities during the extended trading hours.

Concerns with market depth and liquidity greatly increase the probability of market manipulation or disruption. The reputation of the Bourse and of the Canadian markets are at stake.

Furthermore, the lack of underlying benchmarks may greatly increase the difficulty in assessing fair and reasonable pricing of the derivative instruments (re: price discovery degradation). For instance, how will the Bourse assess EFP, EFR and Block trades for fair and reasonable pricing? What measures will the Bourse implement to preserve market quality during unconventional trading hours? What benchmarks will Market operations use during extended hours to adjudicate no-cancel range for off-market trades? Industry members have received answers from the Bourse for some of these questions. The concerns remain.

<u>Opening Time</u>

Our members believe that 2:00 am EST is not a reasonable opening time for the Montreal Exchange.

For example, the Gilt futures open on the ICE/LIFFE at 2:30 am EST. The Montreal Exchange opening at 2:00 am, before major global bond contracts can be traded, suggests to the global investment community that the Bourse may have a misconception on the reliance global investors place on the bourse's products vis-a-vis those of other global exchanges. Global market participants have indicated that they do not need CGBs more than they need Gilts.

To justify extending its trading hours, the Bourse references that Sydney has a practically 24-hour futures market. However, this is a poor comparison given that Sydney is in a time zone almost on its own, where a very small portion of the investment world exists. It is in Sydney's best interest to be open during European and North American trading hours, hence the need for a round-the-clock market.

The First In First Out ("FIFO") Algorithm – Issues

The FIFO fill algorithm on the Bourse's futures exchange means that Good 'Til Canceled ("GTC") orders will be pointless if a client does not want the overnight risk of being filled on a significant event that causes market movement.

The increased risk that an event moves the market will mean people will not work GTC orders, so the only advantage many clients have (GTC in a FIFO market) will effectively be removed.

It should be noted that removing orders in a FIFO market means that the orders go to the back of the queue when they are re-entered. We believe this to be unfair to investors. As previously mentioned, the only fill algorithm that we believe is appropriate in a market that trades for more than regular business hours is a pro-rata algorithm, such that participants can take their order out when they leave and enter the market again later in the morning without putting them at a disadvantage.

As mentioned above, the Bourse's clients may not want to cancel their orders in the book as it would impact the order's priority.

We are asking the Bourse, if the initiative goes forward despite low support from the industry, to introduce a functionality that would allow clients to "hide" their orders in the book during extended hours without losing priority in the book once reactivated. Another acceptable solution would be to move to a pro-rata algorithm as explained above. In any case, the current algorithm does not properly support the Bourse's project.

Licensing and Registration

If the extended trading hours are implemented and our members would wish to participate in the early trading session, they would face licensing and registration issues.

Our members would potentially require their European branches to undergo the same licensing and registration as the Canadian firms to be able to assist Canadian clients if/when they need to trade overnight.

Foreign 24-hour desk staff would therefore need to be “dual-hatted” employees. They would need to be licensed for the Canadian and Foreign jurisdiction, which would effectively mean that members would need a “Canadian branch” of some sort in the Foreign jurisdiction so that employees could be licensed and registered to deal with Canadian clients in regards to Canadian products. That is a costly and large administrative exercise that many firms may refuse to undertake.

Members are also concerned that local regulatory considerations may inhibit the ability to license individuals to perform supervisory functions from non-domestic locations. There is also concern that the act of supervising this activity may bring additional scrutiny from foreign regulatory agencies.

To avoid the dual licensing of foreign staff, Canadian members would need to hire trading staff to work the overnight session from Canada – a minimum of two employees would be required per firm – another costly undertaking.

The issue is that our members do not believe that the incremental revenues they could potentially derive from the Bourse’s initiative would be anywhere close to covering their additional costs.

The addition of domestic personnel to cover the extended session comes with logistical and practical challenges. Because of the unattractiveness of the working hours, extended hours sessions are likely to be staffed by junior personnel who are less equipped to deal with exceptional circumstances. This adds to the potential occurrence of disruptive market events.

Furthermore, the proposal to expand the definition of approved persons (circular 166-17 issued by the Bourse in November 2017) does not help our members comply with other regulatory requirements. The IIAC is currently working with the Investment Industry Regulatory Organization of Canada (IIROC) as well as with the Financial Conduct Authority (FCA) in the United Kingdom in order to fully understand the impact of the Bourse’s proposal on its members. However, the ultimate outcome of these discussions is as yet uncertain.

Regardless of the outcome of the registration issues, firms believe that relying on employees in foreign offices to manage customer relationships for Canadian derivatives products is sub-optimal. Representatives in foreign offices are typically already fully engaged, have less familiarity with the particulars of the Canadian marketplace and, consequently, may not be well positioned to provide optimal customer service or execution for Canadian derivatives products. For some smaller dealers, the option to leverage foreign operations to accommodate the overnight demands may not be available. This would create an unlevel competitive environment among participants.

