CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

Joint CSA/IIROC Consultation Paper 23-406
Internalization within the Canadian Equity Market

March 12, 2019

Part 1 – Introduction

Like many jurisdictions globally, the Canadian equity market has evolved rapidly over recent years. Multiple competing marketplaces have launched operations, new participants have entered the market and the ways in which market participants interact have changed. The technology and tools available to achieve a variety of investing and trading objectives have modernized the Canadian market and made it more efficient. This evolution has in turn raised new issues to consider. On December 5, 2017, the Joint Canadian Securities Administrators (**CSA**)/Investment Industry Regulatory Organization of Canada (**IIROC**) Staff Notice 23-319 *Internalization in the Canadian Market*[1] was published to inform stakeholders that we were gathering information in order to understand current practices related to internalization and to consider how these activities fit within our current rule framework.

The purpose of this consultation paper (the **Consultation Paper)** is to seek feedback in response to concerns regarding the internalization of retail/small orders within the Canadian equity market. The CSA and IIROC, (collectively, **we)** are publishing the Consultation Paper for a 60-day comment period to solicit views. While there are a variety of competing interests, our underlying goal is to ensure the protection of investors, and to foster fair and efficient capital markets and confidence in capital markets. In addition to the specific questions put forth throughout the Consultation Paper, we invite any general comments you may have in relation to internalization.

The comment period will end on **Monday May 13, 2019.**

The remainder of the Consultation Paper is structured as follows:

- Part 2 provides background information, including a description of the relevant aspects of the current Canadian regulatory rule framework and the underlying objectives;
- Part 3 provides relevant data in relation to the magnitude of internalization in Canada;
- Part 4 identifies specific issues and concerns; and
- Part 5 describes other related issues.

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[1] (2017) 40 OSCB 9649 (December 7, 2017).

Part 2 - Background and History

2.1 Internalization

The term "internalization" is broad. It can refer to different types of trading activities and may occur through a variety of means. For introductory and contextual purposes, a trade that has been "internalized" is generally considered to be a trade that is executed with the same dealer as both the buyer and the seller. A dealer may act as an agent on both sides of an internalized trade, or may act as principal in taking the other side of a client order. A trade can be internalized on a marketplace in multiple ways including intentionally, through the execution of an "intentional cross"[2], or through an "unintentional cross"[3] that occurs on a marketplace and is a result of trade matching priority methodologies. For further Canadian context, our rule framework does not permit internalization that results from order execution by a dealer without that execution occurring on a marketplace.

Question 1: How do you define internalization?

As described above, internalization may occur either intentionally or unintentionally. The concept of a dealer intentionally taking steps to maximize the interaction between the orders of clients or between its clients and itself, is not new. In doing so, dealers may benefit from increased efficiencies, greater trading revenue and potentially achieve better outcomes for their clients. However, as technology and trading strategies continue to evolve, we have heard concerns regarding a perceived increase in the magnitude of dealer internalization on Canadian equity marketplaces, and the potential impact of any such increase on the quality of the Canadian market. While there may be some dealer-specific efficiencies and improved client outcomes associated with these changes, these must be weighed against other potential impacts. In section 4.1 of this Consultation Paper, we highlight the issue of the common good versus the individual good. Essential to a discussion about internalization, are questions related to activities and outcomes that may benefit the individual, but which may potentially detract from overall market quality.

It is important to establish at the outset that we have not reached any conclusions regarding internalization. There are a variety of market structure considerations that relate to internalization, and this Consultation Paper seeks feedback on several of these issues. When reviewing the feedback we will consider how evolving market structure and trading practices intersect with existing rules, with the goal of ensuring that the rule framework we have in place continues to protect investors and fosters a fair and efficient market.

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[2] An intentional cross is considered to mean a trade that results from the simultaneous entry by a dealer of both the buy and the sell sides of a transaction in the same security at the same price.

[3] An unintentional cross is considered to mean the execution of a trade where the two orders (not simultaneously entered) are from the same dealer. In addition, and relevant to this Consultation Paper, the order matching methodology on many Canadian marketplaces will match and trade an incoming order with other orders from the same dealer first, even ahead of orders from other dealers that are at the same price and that have time priority. See section 2.2 of this Consultation Paper, under the heading *Broker Preferencing*.

2.2 Broker Preferencing

"Broker preferencing" is an important element of the concerns that have been raised in relation to internalization. Broker preferencing is a common order matching feature of many Canadian equity marketplaces, and allows an incoming order sent to a marketplace to match and trade first with other orders from the same dealer, ahead of orders from other dealers that are at the same price and that have time priority. This order matching methodology can facilitate internalization through the execution of unintentional crosses.

Broker preferencing is not new to the Canadian market and pre-dates modern electronic marketplaces in Canada by many years. Historically, its inclusion in the order matching priority of the Toronto Stock Exchange provided an incentive to encourage dealers to commit orders to the order book, rather than matching orders outside of the order book and then executing an intentional cross. It continues to be an order matching feature of many Canadian marketplaces.

2.3 History and Objectives of the Canadian Rule Framework

The purpose of our review of internalization is to consider how current trading practices fit within our rule framework, with the goal of ensuring that the rules continue to meet their intended objectives. While our rule framework currently accommodates some internalization, we want to ensure these rules continue to:

- meet the policy objectives;
- promote the functioning of a fair and efficient market; and
- reflect the evolution of the market.

In 2001, the CSA implemented rules designed to facilitate competition among marketplaces (the **Marketplace Rules**).[4] The Marketplace Rules consist of National Instrument 21-101 *Marketplace Operation* (**NI 21-101**), National Instrument 23-101 *Trading Rules* (**NI 23-101**) and their Companion Policies (**21-101CP** and **23-101CP**, respectively).

The Marketplace Rules were put in place with the objectives of:

- promoting competition and investor choice;
- improving price discovery;
- decreasing execution costs; and
- improving market integrity.

In the following subsections we outline certain key market attributes or characteristics that have guided the consideration of policy changes in the Canadian market for many years, and have been referenced not only in the continued development of the Marketplace Rules, but specific policy

[4] Published at: http://www.osc.gov.on.ca/documents/en/Securities-Category0/rule_20010817_alternative_trading_systems.pdf

work in relation to dark liquidity[5] and the order protection rule[6]. We also provide a summary of the relevant aspects of our rule framework and the objectives sought through implementation.

2.3.1 Key Attributes of a Market

The following key attributes of a market have been described in several publications including the 1997 TSE *Report of the Special Committee on Market Fragmentation: Responding to the Challenge*, and in Kirzner (2006)[7]. We continue to believe these attributes are relevant, especially in relation to concerns raised about internalization.

1. Liquidity

Liquidity can be defined as the market's capacity to absorb trades from customers' buy and sell orders at, or near, the last sale price of a particular stock. The greater the number of orders and shares available at a particular price, the more liquid the market will be. Some of the characteristics of liquidity are market depth, market breadth, and resiliency.[8]

2. Immediacy

Immediacy refers to how fast an order can be executed. This attribute is closely linked to liquidity, because as liquidity increases, the time to complete a trade should decrease.

3. Transparency

Transparency refers to the degree to which there is real-time dissemination of information about orders and trades to the public.

4. Price Discovery

Price discovery refers to the process through which the execution price for a security is established. The discovery of a security's fair market value is derived primarily from two sources: the supply of and demand for the security, which indicate a participant's willingness to transact at a given price, as well as information about transactions.

5. Fairness

Fairness refers to the perception and the reality that all participants are subject to the same rules and conditions and that no individual or group has an unfair advantage or disadvantage over others.

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[5] Published at: http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20091002_23-404_consultation-paper.pdf

[6] Published at: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140515_23-101_rfc-pro-amd.htm

[7] Kirzner, E., Ideal Attributes of a Marketplace (June 22, 2006). Task Force to Modernize Securities Legislation in Canada, Canada Steps Up, Volume 4 – Maintaining a Competitive Capital Market in Canada.

[8] Market depth refers to the number of orders at different prices that are in an order book. Market breadth is the number of shares that are wanted or offered at a particular price level and the ability to absorb an incoming large order. Resiliency refers to the ability for a market to attract offsetting orders relatively quickly when price changes occur.

The "fairness" of a market may relate to fair access to either a specific marketplace or the entire market itself, fair access to trading information or the fair treatment of orders.

6. Market Integrity

The integrity of the market relates to the level of confidence in the market as a whole or in a particular marketplace. This confidence level is closely associated with both investors' perception of fairness in the market, and the effectiveness of the regulatory environment.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

2.3.2 Marketplace Rules

The Marketplace Rules were established with the objective of creating a rule framework to permit competition between exchanges and alternative trading systems (**ATSs**) that would:

- provide investor choice as to execution methodologies or types of marketplaces;
- improve price discovery;
- decrease execution costs; and
- improve market integrity.[9]

The various elements of the Marketplace Rules are guided by the key attributes of a market described above and impose requirements to ensure that trading is fair and efficient. Specific provisions that are relevant to internalization are described below.

(a) Definition and Regulation of Marketplaces

In furtherance of the objectives of the rule framework, the definition of a "marketplace" is a key element of the Marketplace Rules. The term is used throughout the Marketplace Rules to capture the different types of trading systems that match trades.[10]

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[9] (2003) 26 OSCB 4377 June 13, 2003.
[10] Subsection 2.1(1) of Companion Policy 21-101CP.

NI 21-101 defines "marketplace" to be:[11]

- an exchange
- a quotation and trade reporting system (**QTRS**)
- a person or company that provides a market or facility that uses established, non-discretionary methods[12] to bring orders for securities of multiple buyers and sellers together[13]
- a dealer that executes a trade of an exchange-traded security outside of a marketplace.

With respect to internalization, 21-101CP provides relevant guidance in relation to the activities of a dealer. It provides the following clarifications:

- a dealer that internalizes orders for exchange-traded securities and does not execute and print the trades on an exchange or QTRS in accordance with the rules of the exchange or QTRS is considered to be a marketplace pursuant to the definition.[14]
- a dealer that uses a system to match buy and sell orders or pair orders with contra-side orders outside of a marketplace and routes the matched or paired orders to a marketplace as a cross may be considered to be operating a marketplace.[15]

(b) Fair Access

The fair access requirement prohibits marketplaces from unreasonably prohibiting, conditioning or limiting access to the services it offers.[16] The rule also prohibits unreasonably discriminating among clients, issuers and marketplace participants.[17] Where a system is determined to be a marketplace (including where dealer internalization activities might be considered as such), the fair access requirement applies.

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[11] A similar definition of "marketplace" is included in the *Securities Act* (Ontario).

[12] Subsection 2.1(4) of Companion Policy 21-101CP explains that "established, non-discretionary methods" include any methods that dictate the terms of trading among multiple buyers and sellers entering orders on the system. Such methods include providing a trading facility or setting rules governing trading among marketplace participants. Rules imposing execution priorities, such as time and price priority rules, would be considered as "established, non-discretionary methods".

[13] Subsection 2.1(3) of Companion Policy 21-101CP clarifies that a person or company is considered to bring together orders for securities if it: (a) displays or otherwise represents to marketplace participants, trading interests entered on the system; or (b) receives orders centrally for processing and execution (regardless of the level of automation used).

[14] Subsection 2.1(1) of Companion Policy 21-101CP.

[15] Subsection 2.1(8) of Companion Policy 21-101CP.

[16] Section 5.1 of NI 21-101.

[17] Subsection 5.1(3) of NI 21-101.

(c) Best Execution

While marketplaces may implement additional rules, NI 23-101 also establishes basic common trading rules that apply across all marketplaces in order to ensure market integrity, including best execution. Securities legislation imposes a fundamental obligation on dealers to deal fairly, honestly and in good faith with their clients. Best execution requirements stem from this obligation and require dealers to make reasonable efforts to obtain the most advantageous execution terms reasonably available when acting for a client.[18] While best execution is not assessed on a trade-by-trade basis, dealers are expected to establish and follow policies and procedures for achieving best execution and regularly review for the effectiveness of these policies and procedures.[19]

The objectives of these requirements are two-fold: (i) strengthen investor confidence and (ii) foster market fairness.

Where a dealer is taking steps to increase the magnitude of client orders that are internalized, best execution is an important element to consider for the dealer (in relation to their obligations), but also for the CSA and IIROC in the context of any future regulatory policy work.

2.3.3 Universal Market Integrity Rules

NI 23-101 also requires that exchanges regulate their members directly or through a Regulation Services Provider (**RSP**)[20] and that ATSs retain an RSP to monitor the conduct of the ATS and its subscribers.[21] IIROC acts as the RSP for all Canadian equity marketplaces and is also the self-regulatory organization that oversees all dealers and trading activity on these marketplaces. IIROC's Universal Market Integrity Rules (**UMIR**) were established to promote a fair and orderly market. UMIR is "universal" in that it applies to trading on all equity marketplaces and to anyone accessing these marketplaces,[22] and was established with the belief that the adoption of a single set of rules that is consistently applied and enforced is the best way to ensure market integrity.[23] The underlying policy objectives of UMIR are consistent with both the Marketplace Rules and the key attributes of a market. Relevant to internalization, there are a number of UMIR provisions that are discussed below.

[18] Part 4 of NI 23-101 and IIROC Dealer Member Rule 3300.
[19] Subsection 4.1(3) of Companion Policy 23-101CP.
[20] Section 7.1 of NI 23-101.
[21] Section 8.3 of NI 23-101.
[22] Currently only Participants and Access Persons, as defined in UMIR, may access a marketplace for which IIROC is the RSP.
[23] https://www.bcsc.bc.ca/Securities_Law/Policies/Policy2/PDF/23-401_UMI_Rules/

(a) UMIR 6.3 Exposure of Client Orders

Subject to certain exceptions, Participants[24] must immediately enter client orders that are under a specific size threshold for display on a marketplace that displays orders.[25] The main policy objectives of exposing small orders to the market are:

- to strengthen liquidity;
- to help ensure small orders that can be filled on a marketplace are executed and are not unnecessarily withheld or delayed from being entered on the market; and
- to contribute to price discovery.

A dealer may however, withhold an order if immediately entering it on a marketplace would not serve the best interests of the client. If the Participant withholds the order, it must guarantee that:

- the client receives a price at least as good as the price the client would have received had the client order been executed on receipt by the dealer; or
- if traded against a principal order, a better price[26] than would have been received had the client order been executed on receipt by the dealer.

UMIR 6.3 is relevant to internalization in that where small orders are internalized by dealers, regulatory consideration must be given as to whether certain elements of the policy objectives are being met.

(b) UMIR 6.4 Trades to be on a Marketplace

UMIR 6.4 requires that trades by marketplace participants and related entities, subject to some exceptions, are executed on a marketplace. The main policy objectives of this provision are to strengthen liquidity, support price discovery and contribute to transparency.

UMIR 6.4 is relevant to internalization in the context that in jurisdictions such as the United States, the execution of retail orders can occur off-marketplace. This notable difference is a contributing

[24] "Participant" is defined in UMIR to mean (a) a dealer registered in accordance with securities legislation of any jurisdiction and who is: (i) a member of an Exchange, (ii) a user of a QTRS, or (iii) a subscriber of an ATS; or (b) a person who has been granted trading access to a marketplace and who performs the functions of a derivatives market maker.

[25] Subject to certain exceptions, all orders that are 50 standard trading units or less must be entered for display on a marketplace that displays orders.

[26] "Better price" is defined in UMIR to mean, in respect of each trade resulting from an order for a particular security: (a) in the case of a purchase, a price that is at least one trading increment lower than the best ask price at the time of the entry of the order to a marketplace provided that, if the best bid price is one trading increment lower than the best ask price, the price shall be at least one-half of one trading increment lower; and (b) in the case of a sale, a price that is at least one trading increment higher than the best bid price at the time of the entry of the order to a marketplace provided that, if the best ask price is one trading increment higher than the best bid price, the price shall be at least one-half of one trading increment higher.

factor in how the Canadian market has evolved and is a consideration in our review and discussion of any future policy work.

(c) UMIR 8.1 Client-Principal Trading

UMIR 8.1 requires principal trades with small client orders to be executed at a better price in order to avoid conflicts inherent in the client-principal relationship[27] and to ensure that such conflicts are resolved in favour of the client. Part 2 of Policy 8.1 clarifies that:

- Some clients are in greater need of protection from the potential conflict of interest in client-principal trades and that the onus on the Participant usually will be reduced if the client is a fully informed institutional client with regard to the state of the market.

- If there was no prior discussion with the client concerning executing the client's order in a client-principal trade, or if there are no standing instructions on the handling of orders, the Participant must judge whether any steps need to be taken to ensure that a better price is not available.

UMIR 8.1 is relevant to internalization in that where a dealer may be taking steps to internalize small client orders, the trades must be executed in compliance with applicable provisions, including UMIR 8.1.

(d) Definition of "Standard Trading Unit"

Both UMIR 6.3 and UMIR 8.1 use thresholds of 50 standard trading units[28] to determine whether the rule will apply to a specific order. This threshold is intended to capture smaller size orders that are representative of non-institutional orders.[29]

Part 3 – Magnitude of Internalization in Canada

As a starting point for the consideration of issues related to internalization, we believe that it is appropriate to understand the magnitude of trades that are internalized on Canadian marketplaces. For this purpose, a quantitative analysis is included as Appendix A. This analysis explores:

- intentional crosses,
- unintentional crosses, and
- the use of broker preferencing on certain Canadian marketplaces

[27] IIROC Rules Notice 12-0130 p. 7.

[28] "standard trading unit" is defined in UMIR to mean in respect of: (a) a derivative instrument, 1 contract, (b) a debt security that is a listed security or a quoted security, $1000 in principal amount; or (c) any equity or similar security: (i) 1,000 units of a security trading at less than $0.10 per unit, (ii) 500 units of a security trading at $0.10 or more per unit and less than $1.00 per unit, and (iii) 100 units of a security trading at $1.00 or more per unit.

[29] IIROC is in the process of assessing whether this threshold continues to meet the objectives of the UMIR provisions to which it is applicable. If this threshold is changed as a result of the review, this may result in capturing a greater number of orders subject to UMIR 6.3 and 8.1, and possibly affect how a dealer interacts with its client orders.

Highlights of the statistics presented in Appendix A are set out below.

3.1 Intentional and Unintentional Crosses

Part 1 of Appendix A provides data regarding the magnitude of intentional and unintentional crosses for the period of January 2016 to June 2018. Among other elements provided, it separates the data into six-month buckets and shows the average of all trade executions resulting from intentional and unintentional crosses by volume, value and number of trades. For the most recent period examined (January to June 2018) these averages are:

Unintentional Crosses by Number of Trades	13.91%
Unintentional Crosses by Volume	12.75%
Unintentional Crosses by Value	13.40%
Intentional Crosses by Number of Trades	0.11%
Intentional Crosses by Volume	8.87%
Intentional Crosses by Value	11.67%

The net changes from the average of the first six months of 2016 to the average of the first six months of 2018 are:

Unintentional Crosses by Number of Trades	1.64%
Unintentional Crosses by Volume	0.90%
Unintentional Crosses by Value	1.96%
Intentional Crosses by Number of Trades	0.06%
Intentional Crosses by Volume	-2.66%
Intentional Crosses by Value	-1.51%

3.2 Broker Preferencing

Part 2 of Appendix A details the magnitude of trades that resulted from broker preferencing (i.e. where an order executed ahead of another order (other orders) from a different dealer(s) that was at the same price and that had time priority) for the period of January 2017 to July 2018. Not every Canadian marketplace is able to accurately identify trades that result from broker preferencing and as a result, the data only includes those marketplaces that were able to provide relevant information.

The information is provided in terms of total volume, value and number of trades and as a percentage of total volume, value and number of trades. It is further separated by trades that are client to client, client to inventory and other.

Over the period of January 2017 to July 2018, the following data represents the average volume, value and number of trades resulting from broker preferencing as a percentage of total volume, value and number of trades.

Number of Broker Preferenced Trades	Average as Percent of Total Number of Trades
Client to Client	3.91%
Client to Inventory	1.06%
Other	0.35%

Volume of Broker Preferenced Trades	Average as Percent of Total Volume of Trades
Client to Client	4.44%
Client to Inventory	2.03%
Other	0.30%

Value of Broker Preferenced Trades	Average as Percent of Total Value of Trades
Client to Client	2.54%
Client to Inventory	1.81%
Other	0.27%

Part 4 - Issues and Concerns

The following sections discuss some of the key issues or concerns that have been identified in relation to internalization. They include considerations related to:

- the common versus individual good
- the impact of broker preferencing in an evolving Canadian market
- how advanced dealer systems that leverage technology may intersect with the definition of a marketplace in the Canadian rule framework (and the corresponding marketplace requirements)
- the retail investor and segmentation of retail orders, which are inextricably linked to concerns about increasing levels of internalization

4.1 Common Good Versus Individual Good

The internalization of client orders may potentially benefit both the dealer internalizing the orders and its clients. Some client orders may be of sufficient size that they would trade through multiple price levels in an order book resulting in "market impact" and a less advantageous execution outcome. Other orders may be of sufficient size that they must be routed to multiple marketplaces to access all available liquidity. Depending on the technology utilized, network latencies experienced and the state of the order book at the time the order arrives at a marketplace, execution volumes may be different than expected if available liquidity has changed. Where a dealer internalizes a client order and executes the order at a single price, execution quality for clients may improve. Dealers may also experience reduced trading and/or back office processing costs, which also may ultimately benefit their clients.

Given the above, it may seem reasonable to suggest that in certain instances, the internalization of client orders could be in the best interests of the client, and in furtherance of a dealer's best execution obligations. However, dealers collectively acting in a manner that maximizes their benefits and the benefits to their own clients raises questions about whether and how this impacts the market as a whole. Where a dealer internalizes a client order that would otherwise have traded with existing displayed orders, another market participant has, at least in the immediate term, experienced an inferior outcome. Further, concentrated "silos" of orders interacting exclusively within individual dealers may result in inferior outcomes for participants who are not clients of these individual dealers. This raises important considerations that relate to balancing the principles of fairness and market integrity (i.e. confidence in the market) with the recognition that technology has provided the tools to achieve trading outcomes that provide measurable benefits to individual dealers and their clients.

Question 4: **Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.**

Question 5: **Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.**

Question 6: **Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).**

4.2 Broker Preferencing and Key Attributes of a Market

Broker preferencing is a somewhat unique feature to Canadian marketplaces[30] and has been a divisive issue over the years. Some market participants have expressed concern with the perceived inherent conflict with the use of broker preferencing in trading systems that otherwise prioritize the allocation of trades based on best price followed by time of order entry. Some also believe that it conveys greater benefits to dealers with more client orders, limits access to these orders to only those dealers and that it is at odds with general principles of fairness.

Supporters have expressed the view an "on-marketplace" internalization mechanism such as broker preferencing is more favourable and potentially more beneficial to market quality than alternatives. As previously noted, in other jurisdictions such as the United States, significant amounts of orders are traded by dealers "off-marketplace", and these orders are therefore never made available to the broader market. If broker preferencing were to be prohibited or substantially

[30] While preferencing allocations have historically been employed on certain marketplaces in the United States, to our knowledge there are only limited other examples of this type of matching priority currently being employed by other marketplaces globally.

curtailed, concerns have been raised that dealers will search for alternative means by which to achieve the same outcomes away from Canada's transparent order books.

Broker preferencing can also be viewed as an incentive for dealers (or their clients where direct market access has been provided) to display liquidity in a transparent order book. While critics may argue that it acts as a deterrent to the price discovery process, proponents suggest the opposite.

Over the many years that broker preferencing has been part of the Canadian market, we are not aware of any studies completed or evidence to show that market quality has been negatively impacted as a result. However, if systems are being used to leverage broker preferencing and facilitate automated internalization (further described below), and the breadth of orders that can thus be internalized is larger, the impact on the broader market is not clear. Over time, the expanded use of broker preferencing to internalize a significantly greater magnitude of orders may impact liquidity, price discovery, fairness and market integrity, all of which we continue to believe are key attributes of a well-functioning Canadian market. While the execution results may be positive for clients, we must consider the impact on the broader market.

Question 7: **Please provide your views on the benefits and/or drawbacks of broker preferencing?**

Question 8: **Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).**

Question 9: **Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.**

Question 10: **Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?**

4.3 Interpretation of the Definition of a Marketplace

As noted above, two main characteristics of a marketplace are that it:

(a) brings orders for multiple buyers and sellers together
(b) allows orders to interact using established, non-discretionary methods

The current definition of a marketplace remains largely unchanged from when the Marketplace Rules were first introduced in 2001. However, technology has changed in many ways since that time and has been a key contributor to the evolution of the Canadian equity market. It has both increased the efficiency of our market and contributed to the complexity of trading. Technology has also helped dealers more efficiently match orders between their own clients and to provide liquidity to clients on a principal basis. While these tasks were once largely manual, technology has enabled dealers to automate the processes.

4.3.1 Automated Matching Against Client Orders on a Marketplace

The term “match” is not defined in NI 21-101 but it is intended to capture the process of bringing a buyer and seller together, potentially resulting in a trade execution. 21-101CP provides additional guidance and clarifies that where a system merely routes unmatched orders to a marketplace for execution, that system would not be considered a marketplace.[31] However, 21-101CP also clarifies that if a dealer uses a system to match buy and sell orders or pair orders with contra-side orders outside of a marketplace and routes the matched or paired orders to a marketplace as a cross, the Canadian securities regulatory authorities may consider the dealer to be operating a marketplace under subparagraph (a)(iii) of the definition of "marketplace".[32]

Systems may be used by dealers that identify potential opportunities to route two “unmatched” orders to a marketplace, which may be executed and internalized through broker preferencing. Using a variety of techniques, a dealer may be able to internalize these orders with a high degree of certainty.

Although not contemplated at the time the Marketplace Rules were written, systems operating in a manner similar to that described above may appear to exhibit the characteristics of a marketplace as intended by the definition in NI 21-101 and guidance in 21-101CP. The systems may automatically identify potential internalization opportunities and employ various processes to essentially bring together client and principal orders which, using the established non-discretionary order matching methodology of a marketplace, may execute with a high degree of certainty. While the orders are executed as an “unintentional” cross through broker preferencing, the automated processes and resulting trades are intentional in nature.

The automation of this type of dealer activity may also greatly expand the scope of orders to which these processes can be applied. Subject to pre-determined and systematic parameters, technology can bring together or “match” buy and sell orders from large individual classes of a dealer’s orders. The ability to automate wide-scale internalization of client orders may further call into question whether the activities exhibit enough characteristics of a marketplace that certain provisions of the Marketplace Rules should apply.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

4.4 Segmentation of Retail Orders

In the context of trade execution, segmentation of orders means the separation of orders from one class or type of market participant from that of other classes of participants. This can occur through a variety of methods and in the Canadian context is typically focused on the orders of retail investors. Retail orders have a unique value proposition to a variety of market participants. They not only provide value to the dealer responsible for their execution, but also provide value to

[31] Subsection 2.1(8) of 21-101CP.

[32] Subsection 2.1(8) of 21-101CP.

counterparties on the other side of retail trades (including other investors, market makers and proprietary trading firms) and the marketplaces on which the orders are executed.

For market makers or proprietary trading firms, retail orders are valuable because they are less risky to trade against. Retail orders are often smaller in size, tend to be on aggregate, non-directional, and may be perceived to be less informed. As a result, they may be profitable counterparties to trading strategies that seek to provide liquidity and/or capture the spread between the bid and offer.

For a dealer, part of the value of retail orders may also be linked to their desirability as a trade counterparty. In some jurisdictions, dealers often receive payment for their retail orders. Third-party firms will pay for the right to execute retail orders and then trade off-marketplace on a proprietary basis. These types of arrangements are not permitted within the Canadian rule framework.

Retail investors may also tend to demand immediacy of trade execution (i.e. employ market or marketable limit orders) more frequently than other types of clients. This may result in retail orders being more costly for a dealer to execute, particularly when executing trades on marketplaces that charge a fee for orders that remove liquidity from an order book (such as the standard "maker-taker" marketplace fee model[33]). As a result, dealers may seek ways to achieve best execution for retail orders while also minimizing associated costs.

Marketplaces also value retail orders in that attracting retail orders will also attract liquidity providing participants who are motivated to act as a counterparty to retail orders, which may result in increased trading volume, market share and revenue.

As a result of their value to a variety of market participants, a number of methods designed to segment retail orders, both explicitly and implicitly, have been proposed or introduced by Canadian marketplaces. The traditional maker-taker trading fee model has been modified in the form of an "inverted" maker-taker model, which pays a rebate to an order that removes liquidity from an order book and charges a fee for the execution of an order that provides liquidity. The inverted fee model is attractive to cost-sensitive retail dealers as well as to liquidity providers who are seeking to take the other side of retail orders, and who are willing to pay a fee to do so.

Dark marketplaces[34] in Canada have also been linked to considerations related to segmentation of orders and internalization for many years. As an example, in 2010, Alpha ATS LP proposed to introduce IntraSpread, a dark trading facility within Alpha ATS that sought approval to introduce a "Seek Dark Liquidity" (**SDL**) order that would trade only with undisplayed liquidity in IntraSpread, and only with orders from the same dealer.[35] This explicit internalization feature raised concerns on the part of staff of the Ontario Securities Commission (the principal regulator of Alpha ATS at the time) and certain respondents to the public comment process. While the

[33] The "maker-taker" marketplace fee model charges a fee for the execution of an order that removes liquidity from an order book and pays a rebate to the provider of liquidity for the same transaction.

[34] A dark marketplace is a marketplace that does not publicly display orders on a pre-trade basis.

[35] Published at: http://www.osc.gov.on.ca/documents/en/Marketplaces/ats_20100716_proposed-changes.pdf

proposal was subsequently revised,[36] the underlying rationale was to offer a facility that would allow providers of liquidity the opportunity to interact exclusively with retail orders in a manner that offered the retail client price improvement and offered retail dealers a means by which to more efficiently manage trading costs.

In addition, certain marketplaces have introduced order processing delays, or "speedbumps" that are designed to slow down the execution of certain orders. In some cases, these order processing delays are implicitly operationalized in a way to make the marketplace potentially less attractive to certain orders and trading strategies (such as those of institutional investors) and potentially more attractive to retail dealers and counterparties seeking to trade with retail orders.

Recognized exchanges in Canada have also employed other methods to segment retail orders. Programs associated with exchange market makers have been revised in a manner that, in certain circumstances, allows market makers to interact more exclusively with retail orders. These programs essentially provide an opportunity for the market maker to interact with "eligible" orders at the best available bid or offer, after all displayed liquidity on that marketplace has been traded against. An "eligible" order is narrowly defined such that it is essentially restricted to retail orders. A market maker is thus given the opportunity to exclusively interact with the remaining balance of a retail order that has traded with all available liquidity at the best bid or offer.

Segmentation is not only being facilitated by marketplaces. When developing systems to internalize orders such as those previously described, dealers may be specifically segmenting their own clients; targeting orders from their retail clients and excluding orders from other types of clients. Much of the recent concern about increasing levels of dealer internalization is premised on the view that systems are being employed to segment and internalize predominantly retail orders, leaving significantly less opportunity for the broader market to trade with retail clients and potentially resulting in inferior execution results for market participants in aggregate.

The continued trend towards segmentation of retail orders raises important questions, similar to those discussed in relation to internalization and more broadly in the context of the key attributes of a market.

Question 12: **Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?**

4.5 Internalization and the Retail Investor

The retail investor is inextricably linked to any discussion about internalization. In sections 4.1 through 4.3 of this Consultation Paper, we have highlighted specific issues related to dealer systems that blur the lines between dealer and marketplace activities, as well as concerns about the fairness of broker preferencing. Further, we frame a "bigger picture" issue in the context of the "individual good" versus the "common good" of the entire market. While orders from a variety of

[36] Published at: http://www.osc.gov.on.ca/en/Marketplaces_ats_20101214_rfc-intraspread.htm

market participants can be internalized using various means, the focus of recent concerns is predominantly in relation to the orders of retail investors.

Discussions about the treatment of retail orders are not new. Many of the market structure issues that CSA staff, IIROC staff and the industry as a whole have considered in recent years are in some way related to retail orders. As has been described, the execution of retail orders was an important element in the development of the framework for dark liquidity, changes to the order protection rule, as well as various marketplace proposals related to fees, order processing delays and market making facilities. It was also the direct focus of a CSA publication in 2014 that articulated concerns related to the routing of retail orders to the United States for execution.[37] In that publication, the CSA stated "*retail orders are an important part of the Canadian market ecosystem, and the CSA continue to support the existing rule framework, which emphasizes the importance of these orders to the quality of the Canadian equity market, including the price discovery process*". We further articulated our public interest concerns in stating "*the CSA are concerned that widespread routing of retail order flow to U.S. dealers will negatively impact the quality of the Canadian market, and may affect the quality of execution achieved for investors*." These same issues continue to be relevant in the context of this Consultation Paper on internalization.

It is clear that retail orders have value to a variety of market participants, and a great deal of resources have been expended by various industry stakeholders to create ways to extract this value to the benefit of some, but not necessarily all. In the context of the issues around internalization, we are considering whether and how our rule framework can directly address the questions and issues associated with the execution of retail orders in a manner that both protects the interests of retail investors, and ensures that the Canadian equity market continues to bring together all types of participants in a transparent and efficient manner.

Question 13: **Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?**

Question 14: **Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.**

Part 5 – Other Related Issues

There are also several elements of Canadian market structure that are related to internalization but that we have either not explored in detail in this Consultation Paper, and/or are not in scope when considering potential policy approaches to the issues.

5.1 Block Trades

As has been discussed, internalization can refer to different types of trading activities, and may occur through a variety of means. One method is through the execution of an intentional cross,

[37] Published at: http://www.osc.gov.on.ca/en/NewsEvents_nr_20141215_concerns-routing-retail-equity-orders.htm

where a dealer may work to find the counterparty to a client order or commit its capital and assume the risk of acting as the trade counterparty on a principal basis. Commonly referred to as the "upstairs market", withholding larger orders from immediate entry to a marketplace is a long-standing practice in the Canadian market. Although these trades may ultimately be internalized, and potentially to the exclusion of orders from other marketplace participants, we do not intend to consider policy changes in this regard as we believe such activities to be potentially integral to both the execution of large investor orders and efficient functioning of the Canadian market.

5.2 Dark Liquidity

The Canadian rule framework for dark liquidity was implemented in 2012 as a joint initiative between the CSA and IIROC, with the goal of balancing the use of undisplayed orders and supporting the price discovery process. The key elements of the framework are the prioritization of displayed orders ahead of undisplayed orders at the same price on the same marketplace, and the provision of meaningful price improvement for small orders that execute with undisplayed orders. Section 4.4 of this Consultation Report briefly describes the historical link between the use of dark liquidity and segmentation of orders.

While we will consider potential approaches to address the execution of retail orders, we continue to believe that the dark liquidity framework strikes an appropriate balance that protects the price discovery process while recognizing that dark liquidity serves an important purpose in the execution of certain trading strategies and is a consideration in seeking best execution of client orders. We do not intend to consider revising the dark liquidity framework at this time.

5.3 Trading Fee Models

We have described the link between trading fee models and internalization, and that trading fee models are a tool used by marketplaces to attract and/or segment orders, including retail orders. While trading fee models are an important part of the internalization discussion, at this time we do not intend to consider changes that might impact the trading fee models currently employed by Canadian marketplaces. In addition, on December 18, 2018, the CSA published for comment a proposed pilot study that would examine the impact of limiting or prohibiting the payment of rebates by marketplaces.[38]

Question 15: Are there other relevant areas that should be considered in the scope of our review?

Part 6 – Next Steps

This Consultation Paper seeks feedback on a variety of matters related to internalization. As we recognize the importance of the issue, we must also ensure that all stakeholders are given an opportunity to provide input, and that all feedback is considered in our ongoing policy discussions.

[38] Published at: http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20181218_23-323_trading-fee-rebate-pilot-study.pdf

For this reason, this Consultation Paper does not reach conclusions or propose next steps. We will consider all feedback received and determine next steps at the end of this consultation phase.

Comments and submissions

We invite participants to provide input on the issues outlined in this public Consultation Paper. You may provide written comments in hard copy or electronic form. The consultation period expires **Monday, May 13, 2019.**

Please submit your comments in writing on or before **May 13, 2019**. If you are not sending your comments by email, please send a CD containing the submissions (in Microsoft Word format).

Address your submission to all of the CSA as follows:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Department of Service NL, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

Deliver your comments **only** to the addresses below. Your comments will be distributed to the other participating CSA regulators.

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

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We cannot keep submissions confidential because securities legislation in certain provinces requires publication of the written comments received during the comment period. All comments received will be posted on the websites of each of the Alberta Securities Commission at www.albertasecurities.com , the Autorité des marchés financiers at www.lautorite.qc.ca and the Ontario Securities Commission at www.osc.gov.on.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Part 7 - Questions

Please refer your questions to any of the following:

Kent Bailey Trading Specialist, Market Regulation Ontario Securities Commission kbailey@osc.gov.on.ca	Kortney Shapiro Legal Counsel, Market Regulation Ontario Securities Commission kshapiro@osc.gov.on.ca
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Sasha Cekerevac Regulatory Analyst, Market Regulation Alberta Securities Commission sasha.cekerevac@asc.ca	Bruce Sinclair Securities Market Specialist British Columbia Securities Commission bsinclair@bcsc.bc.ca
Kevin McCoy Vice-President, Market Policy & Trading Conduct Compliance IIROC kmccoy@iiroc.ca	

Appendix A

<u>Quantitative Analysis of Internalization on Canadian Marketplaces</u>

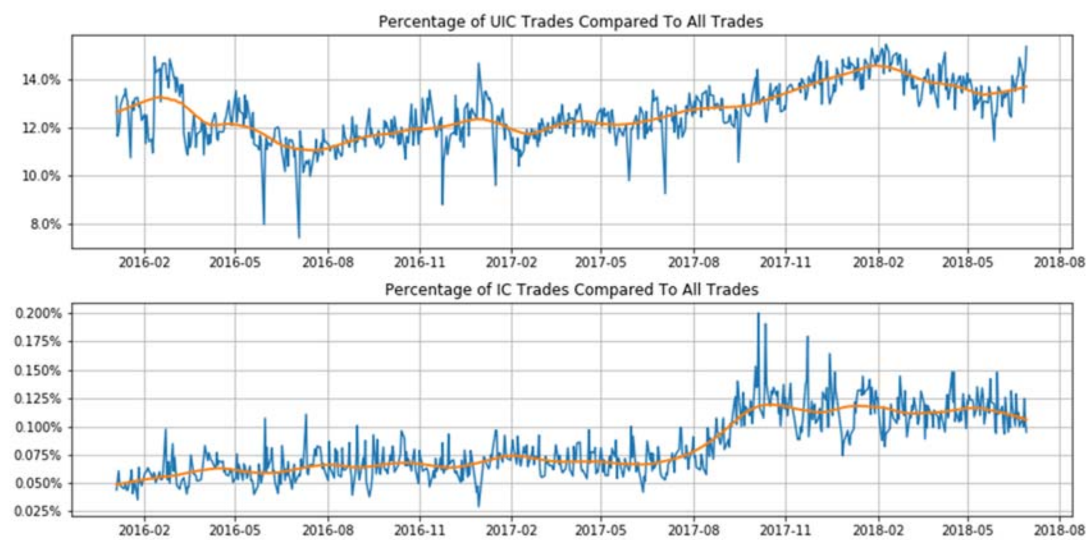
This appendix looks quantitatively at trading activity and features associated with the internalization of orders.

Part 1 of this appendix provides data with respect to the occurrences of intentional and unintentional crosses on all Canadian marketplaces for the period of January 2016 to June 2018 and relies on data received by IIROC through the Market Regulation Feed submitted by each marketplace.

Part 2 of this appendix looks at the magnitude of broker preferencing. The data used for this section only includes the data provided by those marketplaces that are able to accurately track trades resulting from orders that do not follow time priority as a result of broker preferencing, and covers the period of January 2017 to July 2018.

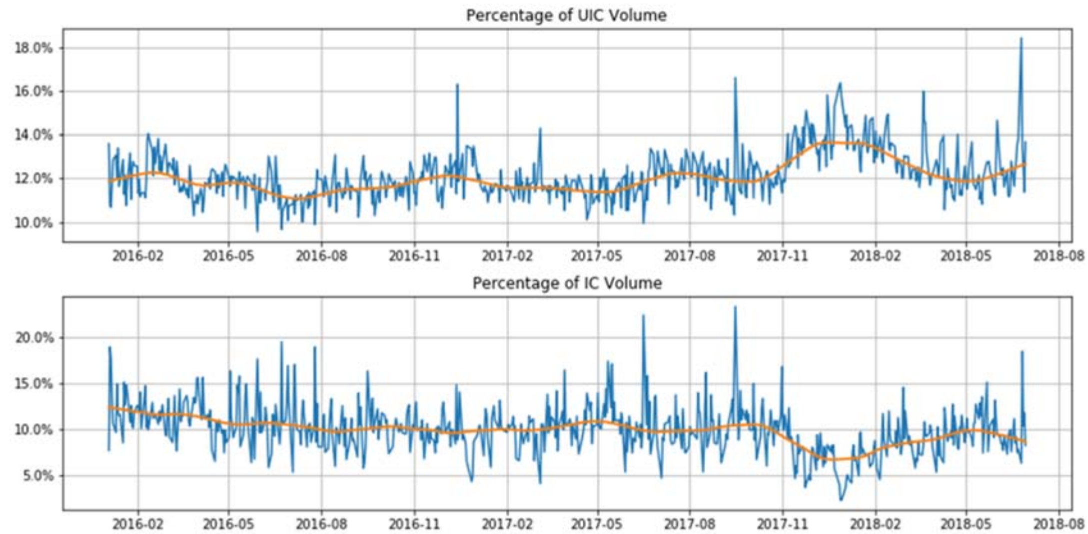
Part 1

Fig. 1 – Percentage of Total Trades Executed as Unintentional (UIC) or Intentional (IC) Crosses



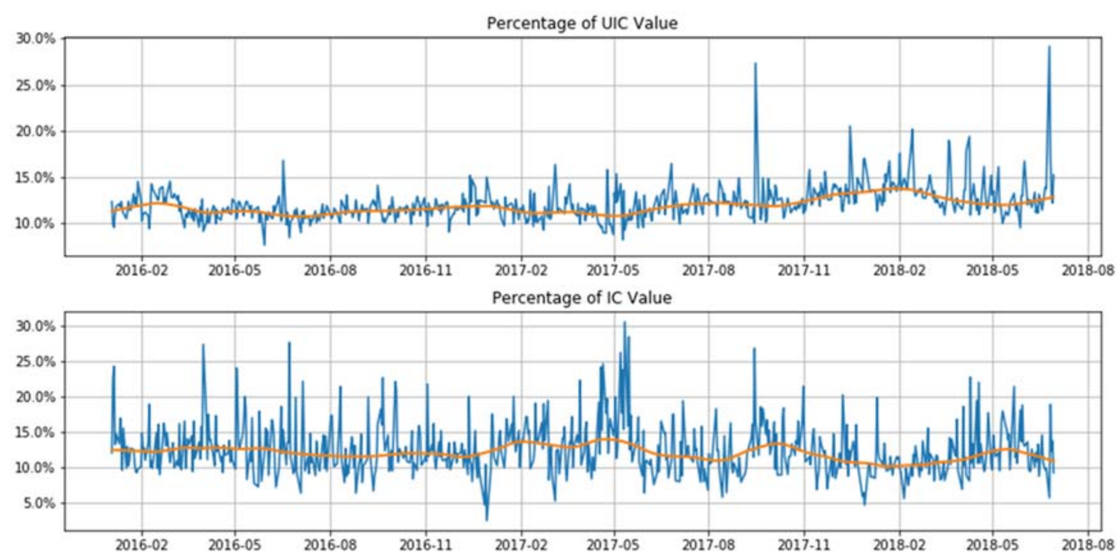
This figure shows overall crosses as a percentage of total number of trades. The upper chart shows unintentional crosses and the lower chart shows intentional crosses. Table 1 provides a summary of the averages and the percentage change over the period.

Fig. 2 - Percentage of Total Volume Executed as Unintentional or Intentional Crosses



This figure shows overall crosses as a percentage of total volume traded. The upper chart shows unintentional crosses and the lower chart shows intentional crosses. Table 1 provides a summary of the averages and the percentage change over the period.

Fig. 3 - Percentage of Total Value Executed as Unintentional or Intentional Crosses



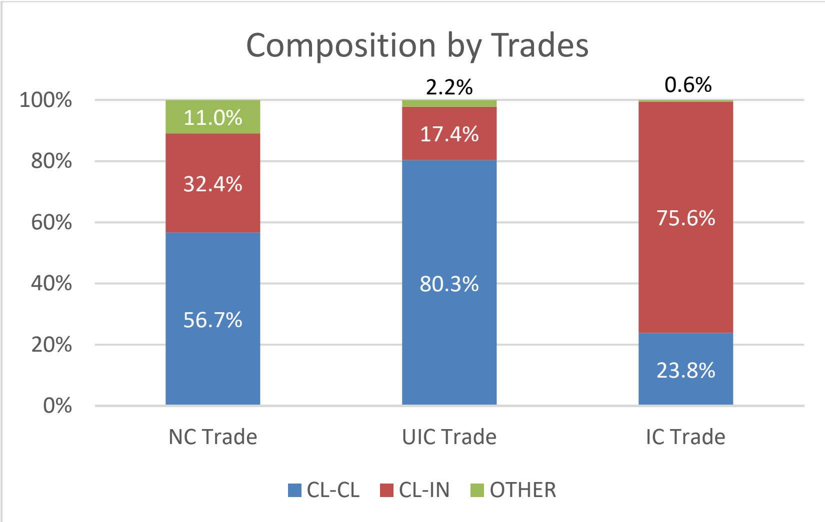
This figure shows overall crosses as a percentage of total value traded. The upper chart shows unintentional crosses and the lower chart shows intentional crosses. Table 1 provides a summary of the averages and the percentage change over the period.

Table 1 – Six-month Averages of Unintentional and Intentional Crosses

	2016 Period1	2016 Period2	2017 Period3	2017 Period4	2018 Period5		Change Over Periods 1-5
	Jan-June	July-Dec	Jan-June	July-Dec	Jan-June	Net Change	% Change
Unintentional by Trade	12.27%	11.64%	12.07%	13.12%	13.91%	1.64%	13.41%
Unintentional by Volume	11.85%	11.70%	11.58%	12.62%	12.75%	0.90%	7.60%
Unintentional by Value	11.44%	11.39%	11.48%	12.65%	13.40%	1.96%	17.13%
Intentional by Trade	0.06%	0.07%	0.07%	0.10%	0.11%	0.06%	94.52%
Intentional by Volume	11.53%	10.03%	10.46%	9.41%	8.87%	-2.66%	-23.09%
Intentional by Value	13.18%	12.13%	13.82%	12.09%	11.67%	-1.51%	-11.46%

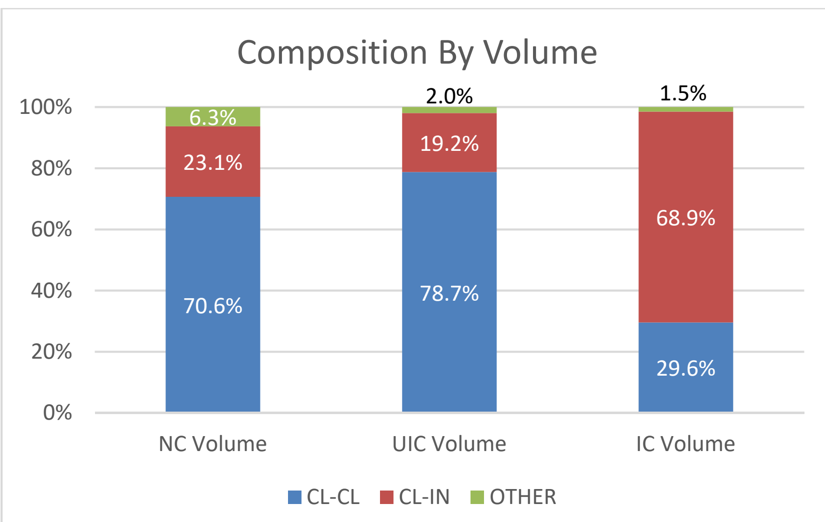
Table 1 shows the average percentages of total trade executions executed as intentional and unintentional crosses by number of trade, total volume and value averaged over a six-month period. Net change is calculated by comparing period 1 (Jan-June 2016) to period 5 (Jan-June 2018). Change over periods 1-5 is the net change as a percentage of the period 1 percentage. Net change and percent change may not be exact due to rounding.

Fig. 4 – Cross Trades by Account Type – Compared Against Non-cross (NC) Trades



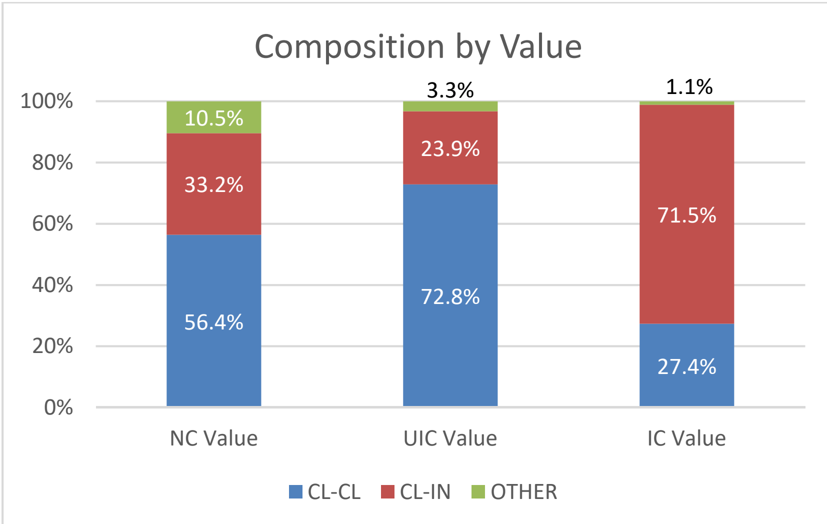
This figure shows the percentage of intentional and unintentional crosses by number of trades and client types. Client types of non-cross trades is provided for comparison purposes. "OTHER" refers to any trade involving an account type marker that is not CL-CL or CL-IN.

Fig. 5 – Cross Volume by Account Type – Compared Against Non-cross Volume



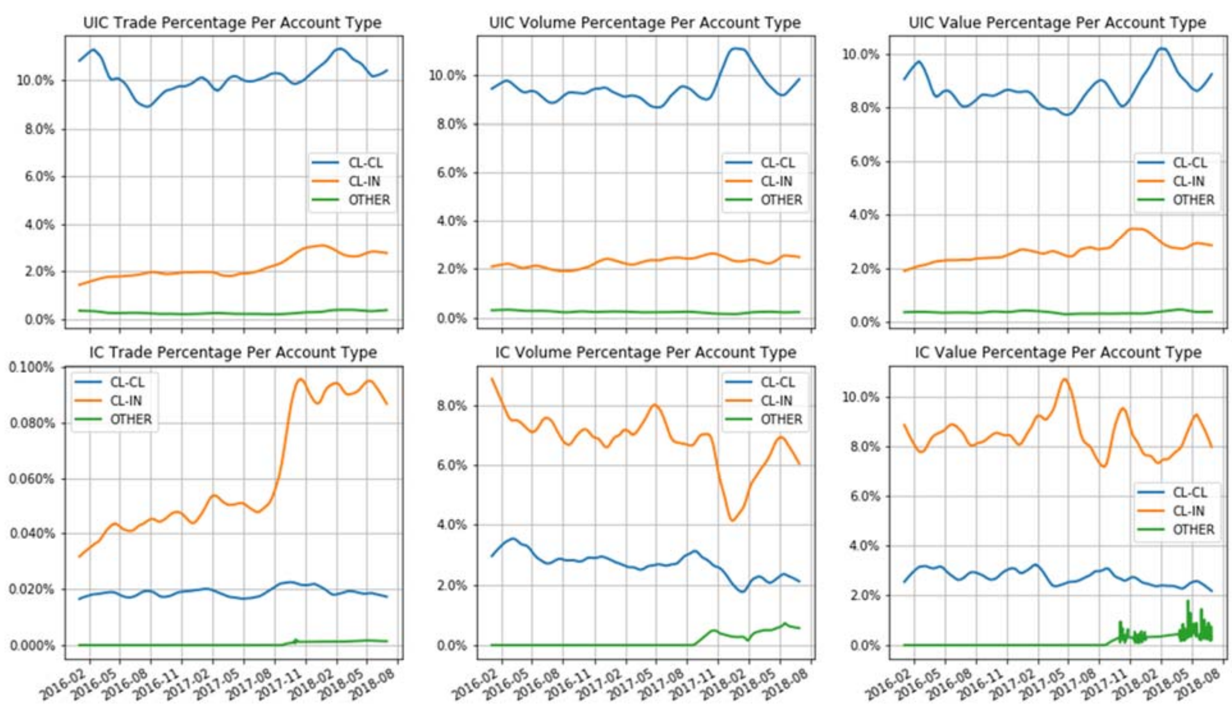
This figure shows the percentage of intentional and unintentional crosses by volume and client types. Client types of non-cross trades is provided for comparison purposes.

Fig. 6 - Cross Value by Account Type – Compared Against Non-cross Value



This figure shows the percentage of intentional and unintentional crosses by value traded and client types. Client types of non-cross trades is provided for comparison purposes.

Fig. 7 – Crosses by Account Type



This figure shows the change over the period by number of trades, total volume traded and total value traded by client type. The percentages are measured against the total trading that occurred on all marketplaces.

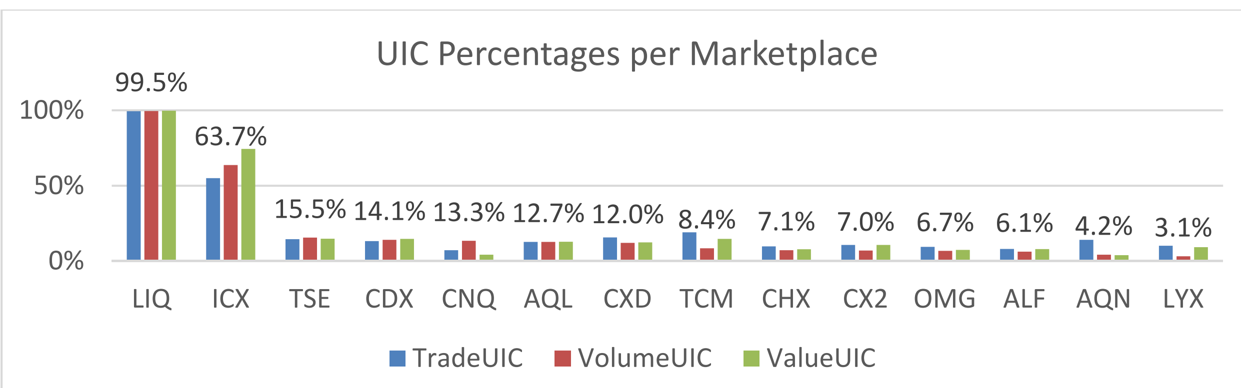
Table 2 – Cross by Account Types – 6-month Averages

		2016 **Period1**	**2016** **Period2**	**2017** **Period3**	**2017** **Period4**	**2018** **Period5**		**Change Over Periods 1-5**
		Jan-June	**July-Dec**	**Jan-June**	**July-Dec**	**Jan-June**	**Net Change**	**% Change**
Unintentional by Trade	CL-CL	10.25%	9.47%	9.89%	10.13%	10.72%	0.47%	4.60%
Unintentional by Trade	CL-IN	1.73%	1.95%	1.95%	2.74%	2.81%	1.08%	62.40%
Unintentional by Trade	OTHER	0.29%	0.23%	0.24%	0.25%	0.39%	0.10%	33.90%
Unintentional by Value	CL-CL	8.80%	8.46%	8.22%	8.79%	9.95%	1.14%	13.00%
Unintentional by Value	CL-IN	2.25%	2.53%	2.91%	3.51%	3.00%	0.75%	33.50%
Unintentional by Value	OTHER	0.39%	0.40%	0.36%	0.35%	0.45%	0.06%	16.20%
Unintentional by Volume	CL-CL	9.37%	9.31%	8.97%	9.83%	10.12%	0.75%	8.00%
Unintentional by Volume	CL-IN	2.18%	2.14%	2.38%	2.58%	2.40%	0.22%	10.10%
Unintentional by Volume	OTHER	0.30%	0.25%	0.23%	0.21%	0.23%	-0.07%	-23.30%
Intentional by Trade	CL-CL	0.02%	0.02%	0.02%	0.02%	0.02%	0.00%	2.60%
Intentional by Trade	CL-IN	0.04%	0.05%	0.05%	0.08%	0.09%	0.05%	132.90%
Intentional by Trade	OTHER	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	NA

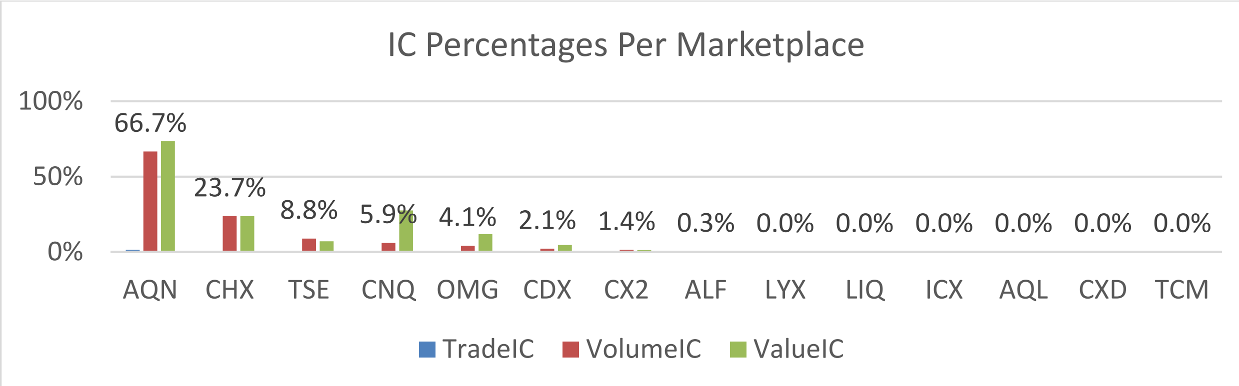
Intentional by Value	CL-CL	4.13%	3.75%	3.56%	3.23%	2.56%	-1.58%	-38.10%
Intentional by Value	CL-IN	9.04%	8.38%	10.26%	8.65%	8.64%	-0.40%	-4.50%
Intentional by Value	OTHER	0.00%	0.00%	0.00%	0.20%	0.47%	0.47%	NA
Intentional by Volume	CL-CL	3.54%	3.16%	2.96%	2.94%	2.24%	-1.30%	-36.80%
Intentional by Volume	CL-IN	7.99%	6.86%	7.50%	6.24%	6.16%	-1.83%	-22.90%
Intentional by Volume	OTHER	0.00%	0.00%	0.00%	0.23%	0.48%	0.47%	NA

Table 2 shows the average percentages of intentional and unintentional crosses by client type and number of trades, total volume and value averaged over a six-month period. Net change is calculated by comparing periods 1 (Jan-June 2016) to period 5 (Jan-June 2018). Change over periods 1-5 is the net change as a percentage of the period 1 percentage. Net change and percent change may not be exact due to rounding.

Fig. 8 – Cross Percentage by Marketplace[39] – Relative to Own Trading

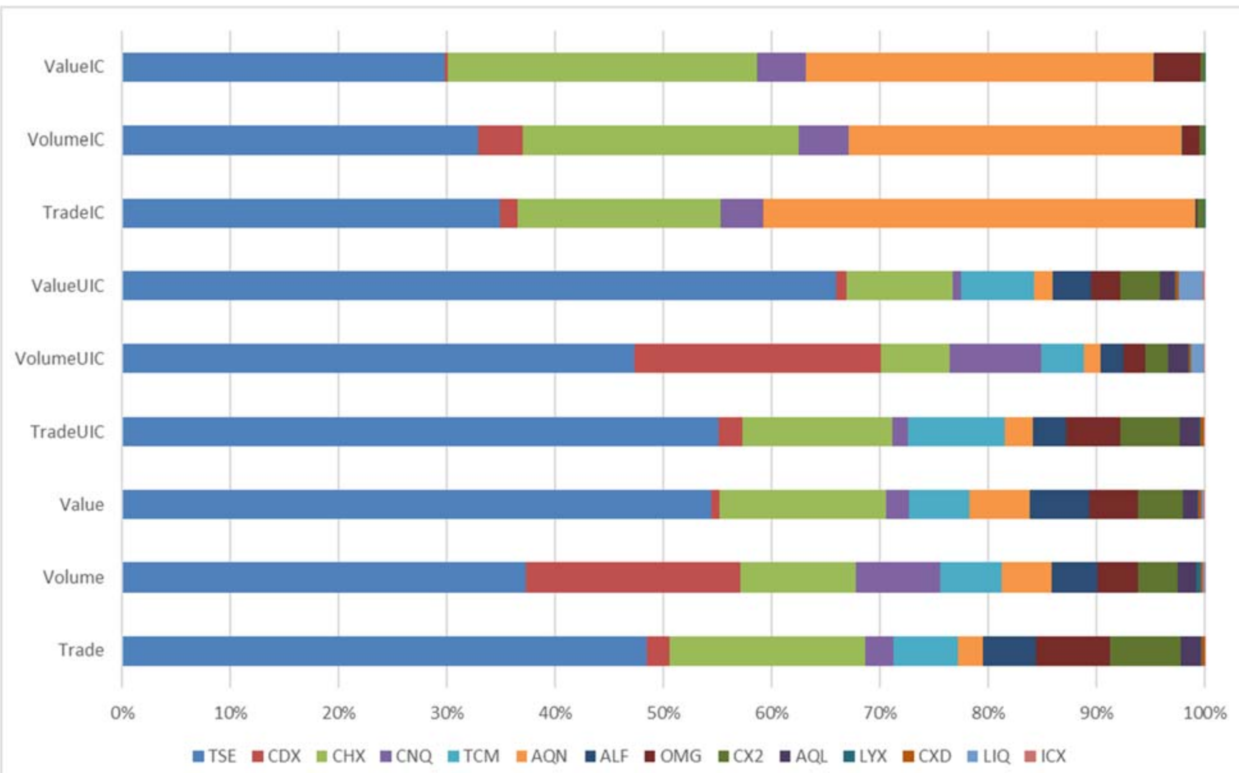


[39] Marketplaces are represented by the following abbreviations: AQN – Aequitas Neo, CHX - Nasdaq CXC, TSE - TSX, CNQ – Canadian Securities Exchange, OMG – Omega, CDX - TSX Venture, CX2 – Nasdaq CX2, ALF – Alpha, LYX – Lynx, LIQ – Liquidnet Canada, ICX – Instinet Canada Cross, AQL – Aequitas Lit, CXD – Nasdaq CXD, TCM – MATCHNow.



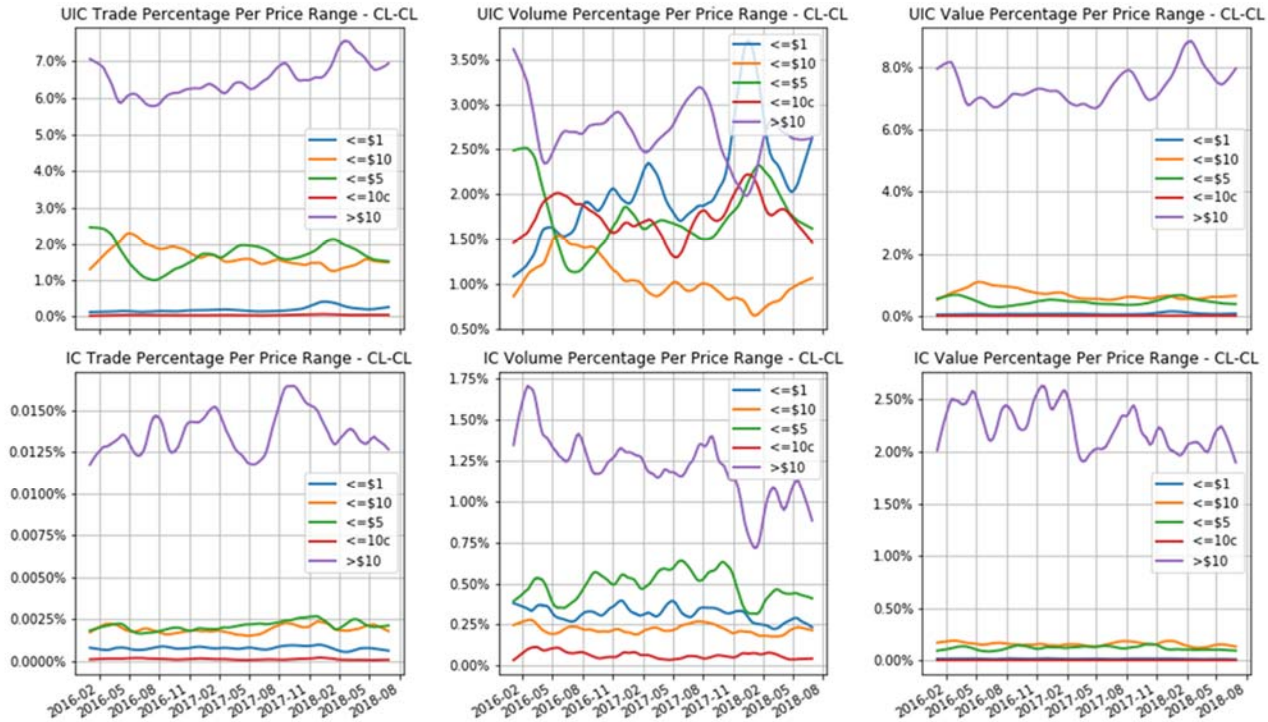
This figure shows the percentage of intentional and unintentional crosses by total trades, total volume and total value measured against each marketplace's own trading. Percentages displayed above the bars correspond to volume.

Fig. 9 – Contribution by Marketplace



This figure shows the percentage contribution by each marketplace against the total traded by all marketplaces. For comparison purposes, total (including cross and non-cross activity) number of trades, volume and value has been included.

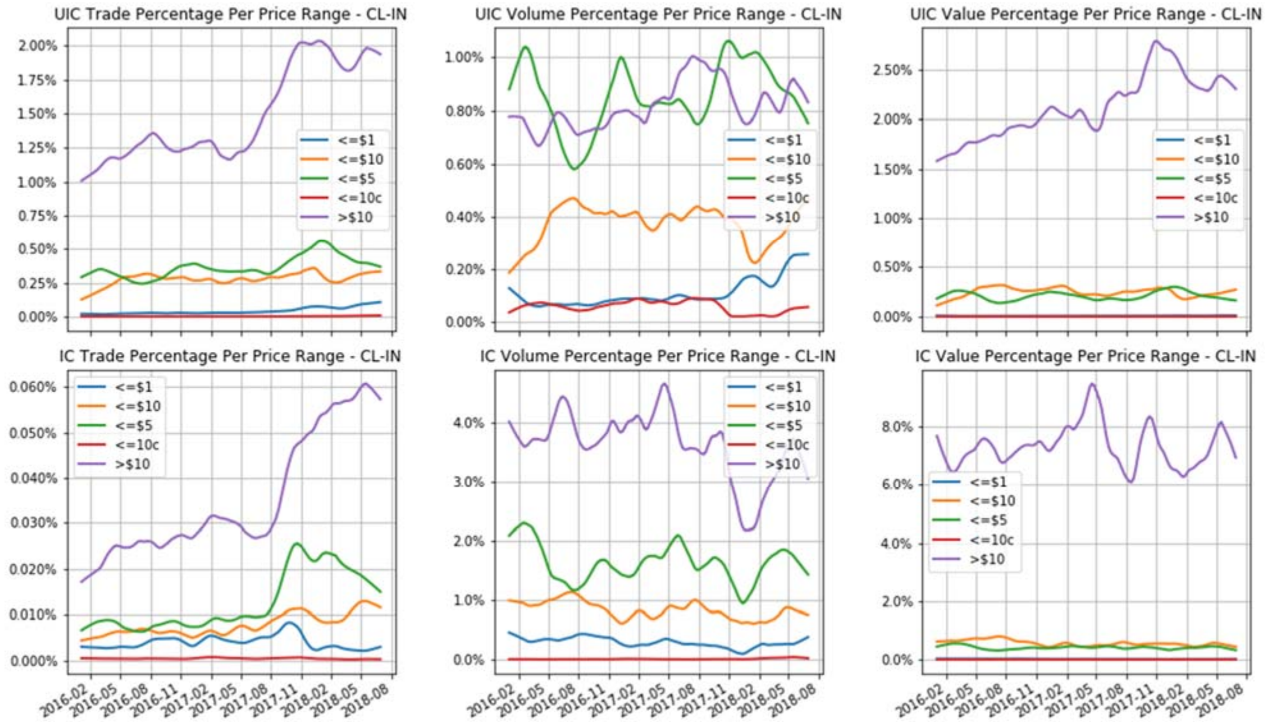
Fig. 10 – CL-CL Crosses by Security Price[40]



This figure shows a breakdown of intentional and unintentional client-client crosses as a percentage of total trading activity over the period by security price. 5 buckets are used: <=.10, <=$1, <=$5, <=$10, >$10.

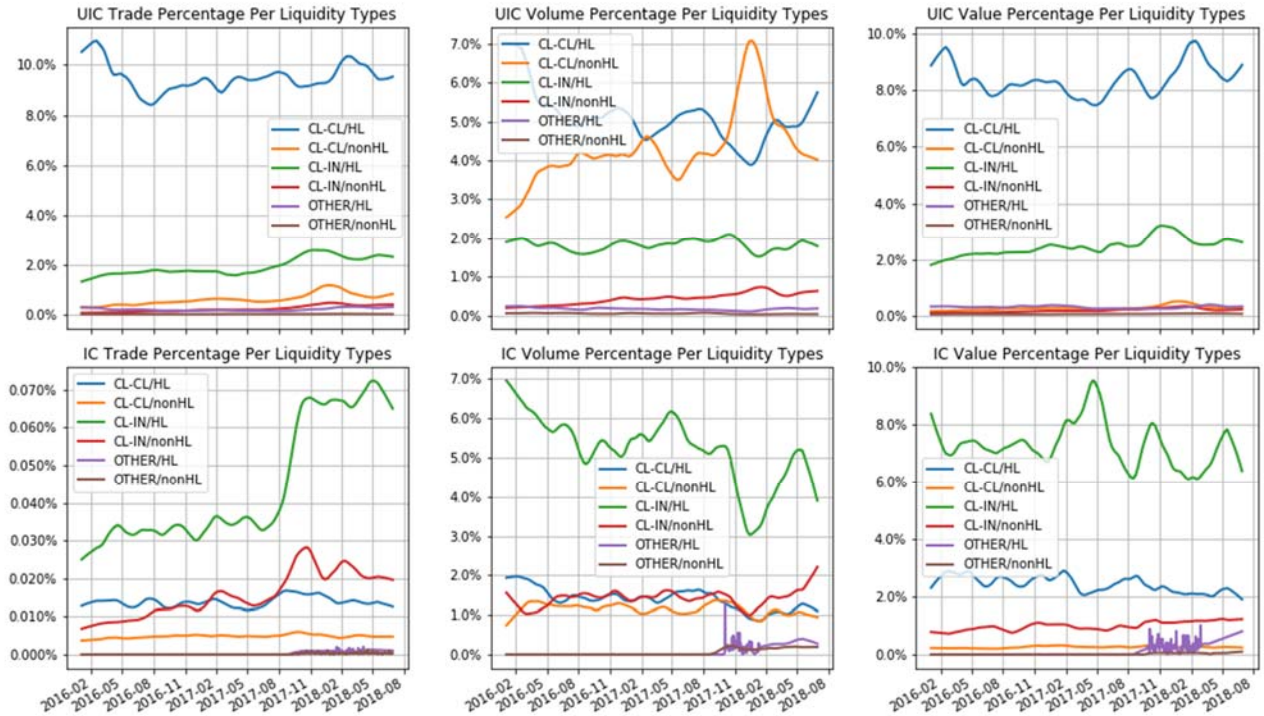
[40] For Fig. 10 and Fig. 11, <=$1 means >.10 and <$1, <=$5 means >$1 and <=$5, <=$10 means >$5 and <=$10

Fig. 11 – CL-IN Crosses by Security Price



This figure shows a breakdown of intentional and unintentional client-inventory crosses as a percentage of total trading activity over the period by security price. 5 buckets are used: <=.10, <=$1, <=$5, <=$10, >$10.