Overall Increased Payroll

To support this costly initiative, our members would need to increase staffing in the following departments:

- Trading, as mentioned above
- Compliance and Surveillance
- Risk management
- Administration
- Information Technology

Furthermore, we believe certain legislation may require that night staff be paid a premium on their salary. The IIAC is still analyzing the legal impact of the proposal.

CDCC – Clearing Impacts:

We wonder if the clearing impacts have been properly assessed by the Bourse.

The industry has many questions and concerns. For example, will transactions be novated on a live basis? If this is not the case, our members would be taking on the complete counterparty risk of a transaction until this transaction gets novated by the CDCC. Concerns remain despite answers received from the Bourse regarding clearing.

Due to the increased counterparty risk (and associated increased financial and regulatory risk), our members may not want to participate in the extended trading hours. We believe this is yet another key issue for our members.

Regardless whether members participate in the extended trading hours, they would have credit exposure resulting from market stress events during the extended session. Without adequate means to remediate credit exposure from customers and counterparties, member firms financial position could be negatively impacted.

The industry would also like additional clarity related to the structure of the proposed 7:15 margin call. It is not currently clear whether the margin call will reflect price movements on contracts during the extended session. If this is the case, it represents a risk to firms whether they decide to participate in the early session or not, since the firms' open positions will be subject to variation margins based on the prices of the early session.

This is a material exposure to overnight market or political events which is compounded by the fact that this 7:15 margin call occurs when Dealers' back offices will be lightly staffed, customers and counterparties are not available to provide offsetting margin deposits to the participant and the participant does not have immediate access to secondary sources of liquidity. The implications to firms' liquidity could be significant in the event of significant overnight stress events.

Furthermore, we highly doubt that the current CDCC systems will be able to support the initiative. It is necessary that the CDCC systems be updated to support the proposed changes if the Bourse goes ahead with the initiative despite low industry support.

MX support:

Our members also have concerns regarding the support provided by the Bourse, the Regulatory Division and the CDCC if the proposal is implemented. The industry participants have many questions:

- Will the Market Operations Department offer proper support during the extended trading hours?
- Will the Technical Help Desk offer proper support during the extended trading hours?
- Will the Bourse's IT Department offer proper support during the extended trading hours?
- Will the Regulatory Division offer proper support during the extended trading hours?
- Will CDCC offer proper support during the extended trading hours?
- Did the Bourse evaluate the cost of providing extended support to market participants?

We believe proper support should be made available to our members during the extended trading hours if the project is adopted. Concerns remain despite answers provided to industry members.

Live Orders – Increased Risk:

Our members feel it would be unreasonable to expect the Bourse's Approved Participants to monitor their orders in the book from 2:00 am to 4:15pm. Members believe it would also be unreasonable to expect that Approved Participants should assume market risk during the unconventional trading hours.

Technology Impacts:

Another impact that may not have been properly assessed by the Bourse is whether the existing IT and Surveillance applications provided by third-party vendors will be able to support the extended trading hours. Once again, members have questions:

- Did the Bourse discuss its project with third-party vendors?
- Has the Bourse enquired about third-party vendors' batch processing time?
- Did the Bourse assess the impact of its project on our members' surveillance tools?

Concerns remain despite answers provided to our members.

The Bourse's Revenues – How Are the Revenues Generated?

The Bourse suggests that a very large portion of its trading activity comes from London, UK. The IIAC agrees. However, the support base that has requested this earlier trading session also consists largely of trading entities that trade large volumes often for no loss or gain.

These entities also pay the exchange minuscule fees relative to the Canadian banks and dealers that have supported the Canadian market for so long.

There needs to be proper consideration for the revenue that the exchange is generating from the participants that have requested the change versus the revenue from the members that are opposed to the change. The Bourse must assess the revenues rather than simply look at the volumes that those foreign participants are trading.

Where Is the Profit?

The Bourse has given guidance to our members on the profits expected from this proposed initiative.

The Bourse also estimates that approximately 10% to 15% of the daily volume would trade in the early session.

The issue is that we do not expect our members' overall volume to increase by 10% to 15% from the extended trading hours. Furthermore, even if a 10% volume would be realistic from the extended trading hours, the decreased volume in the "regular" trading session and the additional costs to our members for making staffing, administrative and infrastructure changes would not create increased profits for our members.

The Chicago Mercantile Exchange Group ("CME") Example

On April 12, 2017, the CME, one of the world's biggest exchanges, issued the following newswire:

"The CME Group is closing two operations in London by year end after they ran up losses of more than $100 million…

*"**While Europe continues to be a critically important and expanding market for CME Group ... our customers have shown that they prefer to access our global products, deep liquidity and greater capital efficiencies through our U.S. infrastructure**," William Knottenbelt, CME Group senior managing director, international, said in a statement".*

We foresee a similar outcome if the Bourse extends its trading hours as proposed.

Market Reputation - Reputational risk

We believe the Bourse needs to be careful in assessing this new initiative and its impact on the industry.