Fig. 12 –Crosses by Liquidity



This figure shows a breakdown of intentional and unintentional crosses as a percentage of total trading activity by client type over the period by liquidity. For the calculation of liquidity, the IIROC highly-liquid security list was used. A highly-liquid security is defined as a listed or quoted security that:

- has traded, in total, on one or more marketplaces as reported on a consolidated market display during a 60-day period ending not earlier than 10 days prior to the commencement of the restricted period:
  - o an average of at least 100 times per trading day, and
  - o with an average trading value of at least $1,000,000 per trading day;

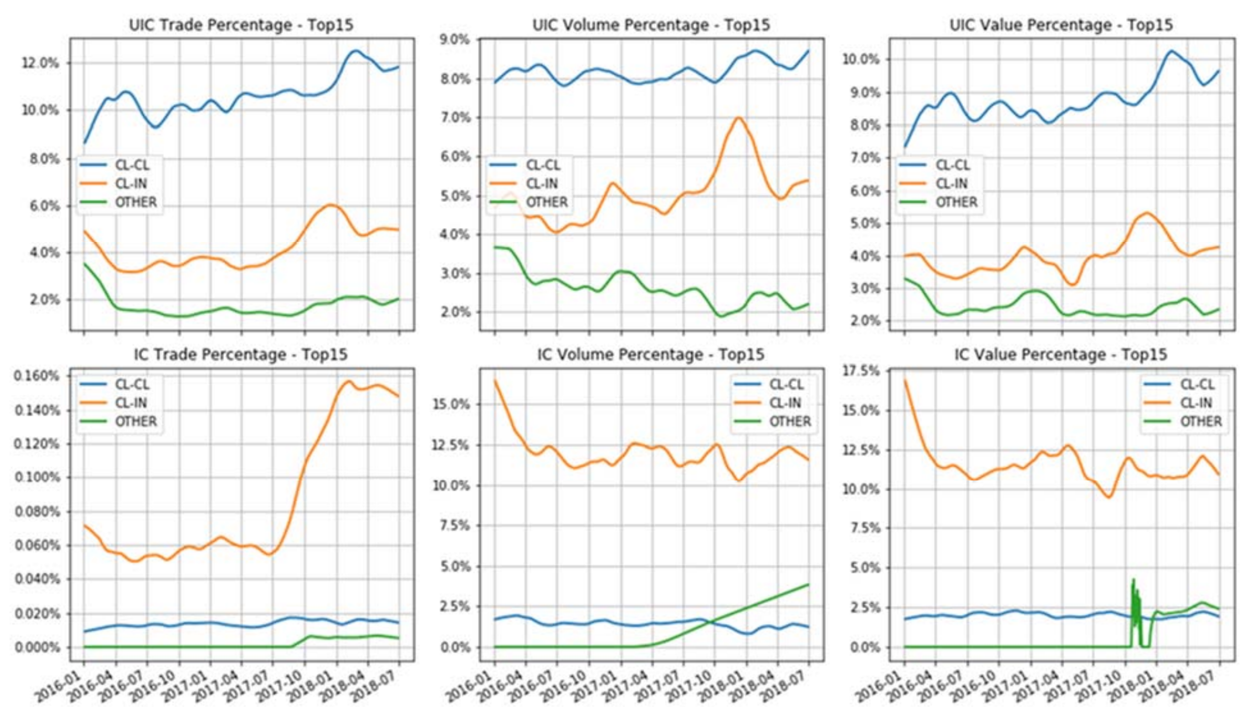
  or
- is subject to Reg. M and is considered to be an "actively-traded security" under that regulation.

Table 3 – Contribution by Top 15 Dealers

Total Value	87.70%
Total Volume	84.20%
Total Trades	87.90%
Intentional Crosses - Value	83.30%
Intentional Crosses - Volume	74.60%
Intentional Crosses - Trades	75.00%
Unintentional Crosses - Value	94.40%
Unintentional Crosses - Volume	94.40%
Unintentional Crosses - Trades	98.60%

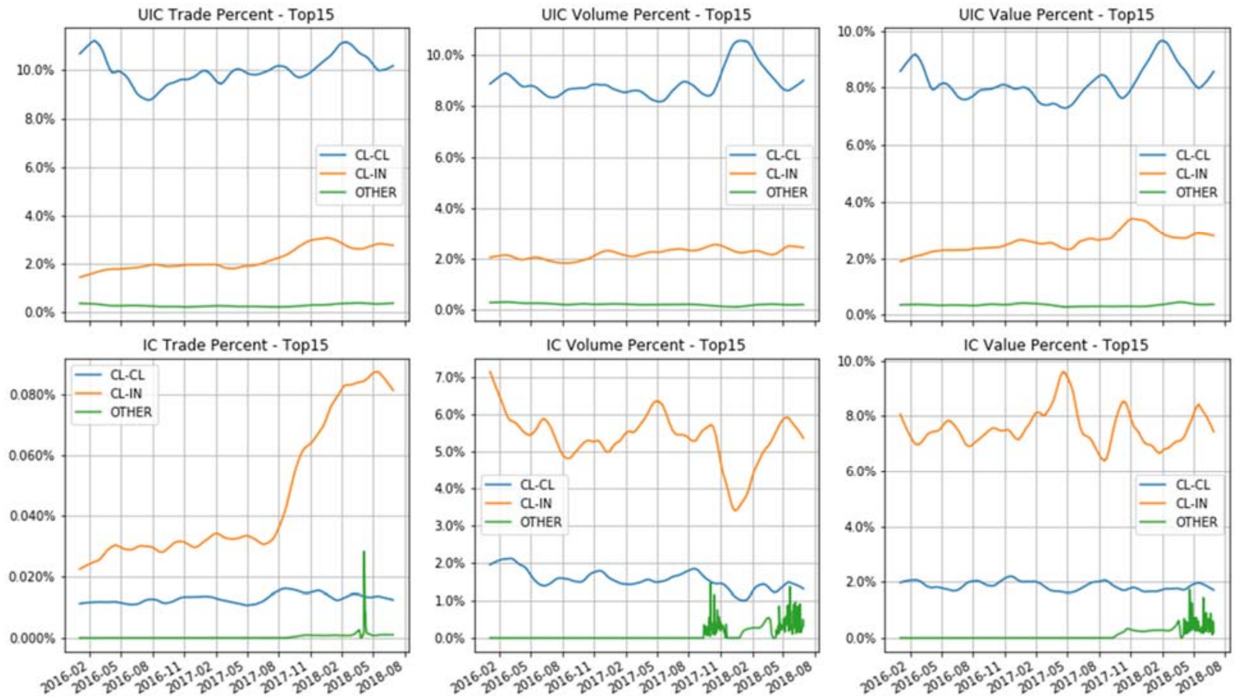
Table 3 aggregates the activity of the top 15 dealers as measured by trading activity. Percentages reflect the aggregate contribution over the period. For comparison purposes, total (including cross and non-cross trades) number of trades, volume and value have been included.

Fig. 13 – Top 15 Dealers - Crosses - Percentage of Own Trading



This figure shows the percentage of intentional and unintentional crosses by client type of the top 15 dealers as compared against the total trading activity of the same top 15 dealers on all marketplaces.

Fig. 14 – Top 15 Dealers - Crosses - Percentage of Total Trading



This figure shows the percentage of intentional and unintentional crosses by client type of the top 15 dealers as compared against the total trading activity of all dealers on all marketplaces.

Part 2

Certain marketplaces can capture executions that result from broker preferencing (i.e. when an order does not follow time priority and executes with another order from the same dealer). Data from these marketplaces is set out below for the period of January 2017 to July 2018. Figures 1 through 3 represent the number of trade executions resulting from broker preferencing (by volume, value and number of trades) aggregated across all marketplaces that are able to provide relevant data. Figures 4 through 6 represent the same information, but shown as a percentage of aggregate volume, value and number of trades (across all marketplaces that are able to provide relevant data).

Fig. 1 –Broker Preferenced Trade Executions by Number of Trades

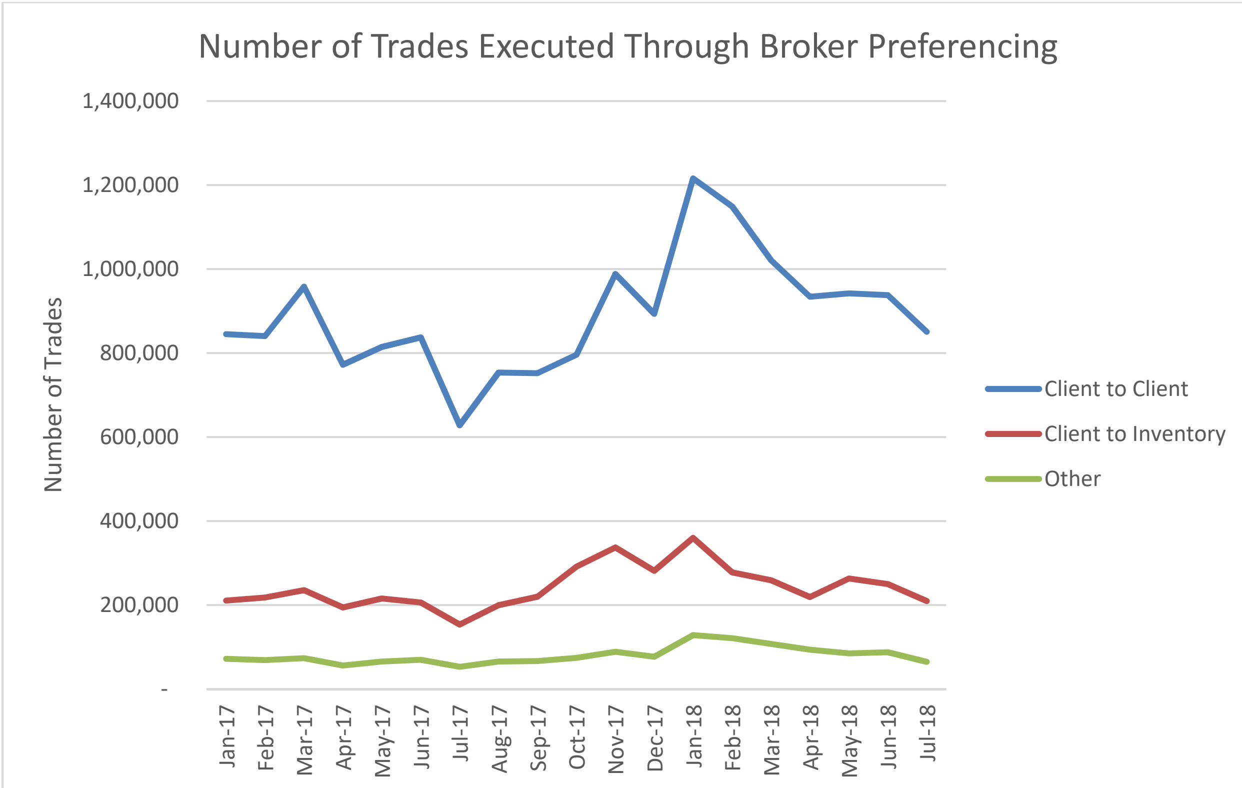


Fig. 2 – Broker Preferenced Trade Executions by Volume

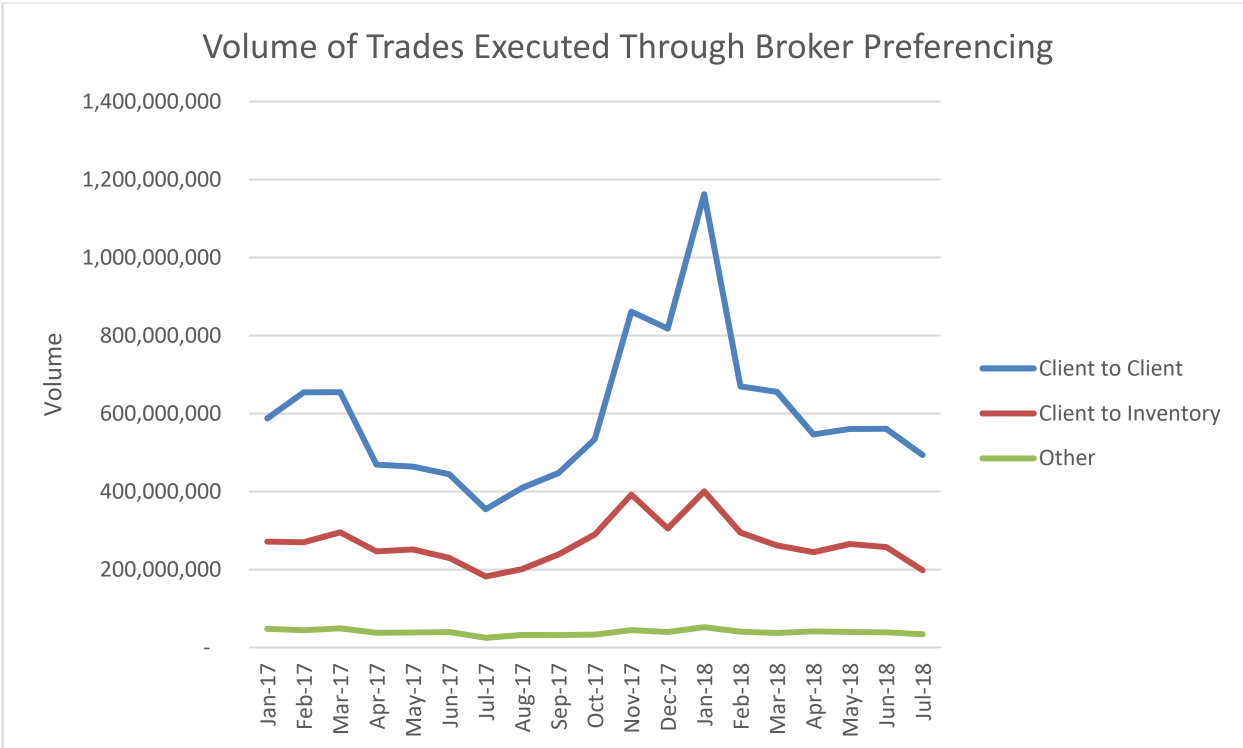


Fig. 3 - Broker Preferenced Trade Executions by Value

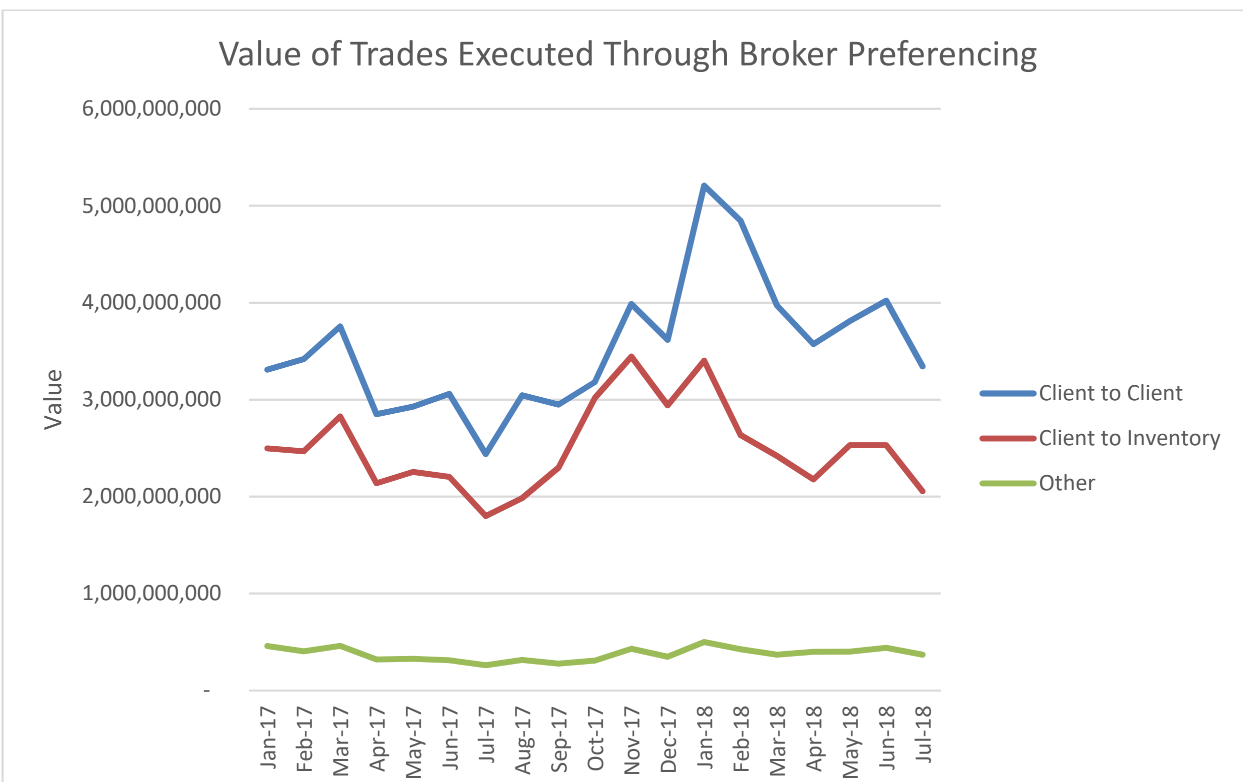


Fig. 4 –Broker Preferenced Trades as a Percentage of Aggregate Number of Trades

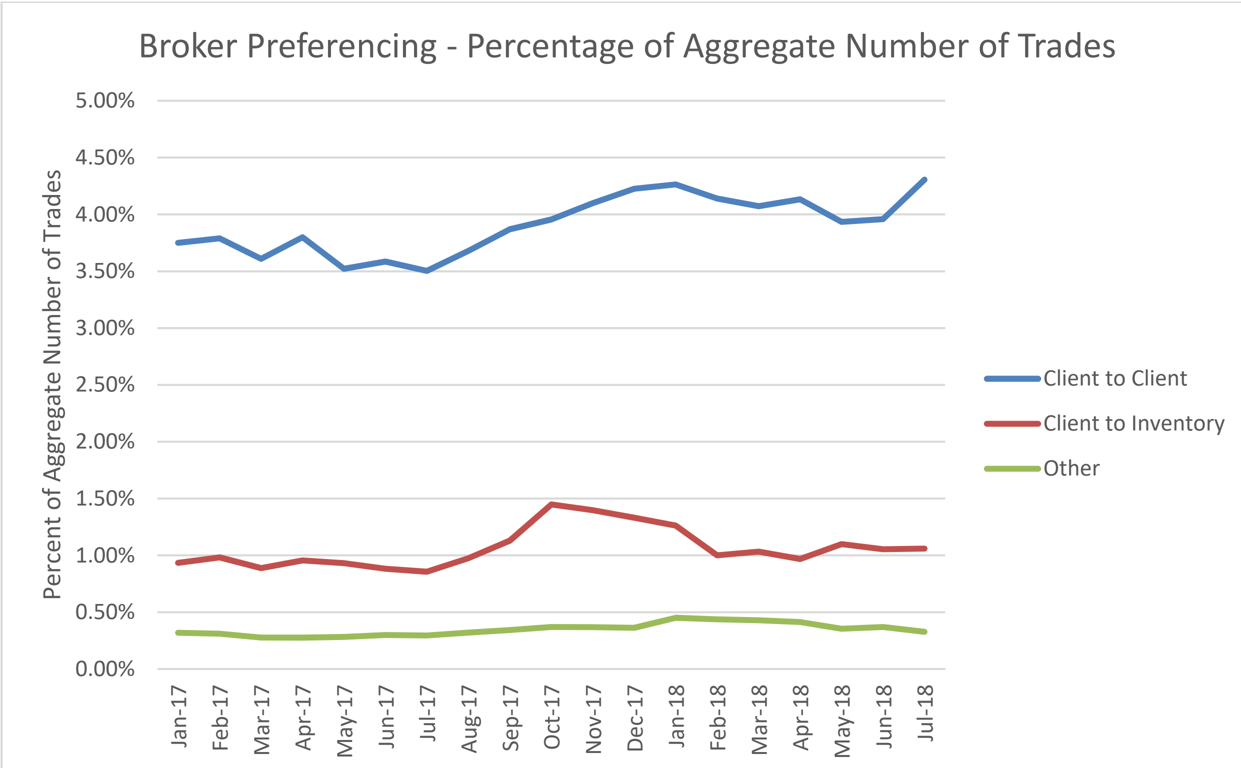


Fig. 5 – Broker Preferenced Trades as a Percentage of Aggregate Volume Traded

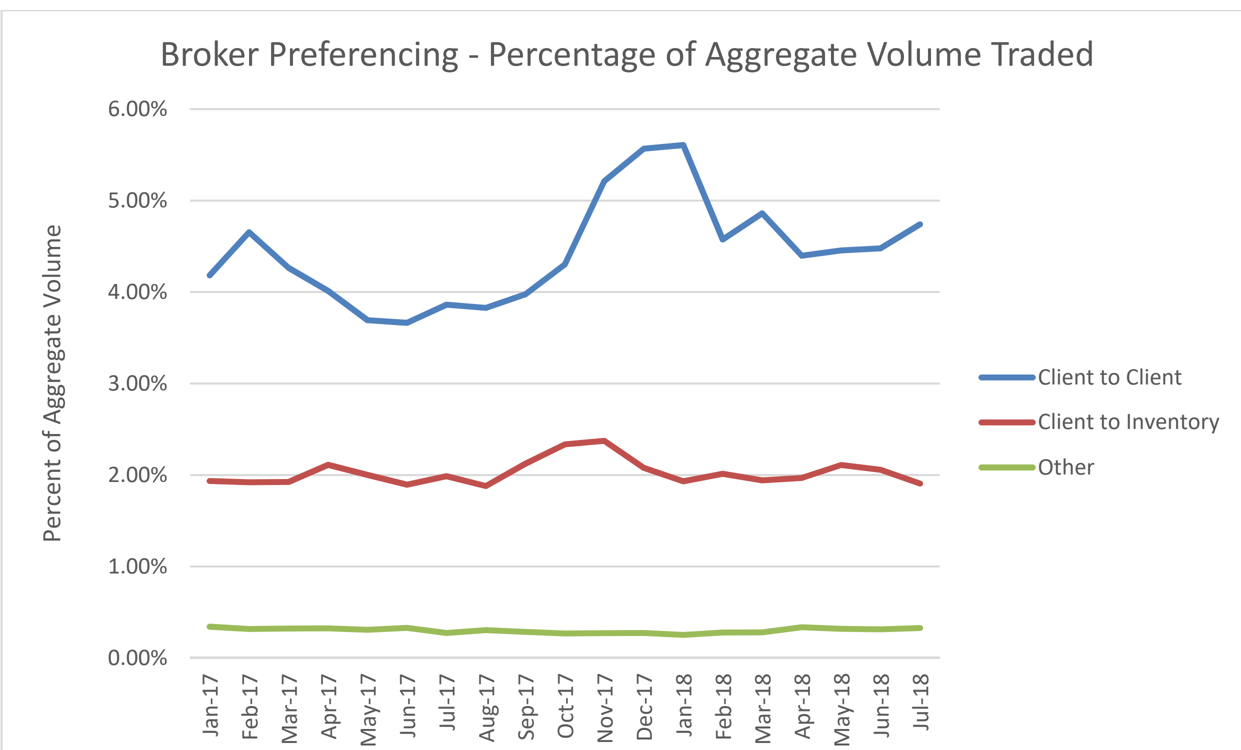
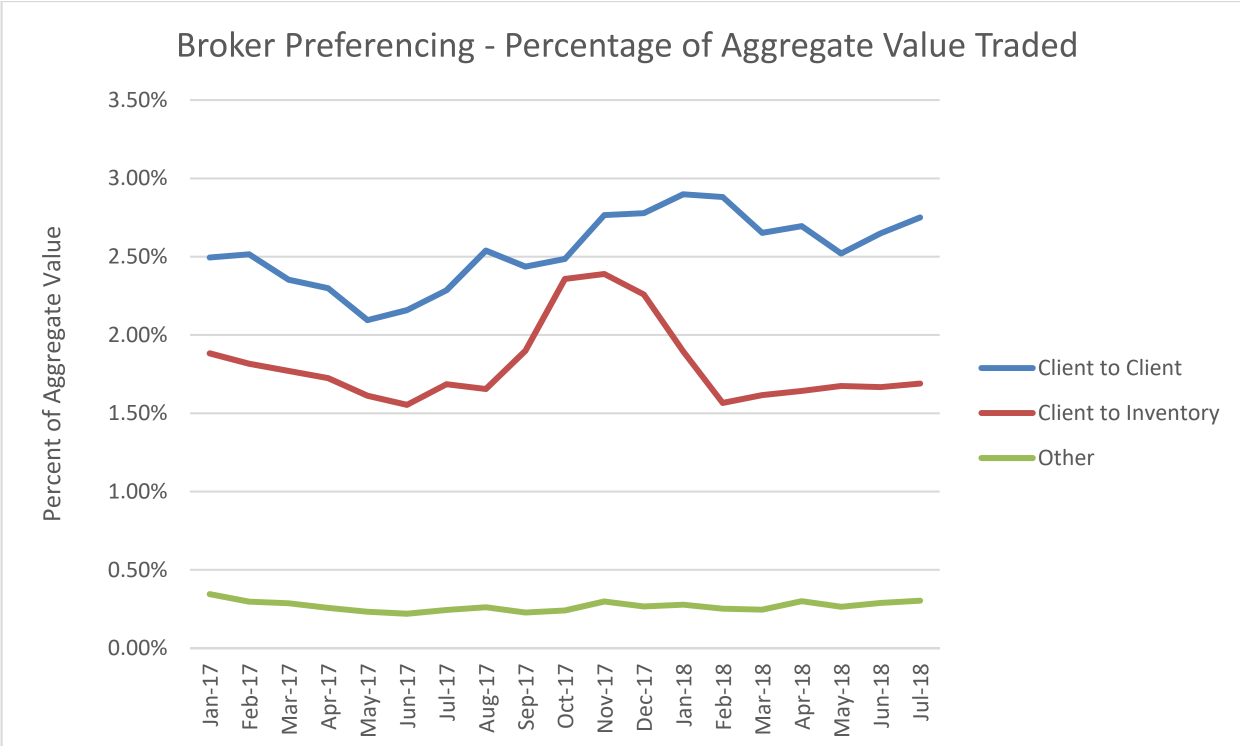


Fig. 6 – Broker Preferenced Trades as a Percentage of Aggregate Value Traded



The Canadian Advocacy Council for Canadian CFA Institute Societies
ADVOCATING THE CFA INSTITUTE'S CODE OF ETHICS AND STANDARDS

April 30, 2019

BY EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Department of Service NL, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

The Secretary
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22nd Floor
Toronto, Ontario M5H 3S8
Email: comments@osc.gov.on.ca

M^e Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square Victoria, 22^e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the "Consultation Paper")

The Canadian Advocacy Council[1] for Canadian CFA Institute[2] Societies (the CAC) appreciates the opportunity to provide general comments on the Consultation Paper and respond to certain of the specific questions outlined below.

As a general comment, we are supportive of the collaborative consultation process undertaken with respect to the Consultation Paper; both with respect to the cooperation

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[1] The CAC is an advocacy council for CFA Societies Canada, representing over 17,000 Canadian charterholders, of the 12 Member Societies across Canada. The council includes investment professionals across Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. Visit www.cfacanada.org to access the advocacy work of the CAC.

[2] CFA Institute is a global, not-for-profit professional association of over 166,000 investment analysts, advisers, portfolio managers, and other investment professionals in 163 markets, of whom more than 159,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 152 member societies in 74 markets. For more information, visit www.cfainstitute.org.

between the CSA and IIROC but also with respect to the industry meetings and input received prior to publication. The Consultation Paper thoroughly describes the factors that inform the discussion on internalization and looks at the issue from different market perspectives.

We agree that it is an important time to hold discussions and seek input on the impact of internalization. Our main concern is that while the marketplace data shows that the amount and volume of trades may be on the lower end, these numbers may increase over time, resulting in a proliferation of internalized trades over time. Such proliferation would result in the segmentation of retail orders and arguably less price discovery for the market as a whole.

The internalization of retail orders on a marketplace is primarily facilitated through the use of the broker preferencing mechanism (price-broker-time priority). Broker preferencing is a violation of time priority and without time priority there is a dis-incentive for others to display liquidity on a marketplace. Effectively, broker preferencing enables queue jumping and queue jumping facilitates the internalization of retail orders by allowing the broker to passively take the opposite side of a retail trade and to earn the bid/ask spread.

The CAC believes that the above internalization concerns are valid. The CAC also believes that the alternative to a broker preferencing regime is a much worse outcome for all investors. An outright ban on retail internalization via the broker preferencing mechanism would likely create an economic incentive for each broker to set up their own trading venue to better access, and to trade against, their own order flow. Currently, investors are witnessing such a scenario unfold in Europe with the proliferation of bank owned systematic internalizers. The European systematic internalizer regime is overly complex and fragmented, especially when compared to the Canadian regime. We would also not support any shift towards a U.S. style wholesaling regime in Canada.

The CAC is generally supportive of the status quo, perhaps subject to a few reasonable limitations, to help dis-incentivize any future proliferation of the current internalization practices. For each broker, once the level of client-inventory unintentional crosses breaches a given threshold, regulators should require the executing broker to demonstrate that their order handling procedures prioritize the best interests of the market as a whole first, followed by the best interests of the client, followed by the best interest of the broker. In addition, upon reaching the threshold, no principal trading should be allowed to trade against client orders via unintentional crosses (i.e., only allow agency trading). Importantly, the burden of proof for such an order handling review should be placed on the broker.

We wish to reply to the specific questions raised in the Consultation Paper as set out below.

Question 1: How do you define internalization?

We agree with the definition in the Consultation Paper; internalization occurs when the same broker is on both sides of a trade, and can be either an intentional or unintentional cross with the dealer acting as agent or principal.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Yes, we are of the view that the listed attributes are relevant considerations from a regulatory policy perspective.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

The internalization discussion is an example of the economic theory of the "tragedy of the commons" where the best interest of the individual conflicts with the best interest of the broader market or the common good. The tragedy of the commons is a term used to describe a system where individual users acting independently according to their own self-interest behave contrary to the common good of all users.

Price discovery and overall market quality ought to be a public good. Everyone benefits from an efficient market. When analyzing the cost/benefits of internalization, it is important for regulators to balance the conflicting interests of brokers vs. the common good owed to the market and price discovery generally. A broker dealer executing a retail order on a client-principal basis through broker preferencing may not be disadvantaging their client, but the broker is certainly acting in their own best interest by providing liquidity via broker preferencing when that retail order would otherwise have been satisfied by an order with higher time priority.

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

We agree with the sentiments expressed by some market participants and summarized previously by the CSA in the CSA/IIROC Joint Staff Notice 23-308 – Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 "*Dark Pools, Dark Orders and Other Developments in Market Structure in Canada and Next Steps*" (the "**Staff Notice**").[3] The CSA/IIROC acknowledged that broker preferencing is a

[3] Canadian Securities Administrators/ Investment Industry Regulatory Organization of Canada Joint Staff Notice 23-308, "Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 "Dark Pools, Dark Orders and Other Developments in Market Structure in Canada and Next Steps", (2010) 33 OSCB 4747, online: https://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20100528_23-308_update-dark-pools.pdf

unique feature of Canadian marketplaces that results from UMIR since dealers must expose small orders on a transparent marketplace. As set out in the notice:

> "We acknowledge that broker preferencing is a unique feature of certain Canadian marketplaces and that it is a by-product of Rule 6.3 of the UMIR that requires dealers to immediately expose "small" orders on a transparent marketplace. This rule supports price discovery and increases the breadth and depth of the displayed market and provides direction to achieve best execution for these small orders. In other jurisdictions, these types of orders are often withheld from the market and matched internally by the dealer, therefore eliminating the need for broker preferencing. We agree that the impact of the internalization of order flow is an important consideration in our review of the issues raised at the forum, including broker preferencing."

The Staff Notice indicated that a common concern was that a lack of broker preferencing might result in dark pools being established by dealers to internalize orders, thereby reducing transparency, and we concur with this concern. The Canadian market has seen significantly less fragmentation of liquidity across trading venues than the U.S. The dark rules, combined with the reasonable use of broker preferencing, facilitated such a regime. It can be argued that the purpose of a market is to bring investors together and to discover price, and thus excessive fragmentation of liquidity across an excessive number of trading venues which pushes investors further apart and increases trading complexity and search costs is not a desirable outcome.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

Broker preferencing has a larger impact on thinly traded securities and securities with a larger fraction of their trading activity concentrated on the primary marketplace. The value of time priority is large for such thinly traded or concentrated securities.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Yes. If the technology used to direct orders to a marketplace is also used to raise the queue priority of an independent contra order from another client or another principal account, on an automated and systematic basis, the technology has moved beyond the scope of a router and is now more similar to the behavior of a marketplace.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

Any such internalization should be compliant with section 8.1 of UMIR, which in general terms only permits a small order to execute against a principal order at a better price. As noted in the Consultation Paper, there is currently a moderate amount of unintentional crosses in the market (12-13%), and those numbers may grow in the future. Participants in those trades should be required to demonstrate that their order handling practices applicable to retail orders are in fact guided by best execution principles that prioritize the interests of the client ahead of the of the executing broker. Brokers could potentially be required to obtain price improvement in these circumstances, or otherwise demonstrate they are giving precedence to client interests.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council for*
Canadian CFA Institute Societies

The Canadian Advocacy Council for
Canadian CFA Institute Societies

May 13, 2019
Delivered Via Email

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)

Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Delivered to

The Secretary
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Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
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IIROC
Kevin McCoy
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kmccoy@iiroc.ca

Dear Sirs/Mesdames,

RE: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market

We are writing in response to CSA Consultation Paper 23-406. We are appreciative of the opportunity to comment on this topic.

Internalization of trades is a complex topic that refers to two different actions. Internalizing trades refers to principal trading against large orders to minimize the trades effect on the market. Internalizing trades also refers to broker preferencing by matching orders (internal cross) within the brokers order book before any residual order is released to the market. Internalizing large orders is positive to the market because large orders can affect the market adversely. Broker preferencing is negative to the market, and our comments focus on how broker preferencing negatively impacts clients at independent firms.

Broker preferencing negatively impacts immediacy, fairness, and the integrity of the marketplace. Investor trades are not being filled even though they have price and time priority. Orders can be 'traded around' entirely through broker preferencing; for example, the market can advance and retreat past the price a client bids or asks because a cross can occur at a large dealer that utilizes broker preferencing. Broker preferencing negatively impacts investors because it impacts the immediacy of orders in the market. Broker preferencing is unfair to investors because it does not allow investors an opportunity to trade when they have price and time priority. This is not a question of common good versus best interest, this is a question of whether its acceptable to provide priority to investors based on the Dealer they trade through.

Large dealers have mentioned that eliminating broker preferencing may cause larger dealers to attempt to find a way to mirror broker preferencing by trading on alternative markets or using algorithms. This is not a reason to maintain broker preferencing, rather this illustrates that broker preferencing is not necessary since large dealers can reproduce the benefits of broker preferencing without an internal cross. This argument shows that broker preferencing is not about the investors best interest, but rather cutting Dealer costs. Broker preferencing creates an uneven playing field that negatively impacts the integrity of the marketplace by providing an un-warranted advantage to one group of clients over another.

We strongly suggest broker preferencing be eliminated. Additionally, Dealers who automate the internalization of small trades should be considered a market and as such be required to provide access to their market and should be required to adhere to the same regulatory requirements markets adhere to. Eliminating broker preferencing preserves market integrity.

We appreciate the opportunity to comment on this proposed rule change. If you have any questions or further inquiry, please feel free to contact us.

Sincerely,
Jason Jardine, CPA, CA
Manager, Regulatory & New Initiatives
Leede Jones Gable Inc.

Buy Side Investment Management Association
31 Adelaide Street East
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May 13, 2019

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-and-

Me Anne-Marie Beaudoin
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-and-

IIROC
Kevin McCoy
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kmccoy@iiroc.ca

Dear Sirs and Madams:

Re: Joint CSA/IIROC Consultation Paper 23-406 - Internalization within the Canadian Equity Market

The Buy Side Investment Management Association ("BIMA") is pleased to make this submission on Consultation Paper 23-406 – Internalization within the Canadian Equity Market.

BIMA was founded by, and represents, investment buyers from, predominantly, Canadian financial firms. Our members include bankers, corporate investors, fund managers, government investors and pension managers. Our mission is to provide our members with a community where buyside traders and

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investors engaged in trading Canadian equity markets can connect with their peers, exchange ideas and information, and learn ways to enhance performance.

We thank you for seeking consultation and input from industry professionals as you engage in policy formation. We applaud your efforts and hope there continues to be open and mutually beneficial dialogue between regulators and industry in this area.

Our high-level concerns and comments can be summarized as follows:

It's our belief that increased rates of internalization leads to fragmenting of the equity marketplace, a reduction in price discovery, and if left unchecked, raises questions around market integrity. In a country as small as Canada's equity market is, when compared to the world stage, an increase in internalization, or any activity that pulls the market apart will result in a diminished capability to match trades. This reduced capability for matching as order flow is fragmented will reduce price discovery.

Incentives drive behaviour. Exchanges can drive behavior through their use of rebate fees such as the TSX increasing rebates for liquidity takers on the Alpha Exchange. For other exchanges that are competing only on costs, there is even more incentive to offer ever increasing rebates (there is no limit on inverted markets) that will continue to create even more fragmentation. A danger here is that retail order flow will be directed to these exchanges even more that could drive a further separation between liquidity providers, generally institutional flow, and liquidity takers, generally retail flow. Fee sensitive routers will direct trades to these exchanges accordingly, further segmenting order flow and harming price discovery. Incentives such as this could lead to more internalization by dealers as they manage their trading costs.

<u>Responses to Questions for Market Participants</u>

You will find below our response to the questions set forth throughout the Consultation Paper. For ease of reference, we have reproduced each question in italics preceding the applicable comment.

1. How do you define internalization?

We define internalization as the practice of dealers trading against their own orders. These trades are conducted without exposing the orders to book priority and goes against the practice of fair access.

2. Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

We believe these attributes are relevant considerations from a regulatory policy perspective.

3. How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Increasing rates of internalization will provide a level of harm to each of these attributes. With lack of transparency and price discovery occurring questions will be raised about the fairness of

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the markets. As this spills over it's reasonable that market integrity will be called into question. This is not a path the Canadian equity marketplace can afford to take.

4. Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

As members of BIMA we have a fiduciary duty to our asset owners to manage their assets to the best of our ability in the current market environment. It's fair to say the common good is in our interest. Having best execution driven by transparency, fair access and price discovery helps to satisfy this fiduciary duty. However, we also realize not all actors in the market are driven in their actions by the common good but rather, as for-profit enterprises, are more likely driven by their individual good and what drives their operations. There is a balance somewhere in the middle that, while neither side would be wholly satisfied, neither would they be wholly unsatisfied.

5. Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.

Nothing to add here.

6. Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).

Nothing to add here.

7. Please provide your views on the benefits and/or drawbacks of broker preferencing?

As your statement in the Consultation Paper reads we are also not aware of any studies completed or evidence to show that market quality has been negatively impacted by broker preferencing. As participants in the markets we see both good and bad with this approach. At times the additional transparency is good for the common use and at times transparency is not as good for the individual use. Our challenge as actors in this market is that our position will change from trade to trade. However, we do have a worry that alternatives to broker preferencing could lead to a U.S. style approach to trading retail flow and/or greater fragmentation. Neither of these potential outcomes could be expected to provide greater transparency and/or price discovery.

8. Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).

Nothing to add here.

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9. Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

Preferencing trades increases the ability to internally cross trades within a dealer. The larger number of trades a dealer has the greater the benefit of internally crossing. Therefore, larger dealers, through larger trade volume, should benefit more from broker preferencing.

10. Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

We're not aware of any studies that cover this area.

11. Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Using the Interpretation of the Definition of a Marketplace as outlined in the Consultation Paper section 4.3 would suggest to us no. But, similar to what is outlined, new technology matching abilities should cause us to rethink what is a marketplace. The question to answer here is whether defining trades that are internalized orders, would they lead to price discovery.

12. Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

As outlined in our response earlier we firmly believe segmentation of order flows is a concern. Actions from market participants through internalization, fee sensitive approaches, of other actions that impair price discovery and transparency is an obstacle to our fiduciary responsibility to our asset owners.

13. Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

Yes.

14. Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

No.

15. Are there other relevant areas that should be considered in the scope of our review?

No.

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Concluding Remarks

At times various members of our organization will benefit from internalization and at times various members of our organization will not benefit from internalization. Somewhere there is a medium that is more beneficial to the common market participant than any one individual market participant. It's our view striking the right balance to not have incentives drive behaviour toward any outcome that does not benefit the greater good should seriously be reviewed. If incentives or behaviours are not beneficial for the common good, they should not be implemented.

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view.

Yours truly,

Brent Robertson
President, BIMA

Select Vantage
Canada

May 13, 2019

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Department of Service NL, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

Re: Consultation Paper 23-406

Before responding to some of the specific questions raised by the Consultation Paper, we open with two general comments on the consultation process itself and the U.S. versus Canadian context to this issue.

Complexity of the Consultation Process

This Consultation Paper is such an extensive questionnaire that we note the difficulty of responding in detail. We have heard from several industry participants that they feel they almost need to hire full-time researchers and writers to respond adequately to such documents. As a result, we believe the current consultation process may be biased towards large participants who can afford such staff, while smaller participants' voices will simply not be heard.

In order to make the consultation process more inclusive of smaller participants, we would strongly encourage the regulators to hold frequent formal *and* informal roundtables to sound out all industry participants on topics of concern. Such roundtables should include a representative cross section of market participants, ensuring all participants have an opportunity to be heard, and be held both prior to, and then following, the formulation and release of consultation papers. Such roundtables, with everyone sitting in one place at one time, would have a couple of benefits.

First, everyone in this industry "talks up their book" to some degree when writing comment letters. Having everyone discuss and debate issues live can often filter out what is simply self-interested lobbying versus sound policy proposals or observations.

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Second, such live meetings, when held prior to the release of consultation papers, could allay concerns regulators have with a particular issue before significant staff resources are invested into the writing consultation papers or rules changes.

U.S. versus Canadian Context

We sense that much of the regulatory concern with this topic is that many in the U.S. securities industry are also concerned with it. However, an important point of context is the fact that retail internalization, or wholesaling, and the resulting segmentation of retail order flow, is a far more significant factor in U.S. equity markets than it currently is in Canada. This point is stressed by academics in writing recently on this topic:

> "An empirical fact, not well known outside market microstructure circles, is that marketable retail orders in US equity markets are not typically executed on stock exchanges. Instead, these orders are routed to wholesale market makers and the retail brokers making these routing decisions receive payment for this order flow. This practice is commonly referred to as retail internalization and represents segmentation of retail order flow. Rosenblatt Securities estimates that retail internalization currently accounts for approximately 16 percent of consolidated U.S. equity market volumes."[1]

By engaging in this practice, broker-dealers who sell their retail client order flow for value are in turn able to charge clients significantly less in execution fees, with some even providing "free" execution. Unfortunately, clients are often blissfully unaware of the fact that such arrangements can result in the client paying significantly more/receiving less on their purchases/sales than they save in execution costs.

A class-action lawsuit against TD Ameritrade, certified in a Nebraska court in September 2018, alleges that this practice violates best execution obligations:

> "The plaintiff contends that defendant's order routing practices involve use of computer algorithms to send its customers' equity orders to venues that pay the defendant the most money, without regard to whether the venues would provide the best possible execution of those orders. The plaintiff further alleges defendant failed to disclose the practice to its customers. The plaintiff contends the practices are inconsistent with the defendant's duty of best execution and seeks remedies for violations of Section 10(b) and 20(a) of the Securities Exchanges Act of 1934, 15 U.S.C. §78a et seq. The plaintiff contends that the purported class suffers economic loss due to orders for securities trades being unfilled,

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[1] See "Regulating Dark Trading: Order Flow Segmentation and Market Quality" by Carole Comerton-Fordea, Katya Malinova, and Andreas Park (September 3, 2016) at https://www.hec.ca/finance/Fichier/Malinova2016.pdf

underfilled, filled at a suboptimal price, and/or filled in a manner that adversely affects the order's performance post-execution."[2]

We raise this here to highlight that such retail internalization/wholesaling is a "made-in-America" controversy. By contrast, we in Canada have the UMIR 6.3 Order Exposure Rule that forces the vast majority of retail orders to be posted to marketplaces (or, if held up due to market conditions, to be traded at the best price or better). This feature of Canada's market structure means that Canadian discount brokerage services can never match their American counterparts in the offering of low- or zero-fee trading. This is something we will revisit in later responses to specific questions.

Question 1: How do you define internalization?

For the purposes of this consultation, we define internalization to mean simply the execution of client orders by a broker-dealer acting on both sides of the trade.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Yes, all six listed attributes (liquidity, immediacy, transparency, price discovery, fairness and market integrity) should be considered from a regulatory policy perspective.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Internalization results in segmentation of order flow which – as we expand on in response to Question 12 – impacts on several of these attributes.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

We believe that a market driven by fair access and with limited segmentation of order-flow should be able to satisfy both the common good and individual good. It is where access to liquidity is no longer fair, as will happen when order-flow is segmented, that conflicts between the common and individual good arise.

[2] See Memorandum and Order 8:14-CV-396 (filed September 14, 2018) at https://www.courthousenews.com/wp-content/uploads/2018/09/Ameritrade.CA_.pdf

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Canada

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Keeping in mind the prevalence of retail internalization in the U.S and given the fact that Canadian dealers compete with American brokers for trading in inter-listed stocks, the more a U.S. broker can subsidize the execution fees charged to clients by selling their order flow, the more the Canadian dealers are squeezed competitively. We recognize the cost savings on executions that can be achieved through broker-preferencing are a benefit to Canadian dealers in this competitive landscape.

While acknowledging that competitive benefit, we believe that broker-preferencing can negatively impact market fairness and integrity in situations where (a) a firm has knowledge of an incoming market/marketable client order and then (b) modifies one of its pre-existing contra orders to match the incoming order, with the result that broker preferencing allows that firm to "jump the queue" and trade against the client order on the open market.

So, for example, a stock is actively trading at a spread of $2.00 x $2.01 and the dealer places a series of small lot orders at slightly inferior prices; if the dealer had knowledge of an incoming client order to sell 1,000 shares at $2.00, the dealer could rapidly modify ("CFO") one of its inferior bids to 1,000 shares @ $2.00 and scoop up a trade that would have gone to another market participant.

We understand dealers are prohibited from sending a *new* order to interact with an incoming client order with knowledge of such order unless they provide price improvement – that is, they are knowingly trading as principal with their client and so fall under UMIR 8.1 Principal Trading. However, modifying the price and volume of a pre-existing order would seem, in substance, to be the same as entry of a new order (price and volume being the core attributes of any order) and so such practice should be similarly held to the standard of UMIR 8.1. Dealers are, of course, routinely audited for their client order handling, but this is a potential area of concern.

An abuse of broker preferencing that our firm *has* observed first-hand involves free-riding off another participant's price discovery. For example, Dealer B notices that Dealer A (or one of its clients) is making effective two-sided markets in a particular name. So Dealer B begins to mimic Dealer A's bids and offers at each relevant price level shortly after each Dealer A order is entered. Ordinarily, Dealer A would get the first fill at each price level and be rewarded for its (or its client's) contribution to price discovery, but because Dealer B has a large retail base, broker preferencing allows it to capture the benefit of its retail base reacting to Dealer A's initial price discovery.

Broker preferencing is inherently about trumping time-priority for the purpose of executing against one's own client order flow and thereby running contrary to the principle of price discovery. Although we accept this long-standing practice provides many dealers with a significant opportunity to reduce client order execution costs, what it should not become is itself a *tool* a dealer uses to calibrate its trading strategies (as in the two examples provided above) in ways which undermine market fairness and integrity.

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

Broker preferencing results in one form of segmentation of order flow by having discrete sub-sets of the overall market interact first, at any given price level, within their own "pools" and then in accordance with time priority with the rest of the market. A dealer with a large retail investor base (retail investors being heavily skewed towards trading "actively" in sending market/marketable orders) will provide an obvious benefit to its clients that trade "passively", as compared to the execution capabilities of dealers with smaller retail investor flow. Smaller firms generally miss out on the "first look" afforded larger firms due to broker preferencing.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

We believe that broker preferencing and the associated segmentation of order-flow will negatively impact the ability of the (few) remaining market making firms and other liquidity providers to profitably make markets in both liquid and illiquid securities, though direct impact will be more pronounced in liquid securities.

Given that such firms often rely on the profits generated in liquid names to subsidize their market making efforts in less liquid names where they make little or no profit, broker preferencing's direct impact on their profits in liquid names will put pressure on such firms' financial viability and their ability to continue making markets in low liquidity names.

We would argue that the potential disappearance of market makers from the less liquid names will have a pronounced negative impact on Canadian markets overall, and small- to mid-cap names in particular.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Many dealers have consolidated their risk operations so that all client and principal orders route to what some call a "Central Risk Desk" or a "Central Risk Book". The principle is a sound one – since all orders going to market under on Broker ID ultimately resort to the firm's pool of capital, all such orders should be screened from one risk perspective.

However, we understand that some firms have gone further and developed algorithmic or automated ways of internally matching multi-party orders. Some of these may be executed as crosses whereas others are simply sent out as marketable orders that will match to other client orders, or the firm's principal orders, due to the marketplace honouring broker preferencing. In other words, broker preferencing has become a tool used by the dealer to create an internal market, rather than merely a historical concession to allow it to minimize client execution costs.

We believe such systems are "marketplaces" as defined under NI 21-101. Each dealer's clients sends orders to it based on the firm's access to an interconnected OPR market regime, and each dealer holds itself out as providing such access. Yet, due to its size, were a large dealer to systematically and on an automated basis intercept and match many such client orders – even while using the crossing and broker preferencing features of marketplaces to do so – it has effectively created a two-tier market system and so violated the principle of fair access.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

We are generally against the segmentation of order flow, even for the ostensible goal of protecting or giving a leg-up to retail investors, because all order flow segmentation proposals are subject to the temptation of "cherry picking" the easiest orders to trade against and reduces fair access to all order flow.

Order flow segmentation starts to silo liquidity into discrete pools and by thinning out opportunities for the broadest degree of order interaction, reduces opportunities for trade execution. When this is combined with the ways in which broker preferencing can allow dealers to "jump the queue" as described in our response to Question 7, the results are undeniably negative for the (few) remaining market making firms and other liquidity providers.

We generally oppose marketplaces creating and sponsoring such segmentation. As for dealers doing so, we cannot tell a dealer how to interact with its own client base, but were a dealer to develop systematic and automated ways of internally matching orders, then we would have the same opposition to such segmentation.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

We believe Canada has unquestionably designed a better model than has the U.S. for maximizing price discovery to the benefit of all investors and trading firms. The pending case against TD Ameritrade highlights the controversy that surrounds retail internalization/wholesaling in the U.S. It is entirely possible that the outcome of the TD Ameritrade lawsuit is a dramatic reduction of retail internalization, bringing the U.S. closer to our own model.

However, with the widely known U.S. marketing efforts to retail investors involving low- or no-fee trading, we suspect that many Canadian retail investors believe they too ought to have cheap

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fees. Nothing is free, and cheap fees will always be cross-subsidized from some other activity affecting clients. While broker preferencing has provided Canadian dealers with a tool for reducing execution costs, we would urge the regulators to do more to educate retail investors as to the true cost of trading as opposed to creating more regulatory complexity to address a problem that seems to be far more of a problem in the U.S.

We believe the relatively heave reliance on the inverted maker-taker model in Canada, as compared to the U.S., is our industry's way of "selling" retail order flow given the effective UMIR prohibition on selling retail order flow the "American" way. In our firm's case, we are generally a large payer of fees on venues where active orders (typically from retail investors) are paid rebates; our traders value having such active flow "take" their offered liquidity. We have separately commented on why we believe the proposed Fee Pilot Study is a risky intervention into free markets, so any similar review of the inverted maker-taker model should start with an analysis of existing data/behavior.

Question 15: Are there other relevant areas that should be considered in the scope of our review?

As we have commented previously on the proposed Fee Pilot Study, direct intervention by regulators to set or limit prices is fraught with unintended consequences. Similarly, we believe that topics at issue should first be subjected to an analysis of available data and engagement in open discussions with all market participants. Such analysis and discussion should come before even considering the pursuit of pilot studies which are, in effect, experiments in live markets.

Sincerely,

Daniel Schlaepfer
President

Hugo Kruyne
Chief Operating Officer

Mario Josipovic
Vice President, Regulatory Affairs and General Counsel

FAIR | Canadian Foundation *for* Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement des droits *des* investisseurs

May 13, 2019

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Re: Joint CSA/IIROC Consultation Paper on Internalization in the Canadian Equity Market

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1. FAIR Canada is pleased to offer comments on the joint CSA/IIROC consultation paper 23-406 on internalization within the Canadian equity market (the "Paper"). We commend the CSA and IIROC for examining the issue of internalization of order flow and its impact on retail investors in particular. As the Paper notes, internalization has long been an issue in equity markets because of its implications for market quality and efficiency, and for fair treatment of investors. FAIR Canada agrees with the observations at section 4.5 of the Paper, *"The retail investor is inextricably linked to any discussion about internalization…. the focus of recent concerns is predominantly in relation to the orders of retail investors."*

2. **Fairness has been of particular concern where conflicts of interest arise between investment dealers' interests and their clients' interests**. Several types of conflicts arise, but the most significant conflicts are created when dealers trading for their own inventory accounts fill their client orders as principal. Dealers have an obligation acting as agents to obtain the best available price for client orders, but when they trade as principal their own interest is in buying at lower prices (if a client is selling) and selling at higher prices (if a client is buying). Those conflicts were largely addressed through strict rules on exposure of orders to the open market and the prices at which dealers can fill their own clients' orders. **Before those rules were adopted, clients were not being well served by many dealers that engaged in principal trading. That is a good illustration of why effective regulation of internalization of order flow is necessary.**

3. **FAIR Canada strongly advocates that the CSA and IIROC should strive to maintain and enhance the fairness and efficiency of equity markets and the competitiveness of**

Canadian markets. Efficient markets best serve the interests of investors generally. More broadly, efficient capital markets best serve the interests of all stakeholders, including issuers of securities seeking to raise capital in the most cost-effective manner, and the interests of the securities industry itself. Further, efficient markets that are well-regulated produce the fairest outcomes for all users of the market.

4. **Canadian capital markets will only remain competitive if the maximum level of efficiency is attained in our markets**. Canada is next door to the largest, most liquid and deepest capital markets in the world, markets that are easily accessible by Canadian issuers and investors at low cost. Sustaining competitive and effective Canadian capital markets is vital to our economy, as well as all participants and stakeholders in the market itself. **We cannot afford to permit market practices that serve the narrower interests of particular marketplaces, dealers or big players at the expense of the overall efficiency of Canadian markets.**

5. **The underlying principle of any organized market is to centralize or pool buyers' and sellers' activity to facilitate transactions (providing liquidity) and so they can obtain the best available price**. The efficiency of the pricing mechanism depends on how effectively buying and selling interest is centralized or pooled. An efficient pricing mechanism means the buyers and sellers can see the best prices that others are willing to trade at, and gauge the level of supply or demand at given prices. A market that provides efficient "price discovery" for interested buyers and sellers, and efficient pricing for trades, is a market that can best fulfill the attributes of an ideal market that the Paper describes. It is a market that provides transparency of prices, supply and demand. Transparency in markets has long been recognized as a significant benefit of central, public markets.

6. The Paper effectively asks about regulatory policy on internalization: **Should the wider interests of fostering fair and efficient markets prevail over the narrower interests of individual dealers and orders? FAIR Canada believes the answer is obviously yes**, for the reasons stated above. Clearly internalization of order flow means that fewer orders will be exposed to open, public markets. That would reduce the efficiency of price discovery and the pricing mechanism, and the visibility of supply and demand. **More internalization would lead to a market that is not only less efficient, but less fair and transparent.**

7. For the above reasons, FAIR Canada endorses the CSA's 2014 statement that, "*Retail orders are an important part of the Canadian market ecosystem, and the CSA continue to support the existing rule framework, which emphasizes the importance of these orders to the quality of the Canadian equity market, including the price discovery process*".

8. **FAIR Canada submits that the important question is, should any more internalization of order flow be permitted in Canadian markets? FAIR Canada believes the answer is no.** What benefits would be provided to the markets and investors generally if more internalization was permitted? What would the costs be in terms of the efficiency and competitiveness of Canadian public markets? Canadian market regulation, as reflected in

securities regulators', Exchanges' and SRO rules, has long provided for compromises on the issue of internalization. Market regulations already permit a reasonable degree of internalization, both on-market (priority of orders for cross trades, subject to rules on client-principal trading) and off-market (arranged crosses, for example). Both intentional and unintentional crosses are expressly allowed and provided for, if certain conditions are met. **While not perfect or optimal for trading retail orders (to use the word in the CSA's question 13), arguably a better compromise on this issue has been reached in Canada than in the US.** The Canadian rules have accommodated the launch of many competing marketplaces, while largely maintaining the core principles of efficient markets: trade execution on a public market, price priority and exposure of orders to the best available market. This remains true even with the advent of high frequency trading (HFT) and dark markets.

9. **This regulatory approach is to be commended. It provides the benefits of competition among marketplaces and permits innovation in markets, while maintaining clear minimum standards of market integrity, fairness and efficiency. Those minimum standards are vital to ensuring fairness for retail investors' orders.** As the Paper explains, the execution of retail orders was an important element in the development of the regulatory framework for market structure (page 17). FAIR Canada supports continuation of that regulatory approach.

10. **Innovations in the markets have been achieved at the cost of some loss in the value of time priority, client priority and potential interference in crosses, but the evidence appears to be that those costs have not been significant.**[1] Question 13 in the Paper asks if the existing rule framework provides for optimal execution outcomes for retail orders. We do not think it ensures "optimal outcomes" – for example, see FAIR Canada's comments on IIROC's proposed rules and guidance on best execution in 2016.[2] Those changes to Rule 3300, effective in 2018, eliminated the requirement for dealers to provide clients with best execution of orders in favour of requiring dealers to establish "policies and procedures that are reasonably designed to achieve best execution", a clearly lower standard. In IIROC's Guidance on Best Execution, IIROC states that dealers "may not be able to achieve best execution for every single order it executes on behalf of a client". See our recommendation #4 concerning to this issue at the end of this letter.

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[1] According to Figures 1 and 2 in Appendix A of the Paper, the percentage of trades executed as unintentional and intentional crosses increased marginally during the period 2016-02 through 2018-08. The percentage of volume and value crossed unintentionally increased slightly to 12.75% and 13.4% respectively. The percentage of volume and value crossed intentionally declined slightly to 8.87% and 11.67%.

Part 2 of Appendix A shows that the number of trades, volume and value executed through broker preferencing was about the same at the beginning and end of the period covered. The same is true for the percentage of trades, volume and value, except for a slight increase in the percentage of client-to-client trades executed in that manner.

[2] https://faircanada.ca/submissions/fair-canada-comments-proposed-rule-guidance-best-execution/

11. However, optimal outcomes may not be achievable in a market structure system that allows for competing marketplaces with different order types and trading priority rules. The current system is designed to achieve several significant policy objectives that reflect the needs and interests of different stakeholders, and the rules need to balance the need to meet objectives that to some degree are competing. We believe that the rule framework does provide for fair outcomes for retail orders, while also meeting other objectives.

12. Trading and order management technology has enabled the introduction of competing marketplaces while maintaining compliance with core regulatory principles by routing orders to, and splitting them among, markets with the best available prices and sizes, in split-seconds. This system enables the effective routing orders and discovery of prices on a consolidated basis, providing markets with liquidity and access to the best price and efficient executions. In theory, a centralized limit order book (CLOB) that applies strict time priority for client orders could produce a more efficient market and better outcomes for retail investors, but the costs of imposing a monopolistic market model would outweigh any additional benefits that might be obtained. It would be neither practical nor beneficial to turn the clock back in such a manner.

13. **It is difficult to identify practical ways to reduce the current level of internalization while retaining the benefits of competition among marketplaces, maintaining service levels for different types of clients, and allowing for innovation in market services**. It would also be difficult to require large, integrated firms to share more of their advantages of scale with other market participants. That might have unintended consequences that could ultimately impair market quality and efficiency.

14. **FAIR Canada submits that the rules and regulators' surveillance and compliance programs should continue to aim to ensure that conflicts of interest do not affect the quality of execution of clients' orders when a dealer is acting as principal.** In paragraph 2 we commented on the conflicts of interest that arise when a dealer intentionally fills its client orders by making a principal trade (i.e. for its own inventory account). We note that the Paper's data sample shows over 75% of intentional cross trades were client-inventory trades, compared to only 17% of unintentional cross trades. However, this data appears to mainly reflect the amount of block or large-sized volume and value executed in the upstairs institutional market, rather than crosses between retail orders and dealers' inventory accounts.[3] Nevertheless, this issue bears continued monitoring by regulators.

15. **FAIR Canada agrees that any trading service that aims to systemically pool and match orders should be a regulated market recognized by the regulators that complies with Canadian marketplace regulations, including UMIR.** If a large firm wants to increase their ability to internalize orders, they have the option to create and register alternative trading systems (ATSs) with the regulators, or even to develop new securities exchanges in

[3] Table 1 of Appendix A shows that in period 5 only 0.11% of all trades were executed as intentional crosses, but those trades accounted for 11.67% of total value.

collaboration with others. Neither dealers nor marketplaces should be permitted to develop systems that facilitate internalization of order flow that are not subject to the minimum standards reflected in equity market regulations.

Recommendations

1. Regulators should continue to ensure that the rules and dealers' internal trading policies and procedures ensure that retail clients' orders are filled at the best possible price, particularly when a dealer fills its own clients' orders acting as principal.

2. Regulators should continue to ensure that the rules and dealers' internal trading policies and procedures ensure that retail clients' limit orders that are not immediately tradeable in the market are exposed on public, regulated marketplaces, except where best execution of an order would not be achieved by exposing the full order.

3. IIROC's UMIR rules on dealers' obligations to supervise trading operations should continue to ensure that its members have supervisory procedures in place to ensure that they comply with the rules and policies on best execution of orders, exposure of orders to marketplaces, internalization of order flow, and client-principal trading. Also, dealers' internal compliance monitoring programs should be required to effectively monitor their compliance with such rules and policies. Dealers' supervisory procedures and internal compliance monitoring programs, as well as the results of their compliance monitoring, should be documented and available for review by regulators.

4. IIROC market surveillance and trade desk compliance examinations should effectively monitor dealers' compliance with rules and procedures on best execution of orders, exposure of orders to marketplaces, internalization of order flow, and client-principal trading. A summary of the results of IIROC's compliance monitoring in these areas should be released to the public on a periodic basis. The results should include IIROC's assessment of the level of compliance, and if concerns arise, its plans to address such concerns. Public reporting of results will assist in efforts to prevent the level of internalization from increasing over current levels.

On this point, we note that IIROC's annual compliance priorities report published in January 2019[4], which summarized compliance findings from 2018, listed best execution as one of four issues highlighted under trading conduct compliance. The report stated:

> 2.2 Best Execution
>
> We introduced changes to best execution requirements on January 2, 2018. We will focus our reviews on the efforts undertaken by dealers to address the changes in the requirements.
>
> Our areas of focus include:

[4] IIROC Notice 19-0008

- documented and implemented policies and procedures that consider the factors and elements that contribute to the best execution of client orders
- content and disclosure of best execution policies
- governance around best execution decisions
- training conducted by the dealer, including that training is provided to all employees who are involved in the best execution process.

The fact that IIROC highlighted best execution as a significant issue based on findings from its 2018 compliance reviews speaks for itself. We noted that the listed “areas of focus” do not include any actual review or assessment of the degree to which dealers are actually obtaining best execution for clients. The reviews will focus on dealers’ approaches to the issue, namely their policies and procedures, rather than the results they achieve for clients. In our view, IIROC’s approach is inadequate because it examines policies instead of results, so fails to assess how well clients’ interests are actually being served. **We recommend that, at a minimum, dealers be required to carry out compliance monitoring of the degree to which they obtain best execution for clients (see recommendation #3 above) and that IIROC review and assess the results of such monitoring when performing its compliance examinations.**

5. The CSA and IIROC should continue to periodically monitor data on the amount of internalization of orders in equity markets, and publish highlights of such monitoring. The purpose of ongoing monitoring would be to enable regulators to assess, on a continuing basis, whether the level of internalization may become a greater concern. The purpose of publishing highlights of the data would be to inform investors, securities dealers and marketplaces about the issue and potential implications for market quality.

We thank you for the opportunity to provide our comments and views in this submission. We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-256-6693 / ermanno.pascuttto@faircanada.ca.

Sincerely,

Ermanno Pascutto
Executive Director, FAIR Canada

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

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May 16, 2019

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Dear Mesdames and Sirs:

Re: Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market* (the "Consultation Paper")

We appreciate the effort that went into summarizing what you consider as potential methods of internalization and the related statistics, as well as the background information that are reflected in the Consultation Paper. We also understand that the intention of this exercise was to present information, ask questions and not to come to any conclusions, but we are concerned that the length of time between the data collection and publication of the paper has made some of the statistics and, arguably, the focus of the paper less relevant.

In addition to the responses to the specific questions raised in the Consultation Paper, we would like to raise the following general points:

1. "Internalization" in its traditional form in Canada (crosses put together by dealers and reported to marketplaces as "intentional crosses", i.e. the "upstairs market") has been approached with caution due to its ability to negatively impact market integrity – primarily because internalized orders do not contribute to price discovery, free-riding on prices set by others and extracting liquidity from the market. On the other hand, it is also acknowledged that if orders of a substantial size are directly exposed to the market, this could lead to substantial price dislocation and resulting market integrity concerns. We believe that over time a fine balance had been struck. Any discussion about internalization should take these underlying market integrity principles into consideration.
2. Referencing unintentional crosses in the Consultation Paper as a form of internalization without any further context is unfortunate. For example, if investment advisors working in a dealer's Victoria and St. John's branches, respectively, happen to place orders that ultimately execute against each other without any assistance from their firm's execution management system, it should not be considered to be internalization.
3. Similarly, considering broker preferencing as a form of internalization without any further context is, in our opinion, also unfortunate. The traditional way that broker preferencing has been enabled by transparent marketplaces does not have certain key attributes of internalization, as defined above, because the posted order contributes to price discovery and is available to be traded against by the orders of other dealers. On the other hand, when leveraging broker preferencing in a dark pool or with knowledge of an incoming liquidity taking order, the question of whether internalization is at play should be raised.
4. As a general principle, we believe that it is the expected outcome of leveraging an order handling method (enabled by a dealer, a marketplace or the combination of the two) that should govern, to determine if trades are to be defined as internalized or not. Further, existing and new

order handing methods should continually be assessed to confirm whether they are being used for achieving the outcome of internalization. We will discuss this further in our response to Question 1.

5. A number of concepts that may be associated with but are not necessarily "internalization" are also covered in the Consultation Paper, including retail segmentation (please see our response to Question 12). Given the recent trends and statistics collected, we believe that retail flow segmentation is the most pressing issue. We therefore suggest that the assessment following the Consultation Paper should focus on this issue, with the impact of dealers internalizing orders as a subset of that analysis.

6. The final, more general point we want to make relates to the fact that the data on broker preferencing does not include trades from all marketplaces because not all marketplaces are "able to accurately identify" such trades. This is a concern from several perspectives:

   - it is difficult to assess the materiality of that gap, as there is no disclosure about how much data is missing;
   - it is somewhat concerning that some marketplaces cannot properly identify broker preferenced trades – all marketplaces' systems identify when an order's broker ID trumps the time priority of other orders, and then execute upon that information; not being able to track those occurrences is concerning from the perspective of auditing and ensuring the proper functioning of a matching engine.

Responses to Specific Questions

Question 1: *How do you define internalization?*

As discussed above, we believe that, for regulatory purposes, the definition of internalization should be limited to the <u>intentional</u> use of methods – whether human or technology based – that ensure same dealer orders match with each other. The key is the high degree of certainty of the outcome: if steps are taken to enhance the likelihood of broker preferencing while respecting best execution and leaving the potential for matching with other dealers' orders unchanged, it should not be considered internalization. Returning to some of the examples discussed above, we don't believe that leveraging broker preferencing in a dark pool (or leveraging dark orders more generally) in itself constitutes internalization, but that leveraging broker preferencing by posting an order with knowledge of an incoming liquidity taking order <u>is</u> internalization. See also our answer to Question 11.

Question 2: Are all of these attributes [liquidity, immediacy, transparency, price discovery, fairness and market integrity] relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

All remain relevant, in our view.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Internalization can impact all of the attributes:

- it extracts liquidity from the market as a whole and this is particularly detrimental to smaller markets, such as Canada's;

- internalization may be beneficial to immediacy if the dealer that is internalizing has a proprietary business to supplement client-to-client order internalization; and
- internalization negatively impacts transparency and, subsequently, price discovery, as the nature of “pre-arranged” trades is that they take place without other market participants being able to see quote adjustments and react, which is also detrimental to liquidity, fairness and market integrity.

We believe that growing levels of internalization in the Canadian market will lead to wider spreads and more unstable quotes, which are measurements of liquidity but also form the boundaries within which internalization takes place. Under these circumstances, quality of execution of internalized client orders, while still benefitting from immediacy, may be negatively impacted from a price perspective.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

As discussed in our response to Question 3, we believe that internalization, while being detrimental to the market in multiple ways, may be beneficial to clients of the dealers who have the capabilities and flows to leverage it.

This is, however, a limited part of the dealer community and would lead to further concentration of flows and an ever-decreasing number of dealers, which would negatively impact competition. There is also a risk that internalization will start to affect quoted spreads, which in turn may be expected to have detrimental consequences for all orders, including internalized client flow.

In other words, while in the shorter term there may be a conflict between the common and the individual good, we believe that with increasing levels of internalization the conflict will disappear and result in a negative impact on all dealers’ clients.

Ultimately the internalization debate is not that different from the debate around dark trading generally, and the same regulatory principles and considerations should apply.

Question 5: Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.

N/A

Question 6: Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).

N/A

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Broker preferencing is a longstanding feature of the Canadian markets that arose as a solution to deal with the concerns of dealers with a significant amount of client orders who were not able to: (a) allow their own clients that had placed limit orders to benefit from faster fills, nor (b) reduce their cost of trading. As a measure put in place to avoid a result where all the large dealers set up their own venues to achieve these objectives, it has generally been successful. In addition, all limit orders that may benefit from broker preferencing are posted on marketplaces, contribute to price discovery (if on a transparent marketplace) and liquidity, and are accessible to other dealers; and, further, crosses in general reduce settlement risks.

The drawbacks are that the perception of fairness can be impacted if other orders do not get executed (or the immediacy of their execution is noticeably reduced).

Based on the partial set of data available for all marketplaces, and the specific set of publicly available data of our own trading books, current levels of broker preferencing do not seem out of range with historical patterns. Even if we assume that broker preferenced trades represent 100% of unintentional crosses, we are looking at a maximum of 12-14% of the overall volume, value and trades, as of the first half of 2018. Given that the closest alternative to abolishing broker preferencing is to fully embrace the US model of dealer-run dark pools, including single-dealer platforms, this would on its face appear to answer the biggest questions about broker preferencing and provide an indication of the metrics that should be tracked at a high level for any red flags. Please see our further thoughts in our responses to Questions 9, 10 and 11.

It is concerning to us, however, when broker preferencing is used in a way that enables internalization as defined and discussed under Question 1, and note that the statistics provided do not allow us to understand the impact of these types of activities, nor their evolution over time.

In addition, we note that there has been some discussion about only allowing broker preferencing for client-client trades. We would like to highlight the fact that if such a step was taken, dealers with low latency DEA Clients would have a distinct competitive advantage over dealers with market making desks, which would also create fairness issues and, worse, further erode the ability of formal market making firms to commit reliable liquidity.

Question 8: Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).

N/A

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

As noted above, dealers that have more two-sided flow and more client orders in general have more opportunities to benefit from broker preferencing. That said, given the low percentage of broker preferenced trades – based on the available statistics – we find it hard to argue that there is evidence that suggests any material disproportionate benefits.

It would have been very useful to this analysis, though, to have access to better statistical information:

- providing a complete view across all marketplaces;
- splitting the data for traditional broker preferencing in transparent marketplaces versus broker preferencing in dark pools versus broker preferencing as part of a method to enable internalization as defined under Question 1; and
- splitting out the types of clients benefitting from broker preferencing, e.g., retail versus institutional and, if possible, low latency DEA Clients versus other clients.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

All things being equal, broker preferencing is more likely to impact perceptions of fairness in illiquid securities that already suffer from less-than-optimal liquidity. However, this result is balanced by the fact that it will attract liquidity provision by dealers active in those securities.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Yes. This is a fundamental principle underpinning Canadian market structure. With large intermediaries and a small market (relative to other capital markets) and a significant amount of direct retail trading, the creation of silos would reduce efficiency and harm fairness. Most research on what makes a healthy market highlights transparency and a mixture of different types of order flows interacting with each other.

A consequence of being treated as a marketplace is that the fair access requirements apply. There is no reason why entities systemically matching multiple buyers and sellers should not be treated similarly. Alternatively, functionality or behaviours that achieve internalization, such as if a dealer automates and systematically leverages broker preferencing on marketplaces or if marketplaces adopt functionality that guarantees that a dealer only trades with itself, the rules relating to intentional crosses as defined in UMIR should be applied, as this activity is more similar to the traditional upstairs market where both sides of a trade are identified and then sent to a marketplace to be "printed".