The industry in not confident that the Bourse has sufficient mechanisms available to mitigate potential price dislocation in the marketplace during periods of stress. The impact to markets as result of extraneous market moving events during the extended hours session will be severely impacted by minimal liquidity. The ability to mitigate disruptive or 'fat finger' events under these circumstances will be circumscribed. This is compounded by a lack of clarity around the sources that the Bourse will leverage to determine trades that are excessive (outside the no-cancel range) given the limited transparency that may be available on the underlying instruments during the early hours session.

The participants requesting the extended trading session will be fickle if they are not generating profits from it. If the Bourse goes to this early session and the "liquidity providers" do not participate, the reputation of the Canadian derivatives market is at stake.

We do not believe the reputational risk is worth the minimal gain in revenue that could potentially be garnered from this exercise.

The Bourse's Analysis

In talking with the Bourse's Financial Markets department, the IIAC Derivatives Committee members learned that this initiative was a 2017 objective ("it will happen", "the extended trading hours will be implemented") to be implemented in 2018. At the time where we first learned about the extended trading hours, the analysis of the project's impact had not yet been completed by the Bourse.

We felt that the documentation provided to members by the Bourse in 2017 in order to justify the initiative was overlooking certain major impacts (which are included in this letter).

Furthermore, when first asking the Bourse's Regulatory Division for its analysis of regulatory impacts, we were told that the analysis had just begun and was yet to be completed. When the official proposal was published in November 2017, we once again asked the Regulatory Division for its analysis of the project as the circular stated that "…the Regulatory Division independently reviews and analyzes such proposals to assess the impacts on its activities as well as those of the approved participants…" [emphasis added]. The Regulatory Division did not provide us with its analysis. Instead, we were told that the Bourse's commercial unit could answer any questions we may have. Concerns remain.

In 2017, we were also told that the Bourse was still in discussion with the CDCC to find solutions to certain clearing problems.

Once again, our members had major concerns. How can a project receive the "go ahead" in early 2017 without a completed commercial, regulatory and clearing analysis?

We feel that the commercial, regulatory and clearing analysis should have been completed before the Bourse made the decision to implement the extended trading hours. As previously mentioned, our members were told in early 2017 that the initiative was “going to happen”.

We must also note that Circular 023-17 issued by the Bourse in regards to the Bourse’s Regulatory Division mission states that the Division “*is responsible for market regulation for the Bourse de Montréal Inc. The Division’s mission is to promote the integrity of exchange-traded derivatives markets at the Bourse or in Canada through the development and consistent application of clear, fair rules and policies that are effectively adapted to market needs*”. We believe, despite an independent analysis (which we did not see and were not given access to), that the Regulatory Division may be overlooking negative market impacts if it ultimately agrees with the extended trading session project.

The industry is also concerned with the involvement of the Regulatory Division in the Bourse’s commercial project throughout 2017. Members have more questions:

- How could the Bourse give the “go ahead” to this initiative in early 2017 before the regulatory analysis was completed?
- Did the Regulatory Division have a say in the project?
- Could the Regulatory Division stop the project, or any project, if the regulatory risks are deemed too great for the Canadian market?
- Why weren’t the industry members given a copy of the Regulatory Division’s independent analysis of the project since the impacts on approved participants were analyzed?
- Why, when asking for the Regulatory Division’s analysis of the project, were we told that the commercial unit of the Bourse could answer any questions we may have? Shouldn’t the Regulatory Division be independent from the commercial unit of the Bourse?

It should be noted that the industry firmly believes that the Autorité des Marchés Financiers should be involved in assessing this project. The risks involved are too important for the Canadian market. A false assessment of the initiative’s impacts is not an option.

<u>Conclusion:</u>

As previously mentioned, there is no industry-wide support for this project. There is low support from our IIAC members. Clients of our members (“locals”) are also concerned about the negative impact the initiative will have on market integrity.

Major concerns exist in the industry. Our members foresee major issues impacting:

- Market liquidity
- Cash market liquidity
- Market integrity
- Canadian market reputation

Our members also foresee:

- Price gaps which may increase the risk of market manipulation
- Increased financial and regulatory risk

As a for-profit enterprise, the Bourse should not abrogate its responsibility as the custodian of the primary derivatives market in Canada for the purpose of incremental revenue gains at the cost of market participants and the potential detrimental impact to market integrity.

We firmly believe the Autorité des Marchés Financiers should be involved in assessing the risks and impacts of this project to ensure that the potential impacts to market integrity have been appropriately addressed. The IIAC and its members are seriously concerned. Concerns increased when our members were recently told that the initiative would involve a 90-day advisory period. Such a period is significantly too short as serious logistical issues exist for our members.

Furthermore, we also have major concerns regarding our members' and the Bourse's readiness for this initiative on the following fronts:

- Internal technology
- External technology
- Operations
- Regulation
- Compliance
- Risk management

Without commitment from our members to participate and to be properly equipped to support these extended trading hours, the Bourse may well be heading towards failure. Lack of market readiness may also create an uneven playing field.

Overall, we strongly believe that this initiative is not a sensible use of exchange or participants resources.

Please note that the IIAC and its members, as always, remain available for further consultations.

Yours sincerely,

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