Again, it is important to distinguish between a dealer that simply optimizes its routing strategies to increase the likelihood for its active orders to hit or lift its passive orders first versus a dealer that uses the information about its marketable order flow to simultaneously place (and remove, if necessary) passive orders on marketplaces with the sole purpose of trading with its own orders.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

Segmentation of orders is a growing concern. There is a reason that professional traders seek to trade against retail orders – they are in general less informed and less price sensitive and rarely driven by fundamentals. They are also less directional. This creates more certainty for, and less price impact on, those that trade against them. This is the same reason why institutional clients prefer that their orders have the opportunity to trade against retail orders and why, ultimately, it would be better for retail to trade against retail without unnecessary intermediation.

On the basis of the assumption, as stated above and backed by research, that the healthiest markets have a good mix of different types of order flow, segmentation is an unhealthy trend, particularly in a market of the size of Canada's, which already faces liquidity challenges.

Segmentation also is often associated with information leakage and all of this together is not good for buy-side institutions and anyone else who is not in a position take advantage of the functionality that creates the segmentation.

We have commented recently[1] that by enhancing segmentation through marketplace functionality (functionality that makes trading unappealing to buy-side and proprietary traders) and adding pricing incentives, one particular marketplace is seeking to replicate the US wholesaling model and create a mechanism for facilitating payment to retail dealers for their order flow. If this outcome was achieved directly, between dealers, it would violate UMIR. The method used for order segmentation, similar to the method used for internalization, should not matter; only the result achieved. In the example about the marketplace discussed above, the form is unimportant, as the impact of the activities – whether at the marketplace or dealer level – is the same whether it is achieved through functionality, fees or any other feature.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

The existing rule framework ensures that dealers must, for "small" orders, either provide the best publicly available price or improve upon it. In general, retail orders are small enough to be filled without a significant amount of effort to source the liquidity and there are a number of different market models to allow dealers to optimize their quality of execution.

The key aspects to provide support for optimal execution outcomes for retail orders that we believe are missing are set out below.

- The absence of meaningful validation tools to address the potential conflicts of interest associated with the payment of rebates by marketplaces, such as standardized reporting on routing strategies and quality of execution, similar to that in the US. In the absence of the widespread availability of such information it is left to regulators to attempt to prove that routing to the marketplace that pays the highest rebate is detrimental to quality of execution, which is in most cases difficult, if not impossible.

- The fact that the vast majority of retail investors and investment advisors do not see consolidated market data (as contrasted with the US, where it is mandated); this provides them with a poor view into the activity in the markets, the amount of liquidity available, and how orders are executed, which leads to uninformed investment decisions, uninformed trading strategies and ultimately being excluded from the markets if there is a TMX outage, such as that experienced in 2018:

    - in the case of TSX-listed ETFs, for instance, they are seeing less than 50% of the orders and trades, which we understand, anecdotally, has caused a number of occurrences of investors walking away from an investment, based purely on an incorrect assessment of the liquidity or because the last sale price on TSX is stale (and no longer a true reflection of the fund NAV), and more accurately-priced trades have taken place on other marketplaces not visible to the investor;

    - relying solely on the operation of the order protection rule will not lead to optimal execution when a retail client might have chosen to put in a limit order rather than a marketable order based on a full view of market activity in a particular security, and received a better price.

[1] https://www.osc.gov.on.ca/documents/en/Marketplaces/com_20190411_neo.pdf

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

As discussed above, we are not in favour of internalization as we defined it under Question 1 beyond traditional upstairs market crosses that are printed on marketplaces and subject to order exposure and price improvement requirements under UMIR. We believe that all the more recent practices using technology to enable internalization without being caught by the regulatory framework for intentional crosses should be banned as they do not benefit the market overall and in that way ultimately harm retail investors.

As suggested in our response to Question 13, we believe that changes should be considered to require the provision of access to consolidated data real time data for retail investors and investment advisors. We are aware that this has been viewed as a choice by each dealer, but it is a choice driven purely by necessity (as costs today would be prohibitive) and investors are not aware they are not seeing all the data. It would be unfair to add requirements imposing significant costs beyond those currently charged, which leaves two potential solutions: the CSA could treat fees for non-professional displayed data similarly to the process for professional data and set maximum fees for each marketplace based on an aggregate benchmark amount (i.e. it could be limited to what is currently paid for only TMX data) and some combination of share of volume, value and trades, or could require dealers to meaningfully analyze their indicative data and include this analysis in their best execution policies and procedures.

We believe that there should be mandatory reporting by dealers with respect to routing strategies and quality of execution. This should be available publicly in aggregate for retail investors as well as privately for institutional investors in a format that allows them to compare dealers on an apples-to-apples basis.

Finally, we support the proposed IIROC changes to the dark rules, which assist in better protecting retail orders in lower priced securities and the CSA's trading fee pilot.

Question 15: Are there other relevant areas that should be considered in the scope of our review?

There are a number of other areas that we believe should be considered in the review:

- *Market Making Programs*

  All exchanges in Canada except NEO offer versions of a "guaranteed minimum fill" facility as part of their market making programs. We are supportive of providing benefits to market makers as long as they are balanced against the obligations imposed on them, and as long as the benefits do not promote segmentation. Although we published a proposal for such a facility several years ago, we ultimately did not implement it as we felt and continue to feel that these types of facilities do not pass that test. There are no meaningful obligations that the market makers must fulfill, and the benefit is that they get to interact with retail flow only. We also question how these type of facilities are in compliance with the current dark rules when small retail orders are getting filled without price improvement by market makers who have not placed any visible orders.

- *Proliferation of Order Types*

  As mentioned in our previous comment letter on the TSX "SDL Plus" order type[2], whenever a marketplace proposes functionality that replaces one or more functions typically performed by

[2] https://www.osc.gov.on.ca/documents/en/Marketplaces/com_20190411_neo.pdf

a dealer (as was the case with the two order types discussed in that comment letter), the proposal should be put through the following lens: would that functionality be allowed if performed by a dealer? In the same spirit, we believe it would be appropriate to review all available order types in the equity markets to determine whether or not they are aimed at or contribute to segmentation.

- *Trading Fees*

  One of the biggest contributors to segmentation is the current bifurcated market structure with maker-taker and taker-maker (inverted) pricing. That is one of the reasons we are supporters of the proposed trading fee pilot and hope that the Canadian regulators will move forward with non-interlisted securities despite the uncertainty in the US around the proposed SEC pilot. In the absence of that step, we would urge the CSA to implement a similar type of fee cap for inverted markets as that which exists for make-take markets, or we will see a continued escalation of inverted fees as marketplaces continue to fight for the highest rebate. Other than to facilitate retail segmentation, it makes no sense that the fee to post on an inverted market can be higher than what is acceptable as a take fee on a make-take market. Although we appreciate that the intention behind the fee cap on active flow is to protect the flow that is "forced" to access a protected quote, another prisoner's dilemma appears to have been neglected. Dealers posting their institutional flow on inverted markets to shorten their time to trade have to cover that cost with commissions. There is a point where posting fees for institutional dealers exceed commission rates, leaving only proprietary firms willing to pay to post to trade with retail flow. Recent proposals in this area are those from TSX Alpha and Nasdaq CX2 to introduce separate (and more beneficial) fees for retail flow. This is even more concerning and is enabling indirect wholesaling of order flow in Canada, despite the prohibition against payment for order flow among dealers.

We believe that Canadian market structure is evolving in an unhealthy direction. It is critical that regulators re-confirm the core regulatory objectives, in consultation with all relevant stakeholders, and then take a clear stance in supporting those objectives.

Thank you for your consideration.

Yours truly,

"Cindy Petlock"

Chief Legal Officer
Neo Exchange Inc.

cc: marketregulation@osc.gov.on.ca
Jos Schmitt, CEO, Neo Exchange
Joacim Wiklander, COO, Neo Exchange

May 21, 2019

SENT BY E-MAIL

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To: All Canadian Securities Administrators and IIROC, via e-email

Re: Internalization within the Canadian Equity Market

TD Direct Investing welcomes the opportunity to comment on the Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*.

TD Direct Investing, as the largest direct investing brokerage service in Canada, supports internalization within the Canadian Equity Market, which advances the interests of Canadian investors. In particular, we stand behind the comments submitted by our affiliate, and executing broker, TD Securities Inc.

We welcome the opportunity to provide additional commentary through in-person discussions with staff.

Sincerely,

Paul Clark
President, TD Direct Investing

Desjardins

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May 21, 2019

Dear Sir/Madam:

Desjardins Securities thanks you for this opportunity to comment on the joint CSA/IIROC Consultation Paper 23-406 – Internalization within the Canadian Equity Market. We are supportive of issues raised in the Consultation Paper and appreciate the complexities that currently exist within our industry. Various dealers, with different corporate objectives, are key players in our market, therefore, we feel this paper will give everyone an opportunity to comment/suggest concepts to better our markets and create an equilibrium amongst everyone.

As illustrated in the paper, Desjardins is supportive and agrees with the listed market attributes as being very relevant. They are the most important mechanisms for a sound and solid market. As we are all subject to a multiple market structure in Canada, we therefore need to ensure a sound and efficient market for our investors. Fairness and market integrity should be looked at with greater importance. As previously mentioned, creating an equilibrium amongst the players will only strengthen our market.

The magnitude of internalization in Canada is of great concern to the majority stakeholders as internalization has a direct impact to market quality. Desjardins understands that sufficient size client orders could be facilitated (CLT vs CLT or facilitation cross) as much as possible to minimize market impact, known as intentional cross. The paper mentioned a second type of cross as unintentional, referred to as broker preferencing, which in our mind needs to be re-evaluated to create a better equilibrium for all players participating with order flow.

The consultation paper often refers to the importance of Retail Orders and how they are imperative to our market places. The paper states *"It is clear that retail orders have value to a variety of market participants, and a great deal of resources have been expended by various industry stakeholders to create ways to extract this value to the benefit of some, but not necessarily all."* What is striking in the phrase is "…*various industry stakeholders to create ways to extract this value..."* This comment is of great concern that is echoed by everyone.

Desjardins believes that broker preferencing is not a total detriment to the current market structure. This is where an equilibrium can be improved. Order exposure rule stresses in routing all orders of 50 standard trading units to a market place, Desjardins believes that these same orders should simply trade directly with the top of the book and not be eligible for broker preferencing. Orders of quantity greater that 50 trading units can trade as broker preferencing and therefore creating an equilibrium amongst all participants. In order to achieve this outcome, dealers would not withhold or delay the orders in order to circumvent the rule.

For years the Canadian market has been trading in a FIFO (first in first out) format. The proposal of 50 lots not eligible for broker preferencing would now give a greater value to the orders who did initiate the best bid/ask.

Thank you for the opportunity to comment on the joint consultation paper. We support this initiative given that it could help the overall Canadian market structure. We would be more than pleased to discuss in further detail this comment letter at your convenience.

Sincerely

Desjardins Securities

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May 28, 2019

Dear Sirs/Mesdams:

Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the "Consultation Paper")

Acumen Capital Finance Partners Limited ("Acumen") appreciates the opportunity to comment on the important issues raised in the Consultation Paper.

Acumen does not object to the practice of internalization for large orders, to reduce market impact. However, we do object to the practice of internalizing a significant portion of trade flow, such that an ever-decreasing number of orders can be interacted with in the order book by other participants, reducing liquidity, transparency, price discovery and fairness. We believe that the key market attributes of liquidity, transparency, price discovery and fairness, are critical to market integrity and are not supported by internalization that is not confined to large orders and are not supported by broker preferencing.

The common good must trump the individual good. We have woven this into our daily lives in countless ways and our capital markets take this as a fundamental principle. We risk fair and efficient markets when "the system" allows certain participants to benefit on an on-going basis at the expense of other participants and confidence in the marketplace as a whole.

As a smaller, independent dealer, Acumen is not able to undertake broker preferencing in any meaningful way, as we do not have a sufficient number of orders to match on real-time, ahead of other orders in the queue. As a result, our firm and our clients are at a disadvantage on a structural level, as our clients' orders may have delayed execution as broker preferenced orders are not subject to order time priority. We note that the Consultation Paper states broker preferencing pre-dates modern electronic marketplaces and was an incentive to encourage dealers to commit orders to the order book. With the evolution of the electronic trading structure, broker preferencing should no longer be necessary and appears to be in place today to advantage dealers with large retail liquidity pools, primarily bank-owned dealers.

In respect of broker preferencing, Acumen believes orders that are created solely to take advantage of existing orders are not appropriate. Acumen supports banning broker preferencing as a whole and supports strict time and price priority to ensure fairness. Exposing orders on a marketplace should come with an opportunity for all to have a chance to trade with the order. As orders are exposed on the marketplace and all dealers are allowed to trade with it, liquidity will be created. Where orders are intercepted without an opportunity for others to trade, the added value to the market is limited. When smaller firms are providing price discovery through providing the quote and are not able to interact with the flow on a fair basis, the perception of the market as a fair and desirable place to trade is diminished. We believe that segmentation, fragmentation, broker preferencing and routine internalization has degraded the quality of the market, and that the more this is permitted, the more orders in the market lose the benefits of being competed for. The perception that the market is unfair may ultimately undermine investor confidence, diminishing the vitality and integrity of the Canadian market in general.

We recognize that dealers with large retail liquidity pools have a strong incentive to maintain broker preferencing and these firms are likely to attempt to replicate the results of broker preferencing in other ways to protect their structural advantage. Strategies and mechanisms to replicate broker preferencing in other ways could harm some of the six key market attributes and result in an increase in market segmentation and fragmentation. Should the CSA/IIROC decide to reform broker preferencing or ban broker preferencing, we request that the CSA/IIROC consider what actions these firms may undertake to ensure the regulatory objectives of any reforms undertaken are achieved.

Yours very truly,

Acumen Capital Finance Partners Limited

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To: All Canadian Securities Administrators and IIROC, via e-mail

May 30, 2019

Re: Internalization within the Canadian Equity Market

Dear Sirs and Mesdames:

TD Securities welcomes the opportunity to comment on the Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*.

TD Securities is a leading securities dealer in Canada and a top ranked block trader in Canadian equities and options based on dollar value and shares traded. TD Securities also acts as the executing dealer for TD Waterhouse, the largest direct investing brokerage firm in Canada.

Internalization of order flow is a topic that has been debated globally throughout the history of markets. The core Canadian order matching rules were developed between the late 1980s and mid 1990s as the TSX transitioned from floor trading to electronic systems. We welcome the CSA/IIROC initiative to revisit this discussion as trading technology continues to evolve.

Market models for internalization vary widely across equities, foreign exchange, fixed income and derivative products. For equities specifically, different approaches have been taken by Canadian, US, European and Asia/Pac regulators. Canada is unique as the only major region without off-marketplace trading facilities. Internalization frameworks require a balance to be struck across various market participants and every model creates some form of a trade-off between best execution and market quality.

Question 1: How do you define internalization?

We view internalization as any trade where the same dealer represents both the buy side and sell side of the transaction, whether the trade is client-client or client-principal.

The role of a dealer extends beyond simply acting as a gatekeeper and providing marketplace access to clients. Two of the primary functions of a dealer are:

- soliciting interest for client orders and matching client buyers with client sellers as agent, and
- providing liquidity to clients as principal.

We recognise these functions may overlap in some respects with the role of a marketplace. The debate on internalization centres around how to enable dealers to source client interest and provide capital to client orders while also supporting price discovery and liquidity on public markets.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

We agree that these key attributes of a market continue to remain relevant from a regulatory policy perspective. We believe the key attributes should be applied to the entire market ecosystem to recognise the dealers' role in contributing to market quality rather than being limited to public marketplaces only.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Internalization plays an important role in a market through the sourcing of contra-side interest and provision of capital to client orders.

The internal liquidity within a dealer improves the capacity of the market ecosystem to absorb client orders and improves the immediacy of execution relative to public marketplaces, where liquidity may be thin or impacted by quote fade.

Under Canadian rules all internalized trades are printed on public marketplaces which contributes to transparency and price discovery. Other regions allow for internalized trades to be printed off-marketplace to a trade reporting facility. This model has some advantages in that market share metrics are more comparable across marketplaces and it simplifies the use of bypass markers. We would be supportive of moving to an off-marketplace trade reporting model if transparency was not affected.

Internal dealer liquidity acts as a buffer on market impact for larger orders and improves price discovery by minimizing unnecessary price displacement.

All dealers operate under the same ruleset and clients have a choice of dealers for order execution which supports fairness and market integrity.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

We think a balance needs to be struck between the conflicting goals of best execution for individual orders and supporting liquidity and price discovery on public markets, but in the context of a global market for order flow.

We recognise that global market participants measure their execution quality on an order-by-order basis and can choose between either the Canadian or US market to trade interlisted securities. If we focus entirely on the "common good" and sacrifice execution quality on individual orders, we risk losing global flows into Canada and hollowing out the Canadian commons.

Question 5: Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.

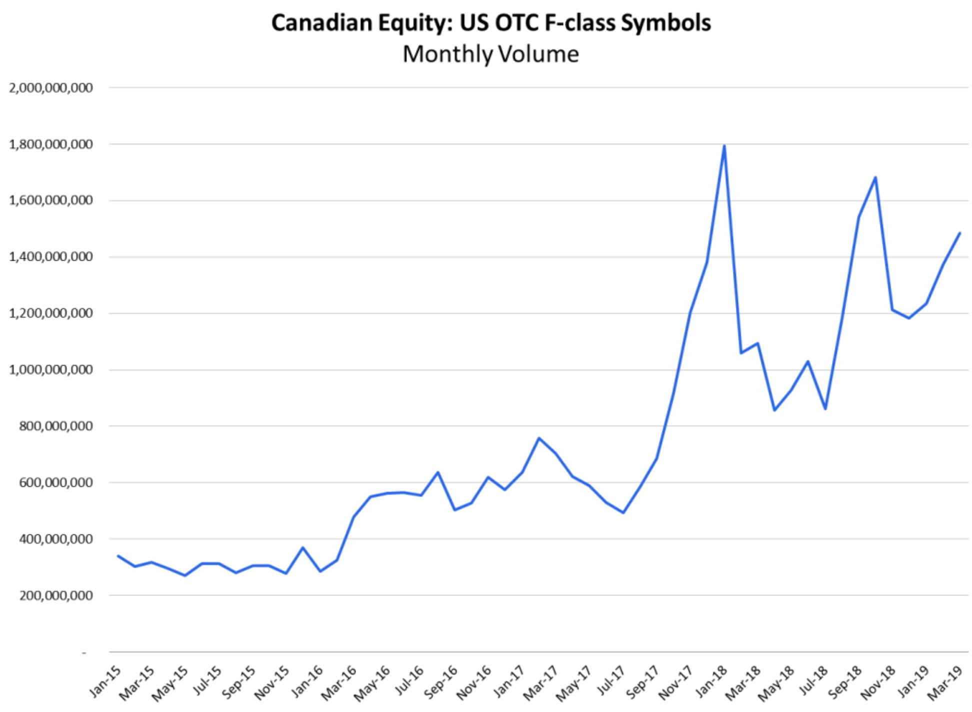
It's difficult to measure the impact of internalization on market quality without a formal data study including test and control groups, but the US market can act as a proxy for a more liberal internalization model.

The US market has enabled internalization in multiple forms. Regulation ATS allows dealers to create private liquidity pools to match internal flows before sending the residual orders to public markets. Virtually all US marketable retail flow is internalised by wholesalers away from the lit book. We estimate over 50% of US volume is internalised (40% on FINRA Trade Reporting Facilities and 10% on public marketplaces) compared to less than 25% in Canada.

The US market is the deepest and most efficient equity market globally, with lower market impact and lower overall transaction costs than any other region. It is hard to say if US market efficiency is a result of its liberal regulatory framework, but the high level of internalization does not seem to harm market quality measures compared to Canadian equities which trade in a more conservative market model.

The Canadian equity market does not trade in isolation from the US. We have 184 interlisted symbols with overlapping listings on Canadian and US primary exchanges. These interlisted symbols represent roughly half of the total value of equity trading in Canada. When including US trading volumes, the North American market for these interlisted securities is double the size of the Canadian market.

In addition to the primary interlisted symbols, there are close to 2,500 Canadian securities available for trading in the US market as over-the-counter F-class symbols. This set has grown from roughly 1,500 securities in 2015 and now covers virtually the entire Canadian tradable universe. US trading volume in these F-class symbols has grown by a factor of five over the past four years, from ~300 million shares per month in 2015 to ~1.5 billion shares per month this year.[1]



The US OTC market enables pure internalization of Canadian securities, where trades may be printed by dealers or market makers directly to the US Trade Reporting Facility. This pure internalization model has been successful in attracting global trading volume in Canadian securities away from the Canadian market.

[1] *Source: Bloomberg*

We regularly review quality of execution in the US and Canada, and we track market quality measures such as:

- Price Improvement (relative to the initial quote at time of order entry)
- Effective Over Quoted spreads (actual execution level as a percentage of initial quoted spread)
- At or Better % (percentage of orders executed at or better than the initial quote)

In all metrics the US market ranks as having higher quality execution than Canada, which may be attributable to the greater level of dealer liquidity made available through internalization.

Question 6: Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).

Our clients benefit from internalization though higher fill rates on passive orders, reduced market impact on marketable orders and lower indirect cost of execution through savings in marketplace fees.

Internalization by other market participants also benefits our clients through reduction in adverse selection. We measure order toxicity in the Canadian marketplace and note that other dealers generally have a larger representation of active HFT orders with high short term alpha. Broker preferencing helps to contain these orders within the same dealer and reduces the odds of adverse selection for our clients.

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Broker preferencing benefits the Canadian market by encouraging liquidity to be posted on public marketplaces compared to the alternative US model of enabling internalization through private dealer pools and retail wholesaling. Canadian broker preferencing also encourages client-client matching, unlike the US model where active retail orderflow is absorbed by wholesalers rather than being matched with resting client orders.

Roughly 65% of our Canadian active retail volume trades with other dealers. In terms of the 35% of our active retail volume that is internalized, the large majority of this is represented by retail clients matched on-marketplace with other retail clients. **The primary beneficiaries of broker preferencing in Canada are retail clients.**

Some market participants are recommending to remove broker preferencing for orders of 50 standard trading units and under. If this proposal is passed, the negative impact will primarily be borne by Canadian retail clients.

In the US model, close to 100% of marketable retail flow is internalized by wholesalers and does not interact with either other dealers or other retail clients. We see the Canadian broker preferencing model as being a more balanced approach to internalization which supports public liquidity, public price discovery and broader access to order flow than the US model.

In the absence of broker preferencing the most frequently suggested order matching model is price-time priority, where same-price orders are filled first-in first-out based on resting time in queue. We have concerns that a pure price-time model will grant a sizable advantage to high frequency trading firms. Under a price-time model, the first dealer to establish a price level or the second dealer to join a price level will capture the majority of fills. A price-time model encourages an arms race in speed/latency which will result in one or two US HFTs dominating the Canadian market and will harm the quality of execution for our retail clients by lowering their passive fill rates.

A frequent criticism of broker preferencing is that resting orders are frequently "traded around" by dealer crosses. We note that without broker preferencing the problem of being traded around is still unavoidable in a multiple marketplace environment, where trades may occur on a marketplace away from where the order is resting. In a pure price-time model, the complaints of being "traded around by broker preferencing" would be replaced by complaints of being "traded ahead by HFT orders with higher queue priority" or "traded around on other marketplaces."

Broker preferencing plays an important role in meeting best execution for client orders and in reducing execution costs. If we have a marketable client order and a passive client order at the same price, we can achieve best execution for both clients by matching the orders rather than trading the marketable order with another dealer and leaving the passive client unfilled. Trading the active side with another dealer would be harmful to our passive client, who would miss an opportunity to be filled and may be exposed to a higher cost to complete the unfilled balance of their order. Matching active and passive orders also reduces the overall cost of execution for a dealer by balancing active fees with passive rebates rather than being exposed to the active fee alone.

Without broker preferencing, dealers would be incentivized to find other means to achieve the same best execution outcomes for their clients. We think this would lead to a more complex market with higher technology costs but ultimately limited changes to the level of internalization.

The European experience with MiFID II is a cautionary example. A policy goal of the MiFID II regulation was to bring more trading activity on exchange, but the combination of batch auction models, Systematic Internalizer registrations and industry innovations such as portfolio swaps and synthetic Prime Brokerage led to a higher level of internalization than before the rules were implemented.[2]

Question 8: Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).

See Question 6 above.

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

Broker preferencing conveys benefits to smaller dealers as it provides greater public liquidity, price discovery and access to order flow than the US internalization model which excludes small dealers entirely. Broker preferencing is also superior to a pure price-time model which would favour US HFTs over smaller dealers.

The benefits of broker preferencing are mostly aligned to the ratio of active to passive flow for a dealer, not necessarily the size of the dealer. For example dealers with primarily active or primarily passive orders would be matched less frequently through broker preferencing than a dealer with a more balanced set of orders.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

We do not have direct data on the impact of broker preferencing on illiquid or thinly-traded securities, but we expect the frequency of broker preferenced trades would be lower on these securities as a function of their lower trading volume. We also expect the low liquidity of these securities would result in more instances where an entire level of an order book is cleared so the application of broker preferencing becomes irrelevant.

We do not see broker preferencing as being a key factor in the liquidity of thinly-traded equities. Liquidity is primarily a function of institutional ownership, retail interest, research coverage and global flows in the sector rather than market microstructure.

[2] *Reuters Business News:Light or dark? Six months on, MiFID 2 rules divide equity traders. June 29, 2018*

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

No we do not believe that dealers who internalize orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules. Two primary functions of a dealer are to solicit contra-side interest for agency orders and to provide capital to clients as principal. Both of these roles require a relationship with the client and cannot be done anonymously on a public marketplace under a fair access model.

Historically these dealer roles were performed manually, but the advancement of technology has enabled greater speed and efficiency in agency order matching and client facilitation trading. We do not think the application of technology should change how an activity is classified from a regulatory point of view.

The CSA/IIROC consultation paper excludes the block trading "upstairs market" from consideration for policy changes. We do not see this market as independent from retail trading but part of a continuum. Some retail orders can be larger than institutional block trades and many small orders (retail or institutional) could be exposed to market impact if they did not have access to dealer capital.

The US upstairs market has rapidly evolved and innovated through the development of actionable IOIs and automated Central Risk Book execution for large size orders. Similar developments have been inhibited in Canada due to the application of "definition of a marketplace" in the Marketplace Rules. Policy changes should be considered to boost Canada's competitiveness in the upstairs market.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

We believe that some level of order segmentation is necessary to improve execution quality for certain classes of orders, but if taken to an extreme would harm market quality through excessive fragmentation. We have already seen examples of harmful marketplace innovations in Canada such as multiple medallions, make/take and take/make pricing and speed bumps.

The segmentation of retail orders in the US through wholesaling has been successful in improving immediacy, execution quality and market impact for retail clients. We have seen significant growth in US trading of Canadian equities through both primary US listings and OTC F-class symbols. This erosion of Canadian market share is a concern and is directly related to the inability to segment retail orders in the existing rule framework. Our mission as an industry should be to attract global flows to Canada by providing higher quality execution on Canadian securities than the US market.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

No, Canadian market structure is not optimal for retail orders. We see lower Price Improvement, higher Effective Over Quoted spreads and lower At Or Better percentages on retail orders in the Canadian market than equivalent retail orders in the US.

In terms of traded value, roughly 50% of the Canadian market is interlisted with US primary exchanges and this rises to close to 100% when including the US OTC market. Canada and the US function as a single North American market for equities, which places Canadian market share at risk if our market structure is not competitive with the US.

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

Yes, we believe the competitiveness of the Canadian market can be improved with a dedicated facility for providing liquidity to retail orders, open to all participants to interact with retail flow on a multilateral basis. This model would bring some of the advantages of the US wholesaling model through price improvement, reduced market impact and open competition for retail orders without the disadvantages of bilateral non-public arrangements. Small one-off institutional orders which have similar characteristics as retail flow could also be included in this facility.

We thank the CSA/IIROC for the opportunity to comment on the Consultation Paper and welcome any questions that either CSA or IIROC staff may have.

Respectfully,

<signed digitally>

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GLOBAL BANKING AND MARKETS

Scotiabank

May 31, 2019

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Via Email

Re: Joint CSA/IIROC Consultation Paper 23-406 – Internalization within the Canadian Equity Market

Scotia Capital Inc. appreciates the opportunity to comment on the Joint CSA/IIROC Consultation Paper on the topic of equity order flow internalization. We believe the topic under discussion is central to the functioning of healthy Canadian equity markets. We will respond to most but not all questions posed within the Consultation Paper. Our response should be considered in its entirety, as our responses to some questions will have applicability to other questions.

Question 1: How do you define internalization?

The practice of dealers matching their various sources of flow with each other before exposing those sources of flow to the broader market

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Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Yes. We believe all these attributes are relevant considerations for the purpose of setting regulatory policy.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

We view the effects of internalization on the listed attributes as follows:

Liquidity:

In situations where order flow is internalized among pre-existing client orders with no incremental facilitation capital, the liquidity characteristics of the market *as a whole* are the same whether orders are internalized or otherwise. However, there is an externality which must be considered: orders outside of the dealer internalizing are not able to participate in the trading activity, and from the perspective of those orders, the market becomes less liquid.

In situations where order flow is internalized through facilitation activities of the dealer, the introduction of dealer risk adds to the overall liquidity of the market. However, this incremental addition of liquidity is only available to the order flow being internalized. Participants operating outside the dealer at question will continue to see the market as becoming "less liquid" as they are not able to interact with either the originating (internalized) order or the dealer's risk capital. We therefore believe that liquidity provided to the open market is more valuable to the health of the overall market than liquidity provided through internalization activities.

Immediacy:

For active, liquidity-seeking orders which can be satisfied from resting orders in the market, the practice of internalization does not generally improve immediacy. These orders are indifferent to which counterparties they trade with; a fill in the open, multilateral market is as good as a fill from an internalization mechanism.

The issue of immediacy is frequently conflated with size improvement offered by some internalizers or by retail wholesaling firms. We acknowledge that size and immediacy are linked. However, we believe that the size improvement being made available to internalized orders (in excess of size available in the open market) as "provision of liquidity" rather than an improvement in the immediacy of execution.

We also believe that internalization techniques may improve immediacy for resting orders, as optimization in routing to improve internalization rates among natural flows should result in resting orders being filled faster than through time priority in the marketplace. Additionally,

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internalization techniques may overcome some of the fragmentation-related issues with competing queues across multiple marketplaces, benefitting the resting order. We highlight, however, that this benefit accrues only to orders within the dealer – and as a result the outcome for other orders in the market may be commensurately negative.

Transparency:

The objectives of transparency are generally compatible with internalization practices in an attributed environment. However, we believe that current practices of unattributed (anonymous) broker preferencing on certain marketplaces compromise the transparency objectives of Canada's regulatory framework.

Price Discovery, Fairness and Market Integrity:

We believe that the price discovery mechanism in the market is predicated on maximizing the diversity of participants willing to express their views on security value through visible orders in the marketplace. Other marketplace functions – equity underwriting, block facilitation, non-displayed trading – are reliant on a sufficient diversity of participants and views to ensure that market prices accurately reflect all available information.

The practice of internalization risks compromising this mechanism by imposing an externality on the participants whose order flow is not being internalized. Those participants will face greater difficulties in execution and have weaker incentives to rest orders in the marketplace. Additionally, the removal of natural flow from the multilateral market mechanism can be expected to increase the overall level of toxicity (risk of adverse selection) in the marketplace. In turn, this reduces the incentive for participants to rest visible limit orders in the marketplace and hence promote price discovery.

Additionally, an increase in order flow toxicity would fuel the perception that the market grants unfair advantages to the larger dealers, those with the scale to internalize effectively, to the detriment of smaller and less-sophisticated participants. Perceptions of such harm could be a risk to market integrity, whether warranted or otherwise.

We do not believe this is a purely hypothetical fear: the publication of certain literature related to high frequency trading led to widespread perception that the U.S. market is "rigged" – whether the facts support that argument or otherwise. We believe that it should be a policy objective for Canadian regulation to avoid such perceptions in the future.

Other attributes:

We believe the common thread in the attributes identified above is the breadth and diversity of participants in the open, multi-lateral marketplace. A greater number of independent risk-seeking participants will improve price discovery, add to liquidity, and promote perceptions of fairness in the open market.

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In the context of internalization, the fundamental objective should be to preserve and foster a wide diversity of participation in the open market. If all dealer flow is internalized, then the individual participants whose flow comprises any one dealer's activity are reduced to a single "dealer" source – and diversity is reduced. Therefore, a key consideration in any policy discussion of internalization should be ensuring that a wide mix of types of participants are involved in the open market, including a range of participant sizes, investment objectives, time horizons, trading strategies and intermediary functions.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

We believe the practice of internalization is, fundamentally, an attempt to achieve individual good (either for the dealer or the client) at the expense of the common good.

Consistently with our response above, the practice of internalization imposes an externality on the participants whose flow is not receiving the benefit of greater immediacy of execution or greater incremental risk capital. The opportunity cost to those participants (missed fills, or ultimately worse execution prices) is the cost to the "common good" resulting from this practice, which must be balanced against individual benefit. .

There are several dimension to the "individual good" being sought by dealers who engage in internalization:

- Maximizing interaction among clients leads to being able to charge commissions on both sides of each trade.
- The market risk (directional or otherwise) from being on the other side of client flow may be seen as ultimately profitable.
- Interacting with other participants in the market (i.e. paying take fees or resting on inverted venues) is expensive. As a result, interacting with retail flow at an overall facilitation loss may still be cheaper than executing it outright.

These are all fundamentally economic factors. Internalization is seen as supportive of either higher revenues or lower costs for the parties internalizing order flow. We do not believe this is necessarily a problem in itself: a profit motive is fundamental to capital markets. However, in the context of the "common good" we believe the regulatory question is one of balancing the profit motive of dealers and market-making firms with the overall integrity and quality of the marketplace.

We believe that dealers which handle both sides of any given trade are deserving of the benefits of bringing those buyers and sellers together. By forcing the interaction between these parties to occur on a marketplace, or (worse) forcing those parties to trade with someone other than each other, costs are imposed on both the clients and the dealer. In other words, direct interaction

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among clients of the same dealer is a beneficial outcome. A dealer which can accomplish this should not be penalized through the imposition of additional frictional costs.

The dominant issue of "individual good" is the internalization of retail order flow. This source of activity consists of many diverse participants whose order flow is considered "non-toxic" due to the independence of each investor's decision making from any other investors' decisions. By internalizing this flow, dealers stand to reduce execution costs, increase revenue, or both. In this situation dealers may not be able to maximize client-to-client interaction, but rather would be facilitating retail activity through the use of risk capital. This practice stands to remove an important source of participation in the open market and hence harm the "common good."

We believe that it is important to strike a balance between these factors. Historically, the Canadian market has achieved this balance by mandating that orders at or below a defined threshold (50 board lots and less than $100,000 in value) be immediately exposed to the market. This ensures that many small orders from many independently-acting retail customers are reflected in the open market and supports the "common good." On the other hand, Canadian regulations require all participants to attempt to do their best for their clients, either as dealers offering "best execution" or as investment managers acting on their fiduciary duties by seeking best execution in the market. The result is that each participant is individually motivated to do what's right for them without necessarily being concerned with the "common good."

Notwithstanding the best execution mandate, there are additional measures which (appropriately) place the common good ahead of the individual good. One key example of this is the Order Protection Rule, which prohibits trade-through with the stated policy objective of preserving market integrity and perceptions of fairness. While a particular participant may choose to "trade through" for the purpose of immediacy or considerations of trade size, the common good argument prevents smaller orders from being bypassed. We note, further, that the Order Protection Rule also imposes direct costs on dealers, as protected orders include those on the marketplaces which are most expensive for dealers to interact on. As a result, dealers support the common good through their cost structure.

On balance, however, the strong requirement to seek individual "best execution" is at odds with a marketplace which preserves the "common good." Best execution and fiduciary obligations prompt both investors and dealers to act in a manner which is self-interested. For example, if the common good is served through practices which result in greater information leakage, this will likely be deemed unacceptable for institutional fiduciaries whose duty, first and foremost, is to their investors. Similarly, dealer active routing practices which result in identical fills but which result in a lower fill rates to natural resting orders in the market may be economically desired by the dealer and meet their best execution obligations, but nonetheless not be in the "common good."

If the conclusion is reached that some rebalancing of incentives and participant actions is required, we believe it would be beneficial to also concurrently clarify what is meant by "best execution" in the context of the common good.

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Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

We view broker preferencing as a "compromise" which attempts to balance dealers' incentive to match orders within their channel against the "common good" imperative of representing orders in the open market.

We believe that broker preferencing is an appropriate trade-off in the context of other key components of the Canadian market framework:

- Attribution of orders to the executing dealer.
- The requirement under the Order Exposure Rule to expose small orders to the public markets.
- The generally concentrated nature of participation in the Canadian market

While broker preferencing itself is a reasonable approach to achieving the trade-off between price discovery and the ability of dealers to match their orders together, it bears noting that the benefits of broker preferencing have greatly eroded in a multiple marketplace environment. Order flow fragmentation in the most liquid stocks has resulted in matching quotes across multiple markets, all of which now offer broker priority for fills. As a result, it is not enough for dealers to simply route to "the market" in the knowledge that their resting orders will be able to take advantage of broker priority for a faster fill. Instead, to benefit from broker preferencing dealers are now required to also optimize the specific marketplaces on which they attempt to benefit from broker priority. These "advanced" routing approaches still cannot result in the same benefits of broker preferencing that existed in the past, when the trading environment was more concentrated among a small number of marketplaces.

If one goal of the broker preferencing is to prevent dealers from creating systems designed to optimize intra-dealer order flow interaction, then this goal is inhibited by the fragmented nature of trading. Dealers with multiple independent source of flow are unable to rely on broker preferencing alone, and will therefore seek more direct means of promoting client-to-client interaction.

Additionally, we believe the "spirit" of the broker preferencing compromise lies in allowing pre-existing long-lived orders an opportunity to receive fill priority for interacting within a particular dealer. The modern practice of using short-lived orders to achieve the effect of broker preferencing appears to be at odds with the intent of the mechanism. The use of broker preferencing in this manner presents questions around fairness, and whether a short-lived order is truly "exposed" to the market.

More generally, some participants have expressed the concern that broker preferencing is currently being used to achieve indirectly (through workflows) an outcome which could be done directly.

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We would prefer that rather than relying on indirect workflows, means to achieve the same result without the use of broker preferencing should be sought.

Question 9: ***Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.***

We believe that broker preferencing provides the greatest benefit to those dealers which have a significant amount of active order flow. This does not necessarily need to be a large dealer. Rather, any dealer with a preponderance of active flow and relatively fewer resting orders will see a benefit from broker preferencing.

Large dealers are not necessarily the main beneficiaries of broker preferencing as some dealers have challenges in coordinating order flow from multiple sources and with a diversity of execution considerations. In the context of a fragmented marketplace with significant differences in execution costs, it can be difficult to achieve the coordination required to maximize the benefit of broker preferencing.

Question 10: ***Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?***

We believe the main benefits of broker priority accrue in the most liquid and most widely-quoted equities.

We believe the main determinant of the value of broker preferencing is the degree of fragmentation and the queue length on each marketplace. Thinly-traded equities will typically have less fragmented order books with shallower queues. As a result, the maximum possible amount of "queue jumping" from broker priority is less.

Conversely, liquid stocks tend to exhibit fragmented order books with deep queues. This phenomenon is particularly acute at lower price points, typically in the $1.00-$5.00 price range. In these situations, the market price changes relatively less frequently, quotes are generally deeper and more stable, and as a result it is difficult for resting orders to be filled from time priority alone. In these cases, broker preferencing provides a valuable benefit to resting orders originating at dealers who also have significant active order flow.

Question 11: ***Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?***

We believe that the Marketplace Rules should not preclude dealers from automating workflows which could be done manually, or workflows which have been done manually in the past. This includes developing mechanisms that optimize routine decisions of intentionally crossing client orders which may be fully or partly represented in the marketplace, whether the activity involves facilitation capital or otherwise.

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On the other hand, we believe that mechanisms for holding large numbers of client orders away from the open market, and systematically seeking to find matches within those orders, is outside the scope of what could be done manually by dealer staff. Such systems are more closely aligned with the functions of marketplaces and should be subject to fair access requirements.

We note that while the "upstairs" block market consists of undisplayed trading interest, and dealers do seek to find matches within their network of clients. However, the Canadian "upstairs" block market typically functions on the basis of indications-of-interest and significant negotiation, involving a process for firming up indications and a "last look." Due to the inherent negotiation process involved in the block market, we do not believe it falls within the confines of the marketplace rules and the definition of a marketplace – whether the workflow is optimized through technology or conducted through verbal negotiations and telephones.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

We believe that, other than dealers' desire for natural client-to-client interaction, internalization is closely linked to choosing the segment of order flow which should be internalized (and conversely, the segments which shouldn't). Any internalization strategy involving commitment of capital to near-term trading will seek to interact with some types of flow (typically retail) and avoid others (typically institutional). As a result, we believe that segmentation and internalization are inextricably linked.

The dominant concern around internalization currently relates specifically to the practice of retail internalization, to the detriment of the non-retail community. The issues around "individual good" and "common good" expressed above relate primarily to what is left over if retail flow is removed from the broader market through systematic internalization. The "common good" is harmed if retail flow is cherry-picked away through systematic internalization. Any effort to balance the interests of the retail community against the interests of the "common good" will necessarily require making a determination of what degree of segmentation is appropriate.

Our views do not differ between segmentation achieved through various means. We believe that marketplace features such as retail guaranteed-fill facilities equally damage the "common good" by allowing a select set of participants to cherry-pick the retail flow which supports price discovery in the market. We are specifically concerned that the proliferation of competing guaranteed-fill facilities on multiple marketplaces have the potential to erode market quality in Canada.

We believe that a centralized facility for providing retail participants with "liquidity of last resort" may be a net benefit, on the condition that the design of this facility respects the interests of the market at large. We believe that such a facility should exhibit the following characteristics:

- The facility must offer a competitive means for liquidity providers (including natural investors) to participate.

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- The facility would be available for additional liquidity only after all visible quotes are on all protected marketplaces are displaced.

In other words, a segmented retail-only facility would not be able to "step in front of" existing displayed orders, but would be able to provide size improvement to retail orders when deemed appropriate.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

We believe that the Canadian market structure and existing rule framework provide an appropriate environment for the execution of retail orders. Most discussions of retail execution focus on the use of the U.S. wholesaling model to overcome the costs of execution and offer size improvement. The cost aspect affects dealers more than it affect retail clients, whereas size improvement can be seen as incremental liquidity for retail customers

We believe that retail investors benefit from the overall Canadian equity market structure, including their contribution to price discovery. We therefore believe that regulatory decisions designed specifically to benefit retail investors must be taken very carefully. Such decisions would inevitably create a tradeoff between the "individual good" of the retail dealers and the "common good" of the market as a whole. Retail clients and their outcomes are part of the "common good" we seek to protect. Therefore, a regulatory outcome which favours retail at the cost of the "common good" could also do long-term harm to the very constituency which is intended to be helped.

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

We are concerned that a two-tier structure, with specific measures for retail, will result in an environment with unintended consequences. Such a rule structure will favour a specific constituency's individual good against the broader considerations for the "common good."

To achieve better balance, we believe that certain specific adjustments to current practices are warranted. These include:

- The elimination of marketplace fee structures which discriminate on the basis of the type of counterparty.
- Introduction on specific limitations on exchange-operated guaranteed-fill facilities for retail customers – such as the framework described above.

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- Re-examining the thresholds for order exposure to ensure that the price discovery mechanism in Canada is preserved.

We believe the rule framework should avoid discriminating based on the nature of participants. We do not believe it is appropriate to distinguish retail investors from institutional, or tailor rules on the basis of whether an order is marked as "client" or "principal." Rather, we favour a structure where all orders of a similar characteristic (such as size) are treated similarly.

Question 15: Are there other relevant areas that should be considered in the scope of our review?

Dealer internalization, particularly of retail flow, is closely linked to the cost of execution in the open market. The practice of make-take pricing on some markets, and inverted pricing on others, creates significant incentives for dealers to match flow away from the broader markets and report to the market through intentional crosses.

Our view is that the fragmentation of flow through differential fee structures is at the core of the internalization debate. Notwithstanding the efficiency benefits of matching orders intra-dealer, the incentive to internalize as a cost-management strategy would be significantly diminished in an environment where the cost of execution in the open market is reduced. As a result, we do not believe that the practice of internalization can be considered without adequately addressing the cost of trading and the externalities of make-take pricing.

For further clarity, regulatory actions which increases the requirements for participants to pursue the "common good" at the expense of their individual economics will result in a greater incentive to find ways to manage costs.

We believe an optimal outcome for the Canadian market is an environment where all participants are able to balance off their own interest with the interest of the "common good." A holistic solution would require addressing all aspects of this complex issue. These include:

- The need to preserve and foster price discovery and liquidity.
- The incentive of dealers to route in a manner which allows them to maximize fills among clients.
- The requirement by all participants to seek best execution for their clients, which may result in outcomes which favour the "individual good" over the "common good."
- The cost of execution in the open market, including all associated costs (marketplace membership, market data, connectivity charges, etc.).

As Canadian market participants, we believe we all collectively have a shared duty to contribute to the greater whole.

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We appreciate the opportunity to comment on this important matter.

Respectfully,

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May 31, 2019

VIA EMAIL

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Ontario Securities Commission
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Financial and Consumer Services Commission, New Brunswick
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Nova Scotia Securities Commission
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Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*

TMX Group Limited ("**TMX**" or "**we**") welcomes the opportunity to comment on behalf of its subsidiaries TSX Inc. ("**TSX**"), TSX Venture Exchange Inc. ("**TSXV**"), and Alpha Exchange Inc. ("**TSX Alpha**"), on the joint consultation paper published for comment by the Canadian Securities Administrators ("**CSA**") and Investment Industry Regulatory Organization of Canada ("**IIROC**") on March 12, 2019 titled "*Internalization within the Canadian Equity Market*" (the "**Consultation Paper**").

For purposes of this letter, all capitalized terms and terms otherwise defined in the Consultation Paper have the same meaning as set out in the Consultation Paper, unless otherwise defined in this letter.

Summary of TMX position

We commend the CSA on its ongoing efforts to examine potential issues regarding internalization, with the objective of protecting investors and fostering fair and efficient capital markets. We also express our appreciation for the thought and effort put into the Consultation Paper. The issues it covers are broad and complex, and the Consultation Paper outlined and framed them well.

We are supportive of the principles and rules underlying the Canadian regulatory framework that help to maximize the opportunities for orders to interact on Canada's public transparent markets, and would generally caution against mechanisms that prohibit or unduly restrict those opportunities to avoid adverse consequences for transparency, liquidity, price discovery, liquidity, and market integrity.

However, it is also necessary to maintain an appropriate balance in recognition of the fact that the markets are comprised of a diverse set of participants with varying needs, and that the market structure envisioned through the general principles and rules cannot accommodate all needs. This has led to market models, features and functionalities designed to service those varied needs, and may have also led participants to seek their balance through other means. While those being serviced under these models might benefit, the outcomes might not always contribute to 'the common good'.

In order to achieve and restore a better balance, we are therefore recommending that certain lines be drawn in the context of internalization and segmentation that will help to constrain the potential for harm, while continuing to recognize the need for flexibility in light of the varied needs and interests of those that participate in our markets. Our recommended actions are identified below and explained further in this letter.

a) Strengthen the existing framework to ensure that small orders are exposed to the market and cannot be easily internalized by addressing shortcomings in the UMIR 'large' size threshold.

b) Address concerns about systematic matching of orders by dealers through additional guidance in the context of the regulatory definition of a 'marketplace'.
c) Revoke recent approvals for guaranteed fill facilities that have resulted in the creation of 'one-to-many' retail segmentation models, except where part of a formal market making program operated by the listing exchange for its listed securities.
d) Cap active rebates for inverted markets to address industry concerns about the effect of the recent escalation in rebate levels on segmentation of retail order flow.

Internalization and segmentation

In our view, internalization and segmentation are intertwined and should be considered together based on commonalities in terms of outcomes, and how those outcomes might affect certain key principles that frame our market structure.

This view and the positions reflected in the letter below are influenced by our definition of internalization and its relation to segmentation. In our eyes, internalization is the outcome of the intent and deliberate actions of a dealer to match two of its orders against each other, regardless of whether that outcome is achieved on- or off-market. It also involves the restricting or minimizing of the exposure of those two orders to the market (i.e., to any other dealer or their clients) so that the desired outcome is achieved. By that definition, internalization is also segmentation in that it results in the segmenting of the internalizing dealer's orders away from the broader market.

While segmentation is broader than internalization, there are forms of segmentation that are similar to internalization in terms of outcomes. This is true where the mechanism or model that facilitates segmentation prevents other participants from accessing the segmented flow. For example - marketplace models or functionality that only allow access to certain participant types. It is these more prohibitive mechanisms that create potential issues in the context of the general principles that govern our market structure.

General principles

The rules and principles that define market structure in Canada have, for the most part, been designed to facilitate the accessibility and transparency of orders in order to promote the broadest degree of participation and thereby support liquidity and the efficiency of the price discovery process.

As the primary listing exchange in Canada and an operator of three trading venues that facilitate the secondary trading of our issuers' securities, we consider liquidity and the efficiency of the price discovery process to be paramount. To that end, we are supportive of the principles and rules underlying the Canadian regulatory framework that help to maximize the opportunities for orders to interact on public, transparent markets, and would generally caution against mechanisms that prohibit or unduly restrict those opportunities on the basis of the general sentiment that Canada's market is not large enough to support these types of mechanisms *en masse* without adverse consequences for transparency, price discovery, liquidity, and market integrity.

This is particularly true as it relates to retail order flow given that retail orders represent a significant proportion of traded volume in Canada - as much 20%-25% of the traded volume as suggested by previous IIROC studies.[1] Retail participation is important for our market in terms of their willingness to continue to contribute to price discovery and liquidity through their posted limit orders, particularly for the less-liquid and more speculative stock of our junior issuers. Retail participation is also important because retail volume is more often liquidity taking,[2] and there is value placed on interacting with this order flow on the basis of it being considered to most likely be non-directional (or ‘uninformed’). Allowing for broad participation against this order flow also promotes price discovery and liquidity by those seeking to interact against that volume - whether institutional clients and their dealer agents seeking to minimize adverse selection costs, or proprietary market makers (dealer or non-dealer) seeking to capture the spread.

We should therefore be particularly cautious about mechanisms that prohibit or unduly restrict access to retail order flow. We believe the general market sentiment is that the level and nature of the internalization and segmentation being undertaken via US equity market structure is beyond the limits of what is acceptable for Canada. This is similarly a function of concerns about the ability for the smaller Canadian market to accommodate the impact of a mass siphoning of retail orders from the market.

The need for balance

At the same time, it is important to recognize that internalization and segmentation can be a mechanism to defray costs to dealer and client business models and avoid impacts to execution outcomes that arise from transacting in a market structure that has arisen from those same general principles.

Participant needs and the resulting competition amongst marketplaces to service those needs also play a role. Marketplace mechanisms that might contribute to the segmentation of order flow (whether retail or otherwise) arise because the market is diverse in terms of participant types and their needs. Marketplaces are incented to seek means to service the unique needs of its diverse client base in order to (a) provide options and choice, (b) provide value to clients and (c) compete with each other by attracting the business of those clients. The result is the level of differentiated offerings that we see today, which go beyond those that might contribute to the segmentation of retail - take for example marketplaces and marketplace functionality designed specifically for or limited to use by institutional client orders.

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[1] See Table 12 of IIROC’s 2014 paper on trader category classification (http://www.iiroc.ca/Documents/2014/169edd4f-15e6-4330-8cb5-2c31e8f2bf82_en.pdf#search=trading%20groups%20methodology) that estimates retail at about 25% of volume, and Table 2 of the joint IIROC / Bank of Canada study on the Alpha speedbump from 2018 (http://www.iiroc.ca/Documents/2018/25d5b306-3420-43cc-b260-a1527b82bfc3_en.pdf) that estimates it at about 23%.

[2] See Table 14 of IIROC’s 2014 paper on trader classification (http://www.iiroc.ca/Documents/2014/169edd4f-15e6-4330-8cb5-2c31e8f2bf82_en.pdf#search=trading%20groups%20methodology).

When considering actions to restrict or limit internalization and segmentation, regulators need to recognize that the effect of any restrictions and limitations could be increased costs (or at least reduced ability to manage costs), reduced competition, and reduced flexibility for both dealers and marketplace to service their clients' needs. We believe these outcomes are also not desirable, nor are they consistent with regulators' general mandate to foster efficient markets (which also necessitates fostering competition).

Any actions should therefore seek to strike an appropriate balance between the desire to ensure accessibility and transparency of orders to promote the broadest degree of participation, and the objective of promoting efficient and competitive markets by allowing for continued differentiation of marketplace services to recognize that orders, the clients they belong to and the dealers that send them have different needs.

The need for a line (or lines) to be drawn

With that being said, it is our view that certain forms of internalization and segmentation run contrary to the general principles and if allowed to expand would most likely have negative effects for transparency, price discovery, liquidity and market integrity. There is therefore a need for a line (or lines) to be drawn. There are a number of more direct actions that regulators could take in order to draw these lines and reduce the extent of internalization and segmentation, or at least restrict the extent to which internalization and segmentation can expand. These are outlined below:

a) Strengthen the existing framework to ensure that small orders are exposed to the market and cannot be easily internalized

Rules are already generally in place to help facilitate this outcome, but would be bolstered by some needed updating of the current UMIR large size threshold applicable to rules governing order exposure and client-principal trading.[3]

As has already been acknowledged by IIROC in connection with recent proposed amendments to its dark rules,[4] the effectiveness of the existing 50 standard trading unit threshold as a proxy for large orders can vary significantly depending on a security's price level. As a result, it can allow for internalization of orders that should not otherwise qualify for exceptions from requirements for the internalized order to be provided with a better price.

We are supportive of IIROC continuing with its ongoing review of the various 'large-size' exceptions contained in UMIR. As part of this, we would also suggest that it may be worthwhile to consider adoption of a threshold based on value only, although additional research may be

[3] See UMIR 6.3 and 8.1 which establish the 'large' size threshold for the purposes of those rules as an order that is greater than either: (a) 50 standard trading units or (b) $100,000 in value.
[4] See IIROC Rules Notice 18-0231 *Proposed Amendments Respecting Provision of Price Improvement by a Dark Order* at http://www.iiroc.ca/Documents/2018/b6fb9bd9-c7fd-4251-97e8-9dacddee45e8_en.pdf.

needed to determine whether the long-standing $100,000 threshold continues to be a relevant proxy for a 'large' order.

b) Address concerns about systematic matching of orders by dealers through additional guidance

We believe that a dealer that is internalizing orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules. We also believe that if a dealer has, as is suggested in the Consultation Paper, implemented technology or processes to pre-match orders that can then be 'internalized' on-market with a high-degree of certainty, then the dealer should also likely be considered to be operating a marketplace. What is important here is the deliberate attempt to achieve the outcome (i.e., the internalized trade), regardless of whether that outcome is achieved on- or off-market.

We believe the general sentiment of many in the industry is that if (a) these practices are in fact currently being undertaken and (b) adoption was allowed to continue, then there will likely be negative impacts for transparency, price discovery, liquidity and for perceptions of market integrity (i.e., confidence). There will also be negative impacts in terms of competition between those that have the technological capabilities and the breadth and depth of order flow to make such endeavours profitable to undertake (i.e., large brokers) vs. those that don't (i.e., small brokers).

We believe that guidance of this sort is needed not only to avoid the above impacts, but also to ensure that rules like fair access that govern how marketplaces must operate will similarly apply to what should otherwise be considered a marketplace operated within a dealer's internal systems.

It is also our view that without such guidance being provided, systematic pre-matching of orders could still be undertaken by dealers where the provision of price improvement is not a material factor for the liquidity providing side of the trade - for example, where the to-be-internalized order is retail and the liquidity providing side of the trade is dealer inventory or a held client's position.

c) Revoke recent approvals for guaranteed fill facilities, except where part of a formal market making program operated by the listing exchange for its listed securities

We believe that recent approvals of guaranteed fill facilities that are similar to the TSX's Minimum Guaranteed Fill (MGF) facility should not have been granted. These types of facilities should only be permitted where part of a formal market making program operated by a listing exchange, and where the eligible securities for the facility are limited to the listings of that exchange.

Allowing other exchanges to operate these facilities under the guise of a market making program on securities the exchange does not list represents explicit segmentation via a one-to-many trading model where the 'one' represents proprietary trading interests and the 'many' is primarily retail order flow. While the argument could be made that the TSX's MGF facility is no different, it is important to consider the intent of these facilities when operated by the listing exchange and the differences in terms of practical outcomes.

TSX has a responsibility to its issuers to promote a vibrant and healthy secondary trading environment. The TSX market making program and the obligations of TSX Market Makers under that program to provide investors with guaranteed fills via the MGF, when there is insufficient liquidity in the CLOB, is meant to help TSX fulfill that responsibility. Other exchanges that operate these facilities for TSX-listeds have no such responsibilities, which begs the question - what objective do these other guaranteed facilities fulfil?

In addition, considering that liquidity in Canada has tended to concentrate on the primary exchange (whether for TSX-listed securities, CSE-listed securities or Aequitas-listed securities), it makes it more likely that the lack of depth at the quote on a non-primary exchange will help to ensure that its guaranteed fill facility will be accessed. The result is then the conferring of benefit upon the liquidity provider that is supporting the facility at the expense of displayed orders on other markets (including the many ‘natural’ orders displayed on the primary exchange) that were denied the opportunity to interact with what was likely to have been a small-sized non-directional retail order.

We therefore believe that revoking, or amending approvals for these other facilities to limit their applicability to the listed securities of the offering exchange, is appropriate as it would eliminate a form of explicit segmentation that is not otherwise justified in the context of fair and efficient markets, and would remove the potential for harm to transparency, price discovery, liquidity and market integrity if volumes within these facilities were to grow.

d) Cap active rebates for inverted markets

It is our belief that a certain amount of industry concern around segmentation arises from the potential for inverted fee models to segment cost-sensitive retail active order flow (which receives a rebate) away from ‘natural’ resting orders that might also be sensitive to paying fees to post (despite best execution obligations of the dealers managing these orders).

The recent escalation in rebate levels amongst inverted markets has brought these concerns to the forefront. We appreciate these concerns and acknowledge that TSX Alpha Exchange has also played a role in the recent escalation.

As marketplace operators, we compete and will continue to compete for order flow. So will our competitors. As a result, we expect that a further escalation of inverted active rebates is possible considering that it is not clear that the maximum level for the contra-side posting fees has yet been found beyond which passive liquidity provision would be negatively affected. Regardless, we acknowledge that various participants are concerned with the continued escalation and the associated costs that many perceive as creating a barrier for ‘natural’ orders to access the segmented active order flow.

We therefore believe that it may now be time to consider the application of a cap on active rebates to help address these concerns.

Our proposal is to set the cap for active rebates at a level that is reasonably reflective of active rebate levels prior to the most recent competitive escalation - i.e., within a range of $0.0010 to $0.0017 per share. Setting it at this level would help to better balance between the cost reduction benefits of active rebates for ‘natural’ liquidity taking order flow against the costs for ‘natural’ liquidity providing orders to participate against that flow. It would also continue to allow marketplaces a reasonable degree of room to compete and continue to provide differentiated offerings to its diverse client base.

If the implementation of a cap via regulation cannot be achieved within a reasonable timeframe, we plan to take the lead by calling together all marketplaces to discuss voluntary approaches to address the concerns.

Where caution is needed

In our view, the four specific recommended areas of action that we have outlined above would help to address industry concerns while in some cases placing limits on the extent to which internalization and segmentation can further expand. They also all generally relate to more recent phenomena that have contributed to the current levels of industry concern, and to a certain extent would help to reset market structure to its state prior to the recent events that had led to the Consultation Paper. As a result, we suggest that our recommended actions present a viable means to help towards addressing the concerns while minimizing overall risk.

We would generally caution against changes that would materially affect long-standing practices or mechanics within the market structure if such changes can be avoided. Included in this are changes that some are suggesting be made to broker preferencing – ranging from the imposition of limitations on when broker preferencing can apply to an outright prohibition. Either will impose unnecessary costs and the related complexity that would accompany such change, while removing or neutralizing a mechanism that has historically acted as a trade-off to the costs and inefficiencies that results from a market structure in Canada that forces retail orders to execute on-market (as opposed to off-market as is more typically the case in the US). If broker preferencing was removed, it would also create incentives for dealers to find other means to internalize their orders, or other means by which to achieve similar outcomes which could include executing their orders away from the Canadian public markets.

In our view, the need for changes to broker preferencing would be unnecessary if regulators were to implement our recommendations to provide additional guidance on systematic pre-matching of orders by dealers, and make needed changes to UMIR to update what is meant by ‘large’ size for rules governing order exposure and client-principal trading. The result would be that dealers’ ability to leverage broker preferencing to effectively and deliberately internalize orders would be greatly diminished, while allowing dealers to continue to obtain some of the benefits of internalization but subject to the controls of a mechanism that should under normal circumstances impose a structural limit on the total amount of on-market internalization that can actually take place.

Before considering any change to broker preferencing, it should also be recognized that the current levels of broker preferencing are likely not sufficient to lead to issues affecting price discovery, liquidity and market integrity that would necessitate and justify a change. As reflected in the Consultation Paper, broker preferencing is currently only 7% of volume, 5% of value and 5.5% of trades.[5] Further, the published rates may be overstated if measured on a trade-by-trade basis (as was the case for the stats provided to the regulators by TSX, TSXV and TSX Alpha which were based on trade flags applied at each individual trade). When reviewing executions on our three venues and excluding trades flagged as having been broker preferenced that would have traded against the incoming order regardless,[6] we found that flagged broker preferencing rates across the three venues might be considered by some to be inflated by about 10% - 15%.[7]

Taking action on broker preferencing would also do nothing to address industry concerns if dealers are allowed to systematically pre-match orders, including those that are small despite being considered 'large' under UMIR, and then effect the internalized trades with a high degree of certainty on low-volume marketplaces or marketplaces that the dealer has set up or sponsored to help it achieve that result.

We therefore suggest regulators' efforts would be better focused on imposing a framework to address concerns regarding internalization further up the order life cycle, as would be achieved through our recommendations to more clearly restrict the systematic pre-matching of orders by dealers and to clarify what is 'large' for the purposes of order exposure and client-principal trading requirements. We also urge the regulators to take the additional steps we have recommended to prevent further internalization and segmentation by limiting certain types of guaranteed fill facilities and implementing a cap on active rebate levels for inverted markets.

Thank you for the opportunity to comment. We would be pleased to discuss any aspect of these matters at your convenience.

Yours truly,

"Kevin Sampson"

Kevin Sampson
President, Equity Trading
TMX Group Limited

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[5] Based on Figures 4-6 in Part 2 of Appendix A to the Consultation Paper.

[6] For example, consider a scenario where there are two resting buy orders in the book at $10.00, each 100 shares in size, with the first in time priority belonging to Broker A and the second belonging to Broker B. If a 200 share sell order from Broker B comes in priced at $10.00, the result will be that the resting order from Broker B will be broker preferenced and jump over the Broker A order to trade first, followed by the trade against the Broker A order. When measured on a trade-by-trade basis, the preferencing of the Broker B resting order is considered to be an instance of broker preferencing. However, given that both orders would have traded regardless, its inclusion may overstate the extent of the volume identified as having benefited from broker preferencing.

[7] Based on Q1 2019.

By Email

May 31, 2019

To:

Investment Industry Regulatory Organization of Canada
British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Service NL (Newfoundland and Labrador)
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

Care of:

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Me Anne-Marie Beaudoin
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Consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23 – 406, Internalization within the Canadian Equity Market

Thank you for the opportunity to comment on your internalization analysis.

As a general principle, internalization activities run contrary to the public interest. Invariably they involve some overt or covert scheme to strip a key element of the reward (price and time fulfillment prioritization) due a participant contributing to the price discovery process and to redirect same to the exclusive benefit of another, non-contributing participant. Allowing such activity erodes the incentive to contribute, thus undermining the collective interest.

Unlike their American counterparts, the Canadian securities regulators have, for the most part, recognized this fundamental principle and have therefore barred most internalization efforts. There have been a few notable exemptions: broker preferencing (which overrides time, but not price, priority) and pegging (typically embedded dark order functionality that is, at its core, parasitic to the price discovery process and which becomes outright insidious when mid-point applications are permitted). Historically, the former was a concession to the dominant brokers when the matching process became computerized. The evolution to multiple trading markets has substantially mitigated the negative impact of this exemption, as time priority is unrealistic across markets at the consolidated level. The latter remains a serious outstanding issue and the inconsistency of permitting trading inside the otherwise minimum trading increments for this specific type of activity is ironically providing an inducement for negative activity. This oversight should probably be addressed in keeping with the goal of promoting fair and efficient markets.

There has emerged, over the last year and a half, a communal consensus that various participants have possibly developed schemes to essentially replicate internalization outcomes while ostensibly staying within the letter of the law. Markets have been persuaded, for a capped monthly fee, to offer virtually unlimited unintentional crossing facilities for what are otherwise typically retail sized orders and participants have, allegedly, devised execution strategies that capitalize on recently introduced kinks in the order protection rules and/or that may also take advantage of latency differentials within their various order handling and execution systems in order to markedly increase their level of unintentional crosses. Other initiatives are not necessarily reliant on the “intentional” unintentional cross gambit. Some apparently rely on using broker preferencing, often on the less active marketplaces, to essentially capture all or much of their offsetting client flows. The specific mechanics will be left for those more capable to describe in detail. However, for our immediate purposes, this analysis will stay focused on the basic underlying principles.

Complementary to asking how, it is submitted that we should also perhaps focus on why. Schemes and strategies will constantly evolve to work within rules and prescriptive guidelines. It might prove more productive to understand how participants are incented to pursue such approaches so that we can understand their fundamental motivations and thus concern ourselves with addressing the core incentives encouraging such untoward activities.

In a nutshell: follow the money. Participants pursue internalization because it will benefit them at the expense of others. So, how big are these advantages and are there ways to reduce these incentives? The answers are, respectively, significant and yes.

At its core, internalization activities arise because we have a regulator mandated minimum trading increment (one cent per share for stocks trading above $1 and half a cent for those trading below $1). Participants have come to realize that, if they structure their processes accordingly, they can execute their clients’ orders in compliance with their best execution obligations while retaining all, or a significant portion, of the mandated bid ask spread for themselves. It may seem inconsequential to be discussing something as small as a penny a share but, given the volumes being traded, there is a lot of money involved. Past analysis of just the Canadian markets has suggested that the regulator imposed minimum bid ask spread often results in investors forsaking as much as $100 million a month through reduced sales proceeds or inflated purchase prices. That is money that internalizing participants are incented to retain for their benefit.

To understand these calculations directly, take the total monthly trading volumes in Canada for shares priced above and below $1. Subtract all institutional blocks being crossed. Then assume that all trading occurred at the tightest bid ask spread permitted and multiply the remaining number of shares by the applicable minimum trading increment. Further assume that (70)% of all trades were in the naturally highly liquid securities typically trading at the minimum bid ask spread. In reality, many bid ask spreads will have actually been much wider because the inherent liquidity of the stocks in question, or the prevailing market risks in general, dictated that liquidity providers required a bigger inducement to provide the market support that benefitted investors. That would result in a greater collective monthly implicit cost, although the regulator mandated portion would not increase. That latter component will vary according to the percentage of trades consummated when the bid ask spread was at the minimum. Presumably IIROC and others will have that level of granular detail at hand and in short order more refined analysis will be available. Regardless, the main point here is that the amount of money available for internalizers is very significant.

The question then becomes: can we remove these incentives and what will be the impact? The immediate answer is fairly straightforward, we can either reduce or eliminate the minimum trading increment. Investors will be huge beneficiaries. However, some intermediaries will likely be less happy. A quick review of these specific dynamics might be in order.

Some dealers feel incented to find ways that they can still meet the obligation to provide best execution (here typically viewed as price) for their clients while, either directly or indirectly, causing their clients' order not to be exposed and thus not contributing as a public good to the open market. Instead, they would like to keep that information quiet, for the exclusive benefit of themselves and/or their associates. At its core, internalization is just a tool to extract the bid ask spread for the intermediaries, to the detriment of all other contributing participants. In some versions, the further irony is that they will use the tools of the dark market and the insidious pegging to facilitate stripping and utilizing the very informational public good that they are dishonouring in the process.

Generally, for the naturally very liquid securities (which usually collectively constitute a significant majority of the daily trading volumes in Canada), minimum trading increments create minimum bid ask spreads, which in turn translate into increased transition costs for investors. They are either receiving less for the sale and/or paying more for the purchase of the securities being traded. Ideally, investors would be best served if the bids and offers for any given stock were identical. There would be no implicit transition cost in the pricing. Historically, liquidity providers demanded wider spreads to compensate for the risks they assume when calling two sided markets. Over time, as volumes rose, investors demanded a reduction in the minimum spread and, over stages, regulators agreed. What was once a 25 cents spread is now a penny. As a rule, when spreads collapsed, liquidity increased and ultimately everyone won, although some may have taken time to realize or admit that.

The prevalence of mid-point pegging and inverted markets clearly tells us that, for many of the more inherently liquid securities, the current minimum trading increments are too wide. When liquidity providers are willing to pay maker fees on both sides of a trade in order to make the one cent spread, then we know that our regulatory model needs updating.

Liquidity providers adapt to market and pricing changes almost instantaneously and will continue to offer their services only if they stand to make a profit, net of all costs and risks. They have consistently proven resilient to change and so will likely just adapt and carry on. They will offer spreads (possibly none if the provision fees are sufficient) that reflect the risks of each security at the time in question. Dynamic market forces will provide the lowest possible transition costs to investors with no artificially imposed minimum spreads where none are otherwise required.

From experience we see that reduced spreads result in greater volumes and improved liquidity. Investors (both retail and institutional) will stand to gain accordingly.

The issue, as has often been the case, will be with the intermediaries. For stocks where the spread collapses entirely, inverted pricing will likely not be available. Dealers will thus no longer be able to receive payment for directing their clients' market orders to inverted markets in such instances. As they have not been under any requirements to forward such payments to their clients, it is reasonable to expect pushback from this stakeholder group. The obvious solution will be for them to adopt a practice of properly passing through the fees and rebates associated with fulfilling their clients' orders. This should possibly include all gains realized from internalization practices or processes. Such a requirement would likely result in all such initiatives being terminated as dealers would no longer have any upside to pursuing internalization strategies.

Investors will be ahead in this scenario as the gains from a reduced spread should outweigh the passed through costs, if any. In fairness to the dealer community, they might benefit from having such a cost and benefit flow through policy mandated by regulation. That way, all will have to comply and no one dealer will feel adversely prejudiced by otherwise being an early adopter of the more efficient pricing practices.

Perhaps this is all easier said than done, but it is the right direction and something that for some time many readers have known needs addressing.

These observations and comments are offered solely with the objective of making our markets as efficient, transparent and fair as possible. Hopefully that will in turn contribute to making Canada the global leader in market structure policies and regulations, as I believe we should be.

Thank you,

Ian Bandeen

Co-founder of the Canadian Securitization markets and past Global Head of Securitization and Structured Finance at BMO Nesbitt Burns
Co-founder and past Chair and CEO of CNSX Markets Inc, operator of the Canadian Securities Exchange
Co-founder and Chair Emeritus, National Angel Capital Organization

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Internalization Commentary May 2019

We would like to thank IIROC for delving into this issue which we consider to be of critical importance to the health and future viability of the Canadian Marketplace. We appreciate the opportunity to provide commentary on this subject as we see it.

Independent Trading Group (ITG) Inc. has been providing Liquidity to ALL market participants on a constant and consistent basis for over 20 years. We feel particularly qualified to comment on this subject and on the overall health of the Canadian Market.

For the purpose of this Consultation, we consider Internalization to mean any order captured and crossed before exposure to the marketplace, for any benefit of the broker delivering the order. Either Direct (spread capture) or Indirect (cost savings). Broker Preferencing is one mechanism which allows this behavior to take place. Based on our status of providing liquidity to ALL market participants, we feel this practice is insidious as it deprives already posted orders, waiting in queue, of the ability to receive a fill. Price discovery is compromised by this practice. And a competitive market is circumvented, to the detriment of ALL Market Participants. Broker Preferencing has become the thin edge of the wedge for some to firms to promote more systematic internalization. We believe it is time to go back to the basics. The simple process of posting an order, is of critical importance to the proper functioning of markets. In our opinion, intercepting any order before it is exposed to a Marketplace contradicts all of the tenets of a fair and open Marketplace. Dark orders are traded through. Posted orders are deprived of a fill and are not rewarded for taking the risk of posting a market. It becomes a question of risk. Market Participants, especially those with Marketplace Obligations, are taking a risk posting markets; for the benefit of ALL Participants. If this risk is not rewarded, or worse taken advantage of by using it as a pricing mechanism, with no reward of a fill, fewer and fewer orders will be posted. The result is less commitment to posting orders in the lit book, depriving ALL Participants of liquidity. Posting orders in the dark markets to offer price improvement to all participants, and not act as a pricing mechanism for Internalizers, is not desirable as it diminishes the depth of the lit book. Creating an order to take advantage of an order via broker preferencing is particularly harmful and contrary to the spirit of the Trading Rules. We feel this is abusive behavior, taking advantage of the handling brokers place in the price discovery mechanism, and is a violation of the spirit of Trading Rules. Market Quality must continue to be a concern, and needs to be protected by the Regulators, as market share of Canadian stocks trading in Canada continues to erode.

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We would like to take this opportunity to dispel some erroneous notions.

- Price Improvement justifies queue jumping. Dark orders are essentially lit orders that have been chased from the lit market in order to counter the effects of Internalizing and Broker Preferencing. This indicates that current minimum tick requirements for price improvement is not enough of a threshold to justify queue jumping. A one cent improvement, often times significantly less than that with dark fills, is too low a threshold as it disenfranchises posted orders and trades through dark orders.

- Clients want a fast fill. If one explained to clients the cost of expediency vs more balanced liquidity results in their forgone revenue collectively, over time clients may prefer the benefit of market prices vs a fast fill. Opening the door to internalization will not give them this choice.

- Costs will increase. Internalization and Broker Preferencing reduces competition among brokers and acts as a barricade to new entrants looking to trade our market. We feel strongly that the cost involved in maintaining a robust, healthy and relevant Canadian Capital Market must be considered against the cost savings of particular dealers implementing internalization systems in their sole self-interest.

Internalizers suggest they enhance liquidity. As Market Makers, we understand our obligation is to provide liquidity to ALL participants. At all times. Internalizers only take advantage of orders they are certain they can unwind at a profit. Any order with a modicum of risk attached, is released to the market. They are liquidity providers at their convenience. And non-desirable orders are turned over to a liquidity depleted Book.

Solutions? No longer can an order be created to take advantage of an incoming client order. If the Internalizing firm has an already existing client order in the book - to be determined by a previously resting time threshold - it may cross a portion of the order. Part of the order should trade with orders that establish the price, part should trade with the market maker, and part should trade with better priced dark orders. This would bring back meaning and integrity to the market. A truly competitive market. Orders would be more willing to be disclosed if they would receive some reward for the risk they have assumed, by participating in the price discovery mechanism.

There is a definite divide between large firms and small firms on this issue. It is imperative that the Regulators take ownership of this issue and create a framework that Makes the Market Matter for the long-term benefit of all Investors. For Internalizers to suggest they would seek out alternate arrangements to crossing flow is disingenuous. Taken further, why even bother having a Capital Market in this Country. A series of crossing networks would suffice according to some Participants.

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The Independent Dealers play a critical role in capital formation and risk assumption for all but the largest corporate entities in this Country. To exclude these Dealers and their intellectual property from the price discovery mechanism is a huge mistake and threatens the very existence of the Capital Markets in this country.

Ultimately, Making the Market Matter must be the primary concern of the Regulators. The integrity of the Marketplace must be defended. If not, it is very likely we will not have a relevant Capital Market in this country. And that cost would be too great for ALL Participants to pay.

We would be happy to discuss this topic further, please do not hesitate to contact us.

BMO Capital Markets

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May 31, 2019

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Autorité des marchés financiers
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Nova Scotia Securities Commission
Superintendent of Securities, Department of Service NL, Provincial Government of Newfoundland and Labrador
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Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the Consultation Paper)

BMO Capital Markets would like to thank the Canadian Securities Administrators (the CSA) and the Investment Industry Regulatory Organization of Canada (IIROC) for this opportunity to comment on the Consultation Paper. We think this consultation raises important issues for the industry and how clients' interests are best served.

BMO supports the advantages accruing to investors through the availability of broker preferencing in Canada. We advocates for measures that reduce unnecessary trade intermediation in favor of internalization that results in reduced costs and better execution quality for client orders which at the same time serves to maintain market integrity, transparency, liquidity and fairness.

We think it is helpful to begin this comment letter by providing some historical data with respect to internalization rates in the Canadian equities market.

On the surface, internalization rates have been on the rise.

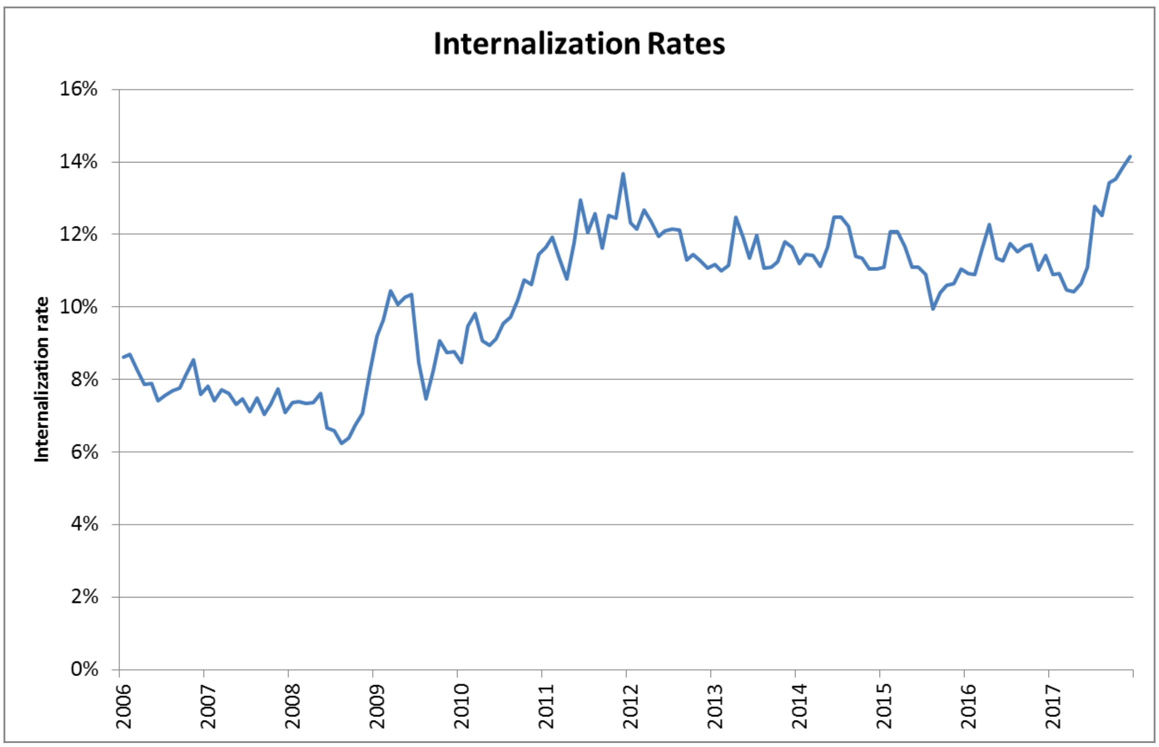
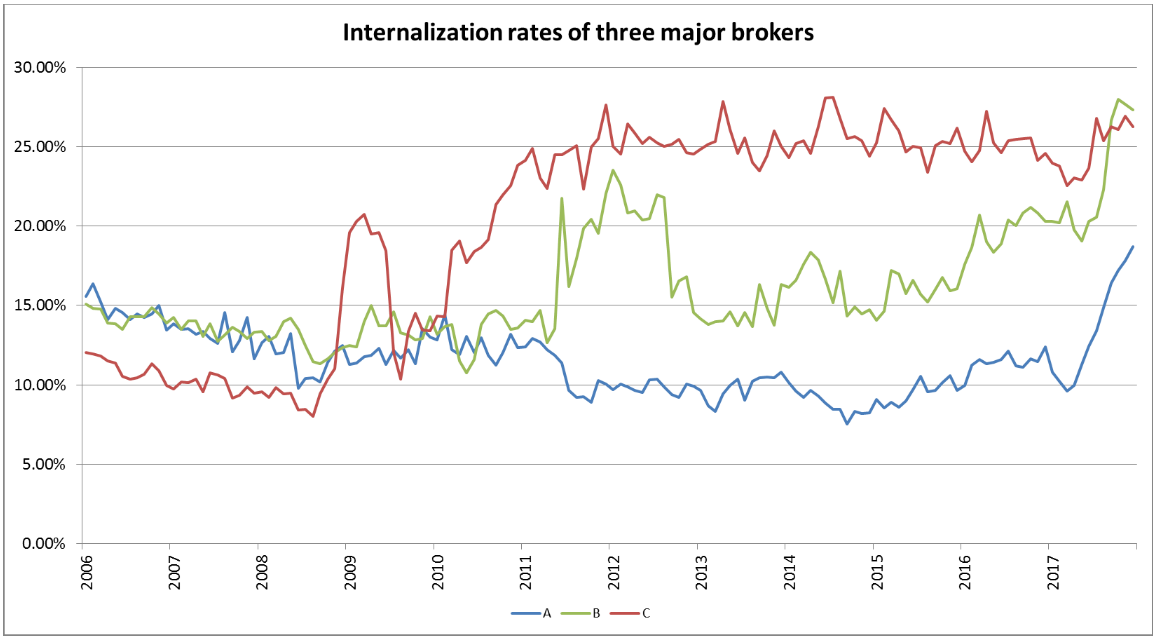
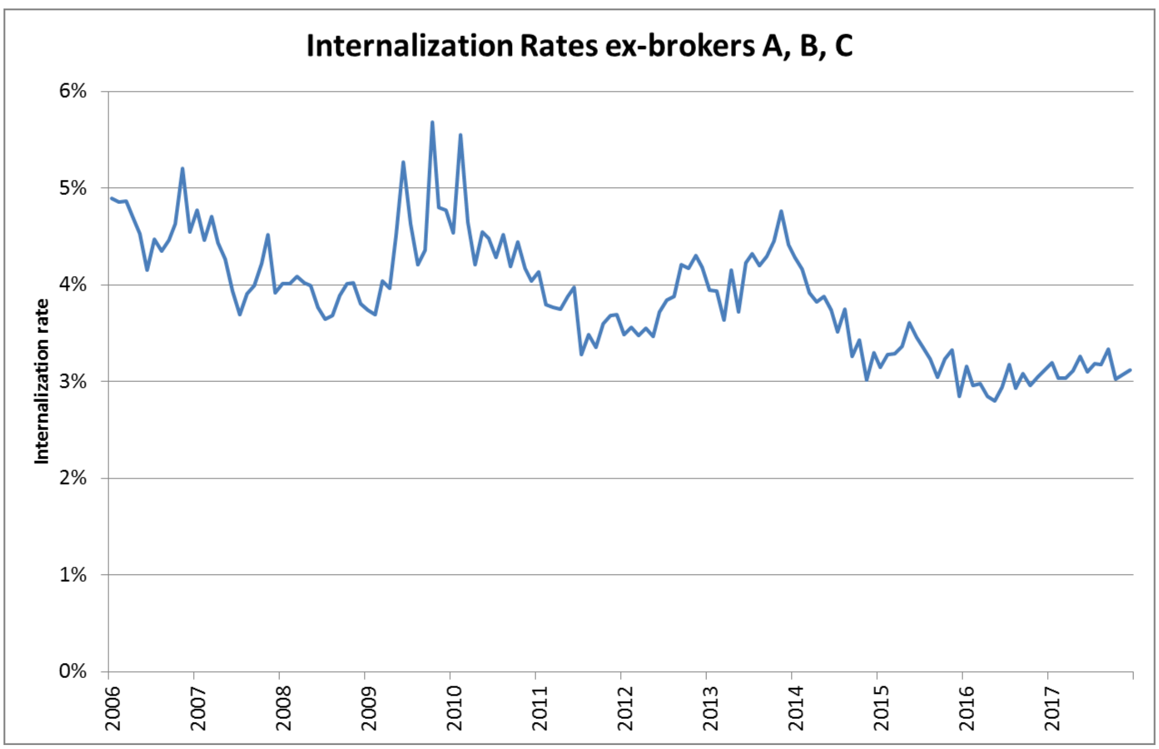


Fig. 1 - Internalization rate: same broker value traded / overall value traded
Excludes open/close auctions, upstairs block liquidity, ETF trades, and anonymous (broker 1) trades

However, when you look at the data a little closer, we can see that the activities of three brokers are the driving force behind the majority of the increase.



And that when the activities of these three dealers are removed, internalization rates have in fact declined by almost half in the Canadian equity market since 2006.



It is also important to be specific about the type of internalization that we believe is at issue. We support internalization that acts to bring together natural orders at the cross.[1] It is the "systematic

[1] References to "internalization" in this letter are to this type of internalization. We refer to "systematic internalization" where necessary to differentiate between the two phenomena.

internalization" of inventory orders by means of high frequency trading-like algorithms is not beneficial to the Canadian equities market.

Furthermore, we believe that any discussion on internalization should be connected to the rise in unnecessary intermediation. Recent history in the Canadian equity markets has seen an explosion of unnecessary intermediation. Marketplaces are incentivized to provide favourable rulebooks for intermediation, as this drives trading volumes which in turn drive revenue. Market makers themselves are motivated to engage in intermediation tactics as it helps them get a "first look" on the order flow. As internalization helps connect natural liquidity, intermediation acts to reduce the amount natural liquidity transacting against natural liquidity.

We agree with all of the Consultation's Paper's listed market attributes, although we believe that the CSA and IIROC should also be concerned with cost. Internalization reduces both explicit and implicit costs in the market. Increased unnecessary intermediation (the majority of which comes from the hand of high frequency traders) reduces of internalization rates, and forces passive natural orders to cross the spread in order to get a fill, increasing costs. Internalization saves market participants from the explicit costs associated with increased fees and commissions, as well as the implicit cost resulting from passive orders being forced to cross the spread.

Internalization through the optimization of routing is not a cost saving exercise for a dealer. This increases explicit trading costs for the dealer. The result though, for passive client orders, is better fill rates as intermediation decreases (and internalization increases). This further benefits market liquidity and transparency as the incentive increases for clients to book their orders "out loud".

Regulators have traditionally treated wholesale and retail markets differently when it comes to internalization, and we think this is appropriate. Within the wholesale market the upstairs matching of orders is a necessary requirement in order to ensure adequate liquidity and to reduce market dislocation. Retail (or small) orders are required to be treated differently in Canada. As a general rule, though there are exceptions which we discuss below, small orders must be displayed. Though we note that this is not the case globally. As the Consultation Paper itself points out, in the "United States, significant amounts of orders are traded by dealers "off-marketplace", and these orders are therefore never made available to the broader market". And what's true from the wholesale market is true for small orders as well.

Internalization in the Canadian equity market through on-market broker preferencing strikes the balance between the potential for small orders to get a better fill in the upstairs market and the need to provide transparency and price improvement to the marketplace as a whole.[2] It should not be the result that dealers, who have optimized their routing as a result of the increase in unnecessary intermediation, are the misplaced target of regulation that would result in permanently ceding the market to high frequency trading and the like. In this respect, internalization efforts of dealers (and their clients) are regaining their space in the market before the arrival of high frequency traders.

Moreover small orders also currently benefit from a number marketplace instruments that support best price execution. UMIR 6.4 and 8.1 mitigate the potential for client orders to be disadvantaged (and eliminate any conflict) by internally matching orders since the orders need to be immediately displayed or price improved. Best execution under NI 23-101 also removes the potential for brokers to route

[2] This argument is not as applicable to systematic internalization.

orders to one specific market in order to enhance the rates of internalization to the disadvantage their clients.

Canadian equity markets have become increasingly complicated, in large part due to a proliferation of order types and pricing models. These are almost singularly designed to increase market segmentation – to lure retail orders away from natural flow. In this sense, segmentation and intermediation are interchangeable. As marketplaces increase complexity, the result is smaller orders and increased intermediation, which results in higher implicit and explicit costs. It is our position that this has resulted in generally negative outcomes for the average investor. Order routing optimization is a chance for dealers, faced with a market that at every turn promotes segmentation and unnecessary intermediation, to look for better execution for their clients.

Finally, the Consultation Paper sets up the common good and individual good as mutually exclusive concepts; that the benefits accruing to some clients as a result of internalization necessarily detract from the overall common good. While we understand the Consultation Paper's interest in promoting the common good, this must still be balanced against the individual investors' interests. Indeed, such interest is enshrined in our market's best execution rules. Internalization connects willing natural orders on the board and thereby increases the efficiency of the markets. We suggest that this serves the original intent of marketplaces – bringing together natural buyers and sellers.

We would like to thank the CSA and IIROC for engaging the industry and for giving us the opportunity to provide feedback on this important topic. We would be happy to discuss any of the above with you by phone or e-mail. Thank you for your consideration.

Sincerely,

"*Dave Moore"*

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May 31, 2019

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Re: Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*

Dear Mesdames and Sirs:

Nasdaq CXC Limited ("Nasdaq Canada" or "we") welcomes the opportunity to provide comments on the Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market* ("Consultation Paper") seeking feedback in response to concerns regarding the internalization of retail orders within the Canadian equity market.

We believe there is a need to balance what helps investors maintain choice and allows them to lower costs with what is best for the market as a whole. As technology advances, participants are provided with new options to improve trading performance and lower costs. In order to ensure that a fair and efficient market is maintained and investors are protected, regulation needs to keep pace with innovation. Regulatory requirements that promote market integrity will vary across jurisdiction because of the need to recognize the unique characteristics of each market. With that in mind, internalization practices and the regulation that permits them must be understood in the context of the unique attributes of the Canadian equity market. In a market where a small number of large integrated dealers control the majority of the order flow, internalization practices must be considered in light of this significant concentration risk.

We believe that recent developments around internalization are not healthy and could negatively impact the market's long term condition. We therefore commend the CSA and IIROC on consulting with industry on these recent developments and recognizing the need to evaluate whether changes are necessary for the current rule framework to address concerns. The Consultation Paper shows a good understanding of the current situation. We applaud the CSA and IIROC for offering comprehensive coverage of the current internalization practices and asking the right questions in order to assess the need for regulatory change.

Nasdaq Canada's view of internalization is based on the following principles:

1. Internalization can benefit individual market participants while simultaneously harming the overall market; the costs and benefits must be balanced carefully.
2. Order interaction promotes price discovery and benefits investors; internalization and order isolation do the opposite.
3. With limited exceptions, price/time priority maximizes fairness.

Our responses to the important questions raised in the Consultation Paper are viewed through this lens.

Question: How do you define internalization?

Internalization should include any trade where the same dealer serves as both the buyer and the seller, whether intentionally or unintentionally. In the case of intentional internalization there is advanced knowledge of an order (either by a trader or trading system), and a decision made based on this knowledge to attempt to internalize by providing the other side of the trade. We believe that intentional internalization should be the main consideration under review whereby specific actions are taken by dealers to match orders before executing on exchange or by using the facilities and features of a marketplace. However, it is still important to track and measure unintentional internalization because marketplaces may offer features that provide benefits to dealers for unintentional crosses (through pricing, priority or other "creative" mechanisms) that create a conflict for dealers between prioritizing the potential opportunities to internalize to capture an incentive over best execution considerations.

Question: Are all marketplace attributes (liquidity, immediacy, transparency, price discovery, fairness and market integrity) relevant considerations from a regulatory perspective? If not please identify those which are not relevant and why.

All of the attributes are relevant considerations from a regulatory perspective. We note market stability, or the ability for a market to handle times of unusual volatility, should be understood as an important component of the investor confidence referred to in the attribute of Market Integrity. A market supported with risk management controls such as market wide or single stock circuit breakers will serve to support investor confidence more than a market without such risk management controls. Similarly, overall trading costs (explicit in the form of marketplace fees and implicit in the form of bid-ask spreads) are important when evaluating the liquidity and immediacy of a market and should be considered when assessing the

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efficiency of a market. Finally, a market's liquidity is supported by an ecosystem which provides for the interaction of order flow from all types of participants.

Question: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Liquidity, and in turn immediacy, are potentially harmed by internalization when orders are matched away from the market before being executed on a marketplace because they would otherwise interact with orders on the book. Restricted access to private pools of order flow (on or off marketplace) not only impairs liquidity but can also raise fairness issues as investors may believe that certain advantages are enjoyed by certain participants and not others. Similarly, when order flow from one type of participant is removed from the market it negatively impacts liquidity by hurting the health of the market's ecosystem. Price discovery can be impacted because internalized trades deprive participants of useful pre trade information. Finally, excessive levels of internalization can also result in wider spreads and less efficient price discovery process.

Question: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution

In general, we believe that order interaction improves market quality for all investors; when order flow is restricted from interacting with other participants' orders, it negatively impacts the overall health of the market. The ecosystem of a healthy market functions best when order flow from different types of investors and participants are able to interact with one another. This interaction results in better quality market metrics including tighter spreads, robust market breadth and depth, effective price discovery and overall confidence benefiting all participants. With this in mind, excessive levels of internalization can be harmful to the market as a whole.

We recognize the benefits of lower execution costs (including trading and ticketing fees) and the resulting economies of scale that can be created for dealers (or their individual good) when able to actualize higher rates of internalization. However, these individual benefits must be evaluated against what is best for the market as a whole. Practices that discourage quote competition, restrict access to order flow and raise fairness concerns need to be scrutinized and overall internalization rates need to be monitored for negative impact to market quality. At some point the cost to the market from a high level of internalization will outweigh the benefits provided to individual dealers. Complicating things further, it may be difficult to identify when internalization practices have gone too far and, at that time, there may be limited options available to reverse its impact.

The Canadian competitive landscape is unique in that it is relatively small, and significant market power is controlled by only a few large integrated dealers. Unlike other markets where order flow is more widely dispersed, this concentration risk creates a real threat to the Canadian equity market. If order flow was permitted to trade off market spreads would widen, price discovery would suffer and overall trading costs would increase. This impact could extend to increasing the cost of capital for issuers and result in compromising Canada's ability to attract investments and capital formation. For this reason, developments

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in internalization practices need to be well understood and internalization levels need to be monitored closely.

Where internalization is permitted, any resulting benefits should be passed onto customers. Examples include when client orders are internalized with one another leading to less intermediation and when internalization facilitated by broker preferencing allows a dealer to unwind a position taken from using firm capital to facilitate a trade. The problem arises when technology is used to internalize retail orders with proprietary market making desks that may be able to use advanced knowledge of a retail order (unavailable to other participants) to internalize the trade. Should this happen, we believe that the individual good of the dealer is clearly being prioritized to the detriment of the common good.

We note that Figure 11 of Appendix A of the Consultation Paper shows an obvious increase in internalization rates between Client and Inventory and that this increase is evident for both unintentional and intentional crosses. These statistics are consistent with the recent efforts by certain participants to maximize internalization via both unintentional and intentional crossing mechanisms.

Question: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers

Strict price-time priority provides equal opportunity to all participants to compete for execution priority based on when an order is received, and in turn, exposed to risk. Philosophically then, we are opposed to broker preferencing because it provides a disincentive for those who are not customers of the preferenced dealer to provide liquidity which in turn adversely impacts quote competition and price discovery. However, we recognize broker preferencing is a viable alternative to internalization practices permitted in other jurisdictions including wholesaling of retail orders and where significant trading volumes are permitted by regulation to execute off exchange using the price discovery of public markets while not contributing to the pre-trade transparency used to reference trades.

Broker preferencing benefits larger dealers over smaller dealers by facilitating higher execution rates based on the number of orders handled instead of the time they are entered. It also serves to compound this advantage by creating an incentive for liquidity providers to become customers of large dealers and by creating a barrier to entry into Canada for foreign participants. However, large economies of scale that can lower costs such as those related to clearing and settlement, including post trade ticketing costs can also be passed onto clients.

Recognizing the advantages that broker preferencing affords large dealers, we also recognize that significant investment has been made by these dealers to develop their deep customer base, including a significant retail presence, and that the resulting economies of scale support the use of capital to facilitate client trades which is essential to the Canadian capital markets. We therefore are not concerned when broker preferencing is used to internalize client orders with one another or when it is used to unwind a position resulting from a liability trade. In our view the fairness issues raised by broker preferencing become a problem when preferencing is used to internalize client orders with proprietary desks and specifically when retail orders are systematically internalized with market making desks. Advances in trading technology systems have permitted market making desks to use broker preferencing to systematically increase the

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probability of internalizing a retail order with proprietary orders entered with the sole purpose to execute against the retail order with little or no chance of interacting with another participant.

Cross-seeking routing strategies also raise issues for best execution when the likelihood of internalization is prioritized over best execution considerations. By breaking up a single order and sending several smaller orders to multiple venues with the objective of maximizing internalization opportunities, the potential opportunity cost is introduced where the order that otherwise could be fully executed on a single market misses a trade after being broken down into multiple orders sent to multiple destinations. These strategies can also result in higher overall trading costs for clients if individual ticketing costs are passed on to clients. Illiquid venues that do not offer best execution metrics actually facilitate cross-seeking strategies because they decrease the likelihood of interference. This can distort best execution analysis by other participants when market share is overstated on smaller venues because of a disproportionate amount of volume traded attributed to cross-seeking strategies.

In the spirit of adding to the discussion there may be some options available to limit broker preferencing to its most noble purposes. We suggest the following alternatives for consideration:

a. ***Client Only***
Regulation could require that only client orders are eligible for broker preferencing. This would ensure that the execution benefits of broker preferencing are provided to clients while the other benefits from internalization could still be retained by dealers. By disallowing an inventory order to be eligible for broker preferencing it would eliminate the incentive for dealers to use broker preferencing to trade against client orders however this would also make it harder for a firm to unwind a position taken from a liability trade. We recognize that there are some issues with using the client marker today that would make implementation difficult (such as the fact that DEA Client orders are marked client) but we believe that markers could be adapted to ensure retail and institutional orders are only afforded the benefit.

b. ***Minimum Resting Time Requirement***
Broker preferencing could be available only for orders that meet a minimum resting time. This alternative would require an order to be exposed to meaningful risk and in turn contribute to liquidity before it is eligible to receive the benefit of broker preferencing. Adding this requirement would create challenges for dealers using strategies to systematically internalize retail orders because orders generated for the sole purpose of interacting with a retail order would not be able to avoid trading against orders from other participants as easily.

c. ***Illiquid Securities***
Because broker preferencing may encourage liquidity provision on illiquid securities its use could be limited to securities with liquidity profiles below a certain threshold. We suggest IIROC explore the impact of broker preferencing on groups of securities with different liquidity profiles to better understand its contribution to liquidity and the liquidity profiles of securities where any benefit is seen.

d. ***Anonymous Orders Requiring Post Trade Attribution***
Broker preferencing could apply only to anonymous orders while mandating that post trade attribution be required for trades resulting from broker preferencing. This option would eliminate

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the conflict created by cross-seeking strategies. Order attribution is generally accepted as the trade-off for receiving the benefits of broker preferencing because of the contribution made to pre-trade transparency. However, we question whether this is still a valid assumption. Most dealers seem very keen on using attribution to advertise their activity in a name, regardless of broker preferencing opportunities and without considering the risk of information leakage. By restricting broker preferencing to anonymous orders, information leakage would be minimized. These benefits would particularly be conveyed to smaller specialized dealers where it is easier to detect when a large sized institutional order is being traded.

We note that at least two marketplaces have been approved to allow broker preferencing on dark orders without requiring any form of attribution (pre or post trade). This form of broker preferencing promotes some intentional internalization practises that "fly under the radar" without requiring any contribution to transparency.

Question: Does broker preferencing impact (either positively or negatively) illiquid or thinly traded equities differently than liquid equities?

Both the positive and negative impacts of broker preferencing are accentuated for illiquid and thinly traded securities. On an illiquid security, broker preferencing may incentivize dealers to make markets thus contributing to liquidity where it is most needed. However, the cost of the fairness issues raised by broker preferencing is accentuated as orders with time priority from smaller dealers specializing in those securities are bypassed.

Question: Do you believe that a dealer that internalizes orders on an automated and systemic basis should be captured under the definition of a marketplace in the NI 21-101? Why or why not?

Yes, a dealer that internalizes orders on an automated and systemic basis should be considered a marketplace because this behavior creates the same concerns the marketplace definition is meant to address. Participants are effectively denied access to interact with this order flow which is effectively siphoned into a private pool and away from the market. In addition, the fair access requirements applicable to marketplaces regarding the use of indications of interest (IOIs), or when IOIs are considered to be displaying orders[1] should apply to a dealer trading system that is using information about orders (that are required to immediately be entered on a marketplace) to generate contra side orders before they are entered. When dealers that internalize orders on an automated and systemic basis are caught under the marketplace definition they should be required to provide information about these orders to all participants in order to meet the fair access requirements of National Instrument 21-101.

[1] Section 7 of CP 21-101.

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Question: Do you believe segmentation of orders is a concern? Why or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

We believe it is essential to ensure that a market supports an ecosystem where different types of order flow, each with its own trading objectives, strategies and time horizon, can interact. By restricting or constraining access or permitting discriminatory access standards across categories of participants the price discovery process is negatively impacted. True prices for securities are best established by all market participants and not a subset of them.

Recognizing the need to provide customers choice and to lower trading costs, we support tools that help achieve these objectives although they may result in a degree of customer segmentation when they attract more use by a segment of investors because they facilitate their trading objectives. For this reason we distinguish between explicit and implicit segmentation. We believe that marketplace features should be accessible by all participants on similar terms and conditions and customers should be free to choose how to use them. There is a difference between competing commercial models that incentivize participants to seek the services that best meet their trading needs and objectives (the by-product of healthy competition) and a trading platform that explicitly restricts access to a segment of participants. In addition, explicit segmentation results in the creation of liquidity silos that negatively impact market integrity and market quality.

We are opposed to features that explicitly segment order flow by restricting access to orders from certain participants. This being said we recognize that Nasdaq Canada has contributed to a form of this segmentation in the Guaranteed Execution Facility (GEF) that was introduced for competitive reasons. We note that although the GEF is only accessible to certain eligible accounts that this marketplace feature is nuanced as it is not provided in isolation. Market makers are required to meet obligations in order to maintain their market maker designation which contribute to market quality by way of better liquidity and market breadth.

Question: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide views on the specific considerations that could be addressed and the proposed solutions

Because of advancements in trading technology and the capabilities of participants we believe that additional guidance needs to be added to UMIR 6.3 - Exposure of Client Orders ("Order Exposure Rule," or "Rule") and that the exception from the Rule for "large" orders be revisited.

The Order Exposure Rule requires an order that does not exceed 50STUs to be immediately entered for display on a lit marketplace.[2] The time frame for "immediately" is not defined and, given advancements in technology what would be considered immediate today is very different than what would have been considered immediate only a few years ago. Because of innovation in trading systems, there is a possibility that a dealer or a dealer system can respond to an order before it is "immediately entered on a marketplace that displays orders." We understand the intention of the Order Exposure Rule at a minimum to mean that

[2] UMIR 6.3 Exposure of Client Orders.

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"immediately" should not permit a trader or a trading system to react to an order it has received by entering an order on the market in advance based on this knowledge. In concept, this is similar to UMIR 4.1 – Front Running (UMIR 4.1) which provides certain prohibitions on trading when a participant has knowledge of a client order because of its role as an intermediary unavailable to other participants. Whereas UMIR 4.1 is concerned about trading in the same direction of the market that a client order may affect the price of,[3] in the context of internalization a dealer is using its knowledge of a client order to enter an order on the opposite side of the market. We believe that guidance needs to be included in UMIR 6.3 that will clarify that an order entered in response to knowledge about a client order that is required to be entered immediately on a market in accordance with the Order Exposure Rule is a violation of the Rule.

We also believe that the minimum size thresholds applicable to the Order Exposure Rule need to be revisited. Combining the 50 STU share requirement with the exemption for an order of $100,000 creates distortions in the application of the Rule. 50 STU on low priced securities is an easy threshold level for a retail order to exceed. Similarly, for high priced securities, an order for less than 50 STU can often meet the requirement to qualify for the $100,000 notional exception. In both cases retail orders are permitted to be withheld and allow time for a dealer to decide whether it wants to enter a contra-side order to internalize the trade. We recommend that IIROC perform an analysis similar to that which resulted in the proposed amendment to UMIR 6.6 where a notional requirement was added to the 50 STU for low priced securities.

Finally, we suggest that the CSA revisit its decision to not implement best execution reporting for dealers originally published in 2007. Similar to Rule 606 of Regulation NMS in the U.S. which require quarterly reporting from dealers about order handling and routing decisions, a Canadian requirements would provide clients with information to better understand how their orders are routed and in turn help them to evaluate the execution quality they are receiving. Disclosure of certain information can be mandated to become publicly available or can be provided upon customer request. Information about internalization rates and practices should be a requirement in this disclosure.

We thank the CSA and IIROC for the opportunity to provide comments and would welcome the opportunity to discuss further our views with staff.

Sincerely,

Nasdaq Canada

[3] UMIR 4.1 Frontrunning.

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May 31, 2019

Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the "Consultation Paper")

The Investment Industry Association of Canada (the "IIAC" or "Association") appreciates the opportunity to comment on the important issues raised in the Consultation Paper. The issues raised in the Consultation Paper illustrate the complexity of topic, and the reality that market participants have diverse, but valid perspectives of the issues, depending on their business model and views as to how clients' interests are best served.

The IIAC represents 118 IIROC members, ranging from small regional and boutique dealers to the largest integrated and bank-owned national firms. Given the differences in our members' size and business models, there were several issues and questions raised in the Consultation Paper where industry consensus could not be achieved. As such, in certain areas, our response will not present one unified industry position, rather, we will articulate the various perspectives of our members where there is clear divergence.

IIAC members agree that the six key market attributes of, liquidity, immediacy, transparency, price discovery, fairness, and market integrity are important to a functional and trustworthy market. Similarly, we agree that marketplace rules should provide investor choice, improve price discovery, decrease execution costs and improve market integrity.

Differences, where they exist between member perspectives on the costs and benefits of internalization and broker preferencing, is how the regulation should balance the attributes, and to what extent certain attributes should be permitted to take precedence where there is an inherent conflict between them. In short, there is a divergence of opinion as to whether, and to what degree to which the common good of the overall market should take precedence over the individual good of internalizing dealers and their clients. There is also disagreement as to whether internalization and broker preferencing enhance or detract from the common good.

All dealers agree that the internalization of large orders does not detract from market integrity, and is necessary in many cases. Members are of the view that dealers should have the option of internalizing such orders via crosses to another client or facilitated trades through inventory of the dealer, in order to avoid market disruption.

Certain members were of the view that pro orders should not be subject to broker preferencing.

Areas of disagreement as between internalizing and non-internalizing firm relate to the issues of broker preferencing, and internalization of small orders.

Some members are concerned that the Consultation Paper contains insufficient data and description of the methodology behind the data contained in the Paper. For instance, in respect of non-intentional broker preferencing, the definition should be confined to situations where the preferencing dealer trades in advance of other dealers that have orders in the queue. It should not include trades where there are no other dealers competing for the trade.

Internalizing Firms – General Position

In general, the larger, bank-owned firms that undertake internalization and broker preferencing as a material part of their trading (the "internalizing firms"), emphasize the regulation goals of investor choice, better quality execution and reduction of execution costs for their clients in their support of these practices. These firms indicate that the regulation must take into account the benefits of lower costs and in certain cases, better execution for their clients resulting from internalization and broker preferencing, as against the focus on broader market goals which they believe may increase costs, reduce choice, and increase market impact for clients of these firms.

Internalizing firms' position on broker preferencing is that it provides best execution by matching clients with each other rather than trading one client order with an intermediary and leaving the other client unfilled. The ability to do so is a key feature a full-service dealer, and this contributes to the low cost and efficiency of trading in the Canadian equity market.

There is a concern that restrictions on internalization and broker preferencing will make dealers less efficient, increase complexity, and increase costs for the industry and clients. This would ultimately reduce Canada's competitiveness as it would become a more expensive place to trade.

In respect of internalization and broker preferencing of small orders, internalizing firms are of the view that UMIR 6.3, the Order Exposure Rule, achieves adequate transparency, price discovery, immediacy and liquidity by ensuring smaller orders are exposed to lit marketplaces, addressing liquidity, timeliness and price discovery objectives.

It was also noted that the US permits full internalization, without evidence that it has harmed that market, in that it remains the lowest cost and most liquid market globally. Although there is not support for moving to a US style structure, allowing full internalization, there is a concern that if Canada prohibits or places additional limits on internalization and broker preferencing, moving far from US practices, it will discourage global participants from sending orders on Canadian securities to our market when more favourable execution terms are available from US internalizers. Close to 2,700 Canadian securities are available for trading on US primary and OTC markets, which places our market in direct competition with US internalization across the majority of Canadian names.

There was also concern that eliminating broker preferencing and moving to a price-time allocation model would lead to additional market complexity and would be counter-productive in meeting the concerns of smaller dealers. A price-time model rewards those participants who are first to establish or join a price level which creates a natural advantage for US High Frequency Trading firms. Eliminating broker preferencing will tilt the playing field toward HFTs at the expense of Canadian retail investors (who are the primary beneficiaries of broker preferencing today), while smaller dealers may see little to no improvement in fill rates.

Eliminating broker preferencing would also create a strong incentive for larger dealers to find other means to achieve best execution for their clients. This could lead to the creation of new non-protected order books, greater investment in technology for placing and moving orders across order books or more complex order types to replicate the client benefits of broker preferencing. The higher cost and complexity of these solutions would not be a good outcome for the Canadian market.

It was also noted that Europe attempted to shift more trading to lit markets through MiFID II regulation, but dealer innovations ultimately led to an increase in off-exchange trading in response to the new rules.[1]

Non-internalizing Firms - Position

To be clear, in respect of internalization of large orders, some smaller dealers undertake client-to-client crosses and facilitation crosses for certain large orders. This is done on a specific transaction basis, and

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[1] *CFA Institute: MiFID II and Systematic Internalisers: If Only Someone Knew This Would Happen, July 2018*

such firms do not have the volume of flow that would allow them to develop routing rules and systems to routinely internalize much of their trading flow.

As noted above, these firms do not object to the practice of internalization for large orders, to reduce market impact. However, these dealers do object to the practice of internalizing a significant portion of trade flow, such that an ever-decreasing number of orders can be interacted with in the order book by other participants, reducing liquidity, transparency, price discovery and fairness.

Non-internalizing firms are of the view that the key market attributes of liquidity, transparency, price discovery, fairness, are critical to and market integrity and are not supported by internalization that is not confined to large orders, and broker preferencing.

Smaller, independent and other dealers are not able to undertake broker preferencing, as they do not have a sufficient number of orders to match on real-time, ahead of other orders in the queue. This places these dealers and their clients at a disadvantage on a structural level, as their clients' orders may have delayed execution as broker preferenced orders are not subject to order priority. At times, the disadvantaged clients are forced to change the terms of their passive orders in order to hit the opposite side, resulting in the clients paying more for their stock or selling at a lower price.

Non-internalizing dealers point to the statement in the notice that broker preferencing pre-dates modern electronic marketplaces and was an incentive to encourage dealers to commit orders to the order book. With the evolution of the electronic trading structure, broker preferencing should no longer be necessary.

Some members indicated that the loss of time priority has led to a situation where many orders are not posted, as it is anticipated that they will be traded around, thus, decreasing liquidity and transparency. These members believe that fragmentation, broker preferencing and routine internalization has degraded the quality of the market, and that the more this is permitted, the more orders in the market lose the benefits of being competed for.

In respect broker preferencing, the non-internalizing dealers believe that in particular, orders that are created solely to take advantage of existing orders are not appropriate. Aside from banning broker preferencing as a whole, which some members support, members indicated that another solution would be to require a delay to allow the order to be exposed, allowing competition, in order to mitigate the liquidity, and fairness issues. Once the order has been exposed for a specific time, broker preferencing would be permitted.

Most non-internalizing dealers support strict time and price priority to ensure fairness, which would effectively eliminate broker preferencing. These members believe that exposure on a marketplace should come with an opportunity for all to have a chance to trade with the order. As those orders are exposed on the marketplace and all dealers are allowed to trade with it, liquidity will be created. Where orders are intercepted without an opportunity for others to trade, the added value to the market is limited.

Non-internalizing dealers also indicated that although inverted pricing rules can mitigate the broker preferencing issue, a more coherent and consistent rule banning broker preferencing would be promote fairness, transparency, and price discovery.

Non-internalizing dealers note that the protections afforded by the Order Exposure Rule do not mitigate the effects of broker preferencing. Orders under 50 standard trading units can be exposed on a lit market, but the over-ride of priority, or pre-arranged crosses that are conducted on the market prevents other dealers from interacting with those orders, violating the fairness and in some cases, real price discovery. Firms want to have fair competition to access a quote. Where these firms are providing price discovery through providing the quote, but they are not able to interact with the flow on a fair basis, this diminishes the perception of the market as a fair and desirable place to trade. These dealers support a requirement that orders under 50 standard trading units should go to the top of the book, so that all dealers have the opportunity to trade with such orders. This addresses the fairness issue, and does not compromise investor interest, as the order will be filled, but in time priority order.

The perception of these firms and their clients that the market is unfair may ultimately undermine investor confidence, diminishing the vitality and integrity of the market in general.

In respect to the observation that full internalization and wholesaling is undertaken in the US, without a degradation of market integrity, non-internalizing dealers indicate that the US market is significantly larger than the Canadian market, and in that context, this form of internalization is intended address the need for immediacy in that market, as timing is critical to their clients. In Canada, a much smaller and less liquid market, price discovery is a much higher priority.

Non-internalizing dealers believe, in contrast to the internalizing dealers, that northbound flow is decreasing due to market fragmentation, and that allowing more internalization and broker preferencing would exacerbate the problem. Ultimately, these dealers believe broker preferencing is unnecessary, and unfair and should be prohibited.

Possible Implications of Regulation

The nature of the situation is that regardless of whether broker preferencing is restricted or not, certain clients may feel they are disadvantaged. Current clients of internalizing firms that use broker preferencing will have a reduced experience in terms of execution quality and perhaps increased cost if their order is traded away from the firm. On the other hand, firms that are unable to utilize broker preferencing currently experience a reduced client experience through inferior execution when other orders are preferenced and trade ahead of their orders.

Once of the implications of restricting broker preferencing is that in order to address the lost efficiencies, and deal with the significantly increased trading and settlement costs, firms may create other systems in order to serve their clients needs and achieve the benefits of broker preferencing, potentially creating other negative unintended consequences for the market. For instance, such rules may create incentives for dealers to post on marketplaces with less liquidity and then re-route their orders there.

Members indicated that creation of rules to limit broker preferencing should look to Europe where MiFid intended to limit internalization and resulted in less visible orders.

Non-internalizing dealers indicate that they have been subject to the high trading and settlement costs, unmitigated by broker preferencing, so rules would level the playing field.

Members all agree that internalization of large orders is acceptable and assists the client and the market in terms of reducing costs and market impact. These large, high market impact orders include both retail and institutional orders. The market impact of orders in Canada is particularly high. Large size orders trade through multiple price levels, increasing costs and market impact. If internalization is prohibited for large orders, the result would be a large amount of algorithmic trading designed to disguise large trades to reduce market impact. This may result not only in increased trading costs, but in orders being in the marketplace all day, which increases risk.

There is less agreement in respect of internalization of small orders. Members agree that the Order Exposure Rule provides some useful limitations, requiring certain orders to occur on the lit markets. This does not, however, address the concerns with broker preferencing, and there is some disagreement as to whether the threshold for a small order under the Order Exposure Rule is too low.

Thank you for considering our comments. If you have any questions, please don't hesitate to contact me.

Yours sincerely,

Susan Copland

Via email: comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca; kmccoy@iiroc.ca

May 31, 2019

The Secretary
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and

Kevin McCoy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, Ontario, M5H 3T9

Dear Sirs/Mesdames,

Re: CSA and IIROC Consultation Paper – Internalization within the Canadian Equity Market

This comment letter is being submitted on behalf of RBC Dominion Securities Inc., Capital Markets and Wealth Management ("RBC" or "we"). We are writing in response to the joint Canadian Securities Administrators ("CSA") and Investment Industry Regulatory Organization of Canada ("IIROC") Consultation Paper 23-406 - *Internalization within the Canadian Equity Market* published on March 12, 2019 (the "Proposal"). RBC appreciates the opportunity to comment on the Proposal; our comments are set out below.

One of the hallmarks of Canada's equity markets in recent years has been change. Similar to the United States, we view a significant portion of the Canadian evolution as being driven by the exchanges, for which innovation is often paired with or predicated on a profit seeking motivation that can have a negative impact on market quality. As a result, we have seen greater complexity and market inefficiencies in recent years, such as the introduction of randomized speed bumps and excessive rebates which can heighten broker order routing conflicts of interest and disrupt best execution. In our view, broker preferencing is a critical counterbalance to what we see as the exchanges' focus on ultra-low latency technologies and complex trading fees and rebates.

Broker preferencing is a unique and transparent feature of the Canadian marketplace. It benefits market quality by incentivizing market participants to post liquidity on lit venues, while improving the ability to capture the spread ahead of speed sensitive traders exploiting a technological advantage. We posit that a pure price/time priority order book may not be optimal for institutional and retail investors.

According to the Proposal, unintentional crosses have not grown materially over the last few years and represent less than 13% of total marketplace volume, a subset of which is a result of broker preferencing

(4.4% client-to-client and 2% client-to-inventory, as such percentages have been provided by venues that were able to offer data, as stated in the Proposal). Based on these percentages, we view time priority as continuing to be the dominate form of order matching on individual venues. While there may be areas for improvement, we do not see fundamental issues with nor substantive changes required to broker preferencing given the data does not demonstrate material marketplace issues.

Canada is a relatively illiquid market compared to its global peers – which makes it particularly difficult to trade passively. Brokers need tools to help their clients achieve best execution in an increasingly automated market. Broker preferencing is one such tool, that used the right way can improve execution quality in light of wider spreads and lower turnover common in Canada. For instance, corporate issuers conducting a normal course issuer bid have defined limitations imposed on their purchases and so benefit from broker preferencing as it improves their ability to trade passively.

We see a number of additional benefits that broker preferencing provides to the Canadian market, including:

- Incentivizing displayed liquidity which promotes price discovery;
- Improving the ability of retail and institutional investors to capture the spread through more effective passive trading;
- Increasing the likelihood of retail and institutional clients interacting with active retail flow, which is generally viewed as a favorable counterparty;
- Facilitating retail investors who benefit from interacting with other retail investors; and
- Helping to mitigate the segmentation driven by exchanges leveraging rebates to attract retail orders.

Potential consequences of limiting broker preferencing may include:

- Increasing focus by exchanges and dealers on maximizing their low latency offerings to the detriment of long-term investors;
- Increasing predatory market behavior, such as “fading quotes” which diminish the quality of liquidity within the market; and
- Decreasing quality execution opportunities for smaller dealers, who can leverage inverted venues to trade passively while benefitting rather high frequency traders to whom exchanges already cater.

Additionally, with less incentives for larger brokers to display liquidly, more liquidity will likely shift to dark venues similar to the United States. An increase in opacity could impact price discovery and require some dealers to develop more complex approaches to maintain execution quality.

As referenced in the Proposal, we agree there is potential for broker preferencing misuse, such as where brokers post within the order book in a systematic fashion with the advance knowledge of an incoming retail order. However, such behavior can be discouraged without significant revision to broker preferencing, such as by only allowing orders that have been resting for a minimum period of time to qualify for broker preferencing.

Excessive segmentation of order flow can lead to an unfair market, negatively impacting the common good. While internalization contributes to segregation, the current data set out in the Proposal does not reflect an excess. Also, exchanges like Alpha have used their ability to offer rebates and randomization to divert retail flow away from protected quotes. This can negatively impact the quality of execution for retail and institutional clients as noted in the CSTA Trading Issues Committee paper - *Discussion and position statement regarding: Speed segmentation on exchanges, Competing for slow flow*. We see broker preferencing as helping to balance exchange driven segmentation and provide an alternative to internalization.

The exchanges maintain a dominant position in the Canadian market structure with the ability to offer outsized rebates and low latency access to their largest market participants. Broker preferencing serves as a counterbalance and helps level the playing field for retail investors, which are vastly out represented by institutional investors. Limiting the tools a dealer has available at its disposal could negatively impact execution quality and create an imbalance that would not serve the marketplace common good.

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We appreciate the opportunity to provide comments and welcome the opportunity to discuss the foregoing with you in further detail. If you have any questions or require further information, please do not hesitate to contact the undersigned.

Thomas Gajer
Managing Director, RBC Dominion Securities Inc.

Cc:
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Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
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May 31, 2019

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Re: Joint CSA/IIROC Consultation Paper 23-406 – Internalization within the Canadian Equity Market

The Canadian Security Traders Association, Inc. 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 Governors from each of four distinct regions (Toronto, Montreal, Prairies 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 complex and multi-faceted topic of order flow internalization within the Canadian equity market. The issues at play are fundamental, far-reaching and strike to the core principles behind Canadian capital markets.

This submission is the result of numerous discussions among Trading Issues Committee members. As an industry group, the CSTA is unable to achieve a consensus opinion on all the issues at question. Rather than attempt to provide a solutions-oriented response, we present the general views of institutional participants, including the competing views at play where appropriate.

The Tragedy of the Commons

A common perception among institutional participants is that the issue of internalization is linked to the concept of the "tragedy of the commons," where the good of the whole is compromised by the profit-seeking motive of individuals. In the context of order flow internalization, there are three types of profit seeking entities that are viewed to be advantaged: the dealers who internalize flow, the retail execution desks whose orders are being intermediated and the retail investors themselves. The concern of our group is that these entities will continue to seek to maximize their commercial interests, even if seeking to do so is at the expense of the public good and of the overall market. In the case of the Canadian equity markets, one facet of the public good can be the collective ability to effect transactions in equities with minimal frictional costs, including counterparty search costs.

We note that commercial solutions and individual actions are not likely sufficient for achieving a balanced outcome. The duty owed by all participants is to their clients or their firm rather than to the market as a whole. This means that any reduction of economic results (either through worse execution for clients or worse financial outcomes for the firm) from actions which favor the interest of the market are likely inappropriate under a best execution or fiduciary duty to investors standard. As a result, many participants believe that balancing the common good against the individual good is the place of regulation rather than commercial solutions.

Institutional participants are particularly concerned with the potential hollowing out of the majority of natural investor activity – particularly small retail investor activity – from the multilateral market. As small natural retail client order flow is internalized by a select few participants, the remaining participants (primarily large institutional investors with significant information leakage concerns, and their executing dealers) may be exposed to an illiquid and more toxic trading environment.

We note that the concern over liquidity effects from order flow internalization is limited primarily to activities involving small retail order flow. While large block trading could also be considered order flow internalization, it is not generally seen as being detrimental to market quality since its primary use is to allow large pooled groups of retail investors (i.e. institutional investors) to execute orders that would otherwise involve material frictional costs and could not otherwise be executed near to or at current market prices. Broker block facilitation activities are also considered beneficial since they tend to involve offsetting large directional client orders with significant information content and a high degree of risk.

We believe that a regulatory initiative aimed at balancing common and individual good must take into account the key dimensions of best execution duties owed to clients and the fiduciary responsibilities of asset managers to their unitholders. Any regulatory action which aims to improve the common outcome must simultaneously address concerns over potential compromises of either fiduciary duties to unitholders or best execution duties to clients.

Some participants have expressed the view that achieving the aims of the common good is not entirely inconsistent with the goals of best execution. For instance, best execution guidelines could be amended to encourage participants faced with equal alternatives to choose the alternative that is seen as more supportive of the common good. However, the details of any such guidance must be carefully considered including all dimensions of best execution – most importantly, information leakage.

Any changes to the best execution regime which aims to support the common good will raise questions of whether dealers' choices in the "common good" conflict with the client's fiduciary interests. We believe that amendments to best execution standards to favor the common good will require clear guidance to both dealers and clients, which may take the form of some type of "obligation to the marketplace" similar to the "best price" obligation before the introduction of the Order Protection Rule.

Broker Preferencing

Several participants view the practice of broker preferencing as a practical compromise between the interests of dealers in allowing their sources of flow to interact, and the interest of the market in allowing a diversity of participants to trade with each other. In this regard, broker preferencing is a somewhat unique Canadian compromise that has served to maintain balance.

Historically, broker preferencing was used by brokers as a tool to assist in the unwinding of risk. With recent technological advances and competitive pressures, dealer workflows that systematically leverage broker preferencing have been developed. These workflows can be controversial, and in the views of some, can violate the very spirit of broker preferencing. The concern arises from the belief that orders which receive the benefits of broker preferencing should be those which are also generally accessible to the market at large. As a result, some adjustment to the mechanism of broker preferencing in the market may be appropriate.

While we are not advocating for any specific measure, we believe that specific actions could be taken to the extent that current broker preferencing practices are seen as damaging to the market. Some possible adjustments, which would require refinement based on industry discussion, include:

- A "minimum life" provision across all marketplaces by which only orders that have been present in the book for a certain length of time may receive broker priority;
- Adjustments to the practice of anonymous broker preferencing in undisplayed "dark" markets;
- Restriction of broker priority to orders from "natural" participants rather than intermediaries, or "client" as opposed to "inventory" orders.

Importantly, to the extent that a restriction on broker preferencing is seen as appropriate, the change cannot come from commercial solutions by a marketplace. Any marketplace which reduces the benefits offered through broker preferencing will penalize its users, who will migrate flow to marketplaces which have not made similar changes. As a result, the "first mover" attempting to rebalance the benefits and costs through their own action will be commercially penalized, without an improvement to the common outcome.

Segmentation

The most contentious aspect of the discussion of internalization is the degree to which internalization should be permitted on specific, targeted segments of the market. The practice of retail segmentation raises several concerns among institutional participants:

- Retail order flow is a significant contributor to price discovery, and its removal (through internalization practices) would compromise the activities of participants reliant on effective price discovery;
- Increased segmentation of retail flow is likely to increase order flow toxicity among the remaining non-retail market, driving volume away from the displayed markets;
- The reduction of the breadth of participation in the open market resulting from retail segmentation will result in greater information leakage for institutional investors.

More generally, the segmentation of retail flow creates a two-tiered market. We question whether the practice of order flow segmentation is consistent with the principles of fair access to the marketplace. The CSTA has historically opposed the practice of segmentation, including in our public comments to various marketplace proposals involving guaranteed-fill facilities for retail orders. We reiterate our historical view that the segmentation of retail flow away from the broader market will be damaging to the average Canadian individual which invests in pooled investment products via institutional asset managers or has a significant portion of their economic wealth managed by pension plans, both of which are considered institutional investors.

Order Routing

Finally, we note that in today's trading environment, marketplaces compete largely through variations on trading fees – including inverted fees. Inverted fees exacerbate concerns around segmentation since structural differences in routing practices can effectively dictate fill priority for various types of clients. The competition for fees is closely linked with the practice of retail flow segmentation. To the extent that segmentation is seen as damaging to market quality, we believe it is equally appropriate to examine the effect of various routing practices and fee structures as potential contributors to the erosion of market quality.

These issues are intertwined with the difficulties that investors face in assessing order routing practices by brokers. Canada currently lacks a standardized framework for order handling disclosures, such as the SEC Rule 606, which was recently updated in 2018. Some of our Committee members believe that standardized and mandated broker order handling disclosures would assist institutional investors in making informed decisions when selecting executing brokers and when determining if their best interests are being prioritized.

Respectfully,

"Signed by the CSTA Trading Issues Committee" c.c. to:

Ontario Securities Commission:

Ms. Maureen Jensen, Chair and CEO
Ms. Leslie Byberg, Executive Director & CAO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

Alberta Securities Commission:

Ms. Lynn Tsutsumi, Director, Market Regulation

Autorité des marchés financiers:

M^e^ Anne-Marie Beaudoin, Secrétaire générale

British Columbia Securities Commission:

Ms. Sandra Jakab, Director, Capital Markets Regulation

IIROC:

Mr. Andrew Kriegler, President and CEO
Ms. Victoria Pinnington, Senior Vice President, Market Regulation
Mr. Kevin McCoy, Vice President, Market Regulation Policy

NATIONAL BANK
FINANCIAL MARKETS

May 31st, 2019

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RE: **Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market,** ("Internalization Study") published on March 12th, 2019.

National Bank Financial Inc. ("NBF") appreciates the opportunity to comment on the following Proposed Pilot. We support the CSA's stated mission to provide a securities regulatory system that protects investors from unfair, improper or fraudulent practices and fosters fair, efficient, and vibrant capital markets.

NBF is part of the diverse National Bank Financial Group ("NBFG") which: (i) manufactures mutual funds, owns proprietary distribution channels and supplies services to third party distributors; (ii) operates a discount brokerage firm; and (iii) is an IIROC-regulated investment dealer across Canada. We take great interest in initiatives contained in the Comment Paper and their potential impact on investors, the mutual fund industry, the investment industry and financial intermediaries.

Worth underlining here, in the NBF business description, is that we are one of Canada's leading market makers in both ETF's and common equities but also an integrated broker-dealer offering equity & ETF research, sales, and trading services to Canadian investors of all sizes including NBF's retail & wealth management clientele. As such, we believe our perspective in market structure topics like this one to be holistic and balanced between these very different stakeholders.

Accordingly, our intention is to share our concerns regarding the Internalization Study. We trust that our comments will be considered during the review process and will provide a productive contribution to the outcome.

Internalization is a complex topic, involving many different stakeholders and a corresponding number of viewpoints. We applaud the CSA for taking the time to craft such a comprehensive consultation paper. The questions posed within it make for a well-structured, logically progressive discussion. We will do our best to answer where we can, in order, and as succinctly as possible in hopes of easing the burden on those CSA members tasked with parsing all the replies.

National Bank Financial Inc.
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After much consideration and internal discussion, our position on this topic is that, in the broadest sense, internalization of order flow is not a problem a priori. Transacting both sides of a trade is one of the primary goals of a broker-dealer in just about any asset class; it is an existential goal of the brokerage function.

Where internalization has begun to pose problems, at least in the current Canadian regulatory framework, is where *systematic* internalization begins to be developed. We believe that this encroaches on the function of a marketplace and as such runs counter to the prevailing rules of *fair access.* Further, when looking at the health of capital markets with the broadest possible lens, we feel that maintaining a *diversity* of participants to be a crucial feature for both near term liquidity and longer-term capital formation. Explicit segmentation of flow with a view to internalizing it directly undermines this attribute, and, we feel, harms the long-term health of the markets.

CSA Internalization Questions

Question 1: How do you define internalization?

In the broadest sense, internalization is any case where a single broker dealer represents both sides of an order. In NBF's opinion, internalization is one of the primary goals in any transactionally oriented brokerage model. From residential real estate brokers to car dealers to packages of loans, all types of brokers strive to earn commissions from both the buy & sell legs as well as lower transaction costs paid out to intermediaries.

NBF believes listed securities trading is no different, the economics of the business model drive participants to seek internalization.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

These are reasonable attributes to consider in evaluation of a market's health. We would underline #5, Fairness, as being a key to -the consultation paper and NBF's response. It is one of the more difficult attributes to evaluate, certainly quantitatively, however is likely the most important attribute for the long term health of a market, particularly for perception from external parties.

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Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Internalization can enhance liquidity & immediacy.

Internalization is unrelated to transparency (in Canada where trades must be printed)

In the extreme, internalization could be considered harmful to price discovery. Further, as the opportunity to internalize flow is greater in larger, integrated broker-dealers, it may challenge the perceived fairness in the markets, a key attribute to integrity.

An additional attribute NBF would submit for consideration on the health of a market is the **diversity** of participants within that market. Investors with different constraints, horizons, and investment strategies are more likely to have natural trading interest, resulting in more available trading liquidity, necessary for a robust, healthy market. NBF often discusses the fact that a marketplace with only deep-value investors likely can't achieve any transactions. They need growth investors to whom they can eventually sell their positions. This attribute relates to Liquidity; but it is measurable and valuable in its own right.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

The balancing of common good vs the individual best execution is the principal conundrum in the context of internalization.

We believe broker-dealers enjoy benefits from internalization, for the reasons discussed at the outset: maximizing revenue, minimizing cost, and improved control over the fairness of the transaction. More importantly, in most cases, an internalized transaction provides better outcomes for both sides of a trade in a transaction. Liquidity is matched, impact is minimized, and pricing is fair as the dealer meets its best execution obligations to both sides.

NBF believes that while best execution is the main priority for order routing, it will be difficult to make the case that broker-dealers must curtail or even desist from this practice.

Introducing additional *societal* considerations to trading practices would be required should regulators seek to limit the increasing pace of internalization. Additional criteria could be considered for routing practices that would require the dealer to consider whether its effects will be contributing to the health of our marketplace or not. However, this would be exceedingly difficult to implement, monitor, and enforce.

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Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Broker preferencing has been a key feature of Canadian market since it graduated from the floor to become fully electronic over 20 years ago. It was implemented with a view to mimicking the common practice in floor trading of matching an incoming ticket with the floor traders own held orders before showing to the rest of the floor. There are aspects of settlement risk that are mitigated by it as well.

Canadian trading rules (under UMIR 6.4 and 6.3) require that all trades be printed on a public trading venue and that all orders under a certain size be immediately exposed. The broker-preferencing feature has served as a trade-off, allowing broker-dealers to fulfil their own orders even while also exposing them, fostering the health of our transparency-focused regime.

Naturally, the drawback is that broker-preferencing favours larger, diversified broker dealers. Many interpret this to mean that it disadvantages Canada's smaller, boutique dealers. It has also contributed to an unusually vibrant *local*-dealer oriented industry. One is pressed to find another developed equity market in the world that does not have global bulge dealers numbered among the top participants. NBF believes that while broker preferencing may favour the larger Canadian dealers, it has served the Canadian markets well.

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

The benefits accrue more to dealers with diversified business lines and types of trading flow than simply to larger dealers. Large foreign dealers typically do not enjoy high rates of preferenced matching as they typically only route institutional flow directly. Dealers that have high matching rates are the ones that have strong wealth management & self-directed retail operations along with institutional &/or market making.

Diverse flow is more likely to match up than like flow.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

The impacts would largely be the same between liquid and illiquid buckets, but possibly felt more severely in the illiquid bucket where concerns about liquidity availability are already high

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Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Yes. It is already our understanding that this is the case. Systematic order matching is the basic definition of an electronic marketplace. This is a key part of the marketplace definition regulation and NBF sees no benefit to changing such a fundamental part of the Canadian Marketplace structure.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

Segmentation is a major concern in the context of the internalization discussion. NBF believes that systematic segmentation of any specific category of orders will undermine the diversity of flow within the marketplace, rendering it less liquid and, ultimately, less competitive. Whether dealers systematically segment and internalize the flow or marketplaces facilitate the mechanism with a combination of pricing and speedbumps, the net result is the same and runs counter to what NBF considers is the fundamental purpose of the fair access rule.

While effective segmentation by marketplaces has been allowed, via the accumulation of various order features over time, systematic internalization by dealers is not permitted. The lines between dealers and marketplaces is already quickly becoming blurred. It is a concern if these two different stakeholder groups enjoy different treatment in the context of internalization, particularly where the practice of segmentation will simply seek out the more lenient route.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

Yes. Retail orders are already well optimized, and it will only get better for this order flow in an increasingly segmented & systematically-internalized future. Pricing schemes on the inverted markets and marketplace-provided guaranteed execution functions like the MGF and GEF have allowed retail trading operations to find better liquidity at the touch than they would if they were not segmented, all while lower their overall trading costs. As segmentation techniques & practices get better, so too will the price improvements, rebates, and liquidity availability.

This is the key aspect that makes the internalization discussion so difficult. Under the best execution regime, absent of regulatory guidance to the contrary, retail order handlers are obligated to continue to improve execution outcomes for their customers regardless of how these practices may impact the broader markets' overall health.

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

As we mentioned, introducing a *societal good* aspect to the quality order handling would help to limit the continued pursuit of potentially unhealthy internalization practices. For example, is a dealer contributing to the liquidity eco-system in addition to pursuing best execution for its clients? However, this would be a significant change in the best-execution regime. And, as mentioned, it would be very difficult to implement, monitor, and enforce. There is precedent in Canada for such principals-based solutions and NBF would support any effort to issue guidance toward these goals.

It would be more practical for the regulators to issue some specific guidance to how they would like to see dealers handle the conflict between seeking best execution and ensuring the ongoing health of the Canadian liquidity complex.

Most simply, an immediately helpful and actionable solution to start with would be increasing the hurdle rate for the standard order exposure size. NBF suggests $250,000 order size and 250 board lots.

Conclusion

NBF appreciates the opportunity to comment on this important topic. There are no easy answers here, but the steps the CSA is taking to advance the discussion are good ones. We look forward to the next steps in this journey toward stronger, fairer, and more durable Canadian capital markets.

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INCLUDES COMMENT LETTERS

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RE: Joint CSA/IIROC Consultation Paper 23-406
Internalization within the Canadian Equity Market

CIBC Capital Markets (CIBCCM) thanks you for this opportunity to comment on Consultation Paper 23-406 *Internalization within the Canadian Equity Market* ("Consultation Paper").

CIBCCM is the investment banking platform of Canadian Imperial Bank of Commerce (CIBC). We are a registered Canadian broker-dealer, engaged in, among other things, providing equities trading and execution services to retail and institutional investors. Our comments reflect the views of an institutional broker dealer and a retail broker dealer who is an active participant in Canadian equity markets.

We compete globally for capital and it is in the best interest of all Canadian participants to deliver high quality capital markets driven by the price discovery process, which concentrates liquidity to the benefit of investors - particularly in a market the size of Canada which has the potential to be impacted by liquidity challenges. In our opinion, a healthy market will include a diversity of investment objectives, a variety of types of order flow, and limited client segmentation.

As we interpret it, the general objective of this consultation is to review whether the existing rules ensure that the Canadian equity markets continue to bring together all types of participants in a transparent and efficient manner, benefiting the collective good. Or, whether the practices broadly characterized as internalization activities, are harming or have the potential to harm the integrity of the Canadian equity markets, although in singularity these practices may provide benefit both to the end investor and the unique participant undertaking these activities – the individual good.

We commend the regulators for their balanced portrayal of the issues in this consultation paper, and for seeking industry guidance prior to the development of policy change meant to address any perceived issues.

Our general position

We support the promotion of balance as it applies to internalization practices. Central to the consultation objective is the alignment of the collective good to the individual good, to the extent practicable. Further to this, in our opinion it is the interests of the market as a whole that ought to take precedence should there be a conflict between the two. From this lens, we submit the following - Canada has, over the evolution of our markets, developed a unique market structure that has served us well and has been to the benefit of Canadian equity markets. Specifically, we believe broker preferencing has been net beneficial to the fabric of Canadian market structure.

Because on-book internalization takes place at the marketplace via broker preferencing, the desire to internalize through dark pools or single-dealer platforms does not currently exist as it does in the US and elsewhere. This has allowed us to escape some of the market structure challenges we have seen in other markets such as the proliferation of dark pools and bilateral arrangements with wholesalers, both of which have the potential to compromise transparency and the price discovery process, as well as being rife with conflicts of interest. In our opinion, by its inclusion in marketplace matching allocations, broker preferencing continues to incent dealers to commit orders to the order book and has been a deterrent to greater fragmentation.

Broker preferencing exists as a consequence of order exposure rules, which to encourage transparency and price discovery, requires that small orders be immediately exposed to the market. Brokers are encouraged to internalize in the central limit order book, therefore the competitively priced orders placed can be accessed by other market participants. This allows brokers to maintain the advantage of their flow and at the same time provide liquidity and information to the market. This matching allocation methodology is a valid approach to marketplace mechanics, and serves the purpose of balancing the collective good for the market with the individual good for the unique participant and client.

Per the data provided in the consultation paper, there has not been a significant increase to broker preferencing rates, and these rates remain largely in range to historic levels, though we acknowledge that this review may be a pre-emptive measure should these rates continue to increase.

What has changed over the more recent evolution of Canada's market structure is an increase of segmentation practices at the marketplace level. Fair access has been compromised through greater and greater client segmentation. The ability to segment order flow and therefore more accurately select the counterparty one trades against has led to potentially abusive practices which leverage broker preferencing in a manner in which it was not originally intended for.

Because of the potential for participants to abuse the system, we are considering the removal of this practice. However, this has been a long standing and legitimate practice in Canada. In our opinion, the more appropriate action may be regulatory enforcement should there exist abusive practices that run contrary to the spirit of the existing rules.

<u>Responses to Questions for Market Participants</u>

1. *How do you define internalization?*

We define internalization as orders matching within a single dealer, that participants have no ability to reasonably interact with. We do not believe that broker preferencing eliminates the ability for this interaction. As it pertains to marketplace matching, it simply means that a broker benefits first from their own resting orders, provided they already have orders in the order book as opposed to providing liquidity post knowledge of the contra order. The incentive to encourage dealers to commit orders to the order book remains.

2. *Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.*

We are in agreement with the defined key attributes of a market which are provided in the consultation paper.

3. *How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.*

We believe that internalization – where orders are not exposed to the market, or where orders may be so briefly exposed to the market that there is no ability to reasonably interact with these orders – will have a negative impact on many key market attributes, in particular liquidity available in the market, price discovery, and dissemination of information (transparency). Although there may be a benefit to specific attributes such as immediacy of a fill, on the whole, should levels of internalization in Canada grow, our market will be adversely impacted.

4. *Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.*

A short term view on profitability benefiting the individual good may have a longer term consequence of harming Canadian markets whereby investors choose to invest in regions other than Canada, ultimately harming both the individual and collective good.

A market that balances these two objectives is the optimal structure, and in order to achieve this, there ought to be limited segmentation of order flow – where access to liquidity is broadly achievable by all.

5. *Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.*

N/A

6. *Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).*

N/A

7. *Please provide your views on the benefits and/or drawbacks of broker preferencing?*

We do not believe that broker preferencing detracts from the common good. To the contrary, we believe this practice to be net beneficial to our markets in the form of a compromise between what is good for the overall market and what is good for the individual participant.

Restrictions on broker preferencing will make dealers less efficient and increase costs for the industry and for clients, making Canada a more expensive place to trade.

We believe that the alternative to a broker preferencing regime is a worse outcome for investors. It will create an economic incentive for a broker to set up their own trading venues to better trade against their contra order flow, to minimize costs and to increase efficiencies for the individual dealer. By way of example of unintended consequences, see the European market and adjustments post the implementation of MiFID II which sought to increase order flow to lit marketplaces. We now see a proliferation of Systematic Internalizers – causing even greater market complexity and increased fragmentation. Similarly, in US markets where internalization is an acceptable practice, we see greater fragmentation of venues and segmentation of order flow – which from our lens is not the best path forward for Canada given the size and scale of our equity markets.

8. *Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).*

From our observations, and based on CIBC statistics, there is no singular client segment that benefits disproportionately from broker preferencing. Like for like, all our client segments benefit similarly.

9. *Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.*

The perception is that broker preferencing provides an out-sized benefit to larger dealers. We oppose that view as it can be beneficial to all dealers provided that they have two-sided order flow.

No doubt there is benefit to full-service dealers, where retail channels may be part of the make-up of their order flow, and may lead to greater opportunities for matching given the diverse nature of their order flow. In addition, the larger the dealer, and the more diverse their order flow, the greater their trading share in the market – which may include a greater proportion of broker-to-broker trades, which may or may not be a result of broker preferencing.

10. *Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?*

Broker preferencing is more frequent in the trading of liquid securities, but more pronounced in the trading of illiquid securities where queue jumping resulting from a broker preferenced trade may have a greater impact on the perception of 'fairness'.

11. *Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?*

Yes – if the technology within a dealer has moved beyond the scope of an order router and is acting as a marketplace then it should be regulated as such, and be held to the appropriate fair access standards.

12. *Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?*

Over the past few years, our markets have seen the addition of exchange mechanisms that facilitate the direct segmentation of client flows. This includes speed bumps, new matching allocation methodologies, more explicit identification of counterparty by trading ID and new pricing models. Without this ability to more directly segment client flows and for counterparties to be more selective about who they may be trading against, the increase in internalization activities may not be perceived an issue.

Greater segmentation, be that through internalization mechanisms or otherwise, has the potential to make Canadian markets considerably less attractive to investors as it leads to dealer workflows or internalization activities that effectively removes retail order flow from the broader market.

Finally, we believe that segmentation at the broker level should be compliant with UMIR 8.1 – and be required to obtain price improvement in these circumstances. Similarly, where a dealer is leveraging segmentation at the market level, they ought to be held to the same standard.

13. *Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?*

We look to other (global) markets for a frame of reference and believe that Canada's model is an excellent model for maximizing price discovery to the benefit of all investors and trading firms.

In respect of broker preferencing, retail benefits as it eliminates the direct need to be the fastest to market to manage queue position.

14. *Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.*

We believe that order routing disclosures, inclusive of retail and institutional channels should be a policy priority. Transparency around broker executions and execution quality statistics would go a long way to informing clients about the manner in which brokers handle orders.

15. *Are there other relevant areas that should be considered in the scope of our review?*

As it pertains to internalization, we believe the scope of the consultation paper to be comprehensive.

We commend the regulators for putting together a thoughtful consultation, and appreciate the opportunity to provide our comments. Please feel free to contact us with any questions or requests for clarification.

Respectfully,

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